

# Economic policy, Australia's economic performance and this year's federal Budget

Talk to Year 11 & 12 Economics Students  
at The Hutchins School

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# The objectives of macro-economic policy

- ❑ Low and stable inflation
  - in Australia, '2-3% on average over the course of the business cycle'
- ❑ 'Full employment'
  - in Australia, unemployment at around 5% of the labour force
- ❑ Steady and stable economic growth
  - in Australia, real GDP growth at about its 'trend' pace of around 3-3½% pa
  - avoiding recessions
- ❑ Financial stability
  - avoiding de-stabilizing boom-bust cycles in credit and in asset prices
- ❑ Sustainable public finances
  - in Australia, that means 'achieving budget surpluses, on average, over the course of the economic cycle'

# The instruments of macro-economic policy

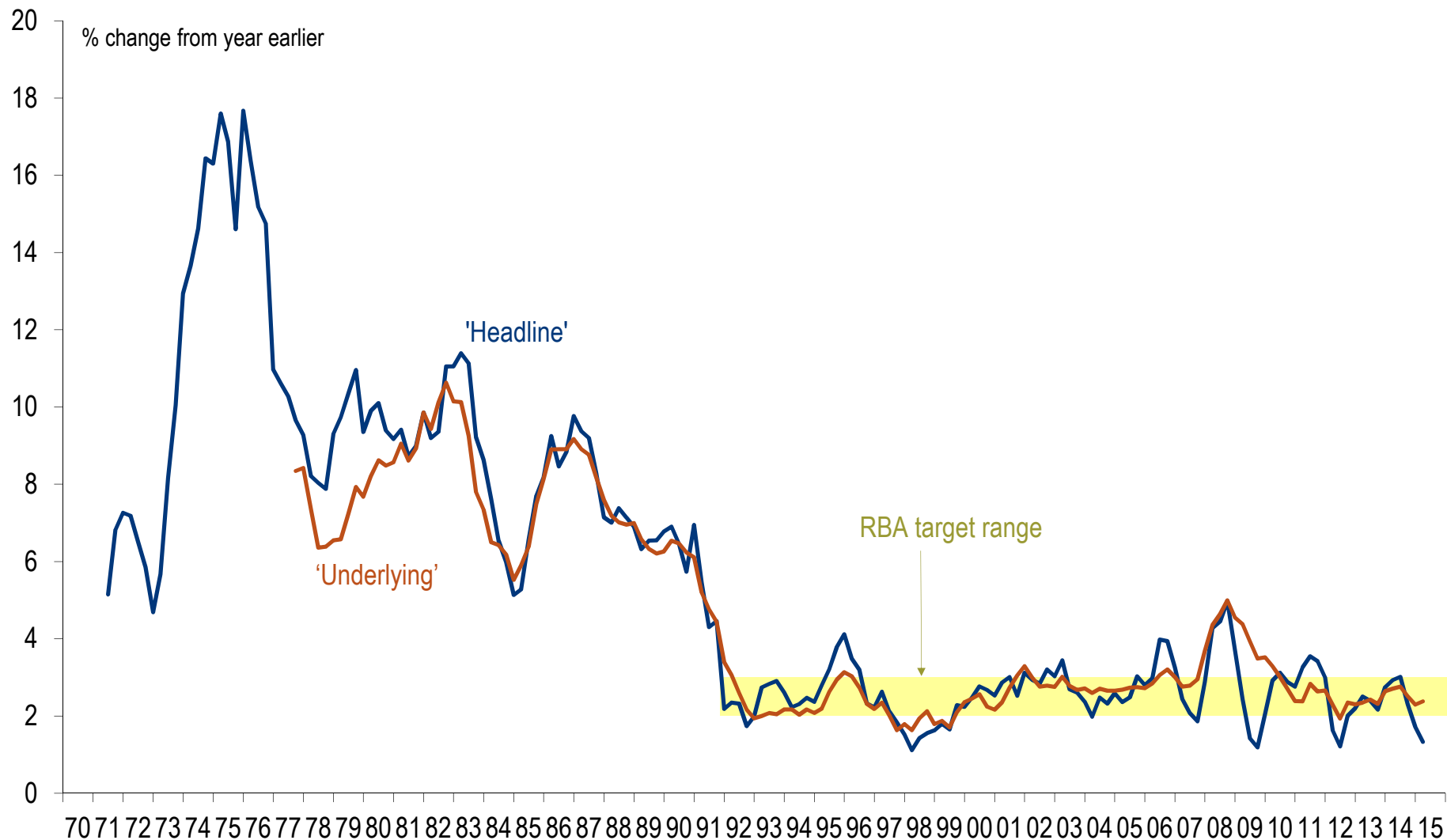
- ❑ Monetary policy
  - the Reserve Bank's setting of its official cash rate
  
- ❑ Fiscal policy
  - changes in taxes and/or spending by the Commonwealth Government
  - and in a more limited way by State Governments
  
- ❑ 'Macro-prudential' policy
  - regulation and supervision of the activities of banks and other lenders by the Australian Prudential Regulatory Authority (APRA)
  
- ❑ Trade policy
  - negotiations with other countries to remove barriers to cross-border trade (in goods and services) and investment flows
  
- ❑ 'Micro-economic' or structural reform
  - deliberate changes to the structure, regulation and functioning of markets with a view to enhancing their resilience and/or flexibility

# The relative importance of monetary and fiscal policy has changed over the past 30 years

- ❑ For 30 years after World War II, fiscal policy was the principal macro-economic policy tool
  - guided by the theories of Maynard Keynes, governments thought they could use fiscal policy to manage 'aggregate demand' so as to maintain full employment with low inflation
- ❑ This 'conventional wisdom' was discredited by the persistence of simultaneous high inflation and unemployment following the first oil shock of the mid-1970s
  - most economists concluded that getting inflation down and keeping it down was a prerequisite to sustaining strong economic growth with low unemployment
  - monetary policy became seen as a better tool for keeping inflation under control
- ❑ After the recession of the early 1990s – somewhat later than in most other countries – monetary policy became the principal policy instrument in Australia
  - monetary policy was viewed as easier to change quickly, as needed, than fiscal policy
  - central banks (including the RBA) became independent of governments, and more influential
- ❑ Fiscal policy came back into favour during the global financial crisis
  - with interest rates at zero in most Western economies it became harder to see how monetary policy could work as it had before

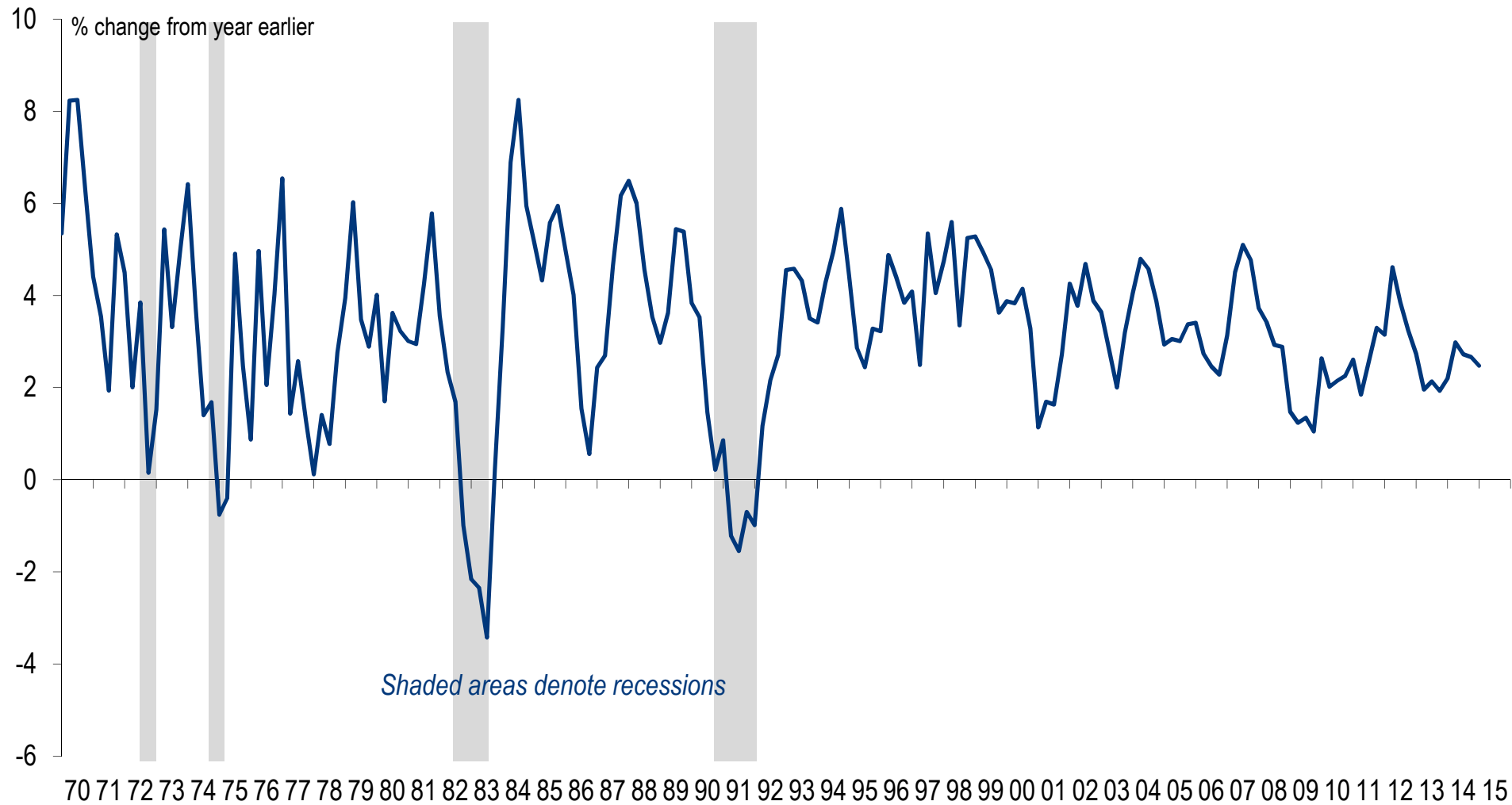
# The RBA has done a good job of keeping inflation under control since it adopted the 2-3% target

## Australia's consumer price index



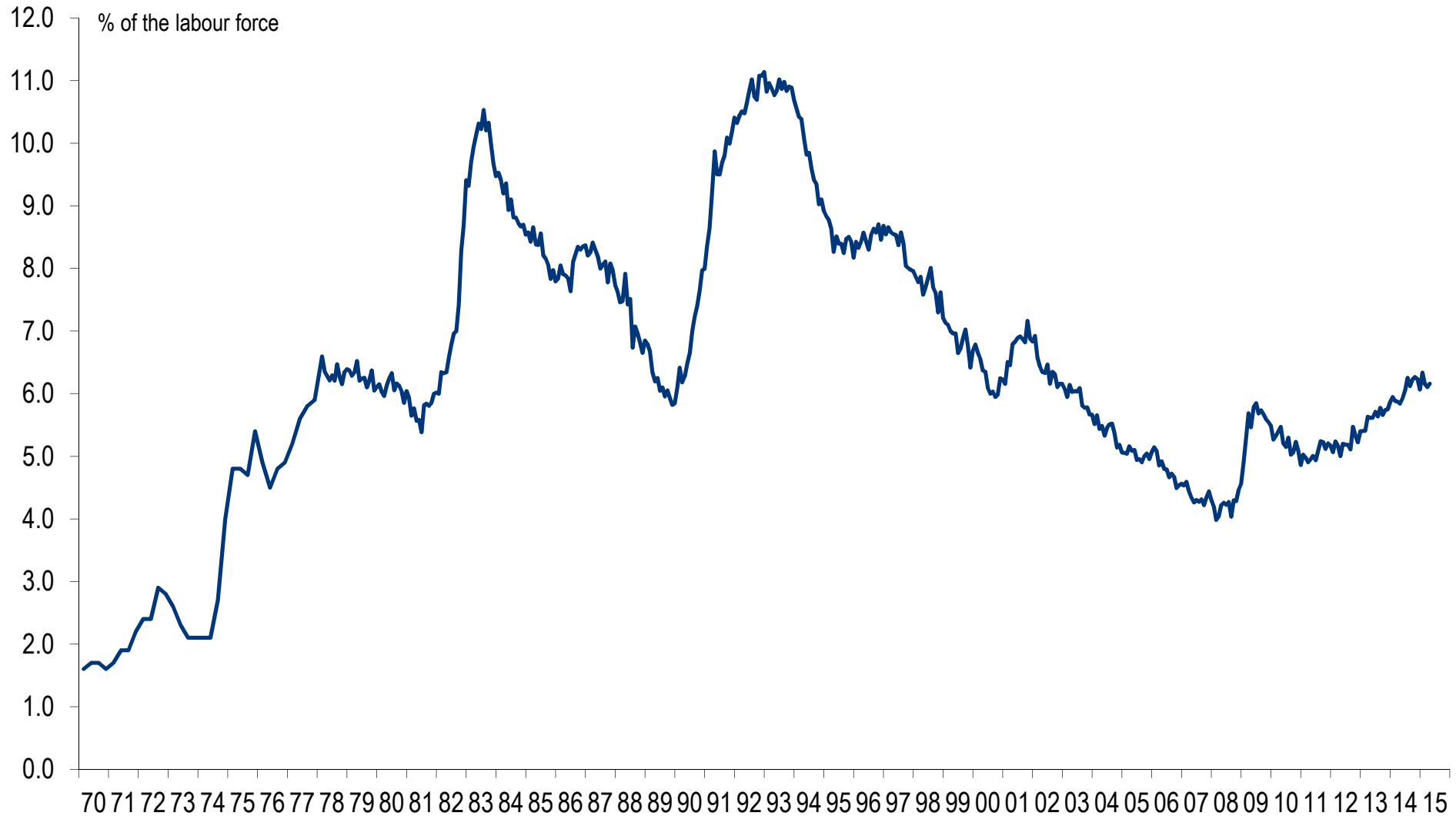
# Australia hasn't had a recession since 1991

