Monday, 15 April 2024

# Fiscal Policy in a More Volatile World

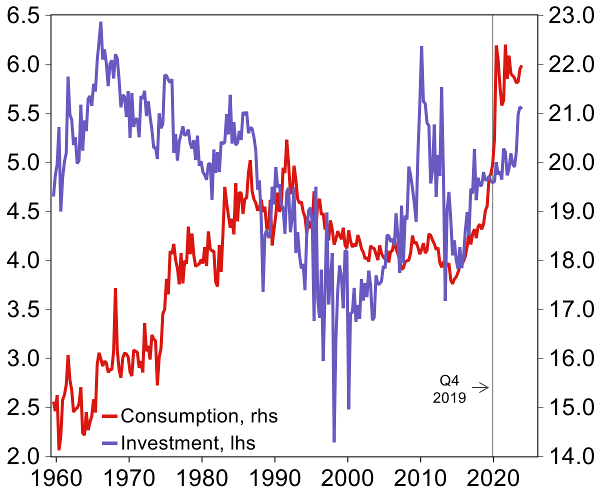
Escalating tensions in the Middle East over the weekend triggered fresh fears of the potential for a region-wide conflict. The usual reaction you would expect to see in markets has been relatively muted during Asian trade today. Even the oil market seems to have shrugged off the news. However, oil futures were already hovering around their highest level since October last year as escalating geopolitical tensions, along with other factors, were being priced in over recent weeks. This likely goes some way in explaining the limited upside.

The initial market response might have been subdued, but it's still a timely reminder of the fragility inherent in the global economy. Further still, the market seems to be hanging its hat on the hopes that the saga will remain contained but there are more chapters to be written yet. Markets will be closely monitoring developments, particularly for any signs of potential disruption to oil markets which could further complicate the global fight against inflation.

Even without a more meaningful impact on oil markets, the recent escalation could affect the eventual timing of central bank rate cuts. An uncertain economic backdrop has prompted policymakers to err on the side of caution, the escalation of tensions in the Middle East have only added another dimension to the uncertainty. Several US Fed and European Central Bank officials are due to speak this week, providing insights on how key central banks are interpreting the recent bout of market volatility and implications for interest rates.

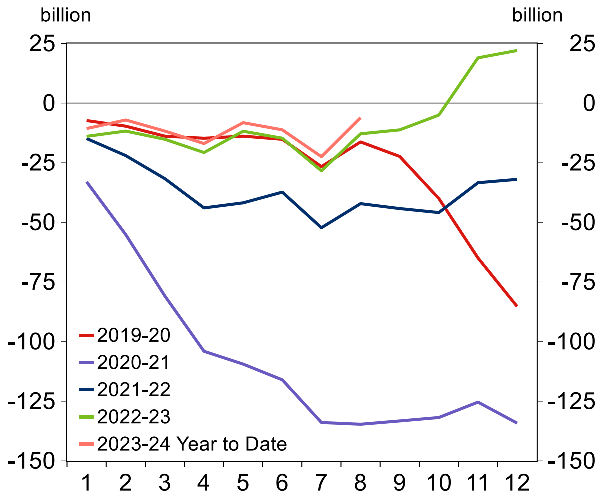
Increased geopolitical tensions have also had a more slow-moving impact on the other arm of macroeconomic policy – fiscal policy. In a more fragmented world, relying less on international supply chains and becoming more self-sufficient is now becoming a policy objective. As a result, we have seen governments across the globe announce significant industry support packages.

**Chart 1: Public investment & consumption**
% of real GDP




Source: ABS, Macrobond, Westpac Economics

**Chart 2: Government Receipts & Payments**
Underlying Cash Balance, Aggregated Financial Year




Source: Australian Department of Finance, Macrobond, Westpac Economics

From an economic perspective, the idea is that there's a public good element to ensuring the ongoing supply of critical goods and services. Given this, if left to its own accord the private market may undersupply these goods and services, suggesting there's a role for governments.

Australia is no different. Over the last few weeks, the Prime Minister and several of his Ministers have announced increased funding to develop manufacturing capacity in Australia, particularly where it will also help us meet emission reduction targets. As an example, the recently announced Solar SunShot program will help develop solar panel manufacturing capability in Australia through $1 billion in government funding, which is likely to include production subsidies and grants.

The Federal Treasurer went further yesterday on the ABC's Insiders program, noting that developing domestic capacity will be a key pillar of the upcoming Budget (which is now less than one month away). The Treasurer hinted at the use of policy to help stimulate private investment including through co-funding investment arrangements, tax breaks and incentives, and production subsidies. To be fair, this is already happening to a degree. For example, last Budget, the Treasurer announced bonus tax deductions for small and medium sized businesses that invest in electrifying energy systems and subsidised funding for households that electrify their appliances.

