AUSTRALIAN MARKETS WEEKLY

A record peace-time budget deficit

National Australia Bank

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Analysis – A record peace-time budget deficit

- The instant recession caused by the coronavirus pandemic has seen an unprecedented easing of both monetary and fiscal policy. On our calculation, the traditional easing of fiscal policy is worth about 12% of GDP and is mainly aimed at limiting the rise in unemployment, boosting consumer spending and supporting business cash flows. Balance-sheet measures aimed at supporting the flow of credit total a further 6%.
- The discretionary easing of fiscal policy drives a deterioration in the budget from broadly in balance in 2018-19 to a deficit of about 4.5% of GDP in 2019-20 and 13% in 2020-21 (excluding stimulus measures, the cyclical deterioration is worth about 4% of GDP next financial year, close to the peaks of the early 1990s recession and the global financial crisis). These estimates are highly uncertain and need to be refined as more information becomes available on the path of the pandemic, the near-term hit to the economy, the shape of recovery, and the take-up of key stimulus measures.
- Public debt in Australia could reach 50% of GDP, which would be the highest level since the early 1960s. This is well below international estimates of the point at which debt becomes a drag on growth, while the cost of servicing debt is very low given bond yields are less than 1%. Unlike past recessions, the run-up in debt is rapid given the nature of the shock and the design of the stimulus measures. We think the run-up in debt is justified given the severity of the shock to the economy and further stimulus is likely to be required as the economy recovers from the pandemic. The budget is expected to sharply improve in 2021-22 given most of the stimulus measures finish next financial year, although the government might end up winding spending back more slowly.

The week ahead – RBA speech, weekly payrolls, retail sales; EZ PMIs

- **Australia.** Today, Governor Lowe gives an *Economic and financial update*, where he may seek to boost confidence in a post-virus recovery and renew calls for structural reform. He is also likely to discuss the Reserve Bank's intervention in the bond market. Also today, the ABS publishes weekly payrolls, which should show a sharp fall in employment and total wage payments. Preliminary retail sales should show a small rise in March as panic buying of essentials offset sharp falls for spending on eating out, department stores and clothing. This trend has now eased and overall consumer spending is declining sharply as in other countries.
- **International.** Flash manufacturing and service-sector PMIs for April for the EZ are due Thursday. The market expects some stabilisation after last month's collapse in service-sector readings, although manufacturing should slow further. Markets are closely monitoring some European countries that have gradually reopened sections of their economies.

Key markets over the past week

	Last	% chg week		Last	bp/% chg week
AUD	0.6334	-1.7	RBA cash	0.15	-2
AUD/CNY	4.51	0.4	3y swap	0.32	-7
AUD/JPY	68.2	-1.3	ASX 200	5,353	-0.6
AUD/EUR	0.583	-0.6	Iron ore	83	-0.2
AUD/NZD	1.049	-0.5	Brent oil	25.9	-18.3

Source: Bloomberg

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A record peace-time budget deficit

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- The discretionary easing of fiscal policy drives a deterioration in the budget from broadly in balance in 2018-19 to a deficit of about 4.5% of GDP in 2019-20 and 13% in 2020-21 (excluding stimulus measures, the cyclical deterioration is worth about 4% of GDP next financial year, close to the peaks of the early 1990s recession and the global financial crisis). These estimates are highly uncertain and need to be refined as more information becomes available on the path of the pandemic, the near-term hit to the economy, the shape of recovery, and the take-up of key stimulus measures.
- Public debt in Australia could reach 50% of GDP, which would be the highest level since the early 1960s. This is well below international estimates of the point at which debt becomes a drag on growth, while the cost of servicing debt is very low given bond yields are less than 1%. Unlike past recessions, the run-up in debt is rapid given the nature of the shock and the design of the stimulus measures. We think the run-up in debt is justified given the severity of the shock to the economy and further stimulus is likely to be required as the economy recovers from the pandemic. The budget is expected to sharply improve in 2021-22 given most of the stimulus measures finish next financial year, although the government might end up winding spending back more slowly.