## Australia's real GDP growth



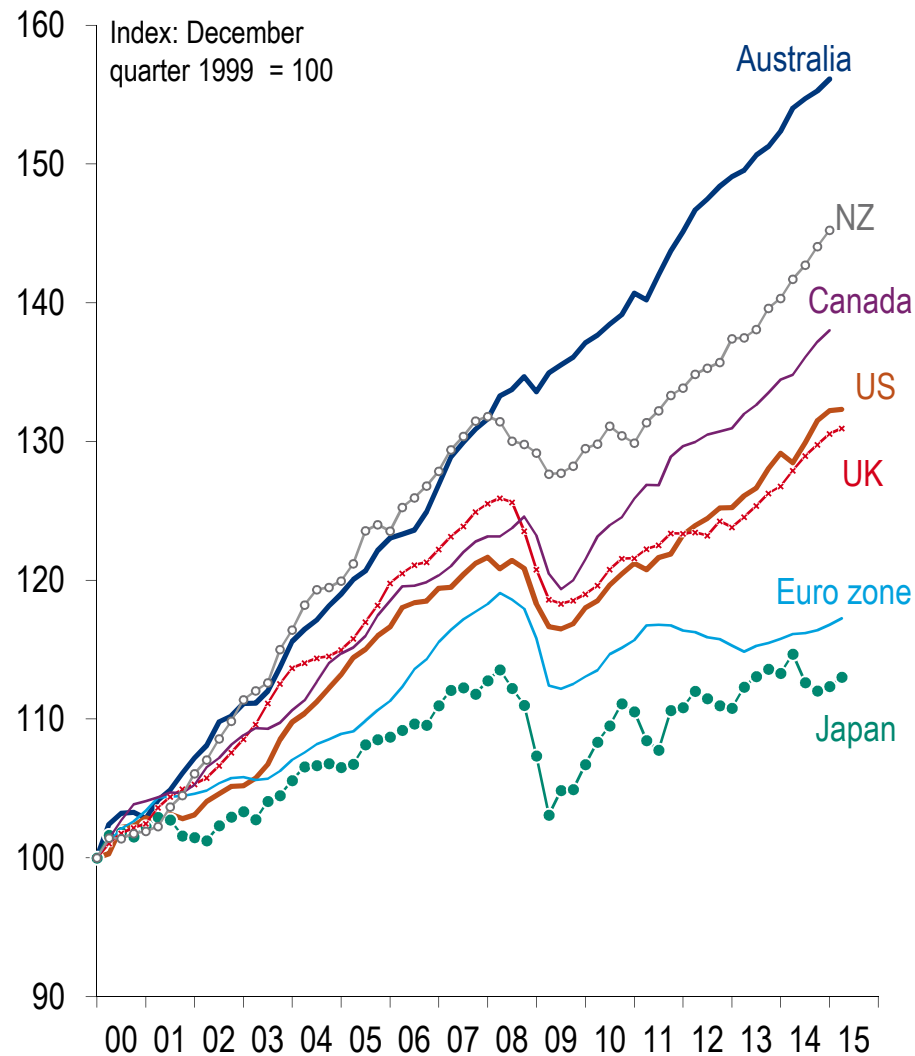
# Australia has avoided large rises in unemployment since the early 1990s

## Australia's unemployment rate

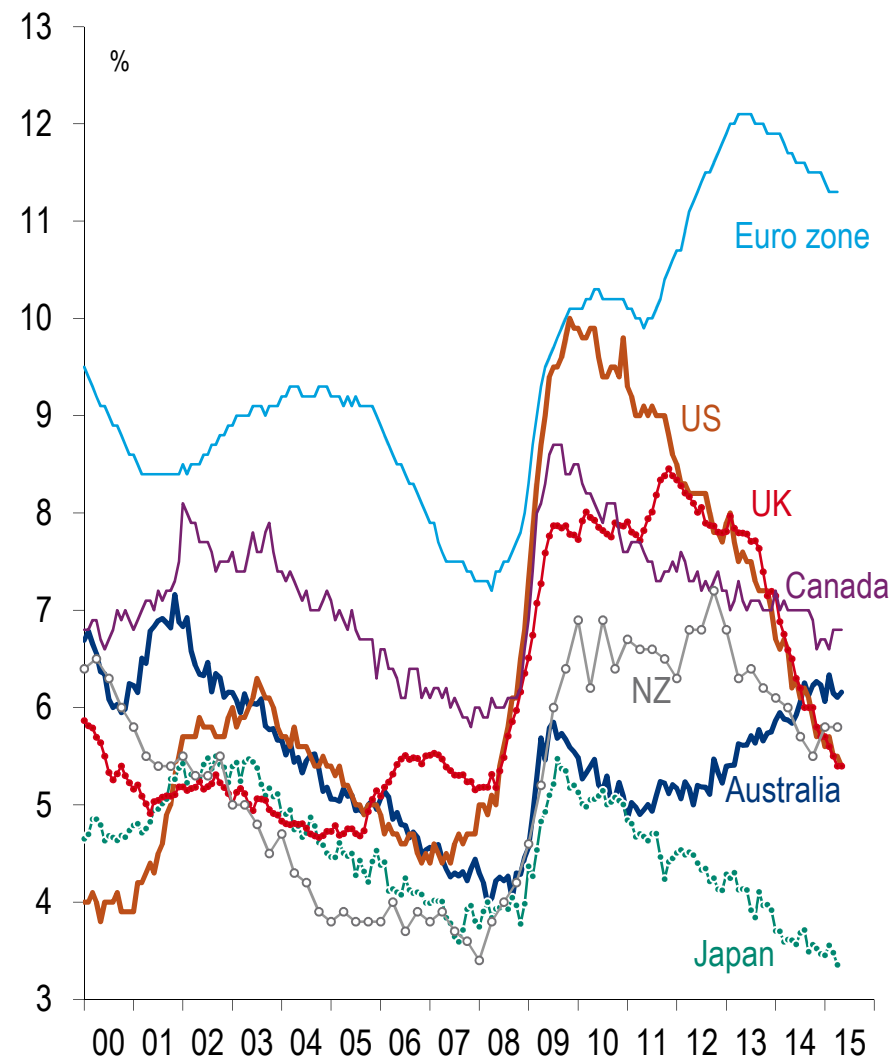


# Australia has done better on economic growth, and (until recently) on unemployment than our peers

## Level of real GDP



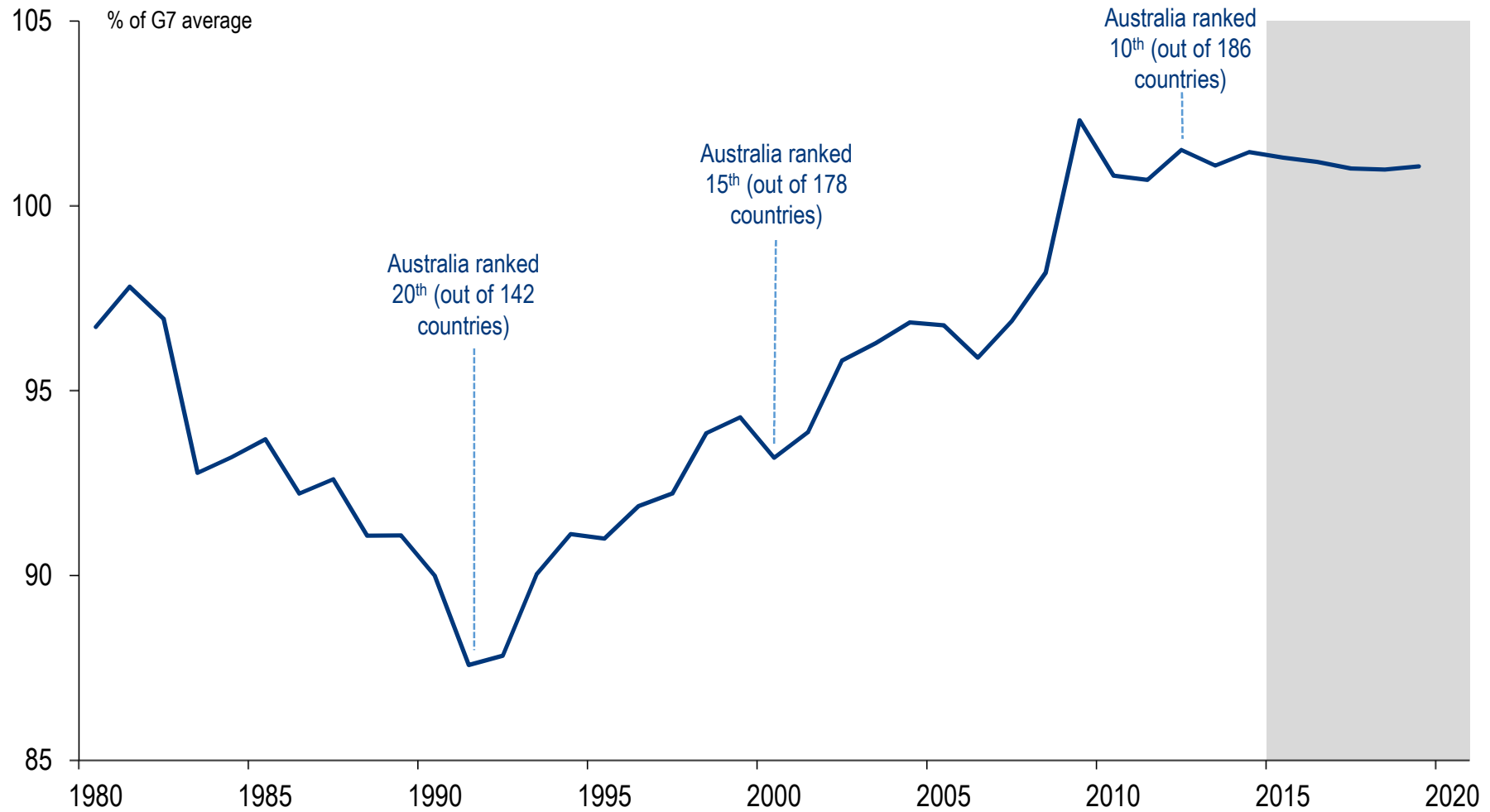
## Unemployment rate





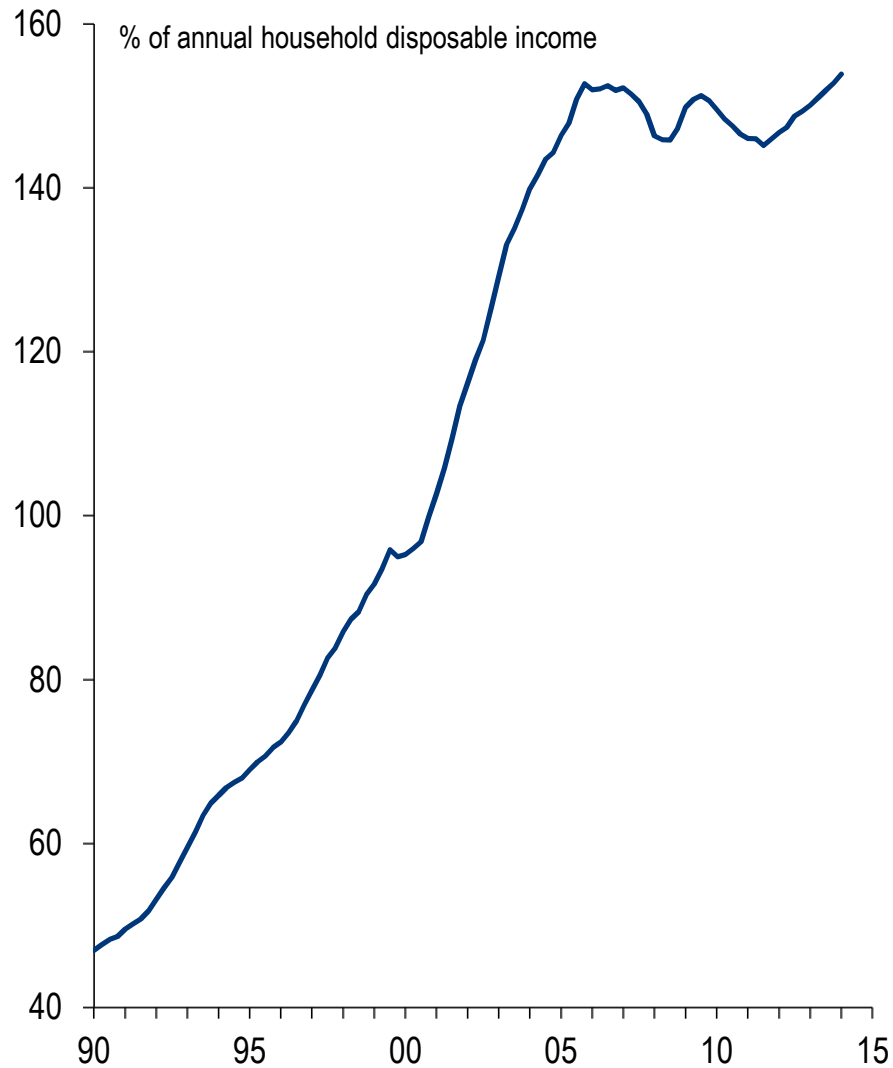
# Australia has become a more prosperous nation over the past 25 years

