Weekly Economic Outlook

bankSA

Monday, 27 July 2020

Debts and Deficits

It was hard to miss last week's major headlines. A record government deficit of $184.5 billion is expected for 2020-21 and net debt is expected to rise to 35.7% as of 30 June 2021, up from below 20% in June 2019.

The size of the deterioration in the budget position is not something we have seen before in our lifetime and was called "eyewatering" by Treasurer Josh Frydenberg. However, we need to put the situation into perspective.

It remains without question that with the Australian economy facing the biggest ever contraction since the 1930s, government help was needed. Unemployment would rise, there would be greater dependence on welfare support and there needed to be a significant fiscal response, otherwise numerous (otherwise viable) businesses would fail.

Focus should be on supporting the economic recovery and using government debt to do so makes sense in the current circumstances. Indeed, the bigger concern is if that focus shifts to trying to pay down debt too soon.

In a speech last month, the Reserve Bank (RBA) Governor presented an intuitive concept in determining whether a government should be able to repay its debt over the long term. It is an argument first purported by MIT's Olivier Blanchard. Lowe said that when the yield on government debt is lower than the long-run nominal growth rate of the economy, then there are few concerns about fiscal sustainability from increased debt issuance.

The logic behind this concept is that if borrowing by the government (at a low rate) is used to 'invest' in the economy (growing at a higher rate), that government spending in turn leads to stronger economic growth, which in turn provides a return back to the government through greater tax receipts and less welfare payments.

It would suggest little trouble for the government in managing its debt burden, given the government can borrow at extremely low levels. The three-year government bond yield is set at close to 0.25% thanks to the RBA's yield curve control policy and the ten-year government bond yield currently sits near 0.90%. By comparison, Australia's ten-year average growth rate stands at 2.6%. In nominal terms, average annual growth is at 4.7%.

This scenario will change if investors start to view that government debt as "risky", which could occur at high levels of debt and if long-run growth prospects deteriorate substantially. This scenario is not likely in Australia while government debt levels are low by international standards.

It also raises the importance of boosting the potential growth rate of the economy, which requires productivity-enhancing reforms as a priority over the government's short-term debt situation.

Many businesses have now re-opened, except for parts of Victoria. However, risks to the outlook remain and unemployment is expected to remain high for some time. It would suggest fiscal support measures are still needed.

An up-to-date snapshot on the labour market will be released tomorrow in the weekly payroll jobs data, covering early July. This data had been suggesting that the recovery in payroll jobs since lockdown measures was slowing. Weak domestic demand has likely dented the need for businesses to take on new hires.

Consumer prices for the June quarter is also due to be released this week on Wednesday. We expect that headline CPI will show a large fall of 2.1%, given the massive drop in demand and big decline in fuel prices. Moreover, annual inflation is expected to show a decline of -0.5%, which would be the first annual decline in 12 years. The annual rate of underlying inflation is also expected to be weak at a pace of 1.3%.

Other data to be released this week include building approvals for June (Thursday), in which we expect a 4.0% fall after a 16.4% decline in May. There has been a delayed impact from COVID-19 on approvals and we expect that weakness will continue into June before the impact of the Government's HomeBuilders' grant, announced later in the month. Today, the NSW government also announced changes to stamp duty thresholds to encourage housing activity.

There is also private-sector credit data on Friday. Credit is also being weighed down by the weakness in domestic demand after an initial surge in business credit. We expect a decline of 0.2% in June, the second consecutive month of contraction.

Overseas, the key event will be the Federal Reserve's FOMC meeting on Wednesday. The Fed is widely expected to keep policy unchanged, but with the US economic outlook looking extremely uncertain given the surge in new COVID-19 cases, markets will be looking for an increasingly dovish message and what more the Fed could do to help. Yield-curve control was discussed previously, but members were wary about adopting the policy. The clouds over the outlook could shift this view.

COVID-19 is still impacting heavily on the outlook for the economy. New global infections hit another new record high on the weekend according to the World Health Organisation (WHO). In Victoria, the number of new cases each day remain worryingly high and highlight the risk that current restrictions could be extended longer than the six weeks currently imposed. In NSW, the list of venues related to a case of COVID-19 continues to grow, suggesting that there remains a risk of tighter restrictions for the State.

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Forecasts are detailed on the following page

Forecasts

Please note that due to the unprecedented nature of the coronavirus's impact on the economy and the rapid change of developments, there is greater than usual variability attached to these forecasts.

		2020			2021	
End Period:	**Close (July 24)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**
Aust. Interest Rates:						
RBA Cash Rate, %	0.25	0.25	0.25	0.25	0.25	0.25
90 Day BBSW, %	0.10	0.10	0.15	0.20	0.25	0.30
3 Year Swap, %	0.21	0.25	0.30	0.35	0.35	0.40
10 Year Bond, %	0.87	0.95	1.00	1.05	1.15	1.25
US Interest Rates:						
Fed Funds Rate, %	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond, %	0.59	0.70	0.75	0.80	0.85	0.90
USD Exchange Rates:						
AUD-USD	0.7105	0.70	0.72	0.73	0.74	0.75
USD-JPY	106.14	106	106	107	107	108
EUR-USD	1.1656	1.14	1.16	1.16	1.17	1.17
GBP-USD	1.2794	1.26	1.27	1.27	1.28	1.29
NZD-USD	0.6641	0.65	0.65	0.64	0.65	0.66
AUD Exchange Rates:						
AUD-USD	0.7105	0.70	0.72	0.73	0.74	0.75
AUD-EUR	0.6096	0.61	0.62	0.63	0.63	0.64
AUD-JPY	75.41	74.2	76.3	78.1	79.2	81.0
AUD-GBP	0.5554	0.56	0.57	0.57	0.58	0.58
AUD-NZD	1.0698	1.08	1.11	1.14	1.14	1.14

	2019	**2020 (f)**	**2021 (f)**
GDP, %	2.2	-4.2	3.0
CPI (Headline), %	1.8	0.4	2.1
CPI (Trimmed mean), %	1.6	1.0	1.8
Unemployment Rate, %	5.2	8.4	7.3
Wages Growth, %	2.2	1.8	1.6

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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