BOQ GROUP

12 May 2023

ECONOMIC UPDATE

Budget: Back in black (briefly)

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Key Points

- **As foreshadowed, the underlying budget is likely to be in surplus in the 2023 financial year;**
- **A deficit of $14b is projected for next financial year, below what had been forecast in October;**
- **This means that fiscal policy will have a modest additional impact on the economy in the coming financial year;**
- **A bigger budget surplus would have helped reduce inflation risks although there are many factors that influence the inflation outlook;**
- **There are good equity grounds for there to be fiscal support to low-income earners at a time of high inflation;**
- **The medium-term fiscal challenge of how to deal with higher spending demands;**
- **The lower debt starting point provides the Government more space in dealing with the challenge;**
- **An improvement in productivity growth would simplify the fiscal outlook.**

Short-term economic outlook – Weaker economy in 2023-24

The main forecasts are pretty much as expected and close to those released by the RBA in its May Monetary Policy Statement. Economic growth is expected to slow this financial year before picking up the following financial year as households real disposable income (disposable income after allowing for inflation) growth improves. The weaker economy will see a modest rise in the unemployment rate that will hit 4.25% by mid next year and peak around the end of next year. Inflation will slow from its current rate of 7% to a bit over 3% by mid next year. Wages growth is expected to rise only modestly further. Business investment is forecast to slow but remain positive (higher inflation means more capex spending gets less).

A big decline is expected in the terms of trade (i.e., commodity prices are expected to decline substantially) next financial year by over 13% and over 8% the following year. This is not quite as sudden a decline as assumed in October (a factor that has helped the budget forecast). Treasury changed its methodology from assuming a quick move back to the assumed long run value of the terms of trade to using financial market pricing. I agree with the updated approach.

I also agree that the economy will slow this year, although I have a weaker outlook in 2025 than what Treasury is currently forecasting. One reason for the difference is that I think economic growth will be at its weakest in the first half of next year, where as Treasury is likely assuming the low point is the second half of calendar 2023. Consumer income growth is likely to be in excess of inflation by early 2024, boosting household spending power, but after having rundown their saving this year I think it more likely that households will spend time rebuilding their saving buffer. Households are also likely to remain cautious if interest rates remain where they are (or head higher). I am not expecting any rate cuts until the second half of next year.

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Key Economic Assumptions

	2022-23		2023-24		2024-25	
	BOQ	Treasury	BOQ	Treasury	BOQ	Treasury
GDP	3.3%	3.25%	1.25%	1.5%	0.9%	2.25%
Unemployment rate	3.5%	3.5%	4.25%	4.25%	5.0%	4.5%
CPI	6%	6%	3.5%	3.25%	1.9%	2.75%
Wages Price Index	3.5%	3.75%	4%	4%	3.5%	3.25%

Source: Federal Government Budget Papers 2023-24, BoQ Chief Economist forecasts

RBA models suggest it takes around 18 months before the full impact of rate hikes impact the economy. With the bulk of the rate hikes happening in the second half of 2022 that suggests that the weakest part of economic growth from tighter monetary policy will be in the first half of next year. For similar reasons that is also when I expect the weakest period of global economic growth. That is consistent with the story being told by the shape of the US yield curve. The high level of fixed rates and the large backlog of work in the residential construction sector are other reasons to expect that we are still about a year away from the bottom of the domestic economic growth cycle.

Both Treasury and I think that the economic outlook for the next 1-2 financial years is sub-trend. I remain positive about the medium-term outlook (3 to 7 years out). Strong population growth will mean that substantially more building of houses is required. Strong population growth will also require ongoing high levels of infrastructure spending. There will be more defence spending. Big spending commitments will also be required to meet our climate change commitments. The big proviso on this positive medium-term outlook is that inflation returns to its 2-3% target band at some stage through 2024-25. Providing it does that, that will allow governments to spend more money and the RBA to reduce interest rates to support stronger economic growth.

