ECONOMIC & FINANCIAL MARKET UPDATE

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Summary:

- A big budget deficit was expected and a big budget deficit was delivered;
- There were few surprise announcements, with the headline the bringing forward of scheduled income tax cuts;
- There is a substantial rise in debt but it should be affordable;
- The fiscal boost will substantially boost the economy.
- Another (smaller) fiscal boost might be required next year.

A big Budget was required. And a big Budget has been delivered. Strong fiscal support is what is needed during emergency times caused by events such as wars and pandemics. And the rock bottom level of interest rates and previous low debt levels should mean the debt burden is affordable. The economic assumptions are not unreasonable, although the peak in the unemployment rate is low relative to consensus.

The aim of the Budget is to get the economy moving back into fourth gear. Whether that happens will depend upon how much of the money the Government is pumping into the economy is saved. And that will depend upon what happens to consumer and business confidence. The path of the virus remains critical. How the global economy evolves will also be important. Strong supporting spending by the states will also be necessary.

I think it is probable that further fiscal stimulus relative to current forecasts will be required next financial year, albeit nowhere near as much as this year. The size of the forecast reduction in the budget deficit might be too much for an economy only just beginning to move forward after the hit from the massive downturn. Providing a vaccine is found over the next year that should be enough to get the economy moving back up through the gears. Importantly, the Government has demonstrated that if it doesn't it will stand ready to provide more help.

A healthy country means a healthy economy

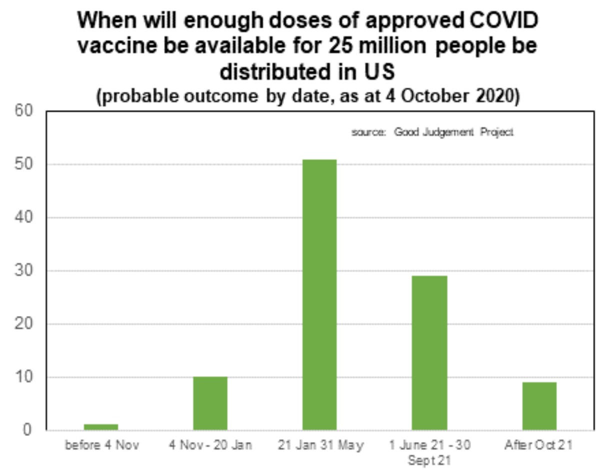
Although it feels like a long time, the COVID crisis has only been with us for only a bit over 6 months. And of course it has not ended. It is a very contagious disease. Because of our success in dealing with the virus, relatively few people in Australia have immunity. This means that the crisis only ends when a vaccine (or a more effective treatment) is discovered and distributed. The Government assumes that will occur by late next year. That assumption is largely consistent with other forecasters (and me).

But that still means that Australia (and the world) are likely to be dealing with the crisis for at least the next year. And of course there is the risk that an effective vaccine/treatment is not found. We will get updates before year-end on the progress of the most advanced candidates. This means that there is a real risk of a third wave before a vaccine is found. That happened during the Spanish Flu.

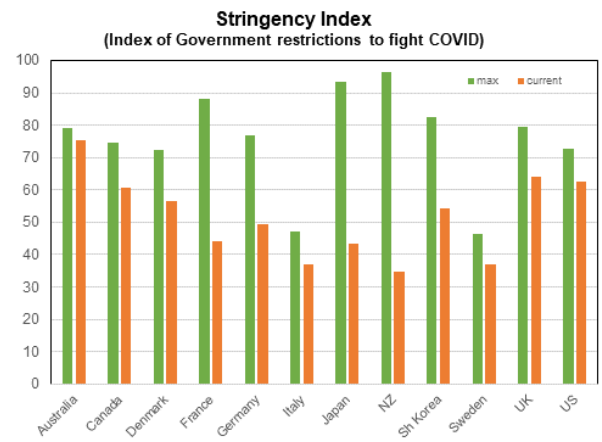
Getting the health response right gets the economic response right. Low (ideally zero) case numbers increases business and consumer confidence. Concerns about the virus leads to stringent lockdowns that directly impacts economic activity. The strong response in NSW shows that if a government gets on top of an outbreak early then a high-quality testing, tracking and tracing system can both flatten the virus curve and minimise the stringency of the lockdown. But concerns about the virus spread has meant that health restrictions are tighter in NSW than other states that have not had an outbreak. Concerns about the virus has impacted confidence in NSW more than in some of the other states.

This means that worries about the risk of further outbreaks will mean some government restrictions are likely to be maintained. Even in WA where there has not been a community transmission for months there remains restrictions on numbers attending sporting events and concerts. The substantial reduction in case numbers in Victoria (and essentially elimination in other states) will mean an opening up of movement between states (and possibly selected countries) by year-end. But at the first sign of an outbreak will likely lead to state borders closing again. Understandably, Treasury assumes that while there will be outbreaks over the next year the impact will be localised and largely contained.

Expectations are that a vaccine will be ready before Q4 next year.



Australia currently has more stringent health regulations than comparable countries.



