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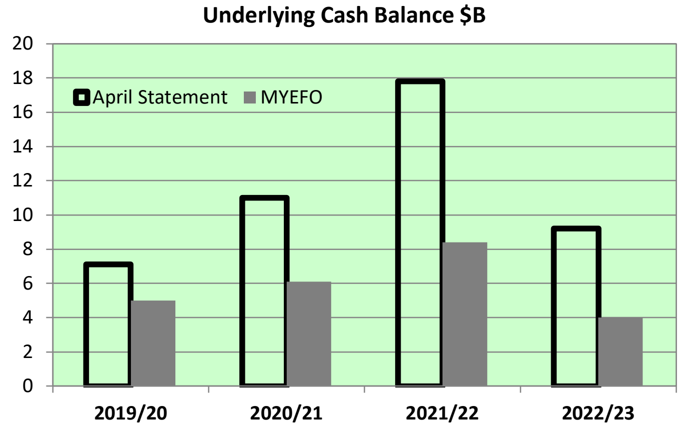
Lower budget surpluses now expected

The Australian Commonwealth Government is now expected to produce slightly lower budget surpluses than was previously forecast. An update of the Government's financial position was provided in the "Mid-Year Economic and Fiscal Outlook" (MYEFO) Statement made in December. The Statement suggested there would be a decline in this financial year's surplus from the $7.1 billion forecast in the Budget Statement last April to $5.0 billion (0.3% of Gross Domestic Product). Further, the size of surpluses projected over the next 3 years is anticipated to be smaller than forecast in April 2019. The surplus expected in 2019/20 will be the first recorded by the Commonwealth Government since 2007/08.



Source: Australian Government MYEFO

Despite the lowering of the expected surplus, the overall stance of fiscal policy adopted by the Commonwealth Government remains mildly contractionary. Growth in revenue is slightly in excess of growth in expenditure, with a net contractionary impact on aggregate demand.

Importantly, however, the MYEFO Statement was made prior to the full impact of Australia's bushfire crisis was known. In January, the Commonwealth Government announced plans to contribute $2 billion to a bushfire recovery fund over the next two years. This expenditure, and the broader economic impact of the bushfires, is expected to reduce the likelihood of the Government meeting the MYEFO forecasts.

The change in the Government's financial forecasts announced in the December MYEFO Statement reflect both policy changes and changes in parameters (i.e. changes in the economic environment, which impact on budget variables). Parameter changes represented a $13.5 billion deterioration in the 4-year financial forecast. Policy changes made since the April Budget were also material and had a net negative impact of $8.1 billion. Included in these policy measures was new spending associated with drought support, aged care and accelerated infrastructure spending.

The most significant parameter changes impacting the Government's financial forecasts related to decreased taxation revenue. This included lower forecasts for superannuation fund taxes and lower Goods & Service Tax (GST) expectations due to downgrades to growth in consumption expenditure across the economy. Lower forecasts for average wage growth and downgrades to company profits have also impacted on the 4-year financial forecasts of income tax and company tax respectively. Partially offsetting the lower financial receipts is an expectation of lower spending due to parameter changes. Contributing to the lower expenditure is a drop in the GST pass through to the State Governments (offsetting the lower GST receipts); as well as a lowering in expected interest payments on the Government's debt.

Changes in expectations around tax revenues are closely related to changes in economic forecasts, which underpin the assumptions around many of the Government's financial variables. The table below details the change in expectations of a number of key economic variables:

Economic Forecasts	2019/20		2020/21	
	Budget	MYEFO	Budget	MYEFO
Real GDP (% growth pa)	2.75	2.25	2.75	2.75
Nominal GDP (% growth pa)	3.25	3.25	3.75	2.25
Consumer Price Index (% growth pa)	2.25	2.00	2.50	2.25
Employment(% growth pa)	1.75	1.75	1.75	1.75
Unemployment rate (June Qtr%)	5.00	5.25	5.00	5.25
Terms of Trade (% Change pa)	(5.25)	(4.00)	(4.75)	(8.75)
Wage Price Index (% growth pa)	2.75	2.50	3.25	2.50

Source: Australian Government Budget, MYEFO 2019/20

As detailed in the above table, real (i.e. after adjusting for price changes) Gross Domestic Product (GDP) is expected to expand by 2.25% in 2019/20 and 2.75% in 2020/21. The growth forecast for this financial year is below the previous forecasts made last April and suggests that economic growth will remain below longer-term averages of approximately 3% per annum. Lower economic growth is typically associated with a worsening in the Government's budget position as lower incomes and profit reduce the base from which tax can be charged. In addition, lower economic growth can also be associated with higher unemployment, creating an increase in the Government's social security spending.

