BUDGET UPDATE

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BOQ GROUP

Summary

- The economic forecasts appear reasonable. Indeed the 2022-23 GDP forecast looks low;
- As advertised, fiscal policy has been set to provide strong support to the economy;
- The Budget had plenty of extra spending as well as tax reductions;
- The extra funding has been 'paid' by the benefits of the stronger-than expected economy;
- This left the deficit profile past this year broadly the same as last year's budget;
- Debt reduction was not a high priority in this year's budget.

By any measure Australia has handled COVID-19 well. That is not to say that the virus still does not create inconvenience. The vaccine is the way we move on from COVID. The good news is that domestically we continue to learn how to handle the virus better and keep more of the economy open. The big long-term issue remains when Australia becomes confident again to open borders to large-scale immigration. The Budget assumes no large scale tourism until mid-next year (it also means we won't be able to go on an overseas holiday until at least then).

Six months ago the big worry was that it would take a while for the economy to warm up following the Big Freeze it was put in when COVID first arrived. It has turned out that the economy has not only warmed up but it almost could be described as being on fire. Given the evident strength of the economy the Government forecasts look light to me. Certainly 4.25% growth for 2021-22 is strong. But I think it will be 4.75%. The thing that stands out is the expectation that GDP growth will be only 2.5% the following financial year. If that ends up being the case that would be disappointing.

From a wider economy standpoint the key issue over the next 1-2 years is the inflation outlook. That is they key factor that will impact the outlook for monetary policy. Interestingly Treasury has inflation over 2% by mid-2023 which would be consistent with thinking about higher interest rates. A return to strong population growth is one of the two long-term challenges the Australian economy faces in recovering from COVID. The second long-term challenge is to boost productivity growth that has been weak for extended period. Here there are some positive signs.

The big-time fiscal stimulus (by both federal and state governments) was a key reason why the Australian economy has performed well. And the fiscal push from last year is still being felt. While the economy is doing well there are plenty of reasons to think the Government should keep its foot on the accelerator. The Government has said its aim is to get unemployment rate under 4.5%. Treasury doesn't think the unemployment rate will reach that level until sometime in 2023-24. I think it will be earlier. Treasury's view is consistent with their forecasts of sizeable budget deficits in both the 2022 and 2023 financial years.

A key question though is at a time of strengthening demand and some limitations to supply how much of the extra fiscal stimulus will create more goods and services in the economy and how much will go on higher prices. A second question is how much of the stimulus will boost the productive capacity of the economy.

Federal Government spending has been becoming a big part of our economy. And lots of spending was a feature in this year's budget. Some of the increased spending will be relatively temporary. But other spending will be permanent. The Budget assumes that payments will grow in line with GDP growth. That may prove a tough challenge. There were also a few major tax announcements. These tax announcements will help boost household and corporate disposable incomes over the next couple of years. But they have not significantly changed the structure of our tax system.

For now there is little talk of Budget surpluses with deficits as far as the eye can see. In my view the Government is right not to worry this year about fiscal consolidation. If they did then there would be talk about the need to cut spending or raise taxes. This could get consumers and firms worried and they might start to save a high proportion of the fiscal stimulus from this year. And Governments always get surprised by how much a strong economy reduces the size of a budget deficit.

The size of Australia's debt is large by our history. And the size has worried some credit rating agencies. But it remains smaller than most OECD countries. The very low level of interest rates means budget deficits are currently affordable.

If interest rates stay low, then Australia could probably afford its current level of debt. Indeed, the recent experience of the US, Europe and Japan suggests that they could even afford a higher level of debt. But Australia has been able to perform well in the past two major global economic crises (GFC and COVID) because it had a relatively small debt burden. From an economic standpoint it would be good if we can get that down again. It will be interesting to see whether that challenge will be taken up by whoever wins Government next year.

A healthy country means a healthy economy

By any measure Australia has handled COVID well. That is not to say that the virus still does not create inconvenience. The ABS reports that two-thirds of firms report that COVID-related restrictions is impacting their business. Snap shutdowns are influencing the way we live (as are the threat of shutdowns). But compared to what is currently taking place in India (and previously in the US and Europe) Australia is doing alright.

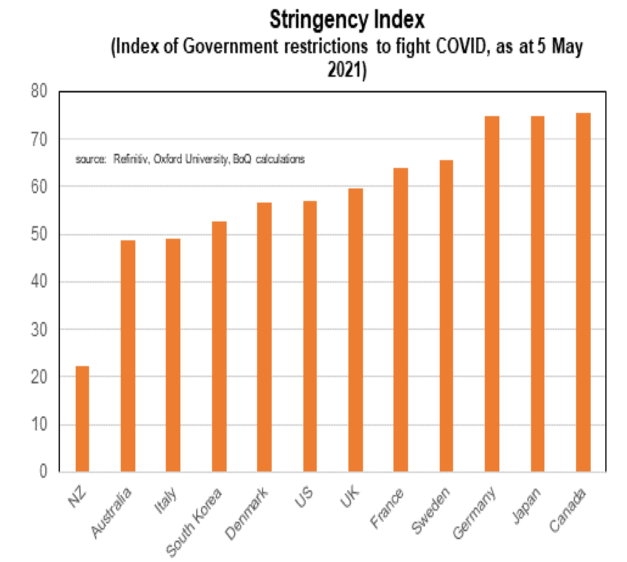
The vaccine is the way we move on from COVID. And to date the rollout has been slow. Israel, the US and UK have led the way. Continental Europe started slow but their rollout is ramping up. In fairness many countries that have handled the virus well to date (Australia, New Zealand and China) have had slower rollouts.

