BUDGET UPDATE

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WEEK ENDING 28TH OCTOBER 2022

BOQ GROUP

Key points

- **The Budget did what was advertised: it updated the economic outlook and the change in Government priorities;**
- **The economic forecasts appear reasonable albeit conservative;**
- **The 2022-23 Budget deficit is now forecast to be substantially narrower primarily reflecting the benefit of higher commodity prices;**
- **The clearest message from the Budget is the structural budget problem with spending projected to be sustainably higher than revenue.**

Economic forecasts

Every year Treasury's forecasts are examined for what they say about the economic outlook. Mostly they are in line with the consensus. And that is broadly the case again this year. The unemployment rate is expected to remain low for much of this year before picking up over the following two years as the economy slows. The tough time firms have had over the past year in finding staff could mean that the unemployment rate forecast that Treasury has may prove a little pessimistic. Given the global economic and interest rate rise backdrop taking a cautious view though is best. Most analysts (including Treasury and myself) do not expect Australia to enter recession although there is a high chance of an economic slowdown.

The inflation rate is projected to peak by the end of this calendar year although is not expected to re-enter the RBA's 2-3% target until 2024. A peak of inflation by year-end looks a good chance, not the least as that is what will likely happen in most countries. Reduced supply-chain concerns and weaker domestic and global demand will be the drivers of lower price growth. This will be partially offset by higher wage costs (and rising rents). Treasury currently has a higher CPI forecast than me for the following year. Given the weather and geo-political issues, that is reasonable. There is not expected to be any real wages growth until 2023-24.

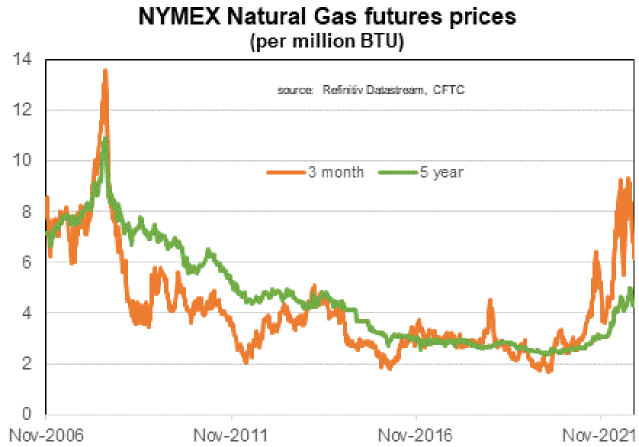
One reason why the Budget is in better shape than predicted earlier in the year is that prices for key commodity exports have been higher than forecast. As would be expected the Treasury is projecting a substantial drop for most commodity prices. That is reasonable. The risks to the forecast are balanced in the near term. There is the likelihood that the global economy will be weaker than is currently expected (and commodity prices lower). But ongoing weather and geo-political problems could cause more supply problems and result in higher prices. In the longer term, changing geo-politics and under investment is likely to lead to structurally higher commodity prices (particularly for energy).

Economic forecasts

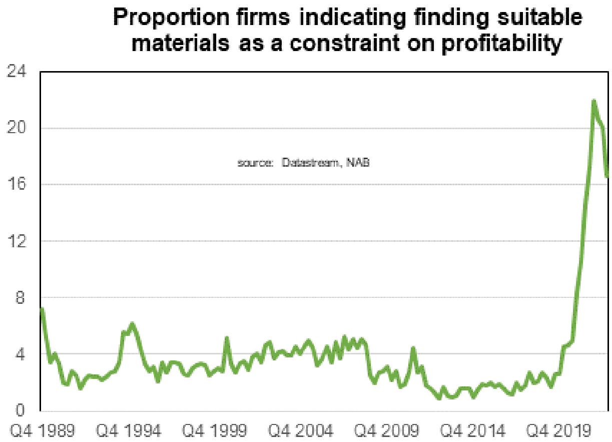
Variable	2022-23		2023-24	
	Treasury	BoQ	Treasury	BoQ
GDP	3.25	3.5	1.5	1.6
Unemployment rate	3.75	3.5	4.5	3.9
Wages growth	3.75	3.75	3.75	4.0
CPI	5.75	6.0	3.5	2.6

The demand for labour is high. That should mean the unemployment rate remains low for this financial year and into the next.

