

Parliamentary Library Pre-Budget Seminar

Professor Warwick McKibbin

and

Dr John Edwards



Parliament of Australia

Department of Parliamentary Services

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Risks and Policy Challenges in the Global Economy to 2030

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Overview

- Global Context
 - Likely shocks
- Drivers of Growth
 - Demographics
 - Productivity
 - (Capital accumulation)
- Policy Risks
 - Fiscal Sustainability
 - President Trump and the change in policy mix
- Summing Up

The Global Context

- The world economy is being fundamentally transformed
 - growth of large emerging economies (China, India, Brazil)
 - technological disruption
- Individual economies are also going through longer term adjustments (excessive debt, demographic change)

The Global Context

- Long term trends are impacting on short term rigidities in many economies
- Policies have been aimed at business cycle when should have been aimed at structural adjustment

Likely shocks out to 2030

- Medium term
 - Global Demographic Adjustment
 - Global Productivity slowdown/ acceleration
 - Fiscal sustainability
 - Global Policies addressing Climate Change
 - Pandemics
- Shorter term
 - President Trump Monetary/Fiscal mix
 - Contradictions in Europe
 - Structural adjustment in China
 - Japanese policy experiment
 - Geopolitical tensions

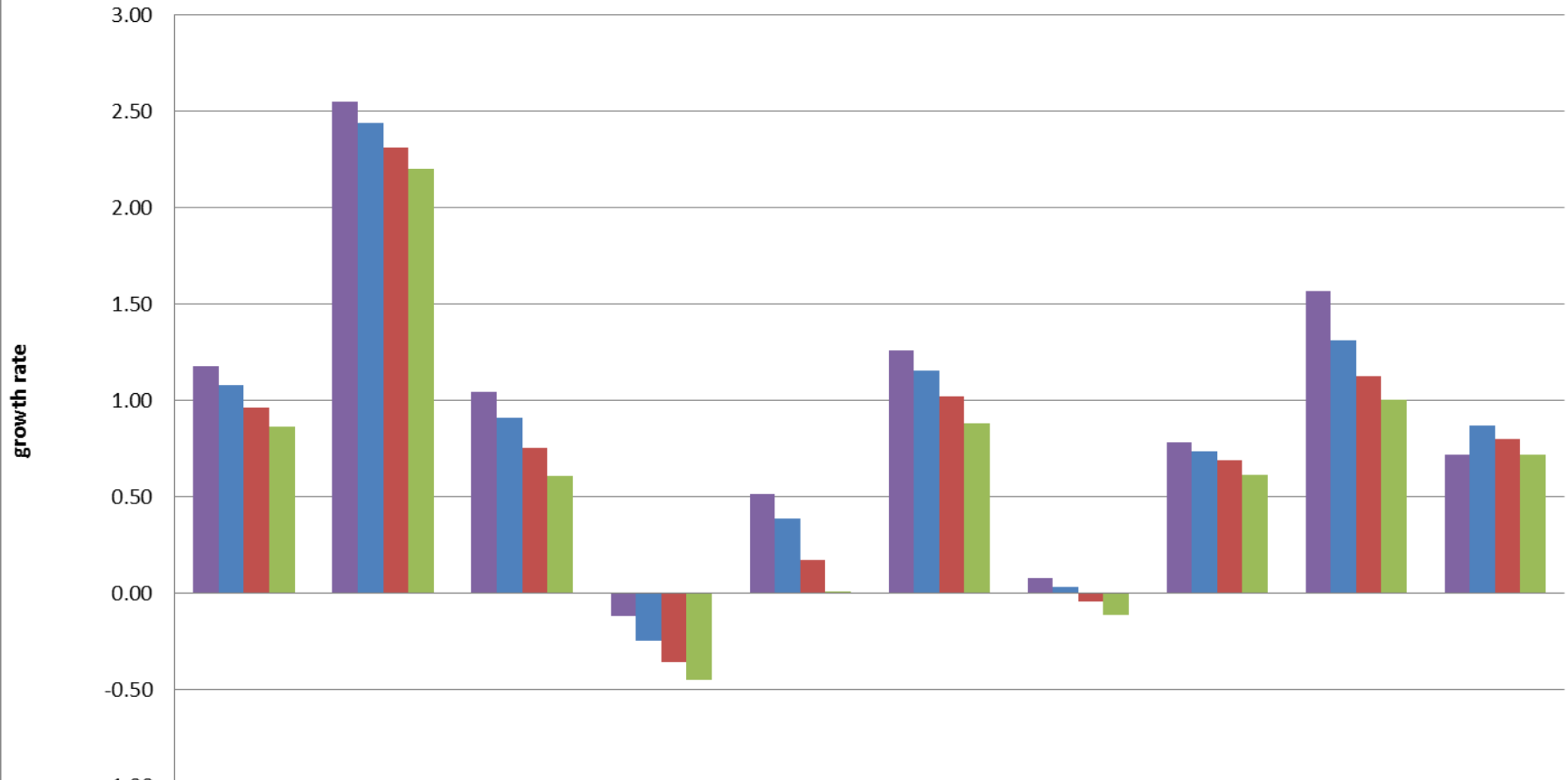
The Drivers of Growth

- Demographics
- Productivity
- Capital
 - Physical
 - Human

Demographic Change

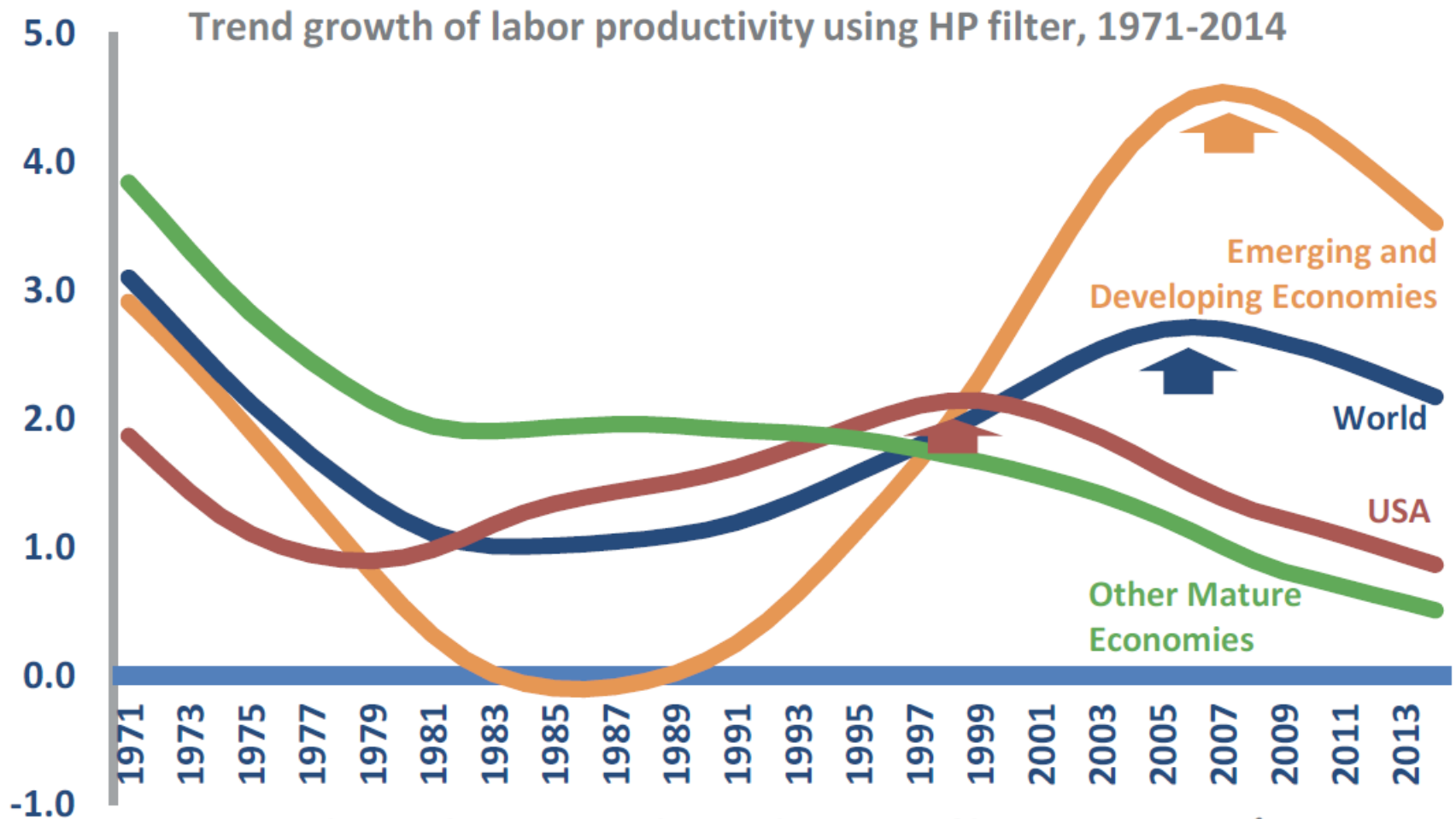
Figure 1: Population Growth Rates 2010-2030

Source: UN Population Projection 2015 Revision, Medium Fertility



	1.18	2.55	1.04	-0.12	0.52	1.26	0.08	0.78	1.57	0.72
	WORLD	AFRICA	ASIA	Japan	China	India	EUROPE	NORTHERN AMERICA	Australia	New Zealand
■ 2010-2015	1.18	2.55	1.04	-0.12	0.52	1.26	0.08	0.78	1.57	0.72
■ 2015-2020	1.08	2.44	0.91	-0.24	0.39	1.15	0.04	0.74	1.32	0.87
■ 2020-2025	0.97	2.31	0.75	-0.36	0.17	1.02	-0.04	0.69	1.13	0.80
■ 2025-2030	0.86	2.20	0.61	-0.45	0.01	0.88	-0.11	0.62	1.01	0.72

Productivity



Note: Trend growth rates are obtained using HP filter, assuming a $\lambda=100$.

Source: Source: The Conference Board Total Economy Database™, May 2015

Alternative Futures

- Where are technological innovations in the productivity outlook?
- Disruptive technologies
 - Positives and negatives

Fiscal Sustainability

Gross Government Debt to GDP Ratio

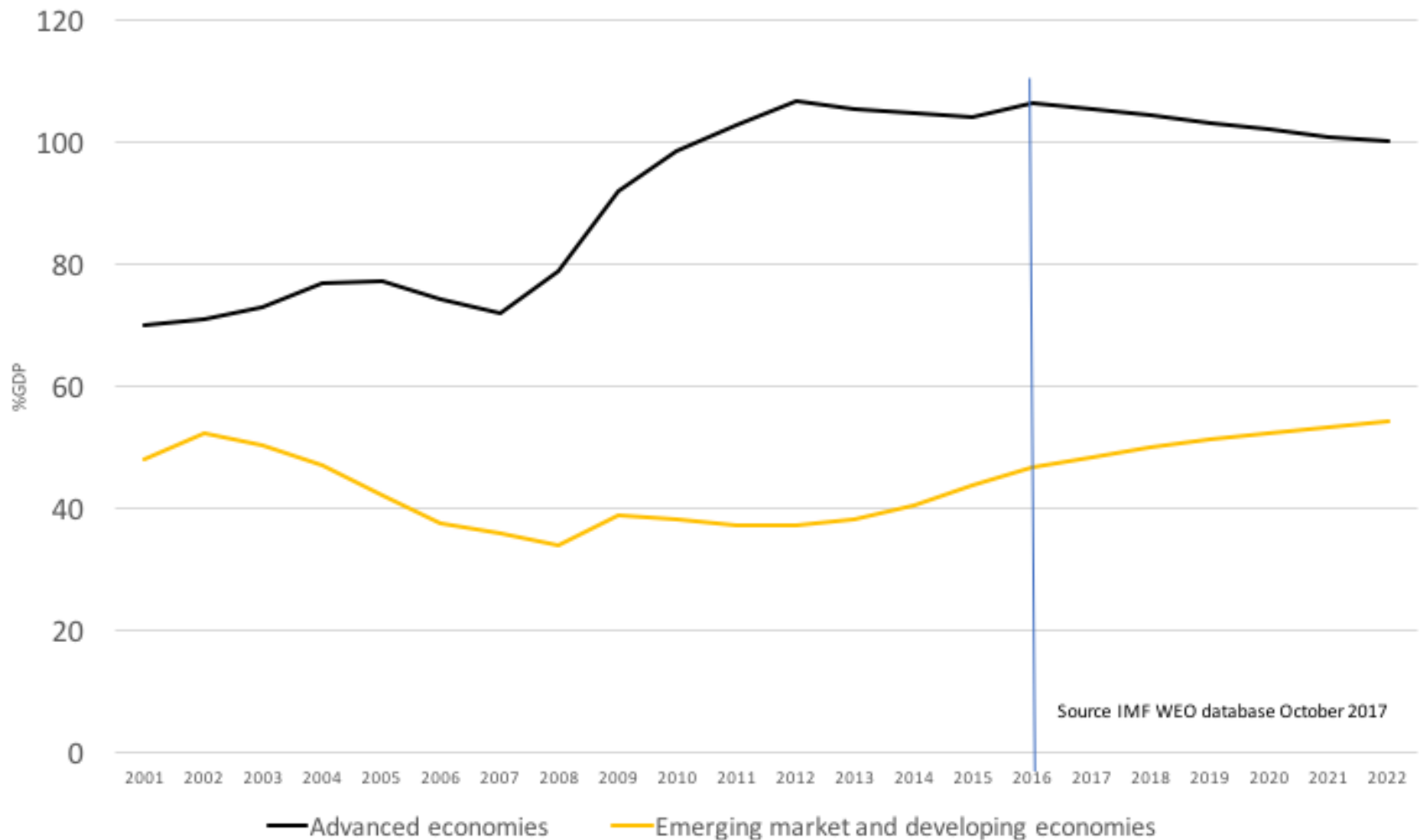
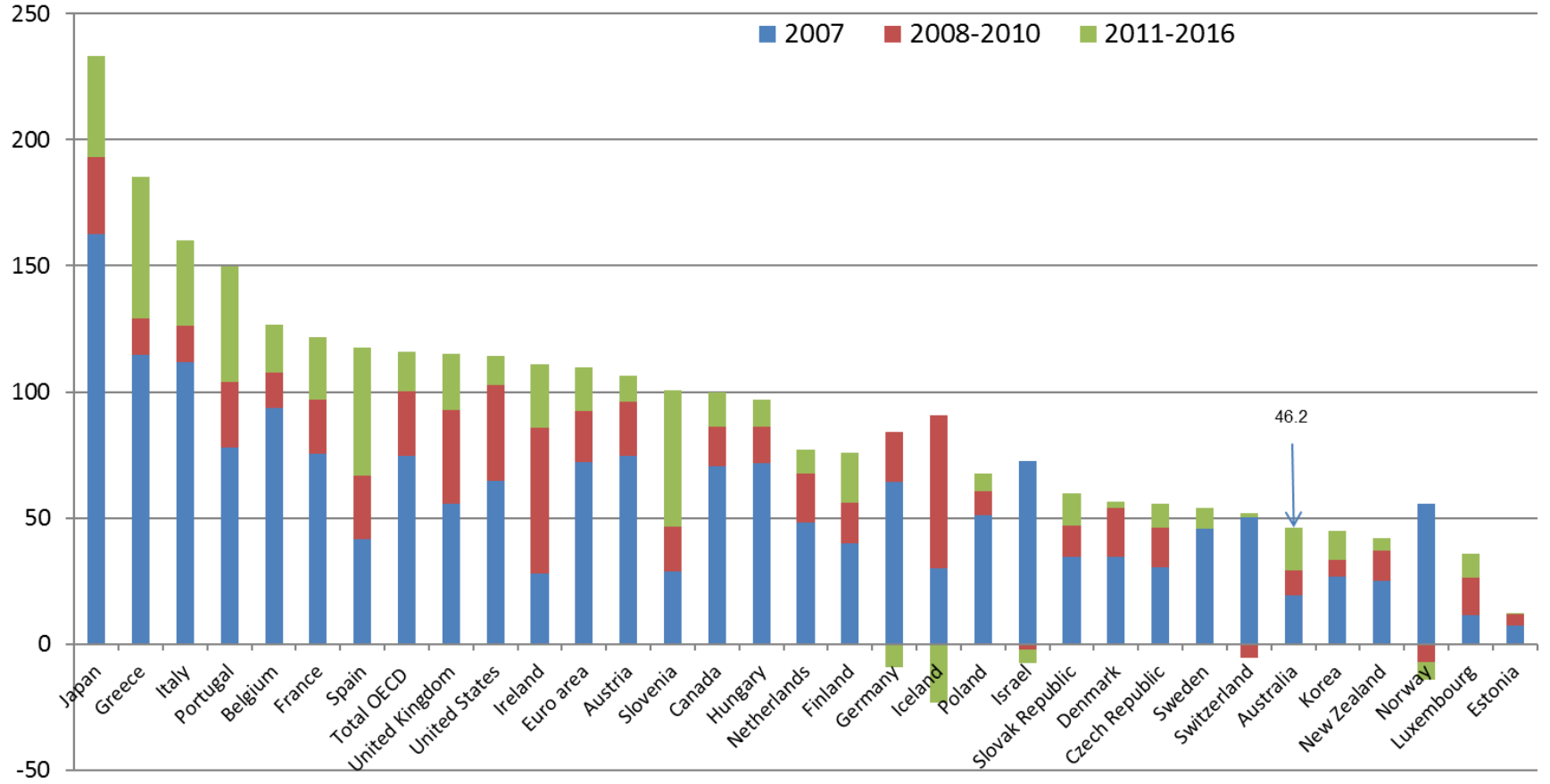


Figure 1: Government Gross Financial Liabilities

(Per cent of nominal GDP)



Source OECD Economic Outlook September 2016, Annex Table 36

Key Issues

- Fiscal problems accentuated by
 - Rising interest rates
 - Low rates of economic growth

President Trump

Possible Economic Policies

- Reduced immigration
- Large fiscal stimulus
 - Cut taxes
 - Increase infrastructure spending
 - Increase defense spending
- Tariff increases
- Fed will already be tightening monetary policy

Implications

- Steepening of the yield curve globally
- Rising short term interest rates in the US
- Potentially very strong \$US

- Countries with large debt and debt in \$US under great stress.
- Another financial crisis is highly likely.