There has been an unprecedented discretionary easing of fiscal policy

The instant recession caused by necessary health containment measures to deal with the coronavirus pandemic has seen an unprecedented easing of monetary and fiscal policy.

On our calculation, the traditional discretionary easing of fiscal policy is worth close to $240b (approximately 12% of annual GDP), while balance-sheet measures – where the government counts the Reserve Bank's $90b (4.5%) term funding facility in its figures – total about $125b (6%).

The traditional discretionary measures are directed at:[1]

- **Supporting employment to limit the rise in unemployment.** The main policy measure is the "JobKeeper" wage subsidy, which is worth $130b (6.5%). This pays a flat subsidy of $750 per week – which is about the same as the minimum wage – to employees and sole traders, although it excludes many casual workers and most migrant workers. Payments start in May and are backdated to when several companies stood down staff in March. There is additional wage assistance for apprentices/ trainees at a cost of $1b. The government is also spending less than $1b to make childcare free in the short term for everyone. So far, 0.8m businesses have registered with the tax office for the JobKeeper programme, including 0.3m sole traders and 0.3 million micro/small businesses.
- **Extensive cash payments to support business cash flows.** The government is making payments of between $20k and $100k to affected small- and medium-sized businesses and charities that employ staff to boost their cash flow. The payment is split between April and July and totals $32b. The government is also temporarily making it harder to force a business into insolvency, while the tax office is acting more flexibly when companies owe it money. The latter measures have no estimated cost to the budget.
- **Extensive cash payments to boost consumer spending.** These comprise: (1) a $225 weekly payment to eligible welfare recipients, paid from late April onwards and totalling $14b; and (2) two $750 payments to eligible households, paid in March and July and worth $9b. The government has trimmed the deeming rate used to calculate pensioner benefits at a cost of $1b, although this would have happened regardless of the pandemic given the low level of interest rates.
- **Early access to pension savings.** Affected workers and sole traders can withdraw up to $10k from their superannuation in 2019-20 and the same again in 2020-21. The withdrawals are tax-free and cost the budget $1b. The treasurer has estimated that about 1.6m individuals will withdraw $27b in total. To date, 0.9m people have lodged applications with the tax office.
- **Temporarily reducing drawdown rates for superannuation.** Some retirees may have to sell assets to fund minimum drawdown rates for account-based pensions. The government is reducing drawdown rates by 50% in 2019-20 and 2020-21 to reduce this pressure. There is no estimated cost to the budget from this change.
- **Boosting business investment.** Depreciation deductions on investment have been accelerated for the 2019-20 tax year at a cost of $3b. In the same tax year, the government has increased the threshold for the instant asset write-off from $30k to $150k and made it easier to write-off assets, which is worth $1b.
- **Funding state health spending.** The government has paid the states $3.5b toward health expenditure

[1] Government costings are published at www.treasury.gov.au.

and will reimburse some of future state spending on health. The advance to the finance minister was increased from $1b to $40b, which reportedly can be used to fund additional health spending if required.

- **Support for affected regions and airlines.** The government is paying $1b to affected regions and communities with another $1b mainly in waived fees for airlines.

The balance-sheet and related measures are aimed at supporting the flow of credit, thereby reinforcing the easing of monetary policy.

