Weekly Economic Outlook

Bank of Melbourne

Monday, 4 April 2022

Budget Over, Focus Again Turns to RBA

Federal Budget

After much anticipation and a little bit of fanfare, at least among economists and policy wonks, the Federal Government delivered the 2022-23 Budget last Tuesday.

A faster-than-expected economic recovery, in addition to elevated commodity prices contributed to large upward revisions to the budget bottom line. A deficit of $79.8 billion is projected for 2021-22. This is an improvement of $19.4 billion versus the Government's forecasts from the December Mid-Year Economic and Fiscal Outlook (MYEFO). In 2022-23, the deficit is expected to be $78.0 billion. In total, there was an improvement to the budget bottom line of $103.6 billion over the five years to 2025-26 versus the MYEFO estimates.

On the policy side of things, with rising inflationary pressures impacting households, a cost-of-living package formed the centrepiece of the Budget. This included: (1) an additional $420 tax offset for low and middle-income earners, (2) a one-off payment of $250 for eligible pensioners, welfare recipients, veterans and concession card holders, and (3) a cut to the rate of fuel excise from 44.2 to 22.1 cents per litre for six months.

Small business also received sweeteners in this year's Budget. There were incentives to encourage small businesses to go digital and upskill employees with external training. A new Australian Apprenticeships Incentive System will also be established to help employers engage and retain apprentices.

Other measures included additional spending on disaster relief, following the floods in NSW and Queensland, and defence, with heightened focus on national security after the outbreak of the Ukraine war.

In his Budget reply speech on Thursday last week, the Opposition Leader committed to supporting the cost-of-living package presented in the Budget. The Opposition Leader also announced a key element to the Opposition's election pitch – a $2.5 billion package to support the aged care sector and fund more nurses and carers over four years.

The Government's strategy presented in the Budget and the Opposition's reply sets the scene for the upcoming Federal election, which the Prime Minister has yet to call. The last possible date is 21 May, although it may also fall on 7 May or 14 May. However, for an election to be held on 7 May, the Prime Minister would need to call the election today and there are no signs that he is on his way to visit the Governor-General. In a recent interview, the Prime Minister said that an election would held in 'mid-May', pointing to 14 May the most likely date.

Monetary Policy Implications

With the Federal Budget out of the way, the focus again turns to the other arm of economic policy making, the Reserve Bank (RBA). One of the important questions on budget night was whether the cost-of-living package and other spending policies will contribute to a further increase in inflation and place pressure on the RBA to increase interest rates sooner.

Supporting households without further fuelling inflationary pressures is a difficult balance for the Government to strike.

In its current form, the cost-of-living package is unlikely to significantly increase inflationary pressures. It was costed at $8.6 billion over the five years to 2025-26. Most of this spending occurs in 2021-22 ($3.4 billion) and 2022-23 ($5 billion). Based on the GDP forecasts in the Budget, the cost-of-living package is expected make up less than 0.25% of GDP in each of those two years. This is a relatively modest amount.

Nonetheless, markets will be watching closely for any change in narrative after the RBA meets on Tuesday for its monthly Board meeting. We do not expect any changes to monetary policy settings at the upcoming meeting. We continue to expect the first rate increase to come in August. However, we wouldn't rule out an earlier move in June or July.

Looking beyond August, we have brought forward our expectations of cash rate increases from the RBA, in line with an expected faster pace of tightening of US monetary policy settings by the Federal Reserve. We expect two rate increases in the fourth quarter of this calendar year. This would take the cash rate to 0.75% by the end of 2022.

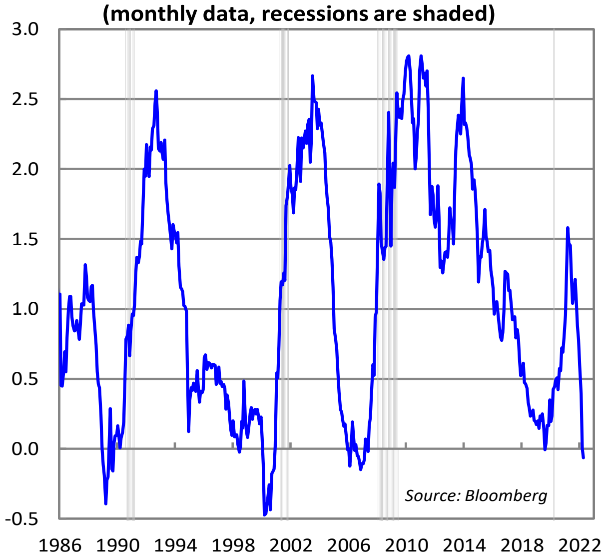
Financial Markets

An important development occurred last week as the US Treasury yield curve inverted for the first time since 2019. The 2-year yield rose above the 10-year yield on Tuesday night.