Summary

- The future is unknowable but scenario planning is one way to help think about alternative futures
- A sensible policy approach is to have structural reform that enhances flexibility
- Policies frameworks should not be designed to only work under a particular forecast of the future
 - Climate policy
 - Budget policy

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The Budget 2018/19

Parliamentary Library Seminar

May 7 2018

John Edwards

Nonresident Fellow

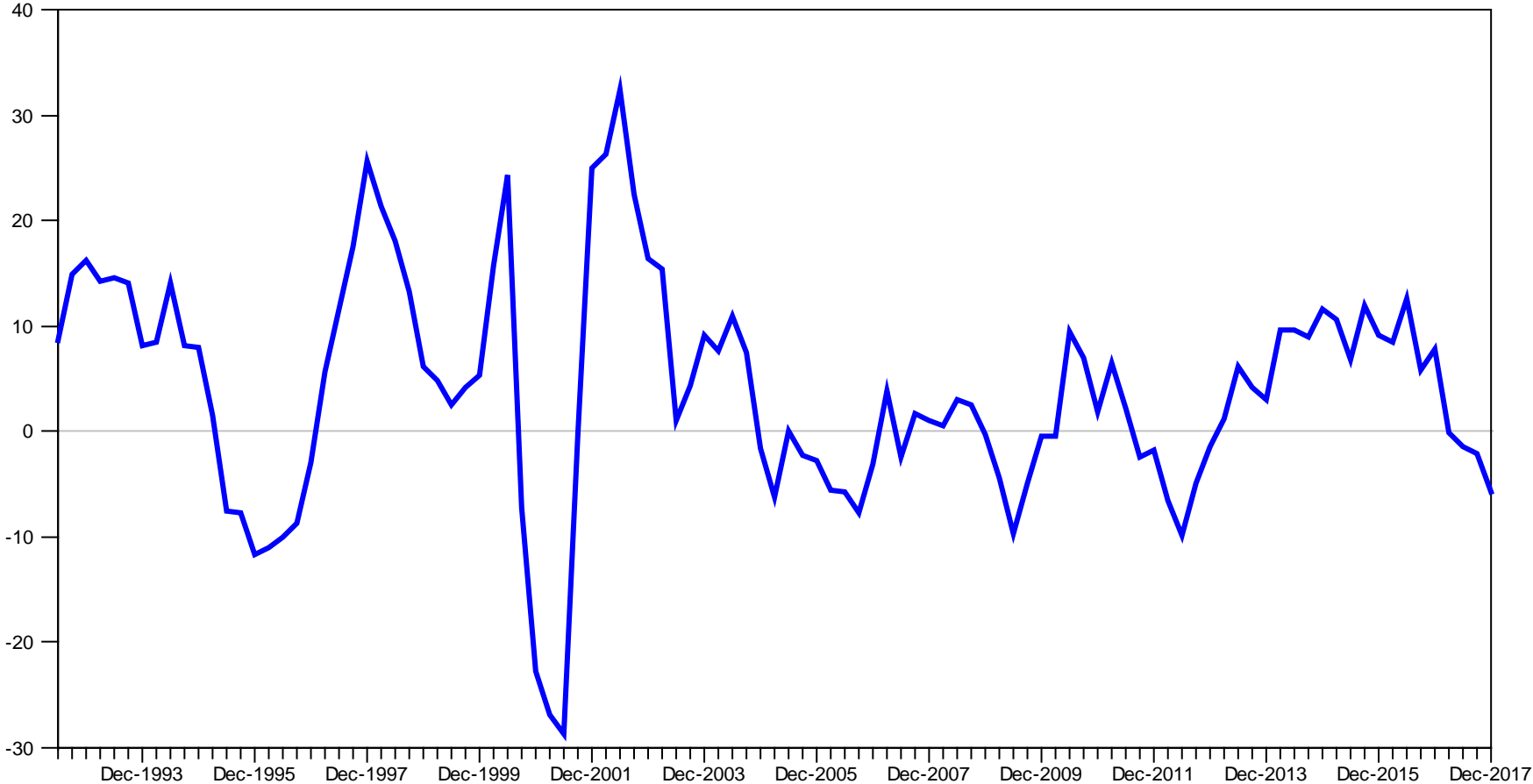
Lowy Institute

Australia's Economic Circumstances

- Concurrent global expansion in US, Europe, Japan, China and most other economies
- Australian output growth modest but well balanced and persistent
- Slow growth in wages, household income
- Inflation at 2% and slowly increasing
- Productivity growth slow but markedly improved compared to the recent mining investment boom phase
- Jobs growth quite firm though recent weakness, but relatively high unemployment and underemployment
- Monetary policy setting stimulatory, fiscal policy mildly contractionary as the fiscal deficit is slowly reduced

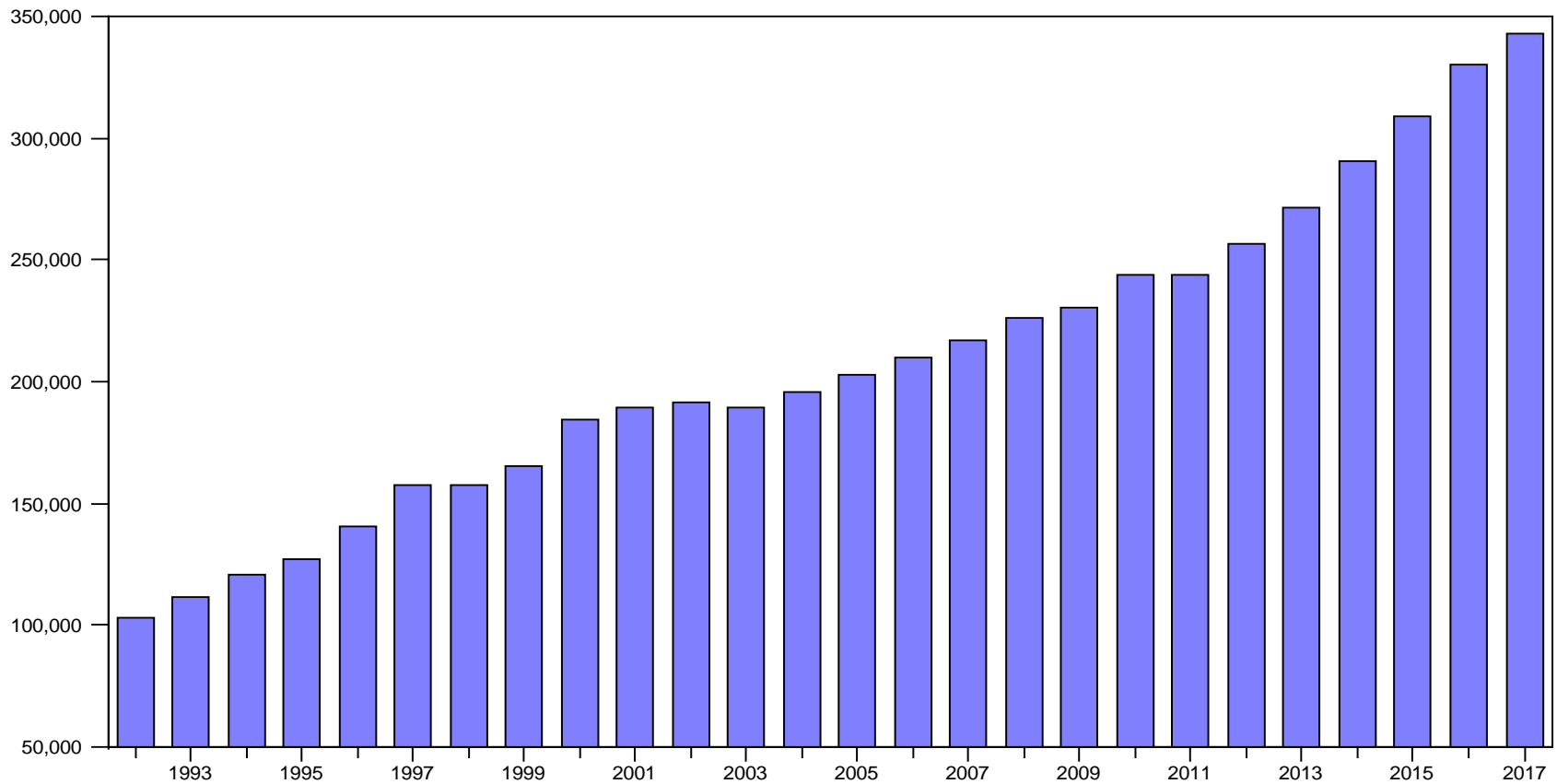
Dwelling investment, real, 4 qtr % change