Financial markets expect gas prices to decline but remain comfortably above pre-pandemic levels.



Pandemic induced supply-chain problems are starting to get resolved.



A world economic recession does not necessarily mean an Australian recession. But it does mean a probable slowdown.

Size of Government debt and deficits

The budget for this financial year is in better shape than when the 2022-23 Budget was originally published back in March, and the subsequent update before the election. But the budget is projected to be in a worse shape in the 2025 and 2026 financial years'. The projected increase in the deficit in those years is modest and will be swamped by changes in the economic environment.

Essentially the stronger economy and higher commodity prices is expected to boost revenue substantially for this financial year before moderating in subsequent years (in line with projected declines in commodity prices and a rise in the unemployment rate). Spending is up across the forecast years. Higher inflation and interest rates play a role. So does greater demand for some government services including the NDIS. The rise in spending from new policies was largely (but not completely) funded from cuts elsewhere and some increase in tax. Revenue is projected to be running at around the high level experienced in the decade before the GFC. A sharp slowing in economic growth could make that forecast hard to achieve. Spending is now projected to be sustainably higher than was the case pre-pandemic (abstracting from the COVID years).

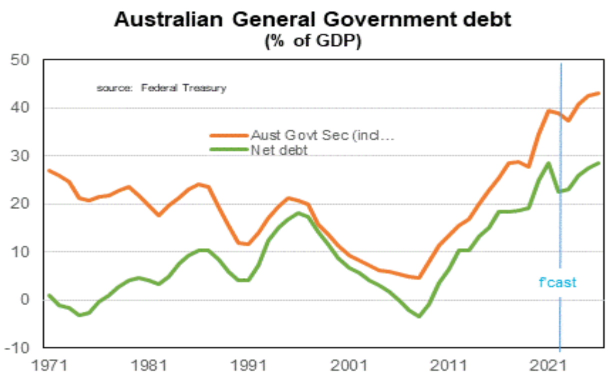
		2022-23	2023-24	2024-25	2025-26
Change Budget balance		41.1	12.5	-4.3	-6.7
Revenue	Total	58.7	36.3	27.7	35.2
	Policy	1.4	2.5	4.0	5.3
	Parameter	57.3	33.8	23.7	29.9
Payments	Total	-17.6	-23.8	-31.9	-41.8
	Policy	-2.5	-1.7	-6.0	-12.7
	Parameter	-15.1	-22.1	-25.9	-29.1

Source: Australian Government Budget papers 2022-23 Oct 2022, positive is improvement, negative a deterioration

The improvement in the budget deficit means that a modest improvement in debt is expected this financial year. But as the deficit widens, debt is expected to rise again. Government debt is low by international standards (although comparably not as low as it was pre-GFC), but high by Australian historical standards. That higher debt level at a time of rising interest rates means more money needs to be spent on interest payments.

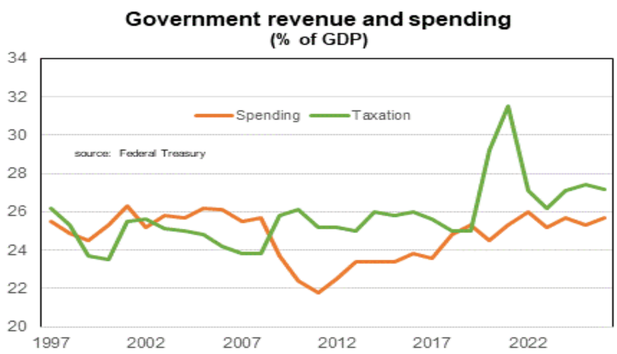
Sometimes the focus is on net government debt (essentially actual debt minus deposits and certain investments). It is a useful measure and tells us something about the strength of the Governments balance sheet. But it is not clear as to how quickly the Government can use those assets if it had to fund debt repayments. Looking at gross debt gives an indication of how much of the Government's cash flow will be eaten up repaying debt. Gross debt has risen by more than net debt over the past decade.

Gross debt is expected to rise again after this financial year.