It looks like that the domestic rollout of the vaccine will not be complete until next year (hopefully). There is some risk that the uncertainty created by recent vaccine announcements may mean a critical enough mass of the population does not receive a vaccine does to create 'herd immunity'. Globally the rollout will take even longer. The virus has already mutated a number of times. The risk is that it could mutate again into a form that may be immune to the current crop of vaccines.

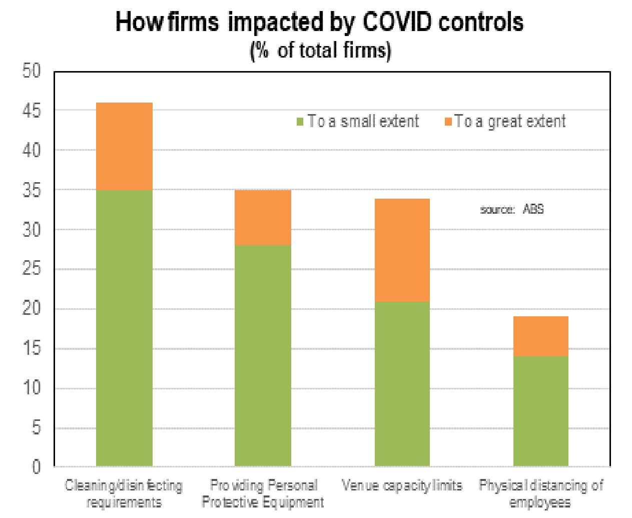
The good news is that domestically we continue to learn how to handle the virus better and keep more of the economy open. Increasingly Government's first port of call for outbreaks is to mandate the wearing of masks and place restrictions on group sizes. Border restrictions initially are focussed on hot spots. Only if there is evidence of more widespread contagion are more drastic measures put in place. Many businesses have adapted to people working and buying from home. Consumer spending is starting to drift away from 'goods' (shoes, computer screens) and back to going out to restaurants.

The big long-term issue remains when Australia becomes confident again to open borders to large-scale immigration. At a minimum that won't occur until a larger enough proportion of the population is immunised. The Budget assumes no large scale tourism until mid-next year (it also means we won't be able to go on an overseas holiday until at least then). The Centre for Population has projected a return to 'normal' immigration flows might have to wait until the 2024 financial year. That does not appear unreasonable. But if it is correct then this could leave a lasting mark on the Australian economy.

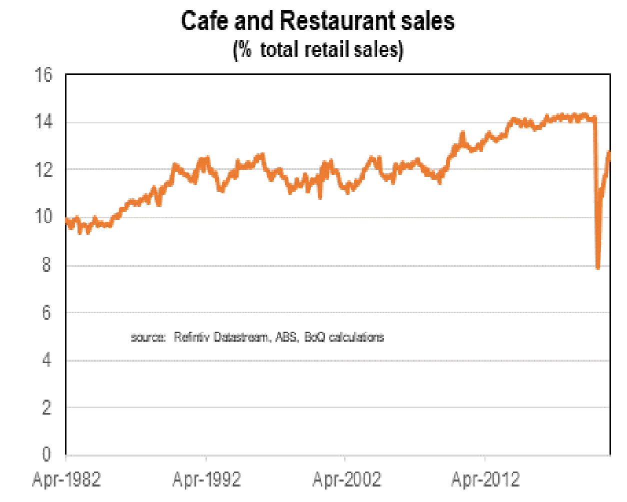
Handling the virus well has meant less restrictions.



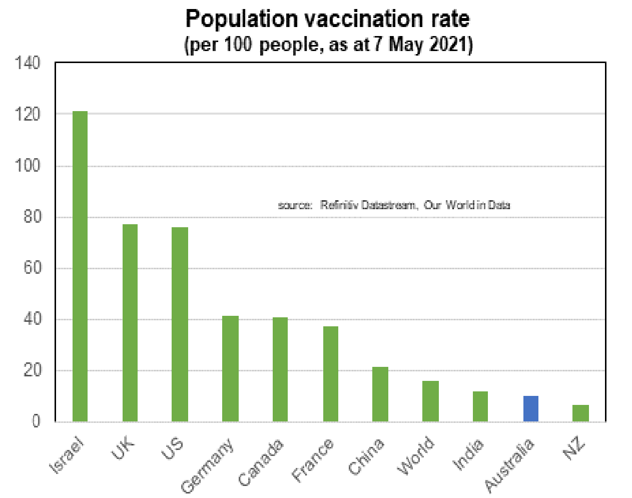
But the restrictions we have are increasing the cost to business.



Consumer spending patterns are starting to return back to those seen in pre-COVID times.



A return to 'normal' will require a high rate of immunisation.



The Economy: Firing on most cylinders

Six months ago the big worry was that it would take a while for the economy to warm up following the Big Freeze it was put in when COVID first arrived. It has turned out that the economy has not only warmed up but it almost could be described as being on fire. Good health outcomes, reduced restrictions, record low interest rates and the Government's fiscal hose turned on full has meant that economists have consistently had to upgrade economic growth forecasts. Business conditions are around record highs. Plenty of jobs means an increasingly buoyant consumer.