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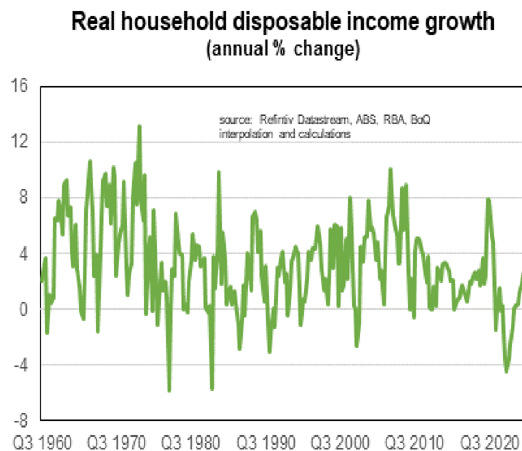
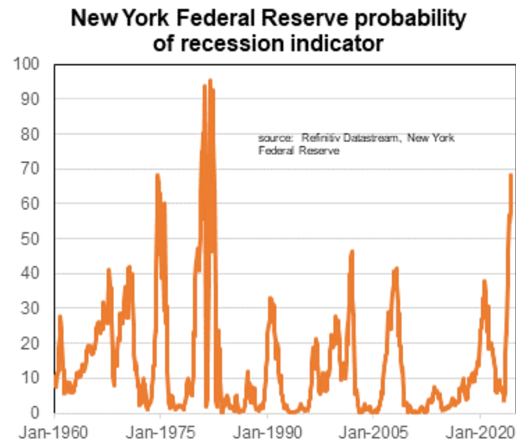
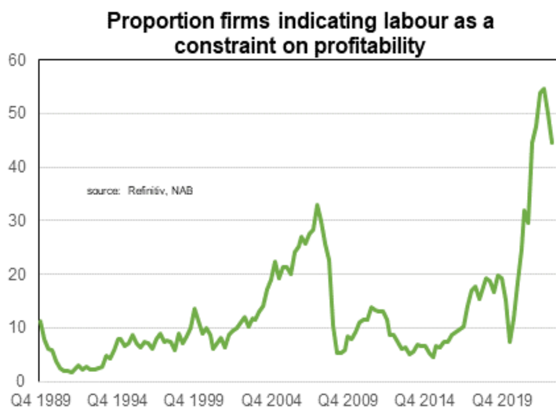
The cost-of-living shock to household disposable incomes will decline next financial year.



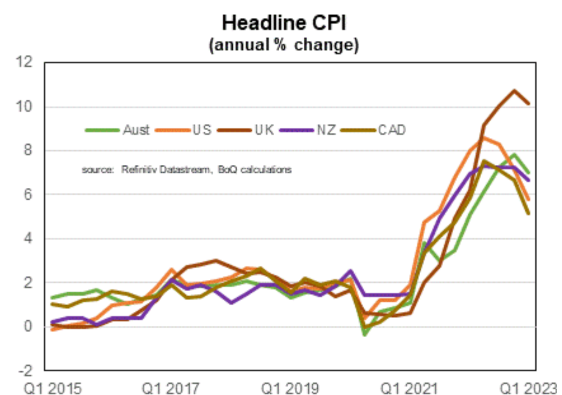
The bond market is pricing a high chance of a recession in the first half of next year.



The jobs market has peaked. But finding good workers remains firms' biggest concern.



Inflation has peaked. But we are some distance from returning to the low inflation days.



The Budget is in surplus – but is it enough?

As was widely speculated, the 'underlying' budget surplus is on track to be in surplus this year. The surplus was overwhelmingly driven by massive revenue flows from high immigration, a strong jobs market and high commodity prices. The Government gets credit for saving a decent chunk of big revenue gain to pay down debt and help reduce inflation.

But according to the RBA, the terms of trade are near one hundred and fifty year highs. The unemployment rate is near fifty-year lows. So, if a budget surplus could not be achieved now, the question would need to be asked when it could be achieved. The structural balance (which adjusts that state of the budget for the current economic cycle) calculated by Federal Treasury suggests a deficit of around 0.5% of GDP in 2022-23. These calculations should be taken with a grain of salt (at face value they suggested the budget was in structural surplus in the preceding two years). But given the current strong state of the jobs market and high inflation rate, the structural budget really should be in surplus.

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A small budget deficit is projected for the next financial year, with modest budget deficits of around 1% forecast in the following financial years. All those deficits are lower than had been projected in the October 2022 Budget although the improvement by the 2026 financial year is modest.