The Economy to get stronger but needs help

The future path of the virus will have implications for how the economy develops. The Treasury outlook for GDP growth to decline by 3.75% this year and grow by 4.5% the next. A snap back is expected in consumption next year, with households supported by a gradually improving jobs market, a very high savings rate and high levels of household wealth. Residential construction is expected to be notably stronger (starting at the beginning of next calendar year) reflecting the benefits of the previously announced HomeBuilder program. Capex spending is expected to be weak this year, before bouncing back next year as the economy improves and the support from announced Government programs.

Every year there is questioning about Treasury's economic assumptions. The Government has had a pretty good forecasting track record over recent years. But it is very hard to forecast recessions (they don't happen often). And it is even harder to forecast recessions caused by global pandemics. And it is not easy to predict the timing and strength of economic recoveries.

Treasury expects a weaker economy than me this financial year but a stronger one next year. In my view third quarter growth is likely to be decent, with three quarters of the national economy moving up a gear or two from their near stall speed in April-May. The most recent business survey indicated that business conditions improved in September after confidence got smashed in August following the arrival of the second wave (as did consumer confidence). The fourth quarter should also show decent growth as Victoria (gradually) re-opens and there is modest ongoing growth in other states. This will be partially offset by the decline of government income support programs.

To my mind the bigger question is how the economy will go in the first half of next year. That half will feel the further reduction in Government income support programs (JobKeeper). A threat of a third virus wave (both domestically and globally) is a wildcard. Growth should be better from the second half of next year if a vaccine is distributed. That remains the Big If. Treasury projects economic growth to be a little higher than average (2.75-3%) over the following two financial years. That does not look unrealistic.

For much of this crisis Treasury had one of the more pessimistic views about unemployment. Now it thinks the unemployment rate will peak at 8% by year end, be 7.25% by mid next year (and 6.5% the year after). Consensus is a bit under 8% by mid next year. So it has swung to relative optimism. Maybe all the job-boosting programs in the Budget will do the trick (after all that is the aim) and the previously announced extension of JobKeeper. But the immediate jobs outlook isn't great. And if growth does slow as I expect in the first half of next year then the unemployment rate might be a little higher than what Treasury expects.

The 'scarring' impact on the labour market of an extended period of weak jobs growth is the big policy worry this Budget is trying to address. The underutilisation rate (18%) is currently at 1990s recession highs. An extended run of long term unemployment is a real worry as it results in a loss of skills. Workers also lose job contacts. Another concern is a reduction in the participation rate as workers drop out of the labour force because they become dispirited about getting a job. The need to limit scarring is the reason why the Government has set an unemployment rate target (6%) for when to start to turn the fiscal tap fully off. Government forecasts suggests that won't be until 2023.

In recent years there has also been (rightly) some questioning over Treasury estimates for wages growth (being too high). This time a wage forecast of 1.25% this year, and 1.5% next year looks right.

Slower population growth: important long term less short term

There has been discussion over recent weeks about Treasury projections of very low population growth. Strong population growth over the past 15 years been an important economic driver. But this year population growth in Australia could be at its slowest pace since World War I. Border closures has meant that immigration growth (responsible for around two-thirds of population growth over recent years) has ground to a halt. Indeed, Treasury thinks that Australia could have net emigration this financial year and next. There will still be population growth. But it is expected to be at a growth rate (0.2% this financial year and 0.4% the next) more typical of Europe than what has typically been seen in Australia (or New Zealand and Canada).

I believe that the economic impact of slow population growth in the short term will be modest. Right now the biggest economic issue is dealing with the health crisis. The next biggest issue is quickly reducing unemployment. Doing so increases the pool of consumers who will be spending, both directly (more workers means more wages) and indirectly (reduces the fear of unemployment boosting consumer and business confidence).

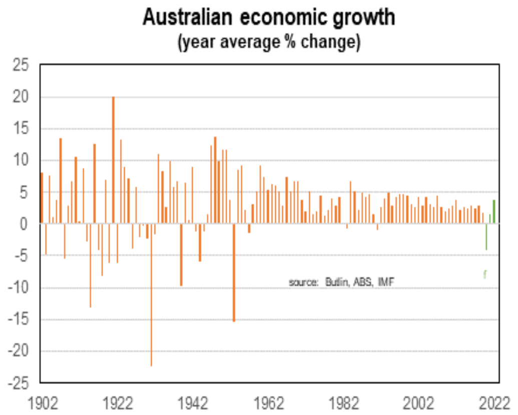
But weak population growth does impact long term growth. Slower population growth means there are less people to buy houses or go to the footy. It reduces the size of the labour force, slowing Australia's potential growth. In recent years immigration has helped mitigate the problem of an aging population (because immigrants have been younger). Immigrants tend to be entrepreneurial by necessity (they have less contacts to get a job).

Immigration can only return to 'normal' when all countries have access to a vaccine. This may not happen until first half of 2022 (at the earliest). Talk of bubbles has risen again between nations that have handled the virus well. There is also discussion about bringing in more foreign students. Whether these happen will depend upon the path of the virus and confidence in quarantine programs.