## Australia's per capita GDP as a pc of average for seven largest 'advanced' economies

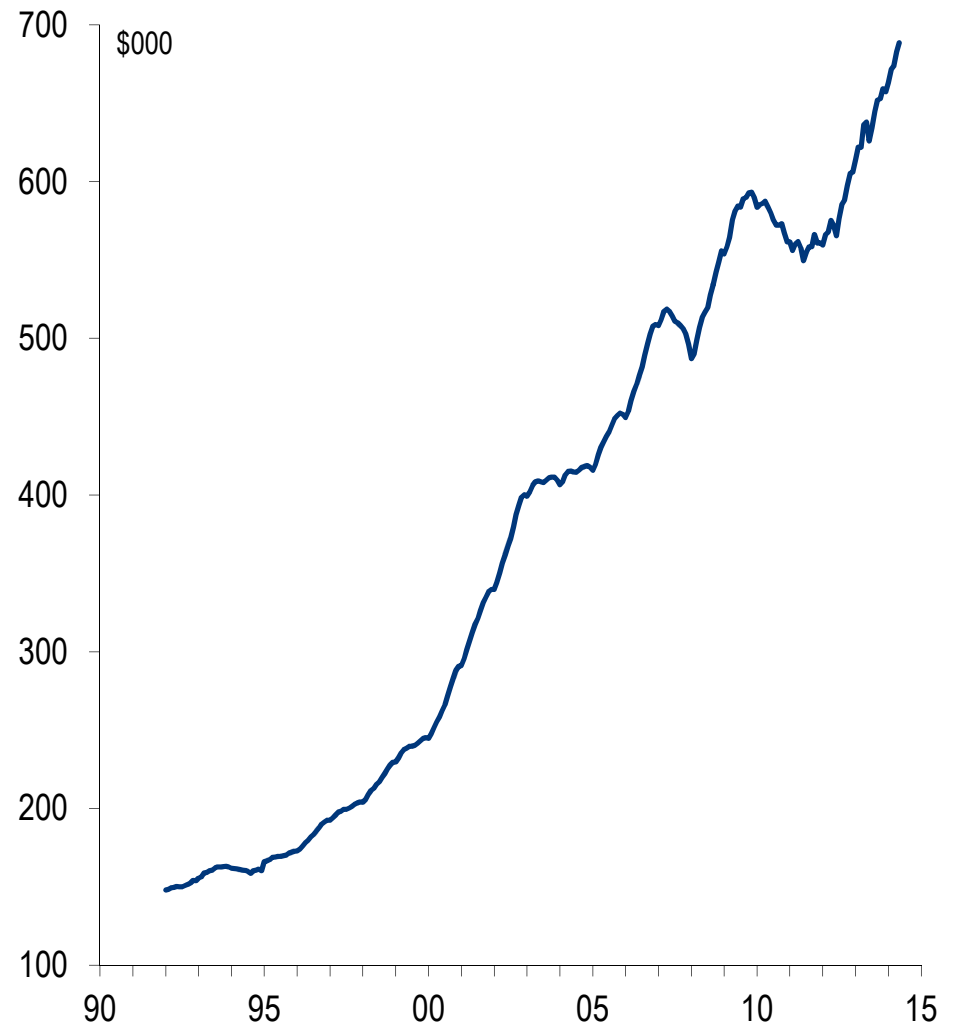


# Australia has had credit and house price 'booms' without any 'busts' – so far ....

## Australian household debt

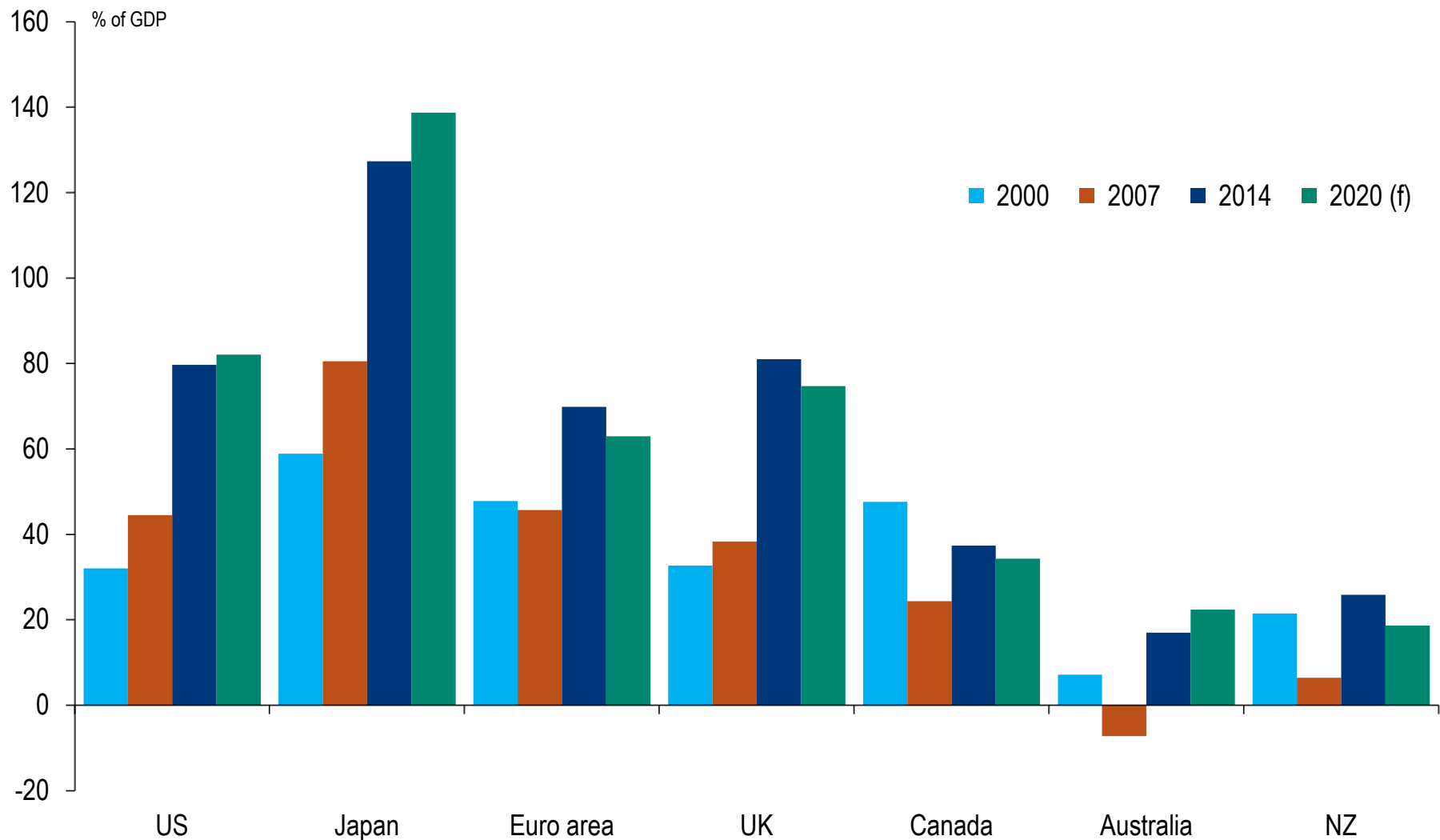


## Capital city residential property prices



# Australia's public finances are in better shape than those of most other 'advanced' economies

## Government net debt as a p.c. of GDP

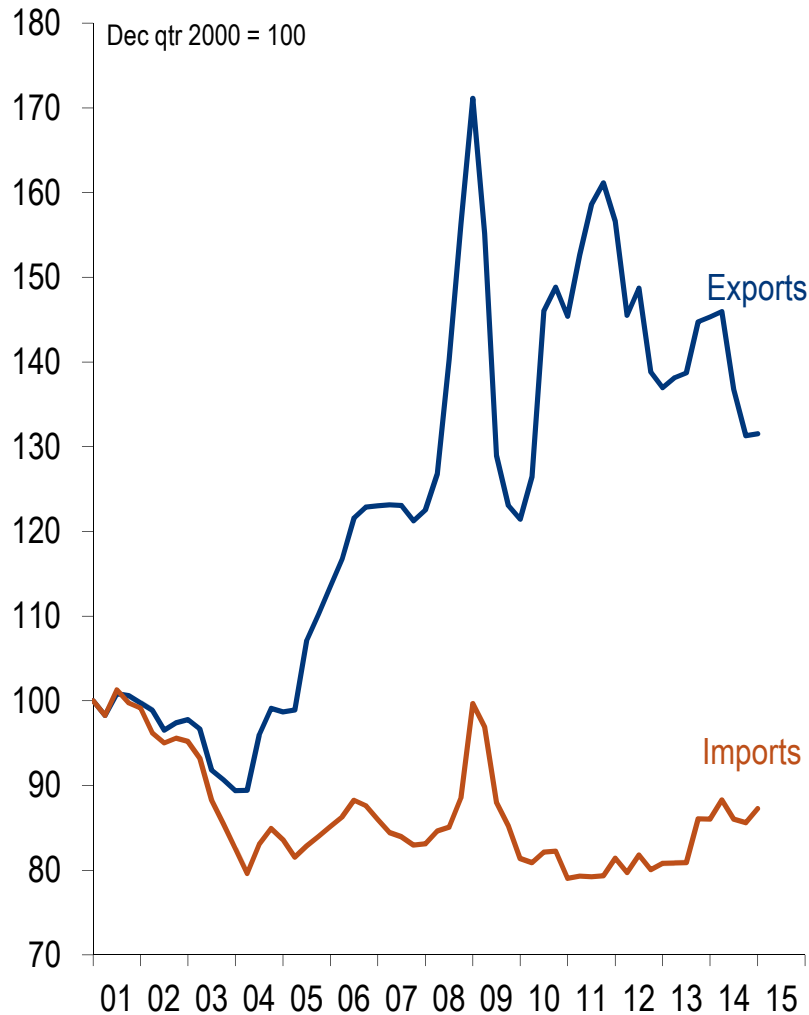


## Australia's good fortune has resulted from 'good management' ...

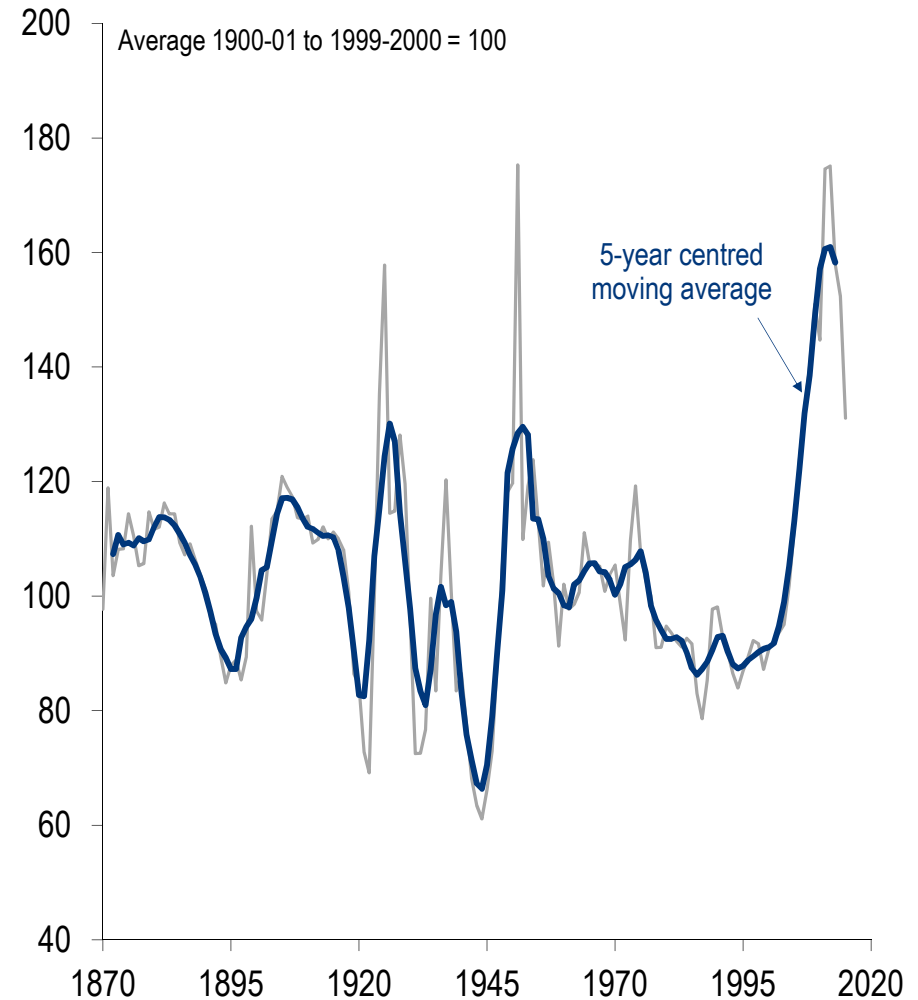
- ❑ Floating of the Australian dollar
- ❑ Dismantling of what was one of the industrialized world's highest set of barriers to international trade
- ❑ Pursuit of greater competition in domestic product markets
- ❑ Progressive dismantling of Australia's system of centralized wage fixation
- ❑ Withdrawal of government from commercial service provision
- ❑ Successive taxation reforms (including dropping top income tax rates from 66% and company tax rates from 46%, introduction of capital gains and fringe benefit taxes, and GST)
- ❑ Abandonment of political interference in setting of interest rates by the Reserve Bank
- ❑ Not leaving interest rates 'too low for too long' in the early 2000s
- ❑ 10 budget surpluses in 11 years to 2007-08