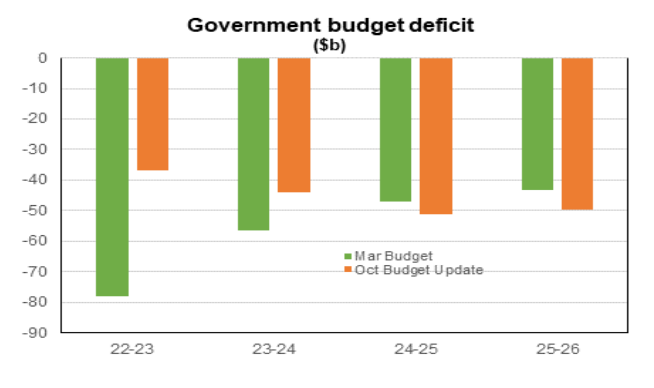


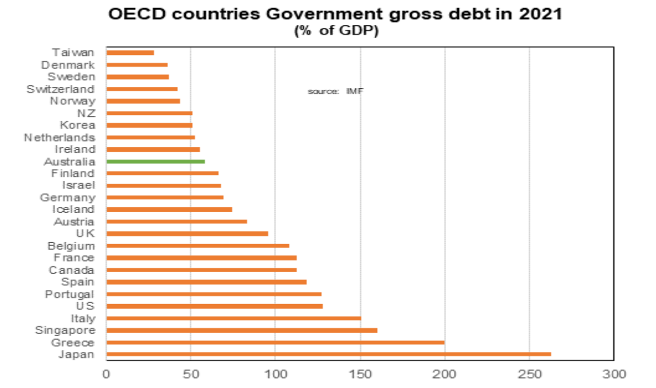
A stronger economy and higher commodity prices means narrower budget deficits for this financial year.

Revenue is expected to get back to the levels seen pre-GFC. But spending is expected to be structurally higher.



Australian Government debt remains low by historical standards.





Fiscal policy stance: Less is more

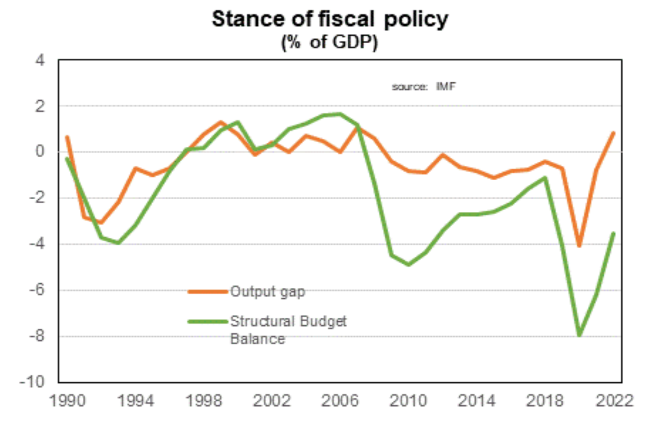
The lesson from the recent UK Budget experience was not so much about concerns of fiscal profligacy (although important) but the need for fiscal policy to be both appropriate for the current state of the economy and working in the same direction as monetary policy.

That is happening in Australia. This Government has allowed a lot of the benefits of a stronger economy to flow through to the Budget bottom line. This has meant that fiscal policy is pumping in less money to the economy this financial year at the same time as the RBA is raising the cash rate.

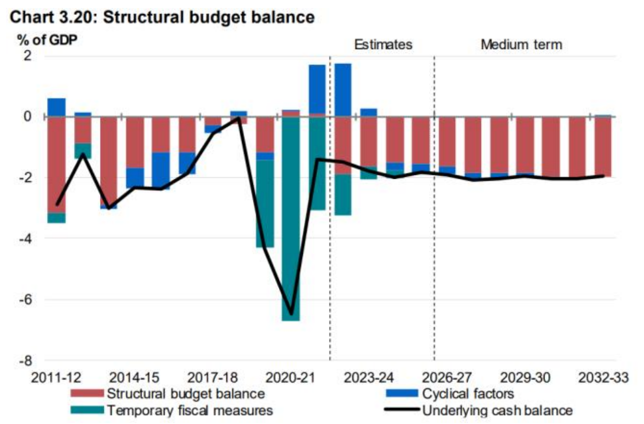
The question though is whether fiscal policy should be even tighter. An argument can be made that given that the unemployment rate is at fifty-year lows, and the terms of trade is near historic highs, the budget should actually be in surplus (as opposed to a modest deficit). Measures of the 'structural' budget balance (that tries to calculate what the budget would look like at full employment and commodity prices at a 'normal' level) indicate that the budget has a decent-sized deficit of the order of 2% of GDP.