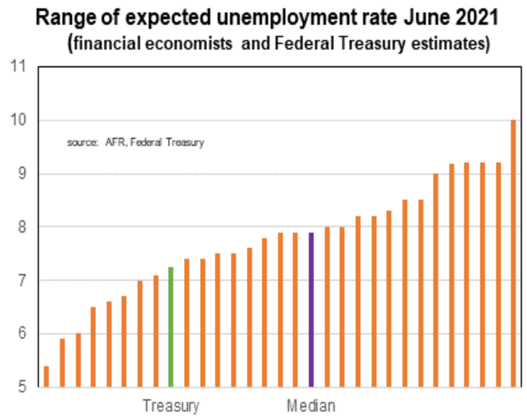
In the long term there has been discussion that Australia's better track record in handling the virus will be an attraction for immigration. Whether that occurs will depend upon government policy and the relative strength of Australia's economy. Treasury think it will be sometime before immigration returns back to its previous level because of heightened economic uncertainty.

Treasury is also forecasting a slowing in the rise of natural population growth. The thinking is that the birth rates drops during recessions (kids are expensive). But the evidence of whether a slower birth rate happens is mixed. It did occur during the 1930's depression, a time when the economy was severely weak for an extended period. But the evidence was less clear around the 1990s recession. Currently consumers are reasonably optimistic about the medium term economic outlook. This probably reflects the extensive income support provided by the Government. Such optimism is not consistent with an imminent drop in the birth rate. Whether that confidence is maintained will depend upon the strength of the jobs market.

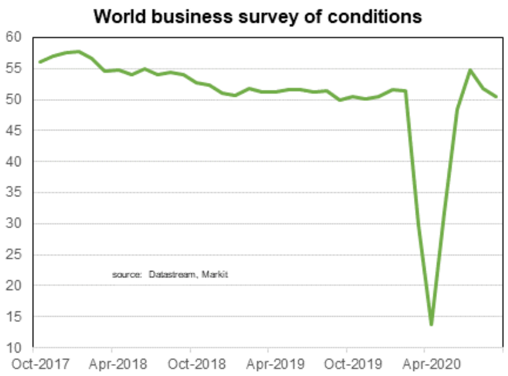
The Australian economy has had a tough year. A better 2021 is likely.



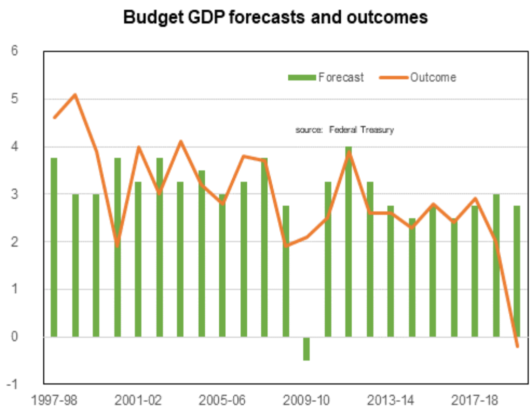
Treasury forecasts are at the optimistic end of the spectrum.



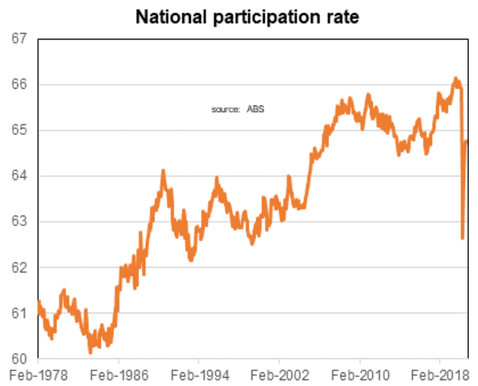
There has been a bounce-back in global growth, although momentum has eased recently. Further fiscal stimulus will be required.



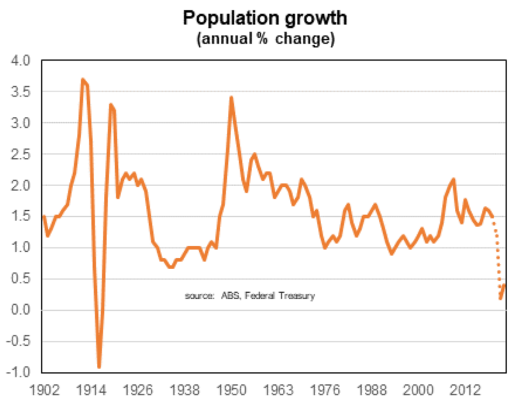
Treasury forecasts have recently been good. But it is tough to predict the path of a pandemic.



Historically, the labour force stays smaller for some years after a recessions.



Population growth over the next two years is likely to be the slowest since World War I.



A big Budget for a big economic problem

Ever since the scale of the crisis was clear back in March the Government (and the RBA) has essentially done whatever is necessary to support the economy. The Government's strategy looks to be to provide maximum economic support over the next 1-2 years. By then the health crisis should be over and the Government can step back and let the private sector take over driving the economy forward. To this end a big part of the major Budget announcements are either programs announced and bought forward (tax cuts and infrastructure) or hopefully temporary (such as job support programs, economic support payments).

