

# THE 2017-18 BUDGET AND THE AUSTRALIAN ECONOMY

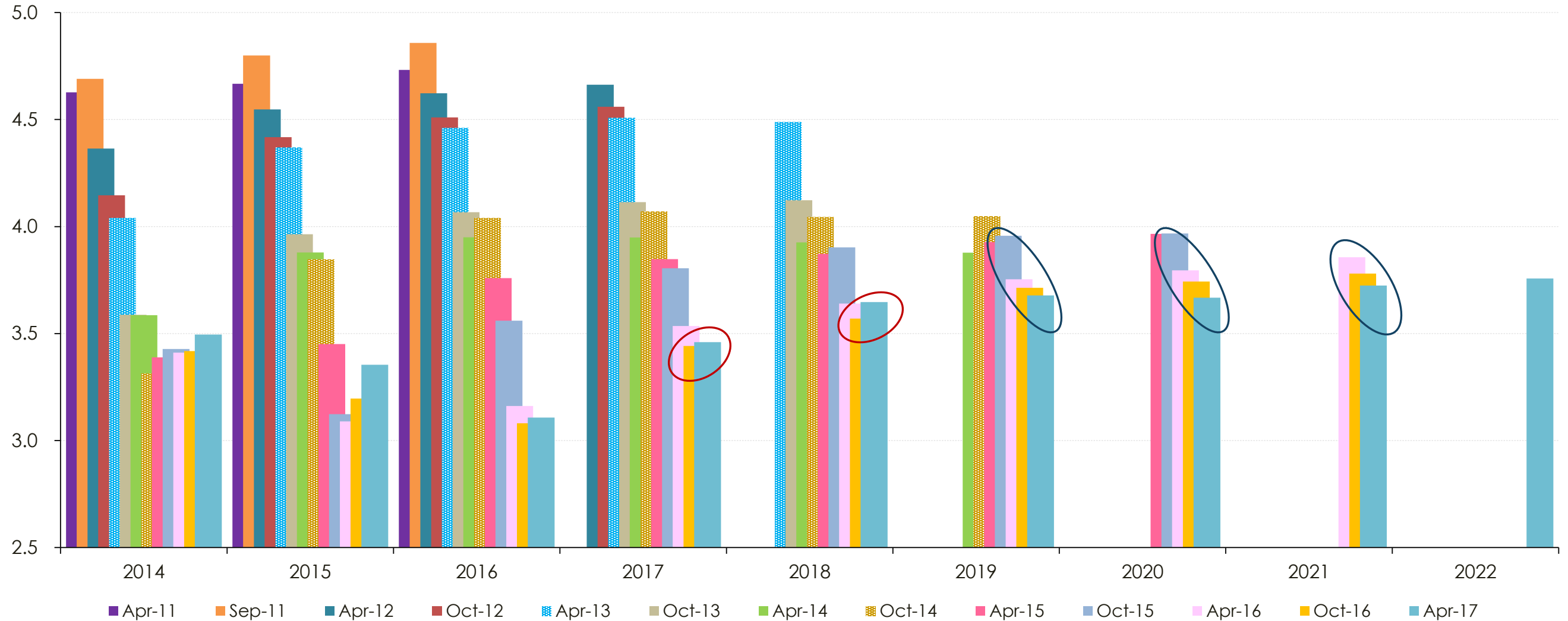
PRESENTATION TO A POST-BUDGET BREAKFAST  
HOSTED BY MOORE STEPHENS

RACV CLUB, MELBOURNE  
11<sup>TH</sup> MAY 2017

# The international economic context

# The IMF upgraded its forecasts for world economic growth for the first time in 5½ years – but continues to downgrade longer-term projections

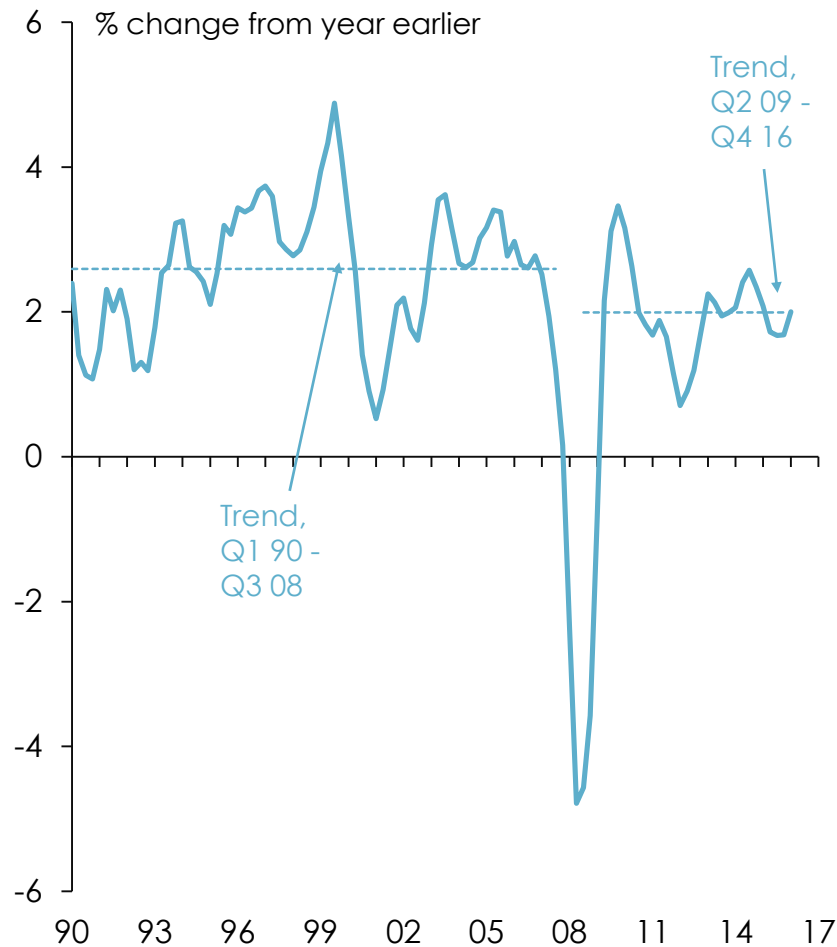
## Successive IMF World Economic Outlook forecasts of world real GDP growth



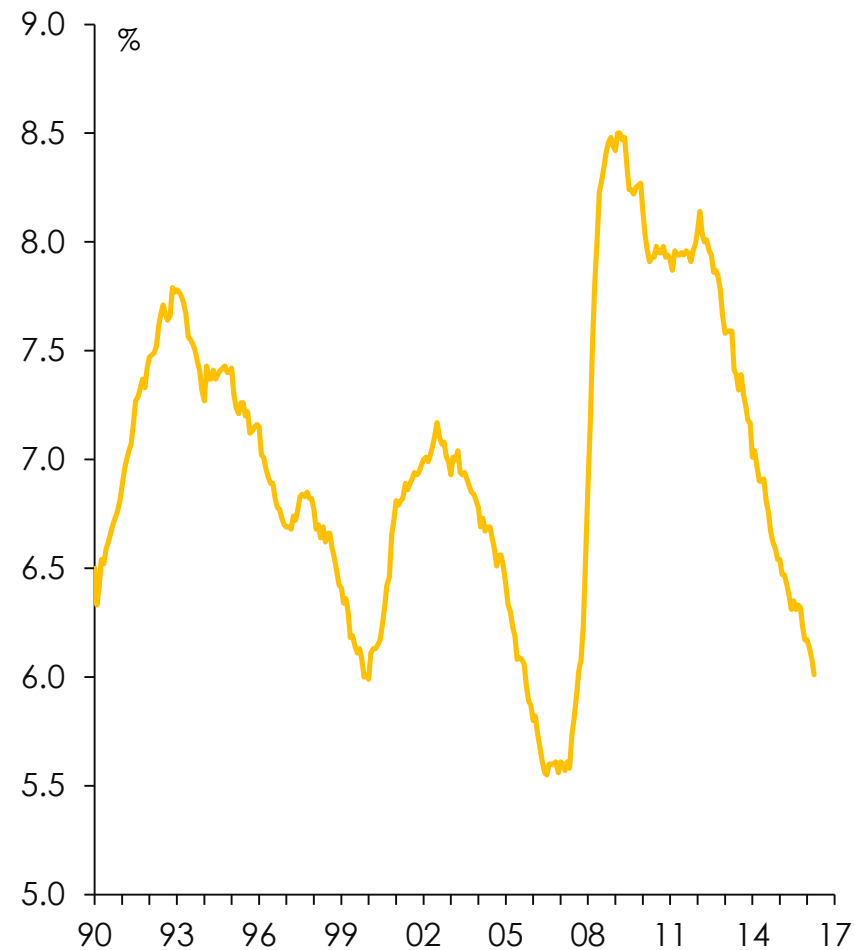
Source: International Monetary Fund, *World Economic Outlook*, April 2017 and previous issues.

# Economic growth across 'advanced' economies has been consistently weaker than expected – yet unemployment has fallen sharply

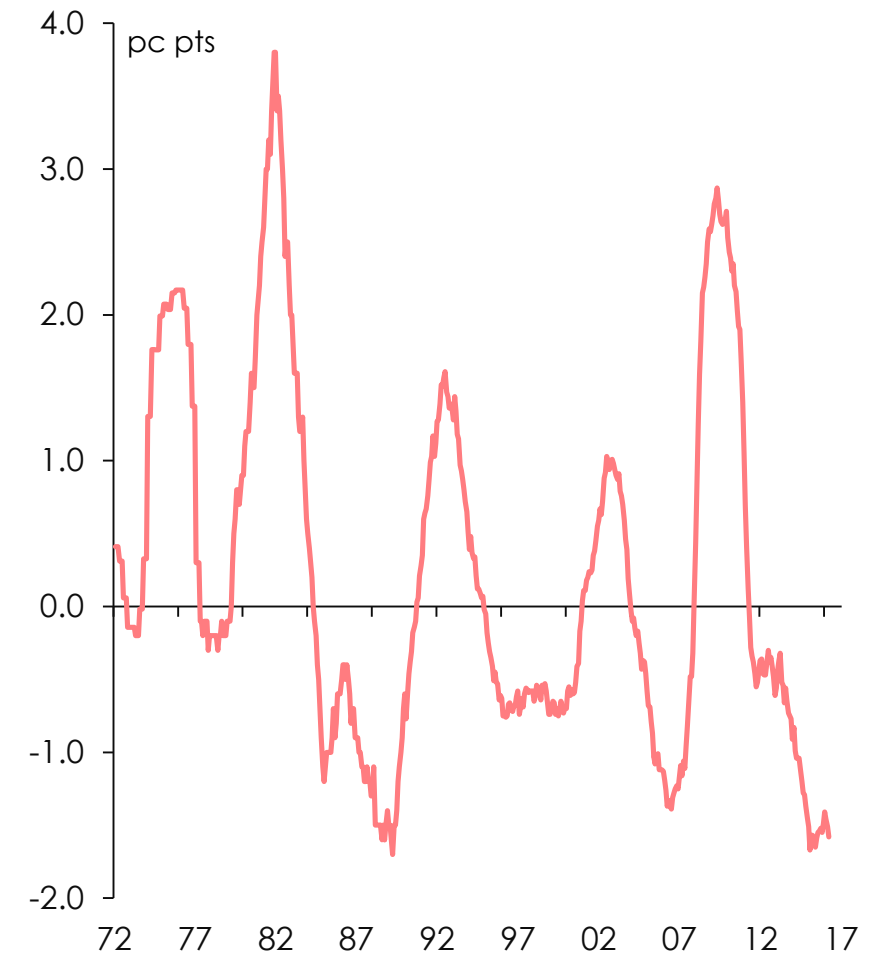
## OECD area real GDP growth



## OECD area unemployment rate



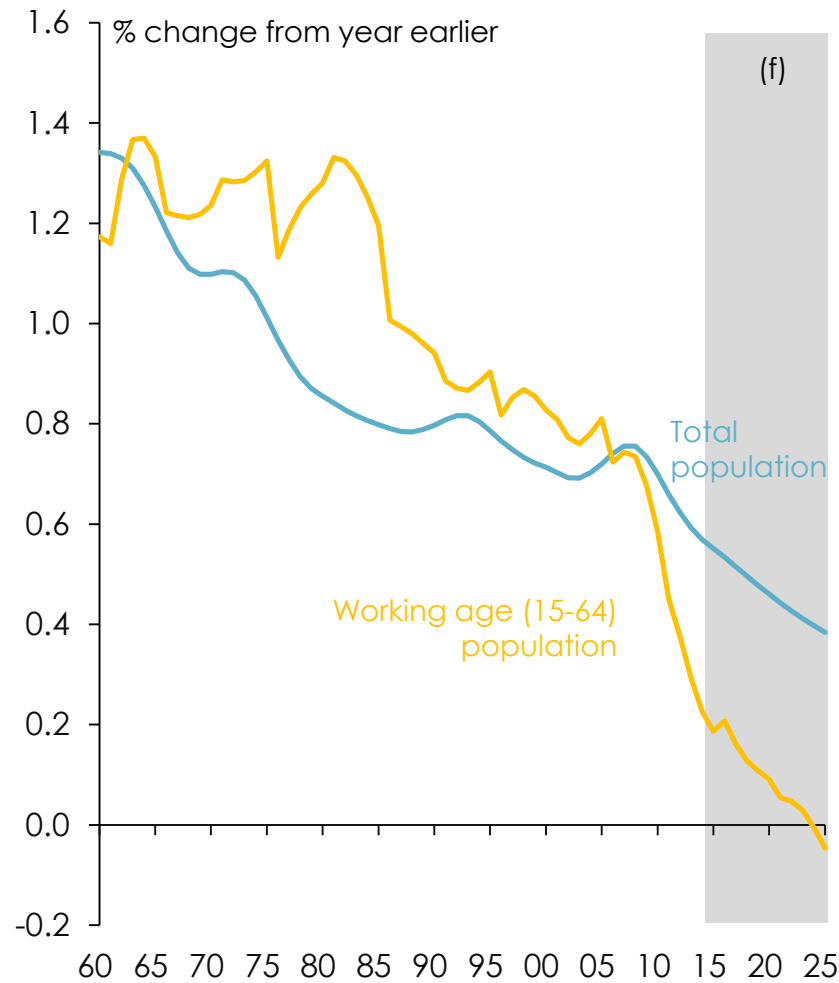
## 3-year change in OECD unemployment rate



Source: Organization for Economic Co-operation & Development (OECD). The OECD comprises 34 (mostly) 'advanced' economies in North America and Europe, plus Japan, Korea, Australia, New Zealand, Mexico, Chile, Turkey & Israel.

# 'Advanced' economies aren't capable of growing as rapidly as they used to

## OECD area population growth



## OECD area labour productivity growth



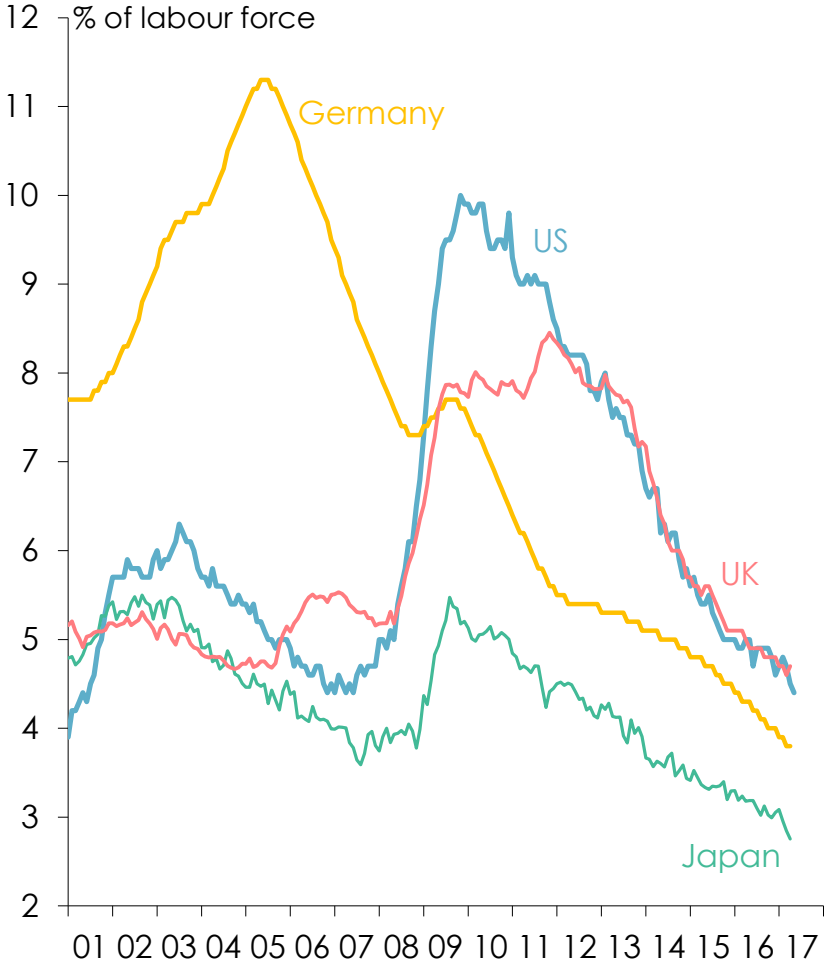
## OECD area potential GDP growth



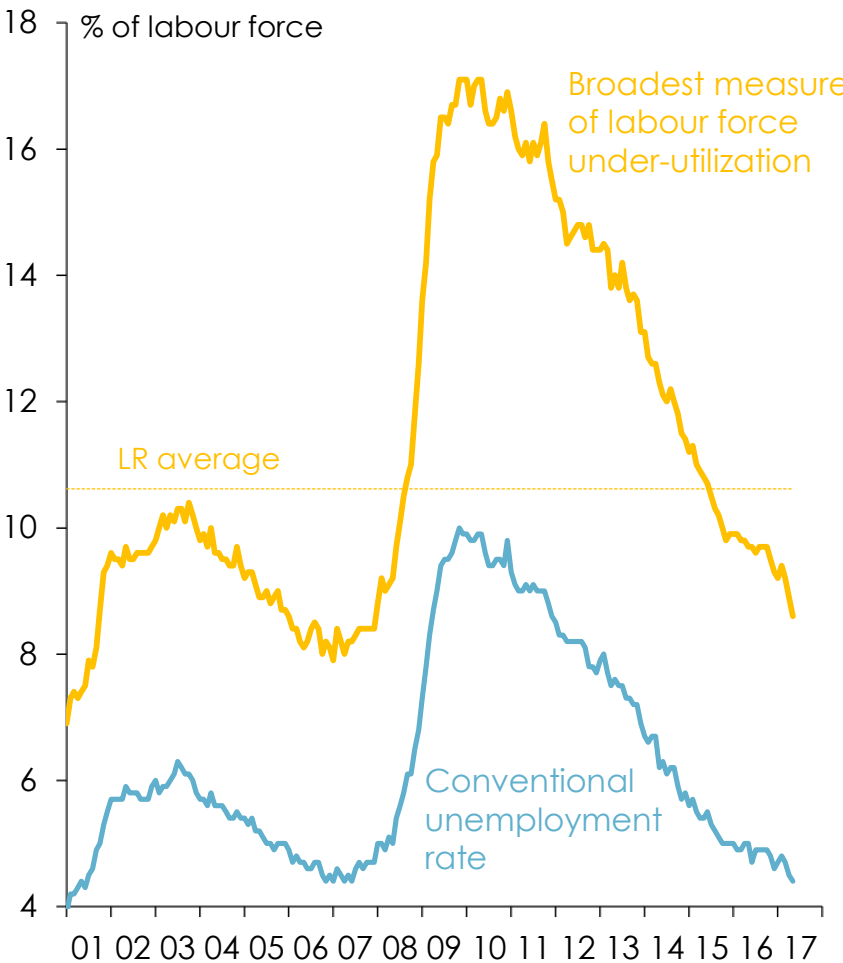
Sources: United Nations Economic & Social Affairs Division, Population Branch, *World Population Prospects – The 2015 Revision*; Organization for Economic Co-operation & Development (OECD), *Economic Outlook* database. 'Potential growth' means growth in the level of real GDP assuming full employment of the available labour force.

# The four largest 'advanced' economies are now more or less at 'full employment'

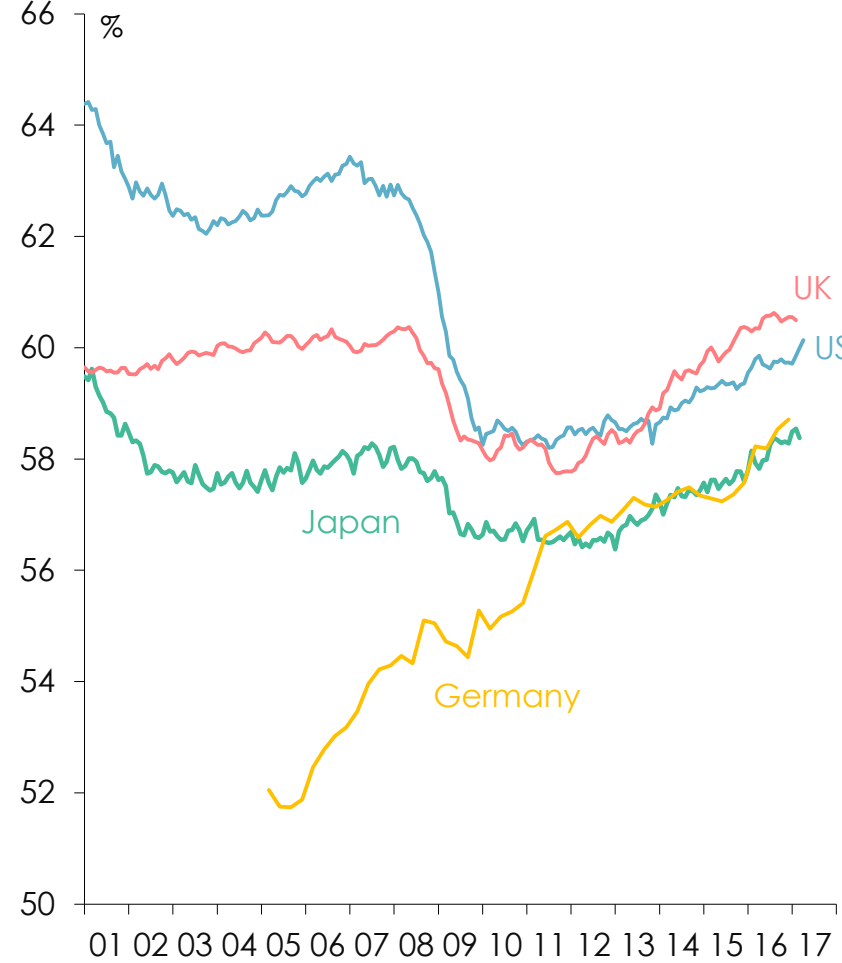
## Four largest 'advanced' economies - unemployment