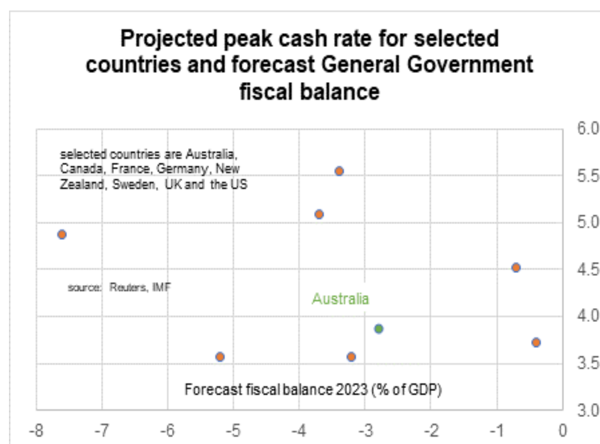
From an economic standpoint the budget ideally would have had a bigger surplus for the current financial year and a small surplus in the next year. It is true that some of the measures (such as the reductions in electricity bills) will act to reduce the CPI. And a lower CPI reduces the likelihood of big wage rises. But the reduction in price of childcare and electricity is likely to boost demand for both services. And money saved on electricity bills can be spent elsewhere in the economy.

Politically it would be very difficult for a new government to deliver a significantly bigger budget surplus at a time when an increasing number of households are struggling financially. I also think that fiscal support to the most vulnerable, at a time of high inflation, is necessary so the economy can adjust in the lowest cost way to reducing inflation. That the wages growth outlook appears benign gives confidence that such an adjustment can take place.

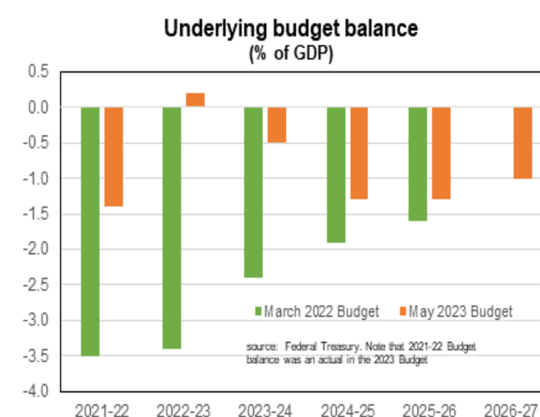
The forecast change in the budget balance is less than 1% of GDP for next financial year. That means the budget will have a modestly positive impact on the economy, but this comes at the same time the cash rate has risen more aggressively than at any time for the past thirty years, with a heavily indebted household sector. Those households have just suffered a significant negative real income shock. The additional income from the Government to households could be saved, particularly by low- to middle-income households with mortgages. The global relationship between country's projected budget balances and the peak of the expected cash rate is mixed.

Whether it turns out the fiscal settings are right for the economy will depend upon whether wages growth is as moderate as forecast, and we get no further disruptions to global supply of goods and services.

The global relationship between the budget and interest rates is not tight.



There has been a significant improvement in the Budget bottom line for the next couple of financial years.



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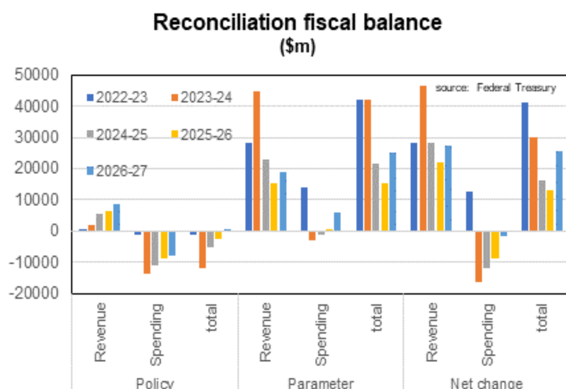
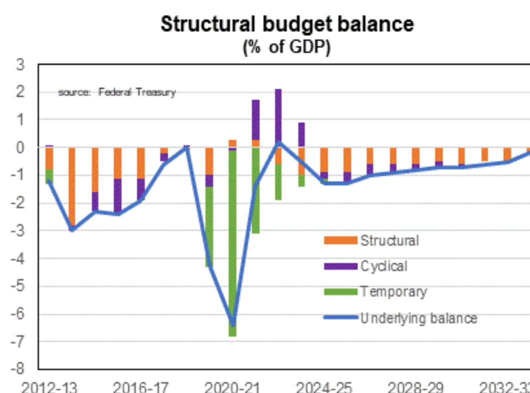
The main reason for the budget surplus was strong revenue income from strong national income growth.