Given the evident strength of the economy the Government forecasts look light to me. Certainly 4.25% growth for 2021-22 is strong. But I think it will be 4.75%. And the RBA is at 5%. The thing that stands out is the expectation that GDP growth will be only 2.5% the following financial year. If that ends up being the case that would be disappointing. The RBA is at 3.25% (and I think it could be higher still).

The Treasury has the unemployment rate at 5% by June next year and 4.75% the year after. The RBA is a quarter percentage point lower for each forecast. I agree with Treasury for next year but think that the unemployment rate could be in the 'low 4's' by mid-2023.

In most budgets there is commentary on a particular forecast. In recent years a number of commentators thought that Treasury (and the RBA) were overestimating wages growth (they were right). Iron ore prices have also received a lot of attention (they have been higher than expected in recent years). Treasury are understandably projecting a big decline in commodity prices over the next couple of years.

But looking at individual forecasts often means there is too much focus upon a particular tree and not enough on the shape of the forest. Getting the pace of income growth in the economy is the most important thing (at least from a Budget outcome standpoint). Often there are offsetting errors to particular individual forecasts (eg, pre-COVID jobs growth was underestimated but wages growth overestimated).

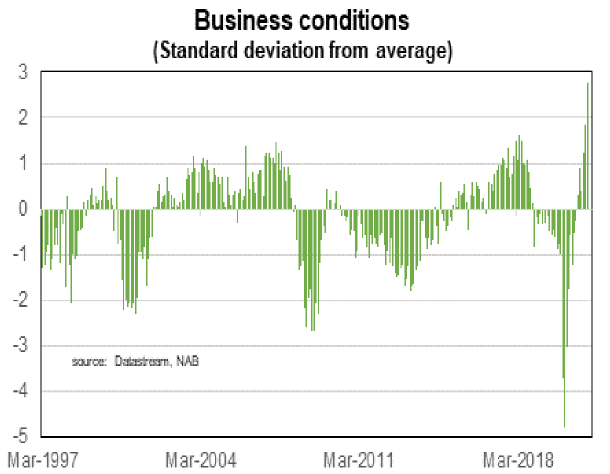
From a wider economy standpoint the key issue over the next 1-2 years is the inflation outlook. That is the key factor that will impact the outlook for monetary policy. Interestingly Treasury has inflation over 2% by mid-2023 which would be consistent with thinking about higher interest rates. By next year Treasury has inflation at 1.75%, comfortably above the RBA (1.25%).

I am in Treasury's camp on this one. Such is the momentum in the economy it is increasingly hard to see how demand will not be strong. But this strong demand is exposing limitations on supply. These include supply-chains problems as well as reported labour shortages. Some of this will be short term until overseas economies are in a position to reduce COVID-related restrictions and start cranking out production. But some of the labour shortages could last until immigration returns to 'normal'.

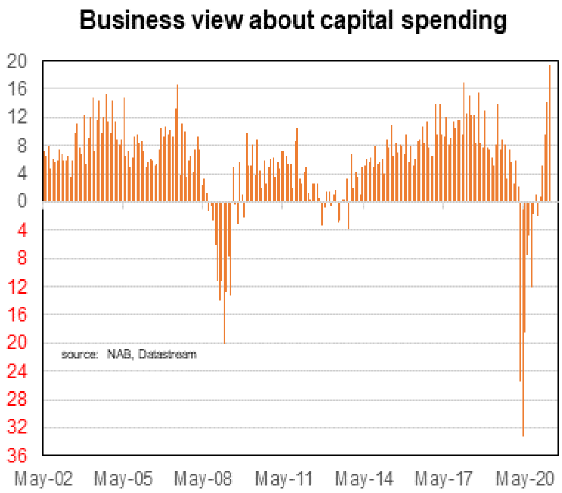
Indeed a return to strong population growth is one of the two long-term challenges the Australian economy faces in recovering from COVID. Treasury figures suggests that this year population growth will be the slowest since World War I. Two-thirds population growth pre-COVID was immigration. How to get large numbers of people coming again into Australia matters (particularly for sectors such as tourism and education). On average immigrants are younger than the existing population (a good portion of the students that come to study stay and work) and so reduces the problems associated with an aging population.

The second long-term challenge is to boost productivity growth that has been weak for extended period. Here there are some positive signs. There was concern that capex spending by firms might be low for some time because of economic uncertainty and this would continue to weigh on productivity. But strong business conditions, rock bottom interest rates, above average capacity utilization rates and government incentives has seen capex budgets boosted. This is particularly the case for plant and equipment (due to the incentives announced in the previous Budget). Digitization investment has remained strong, further turbo-boosted by the shift to working from home and online shopping.