# ... and from 'good luck' (in the form of the China-driven 'commodities boom')

## Prices of Australia's exports and imports

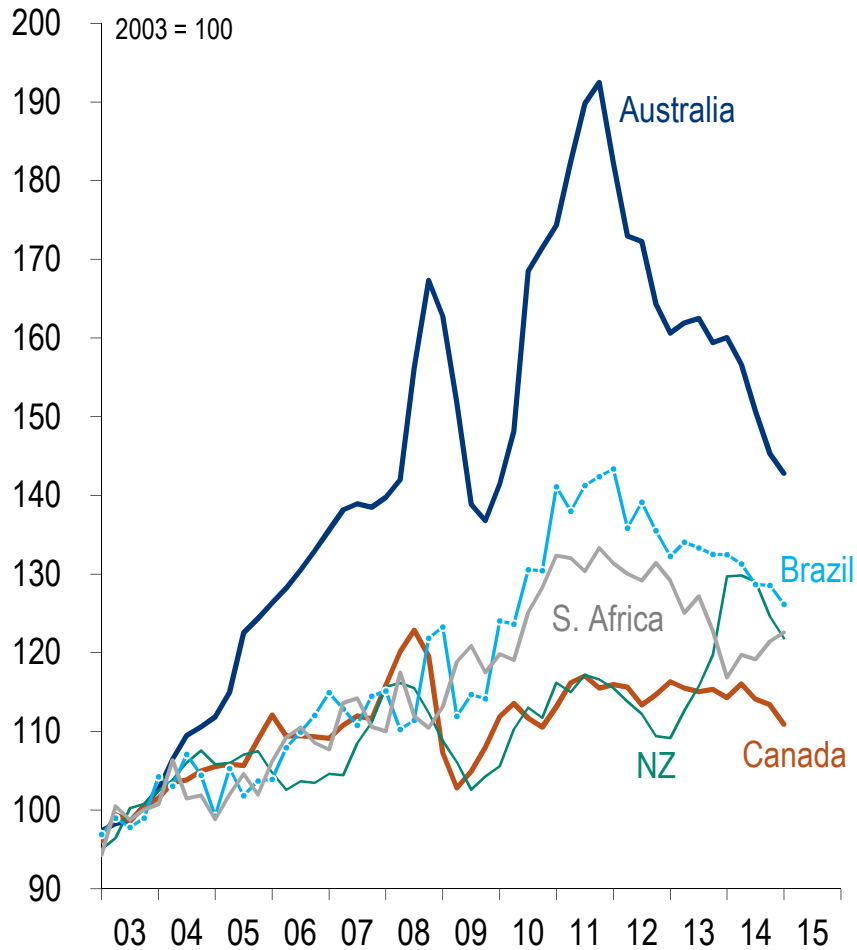


## Australia's "terms of trade"

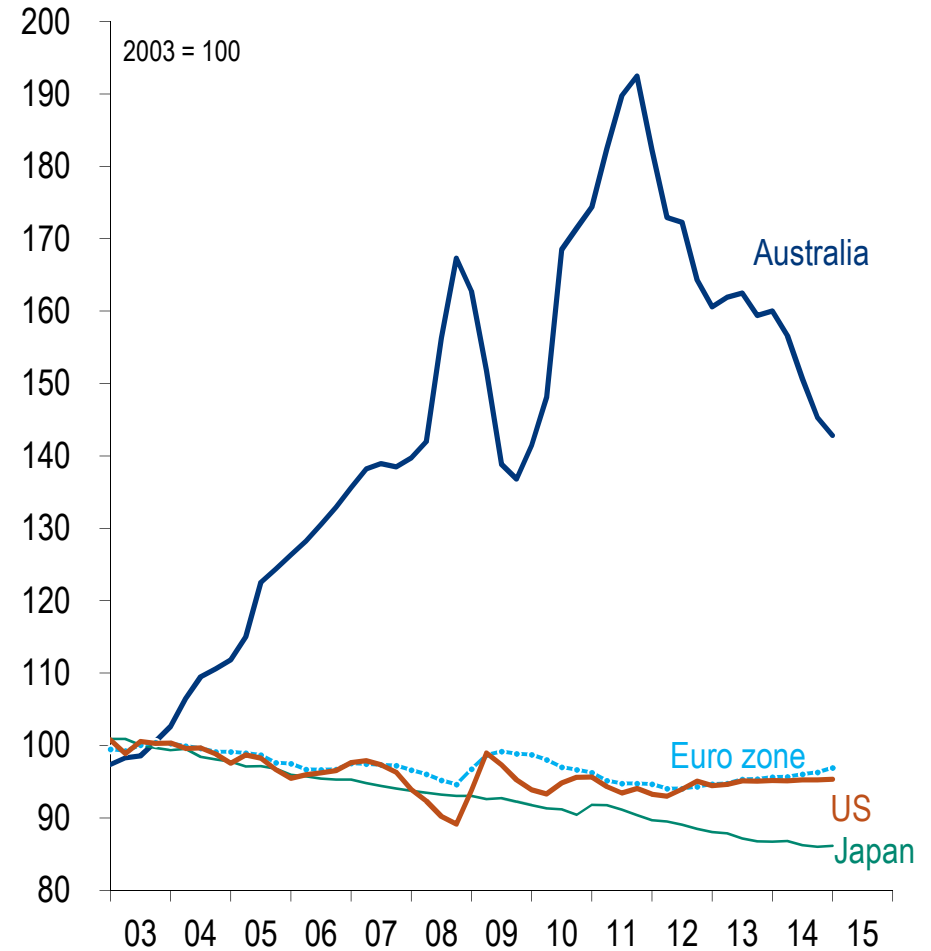


# Australia's had more of this kind of luck than most other countries

## Terms of trade – Australia and other commodity exporters

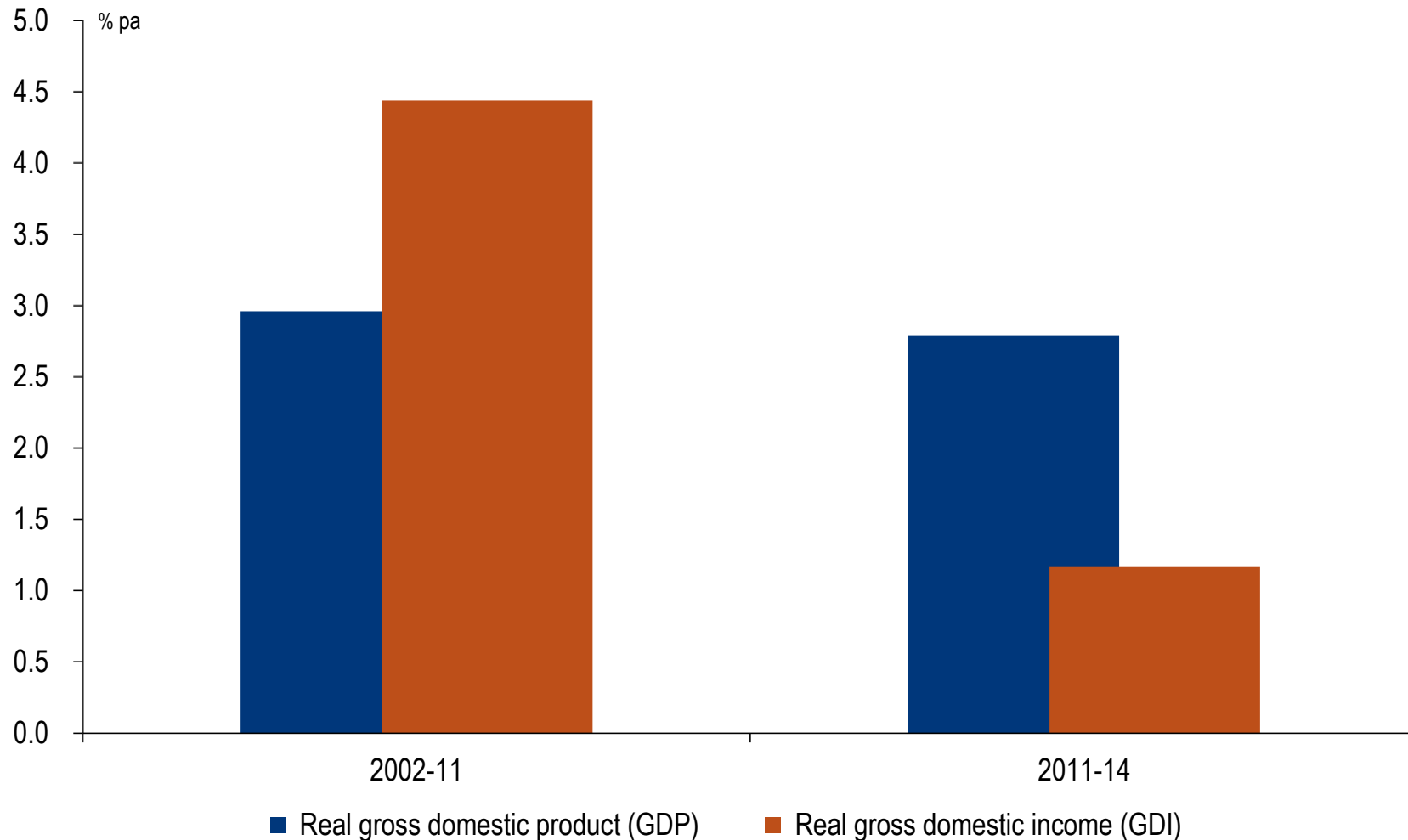


## Terms of trade – Australia and other 'advanced' economies



# Falling 'terms of trade' are now detracting from real income growth

## Growth in real gross domestic product and income-before and after the 2011 peak in the terms of trade

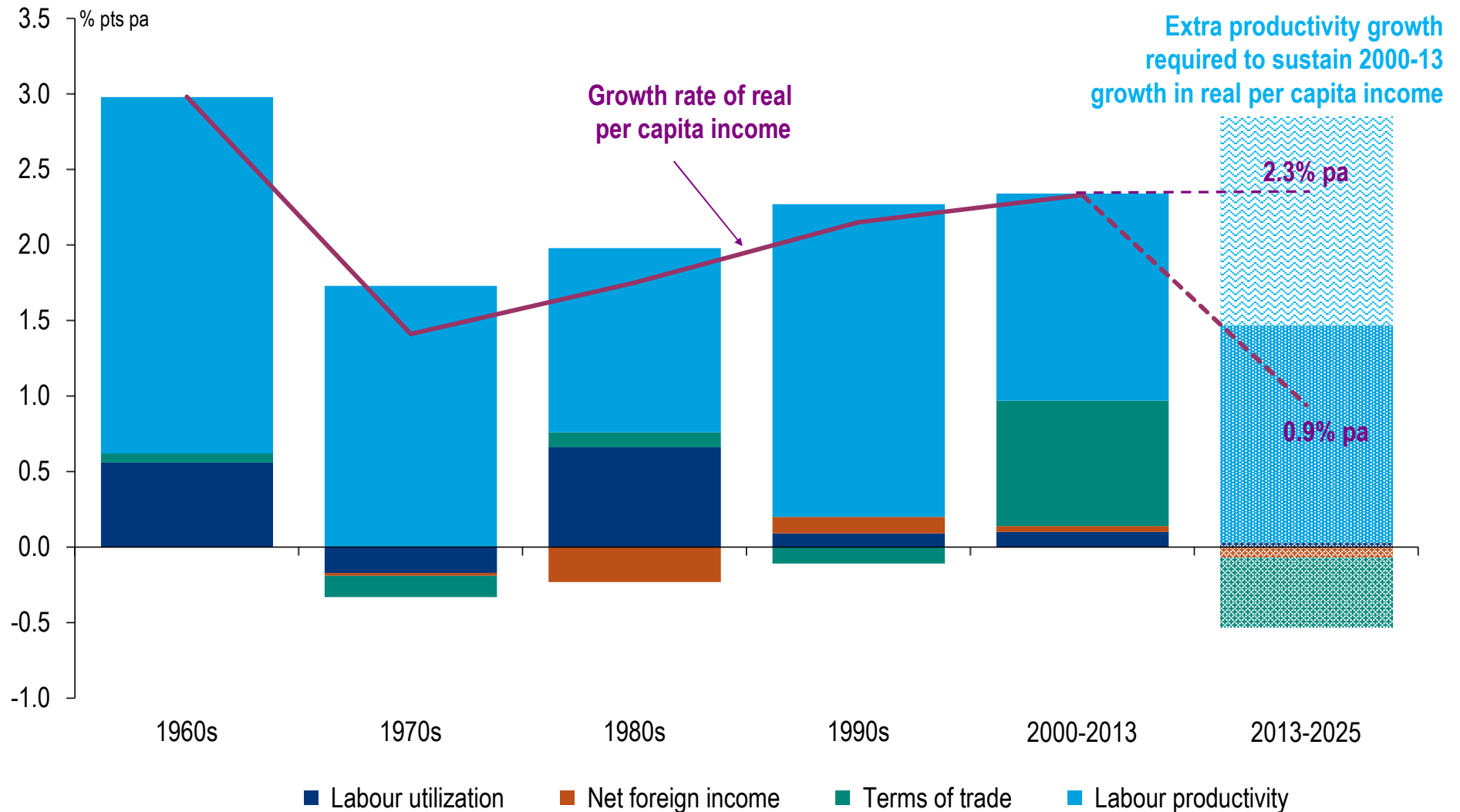


Note: Real gross domestic income (GDI) is real GDP plus (minus) income gains (losses) associated with rises (falls) in the terms of trade.

Sources: ABS; BofA Merrill Lynch Global Research.