At $214b (11% GDP) the size of the deficit is certainly big. But not surprisingly so. The mid-year Budget Update indicated a $185b deficit was expected for this financial year. The impact of the second COVID wave meant that greater fiscal support has been required (and provided). The deficit is projected to halve in the following financial year ($112b). That is a reduction in the size of the budget deficit of 5% GDP in one year. Budget deficits are expected for the next ten years.

My calculations are that the deficit this year could be the largest ever in peacetime. Whether the deficit is big enough to get the economy moving will depend upon how consumer and business confidence evolves. There was a pickup in both in September as concern about the virus eased. But confidence still remains well below 'normal' meaning consumers and business are currently reluctant spenders. Big increases in household saving has been an international phenomena. That reflects the impact of lockdowns reducing the ability of consumers to spend. But it also reflects a decreased desire to spend.

I think the size of the fiscal stimulus will help get the economy moving again. The road though is likely to be bumpy. Some luck with the timing of the vaccine would help. And stronger fiscal support globally will be necessary. The economy though might find it hard to absorb the substantial forecast reduction in the size of the deficit the following financial year. The actions of the Australian Government this year indicates that if further fiscal stimulus is needed it will be provided.

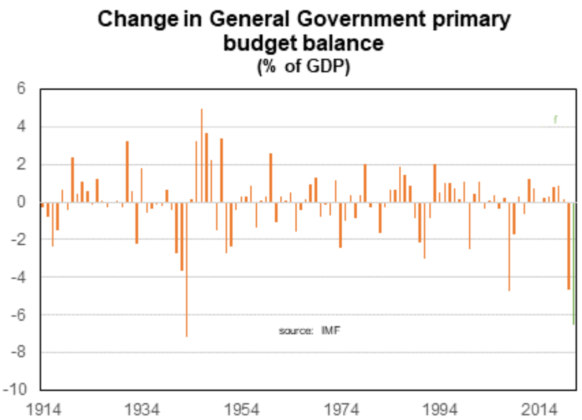
That fiscal policy is so prominent is partly a result of monetary policy being defanged by the already very low level of interest rates. Prior to COVID, monetary policy easing cycles saw interest rates reduced by between 2-4 percentage points. Interest rates were at 0.75% when COVID hitting, reducing the ability of monetary policy to help the economy.

Some further reduction in the cash rate is likely in coming months (potentially as early as November). But the reduction will only be by 15bp. The RBA would prefer the cash rate not be negative unless the Federal Reserve gets there first (or inflation moves substantially lower). The fall in the cash rate will be combined with a further reduction in the 3-year target yield on government bonds (likely from 25bp to 10bp). And further cheaper funding to banks is also possible.

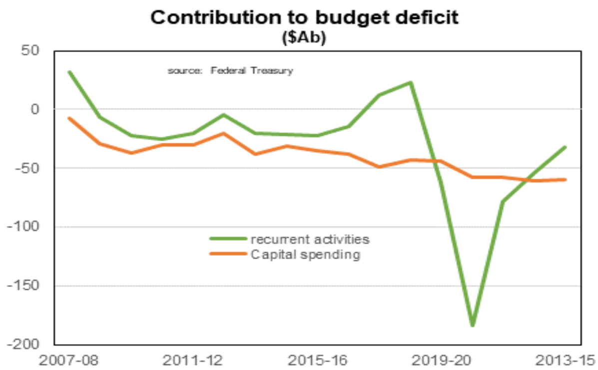
It is also likely at some stage that the RBA will well end up instituting a quantitative easing (QE) program to purchase longer-dated Federal and State Government bonds (5-10 years) to help reduce financing costs in the economy. But cheaper financing is not the critical issue the economy faces. It is a lack of demand for lending (highlighted by the recent weakness of credit growth) from the private sector reflecting their lack of confidence about the economic outlook.

The exchange rate is also not helping as it is only a little below its long-run average. Partly that is a result of a run of current account surpluses (the first since the early 1970s). Related is the support for the $A provided by a high iron ore price (and for other commodities). The Australian dollar is seen to be a bell weather for global growth expectations, so the better global economic data over recent months has played in supporting the 'Aussie'.

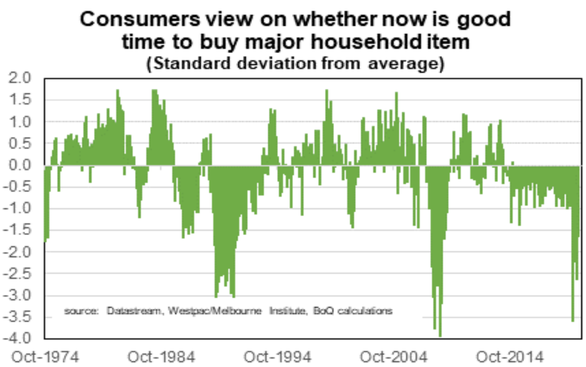
The change in the budget deficit will be the largest ever in peacetime.