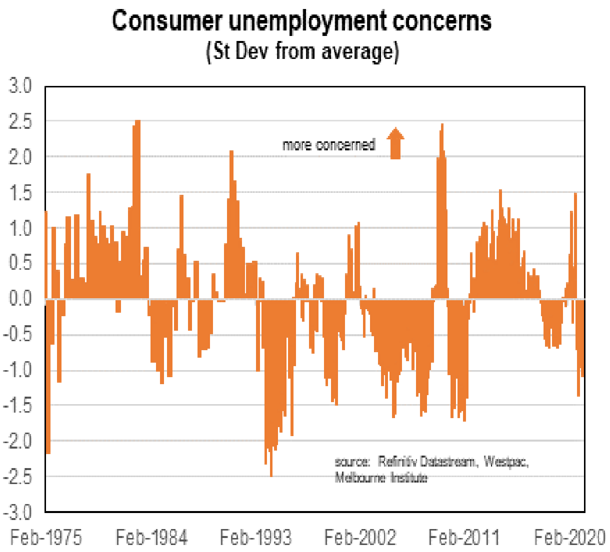
Firms are indicating that conditions are very strong.



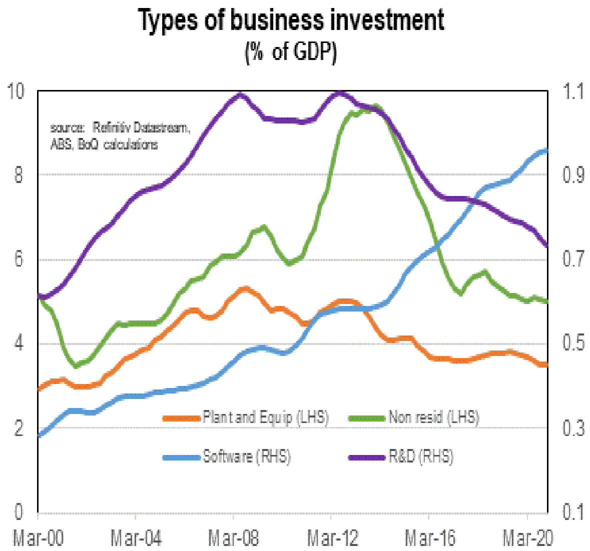
And this has led to a boost to capex budgets.



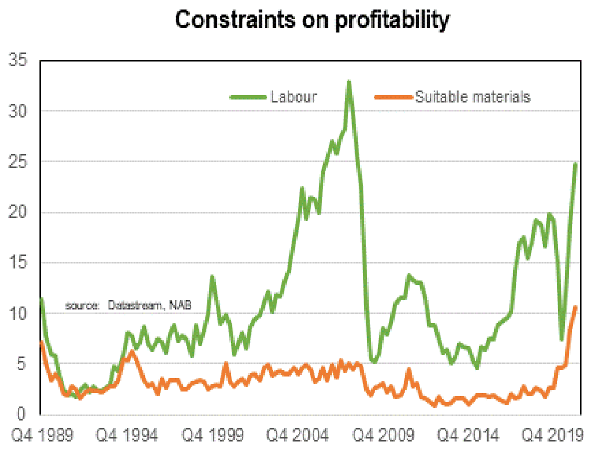
This has also led to strong jobs growth boosting consumer confidence.



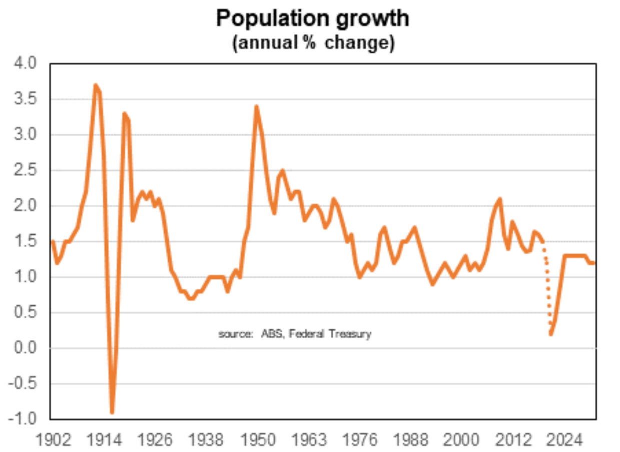
Plant and equipment investment is picking up, digitization investment has remained strong.



Worker shortages and supply-chain worries are growing concerns for firms.

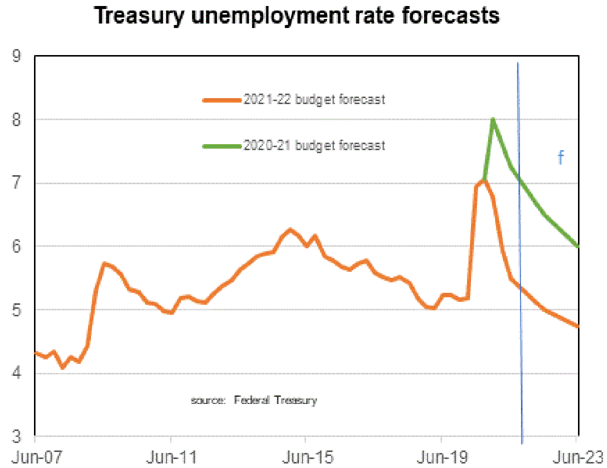


Population growth over the next two years is likely to be the slowest since World War I.



And productivity growth has been very weak over recent years.

Like everyone, Treasury has had to substantially revise down their unemployment rate forecasts.