The strong revenue surge masks an underlying structural budget deficit.



The debt outlook is better, but it is also not forecast to improve

Given the better budget outcomes and stronger growth in nominal income, there has been an improvement in both the net and gross debt to GDP ratios since the October Budget. The debt ratios are now well below what was expected during the pandemic in the 2021 Budget but above where it was projected in the pre-pandemic 2019 Budget. No significant deterioration is expected in the debt outlook. Australia rates well amongst OECD countries on a net debt basis (net debt is the total amount of debt minus financial assets, most of which are included in the Future Fund).

The rise in debt over the past decade mainly reflected the massive Government fiscal support provided during the GFC and the pandemic. The disappointing economic growth performance of the 2010s played a role.

The current level of debt is not a problem. The bigger issue is if we were confronted with a serious recession (a 4-5 percentage point rise in the unemployment rate) it could take government debt from its current level of below the OECD average to something well above. For a small economy this could make financing our debt from global capital markets more expensive. Hence the need to minimise the size of any budget deficits outside of economic downturns. And ideally to reduce debt lower to provide a buffer for the next economic downturn.

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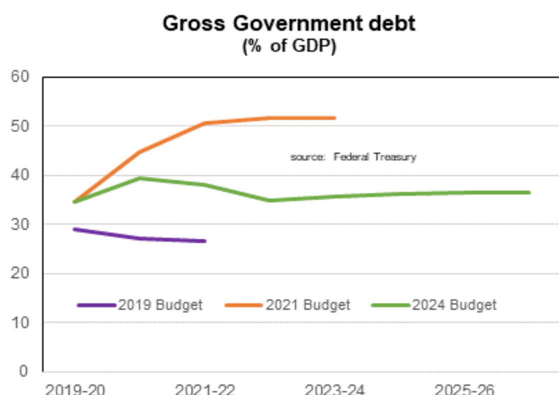
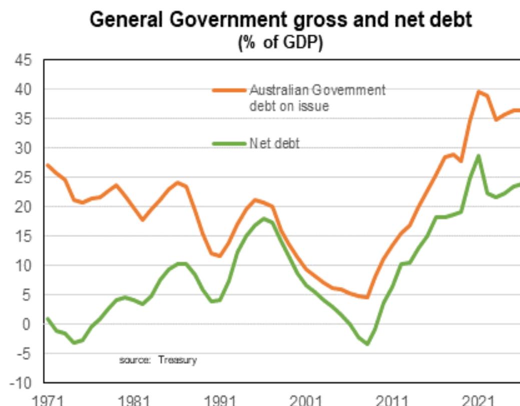
Gross government debt is well below what was projected during the pandemic.



Debt ratios remains comfortably above where they were in previous decades.



Government spending is a bigger part of the economy

As widely flagged, there were a range of new spending initiatives announced in the Budget. New spending policies totalled over $40b over the next four years, with an additional $14b next year. The announced spending included:

- Aged Care wage rises, as well as for additional nurses.
- Cost of living assistance, including electricity subsidies for some households and small businesses.
- Higher Jobseeker payments.
- Increased defence spending.
- Higher health spending.
- Additional payments to single parents.
- Additional funding for the NDIS.
- Increased rental assistance.

The spending on cost of living is temporary and is why the spending increase is largest in the first year. Some of the spending has been financed by spending cuts, such as the reprioritising of defence programs to help pay for higher future defence spending.

Almost certainly reductions to some investment spending (mainly small infrastructure projects) announced by the previous government will be announced in coming months. That is no bad thing. At a macro level it reduces the amount of money going into the economy at a time of inflationary pressure. There are currently too many infrastructure projects taking place for the available materials and labour. It will also help reduce the size of the budget deficit in the forecast years' although infrastructure projects are one-off spending.