Ideally the federal budget should be a lot closer to balance in the current financial year. But you can understand why the Government was cautious. It has only just taken the budgetary reigns. While there is an argument that Australian fiscal policy should be tighter, the argument is stronger for other developed economies with bigger inflation problems (such as the US). And with inflation projected to decline, and the unemployment rate rise, it is likely that fiscal policy will again be required to support the economy. So, stamping on the brake and then quickly pushing back on the accelerator may not be the best thing for the economy.

The structural budget deficit is wider given the current state of the economy.

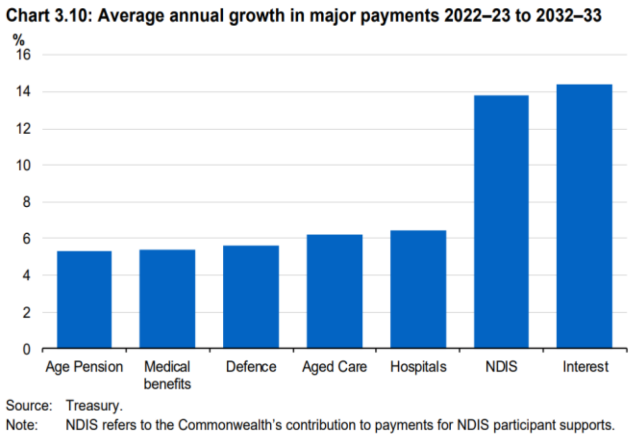


And is not projected to narrow.

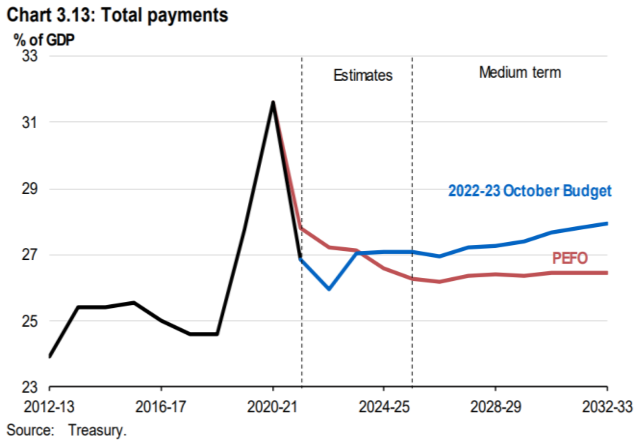


Source: 2022-23 Oct 2022 Budget Papers

Expected growth in some payments programs is large, notably for the NDIS and interest payments.



Projected payments have been marked up since the last Budget update.