## Broader measures of US 'under-employment'



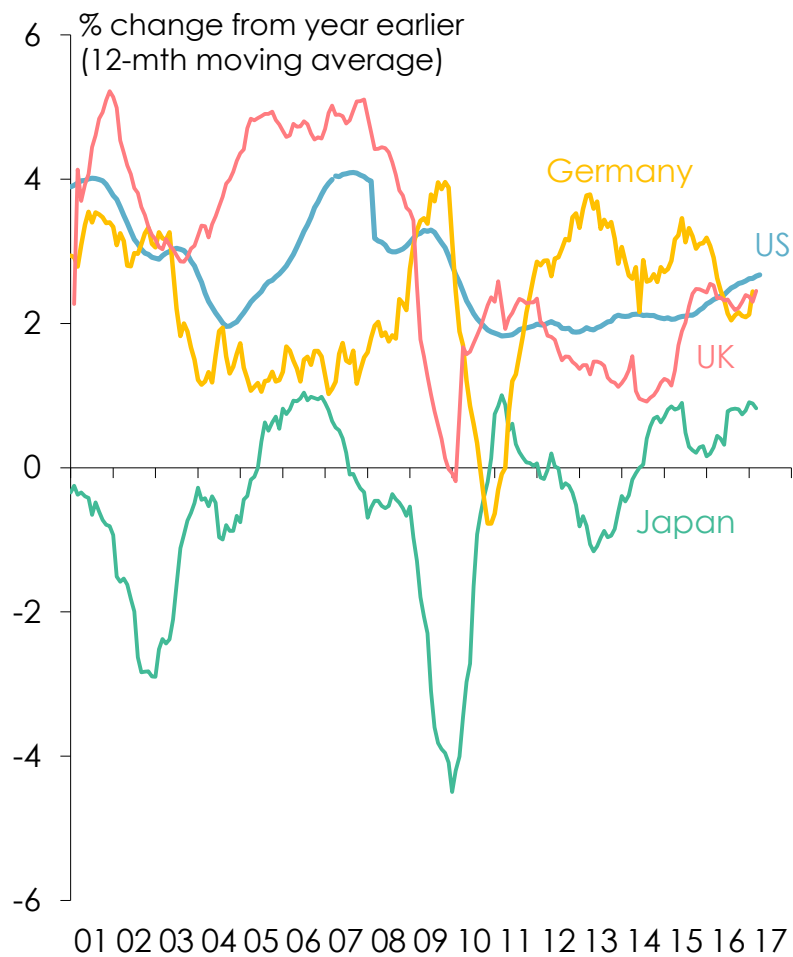
## Employment-population ratios



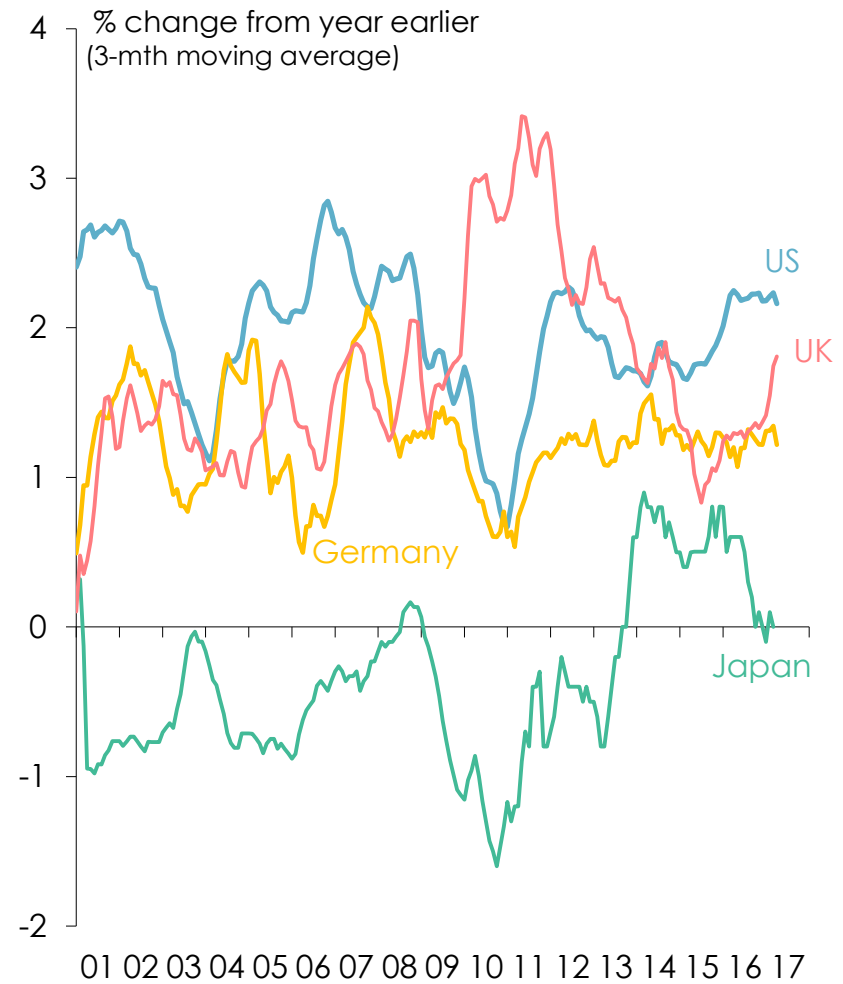
Sources: US Bureau of Labor Statistics; Japan Labour Ministry; Bundesagentur fur Arbeit; UK Office of National Statistics; Thomson Reuters Datastream.

# Inflation looks to have passed its low point in each of the four largest 'advanced' economies – and is picking up in Asia, too

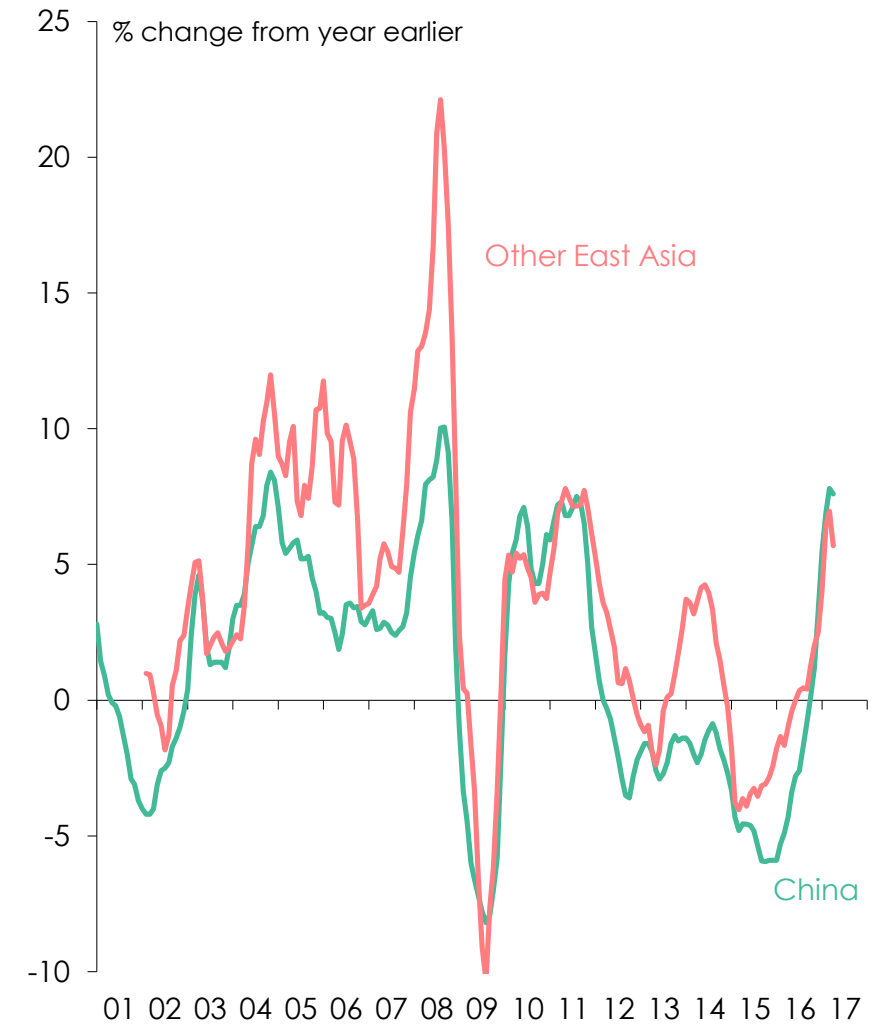
## Wage inflation – four largest 'advanced' economies



## 'Core' CPI inflation – four largest 'advanced' economies

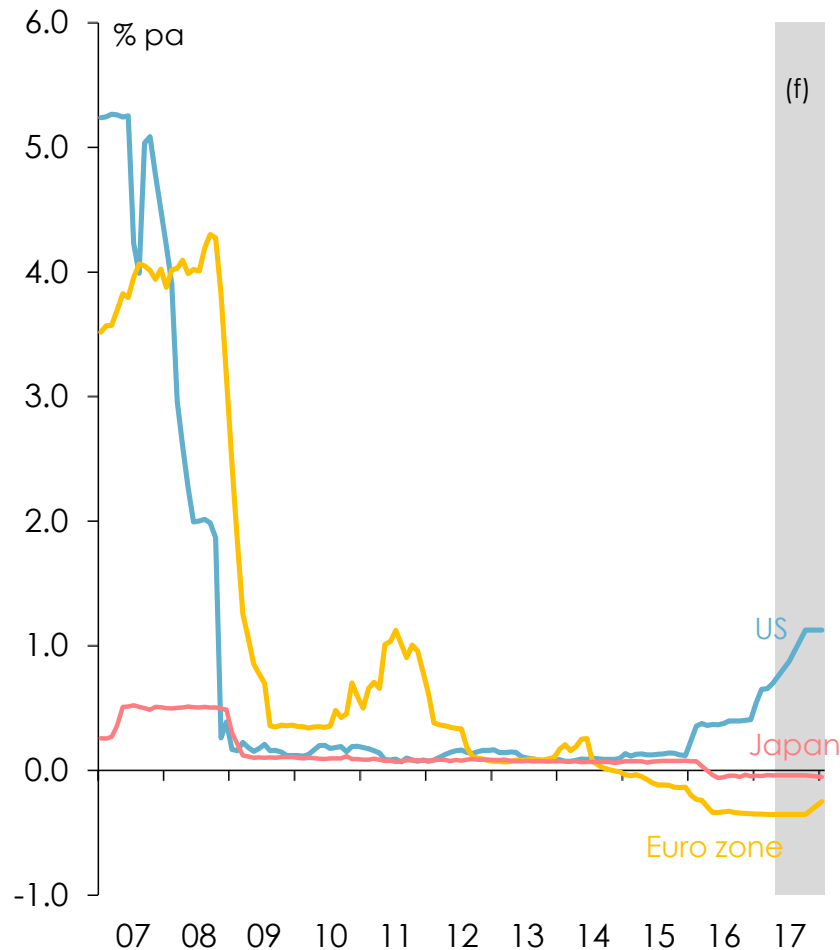


## Asian producer prices

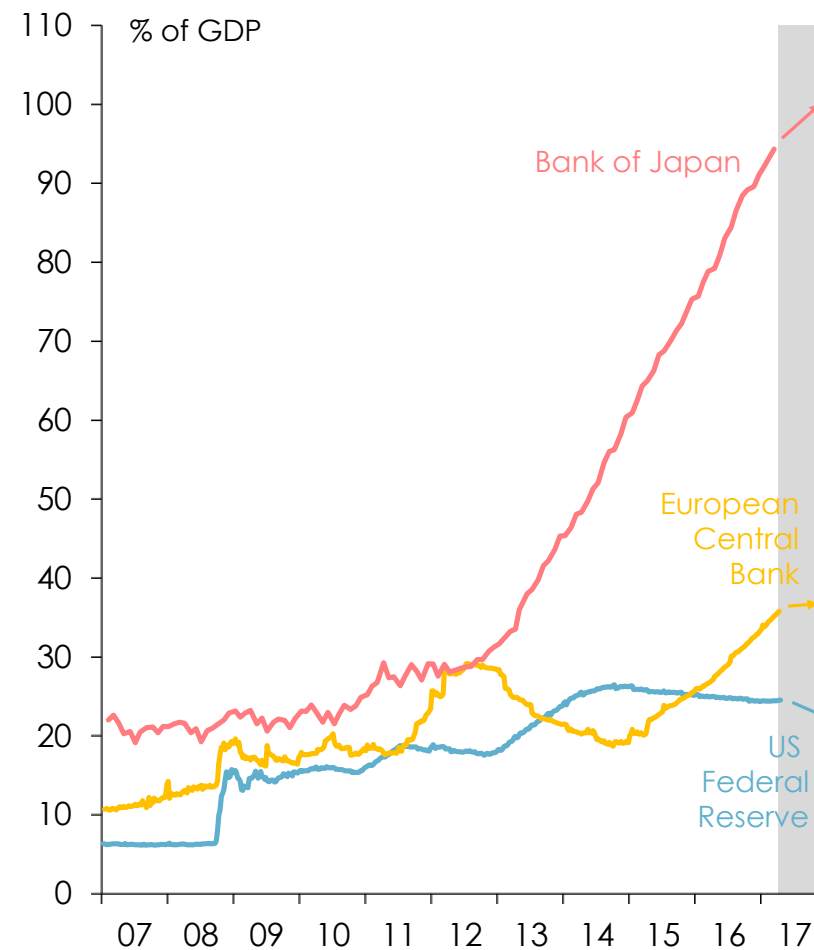


# So the long down-trend in interest rates has come to an end – as bond markets began to sense from the middle of last year

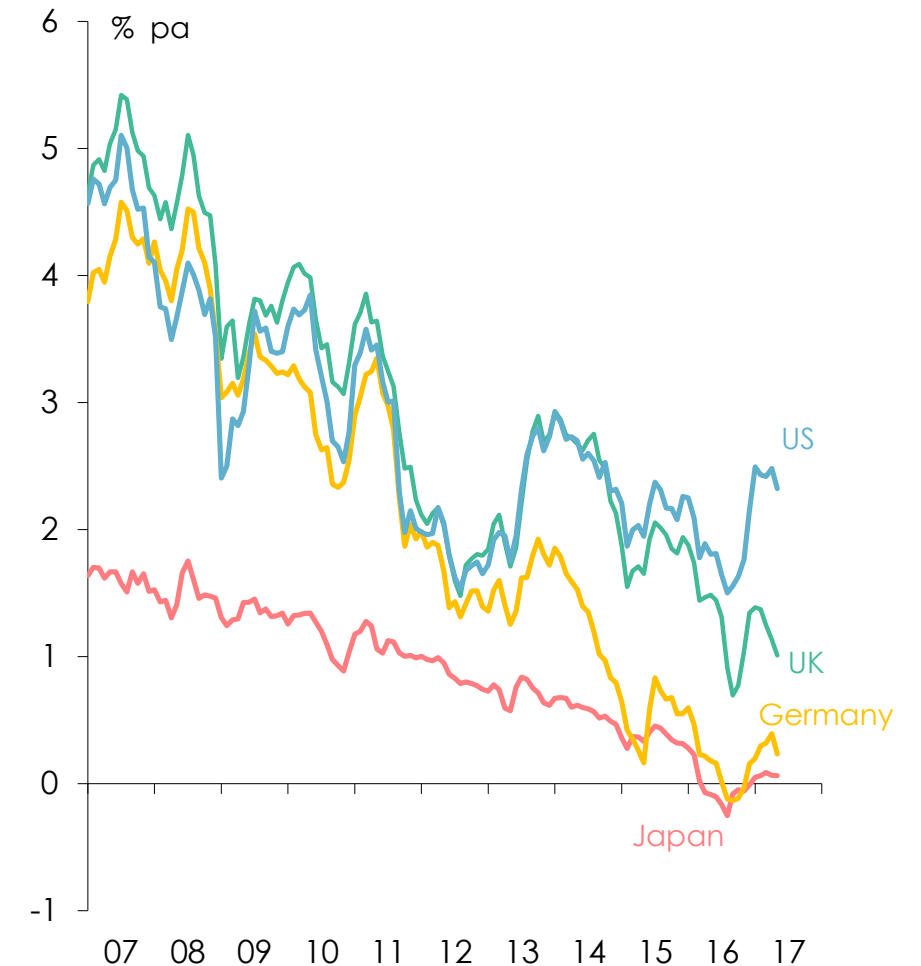
## Major central bank policy interest rates



## Major central bank balance sheets



## 10-year bond yields



Source: Thomson Reuters Datastream; US Federal Reserve; European Central Bank; Bank of Japan.



# The Trump Administration's first 100 days haven't been a great success

## Lack of preparation

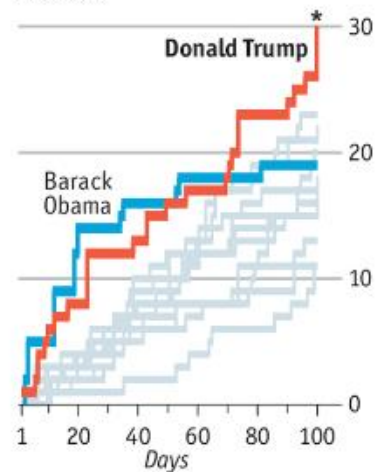
### Presidential appointments in the first 100 days

	Failed nominations	Confirmed	Sent but not yet confirmed	Average days to confirm
<b>D. Trump*</b>	3	27	41	30 days
B. Obama	3	69	118	24
G. W. Bush	0	35	50	8
B. Clinton	2	49	125	13
G. H.W. Bush	1	50	44	21

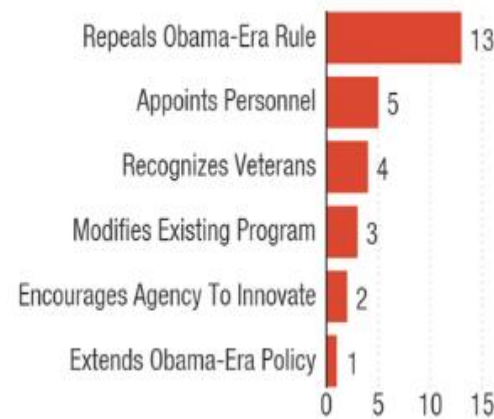
\*Totals include some posts that are not being tracked as 'key positions' in the appointee database. Trump data as of 3:30 p.m. on April 28, or 99 days into the presidency.

## Lack of legislative achievements

### Executive orders issued 1953-2017



### Types Of Laws Signed By Trump



## Lack of detail

**2017 Tax Reform for Economic Growth and American Jobs**

*The Biggest Individual And Business Tax Cut In American History*

**Goals For Tax Reform**

- Grow the economy and create millions of jobs
- Simplify our burdensome tax code
- Provide tax relief to American families—especially middle-income families
- Lower the business tax rate from one of the highest in the world to one of the lowest

**Individual Reform**

- Tax relief for American families, especially middle-income families:
  - Reducing the 7 tax brackets to 3 tax brackets of 10%, 25% and 35%
  - Doubling the standard deduction
  - Providing tax relief for families with child and dependent care expenses
- Simplification:
  - Eliminate targeted tax breaks that mainly benefit the wealthiest taxpayers
  - Protect the home ownership and charitable gift tax deductions
  - Repeal the Alternative Minimum Tax
  - Repeal the death tax
- Repeal the 3.8% Obamacare tax that hits small businesses and investment income

**Business Reform**

- 15% business tax rate
- Territorial tax system to level the playing field for American companies
- One-time tax on trillions of dollars held overseas
- Eliminate tax breaks for special interests

**Process**

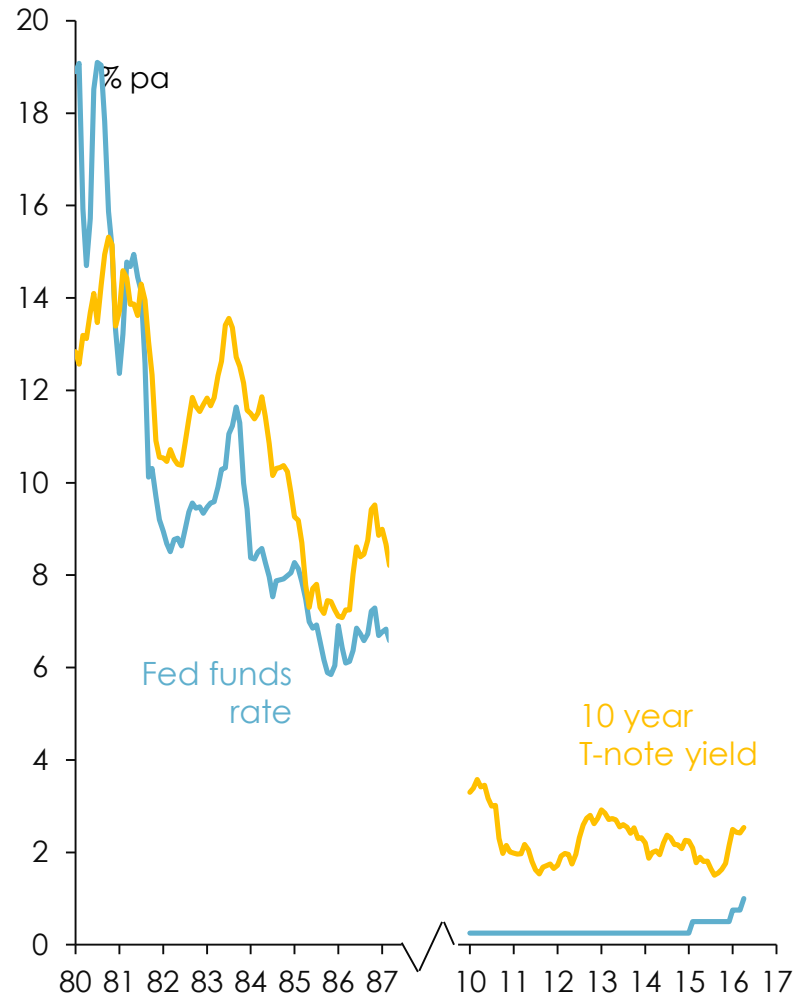
- Throughout the month of May, the Trump Administration will hold listening sessions with stakeholders to receive their input and will continue working with the House and Senate to develop the details of a plan that provides massive tax relief, creates jobs, and makes America more competitive—and can pass both chambers.