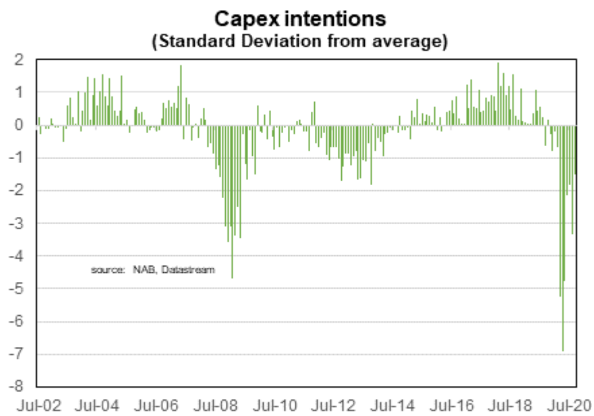
Temporary income support and incentives are the biggest Budget driver.



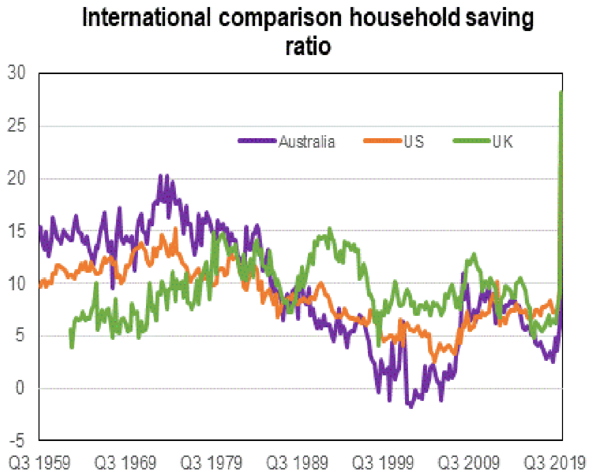
The Government has to do more of the heavy lifting because of consumer caution.



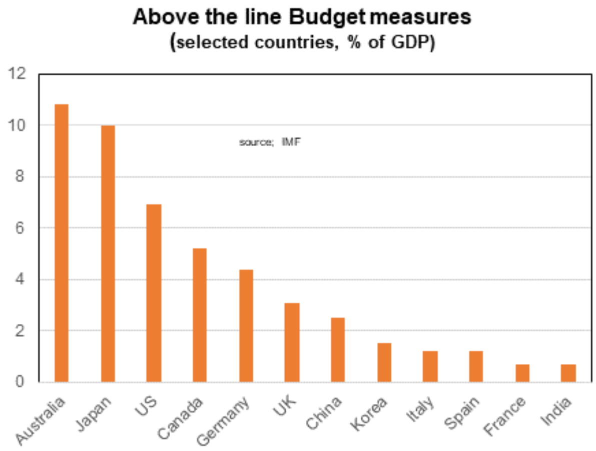
And firms are currently not looking to invest.



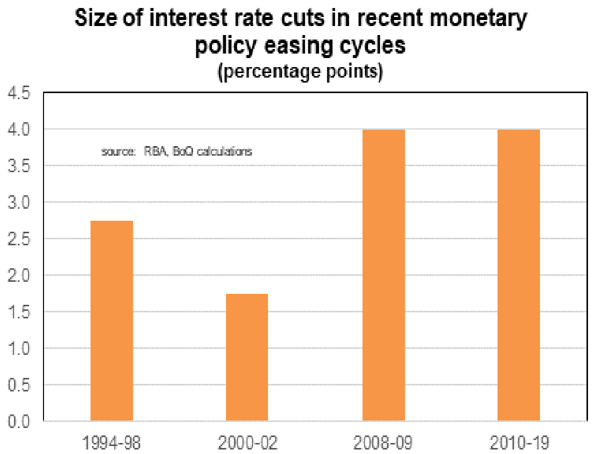
High household saving rates is a global phenomenon.



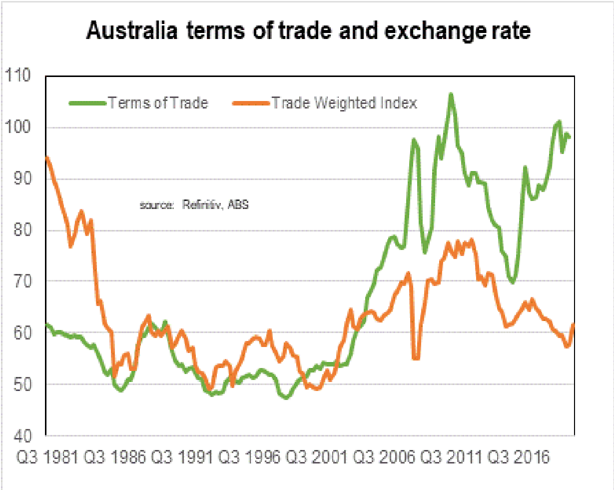
The Australian Government is towards the top end in terms of economic support.



Monetary policy is not able to provide much economic support.



A high iron ore price is helping. A stronger exchange rate is not.



Spending and tax decisions: Where the rubber hits the road

The Budget expects a big (temporary) rise in Government spending. Indeed, spending this financial year (as % of GDP) is forecast to be its highest for over 30 years. Interestingly, the decline in taxation is not as severe as past recessions (despite the tax cuts). History (and Treasury forecasts) does indicate that there will be a decline in government spending relative to GDP in coming years. Given the temporary nature of a fair bit of the spending that is fair enough. But history also shows that Government spending is likely to be a permanently bigger part of the economy.