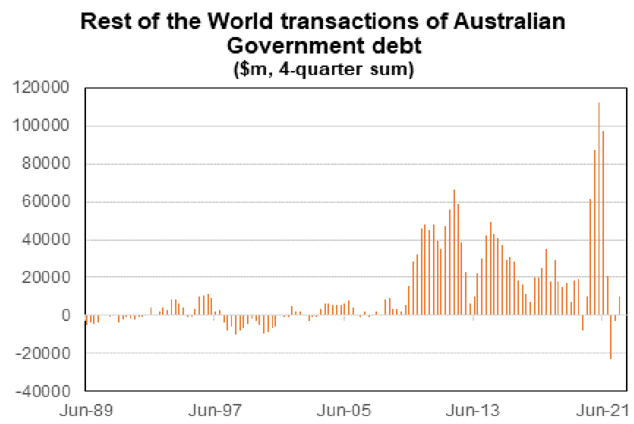


Funding the deficit should be straightforward

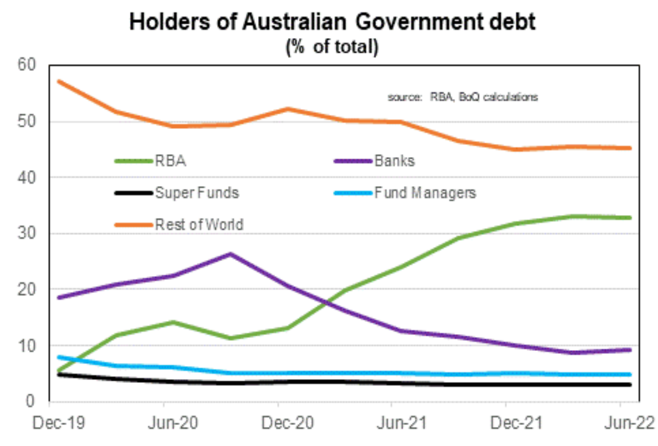
Post the recent UK Budget attention has again returned to Government's ability to fund their budget deficits. This has not been much of an issue for the past decade as Government's around the world have benefited from declining interest rates and central bank buying of government bonds. Now interest rates are on the rise. And the RBA is not only not buying, but will gradually reduce its holdings of Government debt.

The new world of rising interest rates (and strong $US) has already made it harder for some emerging economies to finance their budgets. Australia is unlikely to face a similar issue. According to Standard and Poors', Australia is one of only 11 countries around the world with an AAA credit rating. The budget deficit is small by global standards, as is the amount of debt outstanding. While the RBA is no longer a buyer of government bonds, rising interest rates should encourage greater participation by fund managers. Foreign participation in the Australian Government bond market will likely increase once it's clear that the $AUD is unlikely to decline further.

Overseas buying has recently returned to the Australian Government bond market.



RBA has been the key buyer of government bonds in recent years.



Spending – one step forward, one step back

The additional major spending programs were largely well flagged and consistent with promises made during the election campaign. There is more money for aged and childcare, as well as the NDIS. There is the additional paid parental leave as well as some more money for education (and the Victorian suburban rail project). Apart from the indexation of government payments there was only modest additional spending for cost of living relief (mainly for prescriptions and childcare).

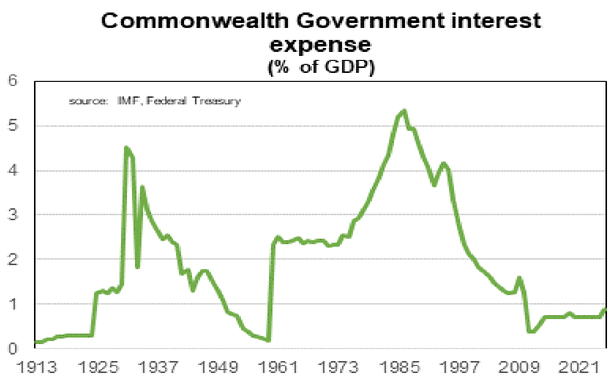
The additional spending programs were largely (but not completely) funded by cuts made to Coalition spending priorities (notably infrastructure projects) as well as reductions in public service spending (consultants, travel). At face value replacing one-off spending on infrastructure projects with recurrent spending makes the structural budget problem worse. But the benefits of some of those infrastructure projects were questioned. It is also not clear as to whether the spending on infrastructure was going to be a one-off. And there is a good chance that at least some of the proposed new spending (such as for childcare) will help boost economic growth (by helping to boost the participation rate of women in the labour force).

The Government will also borrow to create three funds (to invest in the electricity grid, local manufacturing, and public housing). The borrowing for these funds will be done 'off-budget'. There has been a trend rise in the amount of off-balance sheet borrowing done over the past 10-15 years.

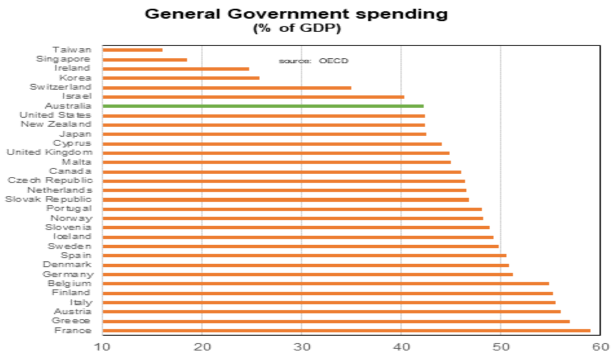
The big picture is that demand for government spending has increased over the past decade. The Treasurer has nominated health, aged care, NDIS, defence, and interest payments as areas of structurally higher spending. The extent of that increase in spending is partially hidden by the current, very low unemployment rate (reducing spending on unemployment benefits and increasing income tax receipts). The trend rise in spending has been noticeable at both the federal and state level.