Fiscal policy: Finishing the job

Governments in Australia can take credit for both the good health and economic outcomes. Australia was one of the better performing economies last year. And big-time fiscal stimulus (by both federal and state governments) was a key reason why. At its worst income in the economy fell by around 7.5% in the second quarter of last year. But household disposable incomes rose. JobKeeper (and an enhanced JobSeeker) were success stories

And the fiscal push from last year is still being felt. Builder order books (particularly for standalone housing) are overflowing. Plant and equipment spending is powering ahead. There is so much infrastructure spending in the pipeline that many new projects are already behind their timelines.

While the economy is doing well there are plenty of reasons to think the Government should keep its foot on the accelerator. The current unemployment rate is still above its pre-COVID level. And that pre-COVID unemployment rate was widely viewed as being too high. It is necessary to keep the economy strong given the rise of long-term unemployment (the most visible 'scar' from a recession). The US experience pre-COVID was that the unemployment rate could get under 4% without major inflation worries.

The Government has said its aim is to get unemployment rate under 4.5%. Treasury doesn't think the unemployment rate will reach that level until sometime in 2023-24. The RBA expectation is a little earlier (June 2023). I think it could be earlier still. Treasury's view is consistent with their forecasts of sizeable budget deficits in both the 2022 and 2023 financial years.

Running a sizeable budget deficit right now is reasonable. Even more so given that the very low level of interest rates has reduced the impact of monetary policy. How big a deficit the Government should run though is an unknowable question. The projected (underlying) budget deficit for the 2022 financial year is $107b (a suspiciously precise 5% of GDP), down substantially from the $161b forecast for this financial year (which was a big fall from the $214b forecast at Budget time). The big reduction in next year's budget deficit largely reflects the end of JobKeeper (and a toned down JobSeeker).

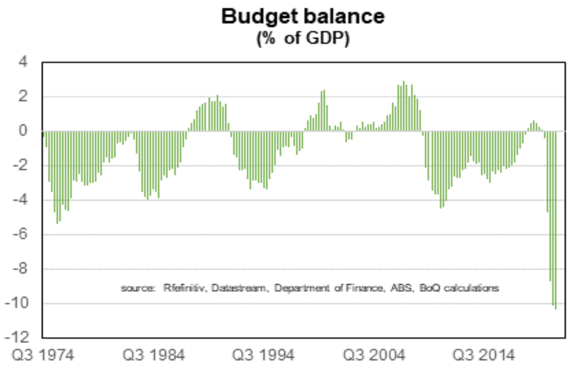
The 2021 underlying budget deficit would still be one of the largest in the past fifty years. Indeed, forecasts don't have the underlying budget deficit under 3% of GDP (a more 'normal' sized deficit) until 2024-25. And this is despite an unemployment rate in the 4's and the current benefit of very high iron ore prices.

With interest rates low and financial markets in a forgiving mood governments have been allowed to borrow substantially (helped by large amount of central bank buying). So it is understandable if governments currently err on the side of generosity towards the economy. A key question though is at a time of strengthening demand and some limitations to supply how much of the extra stimulus will create more goods and services in the economy and how much will go on higher prices. At least this may help the RBA achieve its aim of getting higher inflation.

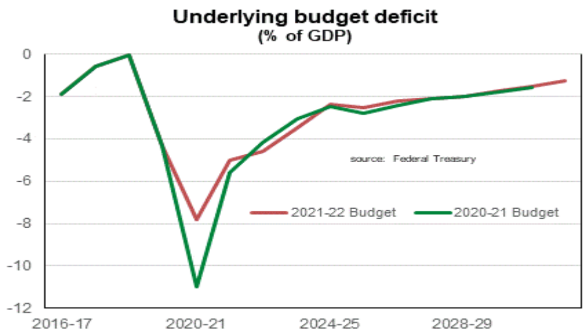
A second question is how much of the stimulus will boost the productive capacity of the economy. Ideally a good portion of the debt should be repaid to allow a future government to run large deficits the next time the economy enters a recession (which hopefully will be many years away). The Government's aim is to reduce debt from the proceeds of a stronger economy (and done gradually). That strategy has some legs to it as a stronger economy has allowed the deficit for this year to be a lot less than originally forecast.

But the size of deficits run up to fight the virus will mean a strong economy will be necessary for an extended period if we are going to get debt down to anywhere near where it was pre-COVID. And this means a more productive economy. The Budget states that at least some of the additional spending (such as on infrastructure) is aimed to boost economic capacity. A problem about infrastructure projects is that they often face delays. And capital spending is only projected to rise by around $5b (about 0.25% GDP) over each of the next two financial years.

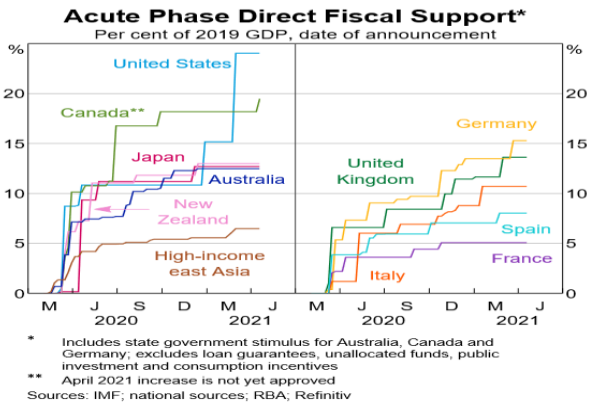
The budget deficit was the largest ever in peacetime.



