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Economic Strategy

Overview Address by Michael Knox at the CEDA Federal Budget Lunch with The Hon Wayne Swan MP, Deputy Prime Minister and Treasurer

Sofitel, Brisbane Friday 11 May 2012

Five years ago, I reviewed a paper presented by an esteemed colleague of mine, Jan Libich. Jan teaches at the University of Latrobe in Melbourne. I called my review “Central Banking as a Game of Chicken”.

In his paper Jan described a notional world comprised of two players. These players were a Treasurer and a Central Banker. Both players were engaged in a game. Jan analysed the game in terms of the mathematical structure called ‘game theory’.

Both players in this game had the ability to create signals. The Treasurer had the ability to create signals through the size and direction of movements in the deficit. The Central Banker had the ability to create signals through the size and direction of movements in interest rates.

When the Treasurer increased the deficit, the Central Banker might reply with an increase in interest rates. Jan was actually able to quote real life examples of this occurring in New Zealand. He was also able to quote examples where the threat of increased interest rates communicated by the Central Banker resulted in deficits not being increased.

Of course there are other actions possible within the game that Jan describes. A Treasurer might reply to the previous increase in interest rates by reducing the deficit. The Central Banker might then reply to the reduction in the deficit by reducing interest rates.

It seems to me that Jan Libich was five years ahead of his time. The game that he was describing in his academic paper is one which predicts the situation we are currently living in.

The Treasurer has presented a Budget in which there is a dramatic decrease in the Australian budget deficit. He has clearly signalled that he thinks that this “gives room” to the Central Bank to cut interest rates. As Sherlock Holmes might say ‘the game is afoot’.

What makes the game more complicated are the other events which are happening at the same time. This Budget does a lot more than provide signals to the Central Bank. Australia is going through an enormous expansion of mining investment. This is proportionately the biggest increase in mining investment that Australia has seen in 60 years. The RBA shows the increases in mining investment on an annual basis in the chart book on the front of its website. The Treasurer, in his speech, noted prospective mining investment of some $450 billion. The information on the RBA website suggests that the annual rate at which this investment will be proceeding rises by some $80 billion in the two years to 2013.

In a normal situation, this kind of surge in investment would generate a titanic boom. When this kind of boom happened before in the 1950’s, it generated a blowout in growth, a blowout in wages and a blowout in inflation. Yet, the macro economic forecasts released with the Budget Papers show no hint or sign of these events recurring. Growth next financial year is expected to be 3.25%. This is almost exactly long term trend. Inflation next financial year, when we take away the affects of the carbon tax, is expected to be 2.5%. This is exactly in the middle of the Reserve Bank preferred range. This is an amazing balancing act.

How is this balancing act achieved? What is happening within the macro economic structure of the Budget? In my job, most of the questions that I get these days are about places like Greece or Spain. As a result of those kinds of questions, I have got into the habit of looking at economies the way the IMF does. The great advantage of this is if you use the same set of measures to look at different countries, then you can compare like with like.

When the IMF looks at an individual country, it doesn’t just look at the deficits of the Central government. It looks at the deficits of the Central government plus all of the State governments plus all of the municipal governments. This turns out to be really important when we are talking about countries like Spain for example, where the provincial governments have been running big deficits in addition to the deficits run by the Central government. This combination of Central, State and municipal governments is called the ‘General Government Sector’. These are not identical to the numbers that the Treasurer referred to on Budget night. They do provide us however with an international standard way of approaching this issue.

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The Budget Papers actually provide us with the numbers for the general government sector. These are provided in Budget Paper 3, page 164. These papers tell us that in 2011/12, the Australian Central government is expected to run a deficit of 3% of GDP. In addition to that, State and local governments will run a budget deficit of 1.2% of GDP. Adding both of these together and rounding them up provides us with a total budget deficit of 4.3% of GDP. Using the framework of the general government sector, this deficit is achieved by spending 36.8% of GDP against receipts of 32.8% of GDP.

Over the next year 2012/13 there is a titanic reduction in fiscal stimulus of 3.2% of GDP as measured by the General Government Sector. The budget deficit falls to 1.1% of GDP. This deficit within the General Government Sector is shown as a razor thin surplus of 0.1% of GDP in the Central government sector at the same time as the deficit in the State and local government sector of 1.1% of GDP. Viewing Australia the way the IMF does, Australia will still have a deficit. However, what is really important to our analysis is the fall in the deficit. This fall again is 3.2% of GDP. Now this turns out to be a really big number.

The Australian economy has a size in dollar terms of almost $1.5 trillion. That is almost $1,500 billion. 3.2% of $1,500 billion is slightly more than $50 billion. On Budget Night, the Treasurer referred to moving from a deficit of $44 billion to a surplus of $1.5 billion. This implies a reduction in the deficit of $45.5 billion. The actual reduction, as viewed by the IMF, is slightly bigger than the number he implied.

So what we have is the balancing of two titanic forces. We have an increase in mining investment of about $80 billion being counterbalanced by a decrease in fiscal stimulus of about $50 billion. The reduction in fiscal stimulus is so massive that in an ordinary time, it would be sufficient to throw the Australian economy down into recession.

We do not live in ordinary times. In the year ahead, we live in a period of the greatest boom in mining investment in three generations. In that circumstance, it takes all of this enormous decrease in fiscal stimulus to provide balance for the Australian economy. Should we actually achieve a growth rate of 3.25% or trend growth rate, together with inflation near the mid range of the RBA range of 2-3%, then this Budget will have achieved the most extraordinary balancing act; a balancing act that results from the action of two opposing forces of titanic size.

Monetary and Fiscal Policy Interaction With Various Degrees and Types of Commitment;
Jan Libich, La Trobe University, Department of Economics and Finance, and CAMA; 13 September 2007

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