Weekly Economic Outlook

Bank of Melbourne

Monday, 21 March 2022

Time to Tighten the Purse Strings?

The Federal Budget will be handed down next Tuesday, 29 March, against the backdrop of the ongoing pandemic, floods across parts of Queensland and NSW, and war in Europe. Plus, with an upcoming election, the government will be looking to shore up its appeal with voters.

Treasurer Josh Frydenberg provided some hints of what to expect in a speech last week. He emphasised that "fiscal settings need to be normalised" and that the time for "large scale economy-wide emergency support is over". In other words, it is time to tighten the purse strings.

The government wants to begin a "gradual and measured" consolidation to rebuild fiscal buffers so that in the future "we have firepower to respond".

But at the same time, cost of living pressures are building. And the government will be under pressure to provide support to those in need.

So, what does this mean in practise for the budget bottom line?

Well, the economy has performed considerably better than the government forecast, which the Treasurer says has underpinned a "substantial improvement" in the deficit. Indeed, the unemployment rate fell to 4.0% in February – the lowest rate in 13½ years. Australia has not had an unemployment rate consistently lower than 4.0% since 1974!

In the Mid-Year Economic and Fiscal Outlook (MYEFO) in December, the government projected a deficit of $99.2 billion in 2021-22 and $98.9 billion in 2022-23. The improvement in the bottom line will reflect that the government has needed to spend less on welfare than expected, with more Australians in work. Higher commodity prices have also given government revenue a boost.

There have been concerns raised about the sustainability of government debt after unprecedented stimulus during the pandemic. First, is important to note that without this spending, many more people would have lost their jobs and many more businesses would have failed. Second, government debt as a share of GDP in Australia remains low relative to other advanced economies.

The Treasurer highlighted that gross debt is expected to "stabilise and decline" over the medium term and that "provided nominal economic growth exceeds the nominal interest rate, economic growth will more than cover the cost of servicing our debt interest payments". Plus, Australia is one of only nine countries in the world to retain its AAA credit rating from all three major credit rating agencies.

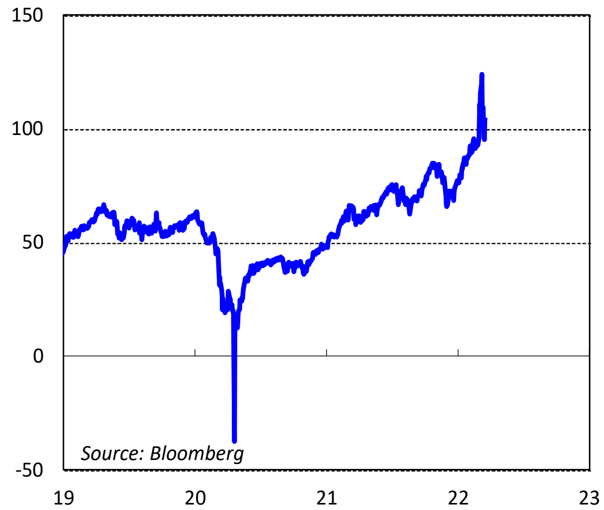
We don't know yet exactly what spending measures will be in the Budget. On the cost of living, the Treasurer noted further "targeted and proportionate" measures to support families would be introduced. However, reports suggest that as a possible trade-off, the Low and Middle Income Tax Offset introduced four years ago may not be extended beyond this year.

The Treasurer also flagged "further investments in infrastructure, skills, digital transformation, energy, our regions and Australia's sovereign manufacturing capability".