Seas adj: CVM: GFCF: Private: Dwellings: Total: PCTCHG
% change



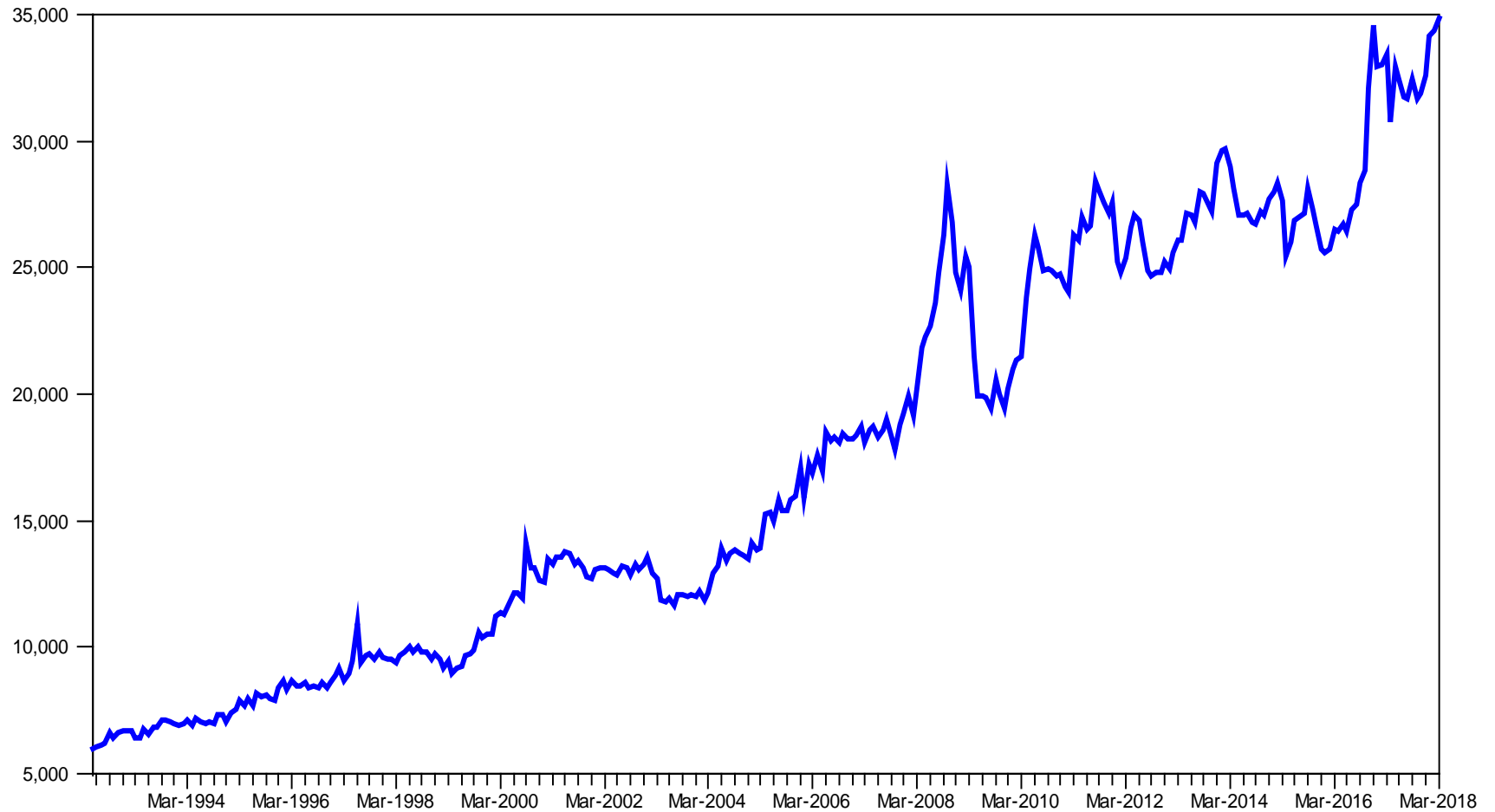
Exports, real, annual totals

Seas adj: CVM: Exports of goods & services: ANNUAL
\$m 2015/16 sa



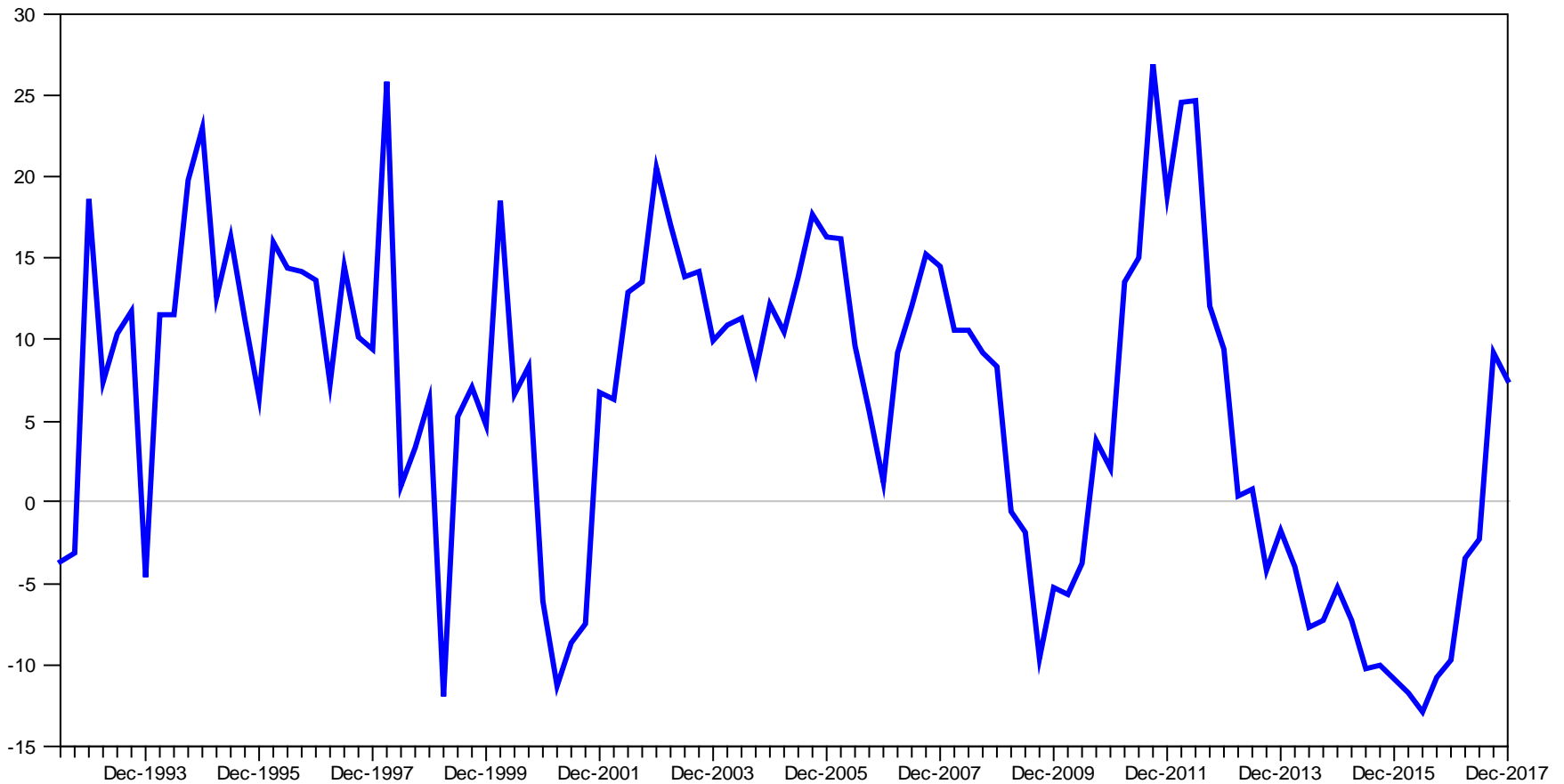
Exports, current dollars, monthly

Seas adj: Credits: Total goods & services
\$m sa



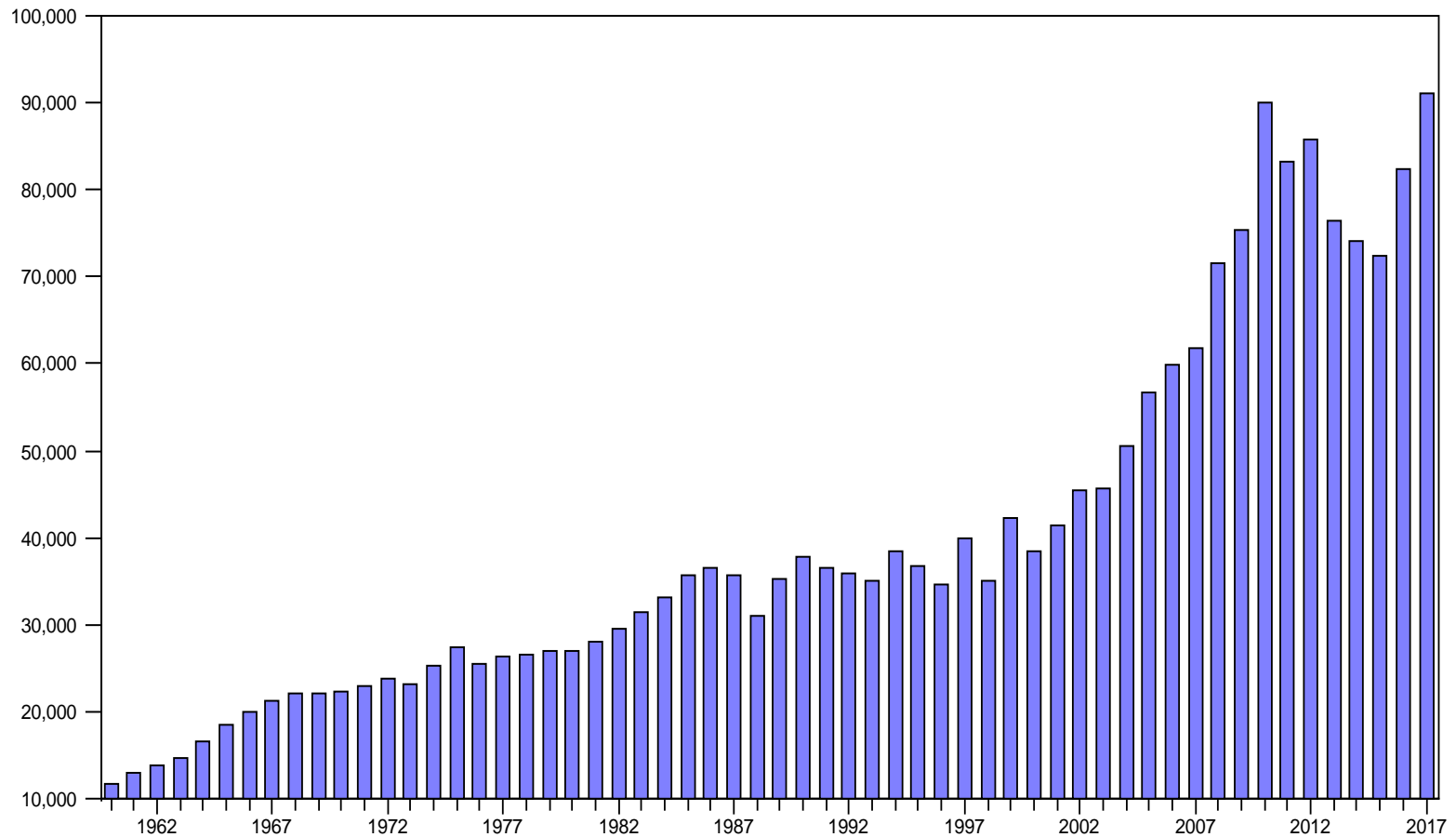
Business investment, 4 qtr % change

Seas adj: CVM: GFCF: Private: Total business investment: PCTCHG
% change



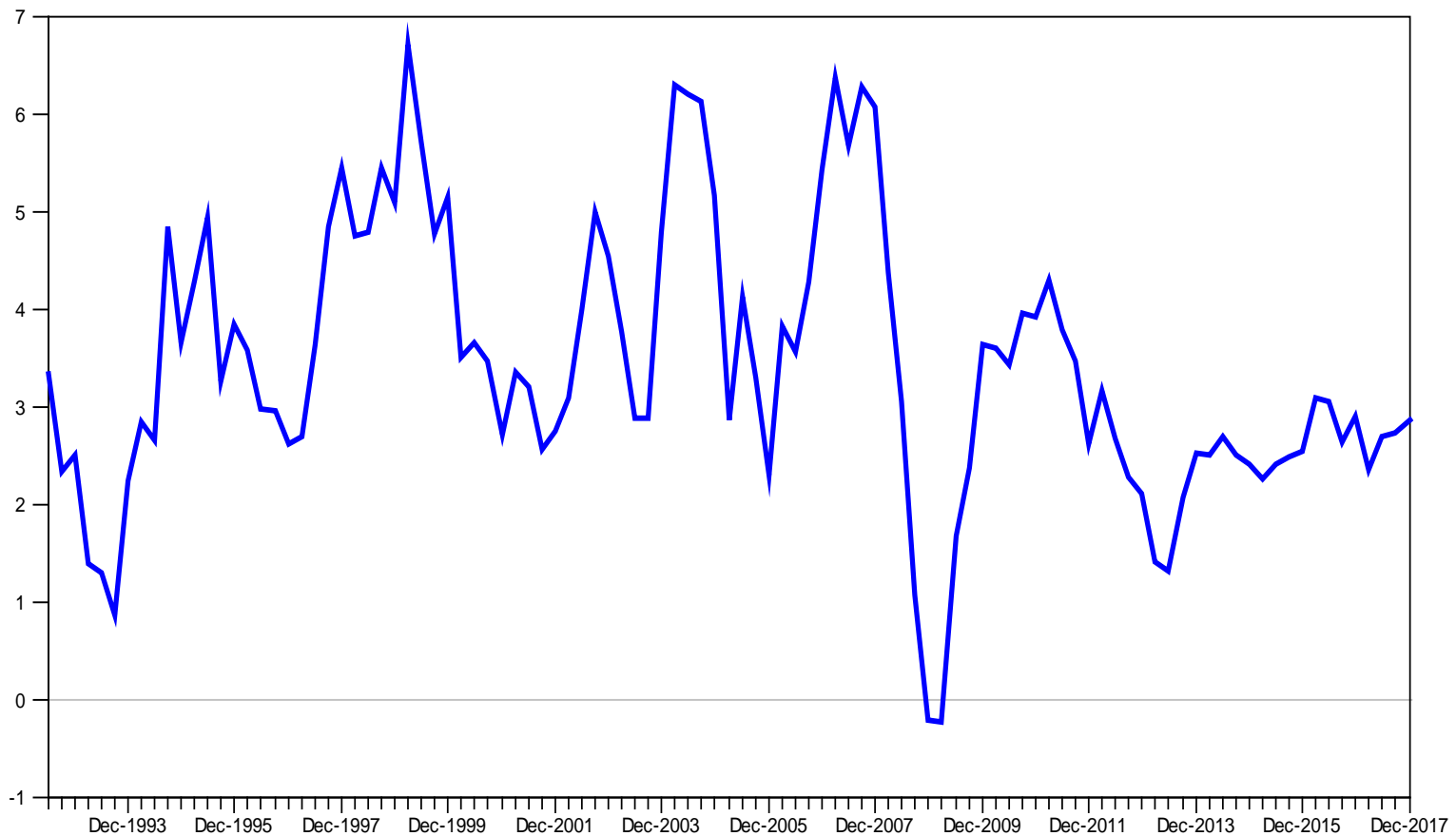
Public investment, real, annual totals

Seas adj: CVM: GFCF: Public: Total: ANNUAL
\$m 2015/16 sa



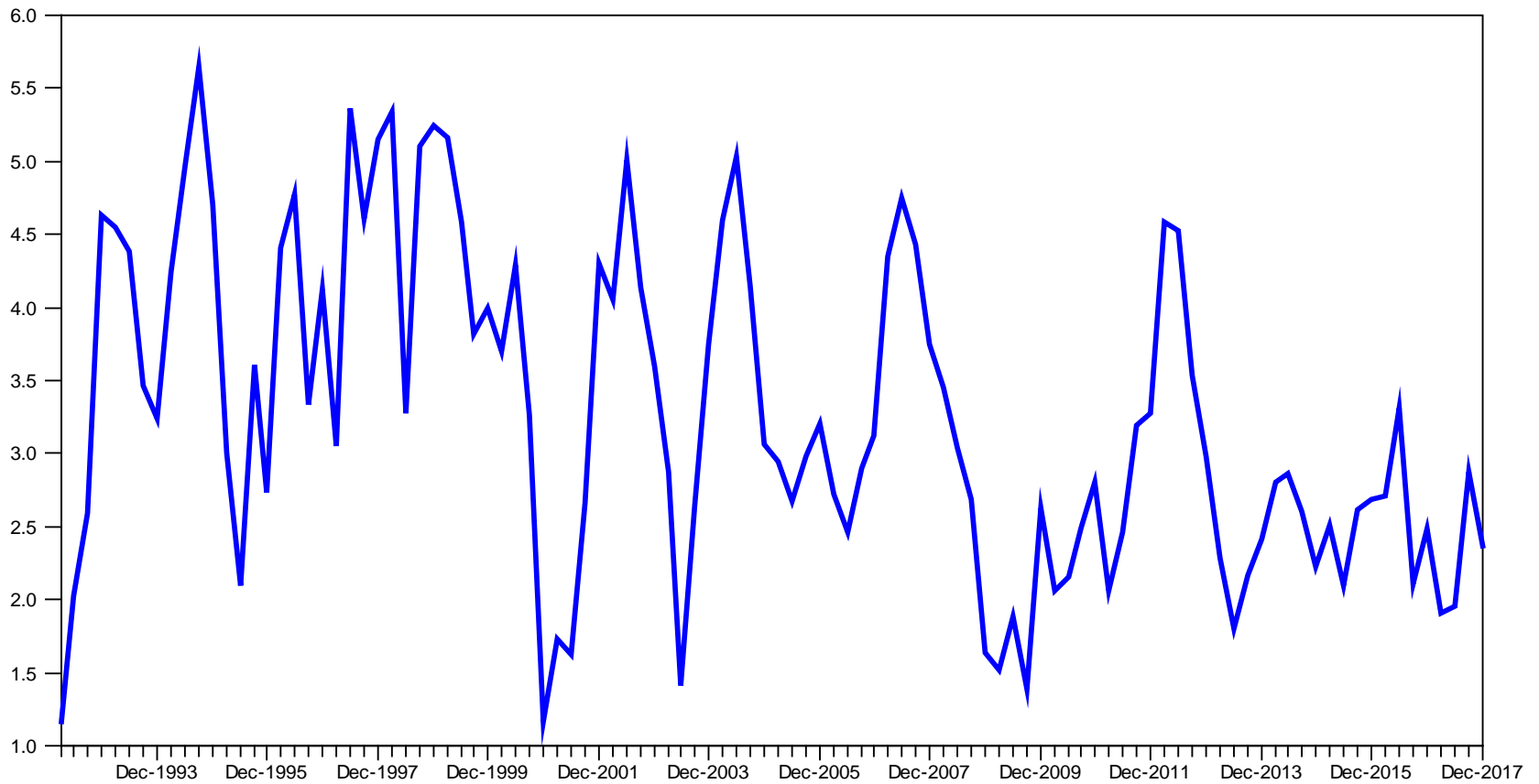
Household consumption, real, 4 qtr % change