A big chunk of the extra spending this year is the JobKeeper program (estimated to cost over $100b). The income tax cuts (including backdating) is almost $18b, although that would have hit the budget in 2022 financial year anyway. Other major programs include:

- Tax incentives for business investment
- Subsidies to hire young workers and apprentices
- Economic support payments to pensioners and eligible recipients
- Additional $10b for infrastructure spending (now $110b over 10 years)
- More funding for first home buyers
- Additional aged care and NDIS funding

For all the talk of infrastructure spending prior to the Budget, the additional spending announced was relatively modest. While infrastructure projects are important in boosting economic growth, the projects are complex and can take time to get under way. This means that they are not the right tool for an economy that needs immediate support. But they should be an important part of supporting economic growth over the next 2-5 years.

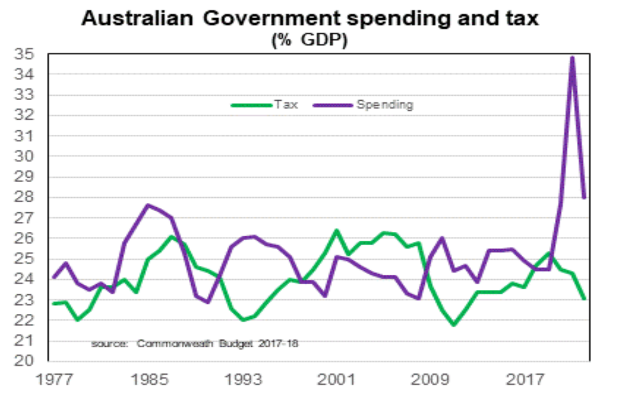
The second phase of income tax cuts have been bought forward to this year from 2022. This means that the 19% tax rate now cuts in at $45,000 instead of $32,500, and the 32.5% is extended to $120,000 from $90,000. There was discussion about whether to also bringing forward the third phase (making all income from $45,000 to $200,000 subject to 30% tax). For now that plan has been put on the backburner. In recent years income tax has been taking a bigger slice out of household disposable incomes so some reduction is warranted. Some analysts had been worried about tax cuts being saved. But proportionally the biggest beneficiaries of this cut are low- to middle income earners who are more likely to spend.

Small business has also become eligible for a range of tax concessions. For many this should improve their cash flow. The incentives to promote business investment and hiring should have some impact. How big these impacts will be will depend upon business confidence and the extent of the pickup of the economic recovery.

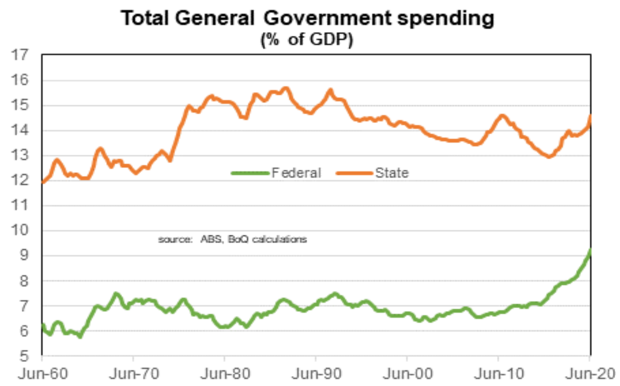
Research has shown that increased government spending is beneficial, particularly during recessions. This is because in a recession the private sector cuts its spending and so stronger government expenditure does not lead to higher interest rates. Certainly the JobKeeper and JobSeeker payments have aided the retail sector in this downturn. Tax cuts during recessions can have positive multiplier effects although the research suggests less so than increased government spending. Tax changes aimed at lower income earners though are likely to provide a bigger economic boost than other tax cuts.

Right now more federal government spending is important. But it is also important that the states increase their spending. State Government spending (in aggregate) is around 50% bigger that federal spending in the economy. Most states have indicated they intend to provide more fiscal support. How much will be revealed in their upcoming budgets.

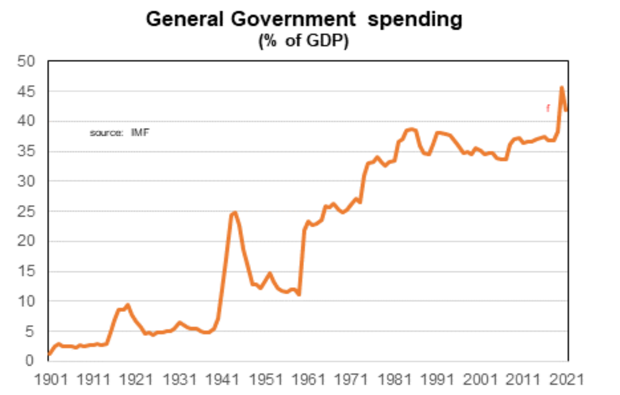
Federal Government spending has been a big support to the economy.



