

23 July 2020

## Australia: Economic and Fiscal Update

### Budget deficit: \$85.8bn in 2019/20. Rising to \$184.5bn in 2020/21 - upward revision likely.

The Treasurer released an Economic and Fiscal Update (EFU) today, the first such update since the pandemic.

The Federal Government provided economic and fiscal figures for the two years 2019/20 and 2020/21. This is ahead of the annual Budget, to be delivered on October 6 – having been postponed from May 12.

The October Budget will include updated estimates for 2019/20 and 2020/21 (incorporating any new policy measures – which we expect to be significant), as well as providing projections for the following two years.

#### Budget: key details

The Federal budget was in balance in 2018/19, prior to the pandemic. Since then, the budget has moved sharply into deficit. This reflects the combined impact of new government spending, policy stimulus, and the economic impact of the recession associated with the pandemic.

The government estimates that the underlying cash budget deficit was \$85.8bn in 2019/20, representing 4.3% of GDP, slumping to a deficit of \$184.5bn in 2020/21, -9.7% of GDP.

At the time of the December 2019 Mid-Year Economic and Fiscal Outlook (MYEFO), the government was forecasting a \$5bn surplus for 2019/20 and a \$6.1bn surplus for 2020/21.

In 2019/20, of the \$80.8bn deterioration in the budget position relative to MYEFO some \$58.4bn is due to the effect of policy decisions – almost entirely associated with increased expenditure, \$58.0bn. The economic downturn dented the budget position by \$32.4bn, entirely centred on lower revenue collections. Curiously, the economic downturn is assessed to have no net impact on expenditures – that is despite the rapidly deteriorating labour market leading to a jump in the cost of unemployment benefit payments. In part this is because the reduction in GST receipts results in reduced payments by the Commonwealth to the States – worth some \$12.7bn over two years.

For the 2020/21 year, the budget deterioration of \$190.6bn includes \$118.4bn of new policy – again with a focus on additional payments (\$113.7bn). The economic downturn punches a \$72.2bn hole in the budget, with revenue down \$56.4bn, while expenditures are impacted, up by \$15.8bn as labour market stress continues.

#### Debt levels rise

Debt levels have increased materially associated with the budget deterioration. That said, they remain at levels below many other advanced nations and at levels arguably still manageable in an environment of ultra-low interest rates – with the 10 year government bond trading below 1% currently, a rate below the nations medium-term growth potential.

Net debt rises to \$488bn (24.6% of GDP) at June 2020, then to \$677bn (35.7% of GDP) at June 2021. That is up from \$373.6bn (19.2% of GDP) at June 2019.

Gross debt, the face value of government securities on issue, was \$684bn (34.4% of GDP) at June 2020, rising to \$852bn (45% of GDP) at June 2021. That is up from \$542bn (27.8% of GDP) at June 2019.

#### Policy measures

The EFU provided a reconciliation of already announced policy measures rather than being a vehicle for a wave of new policy initiatives. Earlier this week, the government announced the extension and modification of the wage subsidy scheme, JobKeeper (JK) from September 2020 to March 2021. The coronavirus supplement provided to those on unemployment benefits was also modified and extended from September, albeit to end December – with a possible further extension to be announced in the October Budget.

The net impact of policy decisions since MYEFO has increased payments by \$171.7bn over the two years to 2020/21. The signature JK program costs \$85.7bn. Temporary tax-free cash flow boosts to small and medium-sized businesses costs some \$31.9bn. The Coronavirus Supplement – as part of JobSeeker (JS) costs \$16.8bn – over five years from 2019/20. Two one-off cash payments to those on income support cost \$9.4bn.

#### Economic Conditions

The pandemic has seen the Australian economy move into recession – the first recession since 1991.

The Government is forecasting the economy to contract by 0.25% in 2019/20, factoring in a 7% decline in the June quarter.

Output in 2020/21 is forecast to be 2.5% below that in 2019/20. This year average forecast is highly sensitive to the extent of weakness around the start of the year (the September quarter 2020, as well as the size of the hole in the June quarter 2020). There is still a high degree of uncertainty around this forecast – particularly given the fluid situation in Victoria, with Melbourne returning to lock-down from July 9. In terms of the detail, weakness is expected to be widespread – across consumer spending and business investment, albeit with a lift in mining investment being a bright spot.

Labour market stress is expected to continue into 2020/21. Employment, having fallen by 4.4% in the year to the June quarter 2020, is forecast to lift by only 1% in the year to the June quarter 2021. The headline unemployment rate is forecast to be at 8.75% in the June quarter 2021, up from around 7.4% currently. This forecast is highly sensitive to the assumed participation rate – which has been particularly volatile in these fluid times and with the implementation of JK and JS.

Nominal GDP growth is forecast to slow to 2% in 201/20, followed by a contraction of 4.75% in 2020/21. The 2020/21 view factors in a 12.25% drop in the terms of trade. The iron ore price is assumed to be at US\$55/t (fob) at end December 2020 – whereas currently the spot price has spiked to US\$110/t associated with supply disruptions from Brazil and stronger demand from China.