## Mixed record on promises

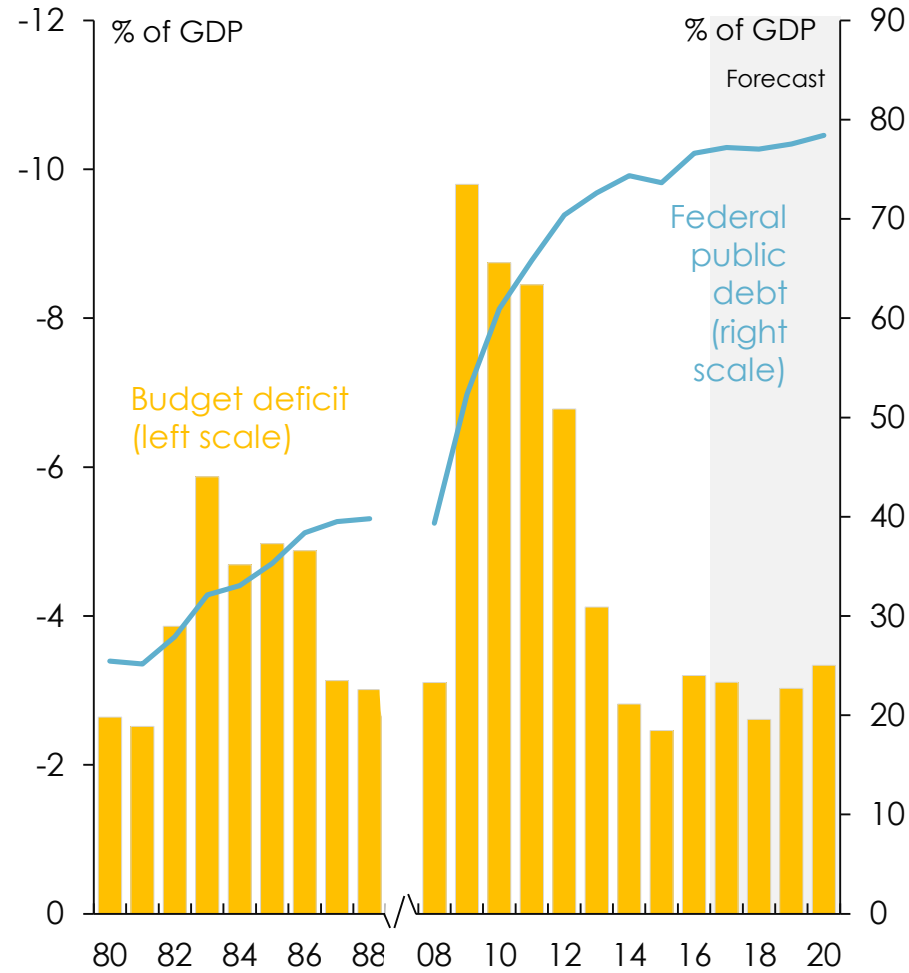
- Conservative judge appointed to US Supreme Court
- Significant changes in environmental regulation
- Failed to repeal 'Obamacare'
- So far hasn't done much on trade
  - Has withdrawn from TPP
  - Intentions re NAFTA unclear
  - Backed away from labelling China a 'currency manipulator' or imposing across-the-board tariffs on imports from China
  - Key trade policy personnel yet to be confirmed
- Appears to have reversed campaign position on 'foreign entanglements'
  - Military strikes on Yemen, Syria and Afghanistan
  - Possible action against North Korea
  - NATO 'relevant' after all
- Nothing thus far on infrastructure spending

# Three reasons why Trump's fiscal policies may not have the same impact on economic growth as Reagan's

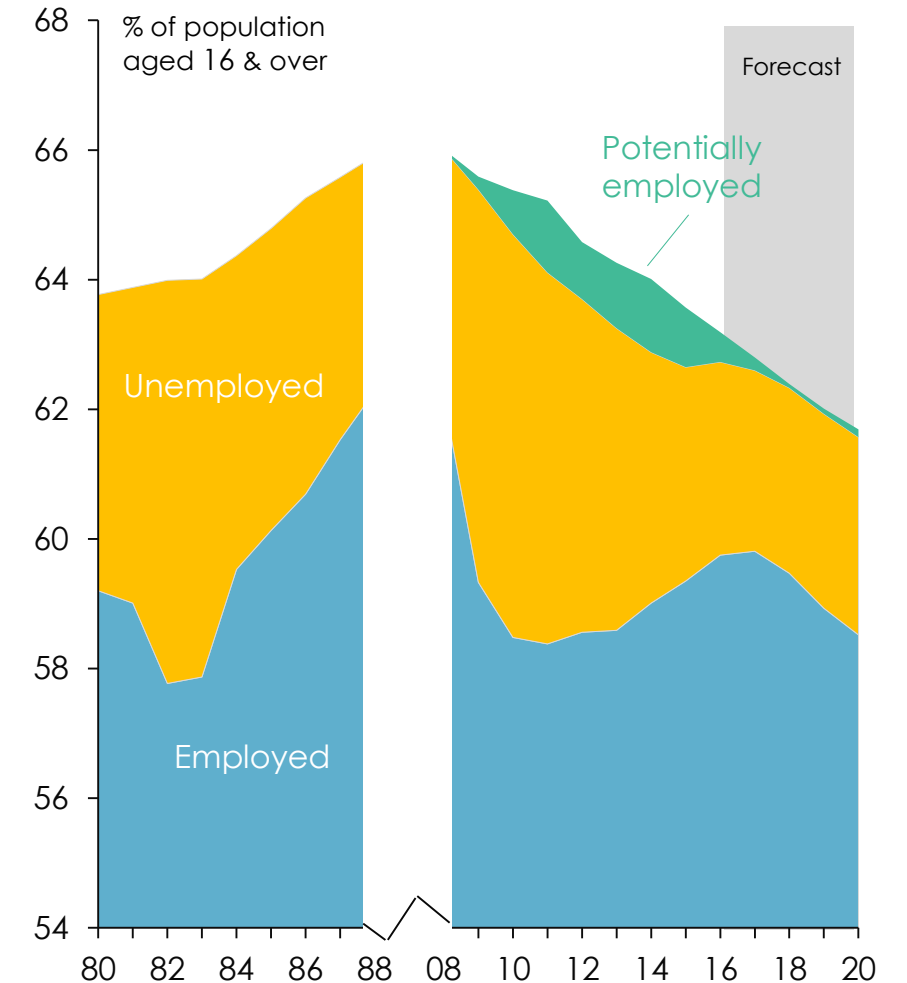
## Interest rates



## Federal budget and debt



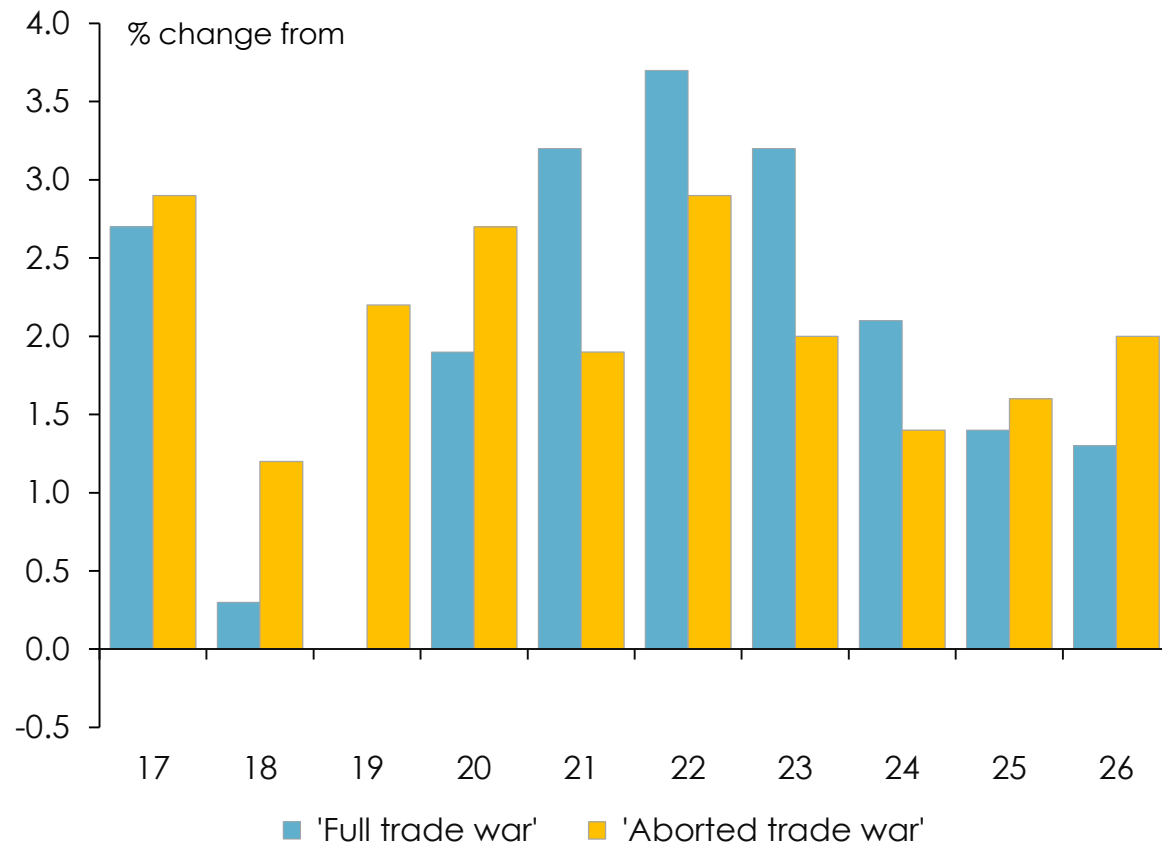
## Labour supply



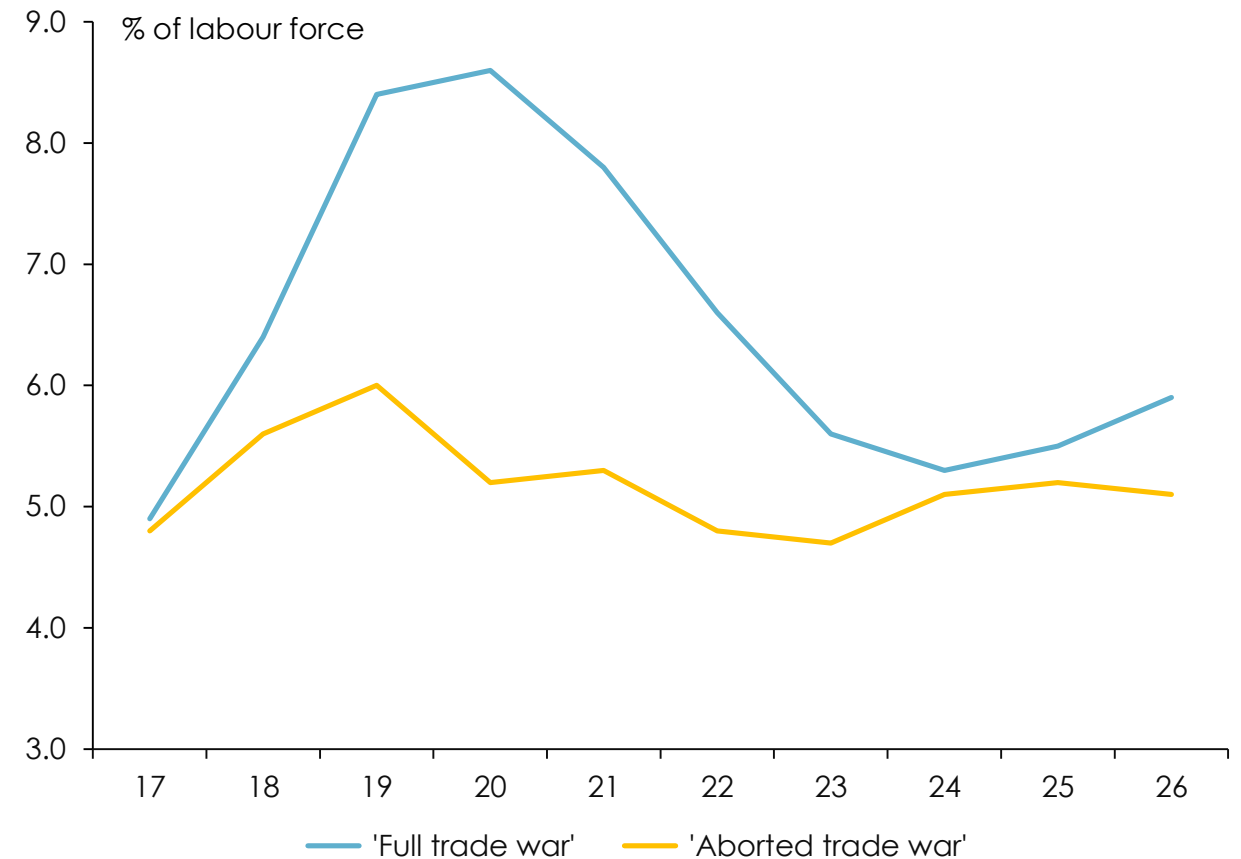
Sources: US Federal Reserve; US Congressional Budget Office.

# A full-blown 'trade war' would send the US economy into recession

## Simulated changes in US real GDP under 'trade war' scenarios



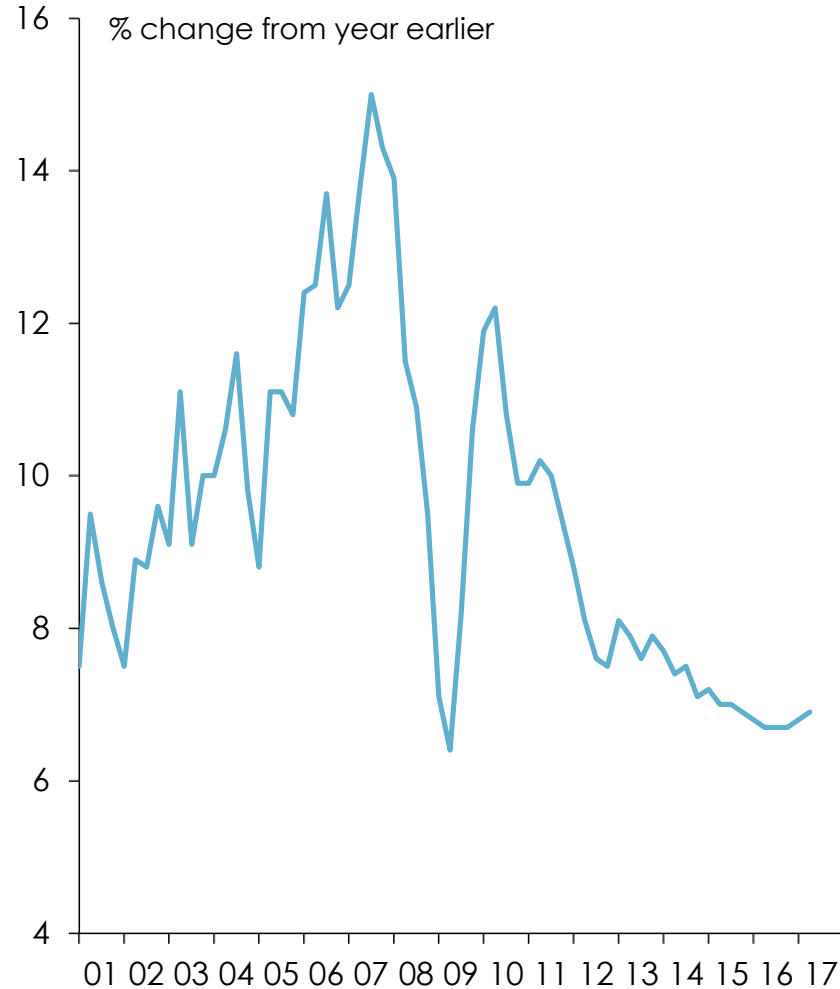
## Simulated levels of US unemployment under 'trade war' scenario



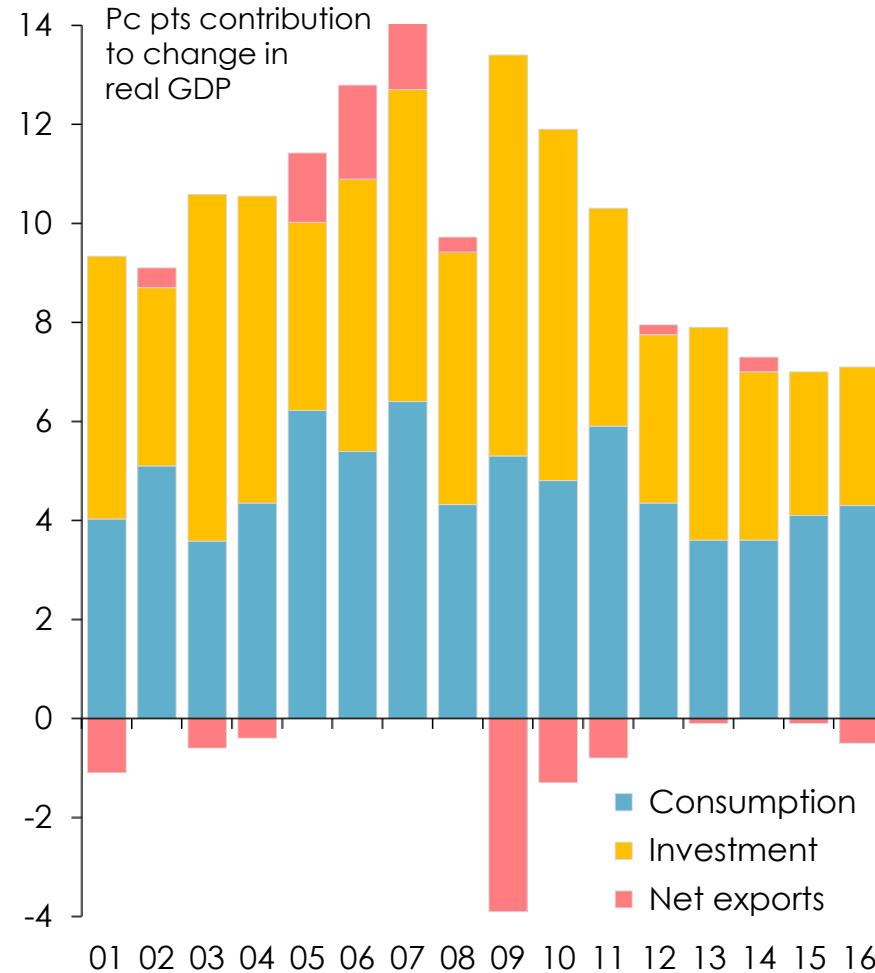
Note: 'full trade war' scenario assumes US imposes 45% tariff on non-oil imports from China and 35% on non-oil imports from Mexico, and China & Mexico impose similar tariffs on imports from US. 'Aborted trade war' assumes US tariffs are imposed for only a single year, because China and Mexico concede to US demands, the US Congress overturns the action, or President Trump loses in the courts, or the public outcry is such that the administration is forced to stand down  
 Source: Marcus Noland, Sherman Robinson and Tyler Moran, 'Impact of Clinton's and Trump's Trade Policies, in Peterson Institute for International Economics, Briefing 16-6, ['Assessing Trade Agendas in the US Presidential Campaign'](#), September 2016.

# China's growth has slowed a lot; it's no longer driven by net exports; and it isn't running big current account surpluses any more

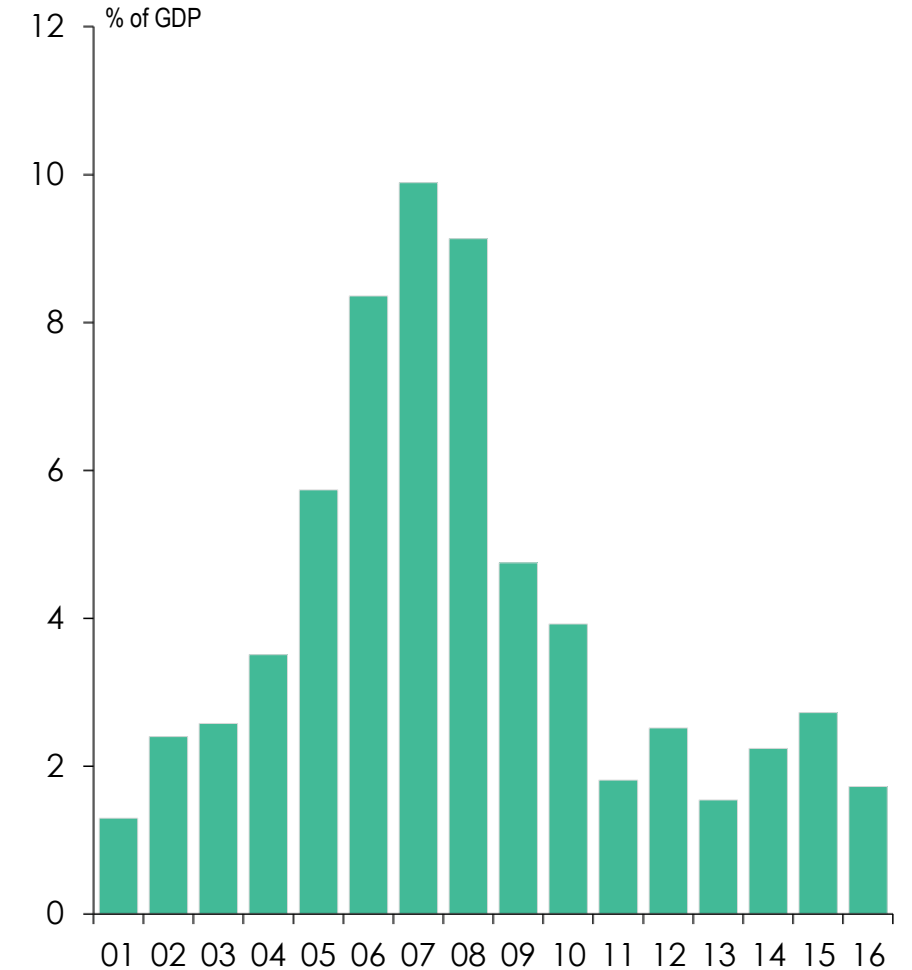
## China real GDP growth



## Contributions to Chinese real GDP growth



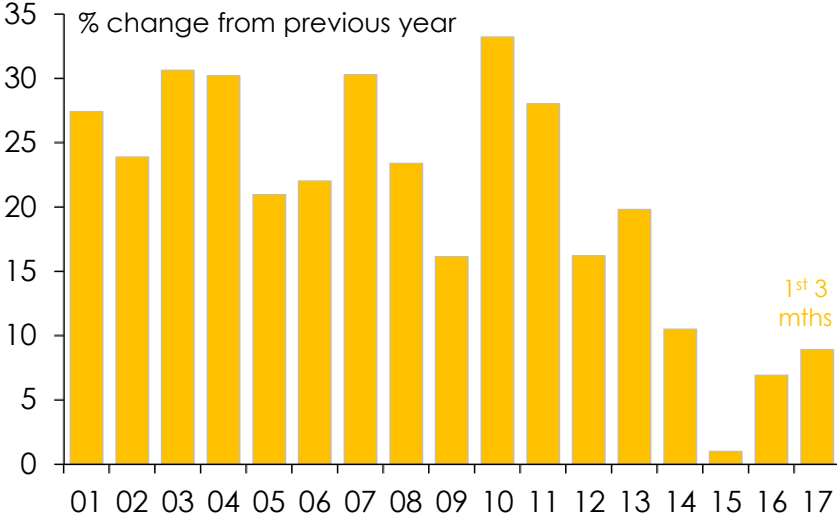
## Chinese current account surplus



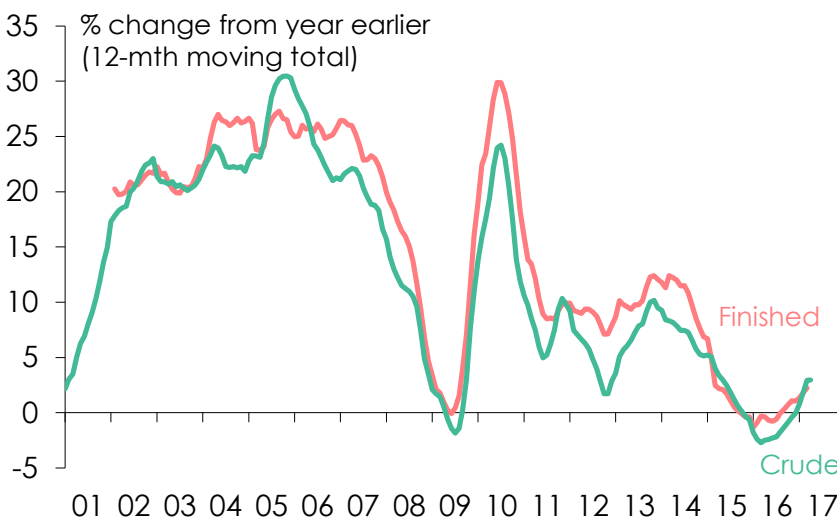
Source: China National Bureau of Statistics.