- **Cheap funding for banks.** The Reserve Bank has established a "term funding facility" of at least $90b (4.5%), which: (1) reduces lending rates by offering collateralised three-year funding at a fixed rate of 0.25% to banks and other authorised lenders of up to 3% of their outstanding business credit until September 2020; and (2) offers additional low-cost funding to lenders that expand their lending to business until March 2021, with incentives for lending to small- and medium-sized business. Banks have borrowed $2b to date from the facility, although it has only been in place for a fortnight.
- **The government is providing a partial guarantee on loans to small- and medium-sized businesses.** The government has established a "Coronavirus SME Guarantee Scheme" to support business cash flows in the near term. The scheme guarantees eligible lenders 50% of new unsecured loans – preferably in the form of a loan facility – to small- and medium-sized businesses, including sole traders and charities. The scheme covers up to $40b of debt at a potential cost to government of up to $20b. Each loan can be up to $0.25m with a term up to 3 years, including an initial 6-month repayment holiday. The Australian Prudential Regulation Authority will start collecting data on the government's loan guarantee scheme in May.
- **Reducing funding costs for small authorised lenders and non-banks.** The Australian Office of Financial Management has established a "Structured Finance Support Fund" that is initially investing $15b in: (1) primary market securitisations of home, small business and consumer loans by small lenders; and (2) warehouse facilities.[2] So far, the office has bought $0.2b of securitised debt.
- **The bank regulator is suspending guidance on bank capital to boost lending.** The Australian Prudential Regulation Authority has set benchmark targets for bank capital that are well above current minimum regulatory requirements and are viewed as "unquestionably strong" by international standards. For the four major banks, this equated to a common equity tier 1 capital ratio of at least 10.5% of risk-weighted assets, whereas the ratio for all banks exceeded 11% at end-2019. The regulator is suspending the targets "during the period of disruption" caused by the pandemic as long as minimum standards are still met, which allows banks to use their large buffers to increase lending.[3]
- **Relaxing regulatory obligations on small business loans.** The government is suspending responsible lending obligations for 6 months on loans to existing small business customers (this covers new loans, limit increases and restructures). Strictly speaking, the obligations do not apply to business loans, but lenders may still undertake the assessment.

[2] See Australian Office of Financial Management, *Structured finance support fund*, www.aofm.gov.au, Accessed 17 April 2020.

[3] See Australian Prudential Regulation Authority, *APRA adjusts bank capital* expectations, Media release, 19 March 2020.

Table 1: The traditional easing of fiscal policy equates to about 12% of GDP

(Note: mostly front-loaded to Q2 2020 and 2020-2021)	1st package ($b)	Separately announced ($b)	2nd package ($b)	Separately announced ($b)	3rd package ($b)	Separately announced ($b)	Total ($b)
(A) Commonwealth taxes / payments etc							
Households							
1. Income support for individuals			14.1				14.1
2. Cash payments to households	4.8		4.0				8.8
3. Temporary early release of super			1.2				1.2
4. Temp. reduce super drawdown rates							na
5. Lower social security deeming rates		0.9					0.9
6. JobSeeker wage subsidy payment					130.0		130.0
6. Early childhood education and childcare						0.3	0.3
Business							
1. Boost cashflow for employers	6.7		25.2				31.9
2. Temp. relief for distressed businesses							na
3. Instant asset writeoff	0.7						0.7
4. Temporary depreciation allowance	3.2						3.2
5. Support for apprentices/trainees	1.3						1.3
6. Regional support	1.0						1.0
7. Support for airlines			0.7	0.3			1.0
State Government							
1. Health		2.4		1.1			3.5
2. Reimbursing state health spending							tbd
Discretionary fund							
1. Advance to finance minister						38.8	38.8
Total	**17.6**	**3.3**	**45.2**	**1.4**	**130.0**	**39.1**	**236.7**
(% of annual GDP)	**0.9**	**0.2**	**2.3**	**0.1**	**6.5**	**2.0**	**11.8**
(B) Commonwealth and Reserve Bank balance-sheet support							
1. Guarantee for small- & medium-sized business loans			Up to 20				Up to 20
2. AOFM support for small lenders		Initially 15					Initially 15
3. RBA term loan facility		At least 90					At least 90
Total		**Approx. 105**	**Up to 20**				**Approx. 125**
(% of annual GDP)		**Approx. 5.3**	**Up to 1.0**				**Up to 6.3**

Note: Expressed as an approximate share of annual GDP of $2tr. "tbd" = to be determined.
Source: Australian Bureau of Statistics, Sydney Morning Herald, The Australian, Treasury, National Australia Bank

The fiscal stimulus could see Australia's largest budget deficit outside of WW2

Estimating the budget bottom-line, we forecast the cyclical deterioration in the budget and added the above Treasury costings of the traditional easing of policy, as well as the funding of the Australian Office of Management's Structured Finance Support Scheme. The cyclical deterioration of the budget reflects the operation of the "automatic stabilisers" of lower tax revenue and increased spending on welfare and was estimated using NAB's economic forecasts for growth, inflation and unemployment.