The deficit will be lower this year. The deficits in forecast years are broadly the same as in the previous Budget



The size of direct fiscal support in Australia was about average for peer countries.



We need to maintain a strong economy to minimize the amount of long-term unemployed.

Spending and tax decisions: Where the rubber hits the road

Federal Government spending has been becoming a big part of our economy. Over the past few years we have introduced a major new welfare program (NDIS) as well as boosting defence spending. Hospitals continue to get plenty of extra cash. The history has been that when government spending rises (as a proportion of the economy) it rarely comes back down. That is because society becomes used to greater spending.

And lots of spending was a feature in this year's budget. The most significant policy changes were more funding for aged care, higher JobSeeker, a further boost to apprenticeships and training, support for the areas still most impacted by COVID (tourism, Arts and Recreation, Air Transport and international education) and mental health. There was also more money for childcare and for the manufacture and distribution of COVID vaccines. More funds were directed towards the NDIS.

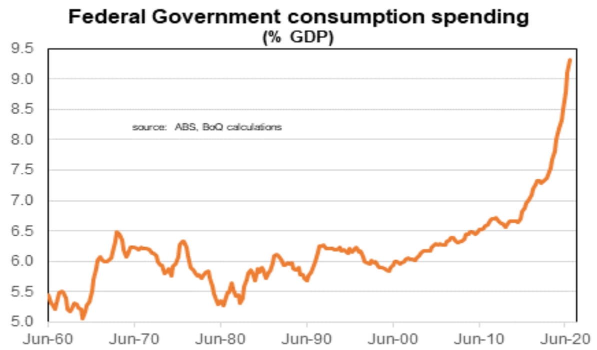
Some of the increased spending will be relatively temporary (vaccines, sector support). But most of the spending on areas such as aged and child care, NDIS, JobSeeker and mental health will be permanent. The Budget assumes that payments will grow in line with GDP growth. That may prove a tough challenge.

There were also a few major tax announcements. The extension of the low- and middle-income tax offset for another financial year will help boost spending (lower income earners typically spend most of their incomes). And the extension of loss carry backs and full expensing of investments should help boost company income and capex spending.

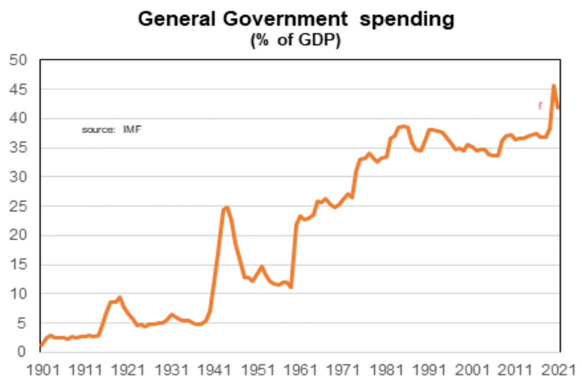
These tax announcements will help boost household and corporate disposable incomes over the next couple of years. But they have not significantly changed the structure of tax system. Australia remains more reliant on raising tax from incomes (both household and corporate) while raising less on spending (GST) and wealth. Interestingly the UK and US Governments' are talking about raising up corporate income taxes. This would be a plus for Australia given our currently relatively high business tax rate.

So this Budget had plenty more spending and big tax reductions. In the main this has been paid by the boon provided by the better economy. This means the economy will continue to get strong fiscal and monetary support this year.

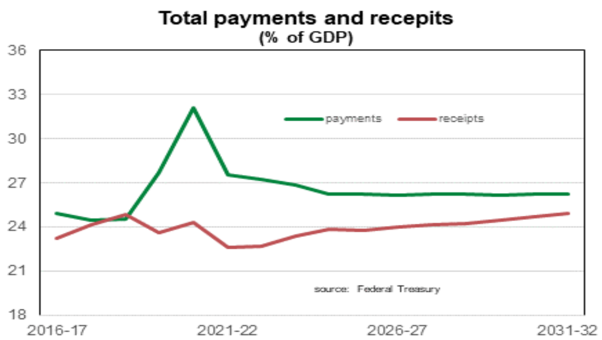
Federal Government spending has become a growing part of the economy.



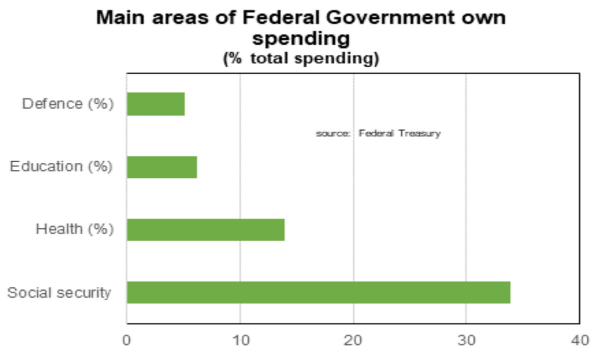
Once spending goes up it rarely comes back down.