# The monetary stimulus which revived China's property sector last year now seems to have been partially withdrawn

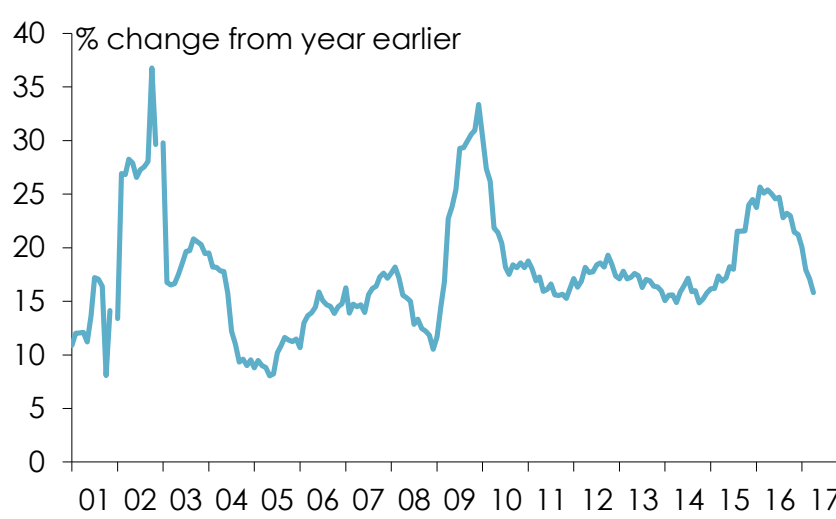
## Real estate investment



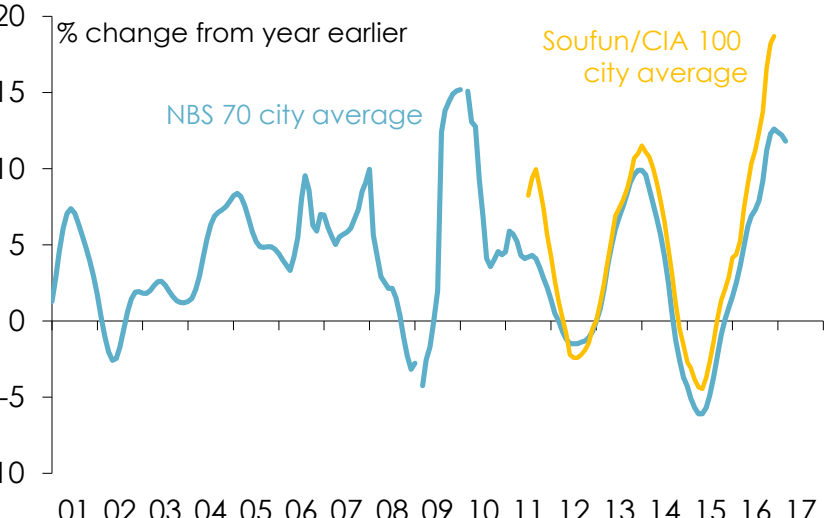
## Steel production



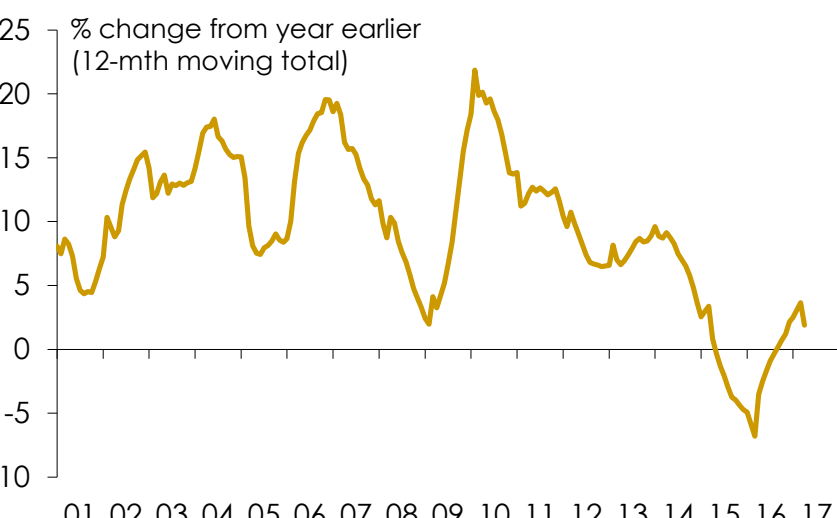
## Credit growth



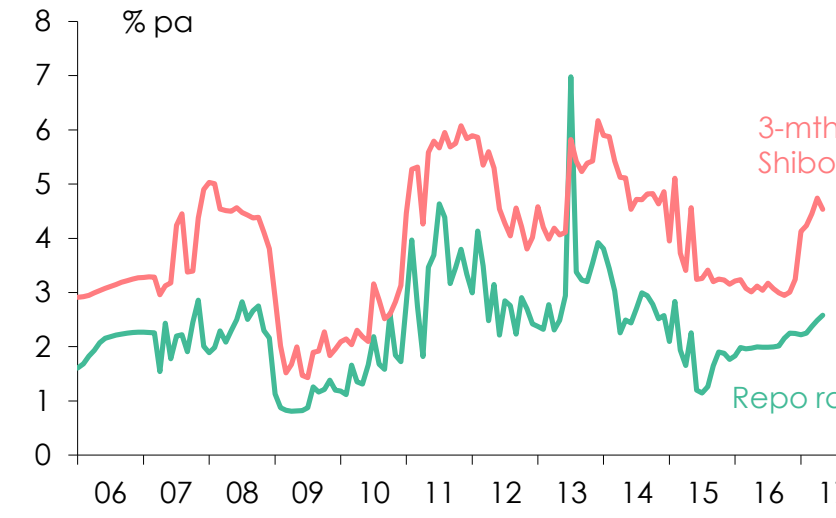
## Urban property prices



## Cement production



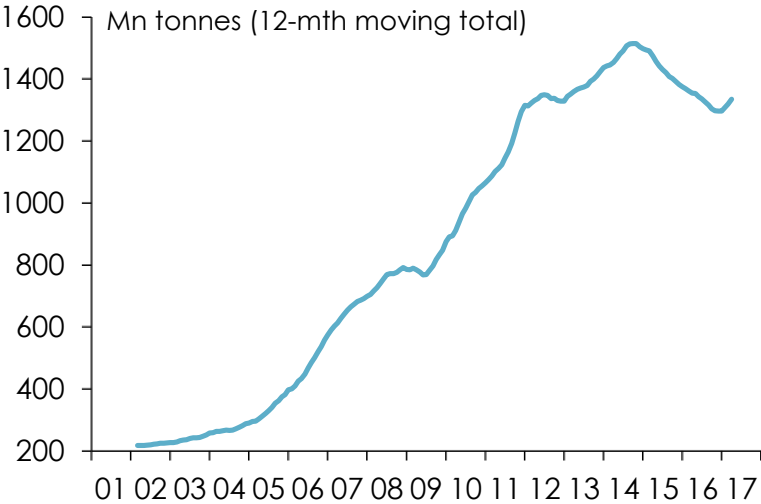
## Short term interest rates



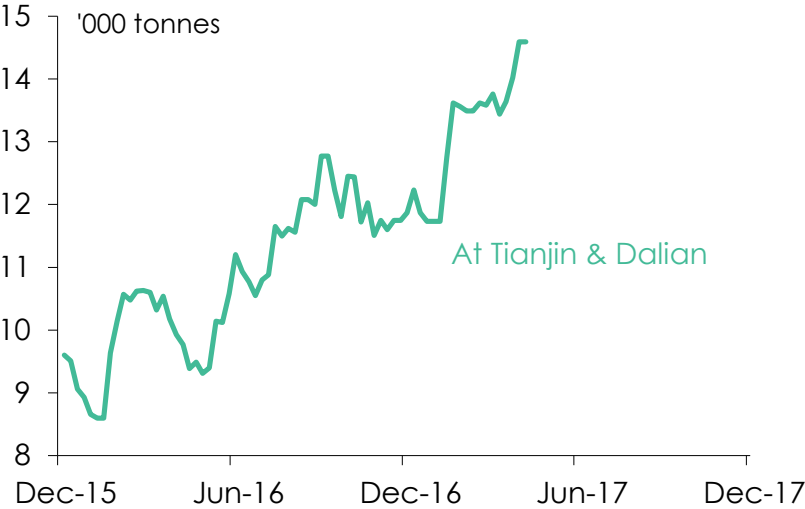
Sources: China National Bureau of Statistics; China Index Academy (CIA) & Soufun; People's Bank of China. Thomson Reuters Datastream.

# So the 'mini-boom' in iron ore prices now seems to be over

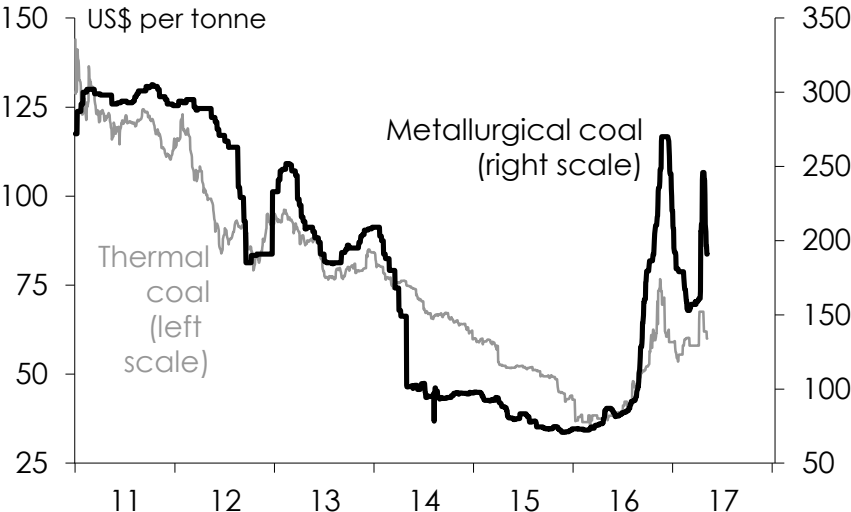
## Chinese iron ore production



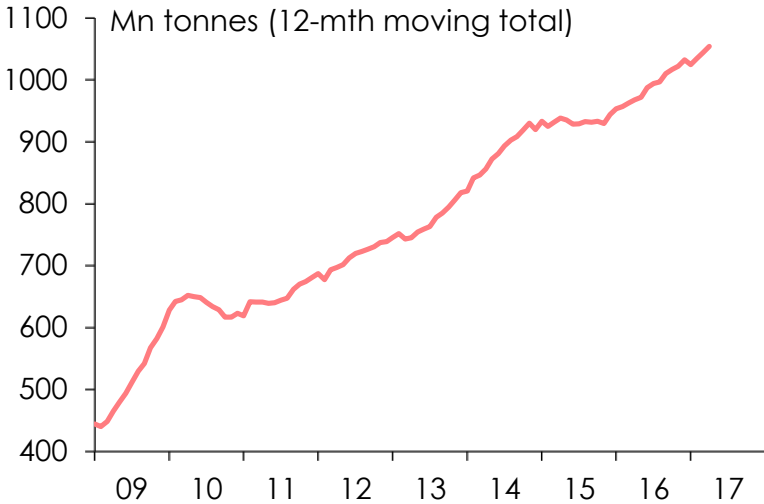
## Chinese iron ore inventories



## Coal spot prices



## Chinese iron ore imports



## Iron ore spot prices

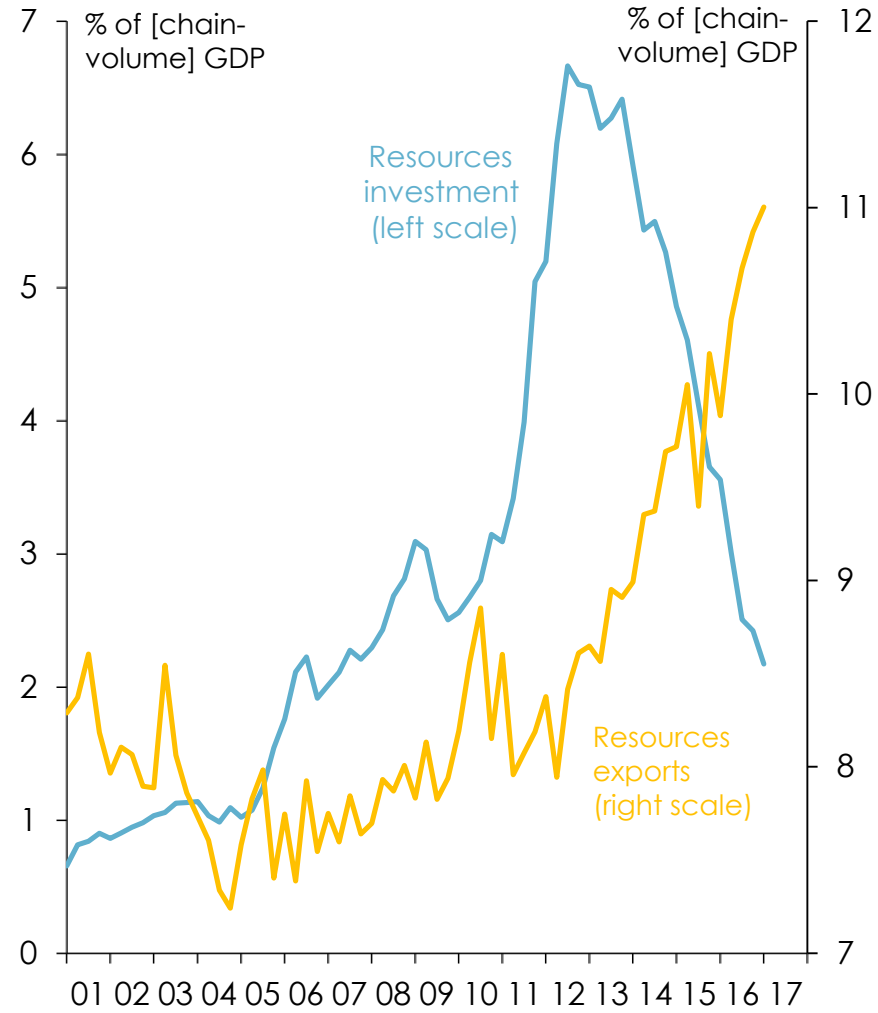


Sources: China National Bureau of Statistics; China Customs Information Centre; Thomson Reuters Datastream.

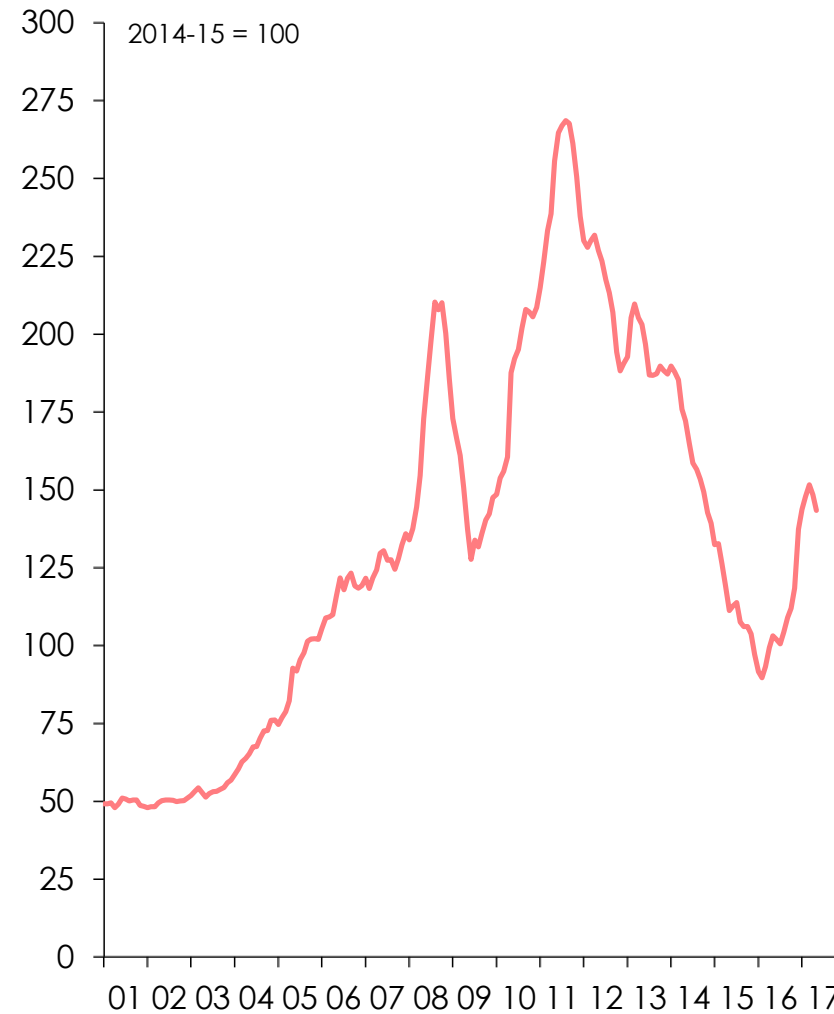
# The Australian economic context

# The resources investment boom is over – but the rebound in commodity prices has pushed Australia’s trade balance back into surplus

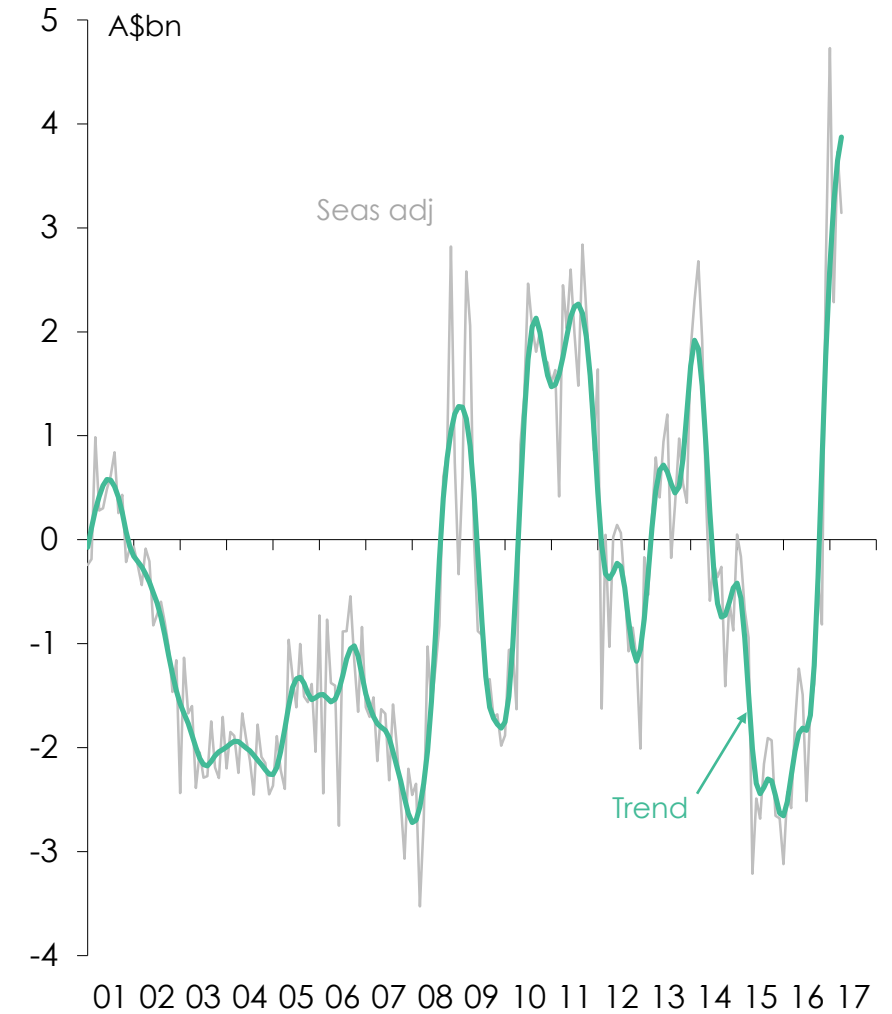
## Australia’s resources investment & export volumes



## Australia’s resources export prices



## Australia’s merchandise trade balance

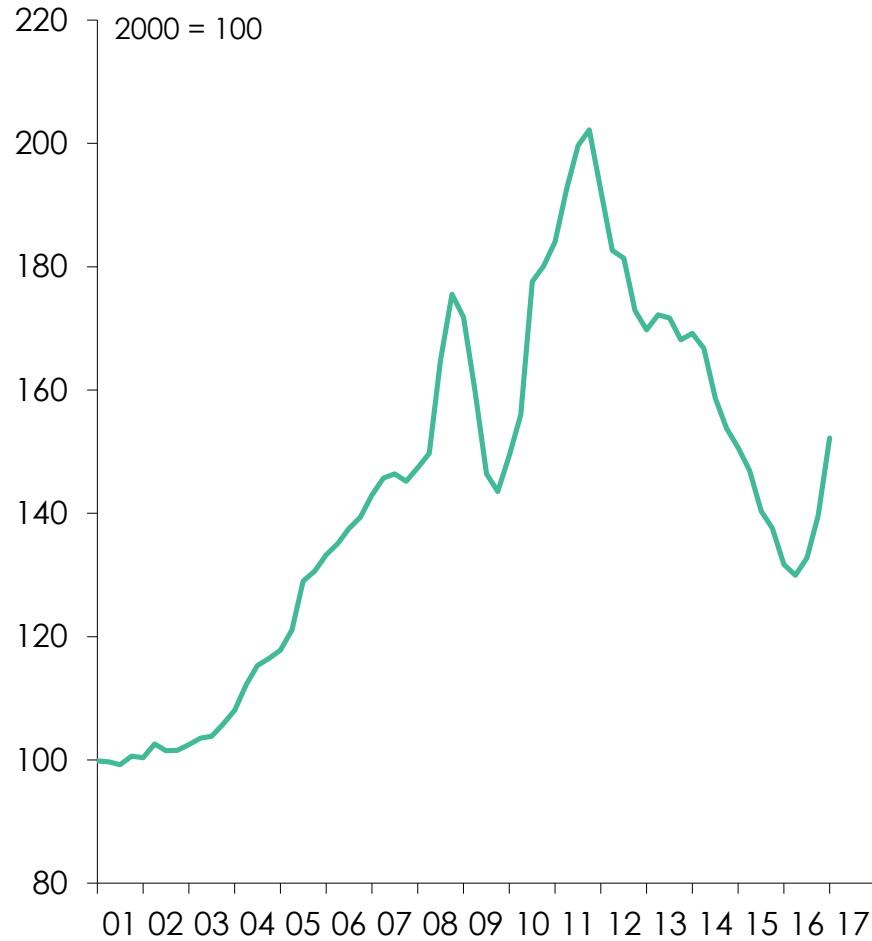


Note: Resources investment includes exploration expenditure.  
Sources: ABS; RBA.