On this basis, we think the budget will widen from near-balance in 2018-19 to about $85b in 2019-20 (about 4.5% of GDP) and then roughly $250b in 2020-21 (13% of GDP). Although outside NAB's forecast horizon, the expected short life of the stimulus measures would see a major improvement in the budget in 2021-22 because Treasury's costings show the stimulus peaks in 2020-21 before falling to almost zero that year.

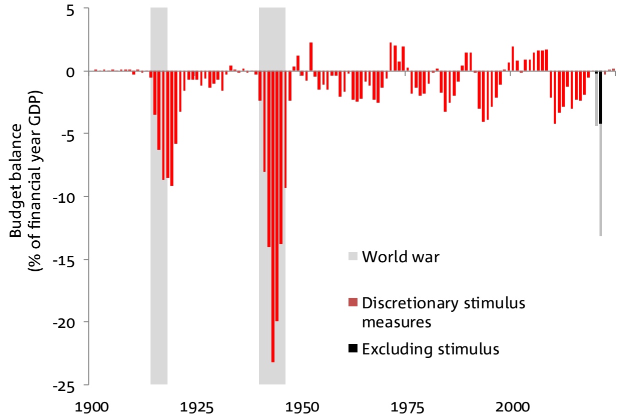
- On our calculation, the approximately 4.5% shortfall in 2019-20 mainly reflects the initial impact of the stimulus measures. The estimated deficit of 13% of GDP in 2020-21 reflects further stimulus of 9% of GDP and a cyclical deterioration in the budget of about 4% of GDP.

It needs to be emphasised that these estimates are subject to significant uncertainty as they hinge on the path of the virus, the near-term hit to the economy, the shape of recovery, and the take-up of some of the key stimulus measures. Accordingly, the forecast profile for the budget will need to be refined as more information on each of these factors becomes available. What is clear, though, is that like the hit to the economy, the impact on the budget is extremely front-loaded due to the containment measures and the design of the stimulus measures.

As a guide, though, the cyclical deterioration in the budget to about 4% of GDP in 2020-21 broadly matches the peaks of the early 1990s recession and the global financial crisis. With the discretionary measures potentially taking the overall deficit to 13% of GDP in 2020-21, such an outcome would only be surpassed by the deficits recorded during World War 2.

Chart 1: The budget could post a deficit of 13% of GDP in 2020-21

			Forecasts:				
		2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
- cyclical	$b	..	-5	-79	..	..	..
component	(% of GDP)	..	-0.3	-4.2	..	..	..
- discretionary	$b	..	-81	-169	-6	1	3
stimulus	(% of GDP)	..	-4.1	-8.9	-0.3	0.1	0.1
Underlying budget	$b	-1	-86	-248	..	..	..
balance	(% of GDP)	0.0	-4.4	-13.1	..	..	..