Government spending in Australia (both Federal and state, including infrastructure) is low by European standards. Some hope that higher spending can be funded from the proceeds generated by a stronger economy. Certainly, that is the best-case scenario. But we have a structural budget deficit at a time when the unemployment rate is at fifty-year lows, and we are enjoying historically high terms of trade. That does suggest that stronger economic growth is only part of the solution, and we will either need to choose between reducing spending or increasing taxation. And given the apparent increase in demand for spending, that suggests the possibility of higher taxation at some stage in the future.

The budget has benefitted from very low interest rates.

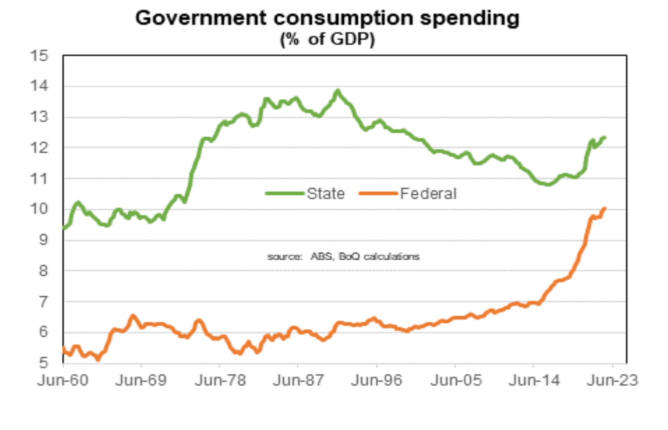


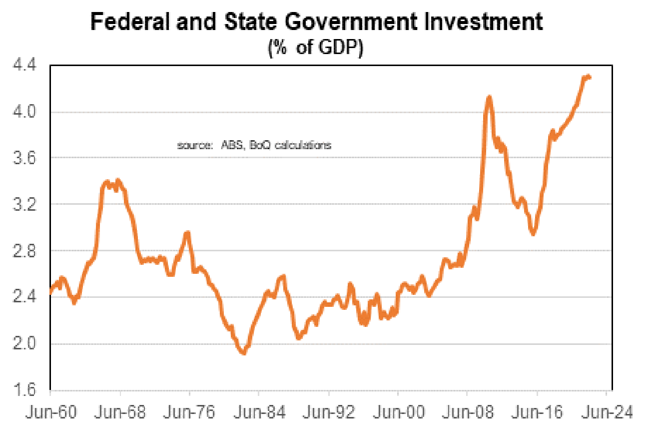
Government spending in Australia is low by OECD standards, notably in Europe.



Government recurrent spending has been on the rise at both the federal and state levels.

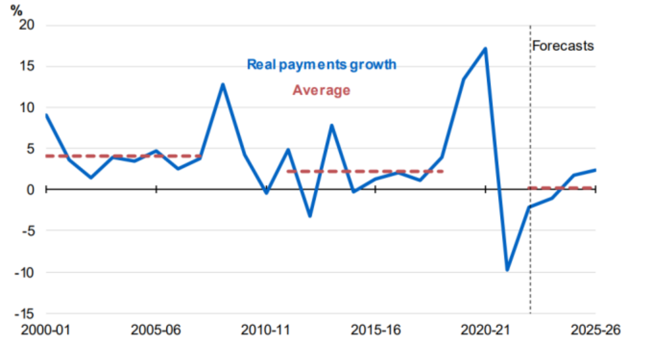
This has also been the case for infrastructure investment.





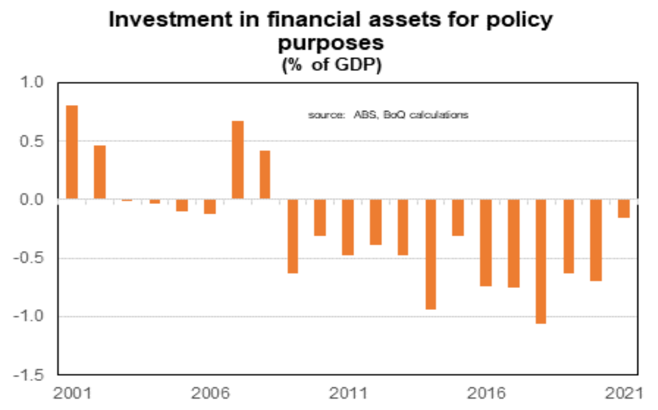
The growth in payments (after inflation) is projected to essentially be flat in coming years. That may prove optimistic.