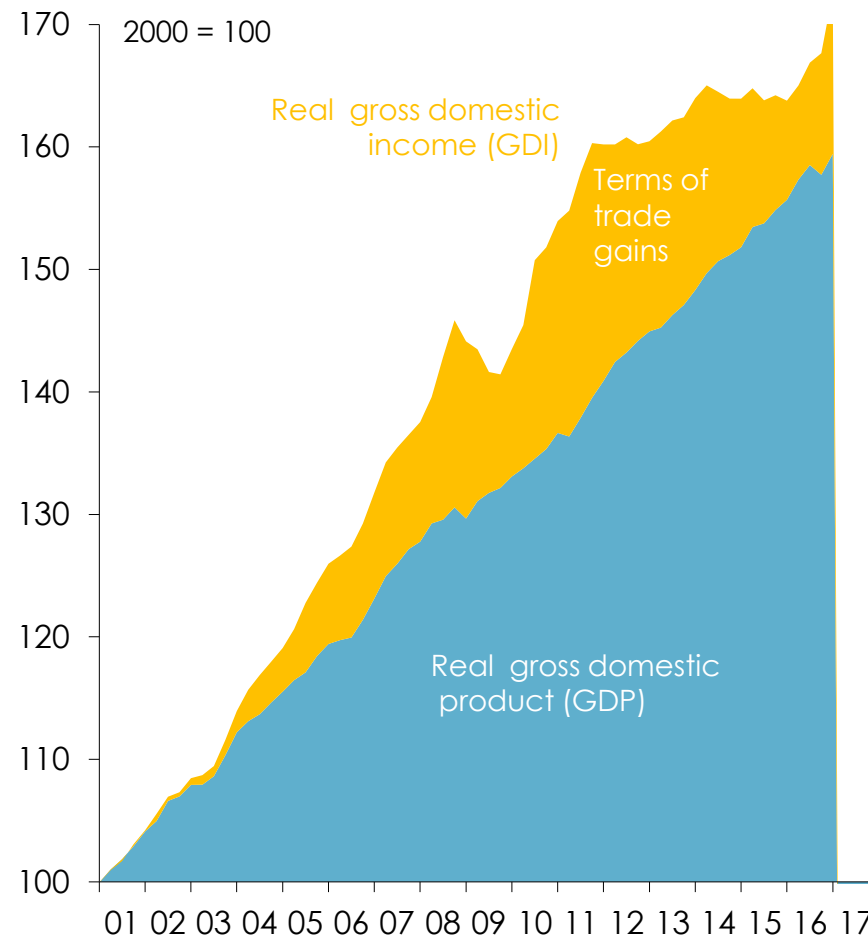


# The recent rebound in commodity prices has provided a boost to national income – but it isn't going to last

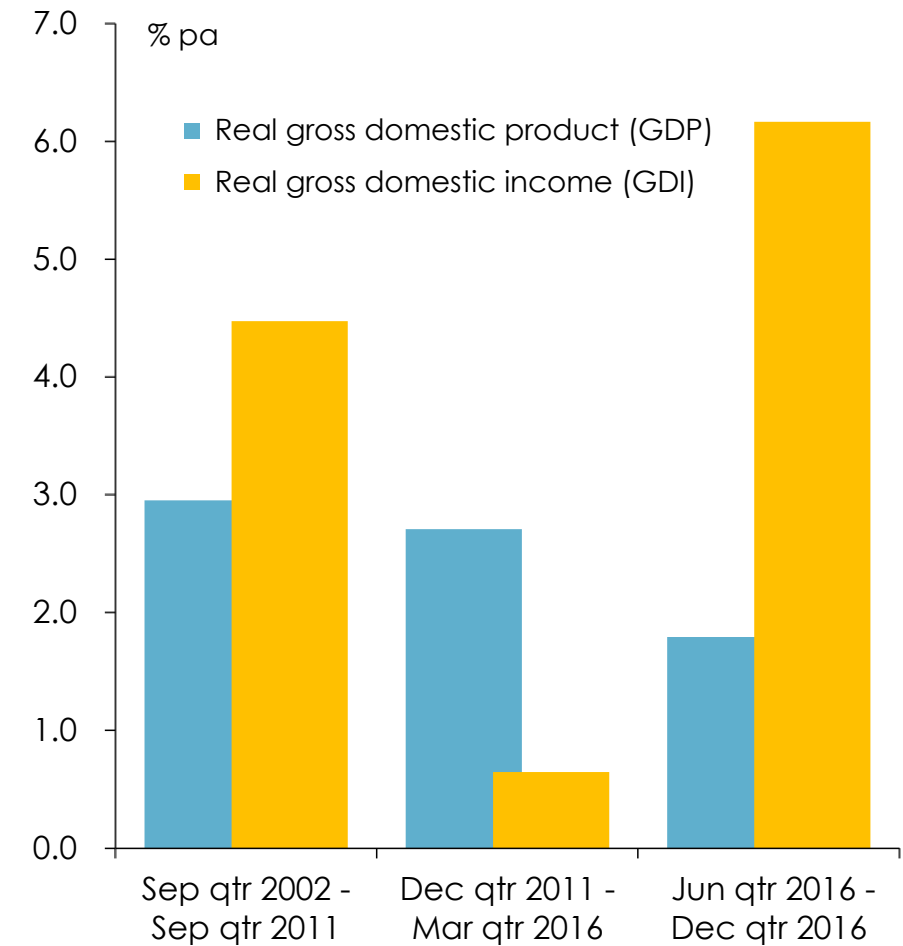
## Australia's terms of trade (ratio of export to import prices)



## Gains in real income arising from changes in the terms of trade



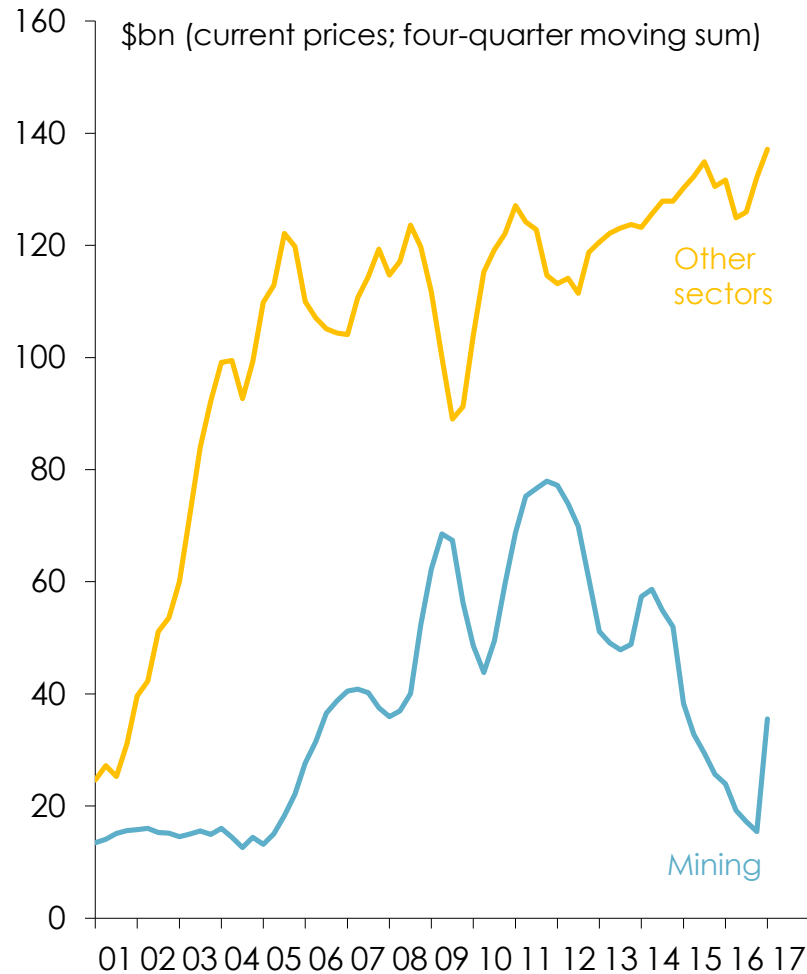
## Growth in real gross domestic income (GDI) vs real GDP



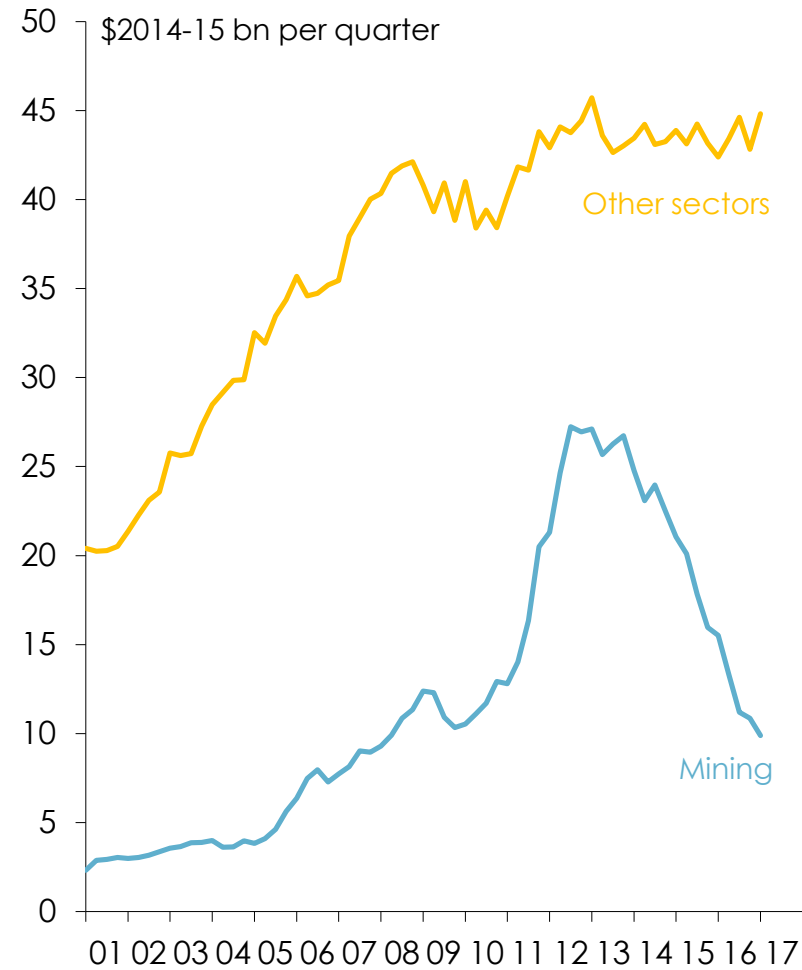
Note: 'The 'terms of trade' is the ratio of the implicit price deflator of exports of goods and services to the implicit price deflator of imports of goods and services. Real gross domestic income (GDI) is real gross domestic product (GDP) adjusted for income gains or losses arising from changes in the terms of trade. Source: ABS.

# Much of the recent uptick in national income growth has gone to profits – but that hasn't resulted in higher investment or employment

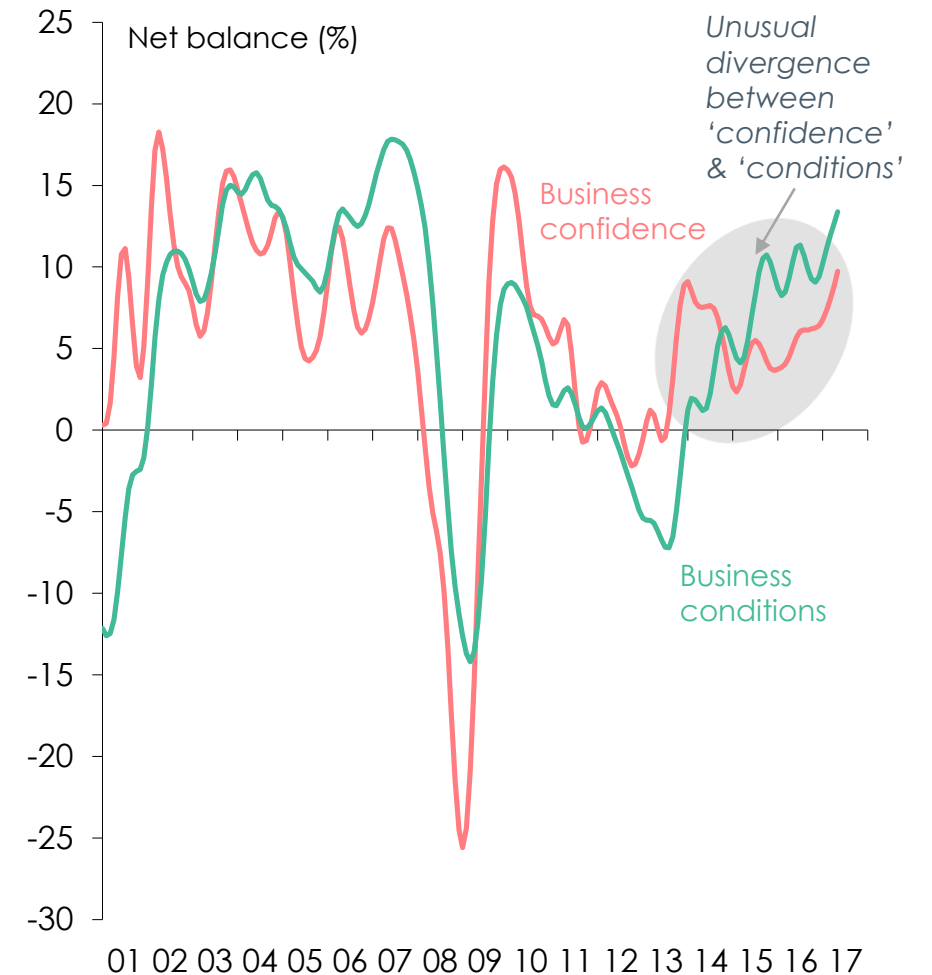
## Pre-tax company profits



## Business investment



## Business conditions and confidence

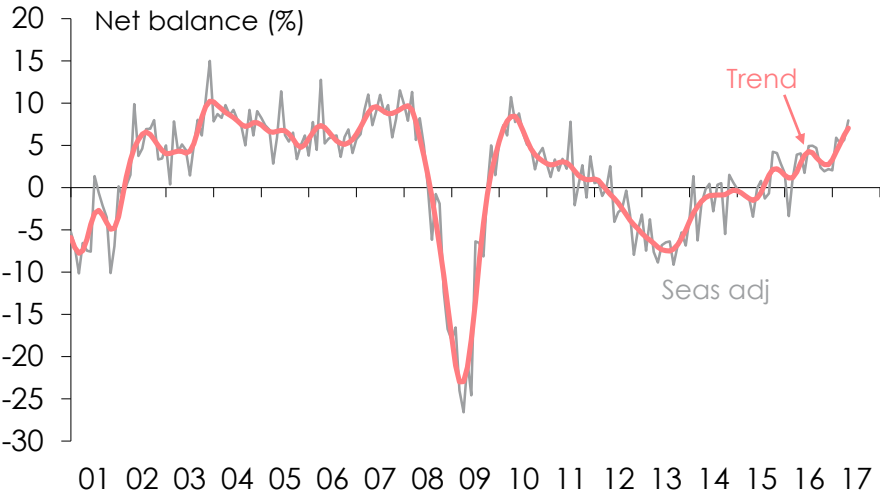


Note: 'Other sectors' in the company profits survey exclude banks and other deposit-taking intermediaries, insurance and super funds, education & training, and health care & social assistance. Mining investment includes buildings & structures and plant, equipment & machinery from the capex survey plus exploration expenditure; investment by 'other sectors' is the national accounts measure of total new business investment minus this estimate of mining investment.

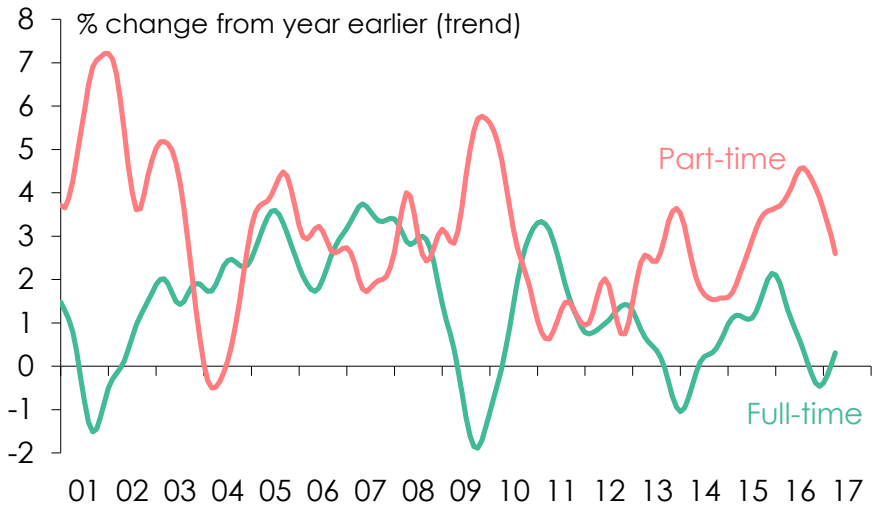
Sources: ABS; National Australia Bank [Monthly Business Survey](#).