Seas adj: CVM: Final consumption expenditure: Households: PCTCHG
% change



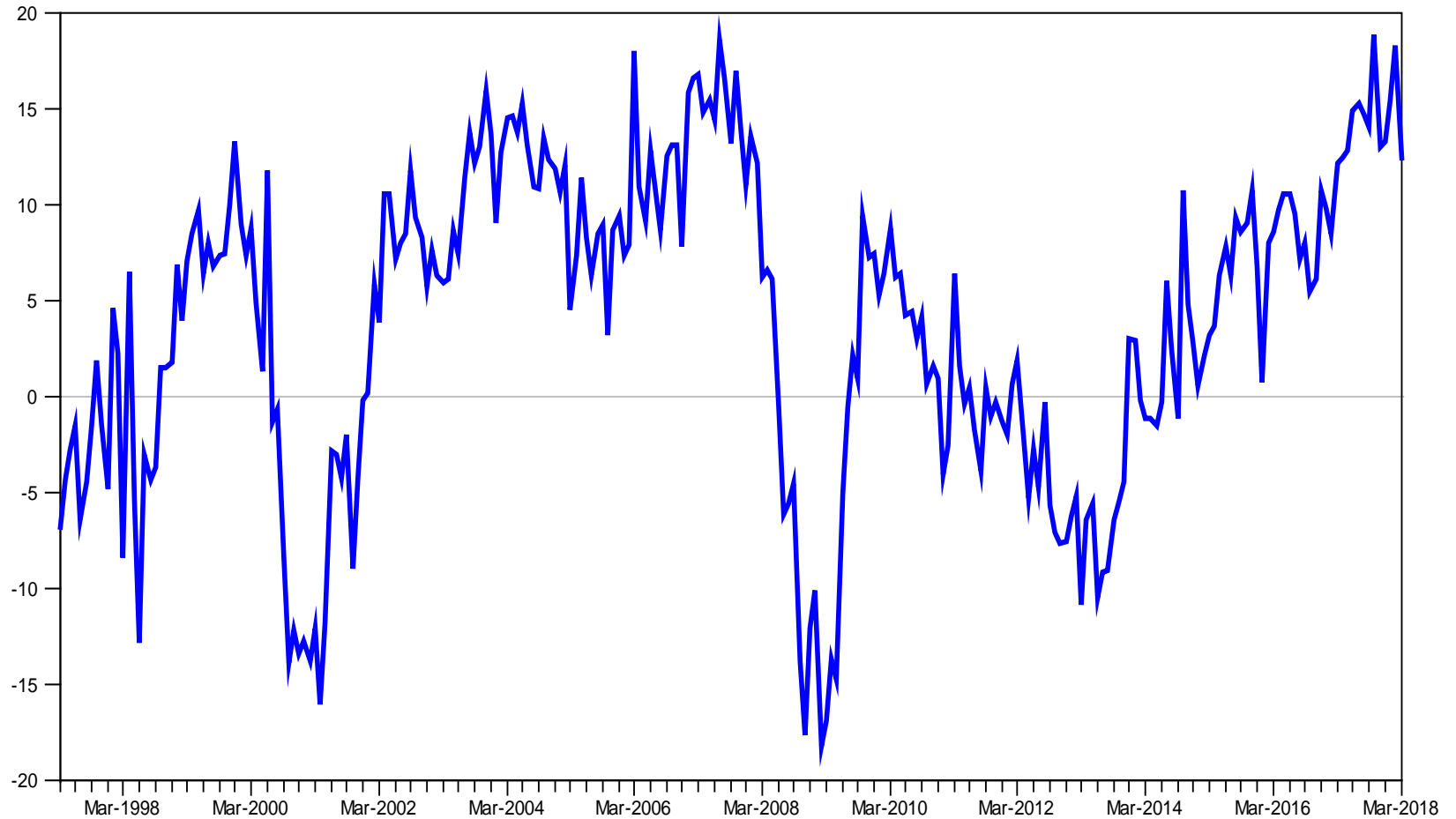
Real GDP 4 qtr % change

Seas adj: CVM: GDP: PCTCHG
% change



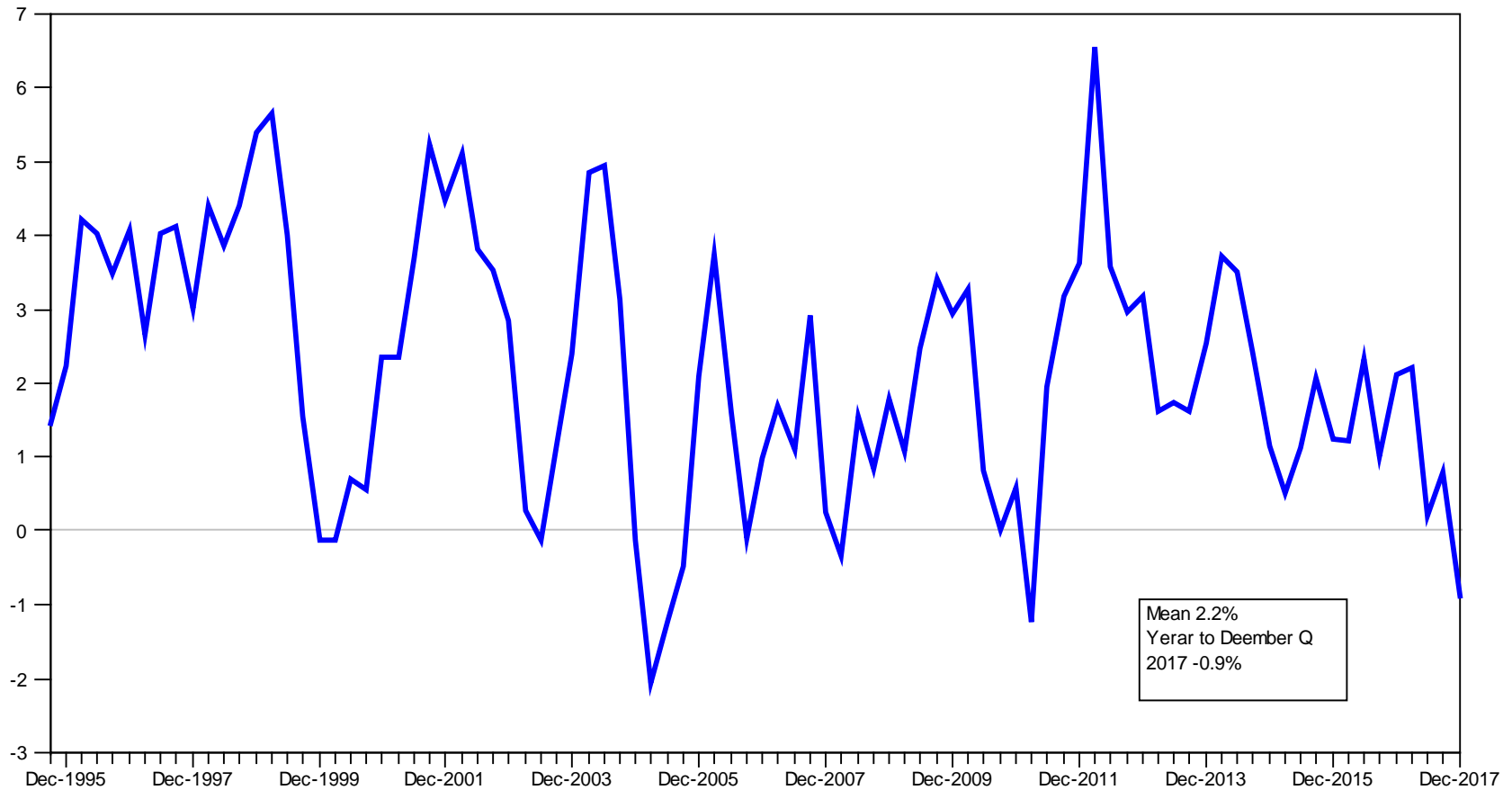
Business conditions

NAB business conditions index: Deviations from average
%



Labour productivity four quarter % change

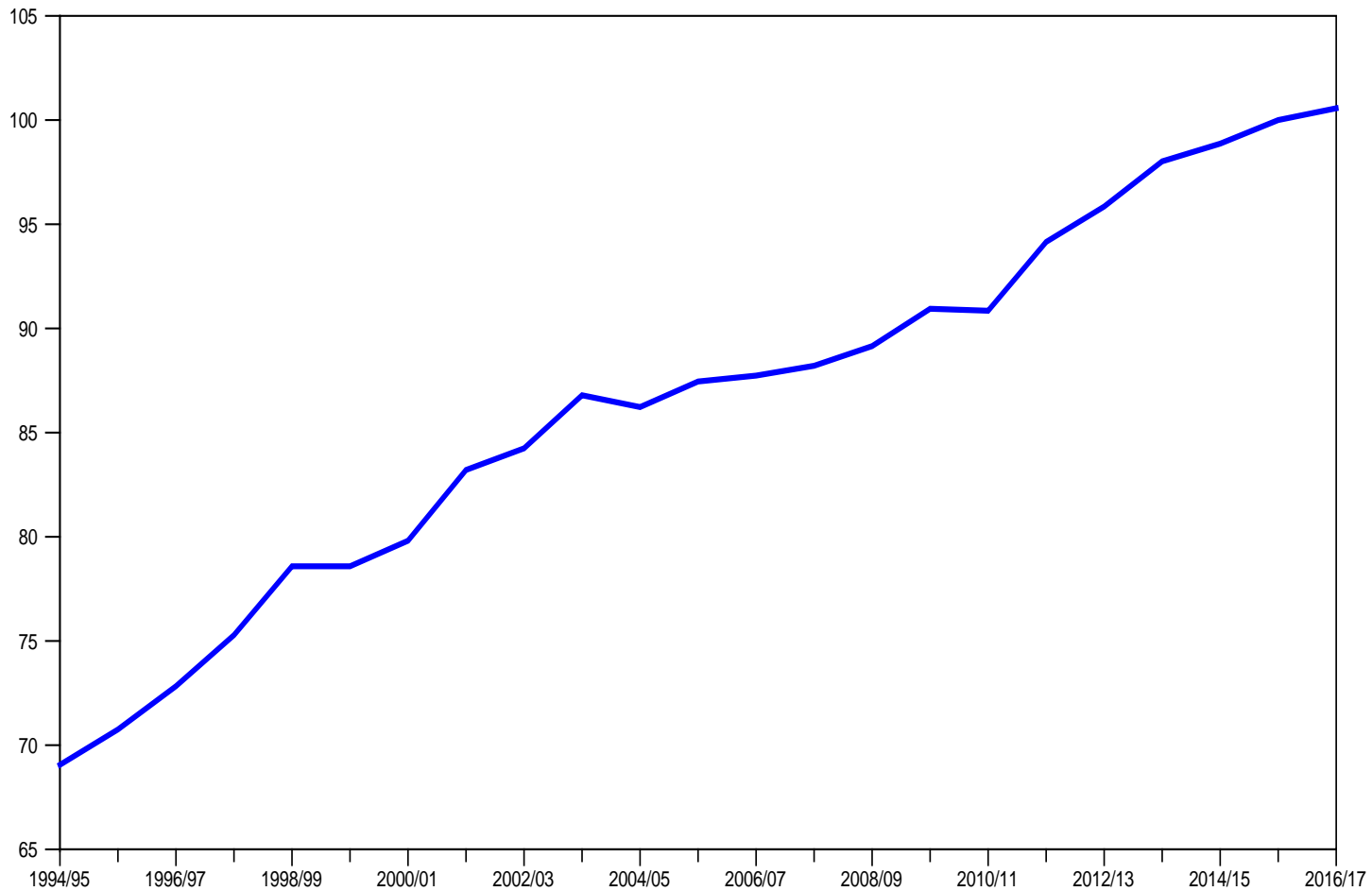
Seas adj: Index: Real GDP (GVA) per hour worked market sector **: PCTCHG
% change