# Australia's big economic policy challenge: how do we sustain the growth rate of per capita real incomes?

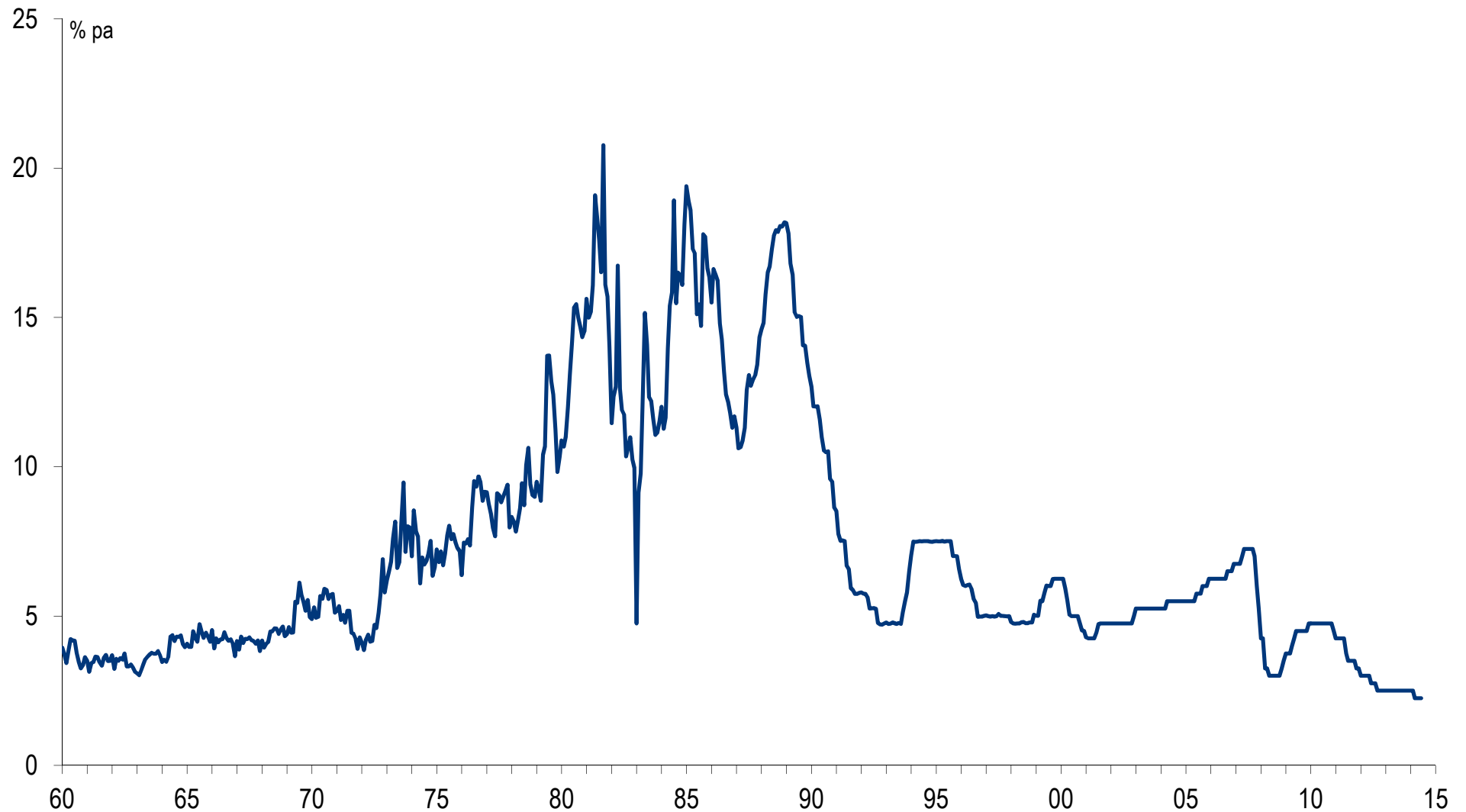
## Sources of growth in Australian real gross national income per capita





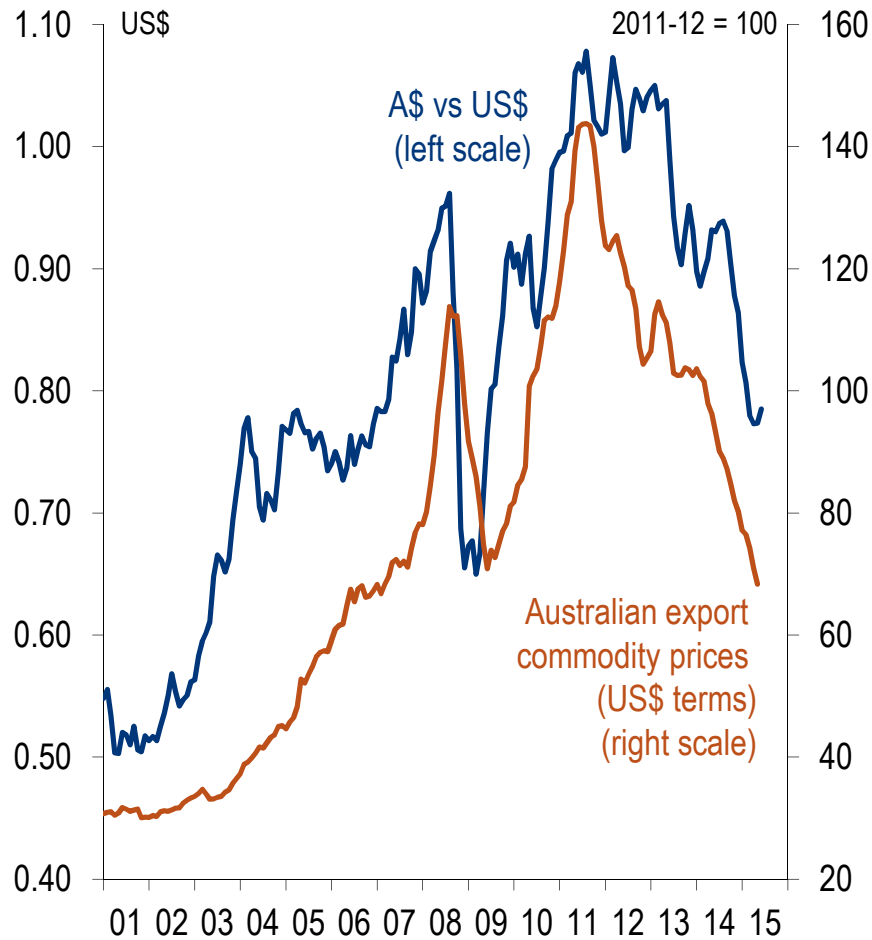
# The RBA has cut its official cash rate to a record low of 2%

## Reserve Bank of Australia's official cash rate

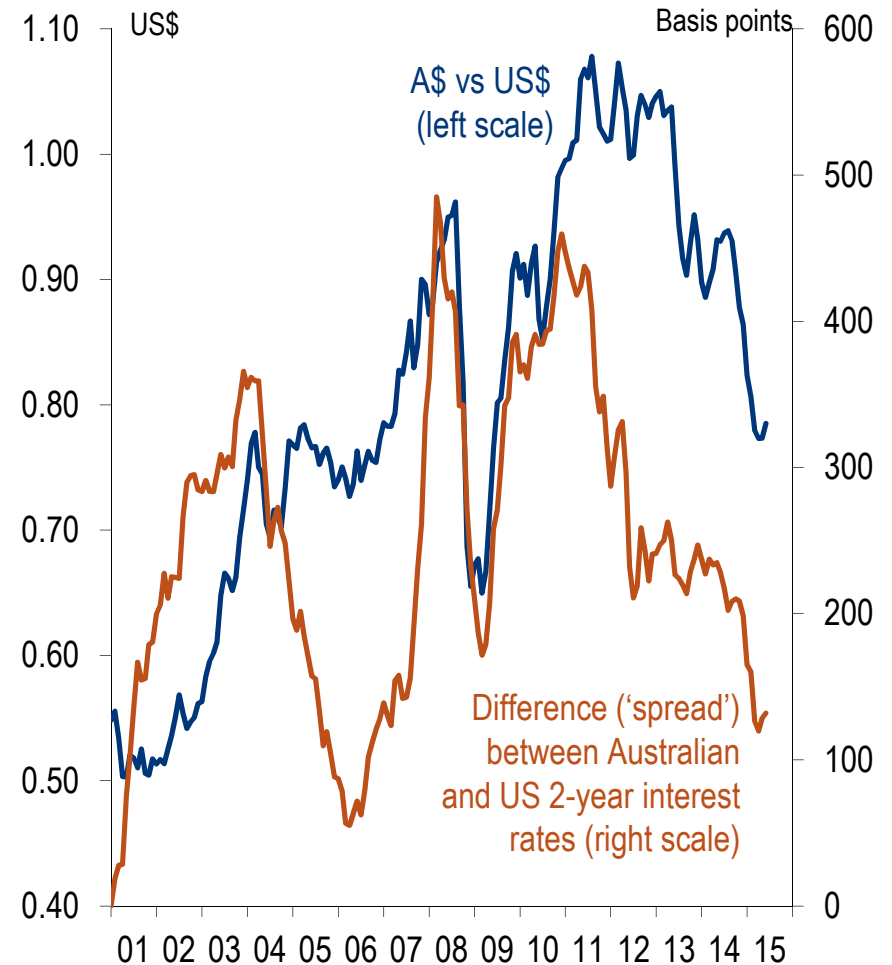


# The RBA is frustrated that the Australian dollar hasn't fallen as far as it 'should have'

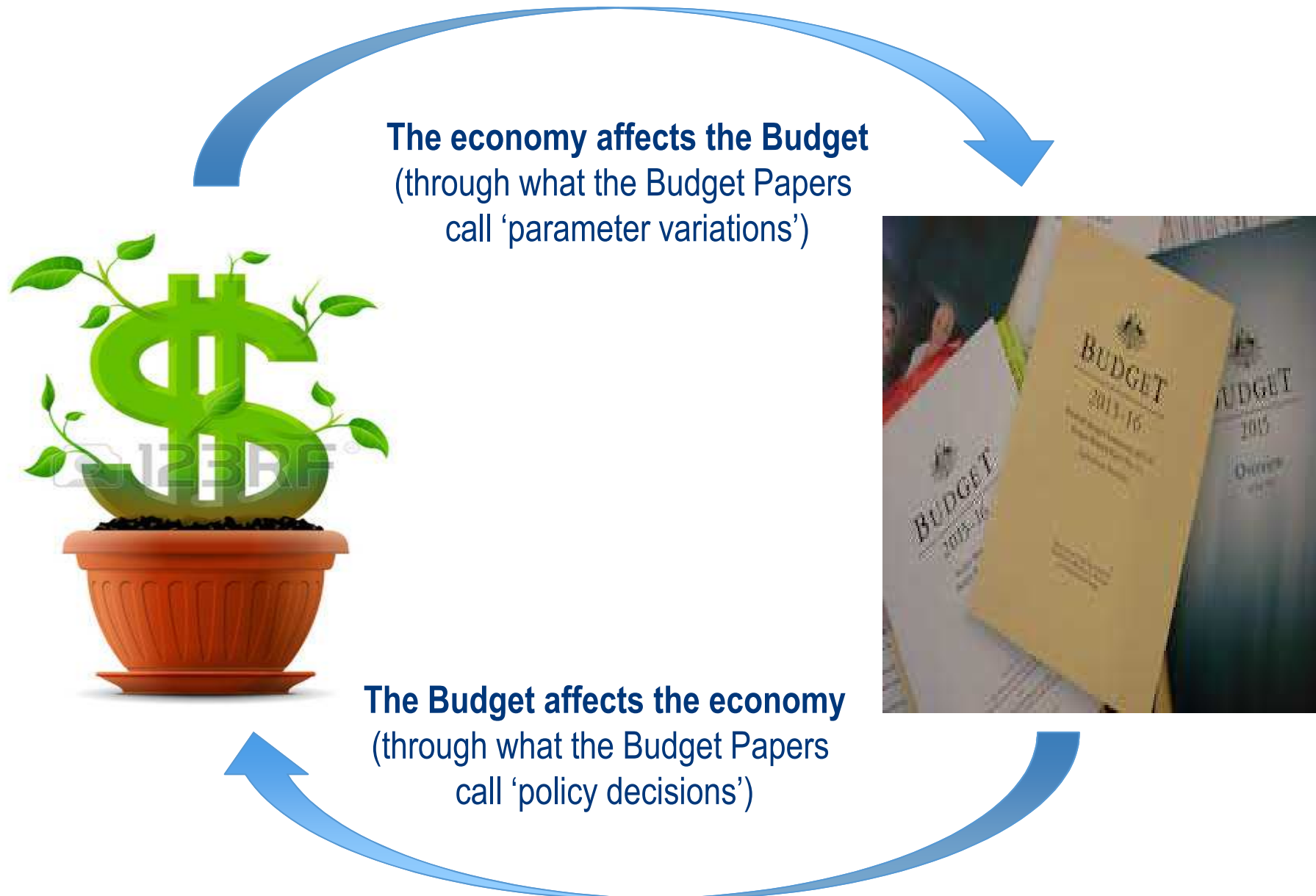
## A\$ and Australian export commodity prices