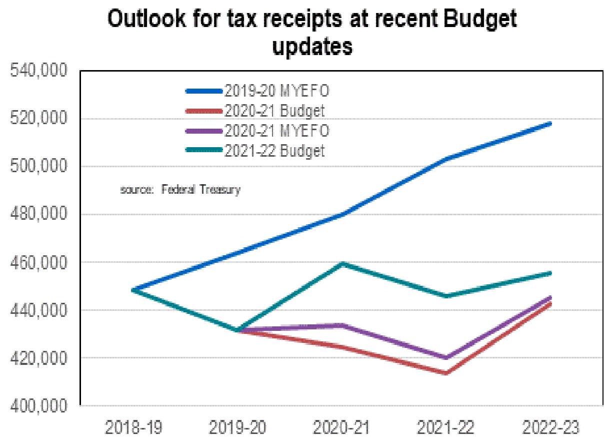
The Budget deficit is forecast to narrow due to some rise in revenue and a tough cap on spending.



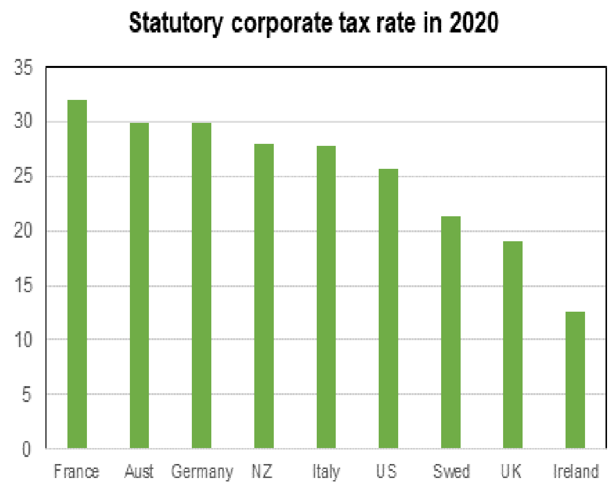
Welfare spending comprises about one-third of all Federal Government spending.



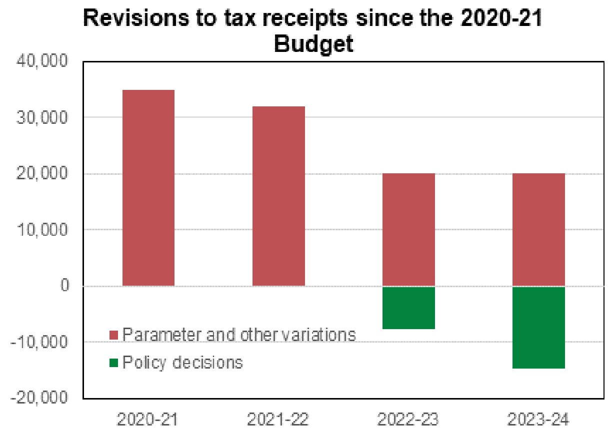
A better economy has meant more tax. But there not as much as the Government thought it was getting pre-COVID.



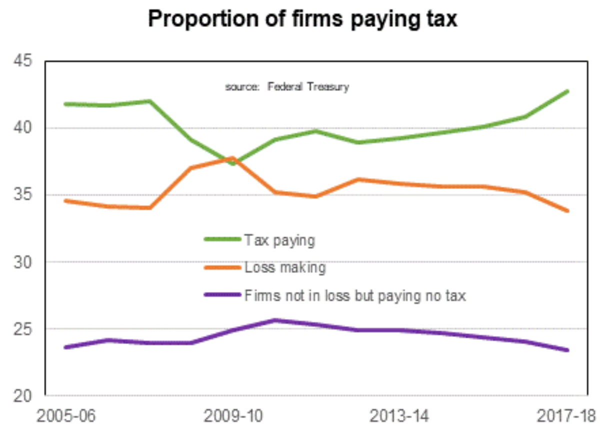
Australia has a high corporate tax rate.



Policy decisions will reduce the boost to government revenue in coming years.



In any one year company tax payments come from about 40% of firms.



Financing the Budget: Plenty of debt but not a disaster

For now there is little talk of Budget surpluses with deficits as far as the eye can see. In my view the Government is right not to worry this year about fiscal consolidation. If they did then there would be talk about the need to cut spending or raise taxes. This could get consumers and firms worried and they might start to save a high proportion of the fiscal stimulus from this year. And Governments always get surprised by how much a strong economy reduces the size of a budget deficit.

The size of Australia's debt is large by our history. And the size has worried some credit rating agencies. But it remains smaller than most OECD countries. The very low level of interest rates means budget deficits are currently affordable. Interest payment are less than 1% of GDP. It is unlikely that interest rates will remain this low forever. But Treasury has been 'locking in' low interest rates by gradually extending the maturity of their debt issuance.

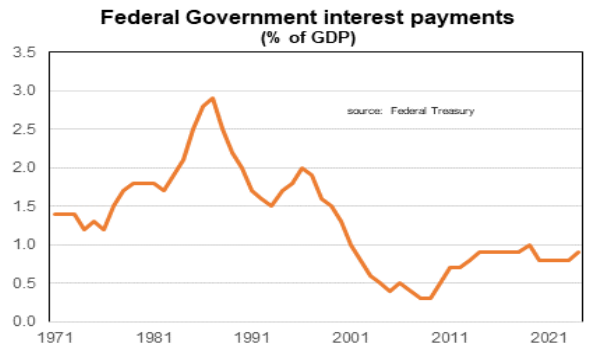
One measure of when deficits are affordable is to compare the interest rate paid by the government relative to the size of growth of the economy (because government tax receipts broadly grow in line with economic growth). Right now projected (nominal) economic growth is well ahead of the level of interest rates.