Labour Productivity

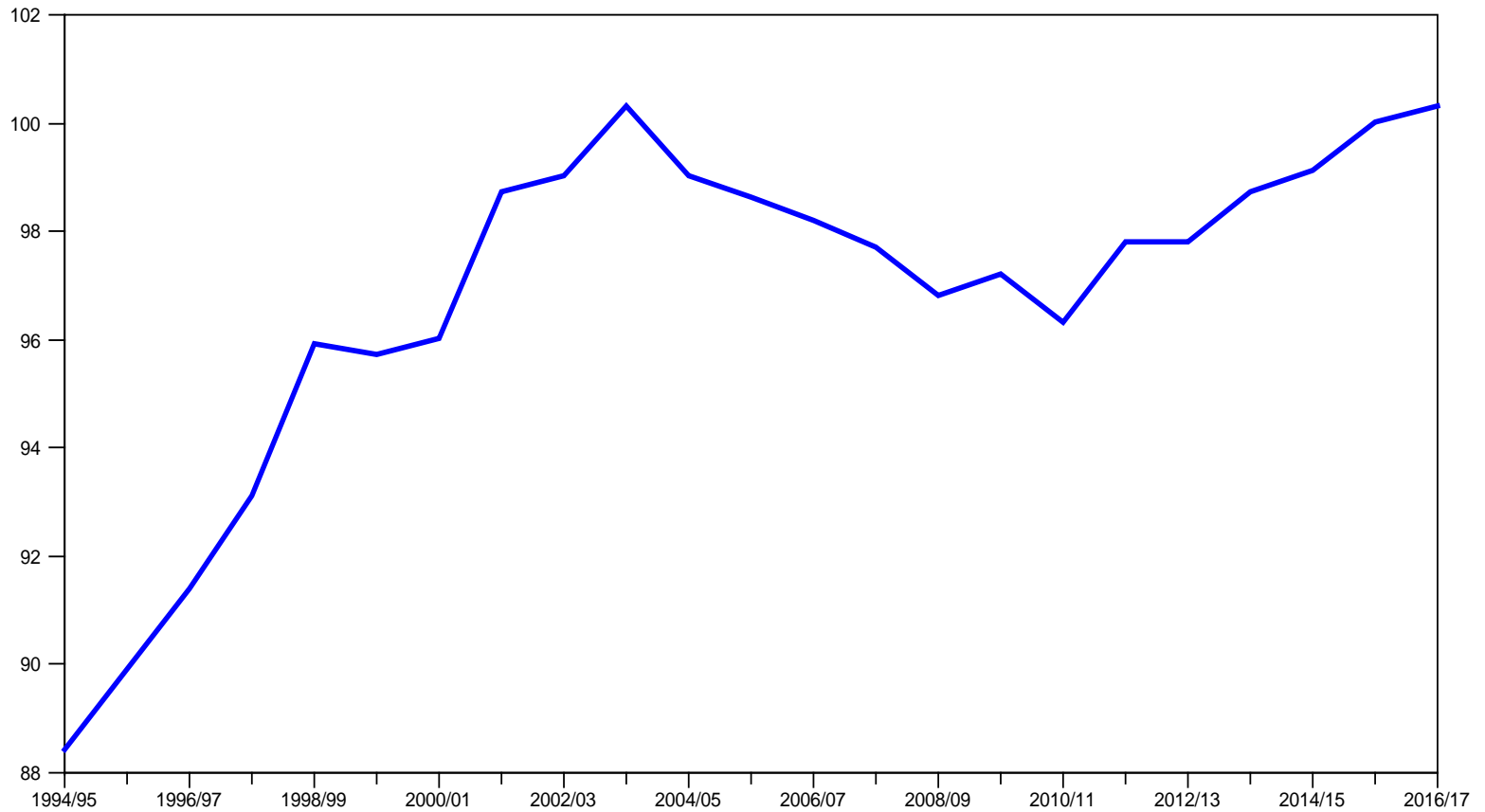
index levels

Productivity: Labour*: Quality adjusted hours worked basis #
2015/16=100



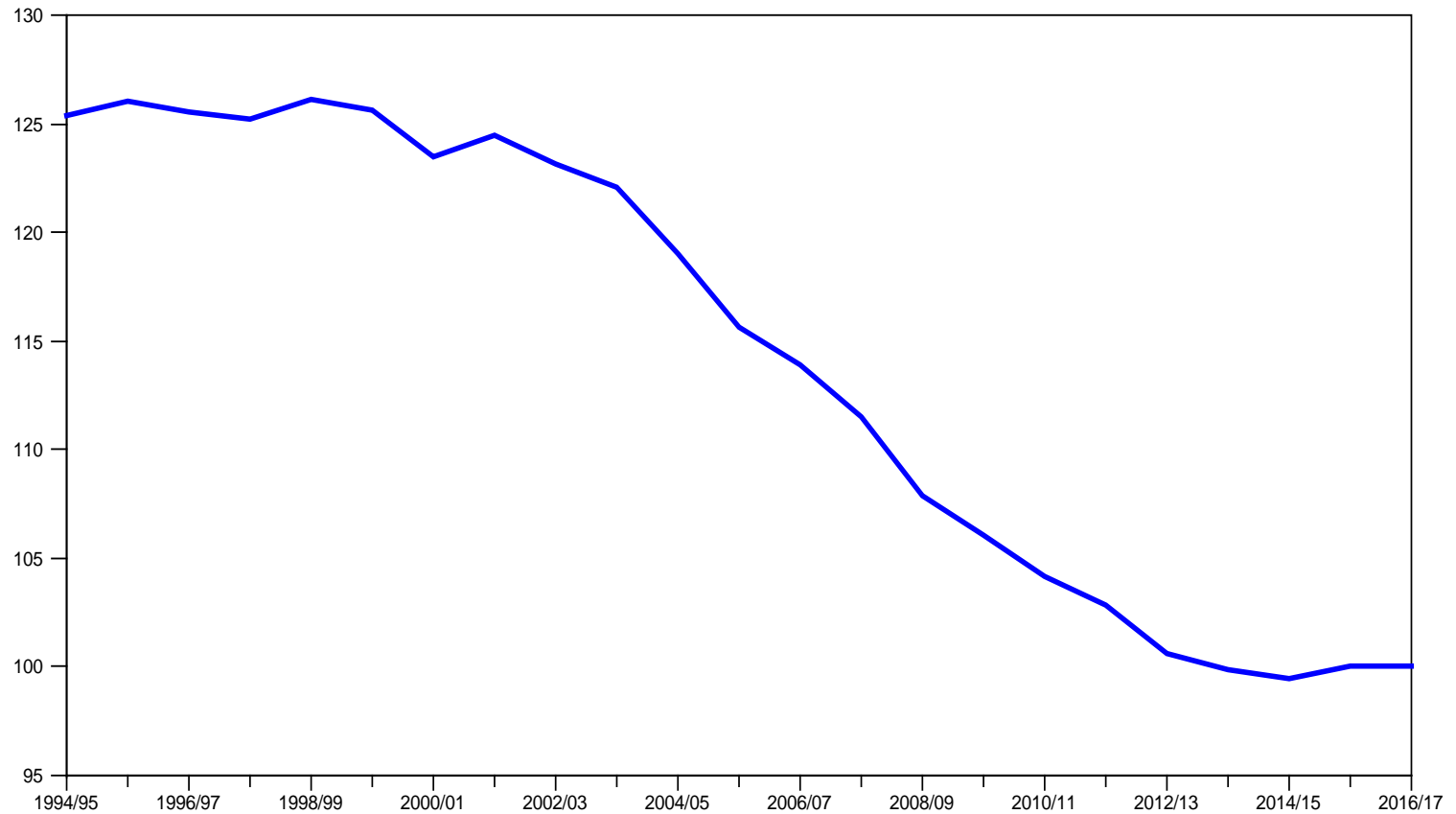
Multifactor Productivity

Productivity: Multi-factor***: Quality adjusted hours worked basis #
2015/16=100



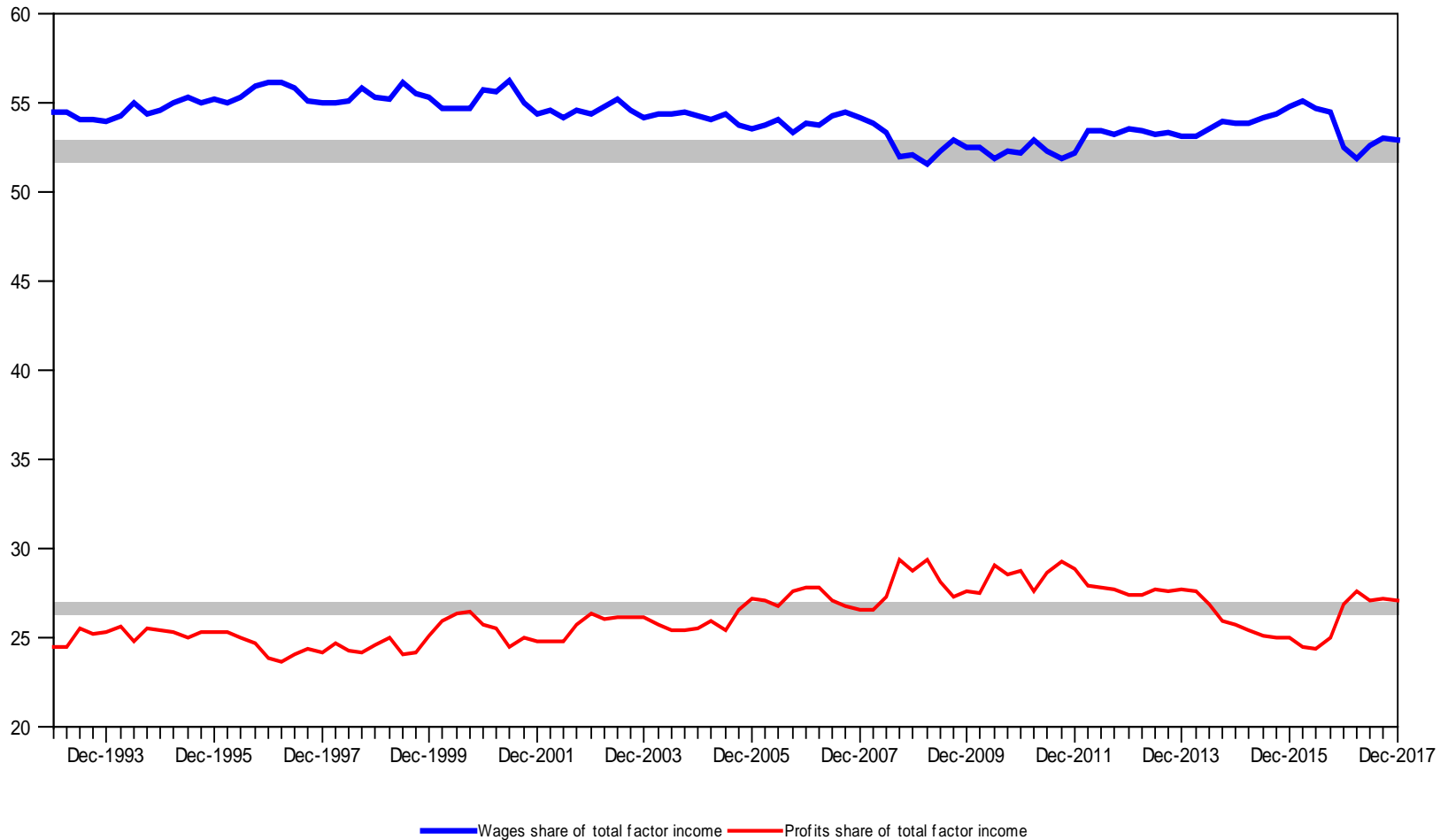
Capital Productivity

Productivity: Capital**
2015/16=100



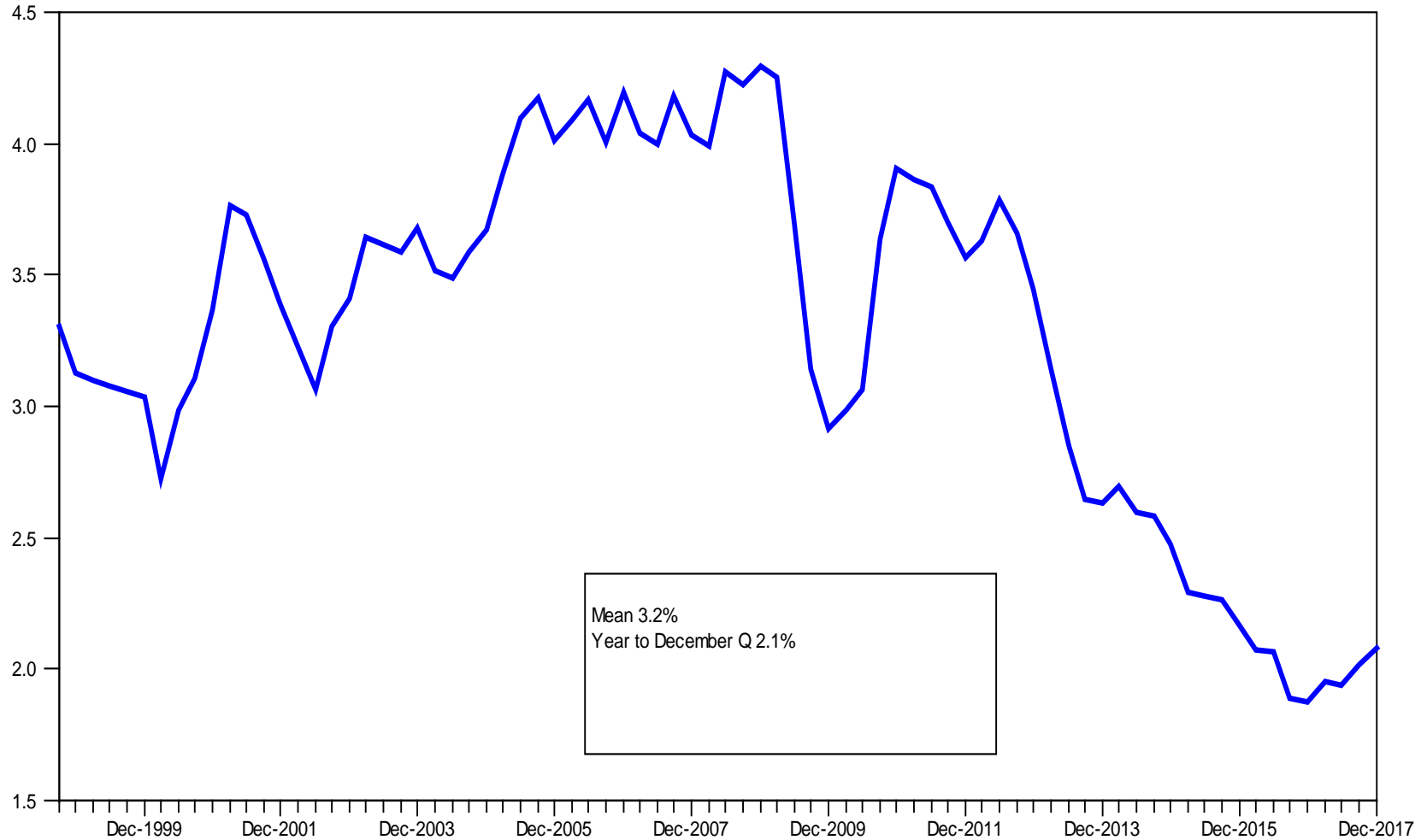
Wages, Profits Shares of Factor Income

Seas adj
Percent sa



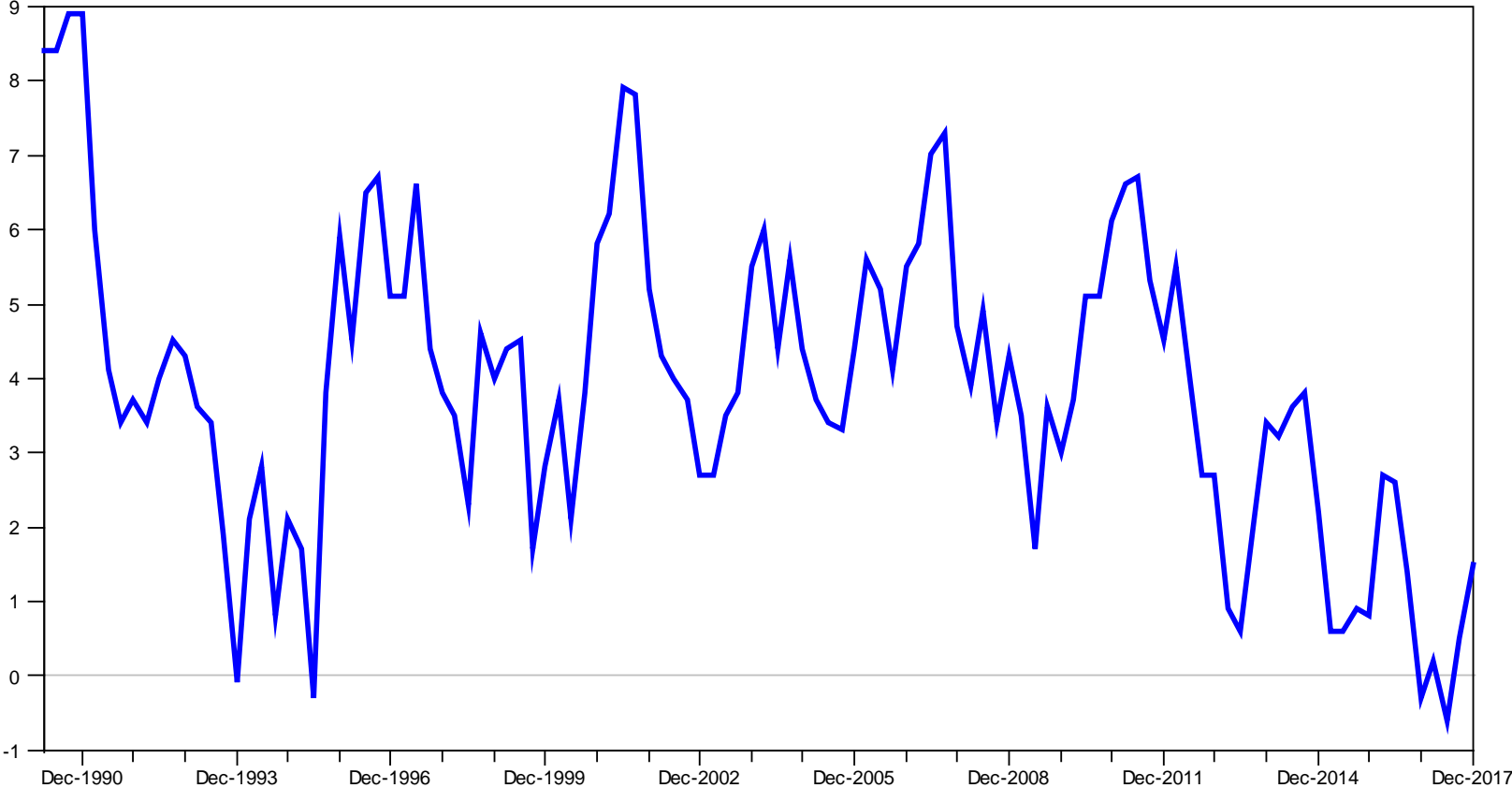
Wage price index 4 qtr % change

Seas adj: WPI: Total hourly rate: Excl bonuses: Private & public: PCTCHG
% change