However, it is nominal (i.e. before adjusting for price change) GDP that can often have a greater impact on budget outcomes. Tax receipts tend to be more sensitive to changes in nominal than real GDP because it is the nominal value of earnings upon which tax revenue is based. The nominal GDP growth forecast has been maintained at 3.25% in the current financial year. However, for next financial year the nominal growth forecast has been reduced from 3.75% to 2.25%. This decrease reflects an expected deterioration in the Terms of Trade, which is now forecast to decline by 8.75% in 2020/21. Lower iron ore prices are the main contributor to the expected Terms of Trade decline. Company taxation receipts are particularly sensitive to movements in the iron ore price.

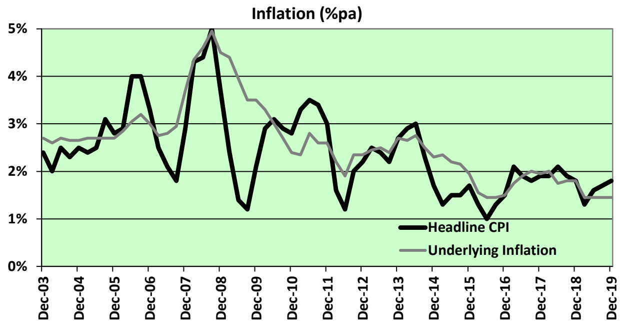
Expectations for wages growth have been revised down by 0.25% in 2019/20 and by 0.75% in 2020/21. A lower level of wages growth reduces the base from which income tax can be collected. This lower wage growth expectation is also consistent with a lowering in the inflation forecast by 0.25% in both years.

Q1: Explain why a change in the rate of economic growth would be expected to be associated with a change in the Government's budget position.

Q2: Describe the difference between nominal and real Gross Domestic Product.

Inflation creeps marginally higher

Notwithstanding the Government's lowering of Australia's inflation forecast, there was a pickup in the rate of price increase in the 3-month period ending December. Australia's Consumer Price Index (CPI) for the December quarter of 2019 showed that prices rose by 0.7%. As a result, the annual rate of inflation rose from 1.7% to 1.8% between the September and December quarters of last year.



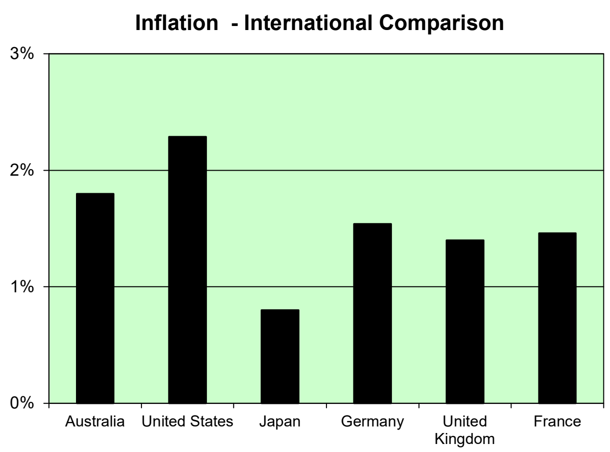
Source: Australian Bureau of Statistics 6401

Showing the largest increase in price over the December quarter was Tobacco, which jumped by 8.4%. This price movement can be largely attributed to a 12.5% increase in the federal excise tax on tobacco in September. Tobacco prices have now risen by 14.0% over the past year. Also showing large price rises were certain food categories, with fruit prices up 6.8% and beef & veal up 2.9%. Ongoing drought conditions are impacting on food prices, with meat prices also affected by stronger global demand for Australian produce due to the spread of African Swine Fever in Asia. Transport costs were also higher, with petrol costs rising 4.4% due to higher global crude oil prices.