## A\$ and the spread between Australian and US interest rates

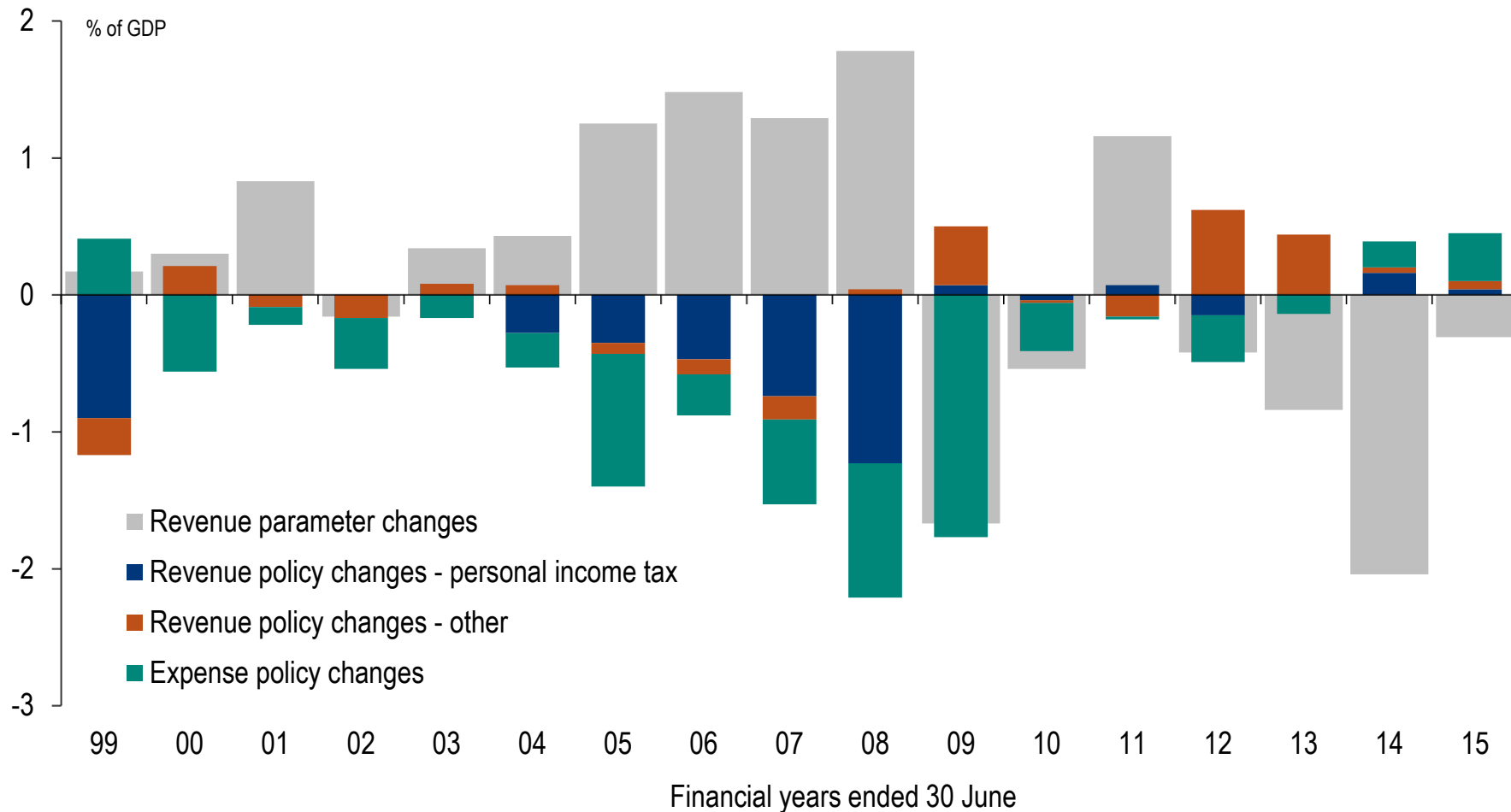


# The Budget affects the economy – but the economy also affects the Budget



# Until the onset of the financial crisis, economic conditions made preparing Budgets easy

The impact of 'parameter variations' and 'policy decisions' on the Budget 'bottom line' since 1998-99

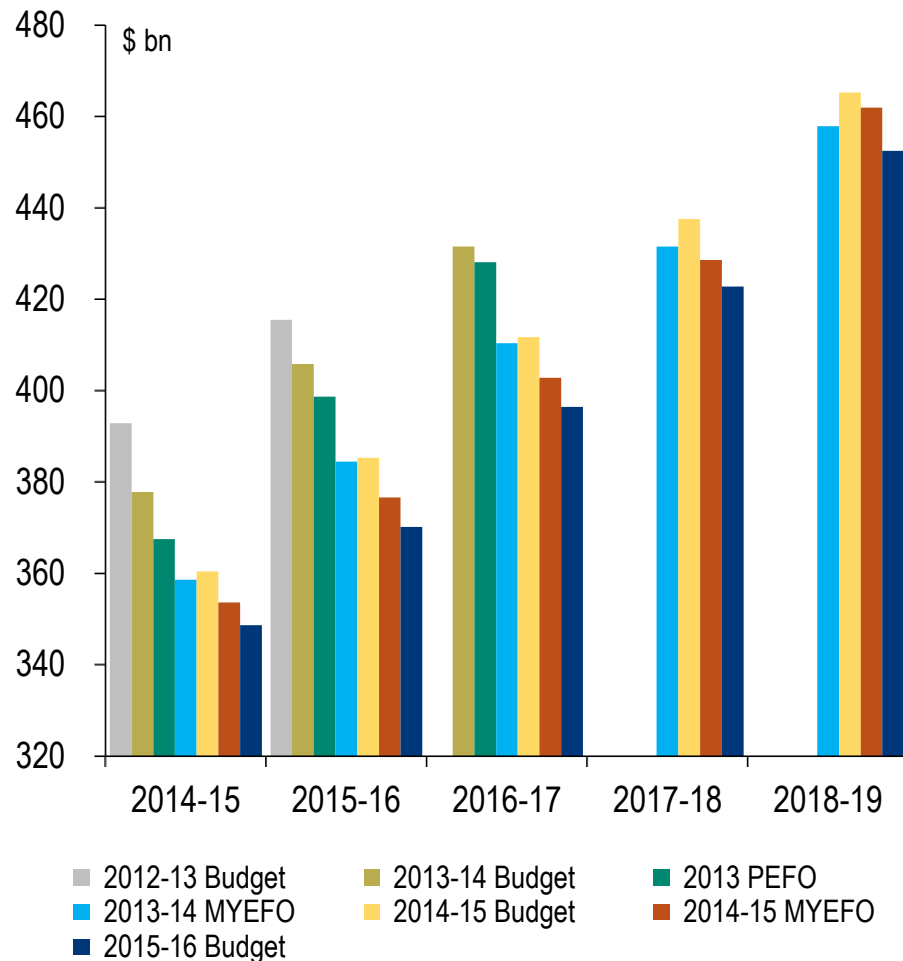


Note: 'Revenue parameter changes' are the gains (or losses) in revenue arising from changes in economic and other assumptions, as distinct from those resulting from policy decisions.

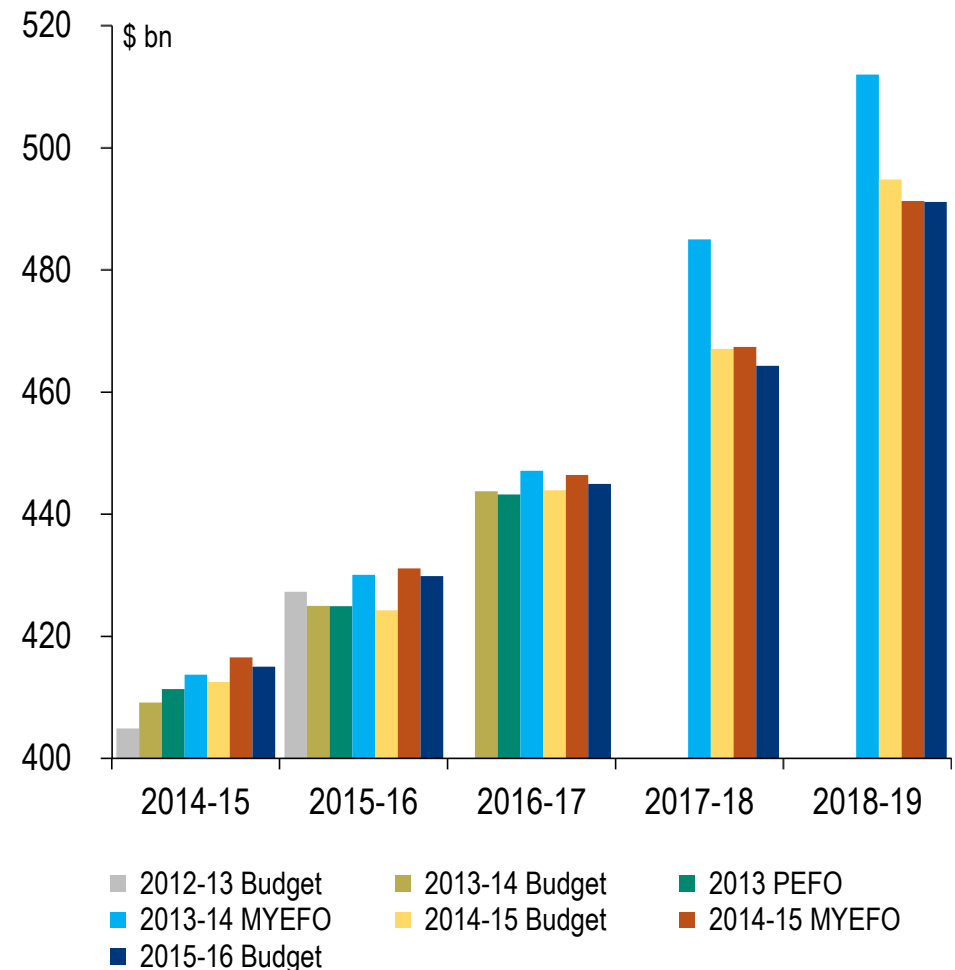
Source: John Fraser (Secretary to the Treasury), 'Australia's Economic Policy Challenges', Address to CEDA, 12<sup>th</sup> December 2014).