# Employers are cautious about additional hiring, especially of full-time workers – and about granting wage increases

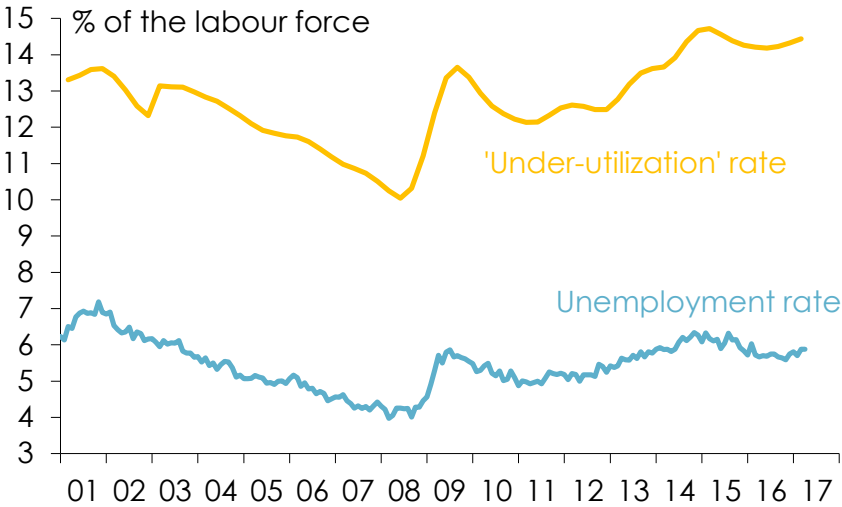
### Employer hiring intentions



### Full- vs part-time employment



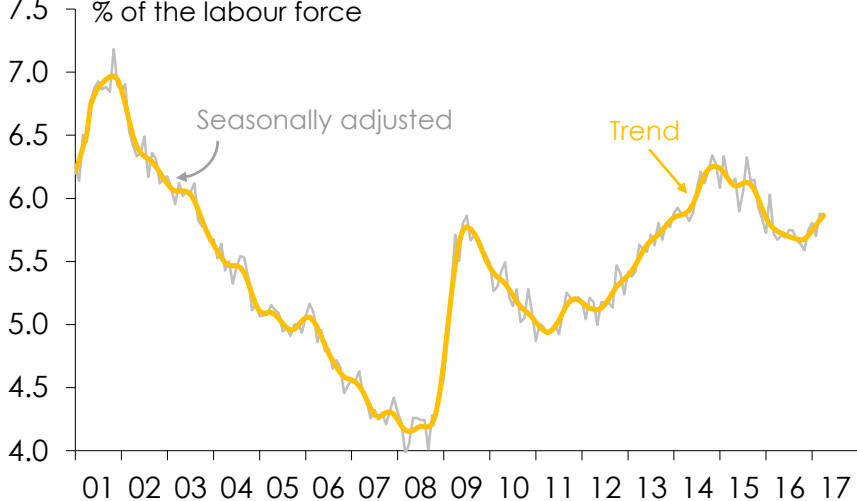
### Labour force under-utilization



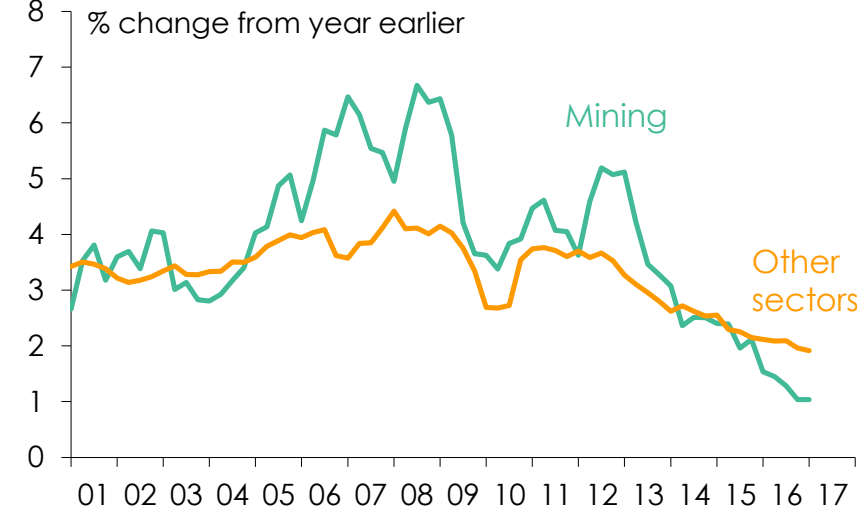
### Employment growth



### Unemployment rate

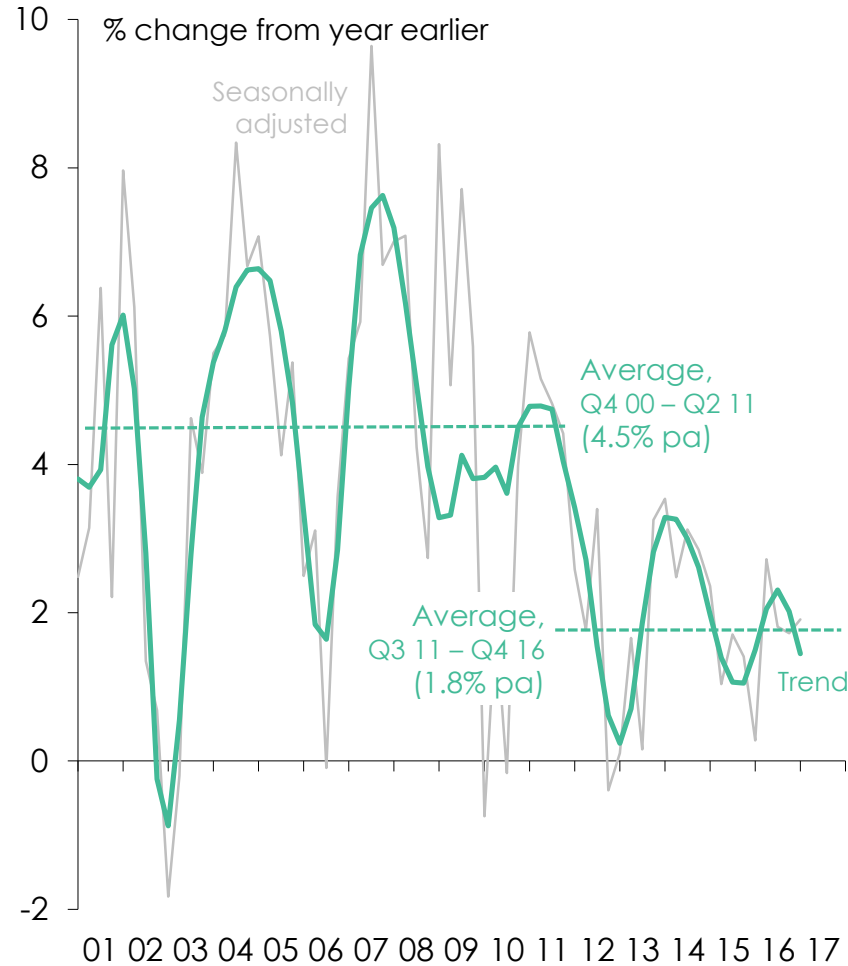


### Wage cost index

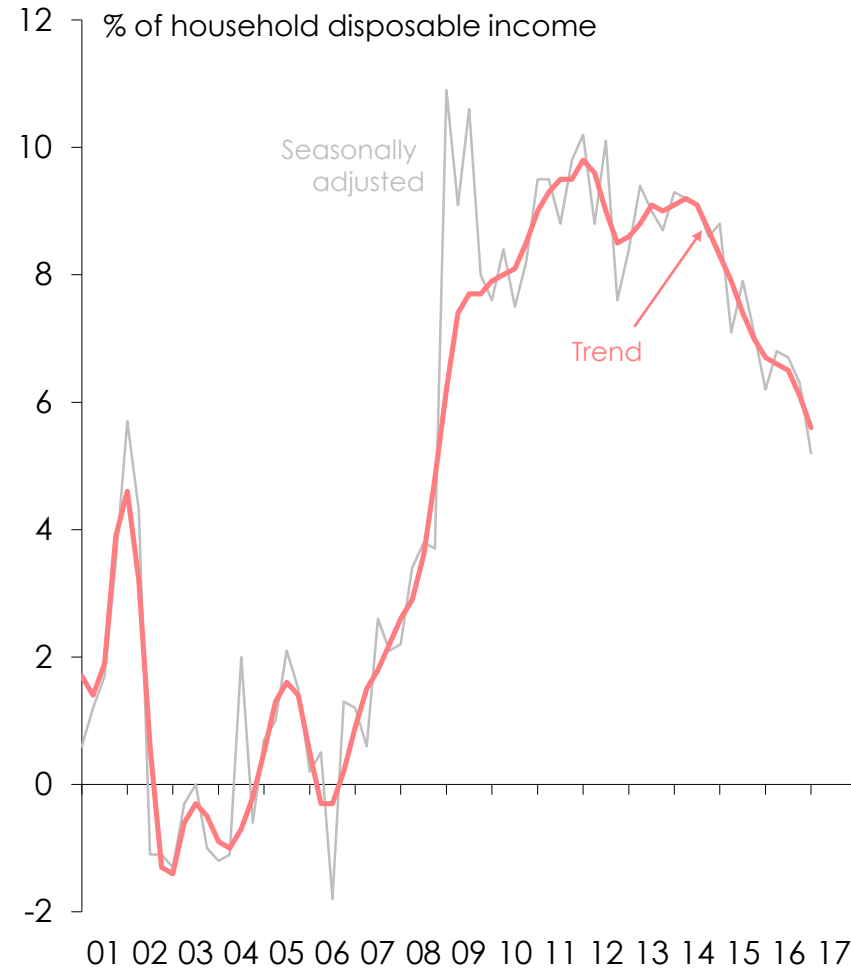


# Weak income growth and debt repayment continue to detract from growth in consumer spending

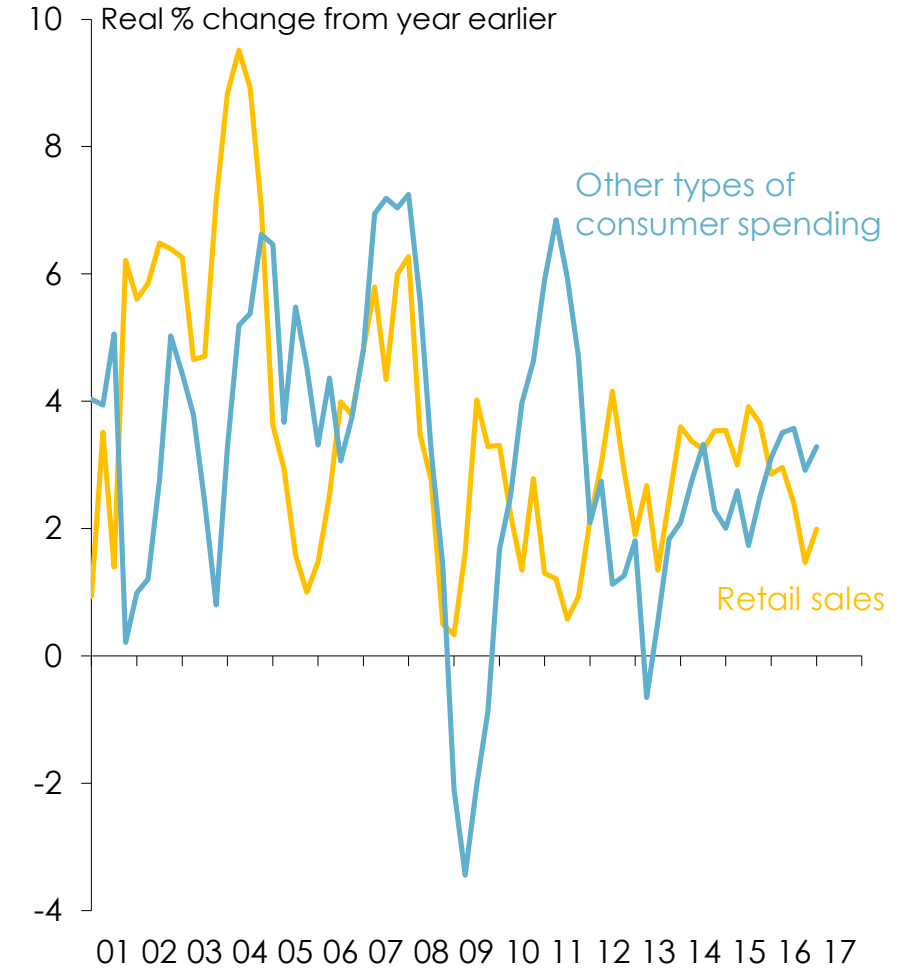
## Real household disposable income



## Household saving rate



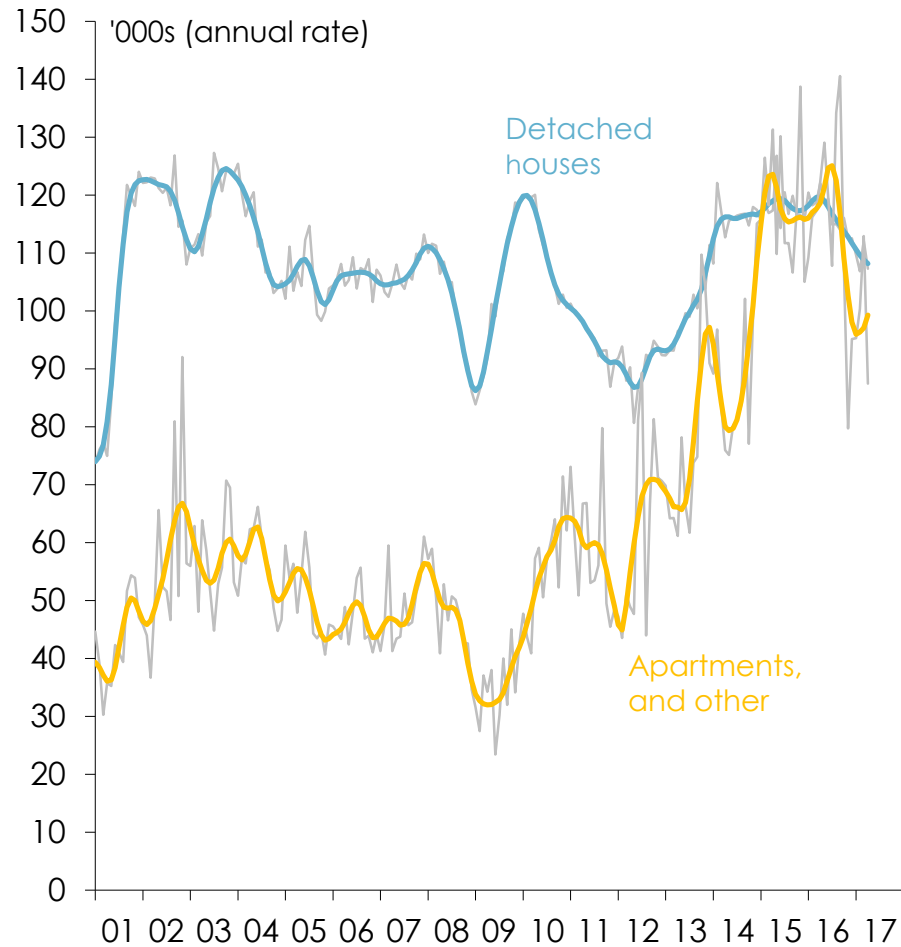
## Consumer spending



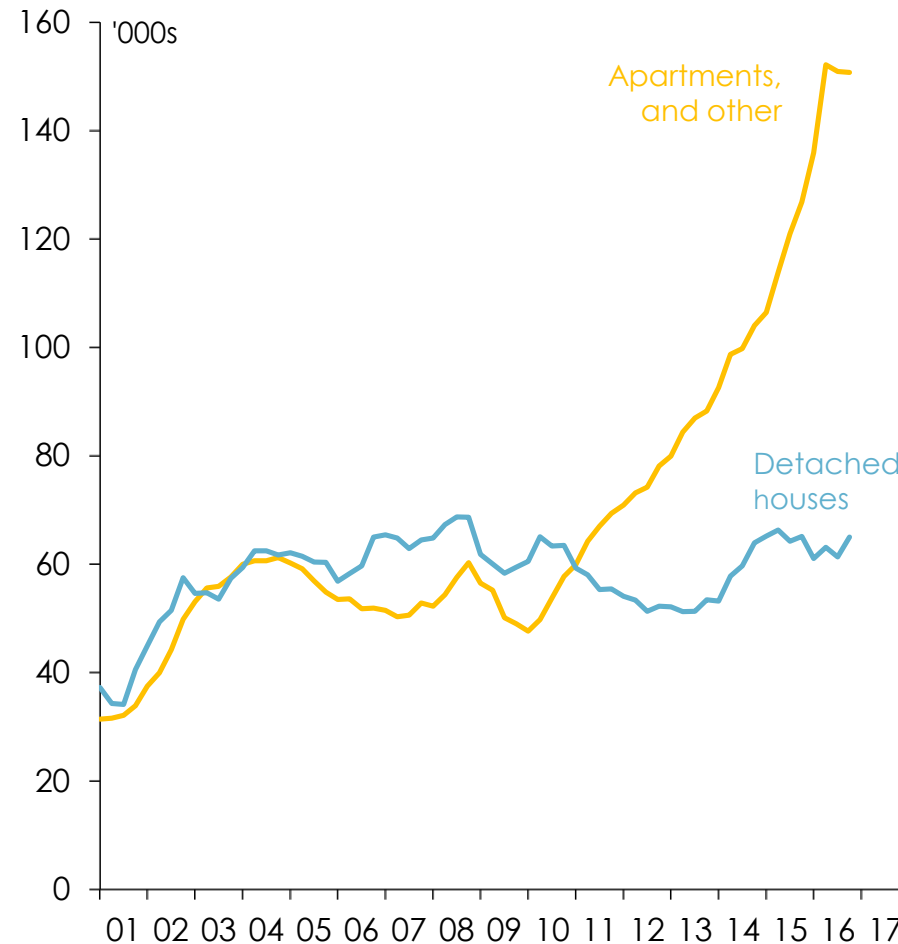
Source: ABS.

# Housing activity is probably close to peaking – although there is still a large ‘pipeline’ of work yet to be completed

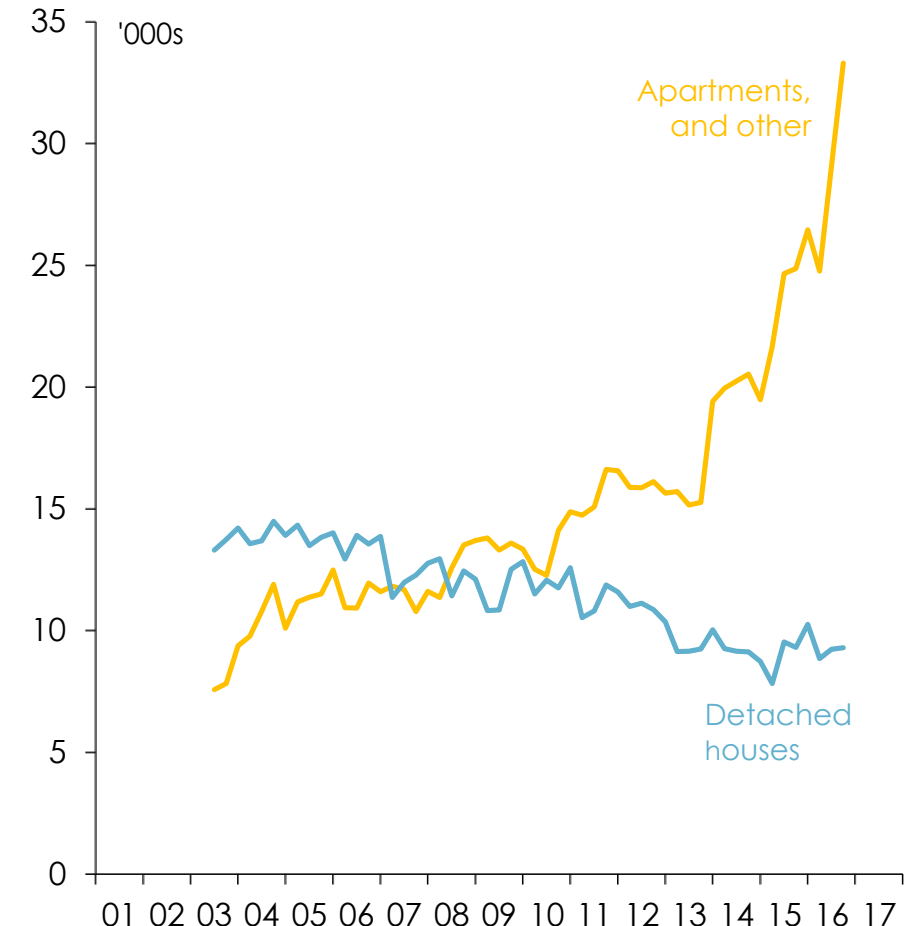
## Private residential building approvals, by type of dwelling



## Residential buildings under construction



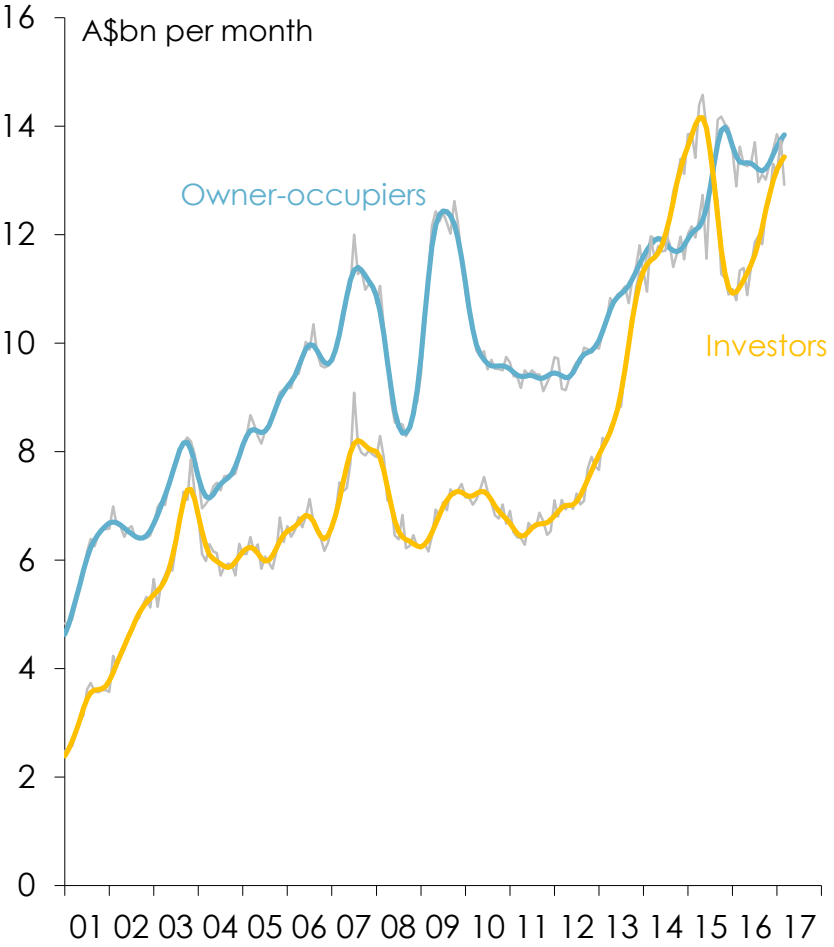
## Dwellings approved but not yet commenced



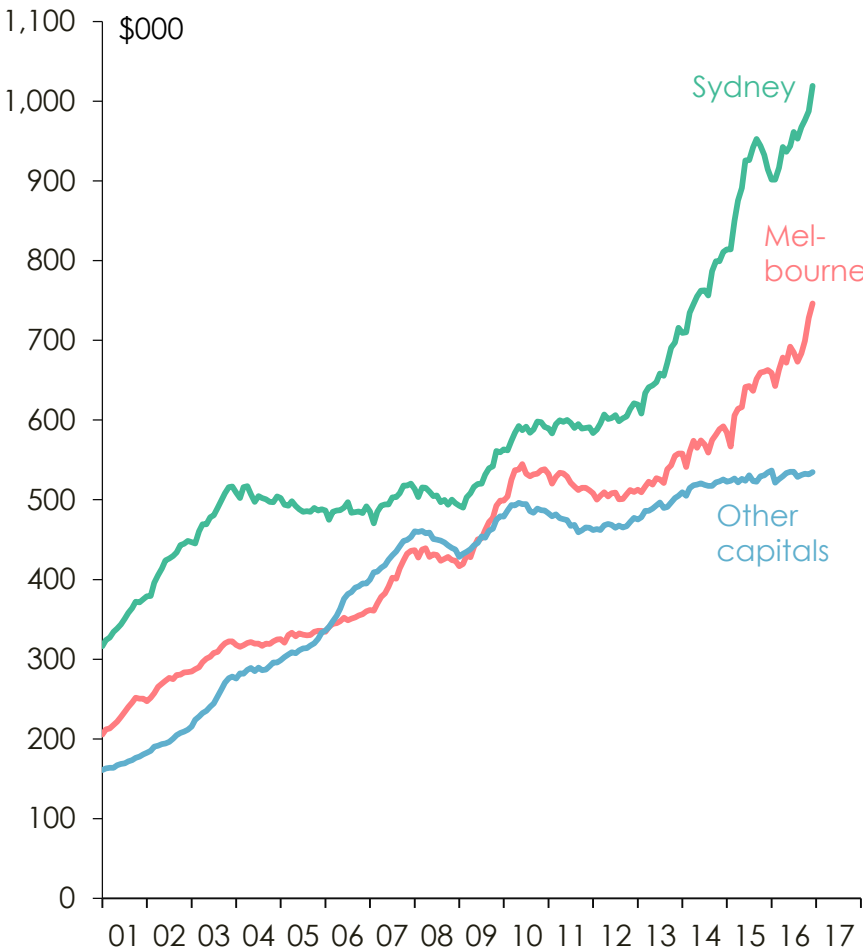
Note: grey lines in first chart above show seasonally adjusted data; thicker coloured lines are the ABS 'trend estimates'. Source: ABS.

# Rapid growth in demand (mainly for existing dwellings) from investors has pushed up prices and squeezed would-be home-buyers out

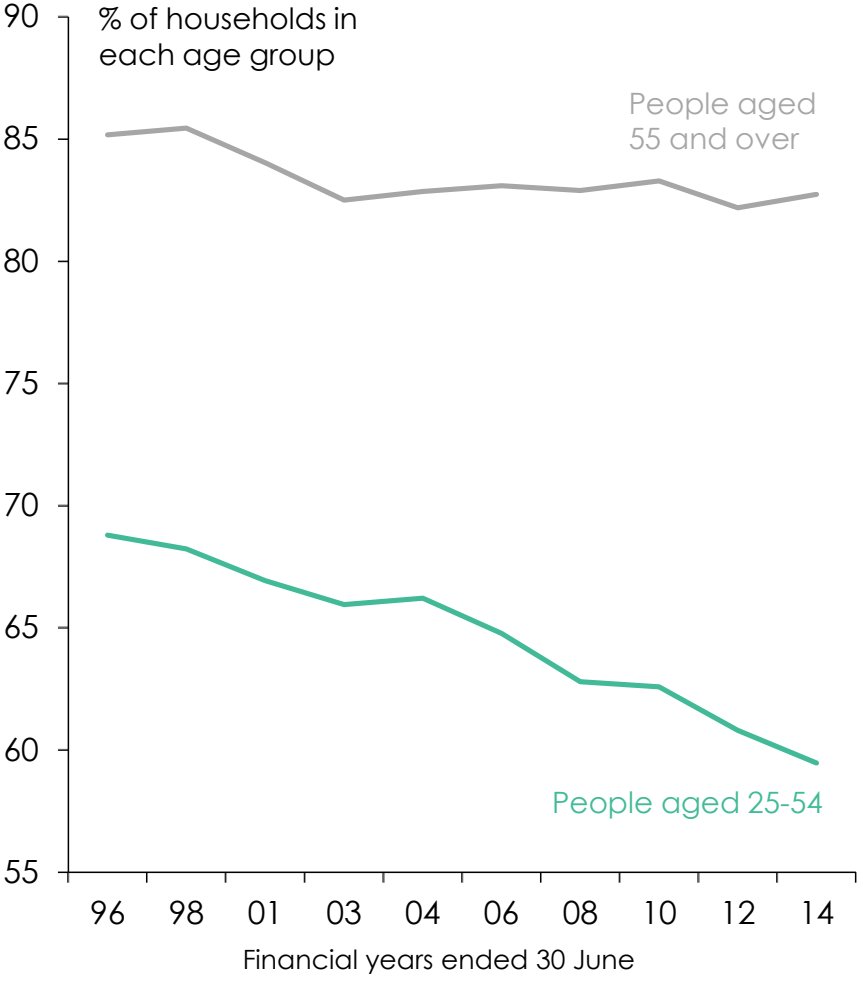
## Finance commitments for residential property purchases



## Capital city residential property prices



## Home ownership rates by age group



Note: grey lines in first chart above show seasonally adjusted data; thicker coloured lines are the ABS 'trend estimates'. Source: ABS.

# The 2017-18 Budget

# The 2017-18 Budget has two principal objectives

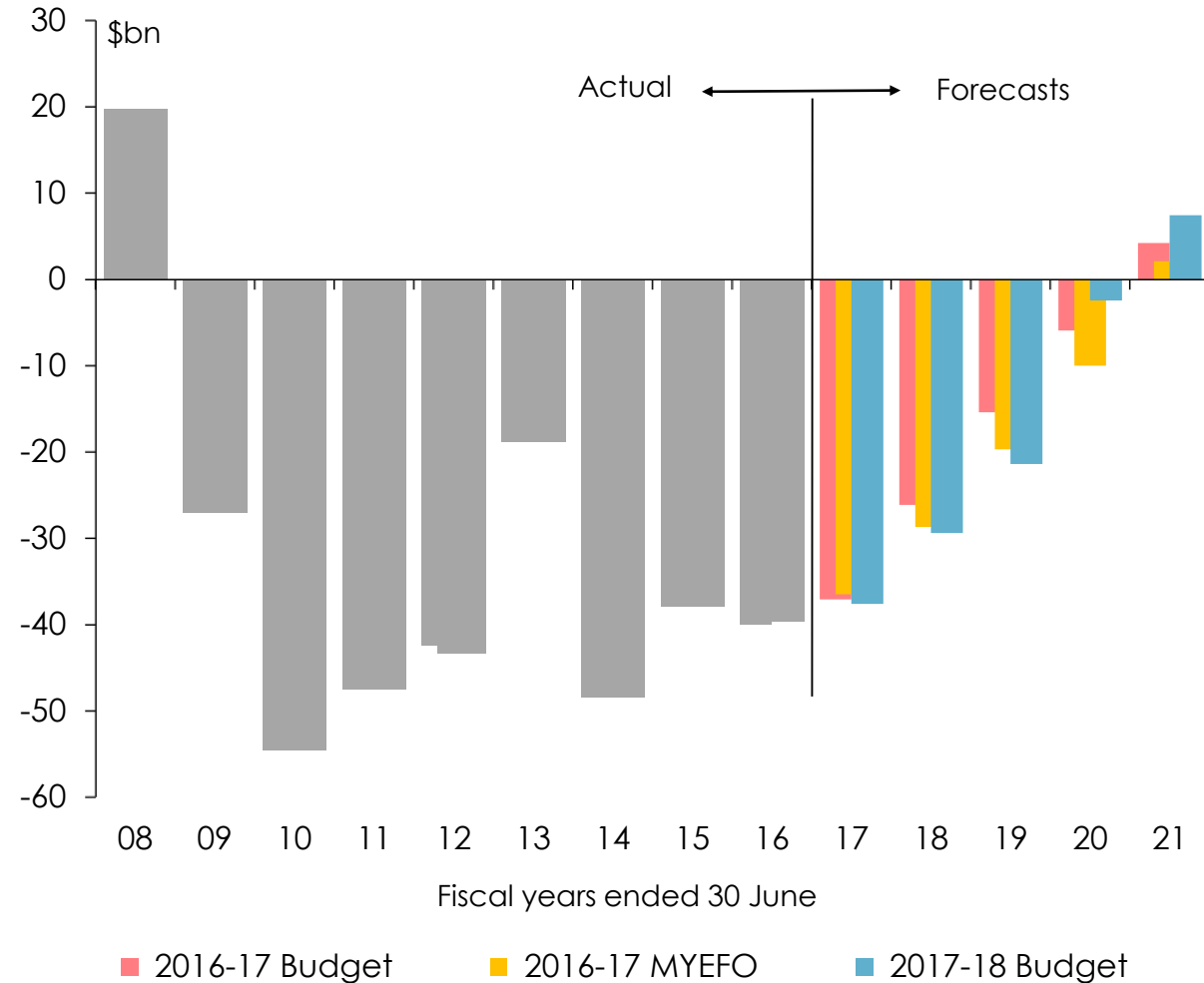
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- ❑ **To put as much distance as possible between the current Government and its predecessor (the Abbott Government, not the Rudd-Gillard Governments)**
  - hence the abandonment of the so-called 'zombie' measures left over from the 2014 Budget, which both the Abbott and Turnbull Governments had been unable to get through the Senate
  - instead the path back to surplus is to be achieved with less reliance on spending cuts and more reliance on revenue increases
  - and a way has been cleared for the Government to accept the advice of the RBA, IMF, and OECD (among others) that borrowing for 'well-chosen' infrastructure projects can be a 'Good Thing', especially when monetary policy has reached the limits of what it can do
  
- ❑ **To neutralize as many of the Opposition's "lines of attack" on the Government as possible, ahead of an election that must be called some time between August 2018 and May 2019**
  - hence the levy on and increased regulation of banks, the tax on employers of temporary foreign workers, new taxes on foreign property investors, etc.
  - hence the efforts to 'guarantee' funding for Medicare and the NDIS, and 'Gonski 2.0'
  - the only significant points of difference on key aspects of economic policy now are negative gearing and the CGT discount, the tax cut for companies with turnover exceeding \$10mn, and the banking royal commission