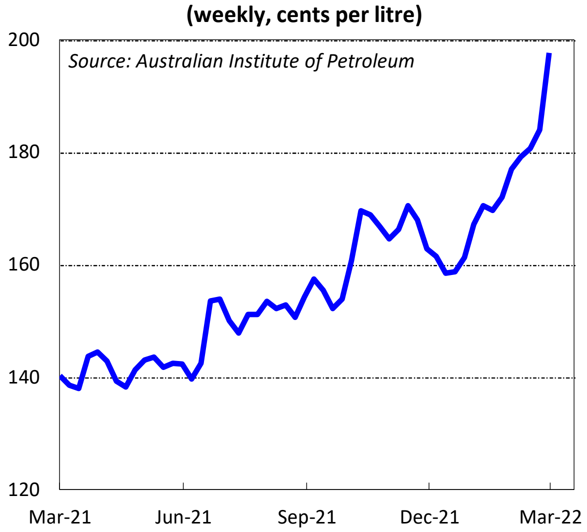
Some key pandemic policies will remain in place. Notably, the government announced in last year's Budget that key tax incentives for businesses will remain in place until at least mid-2023 – namely the Temporary Full Expensing and Loss Carry Back schemes.

International developments are one of the key contributors to the cost-of-living pressures – notably the increase in the oil price has sharply pushed up petrol prices. In the week ending 13 March, the unleaded petrol averaged 197.6 cents per litre across the country. In fact, average prices are likely to have increased even further since then as many motorists are paying well over $2 a litre across the capital cities.

WTI Crude Oil Price
(daily, $US per barrel)



National Average Petrol Price*
(weekly, cents per litre)



*Retail price of unleaded petrol

West Texas Intermediate crude oil futures finished at US$106 per barrel on Friday, down from the peak over $130 earlier in March but still nearly 40% higher since the start of the year. The increase in crude oil prices has been underpinned by a supply shock stemming from the Ukraine crisis. Western nations have implemented a range of sanctions on Russia. The US, UK and Australia are some of the countries that have prohibited oil imports from Russia. However, Europe – which is heavily dependent on Russian oil and natural gas – has not banned energy imports from Russia.

In response to the squeeze at the petrol pump, the government is considering temporarily cutting tax on fuel. Currently, the fuel excise sits at 44.2 cents per litre. The Treasurer has ruled out freezing the automatic indexation of the fuel excise which occurs every February and August but has left the door open to a temporary cut in the tax.

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Forecasts

		2022			2023		
End Period:	**Close (18 Mar)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	0.10	0.10	0.25	0.50	0.75	1.00	1.25
90 Day BBSW, %	0.15	0.20	0.35	0.60	0.95	1.20	1.45
3 Year Swap, %	2.12	1.90	1.95	2.00	2.10	2.15	2.20
10 Year Bond, %	2.51	2.40	2.40	2.50	2.50	2.40	2.30
US Interest Rates:							
Fed Funds Rate, %	0.375	0.875	1.125	1.375	1.625	1.875	1.875
US 10 Year Bond, %	2.14	2.10	2.20	2.30	2.30	2.30	2.30
USD Exchange Rates:							
AUD-USD	0.7371	0.73	0.75	0.76	0.77	0.78	0.79
USD-JPY	118.75	117	117	118	118	119	119
EUR-USD	1.1077	1.10	1.11	1.12	1.13	1.14	1.15
GBP-USD	1.3153	1.33	1.34	1.35	1.36	1.37	1.37
NZD-USD	0.6878	0.68	0.70	0.71	0.72	0.72	0.73
AUD Exchange Rates:							
AUD-USD	0.7371	0.73	0.75	0.76	0.77	0.78	0.79
AUD-EUR	0.6654	0.66	0.68	0.68	0.68	0.68	0.69
AUD-JPY	87.531	85.0	87.8	89.7	90.9	92.8	94.0
AUD-GBP	0.5604	0.55	0.56	0.56	0.57	0.57	0.58
AUD-NZD	1.0718	1.07	1.07	1.07	1.08	1.08	1.09

	2020	**2021**	**2022 (f)**	**2023 (f)**
GDP, %	-0.8	4.2	5.5	2.7
CPI (Headline), %	0.9	3.5	4.1	2.3
CPI (Trimmed mean), %	1.2	2.6	3.4	2.9
Unemployment Rate, %	6.8	4.7	3.8	3.9
Wages Growth, %	1.4	2.3	3.2	3.5

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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