*A focus of the investment enablers is key given elevated demands on governments.*

Ensuring Australia remains an attractive place for global capital should be a priority across all levels of government. But this does not necessarily mean that there should be more subsidies or tax breaks. A focus on the enablers of investment, such as streamlined regulation and a simplified tax system, will also go a long way to ensuring global capital flows into Australia. As such, it was positive to hear the Treasurer talk about working on these enablers, including by streamlining and simplifying foreign investment approval processes.

Focusing on these enablers also helps reduce the risk that government funding crowds out private activity. Public investment across all levels of government as a share of GDP is running at its highest level since the mining investment boom. A lot of this has been driven by infrastructure investment by state governments as well as investment in defence equipment. Public consumption as a share of GDP remains close to a record high. This includes public health services, spending on disability support, and increased subsidies on everyday items like electricity and rents. Its clear demands on government increased during the pandemic and remain elevated (see chart 1).

The tax windfalls from higher commodity prices have masked these spending pressures to some degree, particularly at the federal level where the government recorded a sizable surplus in 2022-23 and is well on track to record a similar sized surplus this financial year (see chart 2).

*Updated fiscal strategy.*

The other key point the Treasurer made was that the balance of risks has shifted, with downside risk to the real economy now starting to take centre stage. As such, the Government's *Fiscal Strategy*, which provides guardrails for budget decisions and a framework to hold the government accountable for its decisions, will also be updated to reflect the emerging economic reality.

This makes this week's labour force release for March, which will be the final labour market release before the Budget is released, even more important. It will help provide a clearer view on whether labour market conditions have indeed eased.

Recall in the February labour force survey the unemployment rate fell to 3.7% from 4.1% and employment increased by more than 110k persons. We know that part of this was driven by shifting seasonality. We expect a bit of payback in March and that the reported unemployment rate increased to 4.0%. Employment is expected to have declined by around 40k people, suggesting that labour market conditions continue to ease in an orderly fashion.

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# Group Forecasts

| | | 2024 | | | 2025 | | |
|---|---|---|---|---|---|---|---|
| **End Period:** | **Close (12 Apr)** | **Q2 (f)** | **Q3 (f)** | **Q4 (f)** | **Q1 (f)** | **Q2 (f)** | **Q3 (f)** |
| **Aust. Interest Rates:** | | | | | | | |
| RBA Cash Rate, % | 4.35 | 4.35 | 4.10 | 3.85 | 3.60 | 3.35 | 3.10 |
| 90 Day BBSW, % | 4.34 | 4.37 | 4.12 | 3.92 | 3.67 | 3.47 | 3.30 |
| 3 Year Swap, % | 3.98 | 3.95 | 3.85 | 3.75 | 3.65 | 3.60 | 3.55 |
| 10 Year Bond, % | 4.27 | 4.05 | 3.95 | 3.85 | 3.90 | 3.90 | 3.95 |
| **US Interest Rates:** | | | | | | | |
| Fed Funds Rate, % | 5.375 | 5.125 | 4.625 | 4.375 | 4.125 | 3.875 | 3.625 |
| US 10 Year Bond, % | 4.52 | 4.00 | 3.90 | 3.80 | 3.85 | 3.90 | 3.95 |
| **USD Exchange Rates:** | | | | | | | |
| AUD-USD | 0.6467 | 0.68 | 0.69 | 0.70 | 0.71 | 0.72 | 0.72 |
| USD-JPY | 153.23 | 148 | 145 | 141 | 137 | 133 | 130 |
| EUR-USD | 1.0643 | 1.11 | 1.13 | 1.14 | 1.15 | 1.16 | 1.17 |
| GBP-USD | 1.2452 | 1.27 | 1.28 | 1.29 | 1.30 | 1.30 | 1.31 |
| NZD-USD | 0.5943 | 0.63 | 0.64 | 0.64 | 0.64 | 0.65 | 0.65 |
| **AUD Exchange Rates:** | | | | | | | |
| AUD-USD | 0.6467 | 0.68 | 0.69 | 0.70 | 0.71 | 0.72 | 0.72 |
| AUD-EUR | 0.6074 | 0.61 | 0.61 | 0.61 | 0.62 | 0.62 | 0.62 |
| AUD-JPY | 99.06 | 99.9 | 100.1 | 98.7 | 97.3 | 95.8 | 93.6 |
| AUD-GBP | 0.5191 | 0.53 | 0.54 | 0.54 | 0.55 | 0.55 | 0.55 |
| AUD-NZD | 1.0885 | 1.07 | 1.09 | 1.09 | 1.11 | 1.12 | 1.11 |

| | **2022** | **2023** | **2024 (f)** | **2025 (f)** |
|---|---|---|---|---|
| GDP, % | 2.4 | 1.5 | 1.6 | 2.5 |
| CPI (Headline), % | 7.8 | 4.1 | 3.0 | 2.7 |
| CPI (Trimmed mean), % | 6.8 | 4.2 | 3.1 | 2.8 |
| Unemployment Rate, % | 3.4 | 3.8 | 4.5 | 4.6 |
| Wages Growth, % | 3.3 | 4.2 | 3.2 | 3.1 |

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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