Chart 3.1: Real payments growth



Source: Treasury.
Note: Averages cover 2000–01 to 2007–08, 2011–12 to 2018–19 and 2022–23 to 2025–26, to exclude the impact of fiscal stimulus during the Global Financial Crisis and COVID-19 pandemic.

There has been an increase in off-balance sheet investments over time.



Taxation

As expected, there was only modest change to taxation arrangements in the budget. The third tranche of the income tax cuts are still in place. Whether they proceed will depend upon the outlook for government finances and the state of the economy.

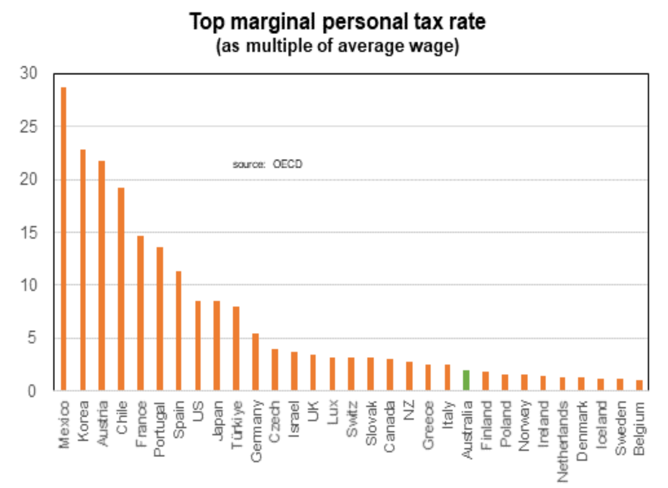
The big picture remains that a big chunk of Government revenue comes from income taxes. This has resulted in the income tax take from households being high by Australian historical standards (strong employment growth has played a part) and the top marginal rate cuts in at a lower level relative to the average wage. The company tax rate is high by global standards.

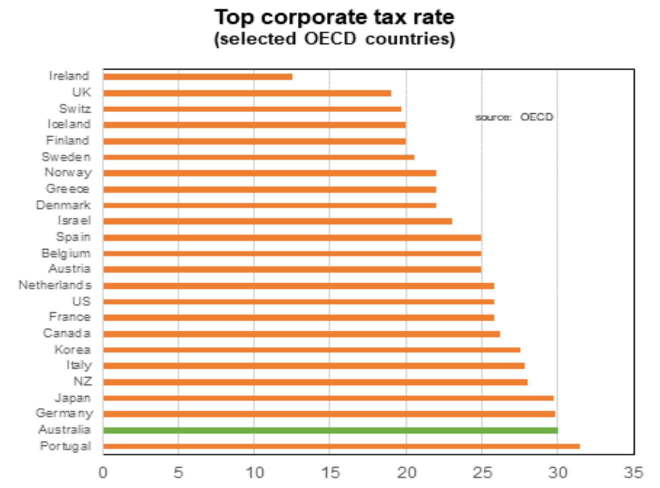
One new policy announced is to raise more revenue from multi-national companies. It is politically popular and something that many governments internationally are looking to do. There has been agreement reached between nations to set a floor rate on company tax. Now we will just have to see how much additional revenue is collected.

Taxes on spending are low by global standards but there is little political support to increase the rate of GST or broaden the range of goods and services taxed. The Government is looking to increase compliance in tax collections.