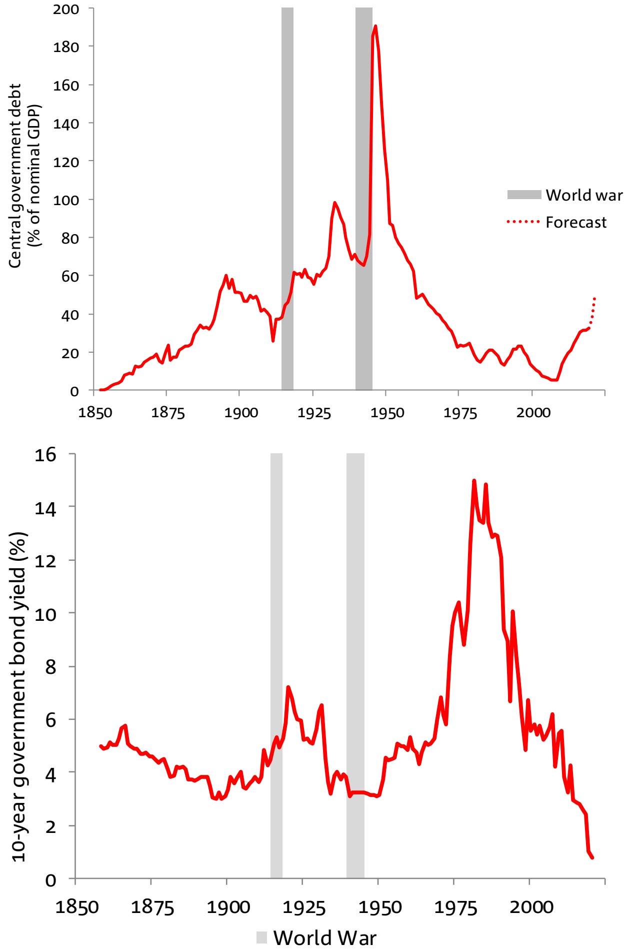
Note: Underlying budget balance from 1970-71 onwards. Numbers may not add because of rounding. ".." = not published.
Source: Australian Bureau of Statistics, Reserve Bank of Australia, Treasury, Vamplew (1987), National Australia Bank

Public debt could reach its highest level since the 1960s

Deficits this large would see Commonwealth debt rise from 33% of GDP to about 50%. If achieved, this would be the highest level of debt since the early 1960s. Even if public debt reaches this point, it is well below international estimates of the point at which high public debt becomes a drag on growth, which centre on 90% of GDP. Also, the cost of servicing this debt is very low as the 10-year bond yield is still below 1%, partly anchored by Reserve Bank purchases of bonds and related limited yield curve control, the record low official cash rate and low global interest rates.

More generally, we believe that such a run-up in debt is justifiable as the economic cost of the pandemic would be far greater if the government had not decided to aggressively ease policy to support recovery once the virus is brought under control.

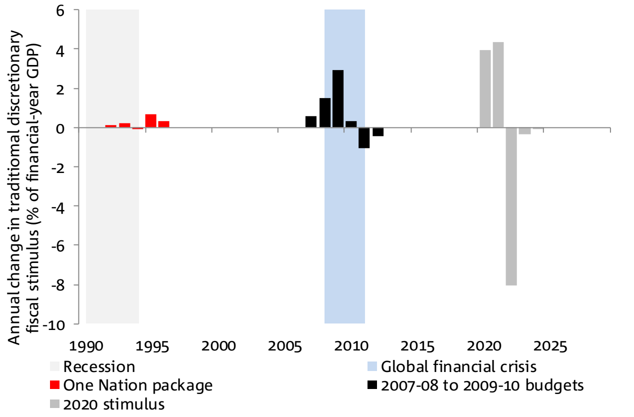
Chart 2: Public debt could hit 50% of GDP, although bond yields are extremely low



Note: Pre-federation estimates are for the colonies. Public debt differs from the cumulated sum of the budget balance because in some decades the Commonwealth issued debt on behalf of the states.
Source: Australian Bureau of Statistics, International Monetary Fund, Jorda-Schularick-Taylor Macrohistory Database, Reinhart and Rogoff (2012), Vamplew (1987), National Australia Bank

Indeed, it is quite likely that further fiscal stimulus will be required as the economy rebounds, possibly by unwinding the current measures more slowly or providing additional cash handouts. This former is seen by using the annual change in the discretionary measures as share of GDP as a proxy for the boost to economic growth. On this basis, there is a record discretionary boost to growth over 2019-20 and 2020-21, which becomes a record drag in 2021-22 as nearly all the stimulus measures have ended at that point.