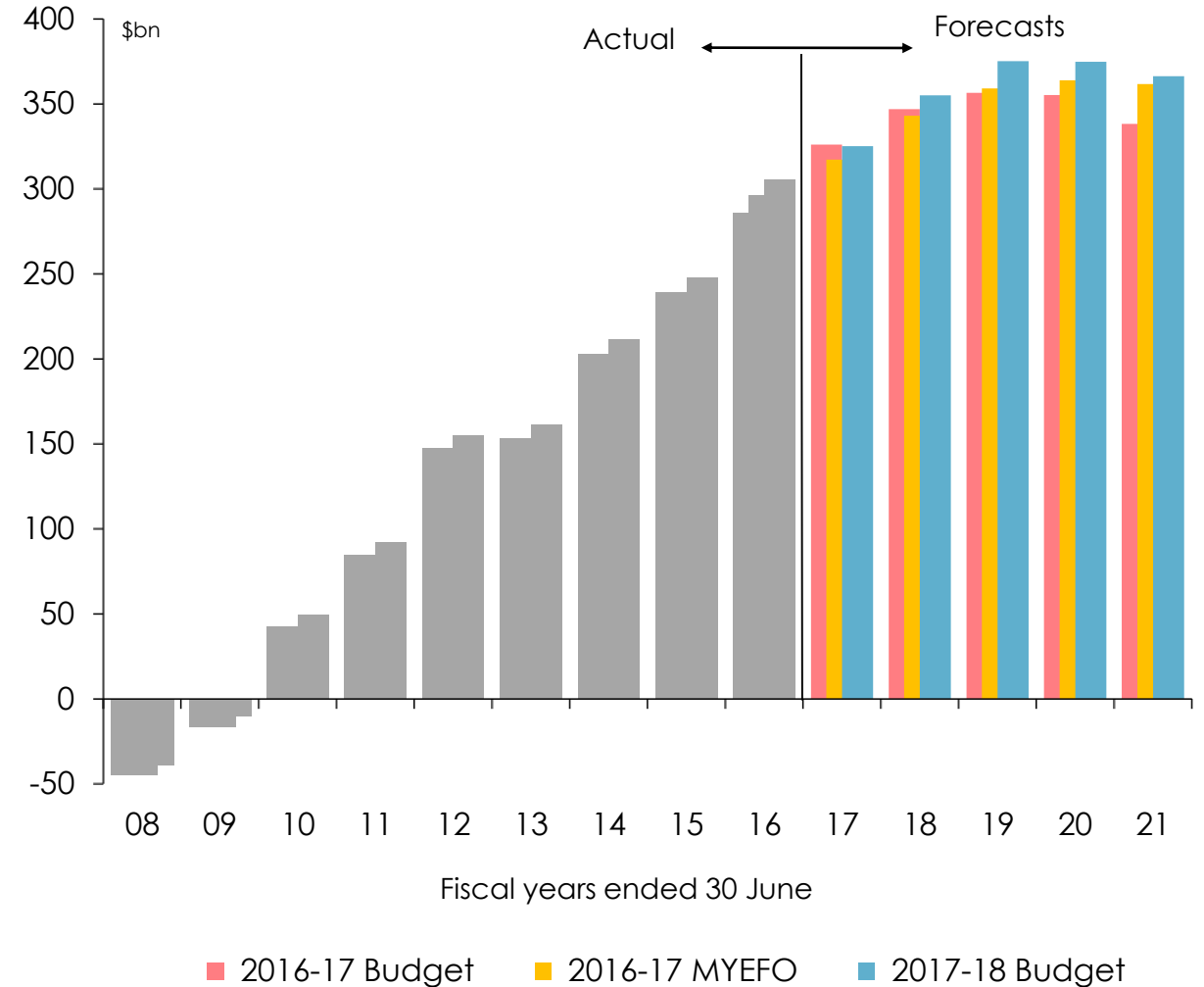


# Budget deficits will be slightly larger in the next two years than previously forecast, but a surplus is still projected for 2020-21

## 'Underlying' cash balance



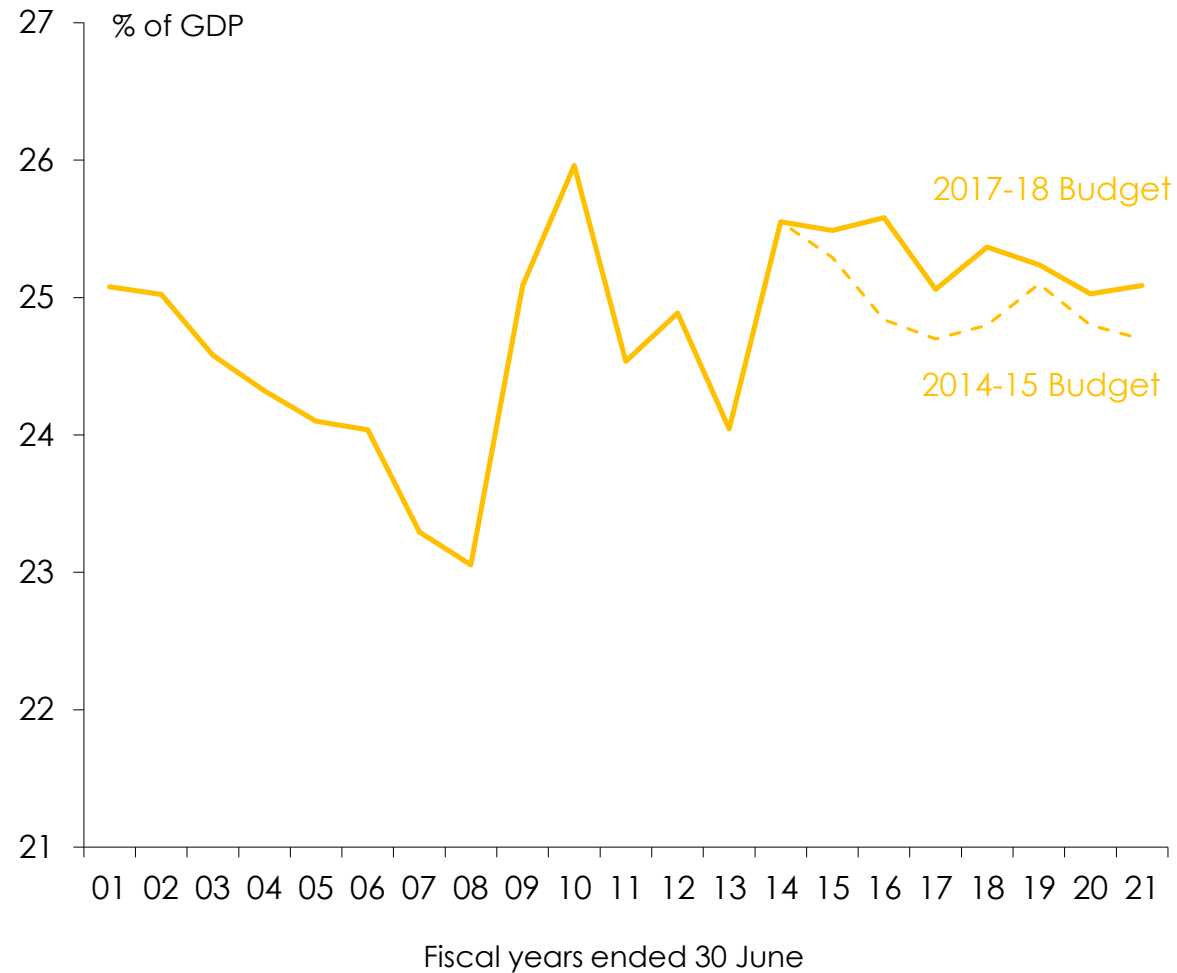
## Net debt



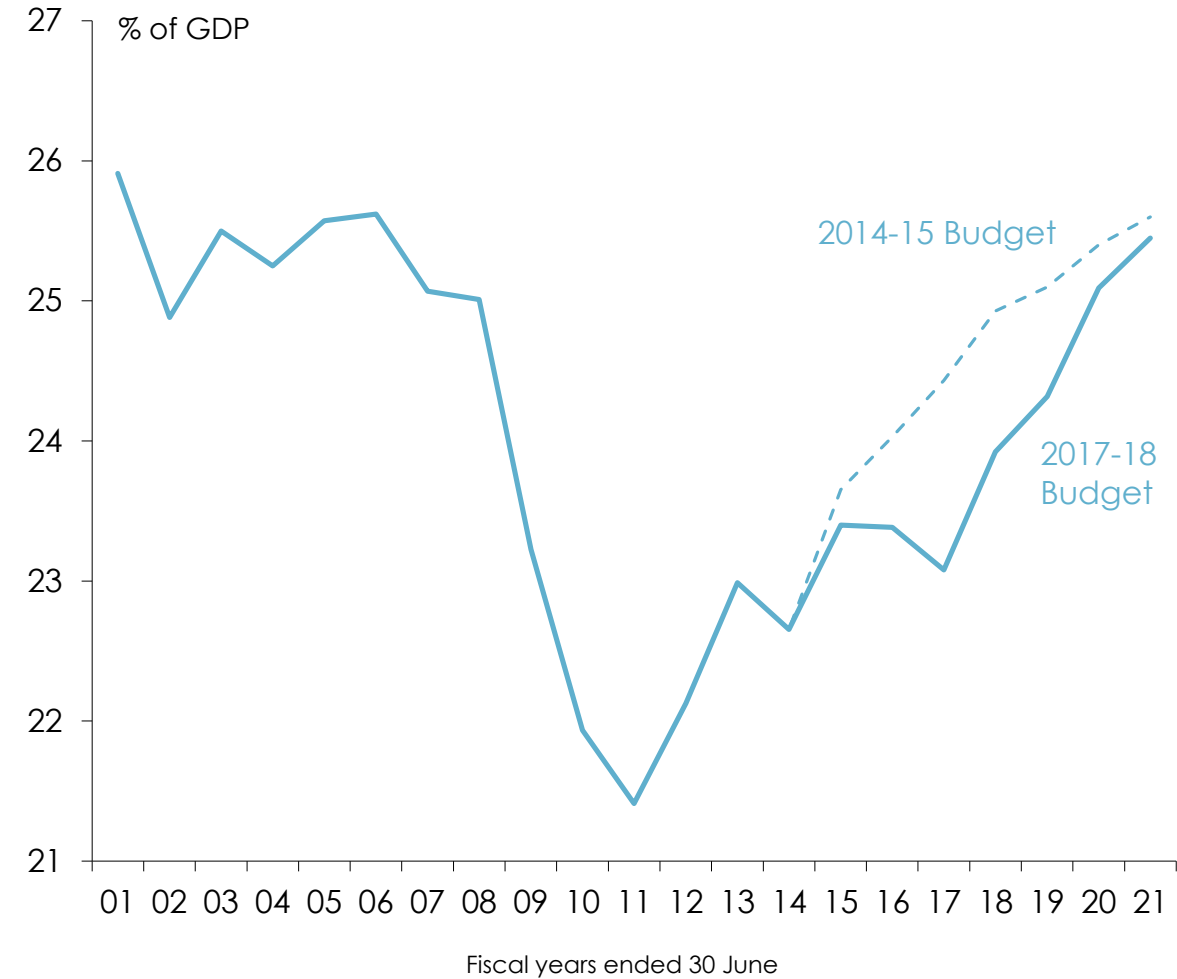
Note: 'MYEFO' = Mid-Year Economic and Fiscal Outlook. Historical figures for net debt were revised in the 2017-18 Budget as a result of the reclassification of Australia's subscriptions to some international financial institutions. Sources: Budget and MYEFO Papers

# The return to surplus now owes less to cuts in spending, and more to increases in revenue, than was envisaged in the 2014-15 Budget

## Payments



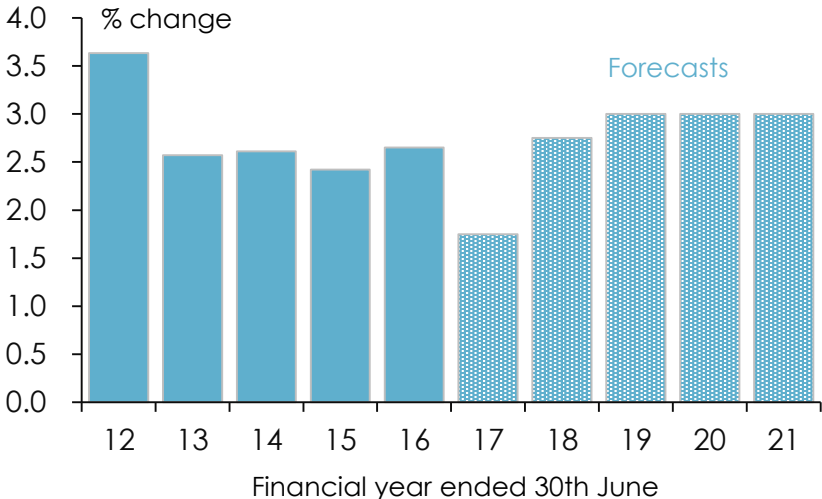
## Receipts



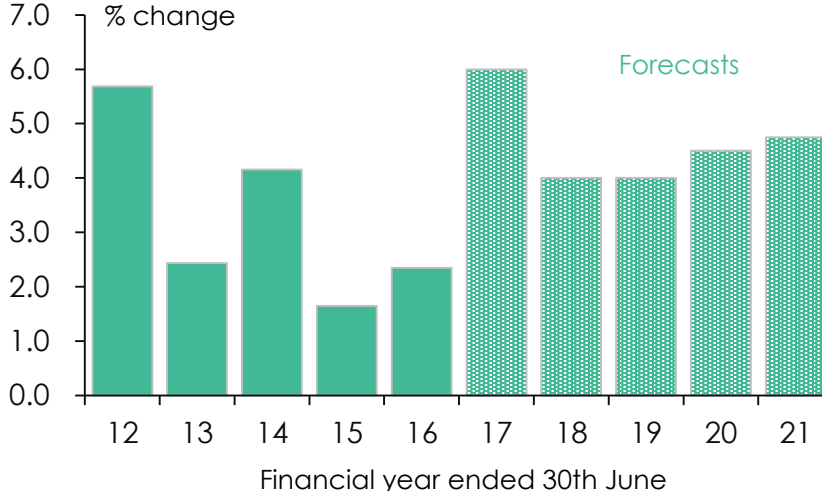
Sources: 2014-15 and 2016-17 Budget Papers.