# In recent years revenue forecasts have been revised down, and spending forecasts revised up

## Successive estimates of tax revenues

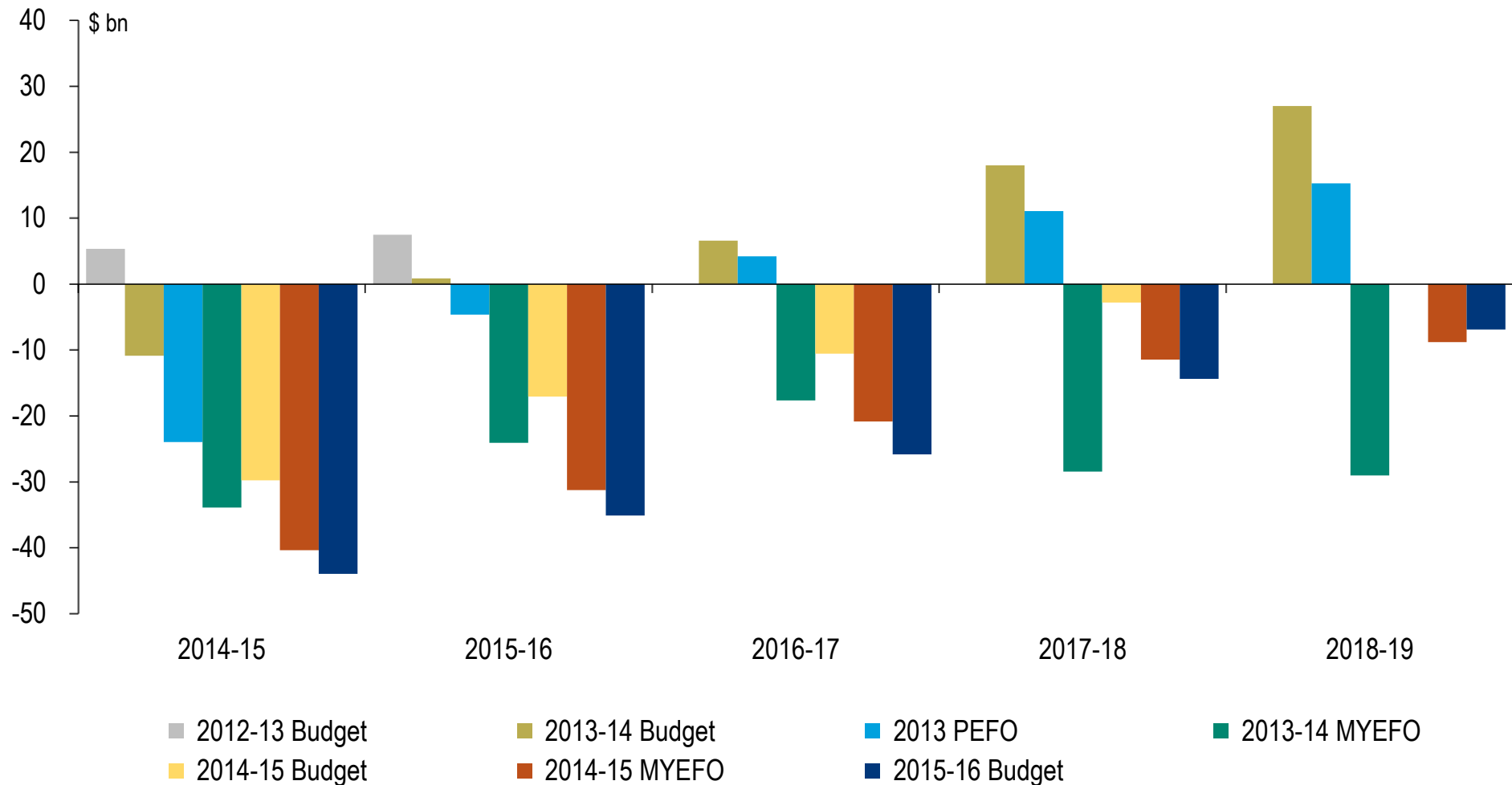


## Successive estimates of spending



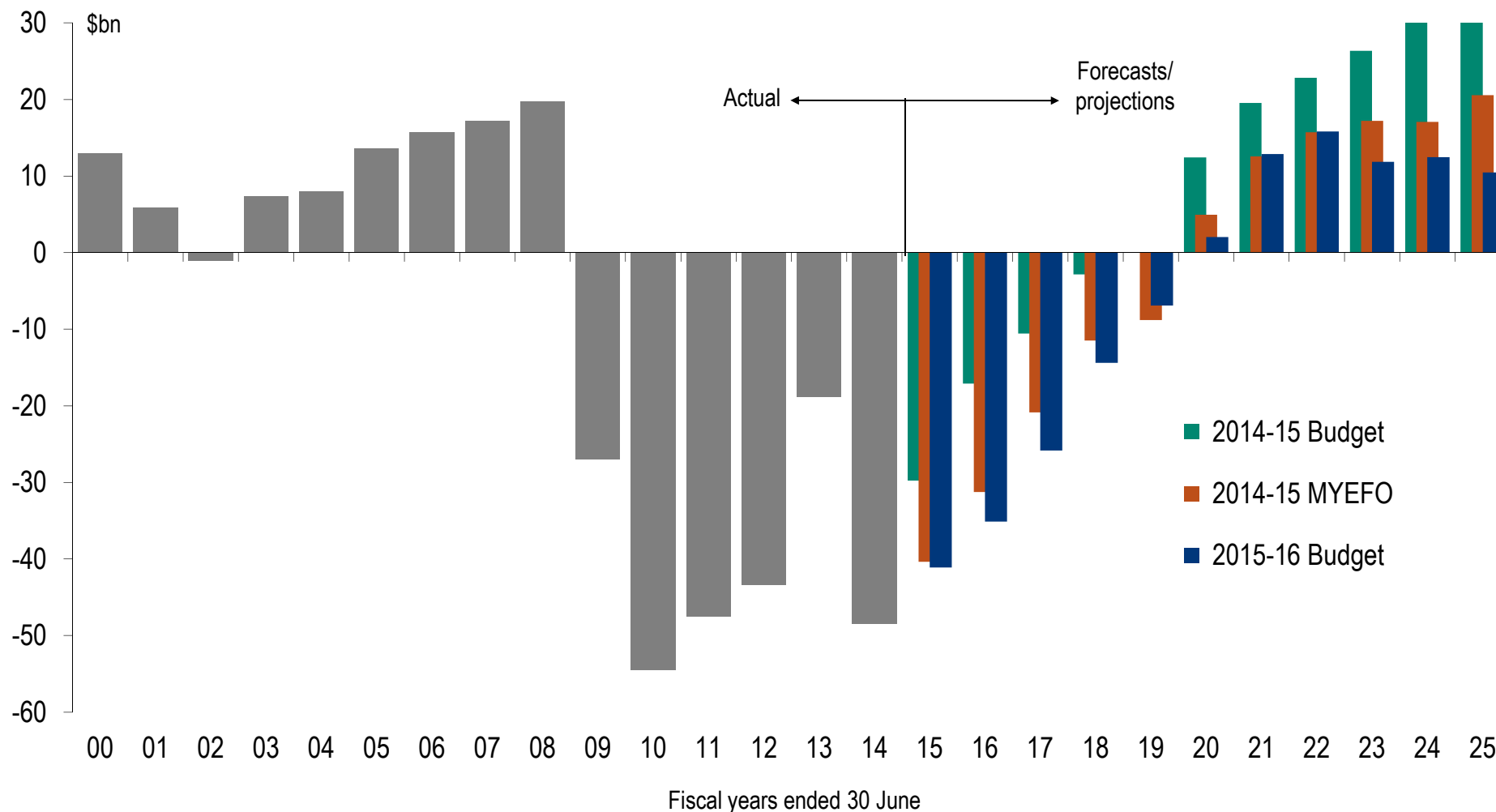
# That's why the Budget deficit keeps getting revised up each year, and the return to surplus pushed back

Successive forward estimates of the Budget 'bottom line'  
(the 'underlying' cash balance)



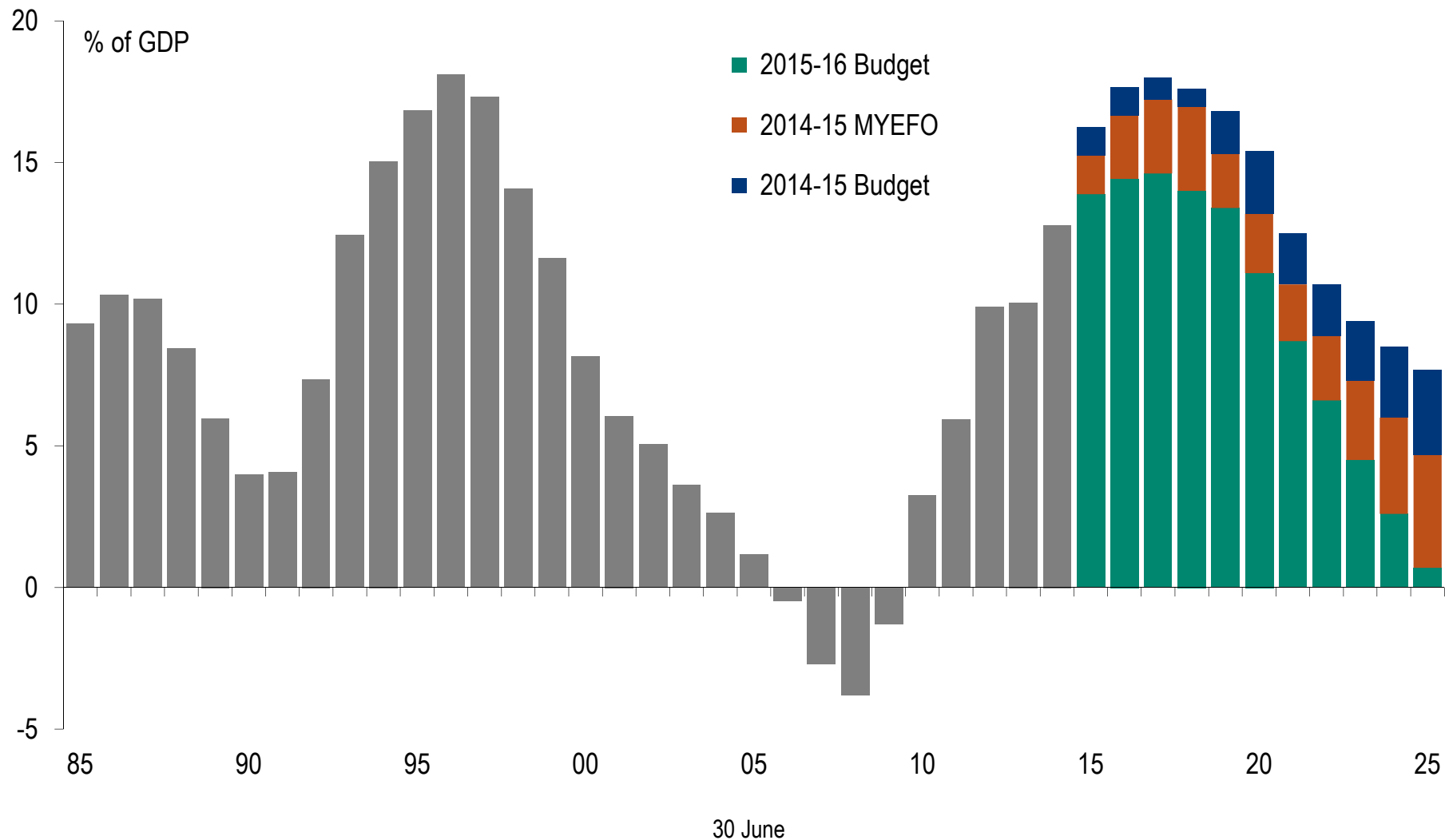
# Budget deficits will be higher than previously forecast until 2018-19, and surpluses smaller in next decade

## Australian Government 'underlying' cash balance



# Net debt will peak at a higher level, and persist for longer, than previously forecast ...

## Australian Government net debt





# This year's Budget had very different objectives from last year's

## Reason for changes in estimates of the cash balance between Budget statements

	\$ billion					
	14-15	15-16	16-17	17-18	18-19	4-yr total
<b>Cash balance as at Aug 2013 PEFO</b>	<b>-24.0</b>	<b>-4.7</b>	<b>+4.2</b>	..	..	
‘Policy decisions’	-0.7	-1.5	-1.3			
‘Parameter variations’	-9.3	-18.0	-20.6			
<b>Cash balance as at Dec 2013 MYEFO</b>	<b>-33.8</b>	<b>-24.1</b>	<b>-17.7</b>	<b>-28.5</b>		
‘Policy decisions’	1.7	5.9	10.4	19.5	..	<b>+37.5</b>
‘Parameter variations’	2.4	1.1	-3.3	6.2	..	+6.4
<b>Cash balance as at May 2014 Budget</b>	<b>-29.8</b>	<b>-17.1</b>	<b>-10.5</b>	<b>-2.8</b>	..	
‘Policy decisions’	-2.3	-2.2	-0.5	1.0		-4.1
‘Parameter variations’	-8.3	-12.0	-9.8	-9.6		-39.7
<b>Cash balance as at Dec 2015 MYEFO</b>	<b>-40.4</b>	<b>-31.2</b>	<b>-20.8</b>	<b>-11.5</b>	<b>-8.8</b>	
‘Policy decisions’	-0.6	-4.5	-2.5	-1.7	0.5	<b>-8.2</b>
Provisions made in previous Budget (for PPL)	0.2	2.4	2.8	2.5	2.6	+10.3
‘Parameter variations’	-0.2	-2.0	-5.6	-3.9	-1.4	-11.7
<b>Cash balance as at May 2015 Budget</b>	<b>-41.1</b>	<b>-35.1</b>	<b>-25.8</b>	<b>-14.4</b>	<b>-6.9</b>	

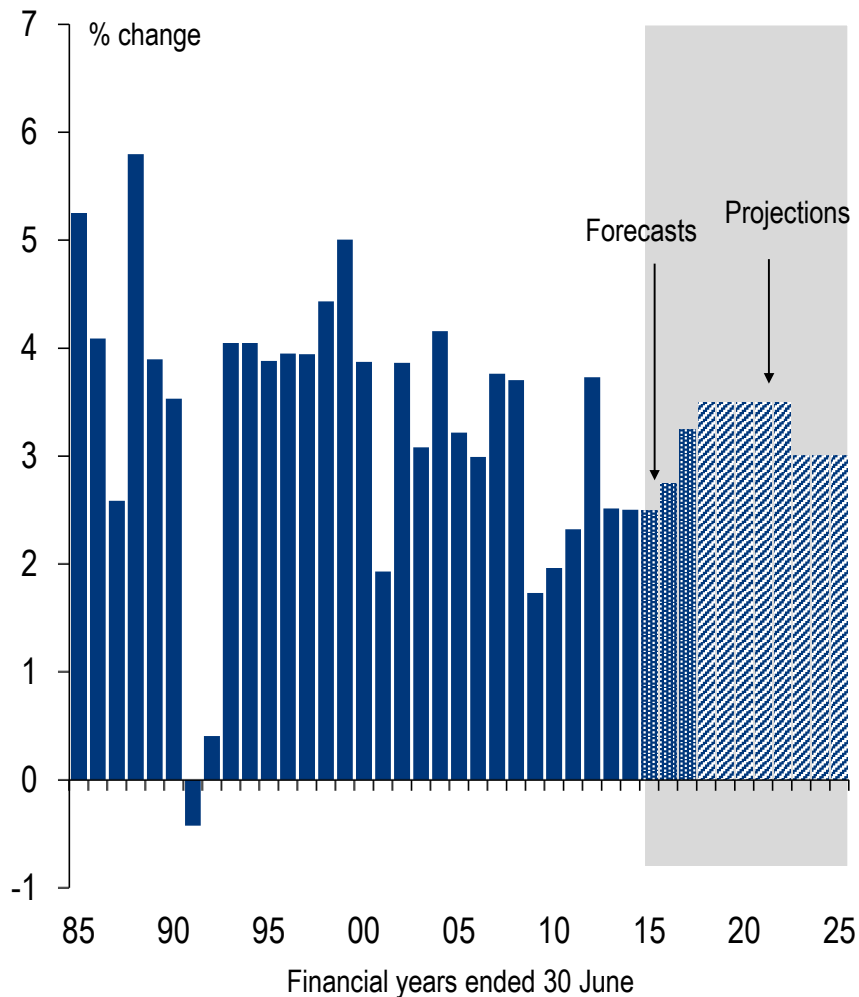
Note ‘PEFO’ is Pre-Election Economic & Fiscal Outlook; ‘MYEFO’ is Mid-Year Economic & Fiscal Outlook. ‘Parameter variations’ are changes in estimates of the cash balance due to changes in economic, administrative or other technical assumptions. ‘Provisions made in previous Budget’ were for PPL scheme and associated financing. Sources: Budget & MYEFO Papers; BofA-ML.