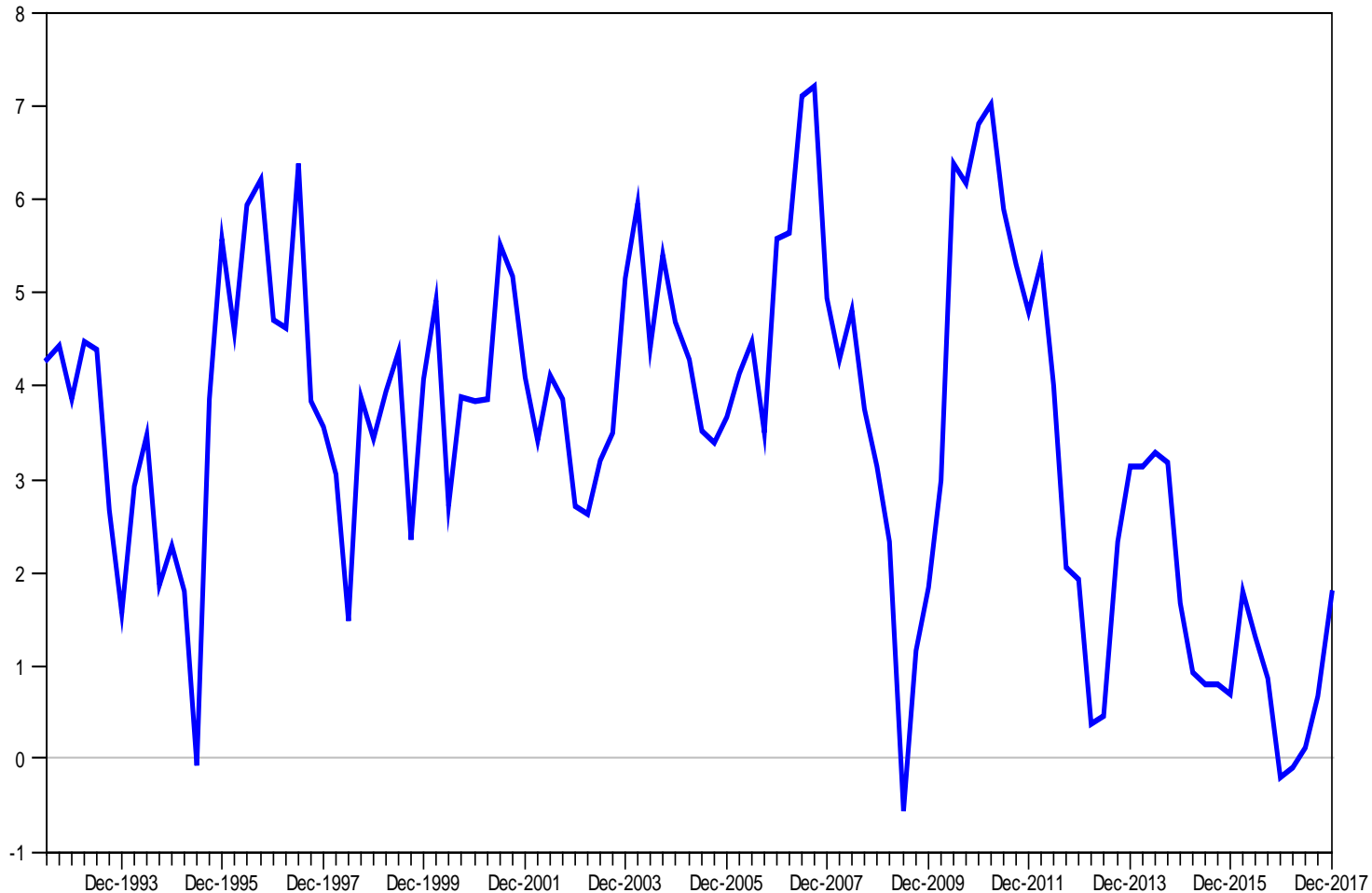
Average earnings

Non-farm average earnings per hour: Year-ended change
%pa sa



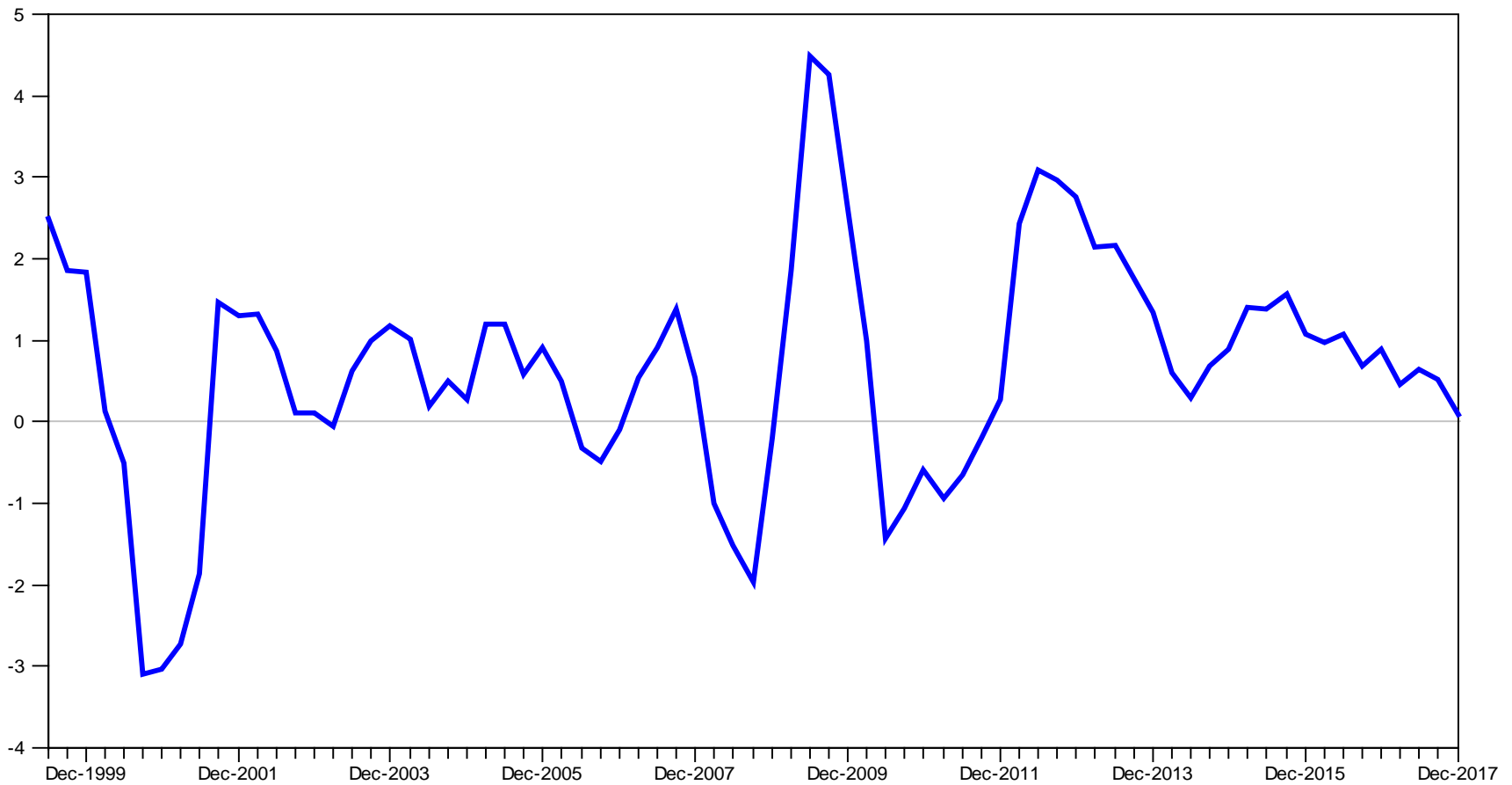
Average compensation per employee

Seas adj: Average non-farm compensation per employee: PCTCHG
% change



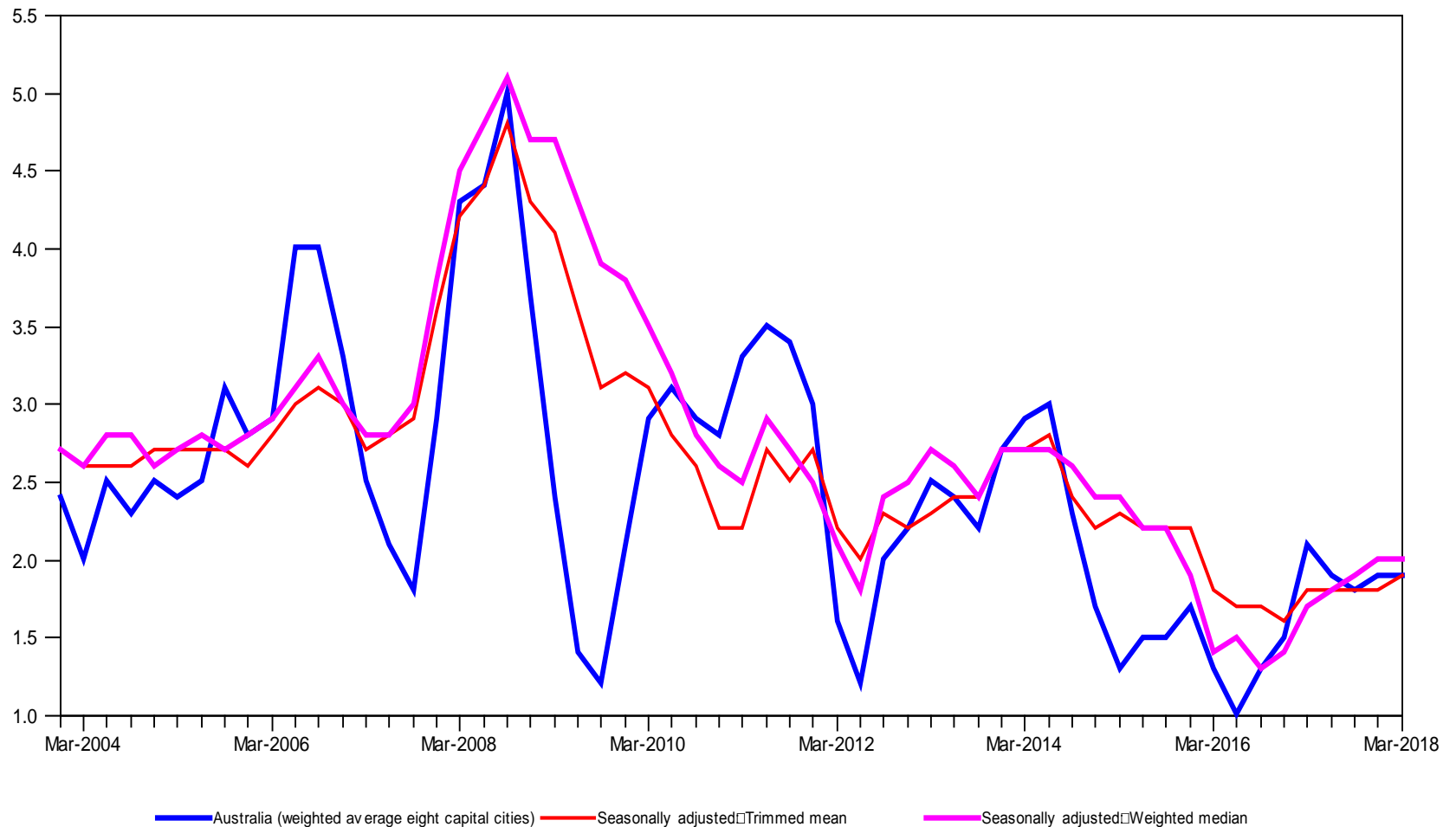
Growth in real wages

Wage price index deflated by employee household price index



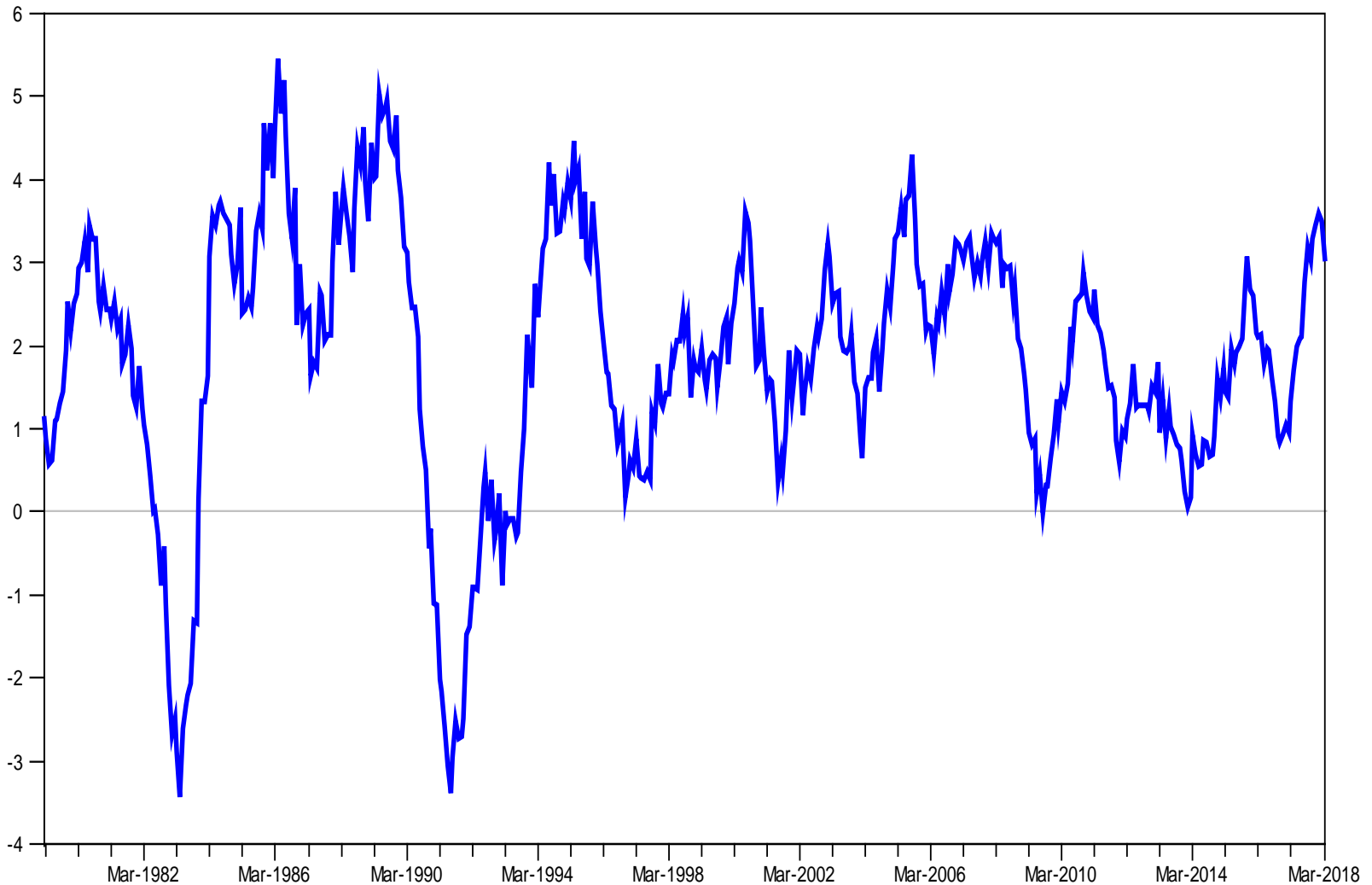
Consumer price inflation

CPI: %y: All groups
%pa, %pa sa, %pa sa



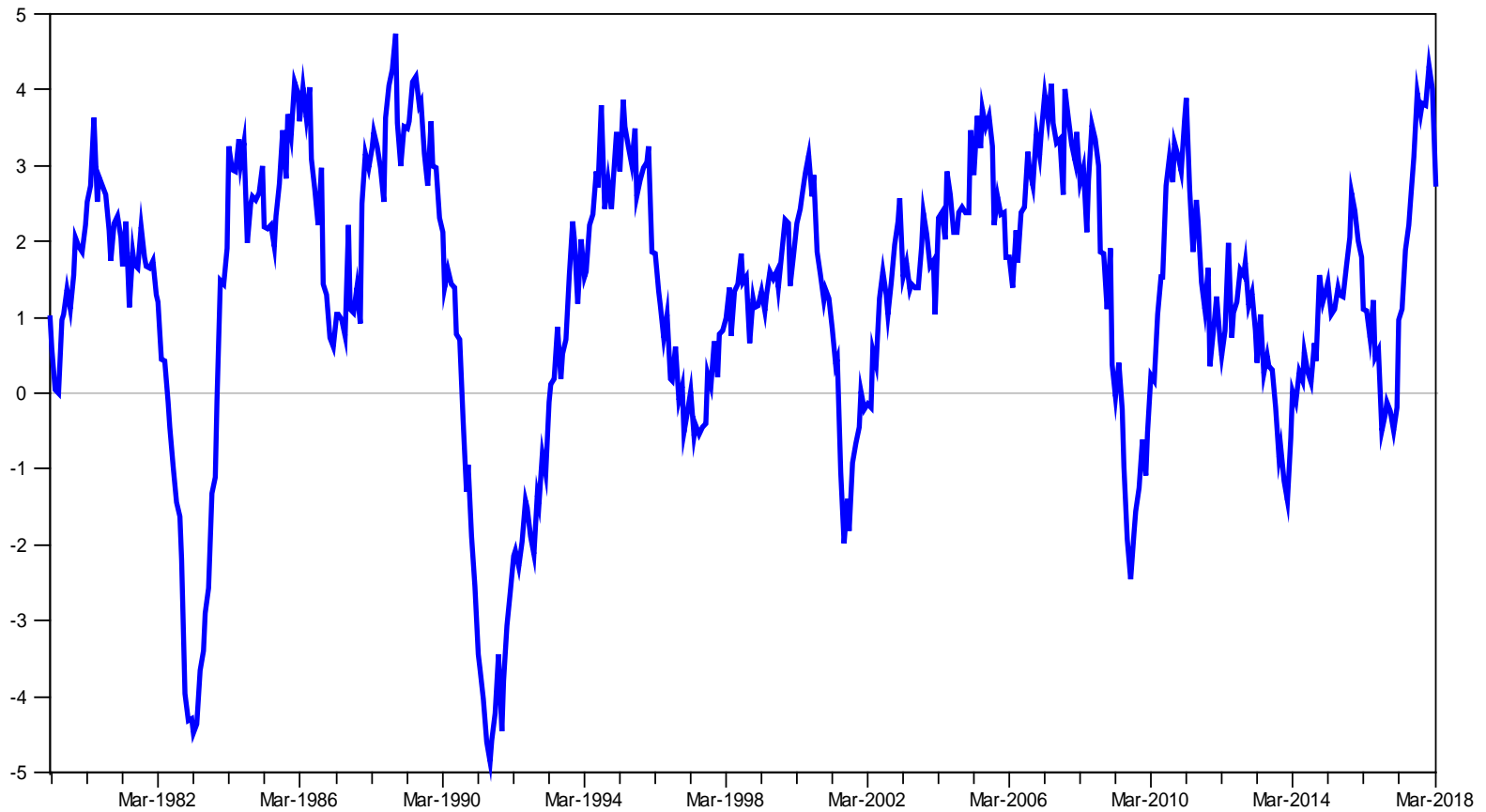
Employment 4 qtr % change

Employed total: Persons: Seas adj: PCTCHG
% change



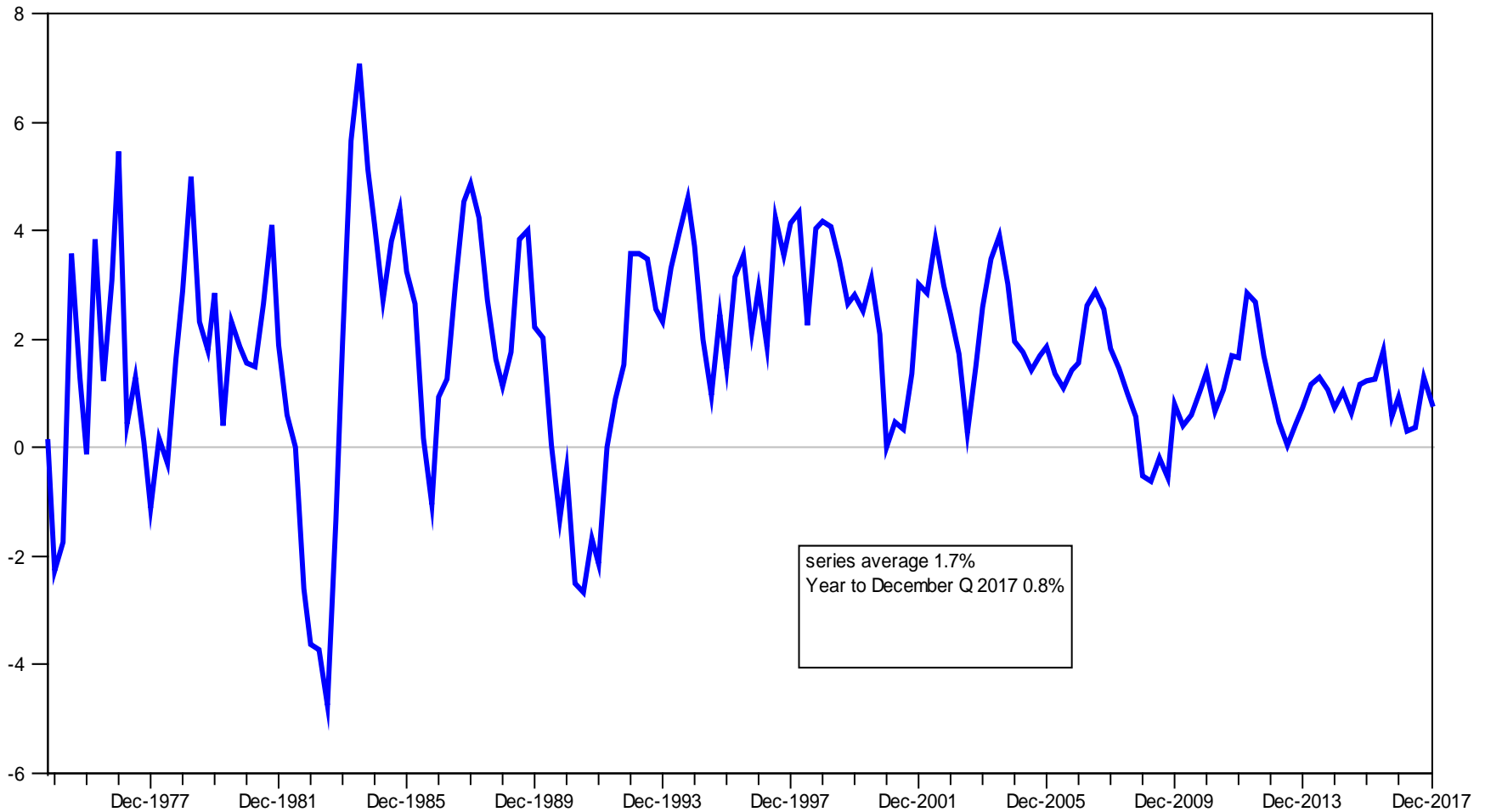
Full time employment 4 qtr % change

Employed full-time: Persons: Seas adj: PCTCHG
% change



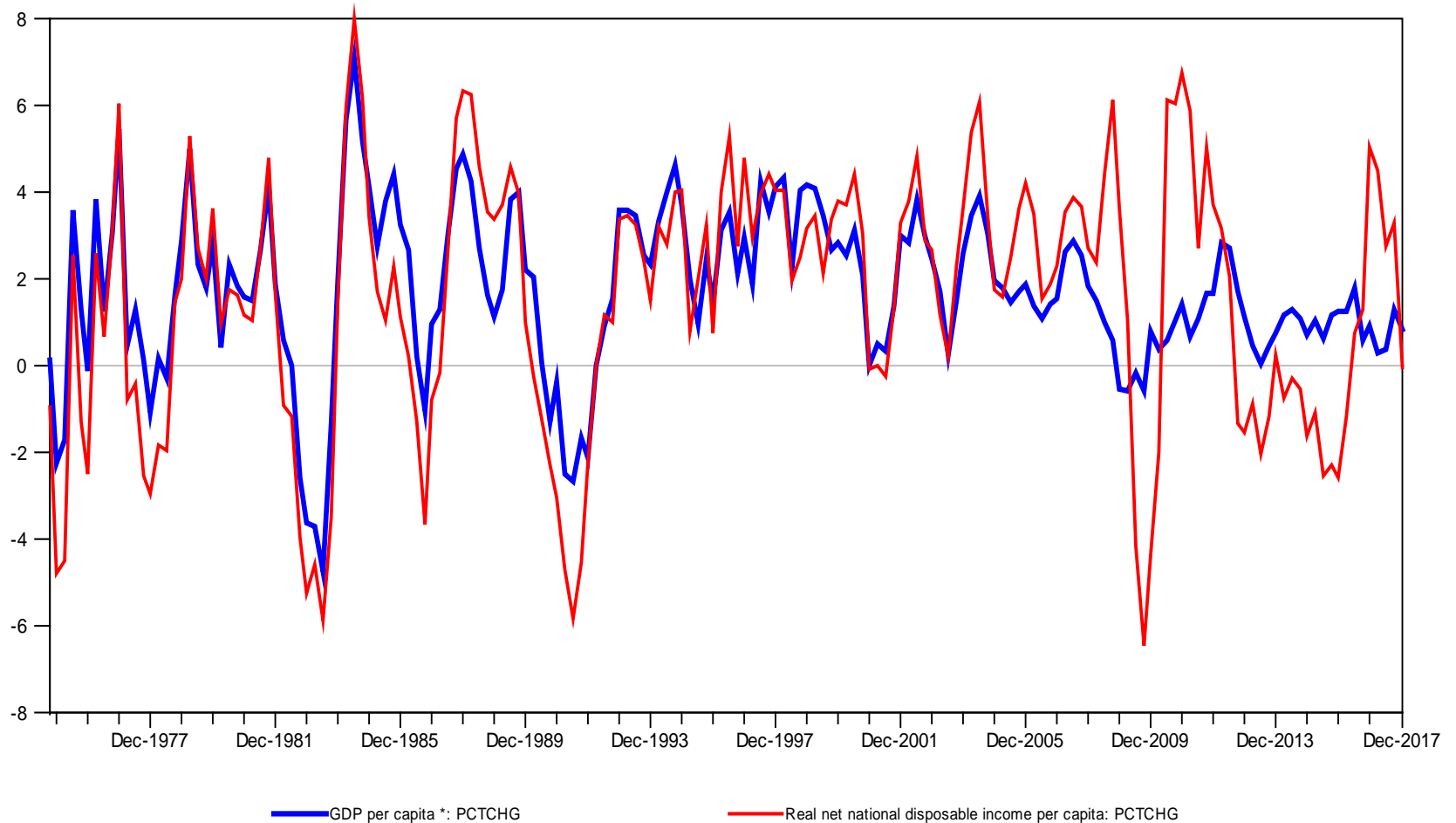