# Some of the economic forecasts underpinning the Budget look optimistic, particularly with regard to wages growth

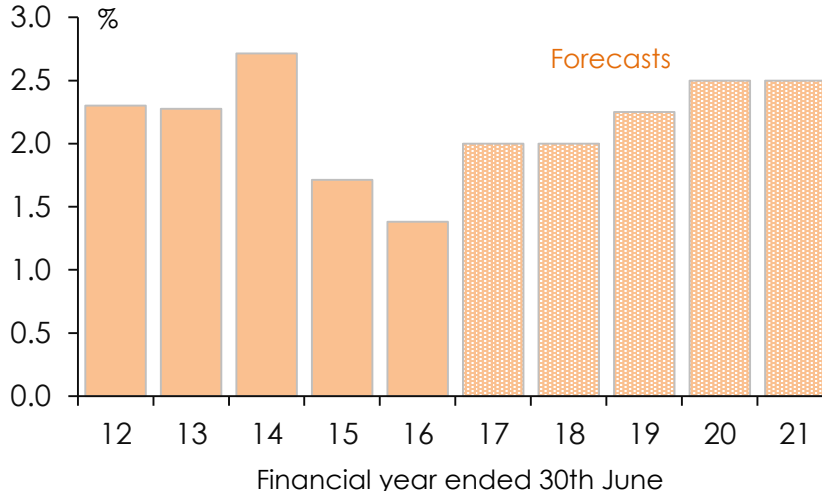
### Real GDP



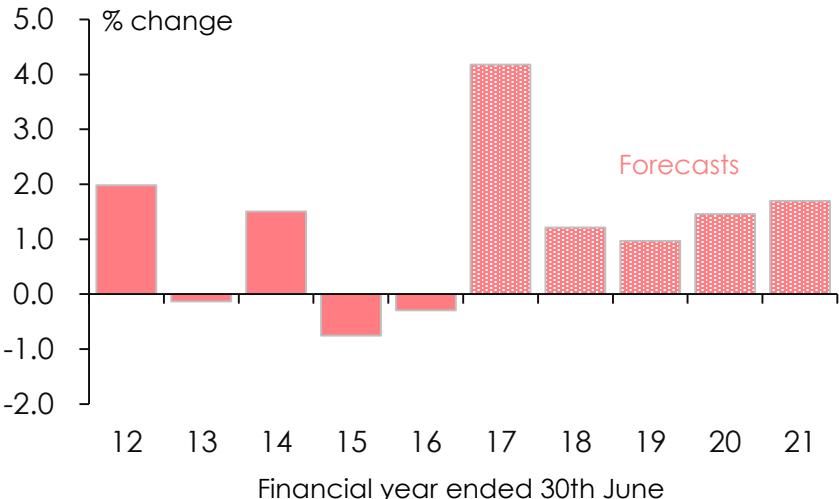
### Nominal GDP



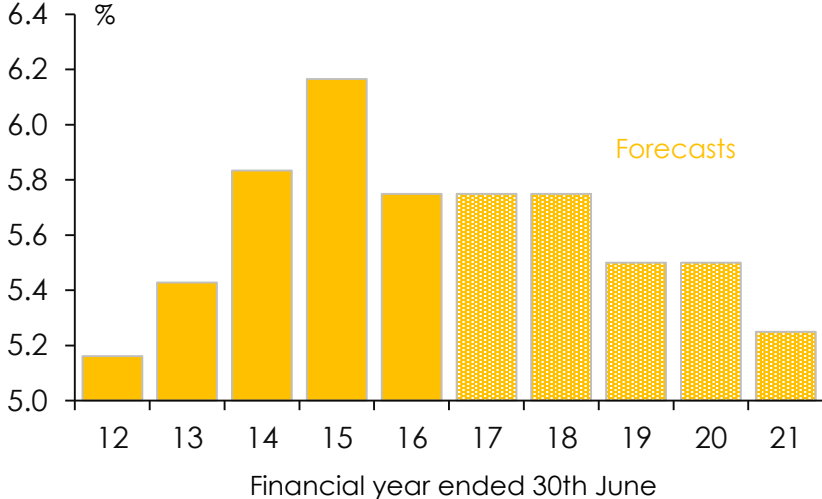
### Consumer prices



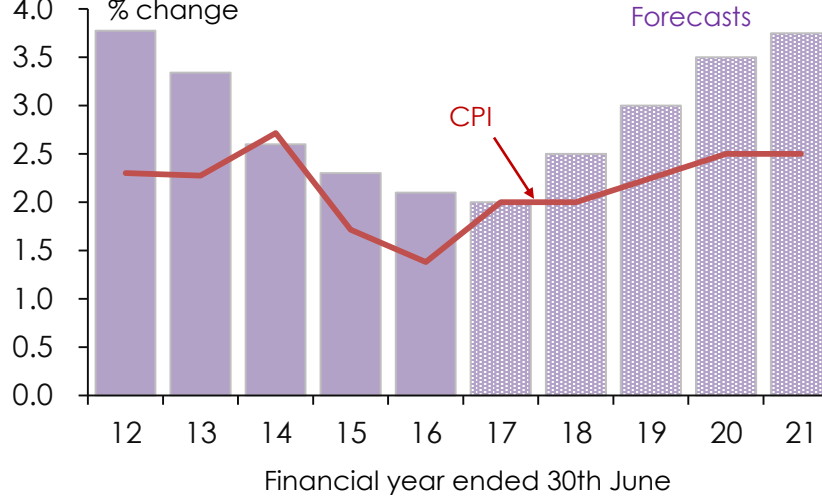
### GDP price deflator



### Unemployment

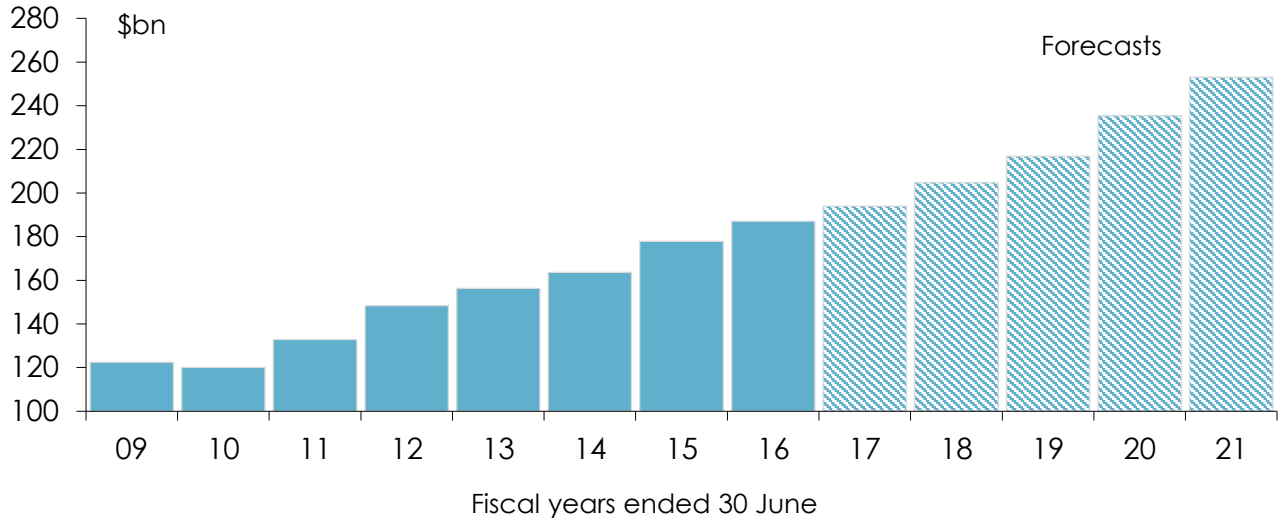


### Wages

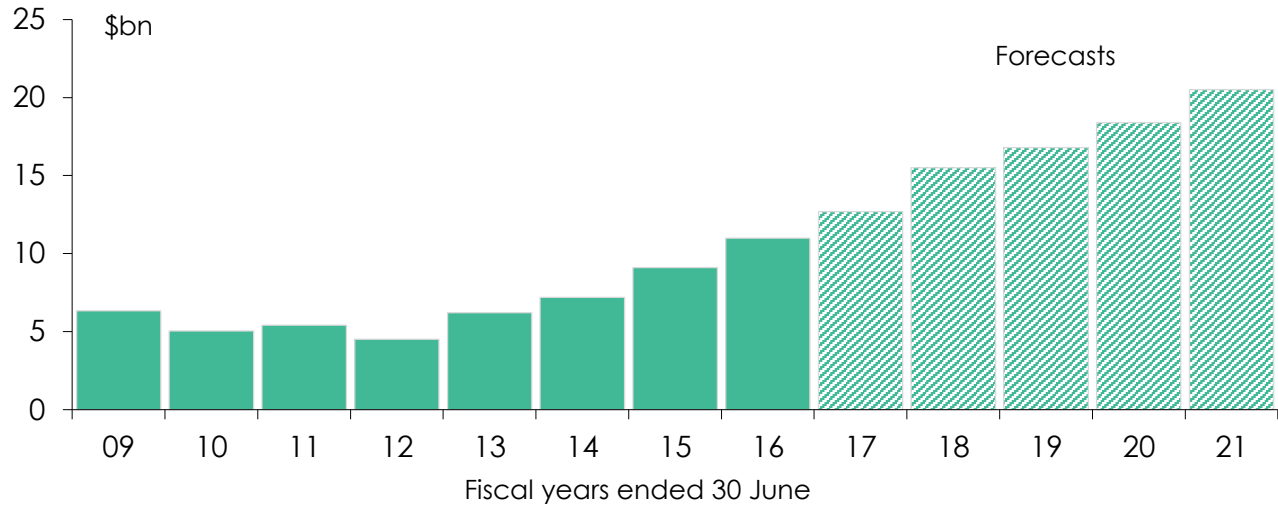


# As a result, some of the Budget revenue forecasts could (again) prove optimistic

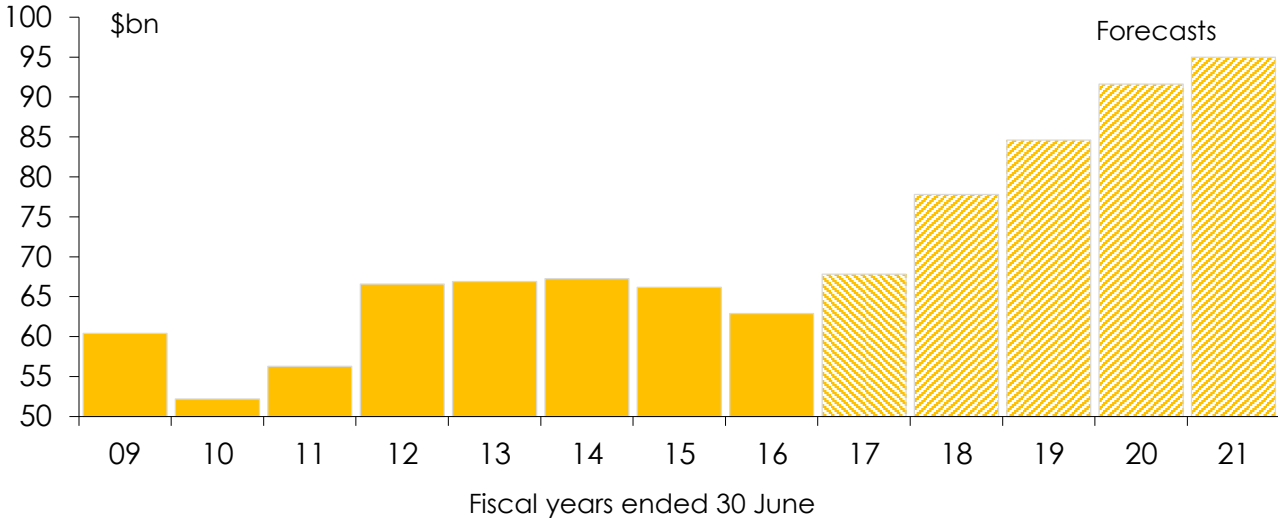
## Personal income tax revenue



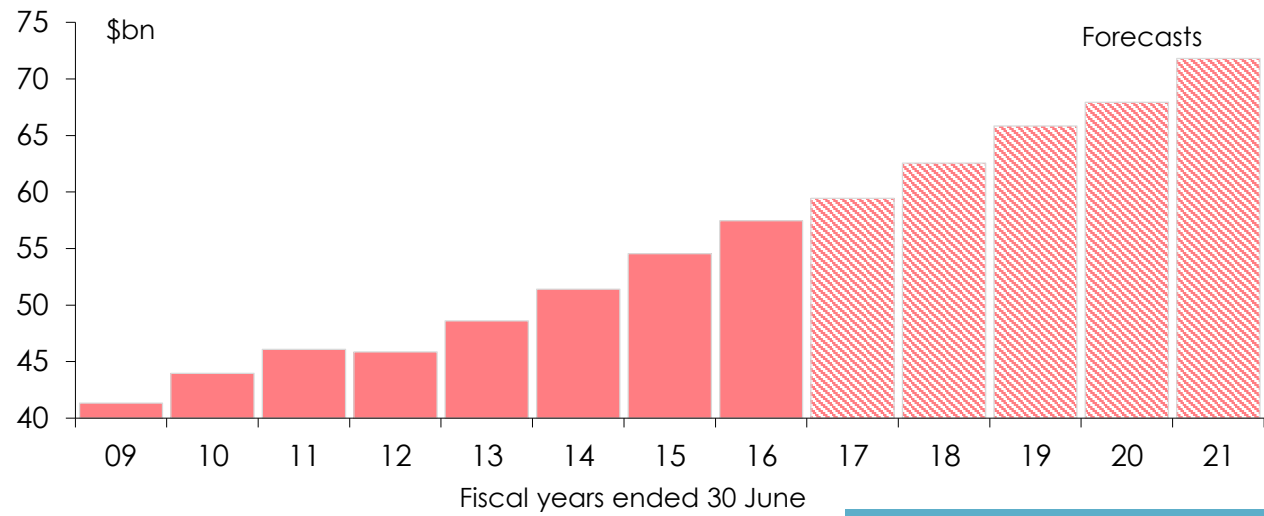
## Capital gains tax revenue



## Company tax revenue



## GST revenue



# Revenue measures include Medicare levy increase, a new tax on banks, and a tax on employers of foreign workers

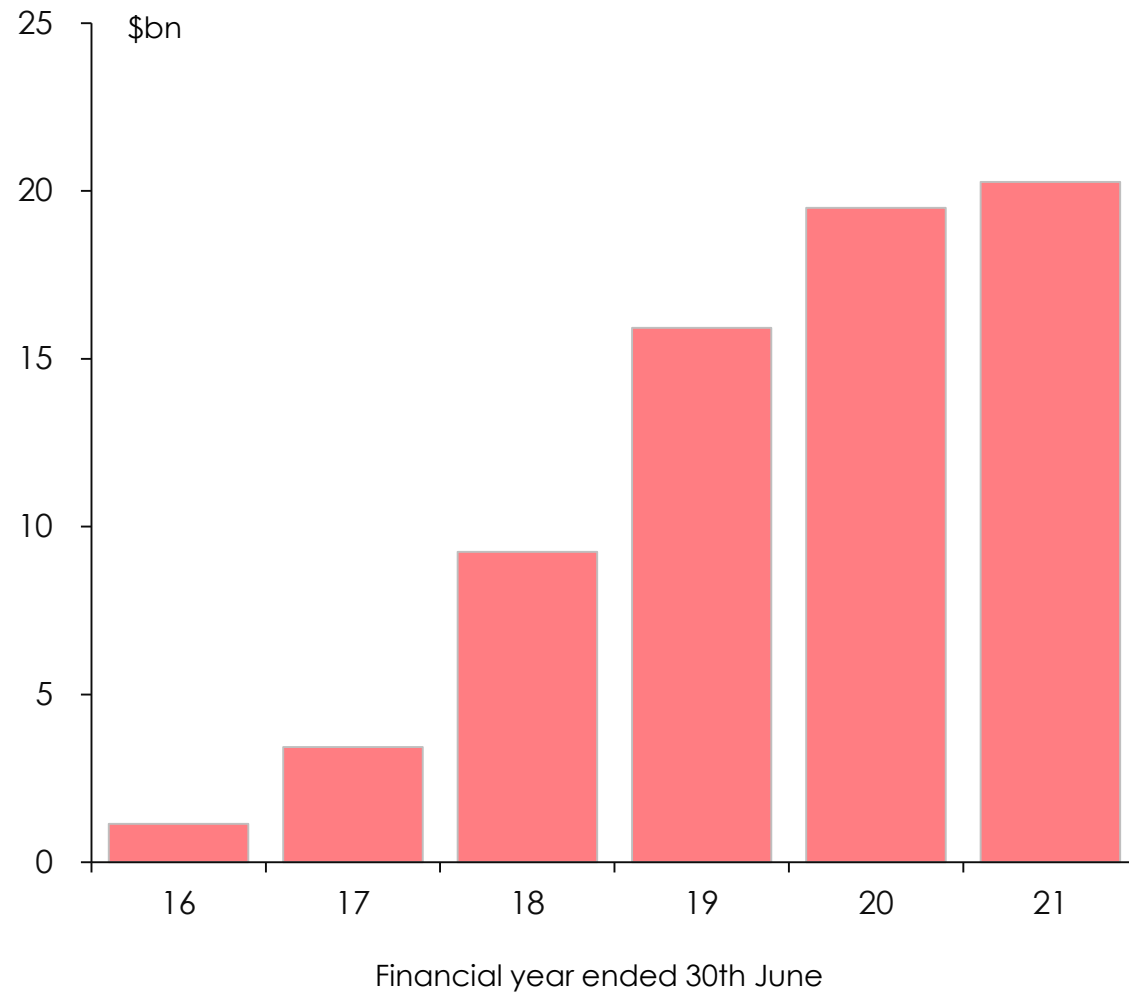
	<i>\$ million</i>				
	<i>2017-18</i>	<i>2018-19</i>	<i>2019-20</i>	<i>2020-21</i>	<i>Total</i>
0.5 pc increase in Medicare levy		400	3,550	4,250	8,200
Major bank 'levy'	1,600	1,500	1,500	1,600	6,200
Levy on employers of foreign workers	90	360	390	370	1,210
Increased CGT on foreign property investors	150	100	150	200	600
Disallow travel expenses for property investors		160	180	200	540
Increased visa fees	35	70	125	180	410
Increased excise on RYO tobacco	30	70	110	150	360
Extension of small biz instant asset write-off		-950	50	250	-650
First home 'super saver' scheme	-50	-60	-70	-70	-250
Other	985	1,588	1,695	2,149	6,417
<b>Total</b>	<b>2,840</b>	<b>3,238</b>	<b>7,680</b>	<b>9,279</b>	<b>23,037</b>

# Spending increases largely the result of abandoning 'zombie' savings left over from the 2014-15 Budget

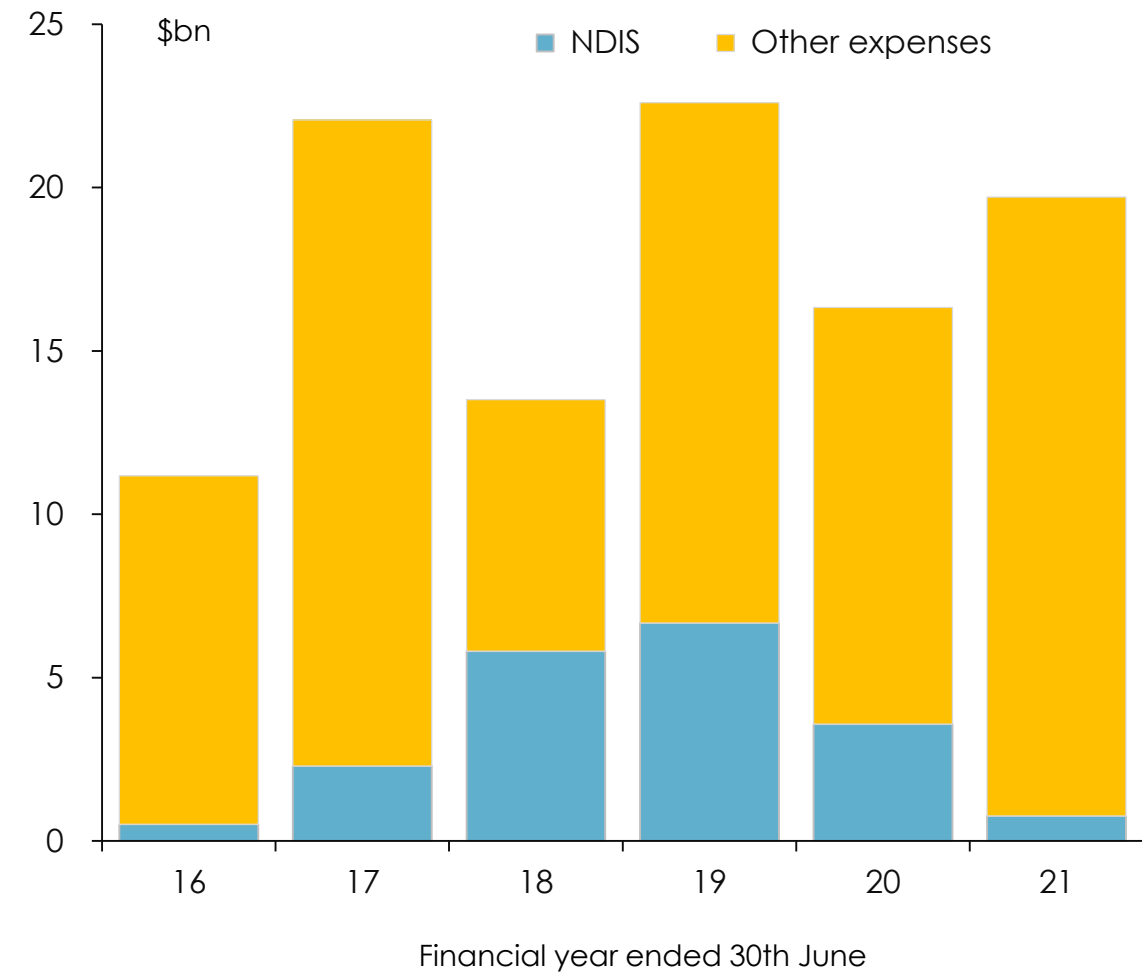
	\$ million				Total
	2017-18	2018-19	2019-20	2020-21	
Abandonment of 'zombie' savings	3,171	4,476	4,691	4,816	17,154
Gonski 2.0	106	295	511	840	1,752
New PBS listings	213	264	312	346	1,135
Medicare benefits schedule indexation	10	146	403	443	1,002
National rail program			200	400	600
Higher education savings	-322	-764	-1,154	-1,486	-3,726
Use of cheaper medicines	-247	-572	-572	-571	-1,962
'Better targeting' of assistance to jobseekers	-4	-185	-216	-231	-636
Other	1,972	1,639	-358	-3,041	212
<b>Total</b>	<b>4,899</b>	<b>5,299</b>	<b>3,817</b>	<b>1,516</b>	<b>15,531</b>

# The National Disability Insurance Scheme is a very expensive program

## Spending on the NDIS



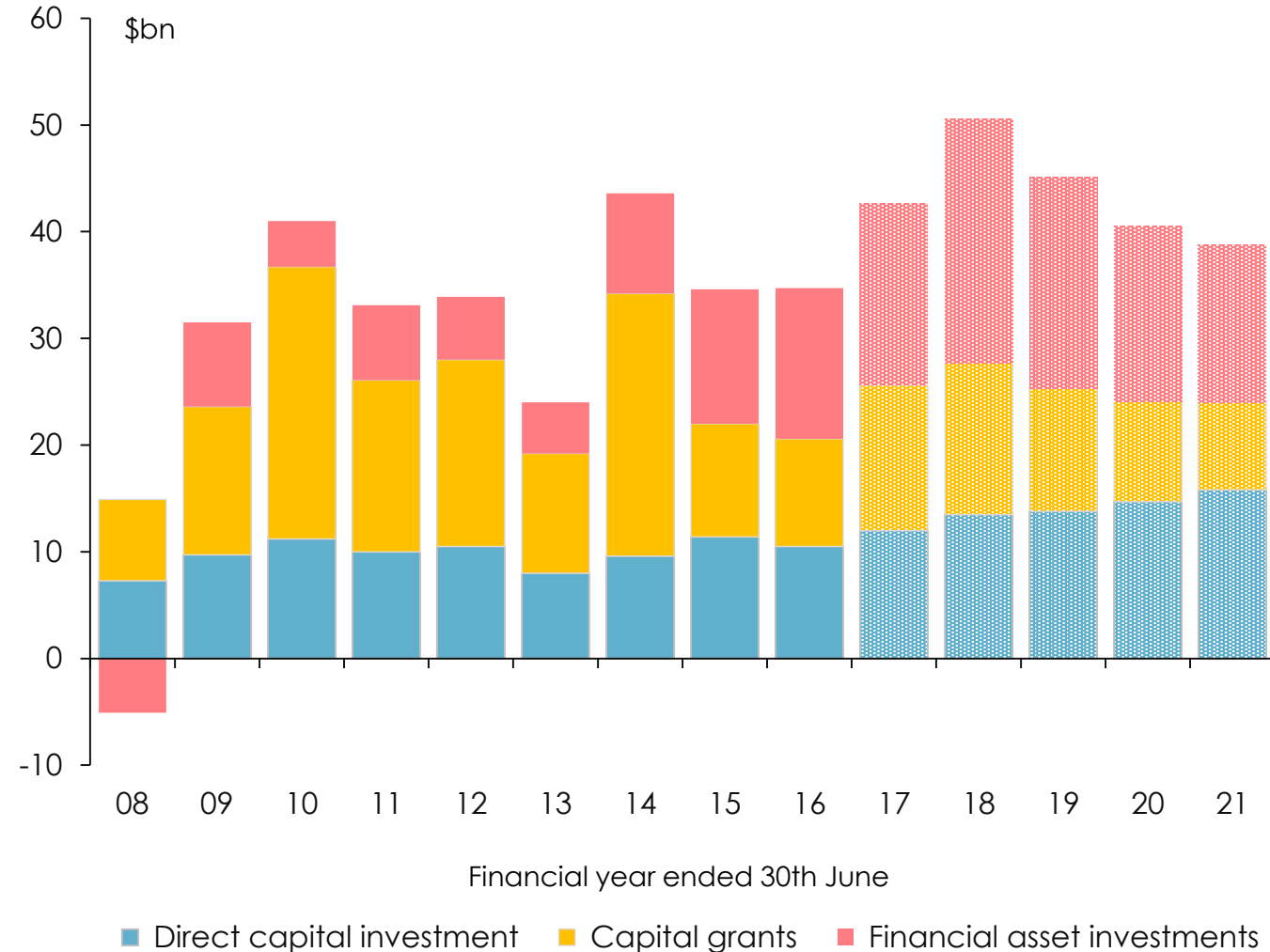
## Increases in spending



Source: 2016-17 Budget Papers.

# Increased infrastructure spending – funded in part by ‘good debt’ – is another feature of the 2017-18 Budget

## Commonwealth Government capital spending



Source: 2016-17 Budget Papers. Statement No. 4.

- ❑ The ‘budget reset’ has allowed the Government to accept the advice of the RBA, the IMF and the OECD (among others) that borrowing in order to fund ‘well targeted’ and ‘appropriately governed’ infrastructure investment can be ‘good policy’
- ❑ The Budget provides for almost \$51bn of capital spending in 2017-18, and \$175bn over the four years to 2020-21 ...
- ❑ ... although on current plans, the level of capital spending peaks in 2017-18
- ❑ The ‘headline’ infrastructure projects announced in the Budget will be funded ‘off-budget’ through government-owned companies (similar to the NBN)
- ❑ Not all of the proposed investments would pass the ‘rigorous project assessment and program evaluation’ that the Budget says should apply to ‘all government spending’



# The 'housing affordability' measures are good in parts

## ❑ The Government deserves credit for focusing on the importance of increasing the supply of affordable rental housing for low income households

- the National Housing Finance and Investment Corporation (the 'bond aggregator') will help not-for-profit affordable housing providers borrow larger amounts at lower interest rates to provide more affordable housing
- the Government will provide some tax incentives (including a 60% CGT discount) to encourage more private investment in affordable rental housing
- An additional \$375mn over three years from 2018-19 for homelessness programs

## ❑ The Government will put pressure on the States to improve housing supply

- by setting housing supply targets and objectives for planning and zoning reforms
- And providing \$1bn for investment in 'infrastructure choke points' that are impeding new housing developments

## ❑ However the proposals to improve affordability for first time buyers are unlikely to help much

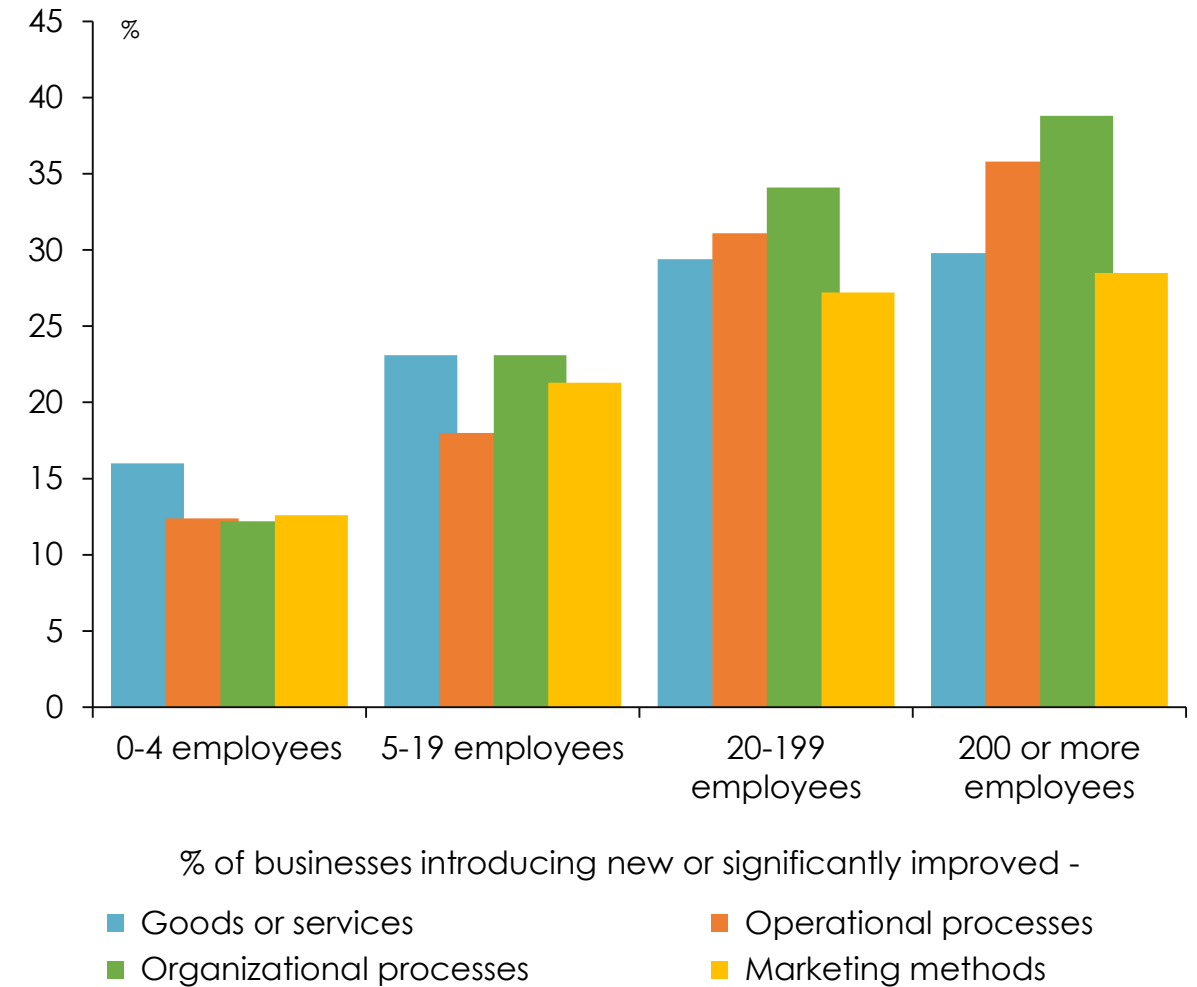
- 'Super for Housing Lite' will at best 'reshuffle the queue' of would-be buyers in favour of those who are able to take advantage of the scheme
- but its practical effect will be similar to that of FHOGs, stamp duty concessions etc – allowing people to spend more on housing than they otherwise would, which inevitably results in higher housing prices, not higher home ownership
- the 'downsizing' incentives will not appeal to many people
- it's such a pity the Government won't move on the CGT discount

# Preferencing small business – through the taxation system or in other ways – isn't going to boost employment or innovation

## Employment and employment growth by business size



## Business innovation, by business size



Sources: ABS, Australian Industry (8155.0), 2014-15; Summary of IT Use and Innovation in Australian Businesses (8166.0), 2014-15.

# Summary

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## ❑ The world economy does seem to be picking up a bit

- but governments, central banks and investors are still coming to grips with the long-term slowdown in potential growth stemming from demographic change and slower productivity growth
- 'policy surprises' out of the US and a credit/property crunch in China are potential sources of downside risk

## ❑ The Australian economy is still 'treading water' in the aftermath of the end of the mining boom

- the 'mini-commodity boom' of the past year is now fading, while housing investment is approaching a peak
- businesses remain hesitant about new investment and permanent job creation, while households remain hesitant about spending

## ❑ The 2017-18 Budget aims to 're-position' the Turnbull Government politically

- drawing a clear distinction from the Abbott Government, and neutralizing many of the Opposition's principle lines of attack
- the path back to surplus now relies more on higher revenue and less on lower spending
- while that reduces the legislative risks to getting back to surplus, there are still some risks around the economic forecasts
- borrowing for infrastructure spending is only 'good' if the infrastructure projects themselves are 'good'
- the housing affordability measures won't do much, if anything, to improve housing affordability for would-be home-buyers, although it might help low-income renters a bit