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## Comments

### Growth Forecasts

The government's Budget Update provides useful insights into its assessment of the economic outlook and the forecast impact on the Budget deficits for 2019/20 and 2020/21.

The forecast budget deficit for 2019/20 is \$85.8 billion and for 2020/21 is forecast at \$184.5 billion.

GDP growth is forecast at -0.25% in 2019/20 and -2.5% in 2020/21 (year average fiscal year).

Westpac prefers to talk about through the year growth (using the standard approach of the Reserve Bank) which we have forecast as -4.2% in 2020 (including -7% in the June quarter) and 3% in 2021.

These forecasts translate into -0.25% in 2019/20 and -2.0% in 2020/21 – broadly in line with the government's view.

We suspect that given the degree of uncertainty around the current outlook the government is likely to have taken more of a top down approach to the growth outlook than is normally the case when the various components of GDP are forecast individually.

In perusing the government's forecast breakdown in 2020/2021 we note that they are much more pessimistic about business investment and more confident about the consumer than we have been in our forecasts.

That soft outlook for business is probably one of the reasons behind the pessimistic outlook for employment growth of only 1% through 2020/2021 – the pace and extent of the opening-up of the economy will be the most important driver of jobs growth. We see the government's underlying assumptions around that profile as a "best case scenario" and are very surprised that they are only forecasting 1% jobs growth.

Indeed, while our central forecast also assumes that base case around government related policy we are forecasting employment growth of 4% through 2020/2021 (we find that number to be broadly consistent with our forecast for through the year output growth in 2020/21 of around 5.2%) – a much more constrained approach to the opening up (which has to be the default risk) would see markedly slower employment growth – indeed, presumably net job losses, under the government's 1% base case.

### Budget Forecasts

Westpac has been forecasting a budget deficit in 2019/20 of \$95 billion in 2019/20 and \$210 billion in 2020/21. (We revised our forecast for the number that the government would release today for 2020/2021 from the \$240 billion we expect on Budget Night since we expect around \$30 billion in additional stimulus to be announced on October 6).

The government has announced \$85.8 billion in 2019/2020 and \$184.5 billion in 2020/2021.

That \$85 billion includes an allowance of "only" \$32 billion for the cyclical deficit with no assessed increase in expenditures despite the loss of 875k jobs in the June quarter. That increase in unemployment benefits appears to be captured in a larger than expected policy cost on the curious basis that all the cost of the deterioration in the labour market was allocated to policy (with some allowance for lower GST payments to the states).

The budget deficit for the 2019/2020 financial year is publicly known out to May, at a reported \$65 billion – so the government

may have some insight into the deficit for the month of June that is less than the \$30 billion we had expected.

With 2020/2021 starting at a \$10 billion lower deficit, then \$10 billion of the \$25 billion difference between the government's numbers can be explained. But we are still surprised that the government's estimate of the cyclical deficit (that component of the deficit resulting from the weakness in the economy) is only \$72 billion in 2020/2021 compared to our own forecast of \$100 billion particularly when the government is forecasting only 1% employment growth through 2020/2021.

Note that the government has based its forecasts on what we consider to be the most optimistic view on the time-line for key social distancing restrictions: 4 square meter/ 100 person indoor limit in place from mid-July until end December (with 100 person limit fully relaxed by end September) everywhere apart from Victoria where current lockdown is gradually assumed to be eased from mid-August.

We accept that this approach is the best that can be taken but emphasise there are only downside risks to these assumptions and, in our view, the final deficit.

### Policy Outlook

There were few new policies announced in this document. The most eye catching was the extension of the time to drawdown \$10,000 from superannuation balances from end September to end December.

That policy comes at no direct cost to the government. We estimate that around \$35 billion will have already been drawn down by September including \$20 billion in the first tranche in the June quarter; helping support the lift in retail sales we have seen since May and also contributing to large increase in retail bank deposit balances.

The foreign border policy assumes resumption of international arrivals for non-residents albeit requiring the 14 day quarantine restrictions. It is forecast that net migration will fall from 232,000 in 2018/19 to 31,000 in 2020/21 – an 85% reduction. If we assume this estimate is based on the bulk of the 31,000 arriving in the January – June period in 2021 (a 75% reduction on the equivalent period in 2019) then this looks too low. Foreign students represented more than 50% of net migration in 2018/19 – they are a critical contributor to the Australian economy. Once the foreign borders are opened through a strict quarantine model we should be more ambitious with our immigration plans than assumed in the Statement.

Once we had seen the extensions to the JK and JS policies we made some adjustments to our assumptions around expected policy announcements in the Budget. The expected costs of those announcements which would include an extension of JS at its new level from December to end June (costing an additional \$11 billion) and a further extension of JK (costing \$4 billion) to June we added \$15 billion to our \$210 billion "target".

We also expect additional policy stimulus to be announced in the October Budget, including bringing forward the personal tax cuts which are legislated for July 2022 (costing around \$14 billion per year) to January 2021 and additional infrastructure and cash payments (costing around \$8 billion).

Those policies combined would lift the estimated Budget deficit by around \$30 billion.

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