Partially offsetting the higher prices described above were falls in the price of clothing (down 0.3%), telecommunication equipment (down 0.9%) and pharmaceutical products (down 1.3%). The lower cost of pharmaceutical products was largely seasonal, with an increase in the proportion of individuals exceeding the Pharmaceutical Benefits Scheme (PBS) safety net level towards the end of the calendar year.

One off or "outlier" impacts on the CPI, such as a spike in tobacco prices, can be removed in calculations of the "*underlying rate of inflation*", which are intended to provide a more accurate assessment of the trend and longer-term position of inflation. In the year to December 2019, the underlying level of inflation was calculated as being below the “headline” rate at 1.45%. This rate of inflation is below the bottom of the Reserve Bank’s 2% to 3% target range for the average level of inflation over the medium term. As shown on the above chart, underlying inflation has been below the target range for the majority of the period since late in 2015, after a steady decline in the previous decade.

The low inflation that has prevailed in the Australian economy in recent years has been a characteristic of most developed economies. Following the Global Financial Crisis, demand was generally weak with producers having excess capacity (i.e. operating below their maximum level of output given capital and labour resources).



Source: OECD, ABS. Latest annual data.

However, despite some recent improvement in global economic growth and tightening labour markets (i.e. where demand for labour has grown relative to supply), there has been little response in terms of higher wages across many economies (outside of the U.S.). This lack of growth in wages has continued to result in an absence of any significant “cost push” inflation. The chart above displays inflation rates in selected economies. As shown, Australia’s inflation rate is similar to that of the major European economies; but below that of the United States, which is currently experiencing stronger rates of economic growth and lower levels of unemployment.

Q3: Define the Reserve Bank’s target range for inflation.

Q4: Describe the impact that a rise in the demand for labour would normally be expected to have on inflation.

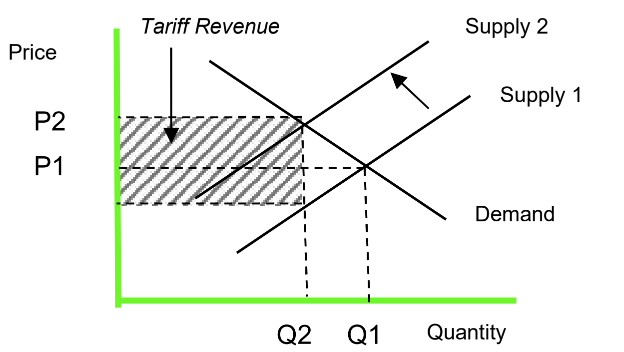
U.S. & China sign phase 1 trade deal

A key focus of financial markets over recent months has been on developments around the negotiations between the United States and China in relation to trade. This follows two years of significant tariff imposition by both countries (tariffs are effectively taxes applied by governments on the import of specific goods & services). The rise in tariffs on items traded between China and the U.S. was initially triggered in January 2018 by the U.S. administration in an attempt to improve the competitiveness of U.S. industries and address perceived “unfair” Chinese trade practices. The U.S. has a significant trade deficit with China, with Chinese exports of goods to the U.S. totaling approximately $US 540 billion each year; whilst U.S. exports to China total approximately $120 billion.

Underpinning the rationale for the program of tariff increases implemented by the U.S. is the intention to support the U.S. manufacturing industry. Declining manufacturing competitiveness in the U.S. over the past 2 decades has significantly impacted on the living standards of manufacturing workers and economic conditions in specific regions in the US.

The chart below shows how the imposition of tariffs can lead to the increase in price of imports and also a lowering in the volume of production of those items subject to the tariffs.