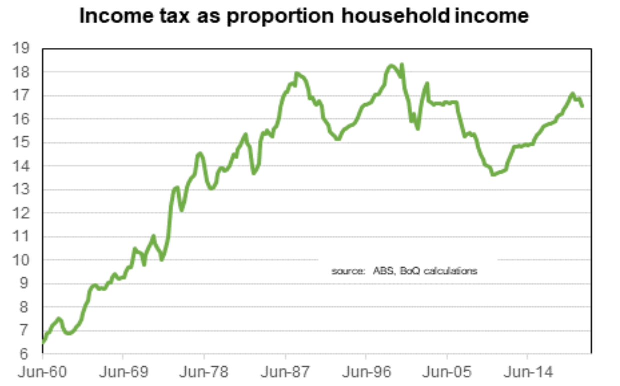
States do most of the spending, although the Feds are catching.



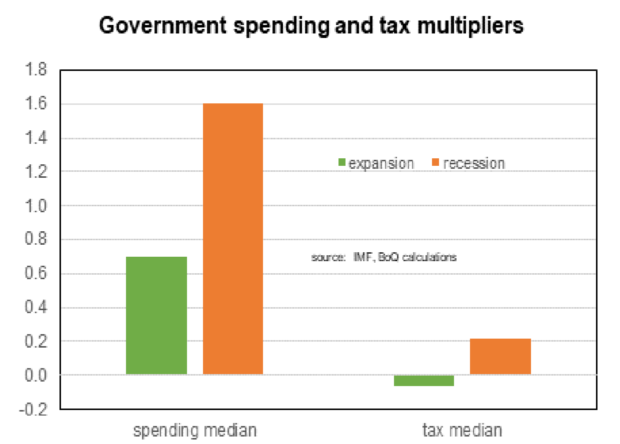
The Government is likely to remain a bigger part of the Australian economy.



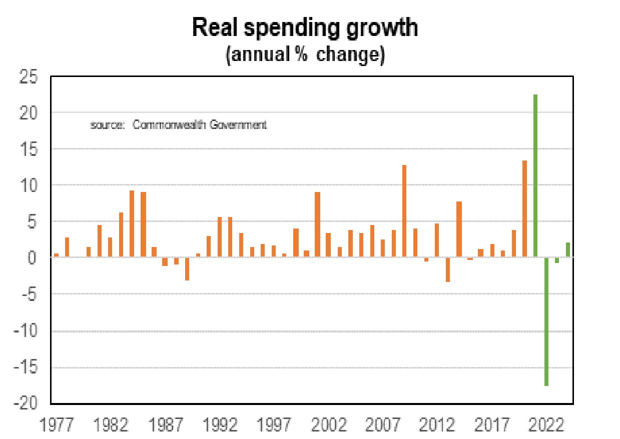
Income tax has been taking a bigger chunk of household incomes.



Government spending during recessions provides good return for the buck.



Expected spending growth is (almost) off the chart.



More debt but affordable debt

According to Treasury projections, debt is forecast to rise to over $1 trillion by 2022 (over 50% of GDP). The risks are that debt may need to go even higher if fiscal policy is needed to provide more economic support. These debt numbers are big by Australian historical standards, the largest since the Second World War. But Australian Government debt levels remains low by global standards even after the big increase.

The state of the economy meant that the government had little choice but to run sizeable budget deficits. But at least very low debt levels preceding COVID provided the Australian Government with that choice. Rock bottom interest rates helps. It has meant that interest payments are only taking a small slice of the budget. The current level of interest rates is well below the expected long-term growth rate of national income. This provides confidence that Governments' should be able to fund the higher level of debt.

There has been concern that the big boost in debt could lead to a rating downgrade. Currently Australia is rated AAA by the three major agencies. Much of the rise in the deficit from that announced mid-year has reflected either policies that have already been announced and bought forward (infrastructure and tax cuts) or temporary (economic support payments, investment allowances).

Standard and Poor's and Fitch already has Australia on negative watch for a possible downgrade. Most analysts expect the economy to improve over the next couple of years. This should reduce the chance of a downgrade. Australia's credit rating is likely to remain unchanged following the Budget announcement. But if the economy does not pickup as expected and requires further fiscal stimulus a downgrade becomes a stronger chance.

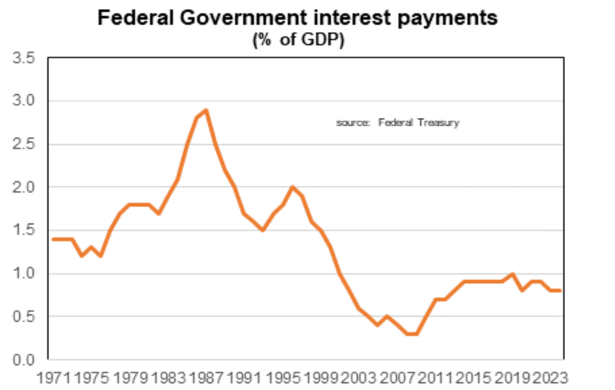
In any event, the practical implications of a downgrade for Australia would be low. As it stands Australia is one of only 9 AAA rated countries by all three major rating agencies. A downgrade to AA+ would have minimal impact on either the level of interest rates Australia would have to pay or access to financial markets. The credit rating downgrades of the US, UK and Japan had little financial market.