Real GDP per head, percentage change

Seas adj: CVM: GDP per capita *: PCTCHG
% change



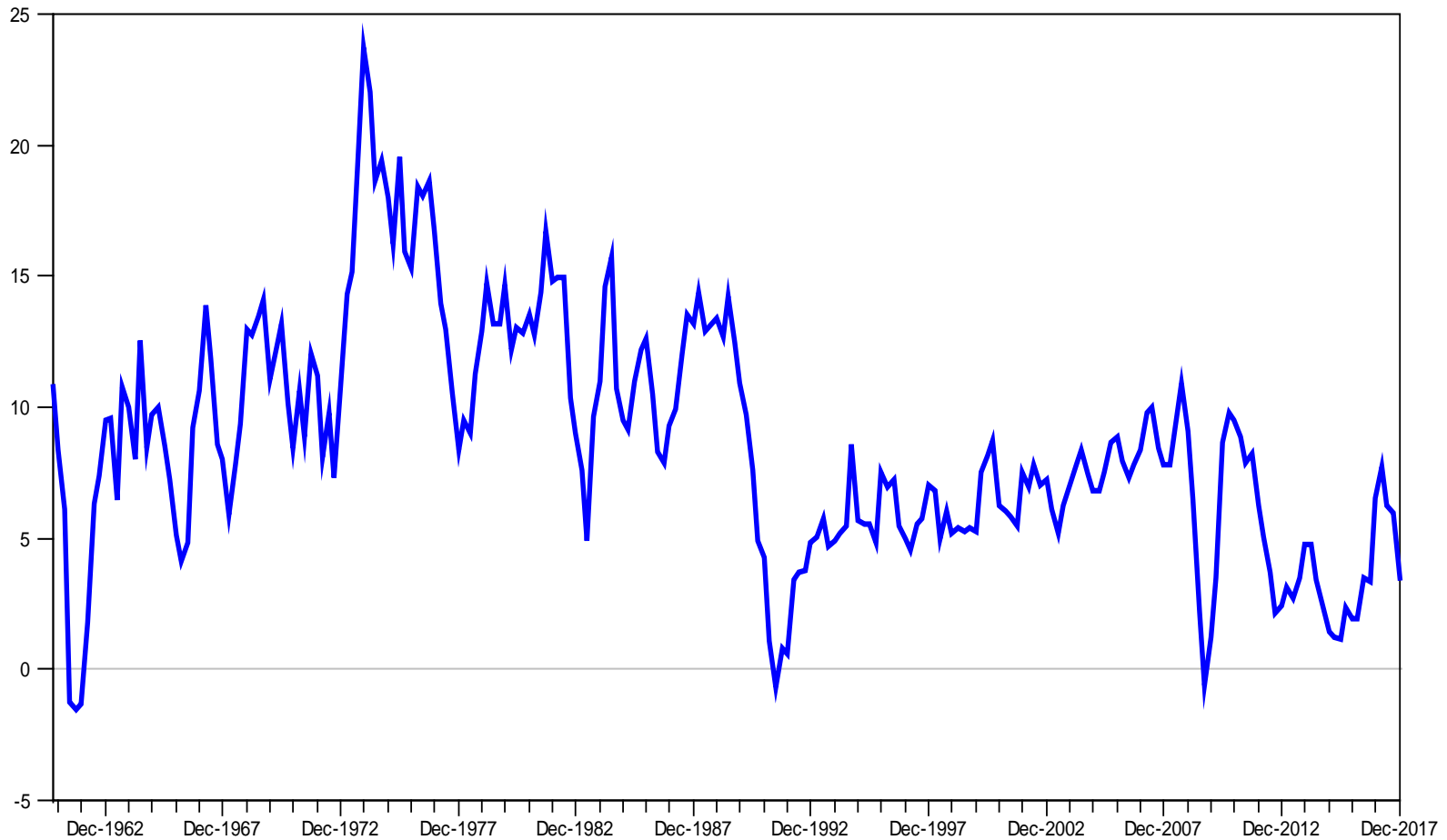
GDP per head v RNNDP per head

Seas adj: CVM
% change

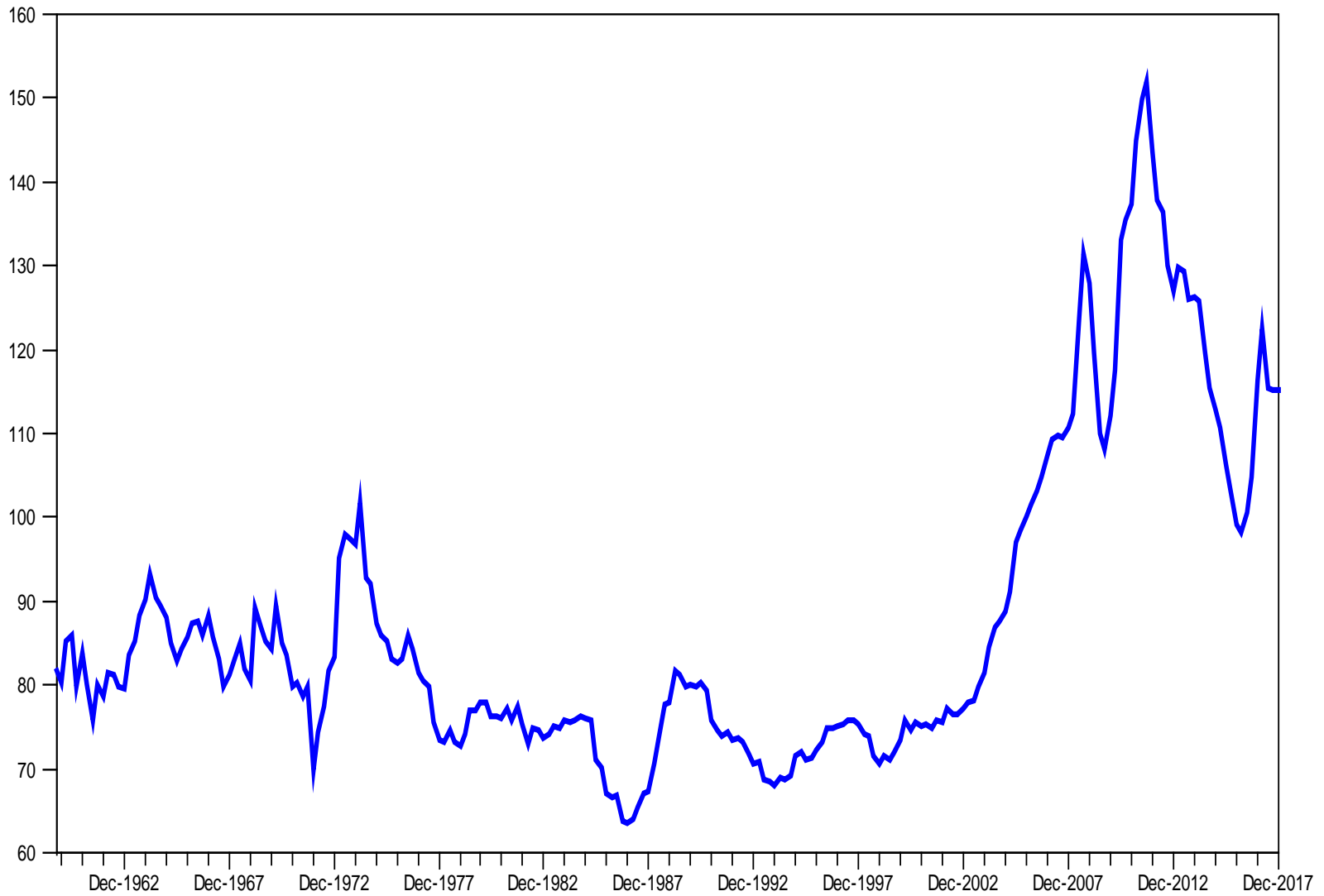


Nominal GDP % change

Seas adj: Current prices: GDP: PCTCHG
% change



Seas adj: Index: Terms of trade
2015/16=100 sa

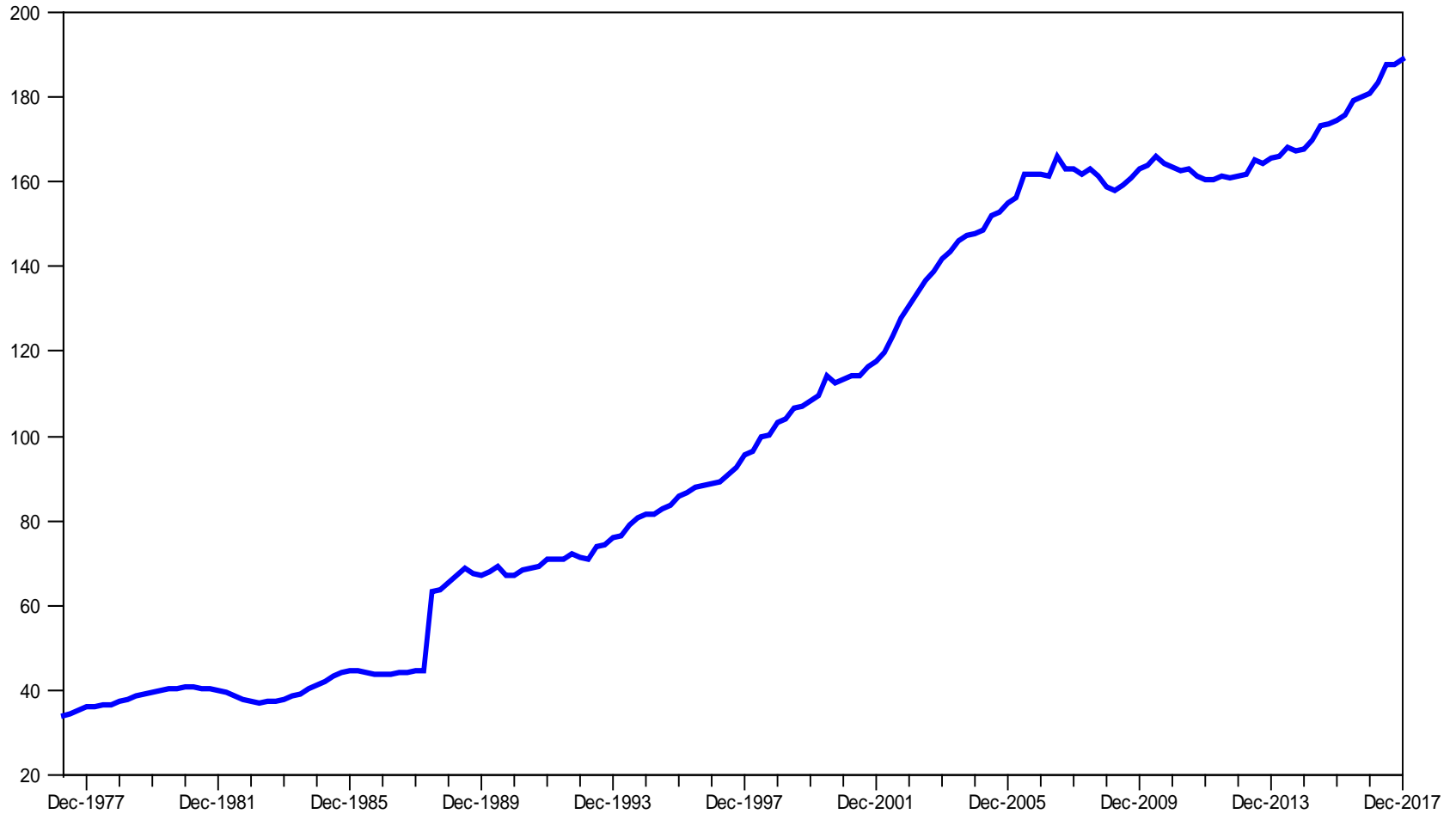


Three issues

- The constraint of high household debt
- Corporate taxation – are we competitive?
- The impact of progressive personal income tax

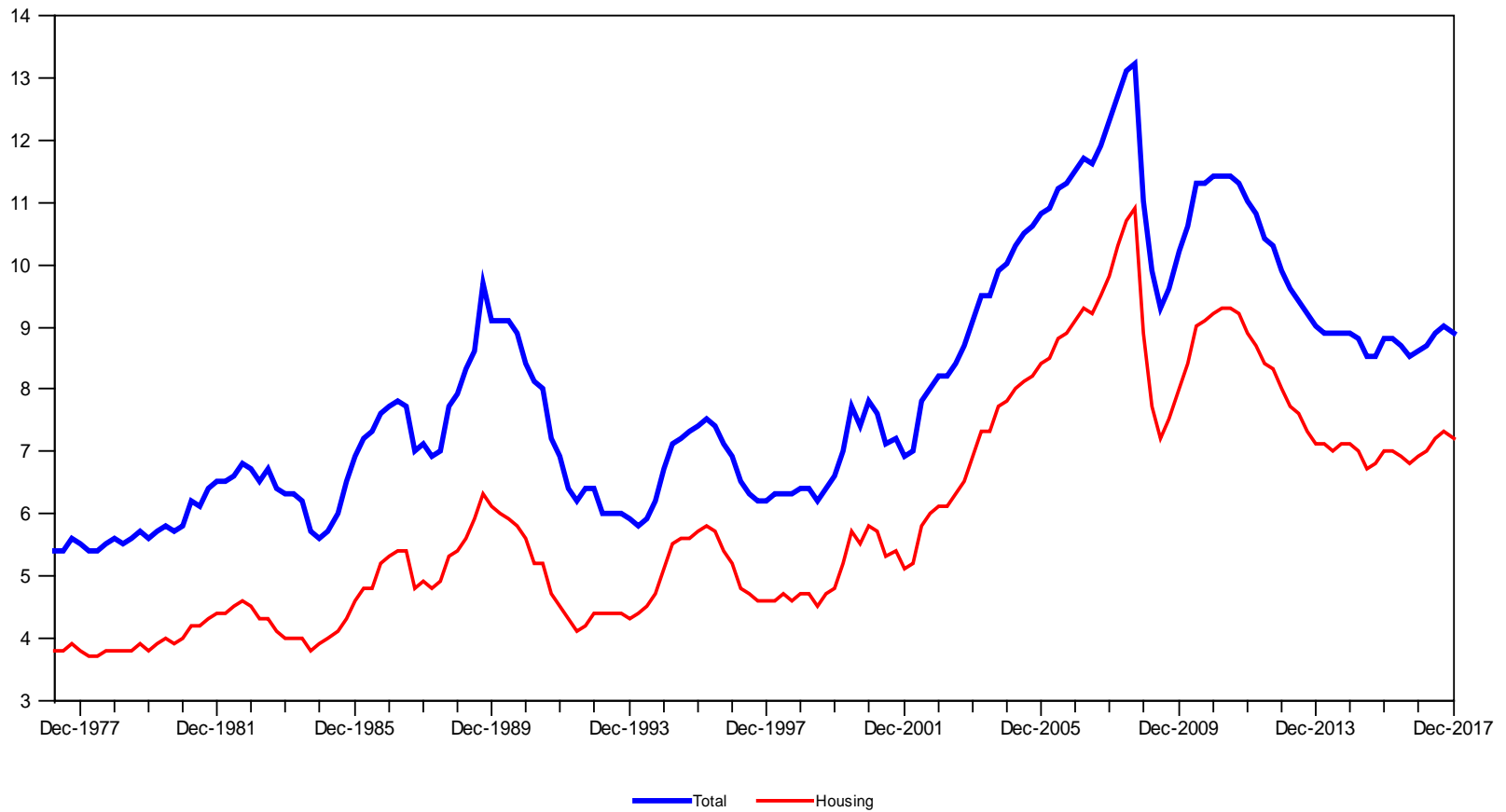
Household debt to disposable income %

Household finances: Ratio: Debt to disposable income: Total
Percent



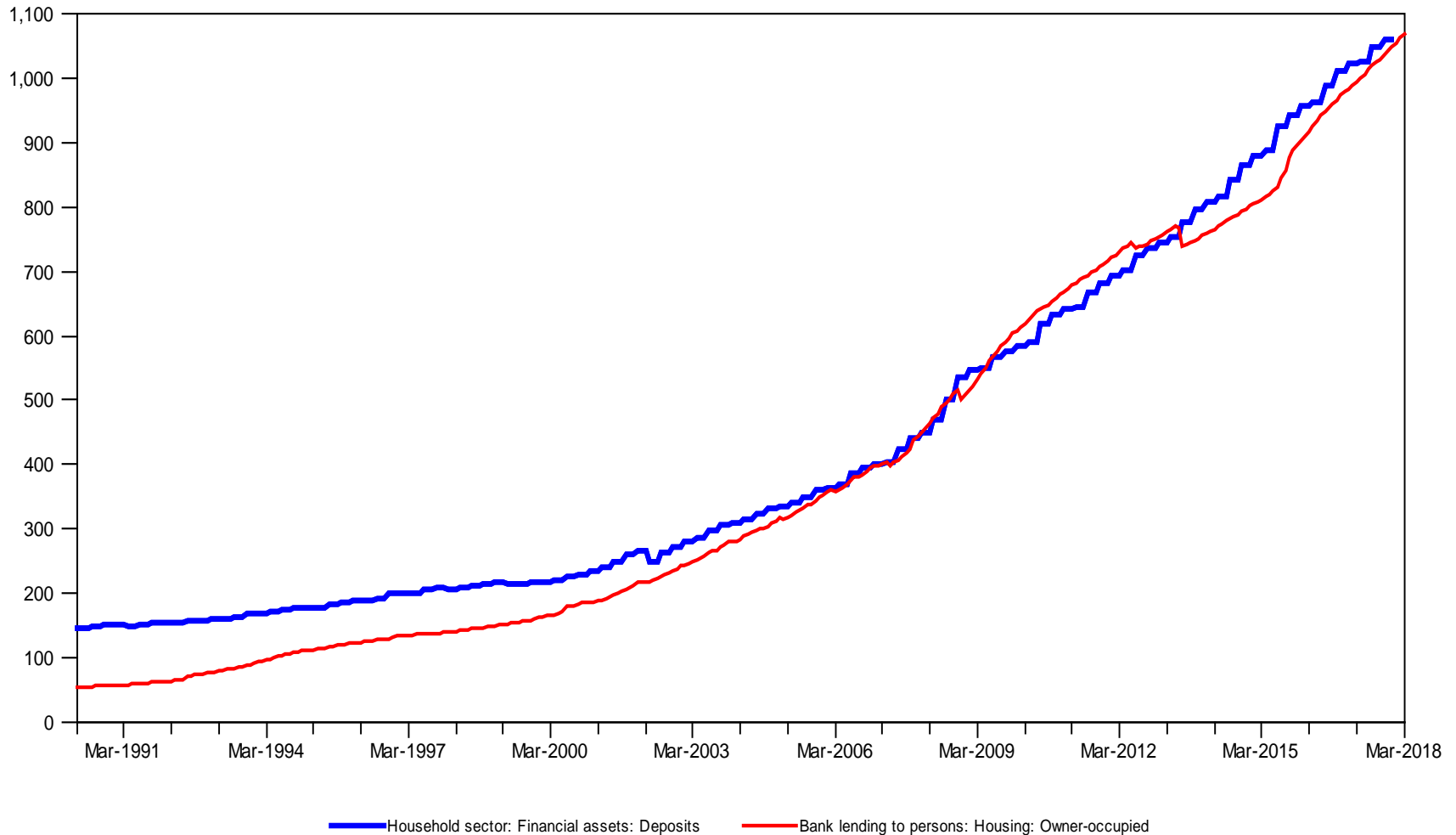
Household interest payments to disposable income