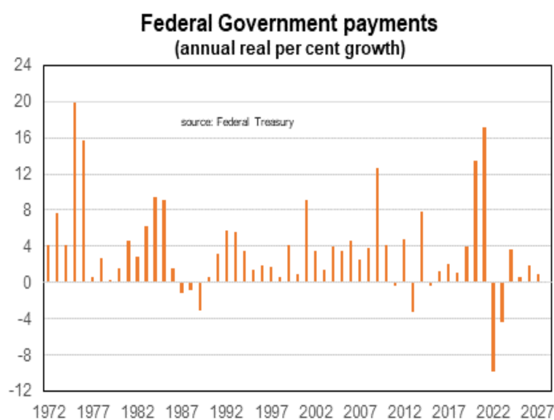
While Government spending in Australia (as % GDP) is still low by OECD standards it has been on the rise. Higher spending in recent years has partly reflected an aging population (a problem dampened by the arrival of large numbers of young immigrants) that has led to more demand for aged care and health services. But more generally wealthier societies tend to demand more government services, whether that

be on new programs (NDIS) or better-quality existing ones (health). More recently rising geo-political tensions has added a third factor driving higher defence spending.

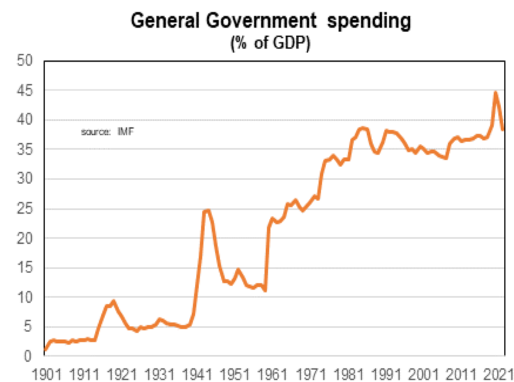
Following a decent rise in spending next financial year, spending growth in subsequent years is forecast to be subdued. A period of low spending growth is possible although the risks are that spending levels may go higher than current forecasts. There are demands for a bigger boost to unemployment benefits. Defence spending is not unusually high by historical standards. Health inflation is starting to rise again after being relatively low in recent years. Demands on aged care and NDIS services are likely to remain high.

Despite concerns raised about rising debt repayments, interest payments (as % GDP) have been at the low end of its historical range.

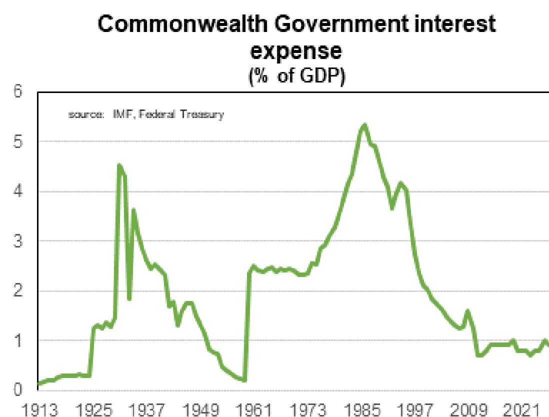
Government spending growth is forecast to remain subdued. But can this be met?



Government spending looks to have taken a step up relative to the size of the economy.

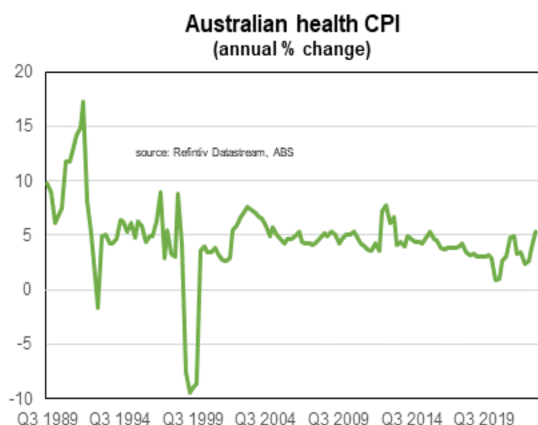


Interest payments have been at the low end of their historical range over the past decade.



Defence spending has picked up over recent years.

Health inflation is started to pick up after a period of relatively low growth.



The NDIS has had a marked impact on the jobs market.