The Australian Government is also benefitting from the RBA bond buying program. The RBA believes it will own around 10% of the stock of government debt at the end of its bond buying program. Regulations has meant that banks have become bigger owners of government debt over recent years. And relatively high interest rates (at least compared to Europe and Japan) and the need to diversify has seen continued good interest from international buyers.

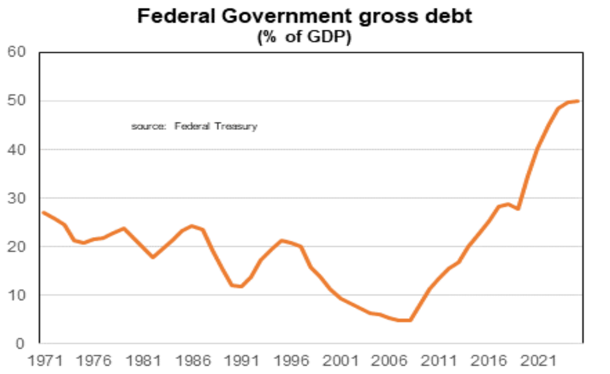
If interest rates stay low, then Australia could probably afford its current level of debt. Indeed, the recent experience of the US, Europe and Japan suggests that they could even afford a higher level of debt. But Australia has been able to perform well in the past two major global economic crisis (GFC and COVID) because it had a relatively small debt burden. From an economic standpoint it would be good if we can get that down again.

A stronger economy will play an important role in reducing government debt. It will be interesting to see whether the challenge of fiscal consolidation is taken up by whoever wins Government next year.

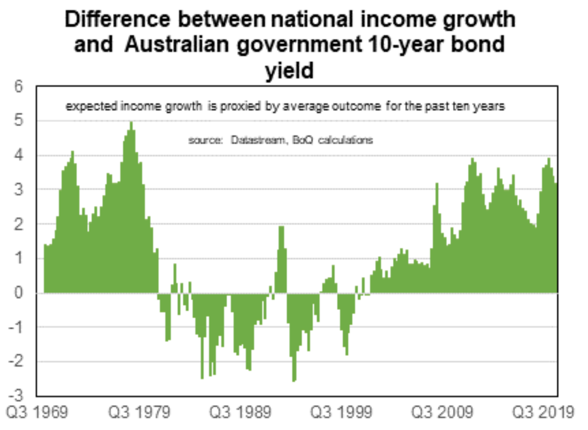
Interest payments are currently a small part of the Federal Government budget.



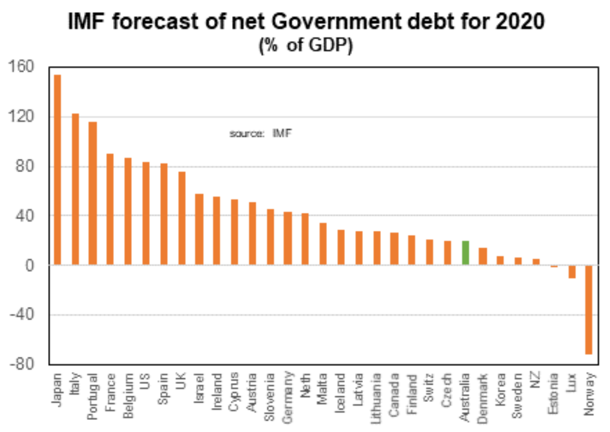
This is despite debt being high.



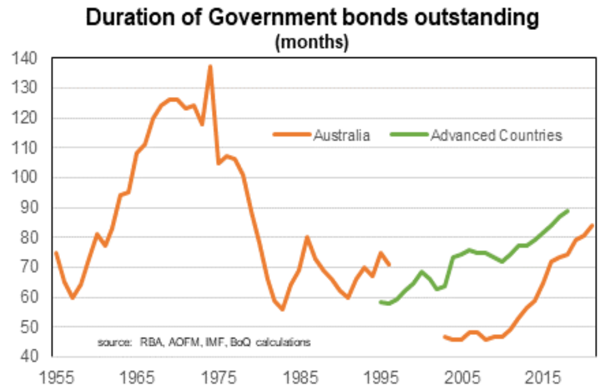
The debt levels are affordable with income growth higher than interest rates.



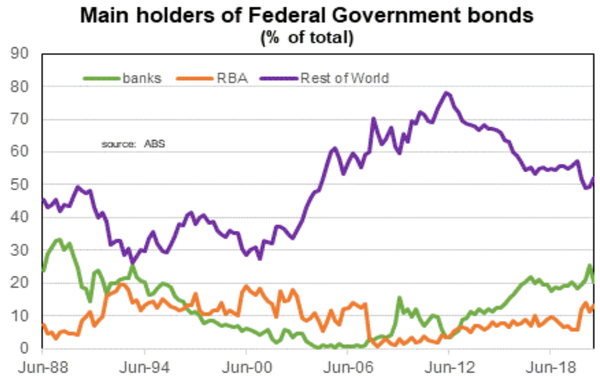
And government debt in Australia remains low by peer country standards.



The Governments has been locking in low borrowing costs.



Banks and the RBA have become bigger buys of government debt.



We live in interesting times.

Regards

Peter Munckton
Chief Economist
Bank of Queensland