Impact of tariff on supply and demand for imports



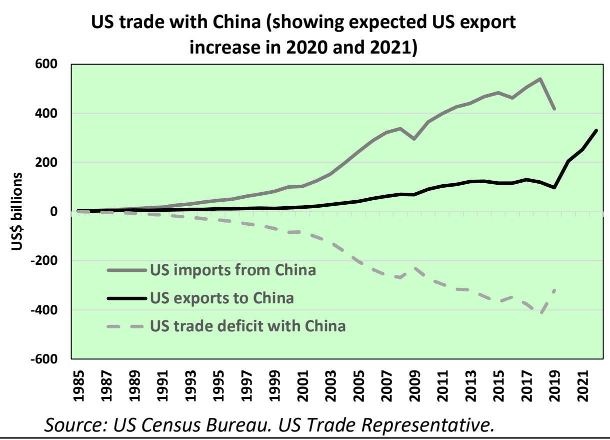
Free trade and initiatives to remove trade protection are supported by economic theory that suggests countries will gain from trade if they focus their production on those items in which they have a comparative advantage (i.e. can produce at a lower relative cost). Surpluses in production can then be traded for items in which another country has a comparative advantage.

Despite the theoretical case for free trade, there has been little progress in the removal of trade barriers over the past few years. This is in contrast to the general trend of recent decades where there has been a considerable long-term reduction in trade barriers around the globe. There is a risk that any introduction of new protectionist measures creates momentum towards more trade protection, as affected governments retaliate in order to neutralise the effect of protection by another country on their own industries. As such, the recent escalation in tariffs between the world's two largest economies was seen as a potential threat to both broader free trade principles, as well as longer term global economic growth.

However, the imposition of ongoing higher tariffs between the U.S. and China has been stemmed at least temporarily via a "Phase 1" trade agreement between the two nations announced in January. The agreement covers the following areas:

- An extensive discussion of changes China is to make to safeguard intellectual property of various forms
- A similarly extensive list of changes to trade barriers for agricultural products
- A reaffirmation of adherence to International Monetary Fund (IMF) principles for macro-economic policy and exchange rate settings
- Detailed dispute resolution procedures
- An increase in the volume of imports of US goods & services by China

The expected increase in Chinese imports of U.S. goods &services is significant, totaling $US 200 billion over the next two years. Increases are targeted across manufactured items, energy, agriculture and services.



Source: US Census Bureau. US Trade Representative.

Both nations have indicated they will pursue a second phase of the agreement. This second phase is expected to address the reversal of some of the tariffs that have been implemented.

For Australia, the nature of the trade deal is not necessarily all positive. A key issue for Australia is the potential impact on Australian sales to China of liquefied natural gas (LNG), food products and particularly milk products. These will potentially be reduced by mandated purchases by China from the US. The change in the US-China trade arrangement to a "most-favoured" trading partner relationship will also mean other countries must find new markets. New Zealand, as a very large exporter of milk products, will also likely be affected. China is Australia's largest trading partner with a 34% share of exports, of which LNG is 12%. In 2017, Australia represented 4.9% of China's imports, which is above the US share at 3.4%.

By contracting to favour one trading partner over others, the Phase 1 trade deal could be seen to be inconsistent with the broader free trade principles of the World Trade Organisation. Although countries, such as Australia, could be negatively impacted by China switching some purchasing of imports from the U.S., other aspects to the agreement may have more universal benefit. Requirements around the protection of intellectual property, the need to make sure that product piracy is managed in China and transparent currency management practices are initiatives that may ultimately benefit the broader global economy.

Q5: Describe how rising trade tariffs can lower living standards in both exporting and importing countries.

Q6: Discuss both the potential positive and negative implications of the "Phase 1" trade deal for the Australian economy.

Stats on Australia	Latest	Previous Year
Economic Growth	1.7% (Year to Sep)	2.5%
Inflation	1.8% (Year to Dec)	1.8%
Unemployment	5.1% (Dec)	5.0%
Employment Growth	2.1% (Year to Dec)	2.2%
Wage Price Index	2.2% (Year to Sep)	2.3%
Exchange Rate (TWI)	58.5 (29th Jan)	61.0
Cash Interest Rate	0.75% (December)	1.50%
Current Account Surplus	$4.3 bn (Yr to Sep)	-$48.4 bn
Current Acct (% GDP)	0.2% (Year to Sep)	-2.6%
Foreign Debt (% GDP)	58.9% (End Sep)	57.2%

Source: Australian Bureau of Statistics & Reserve Bank