The higher spending is being funded by a higher tax take

The big rise in Government revenue is helping to fund the higher spending in the forecast period, as well as reducing debt. The Government's revenue tax as a proportion of the economy has returned to cyclical highs. But by OECD standards Australia's tax take as a proportion of the economy remains low.

Much of the rise in revenue growth reflects the combination of a very strong jobs market (more people working, getting higher wage rises means more income tax), rising profits and very strong commodity prices. The expected weakening of the economy will slow revenue growth in coming years.

Some of the increase in forecast revenue has reflected government decisions (increased taxes on oil and gas firms, higher taxes on large superannuation balances, 5% increase in the tobacco excise, higher charges on truckies, tourists, and immigration visas).

Which brings us to the big picture. If the Government keeps to its current spending plans the fiscal outlook is fine. But if there are higher spending demands that will likely require higher growth in revenue. While total government revenue in Australia (as % of GDP) is not high by OECD standards the proportion of taxes from incomes (both personal and company) is high. One consequence is that by my calculations the proportion of household disposable income going to income tax is at its highest level in twenty years.

The third and final tranche of personal income tax cuts are due to be delivered in the 2024-25 financial year. There has been discussion that those cuts could be cancelled to help fund more government spending (such as higher unemployment benefits). Given that economic growth is projected to be weak next year I expect income tax cuts for middle-income earners to be delivered. Depending upon how the government deals with spending demands and what happens to the economy will determine whether the tax cuts for higher-income earners are watered down.

The Government has already announced that it will increase taxes on superannuation and oil and gas producers. If the Government does need to find additional revenue to meet higher spending it would not surprise to see discussion re-emerge about additional taxes on super. As with any tax change, a move on that front would certainly meet resistance.

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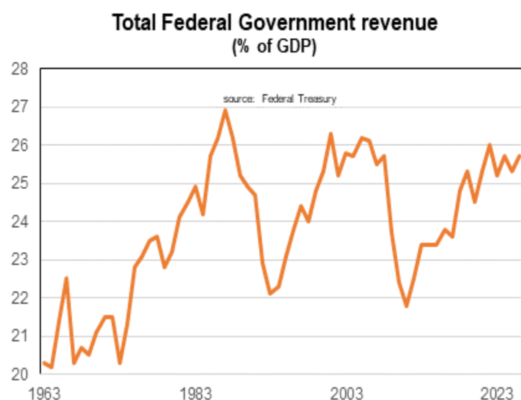
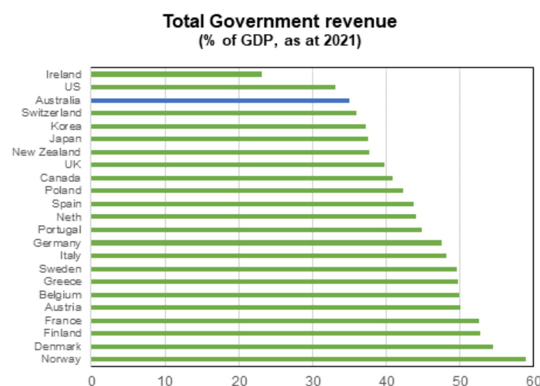
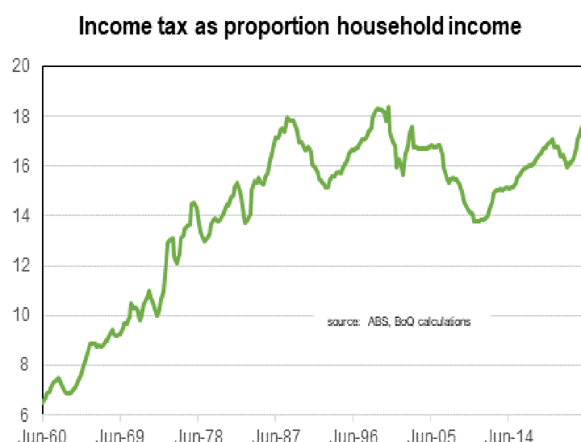
Government revenue has returned back to its cyclical high.



Taxation in Australia is low by OECD standards.



An increasing amount of household disposable incomes is being paid in income tax.



A stronger economy can help pay for higher spending

An alternative and less politically divisive way to pay for more spending (or to reduce debt) is to have stronger national income growth. In the long-term there are three ways to get stronger growth: more people (stronger population growth), a higher proportion of the population work (higher participation rate) and each worker is more productive (higher productivity growth).