Household finances: Ratio: Interest payments to disposable income
Percent sa



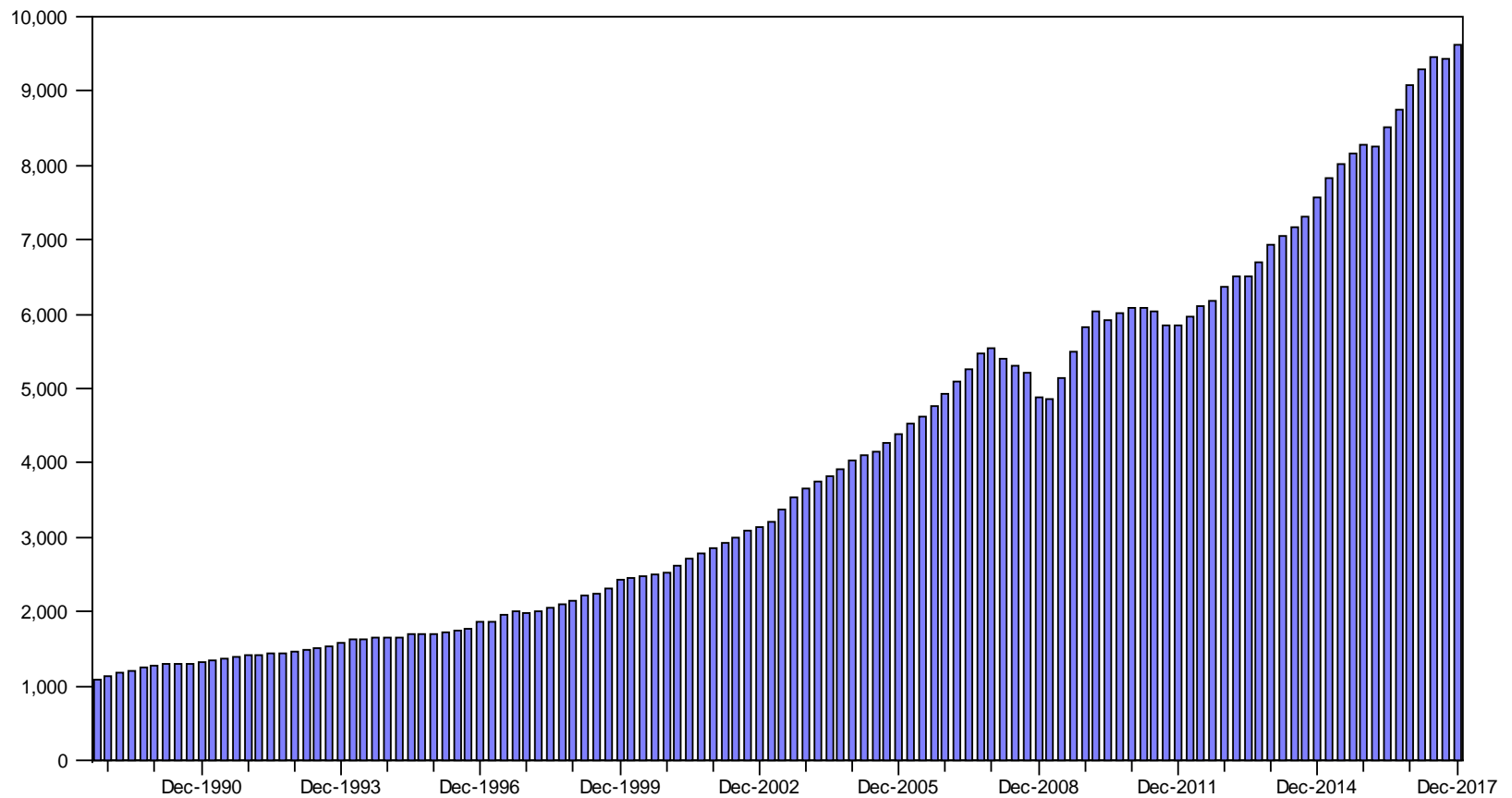
Household deposits versus owner occupied housing debt

Household deposits roughly equal to owner occupied housing lending
\$b



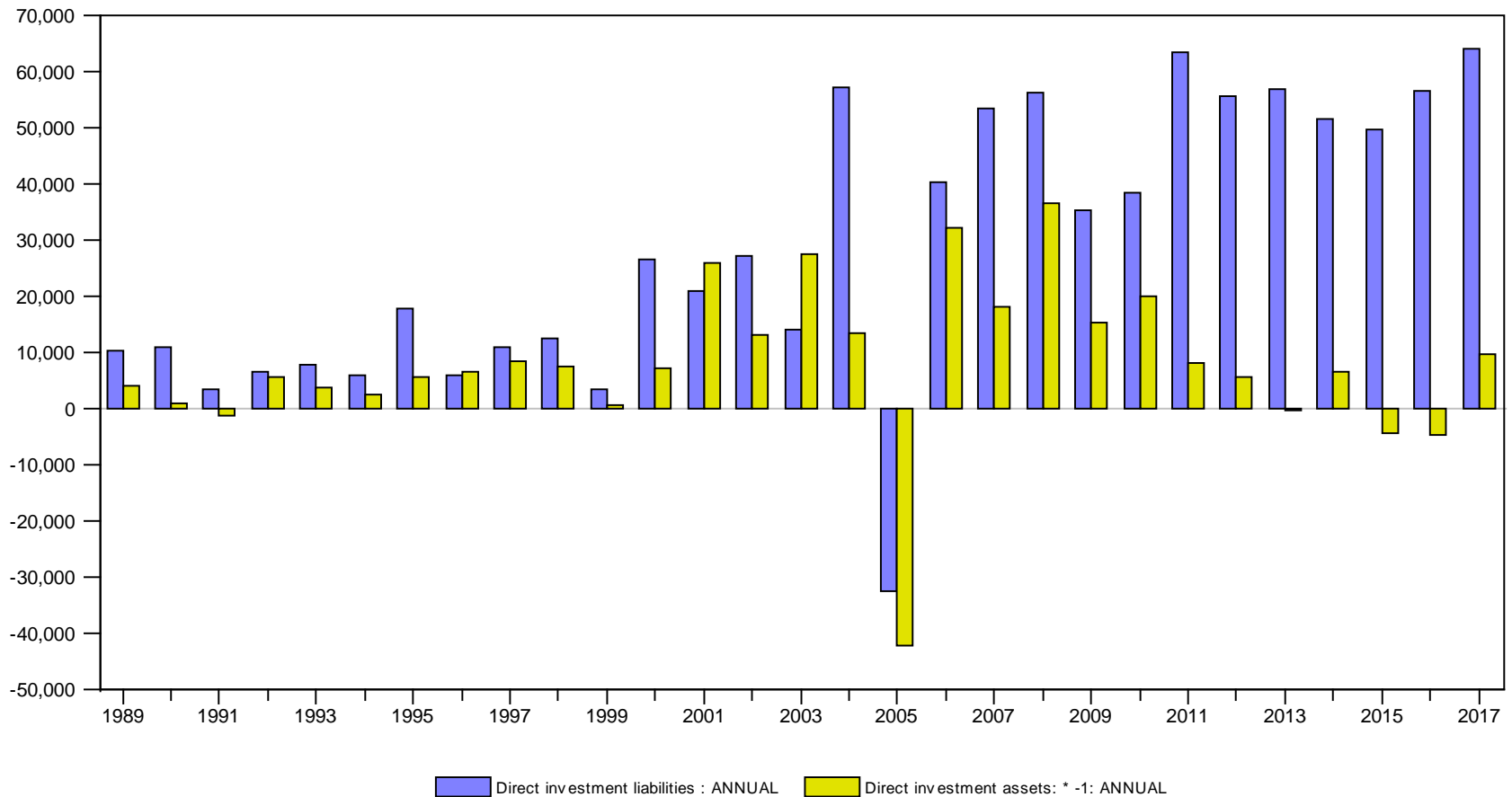
Household sector net worth

Household sector: Net worth (total assets less total liabilities)
\$b



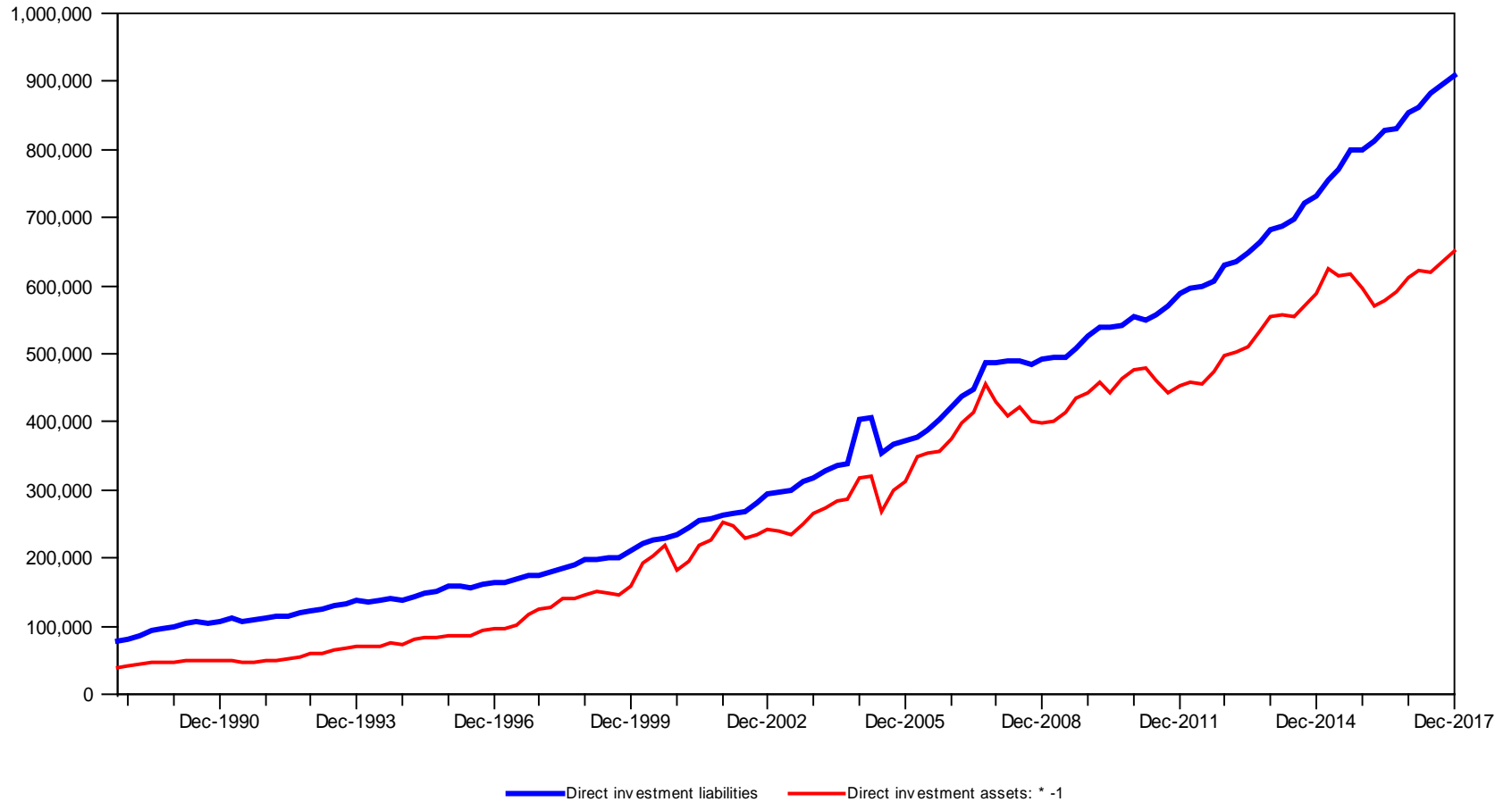
Foreign direct investment, transactions, annual 'assets'=outward, liabilities=inward

Transactions
\$m,



Inward and outward direct investment stocks

Closing position
\$m,



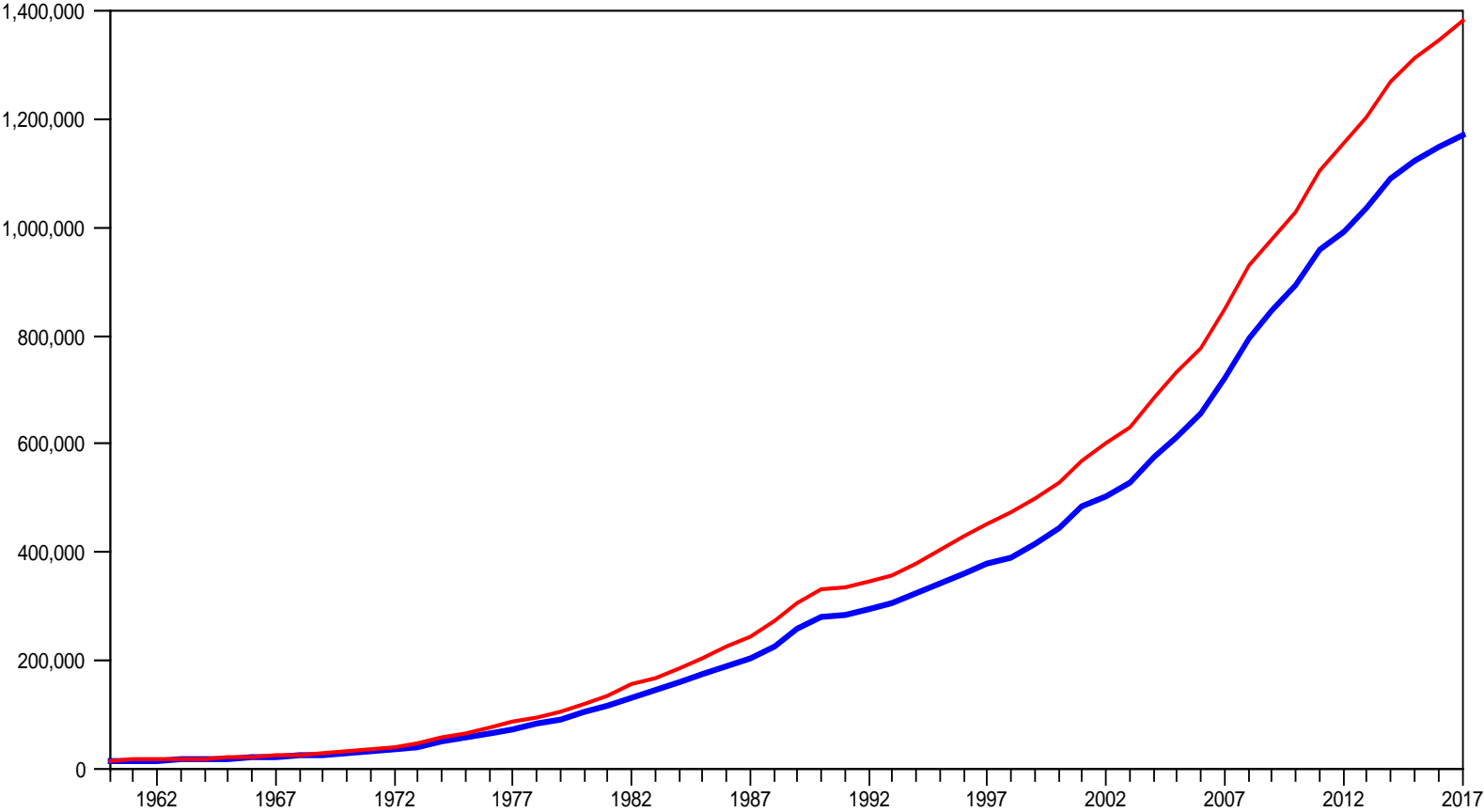
Income tax rising faster than hh disposable income

Personal income tax is now increasing at three times the rate of h/h disposable income
% change



Income tax wedge in household income

\$m sa



— Gross disposable income: ANNUAL — Gross disposable income plus income tax

Budget Rules: 2 key revisions

- Six months ago (MYEFO) the government recommitted to projecting 1% surpluses, after 20/21
 - Tomorrow night, this is likely to be abandoned in favour of 0.5% of GDP surplus projections
- Six months ago the government recommitted to ‘bank’ improvements to the bottom line which are ‘due to changes in the economy’
 - We are now told that tax ‘cuts’ will be offered in 2018/19 because revenue is stronger than expected, and spending growth lower than expected.
 - Should we take the MYEFO projections to be the new baseline?
 - This would mean for 2018/19 tax to GDP 22.9%, receipts 24.5% GDP, deficit 1.1% of GDP, with favourable variation presented as tax ‘cuts’. Maybe ‘bank’ 2017/18 improvements for a smaller deficit (say 1.1%)? Or find a way of transferring into 2018/19?
- These two changes in policy are the keys to the government’s political strategy

Budget rules, continued...

- Even so, we should assume that tax continues to rise as a share of GDP, and in particular personal income tax faster than household income
 - MYEFO projected that personal income tax collections will rise 22% from 2017/18 to 2020/21. Nominal GDP maybe 17%
 - Presumably, this is the base case from which personal income tax ‘cuts’ are now offered.
 - We know tax as a share of GDP will continue to increase to 23.9%
- We should probably also assume that the path towards surplus closely resembles the path in MYEFO, with favourable deviations now offered as tax ‘cuts’ rather than ‘banked’
- The tax ‘cuts’ are *not* an addition to household income except compared to the option of ‘banking’ higher than expected revenues. They are ‘cuts’ from the increase that would otherwise occur – but there will continue to be an increase in average tax until we get to the 23.9% of GDP ‘cap’.
- Not a strong case to change forecasts of household consumption
 - RBA SMP does not identify the Budget as a risk to its forecasts

Conclusion

- Budget will be mildly contractionary, with a falling deficit to GDP and rising taxes to income.
 - Maybe Labor will project higher surpluses, but not much higher
- If not already true, it will soon be true that all additional borrowing is for additional public investment. Recurrent receipts will more than match recurrent spending.
- The real political debate will be a useful one:
 - How should tax revenue be rearranged?
 - Labor has something like \$200b over ten years to re-purpose. Reduce concessions, broaden the base, lower the thresholds and rates.
 - How should spending be rearranged?
 - Pre-election debate there likely to be less lively. Typically an incoming government has a major expenditure review in the first year, and resets priorities

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