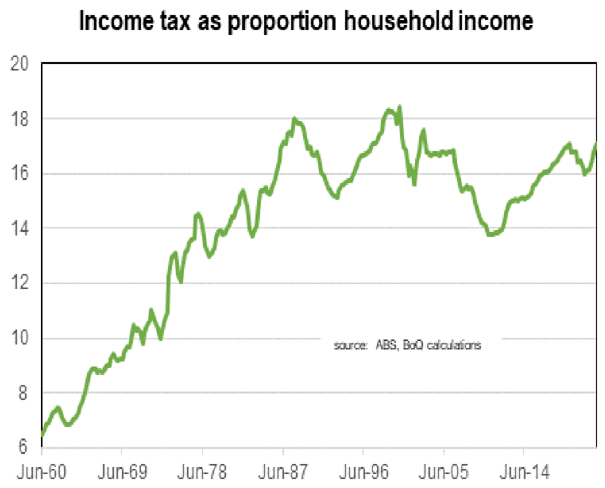
The top marginal income tax rate cuts in at a relatively low wage in Australia.

The corporate tax rate in Australia is high by OECD standards.

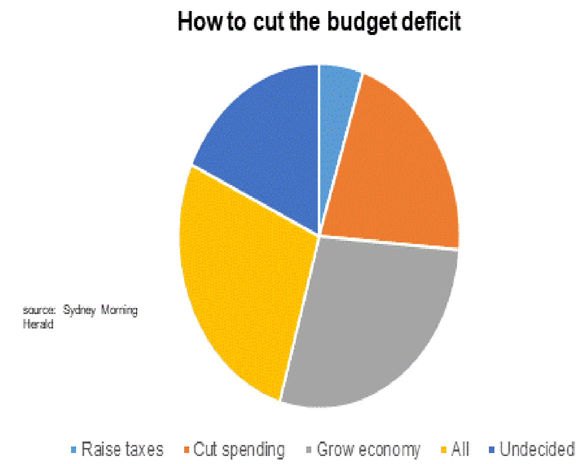




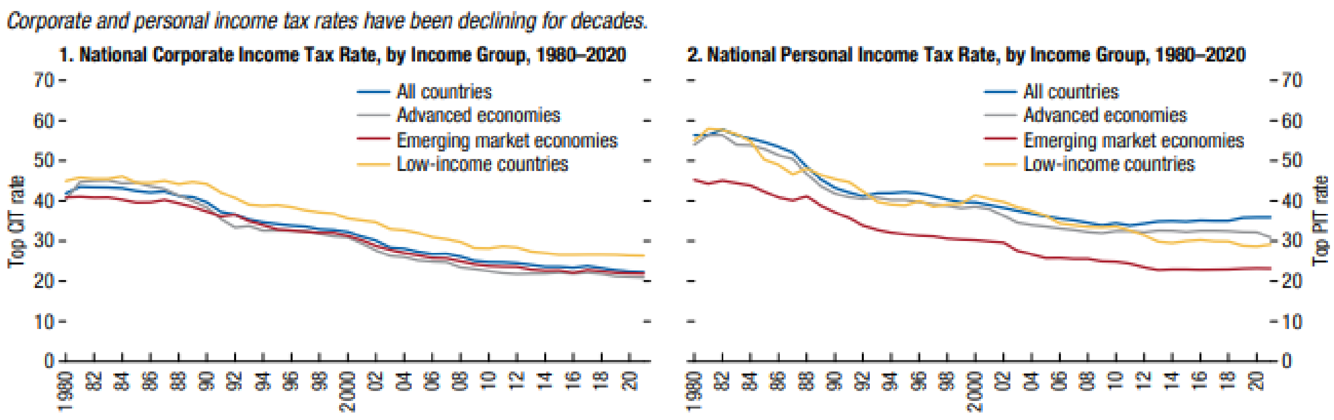
The proportion of income taken as tax has risen in recent years.



Growing the economy has most support as a way of reducing budget deficits.



The rate of income taxes has been declining over time although that trend has plateaued over the past decade.



Source: IMF Fiscal Outlook Oct 2021

Relatively few immediate monetary policy implications

In net terms the Government has made little change in the stance of fiscal policy. The economic forecasts are close to consensus. If anything, they are conservative. So, it is difficult to see this Budget sustainably changing financial market views on the interest rate outlook. At the time of writing, financial markets expect the cash rate to be a bit over 3% by end-2022 and 4-4.25% by mid next year. I agree with the first projection. But the high level of household debt means I am more dubious about the second. We shall see. There was little immediate reaction in the currency market to the Budget. More important for financial markets will be the following day's CPI release. Given the recent example of the UK it can be a good thing to deliver a 'boring' budget.

We live in interesting times.

Regards

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