The largest driver of population growth in Australia is immigration. After the extremely strong 400,000 this financial year the Treasury is assuming immigration growth of 315,000 next financial year before declining further towards its longer-term average of 235,000. The population forecasts for the next couple of years are stronger than had been assumed and has helped the budget bottom line.

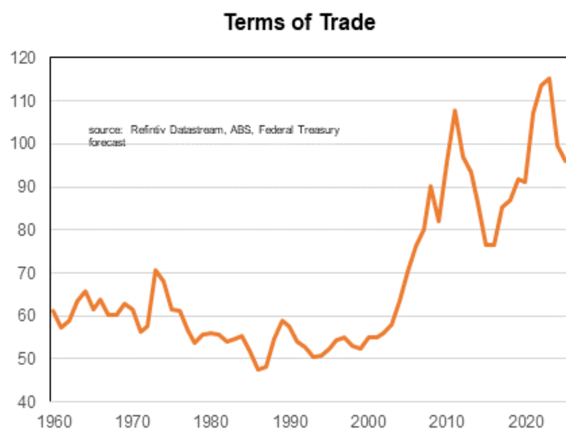
The Treasury thinks there is potential a higher participation rate, and I agree. Participation for females and those over 55 has picked up strongly in recent decades. The boost to childcare assistance has the potential to boost the female participation rate.

A bigger concern though is the low rate of productivity growth, something that the RBA Governor has remarked upon a few times in recent years. Productivity growth always is low when the jobs markets is extremely tight as it is currently.

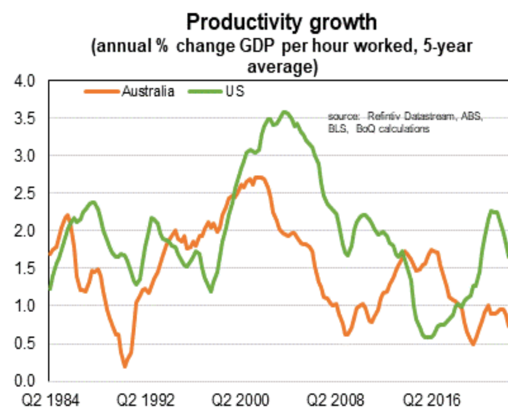
Productivity growth in Australia has been notably lower than in the US in recent years that also has a very tight labour market. Possibly the bump in capital spending that has taken place will in time lead to higher productivity. Technological progress in areas such as AI has potential. The Government though has not yet made many policy announcements about productivity. The Budget assumption of productivity growth of around 1.2% in the medium term is looking high relative to its current five-year average (0.75%).

So, it is possible that the economic variables could do more of the heavy lifting in helping us to meet the fiscal challenge. As noted, there is a good chance that the terms of trade will remain historically elevated, something that will continue to help government revenue collections. If the economic variables continue to go the right way, it would prove that Australia would really be the lucky country. More likely keeping debt under control will require a combination of ongoing spending restraint and additional revenue growth.

The terms of trade is expected to decline but still be at a high historical level.

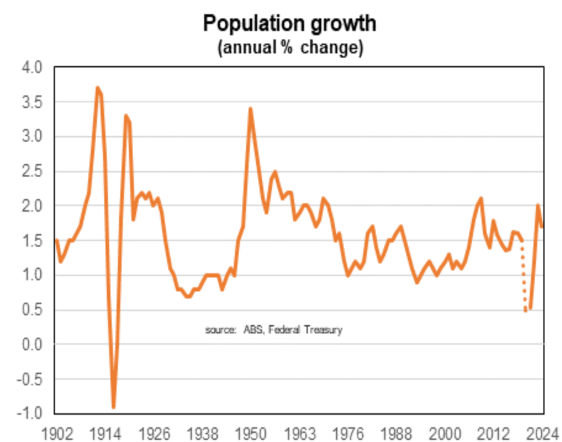


Productivity growth in Australia has been low in recent years.



The participation rate is at a record high. But it could head still higher in coming years.

Population growth is forecast to head down towards the low end of its historical range.



We really do live in interesting times.

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Regards

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