The current very low interest rates makes it easier for the government to repay debt. Although not expected any time in the near future, the Government could be vulnerable if interest rates rose significantly. One way to mitigate that risk is to issue more long-term debt to lock in low borrowing costs. The Government (and other developed countries) are doing that, with the maturity of their issued debt rising over the past decade.

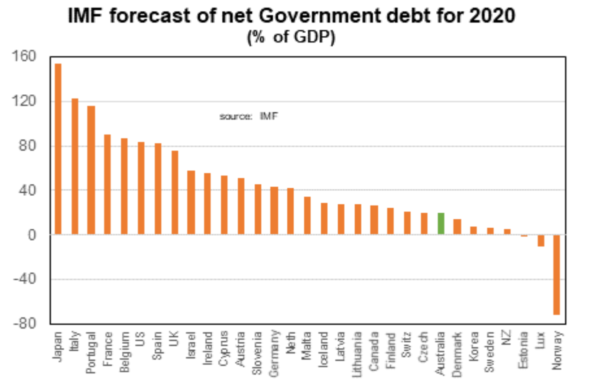
Currently there have been more than enough buyers for Australian Government debt. Since April the amount of investor bids for Government debt at auctions has been 4.5 times the amount the Government has wanted to issue. This is high by historical standards.

Overseas investors are the biggest buyer of government debt. Partly that reflects the relatively attractive level of long-term interest rates in Australia. It also reflects the relatively good credit rating of the Australian Government (which wouldn't change if Australia was downgraded one level). Liquidity regulations will see banks become bigger buyers of Government debt. And if interest rates do rise because there are not enough buyers the RBA would almost certainly step in to reducing financing costs.

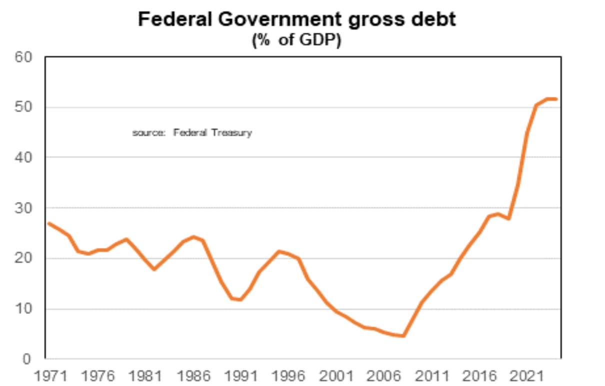
Interest payments is only a very small part of the Federal Government budget.



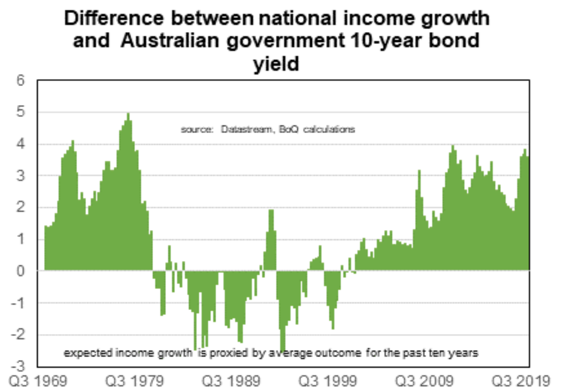
Government debt in Australia is low by peer country standards.



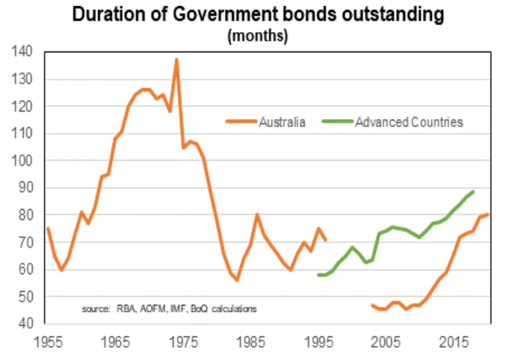
But total Government debt is high by Australian historical standards.



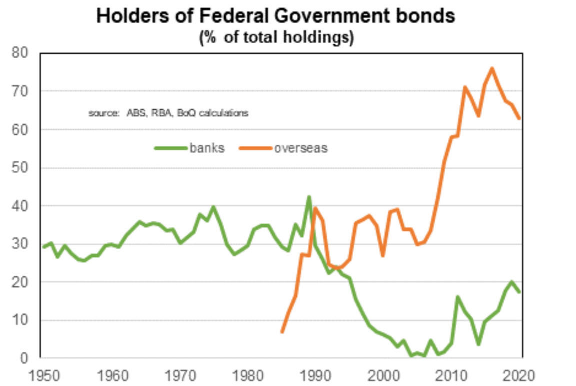
Very low interest rates makes it easier for the Government to take on more debt.



The expectation of very low interest rates for a long time is encouraging Governments to lock in low borrowing costs.



Relatively high interest rates should continue to attract global investors'.



We live in interesting times.

Peter Munckton
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