Company tax cuts shelved

A key element of the Commonwealth Government’s fiscal policy has been cancelled with the plans to pass legislation to lower company tax rates not being supported in the Senate. Reductions in the company tax rate from 30% to 27.5% for small businesses had already been approved. However, the planned widening of the cuts to all businesses, and the eventual lowering in the rate to 25%, failed to gain sufficient votes in the Senate. As a result, the Government has announced that it will “not be seeking to make any further cuts to the company tax rate for larger companies in the next term of Parliament.”

In a tumultuous month for the Government, which culminated in Scott Morrison taking over as Prime Minister, it was also announced that the Government would not introduce the emissions component of the National Energy Guarantee policy into Parliament. This component of the policy was designed to legislate the energy sector emission reductions that were aligned with obligations under the “Paris Agreement on Climate Change”. Australia’s commitment under the agreement is to reduce greenhouse gas emissions to 26%–28% below 2005 levels by 2030.

Wages growth remains low

The expectation of ongoing low inflationary pressure in the Australian economy was reinforced by the most recent data on wages growth. In the 3 months to June, the Wage Price Index increased by 0.6%, resulting in the annual rate of increase rising from 2.0% to 2.1%. This annual rate is only marginally above the record low of 1.9% that prevailed one year ago. The Wage Price Index measures the price of wages and salaries over time and is not influenced by changes in the quality or quantity of work performed.

Notwithstanding the near record low rate of growth in wages, the Wage Price Index suggests that wages are expanding at a rate marginally above the underlying rate of inflation rate i.e. there is some growth in real wages. The rate of increase in underlying inflation is currently 1.9%. With the rate of price increase almost the same as the rate of wage increase, there is little apparent “cost-push” pressure on the inflation rate.

It is, however, normal to have a higher rate of growth in real wages than is being experienced today. Firms are generally able to afford wage increases above the level of price growth if productivity improvements create decreased real per unit production costs. When this is the case, real wage growth can be absorbed without necessarily being inflationary.

The rate of growth in private sector wages has continued to be below that of the public (government sector). Over the year to June, the Wage Price Index for the private sector rose by 2.0%, which was 0.4% below the public sector increase. Public sector wage growth has continuously exceeded private sector wage growth in annual terms since September 2013. This may be indicative of the extent to which the environment of low wages growth is being determined by the market forces of supply and demand for labour.
Q1: Define the term “real wages growth”.

Q2: Discuss the possible cause or causes of the low rate of growth in wages currently prevailing in Australia.

**Yield curve implies ongoing low rates**

Despite Australian overnight cash interest rates being at record lows, money markets are anticipating that interest rates will only increase very gradually in the period ahead.

Market expectations of future interest rates can be gauged by the level of interest rates (or yields) available for different investment time periods. For example, the interest rate available on a Government bond with a term of 10 years is indicative of the market’s expected average overnight interest rate for the next 10 years.

The “Yield Curve” shows the differential in interest rates across the horizon of time periods for which interest rates are set. Currently, 5-year Government bonds in Australia are priced to produce a yield of 2.2%. As this is above the existing 1.5% cash interest rate, there is an implied expectation that short term interest rates will be slightly higher over the next 5 years than they are today. This situation describes a yield curve that is “positive” in shape.

In contrast to the current positively shaped yield curve, it is also possible to have a “negative” or “inverse” yield curve. This situation arises when money markets anticipate that interest rates will materially fall in the future i.e. longer-term interest rates are below shorter-term interest rates.

Situations of positive yield curves are far more “normal” or prevalent over time than inverse (negative) curves. Since the early 1970s, the yield curve has been “inverse” on less than 20% of occasions. In normal times, investors will be rewarded for locking their money away for periods of time. In addition, borrowers are normally willing to pay a “premium” for having their interest rate fixed for a set period.

“Positive” yield curves are often viewed as encouraging borrowing and economic activity as they imply that existing interest rates are “cheap” relative to longer term rates. Conversely, inverse yield curves could be detrimental to economic growth. Inverse yield curves create an incentive to hold off borrowing and spending decisions until funding costs fall to expected lower levels in the future.

Q3: Define the term “Yield Curve”.

Q4: Describe how the shape of the yield curve could encourage or discourage economic growth.

**Money supply growth continues to ease**

One feature of the Australian economy over recent years has been the absence of excessive credit (lending) growth from financial institutions to the private sector. In fact, credit growth overall, taking into account household and business lending, has been relatively subdued despite the record low interest rates in place.