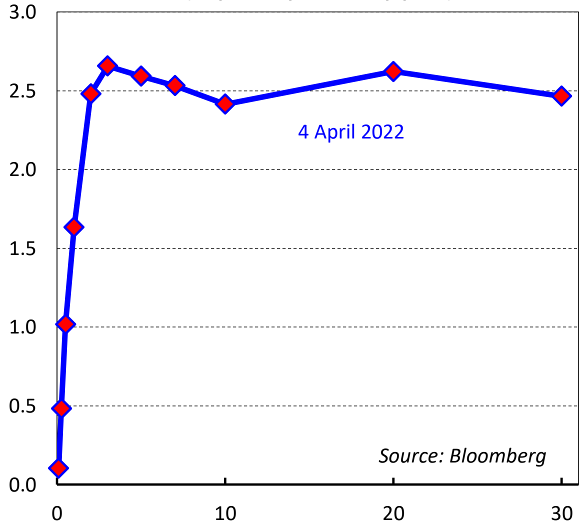
A yield curve inversion occurs when longer-term interest rates are below shorter-term interest rates. This is unusual, as interest rates typical increase for longer dated bonds to compensate investors for risk and the time value of money.

A yield curve inversion is often considered to be a signal that a recession is on the horizon. Over the past 60 years, every US recession has been preceded by an inverted yield curve. But not every yield curve inversion has been followed by a recession.

US 2-10-Year Bond Yield Curve
(monthly data, recessions are shaded)



US Treasury Yield Curve
(% yield by maturity year)



However, there are some important differences to consider today relative to history. The unconventional monetary policies implemented following the onset of the pandemic, namely quantitative easing, have impacted the signal provided by the yield curve. This is because the central bank has depressed long-end yields by purchasing government bonds. In turn, a yield curve inversion is likely to be a less powerful predictor of recessions in the current circumstances.

It is not our baseline expectation that the US will face a recession in the near-term. In fact, the Fed is projecting solid growth for the US with 2.8% GDP growth in 2022 and 2.2% in 2023, which is higher than the average growth rate in the two decades preceding the pandemic.

Economic Data

On the data front, February trade balance numbers will be released on Thursday. Australia's trade balance continues to be supported by strong commodity prices, which increase the revenue that we receive for our commodity exports. We expect a surplus of around $13.2 billion in February, which would be a $0.3 billion increase on the January outcome of $12.9 billion. The larger trade surplus is expected to be driven by an increase in export earnings. Additionally, imports are also expected to rise, in line with an improvement in domestic economic conditions, but by a smaller amount than exports.

The RBA will again be in focus later in the week as it publishes its half-yearly Financial Stability Review on Friday. In this document, the RBA outlines its views around the financial system, both globally and domestically, and investigates emerging trends and potential risks to financial stability.

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Forecasts

		2022			2023		
End Period:	**Close (1 Apr)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	0.10	0.10	0.25	0.75	1.00	1.25	1.50
90 Day BBSW, %	0.23	0.20	0.35	0.85	1.20	1.45	1.70
3 Year Swap, %	2.61	2.60	2.50	2.40	2.40	2.35	2.30
10 Year Bond, %	2.85	3.00	3.00	2.60	2.40	2.25	2.10
US Interest Rates:							
Fed Funds Rate, %	0.375	1.375	1.875	2.375	2.375	2.375	2.375
US 10 Year Bond, %	2.37	2.60	2.60	2.30	2.20	2.15	2.10
USD Exchange Rates:							
AUD-USD	0.7489	0.74	0.75	0.76	0.77	0.78	0.79
USD-JPY	121.93	122	121	121	120	120	119
EUR-USD	1.1067	1.10	1.11	1.12	1.13	1.14	1.15
GBP-USD	1.3142	1.33	1.34	1.35	1.36	1.37	1.37
NZD-USD	0.6935	0.69	0.70	0.71	0.72	0.72	0.73
AUD Exchange Rates:							
AUD-USD	0.7489	0.74	0.75	0.76	0.77	0.78	0.79
AUD-EUR	0.6767	0.67	0.68	0.68	0.68	0.68	0.69
AUD-JPY	91.313	90.3	90.8	92.0	92.4	93.6	94.0
AUD-GBP	0.5699	0.56	0.56	0.56	0.57	0.57	0.58
AUD-NZD	1.0804	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	4.3	2.3
CPI (Trimmed mean), %	1.2	2.6	3.5	2.9
Unemployment Rate, %	6.8	4.7	3.7	3.8
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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