# Short-term economic forecasts look reasonable, but there's not much stimulus in the Budget

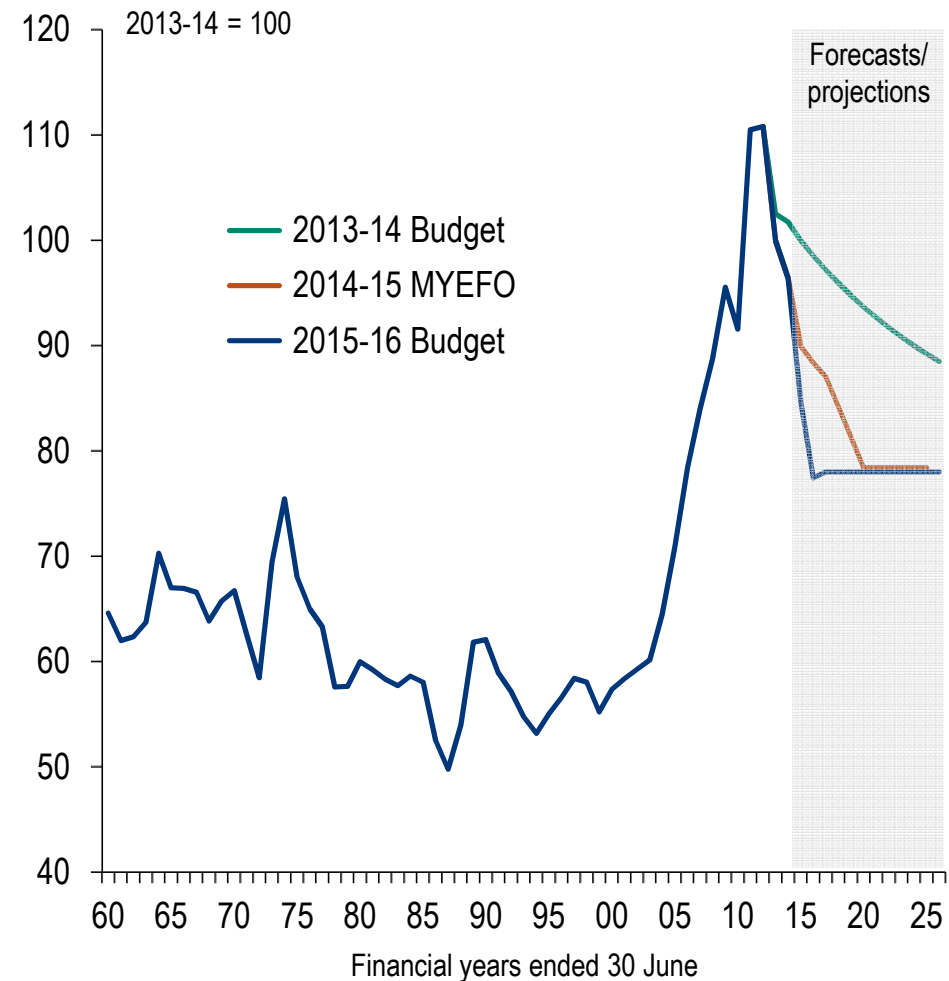
- ❑ Real GDP growth of 2½% in 2014-15, 2¾% in 2015-16, and 3¼% in 2016-17
  - 2015-16 and 2016-17 revised down by ½ pc pt since December
  - 2015-16 forecast is ¼ pc pt below mid-point of RBA forecast range but 2014-15 and 2016-17 are in line with latest RBA forecasts released last Friday
  - growth led by housing investment and resources exports with only modest acceleration in consumer spending and business investment declining markedly
- ❑ Commodity price assumptions look appropriately conservative
  - iron ore at US\$48/t (down from US\$60/t in December and compared with current market price of just over US\$60)
  - overall 'terms of trade' down another 8½% in 2015-16 (previously down 3¾%)
- ❑ The main stimulus measures in the Budget are the cut in the company tax rate for small business (and the parallel discount of up to \$1000 for unincorporated businesses) and the 'instant write off' for asset purchases of less than \$20,000
  - there's no economic reason why 'small' businesses should be taxed at a lower rate than 'large' ones
  - Introducing multiple company tax rates seems at odds with the Government's (elsewhere) stated objective of a 'simpler' tax system
  - the cut in tax rates for small business probably won't do much to stimulate economic growth, but the immediate write-off for small asset purchases could have a more significant impact (albeit much of it directed towards imported goods)

# The medium-term assumptions about economic growth and the terms of trade look a bit optimistic

## Real GDP growth



## Terms of trade

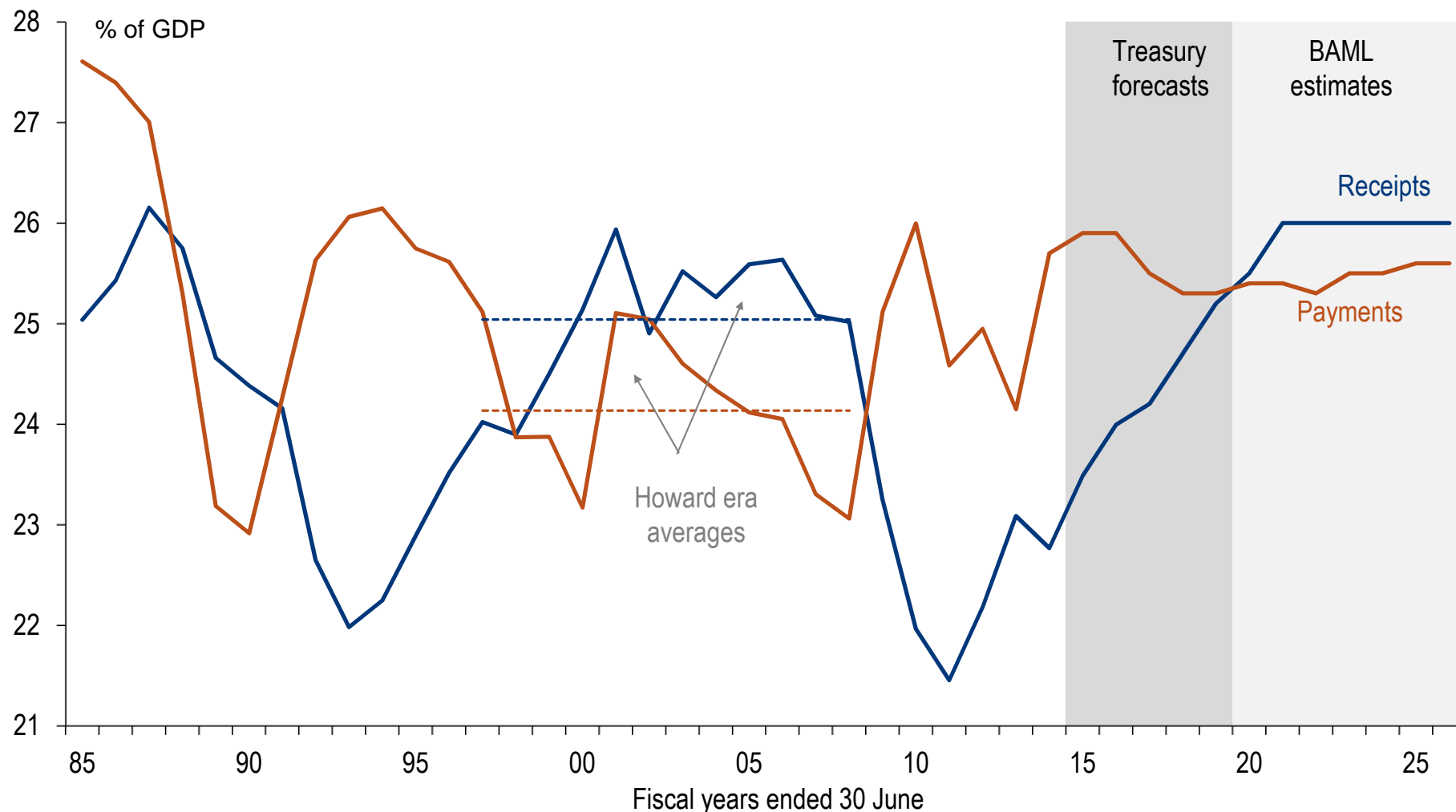


Note: The 'terms of trade' is the ratio of export to import prices.

Sources: Australian Government, 2015-16 Budget Paper No. 1, Budget Strategy and Outlook; ABS; BofA Merrill Lynch Global Research.

# The 'return to surplus' over the medium term is largely driven by rising revenues, not falling spending

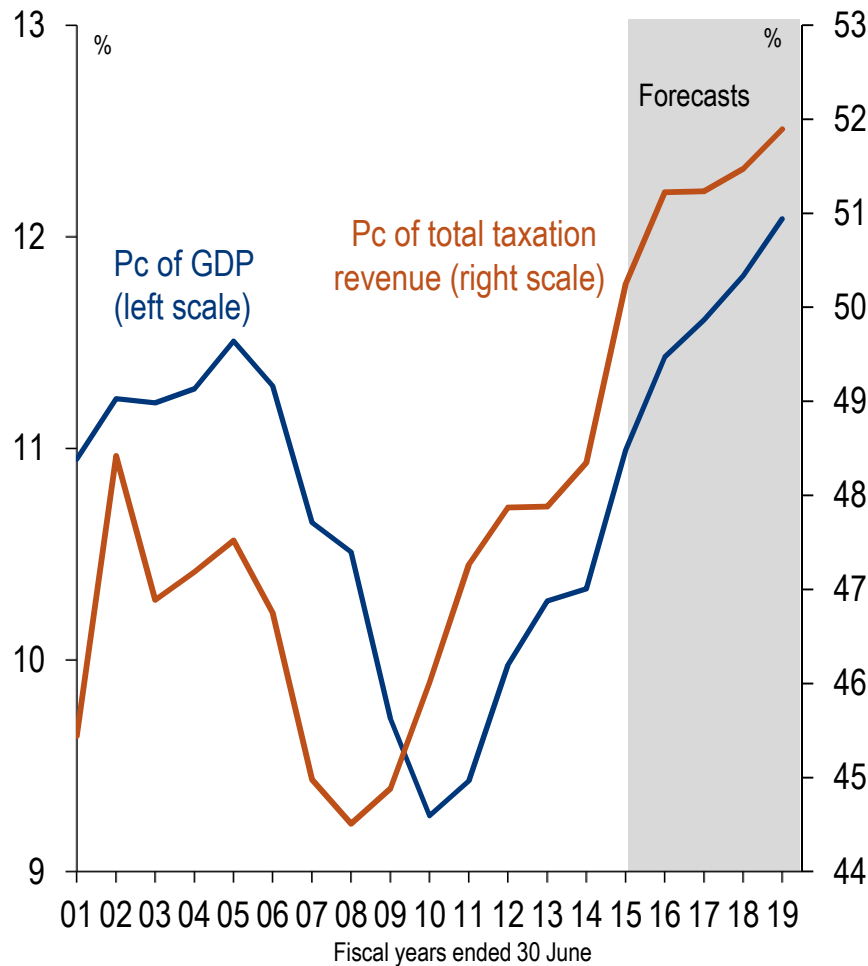
## Australian Government cash receipts and payments as percentages of GDP



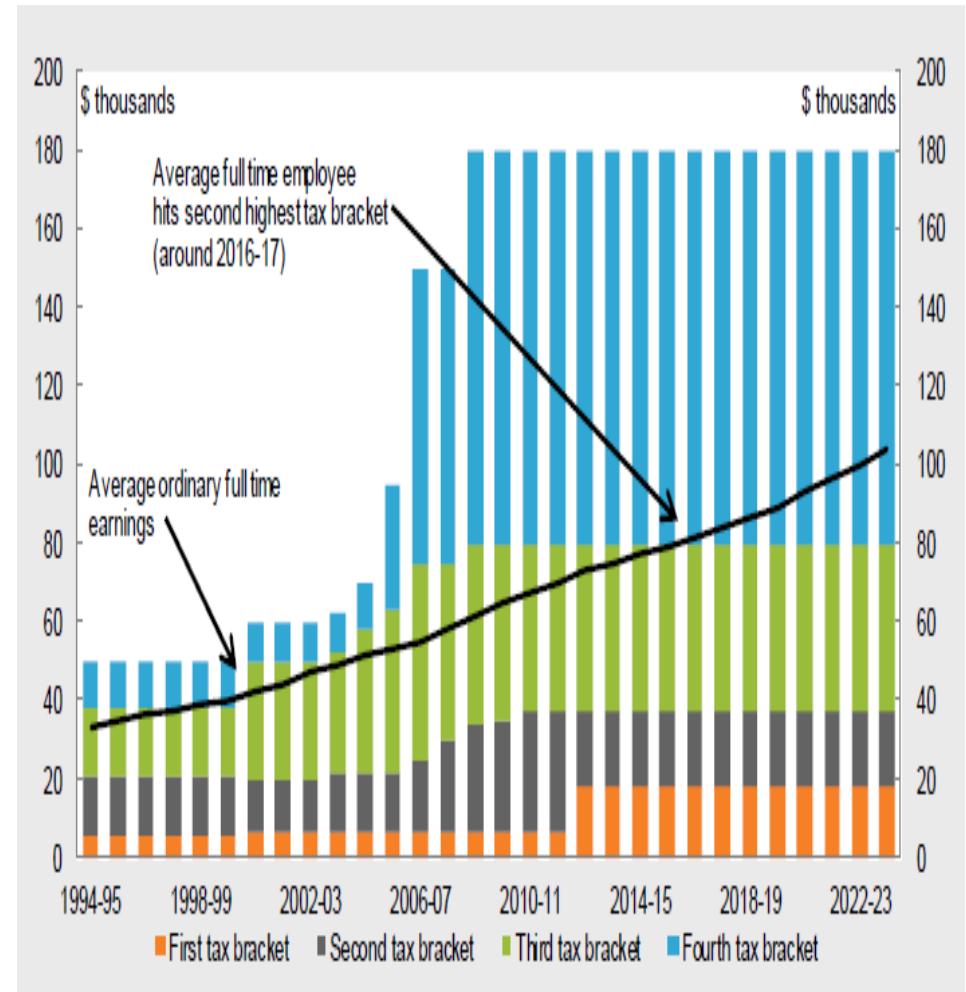
Note: Estimates for 2020-21 through 2025-26 are derived from the 'cap' on tax revenues of 23.9% of GDP from 2020-21 assumed in the Budget Papers, an assumption that Future Fund earnings grow by \$350mn pa after 2018-19, and the published trajectory of the 'underlying' cash balance as a pc of GDP published in the Budget Papers.  
Sources: Australian Government, 2015-16 Budget Paper No. 1, *Budget Strategy and Outlook*; BofA Merrill Lynch Global Research.

# In particular, the 'return to surplus' is highly dependent on 'bracket creep'

## Personal income tax receipts



## The effects of 'bracket creep'



Sources: Australian Government, 2015-16 Budget Paper No. 1, Budget Strategy and Outlook, and Re:Think – Tax Discussion Paper; BofA Merrill Lynch Global Research.

## Summing up on this year's Federal Budget

- ❑ Last year's Budget got its economics broadly right, but was derailed by its politics
  - it sought to address the fiscal problem Australia actually had
  - but that wasn't the one the Coalition had told the people we had
  - and it sought to address the problem in ways that were easily portrayed as 'unfair', emboldening the Government's political opponents to block them
- ❑ Hence the Government ended up achieving less deficit reduction than it wanted, eroding business and consumer confidence, and squandering 'political capital'
- ❑ This year's Budget is a reaction to that experience
  - its primary purpose is to get the politics right
  - hence it is much more concerned with 'who gets what', and much less concerned with the 'bottom line' than last years was
- ❑ The Budget also had to absorb further write-downs in revenues
  - resulting from the ongoing decline in commodity prices
  - and a more recent problem – slowing growth in wages
- ❑ Properly, the Budget doesn't seek to offset these with new spending cuts
- ❑ But nor does the Budget do anything to bolster confidence that it really is on a 'credible path back to surplus' over the medium term

# Important information

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