Monetary stimulus programs, such as that currently operating Australia, rely on financial institutions increasing lending activity for the full effect of increased liquidity and lower interest rates to be felt on the real economy. However, the rate of expansion in financial sector lending has generally been weak in recent years. A lower willingness by consumers and businesses to take on debt, as well as a more conservative lending approach by banks, could be factors responsible for the slow monetary expansion.
In Australia, the annual growth rate in the amount of credit (loans) made available by financial institutions to the private sector was 4.4% at the end of July. Although above the rate of inflation, the current rate of expansion is well below the credit growth rates in excess of 15% recorded prior to the Global Financial Crisis. The chart below shows that the growth rate has declined over the past 2 years, following a gradual lift from around the 3% level in 2013.

- limit the flow of new “interest-only” lending (where there is no initial requirement to pay back loan principal) to 30% of total new residential mortgage lending, and
- cap lending for housing investment below an annual growth rate of 10%. This temporary measure was introduced in 2014 and removed in April 2018.

APRA’s focus on “moderating” the growth in residential property investment lending appears to have had an impact on the pattern of credit growth. The annual growth in residential investment loans outstanding has fallen from a peak of 10.8% in June 2015 to 1.5% in July 2018. The rate of housing price inflation has subsequently declined, with price falls recorded in some cities over recent quarters. This change in the pattern of lending growth may result in a more even impact from monetary expansion across the housing and non-housing sectors of the economy.

Q5: Explain why expansionary monetary policy may be more effective in periods when bank lending growth is strong.

Q6: Describe the possible implications of a fall in lending for housing on house price inflation.

Net Services Balance improves

Australia’s export competitiveness can be heavily influenced by movements in the value of the $A. As discussed in Plain English Economics Issue No.5, a recent fall in the $A increases Australia’s competitiveness, as our exports become cheaper on world markets. The drift lower in the value of the $A continued over August, with the $A now trading at U.S. 72.6 cents. This compares with U.S. 80.7 cents at the end of January 2018.

Often the impact of currency movements on the competitiveness of Australia’s goods exports is neutralised to some extent by movements in export prices. For example, a falling $A is often associated with falling commodity prices and vice versa. However, in the case of service exports, (e.g. education and tourism) there is less likely to be any general price change to compensate for movements in the level of the exchange rate. As a result, the Services Account can be very sensitive to movements in the value of the $A.
The Net Services Account balance measures the difference between what Australia earns and pays for overseas trade in service items. The Services Account has been in deficit over recent years, with the largest quarterly deficit of $4.8 billion recorded in June 2013. However, the chart below shows a period of steady improvement in the Service Account since then, with the quarterly deficit in June 2018 being $1.2 billion.

It can be seen from the above chart that periods of rising currency value have tended to be accompanied by periods of a widening in the Net Services deficit. In contrast, periods in which there has been a material fall in the $A have coincided with a reduced Services deficit. Hence, given the depreciation in the $A over recent months, this pattern of improvement in net services revenue may continue.

Within service industries, tourism appears to be particularly sensitive to exchange rates. The lowering of the $A since 2013 has made Australia a relatively cheaper tourist destination. This has encouraged Australians to travel domestically and foreigners to holiday in Australia. In the 5 years to June 2018, the number of arrivals by Australians travelling overseas rose by 25%. In contrast, short term arrivals into Australia by overseas tourists were some 34% higher.

**Q7: Describe a likely explanation for the improvement in the Service Account balance over the past 5 years.**

**Chinese exchange rate management**

In the last week of August, the People’s Bank of China (the central bank) announced that they would resume using the “counter-cyclical” factor when determining the reference rate for China’s exchange rate. This change, which may only be temporary, effectively reduces the impact of market forces on the exchange rate. Prior to this change, the Chinese currency (the Yuan) had been under downward pressure.

Unlike Australia and the majority of developed economies that operate “freely floating” exchange rates, China “peggs” its exchange rate to a basket of currencies. This peg involves setting a fixed currency mid-point conversion rate for the Yuan. The central bank then buys and sells currency within a band around this mid-point. The band had previously been restricted to 2%. However, in August 2015 Chinese authorities announced that they would consider the previous day’s trading in the establishment of the currency rate, thereby allowing greater influence from the market. However, as the latest initiative demonstrates, the Chinese central bank can choose to limit the extent to which market forces determine the value of the currency.

For China’s trading partners, such as the U.S. and Australia, a depreciation in China’s currency makes imports from China cheaper, as well as making imports into China more expensive for the Chinese to purchase. In theory, therefore, the devaluation that has taken place over recent months would be expected to improve China’s trade balance with the rest of the world.

**Q8: Define what is meant by the term “freely floating exchange rate”**.