Chart 3: Fiscal policy is a major drag on growth in 2021-22 as most discretionary measures abruptly end



Source: Australian Bureau of Statistics, Treasury, National Australia Bank

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CALENDAR OF ECONOMIC RELEASES

Country	Economic Indicator	Period	Forecast	Consensus	Actual	Previous	GMT	AEDT
Monday 20 April 2020								
NZ	CPI QoQ / YoY	1Q	0.5 / 2.2	0.4 / 2.1		0.5 / 1.9	21.45	8.45
AU	ABS household survey on COVID-19 impact						0.30	11.30
Tuesday 21 April 2020								
AU	Weekly payrolls						0.30	11.30
AU	RBA minutes						0.30	11.30
AU	RBA Governor Lowe speaks - Economic and Financial Update						4.00	15.00
UK	ILO Unemployment Rate 3Mths	Feb		4		3.9	5.00	16.00
UK	Jobless Claims Change	Mar		--		17.3	5.00	16.00
GE	ZEW Survey Current Situation	Apr		-65		-43.1	8.00	19.00
GE	ZEW Survey Expectations	Apr		-51.5		-49.5	8.00	19.00
CA	Retail Sales MoM	Feb		--		0.4	11.30	22.30
CA	Retail Sales Ex Auto MoM	Feb		--		-0.1	11.30	22.30
Wednesday 22 April 2020								
AU	Westpac Leading Index MoM	Mar		--		-0.43	23.30	10.30
AU	Preliminary retail sales	Mar	-0.2			0.5	0.30	11.30
UK	CPI MoM / YoY	Mar		0.1 / 1.6		0.4 / 1.7	5.00	16.00
CA	CPI NSA MoM / YoY	Mar		--		0.4 / 2.2	11.30	22.30
CA	CPI Core- Common YoY%	Mar		--		1.8	11.30	22.30
EC	Consumer Confidence	Apr A		-17.5		-11.6	13.00	0.00
Thursday 23 April 2020								
JN	Jibun Bank Japan PMI Mfg	Apr P		--		44.8	23.30	10.30
AU	Preliminary merchandise trade figures	Mar					0.30	11.30
NZ	Credit Card Spending YoY	Mar		--		2.5	2.00	13.00
UK	Retail Sales Inc Auto Fuel MoM / YoY	Mar		-3.5 / -4		-0.3 / 0	5.00	16.00
GE	Markit/BME Germany Manufacturing PMI	Apr P		39		45.4	6.30	17.30
GE	Markit Germany Services PMI	Apr P		30		31.7	6.30	17.30
EC	Markit Eurozone Manufacturing PMI	Apr P		40		44.5	7.00	18.00
UK	Markit UK PMI Manufacturing SA	Apr P		45		47.8	7.30	18.30
US	Markit US Manufacturing PMI	Apr P		38.5		48.5	12.45	23.45
US	Markit US Services PMI	Apr P		32.5		39.8	12.45	23.45
US	New Home Sales	Mar		650		765	13.00	0.00
Friday 24 April 2020								
JN	Natl CPI YoY	Mar		0.4		0.4	22.30	9.30
JN	All Industry Activity Index MoM	Feb		-0.6		0.8	3.30	14.30
GE	IFO Current Assessment	Apr		82		93	7.00	18.00
GE	IFO Business Climate	Apr		80		86.1	7.00	18.00
US	Durable Goods Orders	Mar P		-11.1		1.2	11.30	22.30
US	U. of Mich. Sentiment	Apr F		69		71	13.00	0.00
Upcoming Central Bank Interest Rate Announcements								
Japan, BoJ		Apr 28	-0.10	-0.10		-0.10		
US, Federal Reserve		Apr 29	0/0.25	0/0.25		0/0.25		
Europe, ECB		Apr 30	-0.50	-0.50		-0.50		
Australia, RBA		May 5	0.25	0.25		0.25		
UK, BOE		May 7	0.10	0.10		0.10		
New Zealand, RBNZ		May 13	0.25	0.25		0.25		
Canada, BoC		Jun 3	0.25	0.25		0.25		

GMT: Greenwich Mean Time; AEDT: Australian Eastern Standard Time

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