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TOP STORY FOR THE WEEK 4 Oct - 8 Oct 2021

Lockdowns: the price Victorians will end up paying

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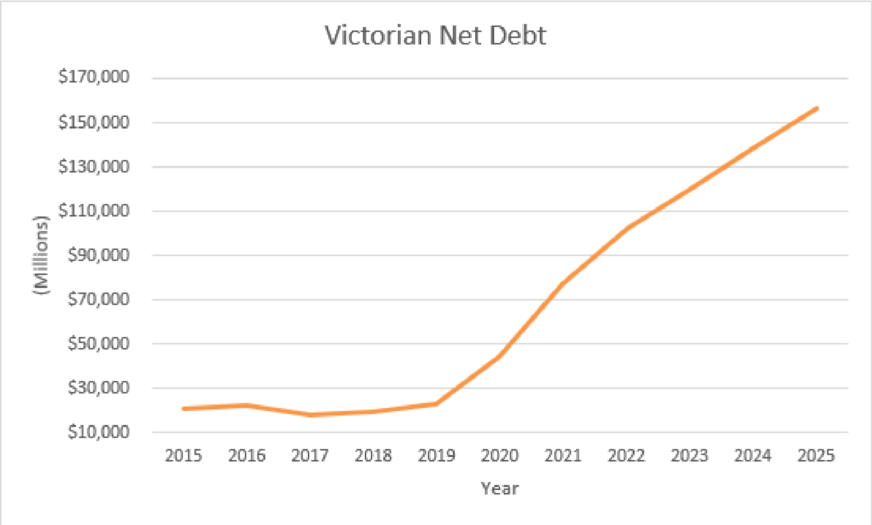
Increasing debt has been the outcome of actions of the Victorian Government when they persistently lockdown Melbourne. It originates from a flawed belief that only government knows best. It does not recognise the future decline in living standards for all Victorians which will occur from excessive debt.

Every response by the Victorian Government regarding the pandemic has been that there is no alternative to lockdowns. The government has then spent at a rapid pace as the financial consequences of collapse of businesses, rising unemployment and lower tax revenue of the lockdowns have grown. All spending has been borrowed. Scrutiny though parliamentary sittings has been avoided. The Victorian Premier stated that accountability measures such as parliamentary scrutiny is not important. When the spending has become excessive the Victorian Treasurer has sought to spend national funds in addition to the state funds. He stated, "What has been incredibly disappointing about this is a Federal Government who have sought to be miserly with money." No responsibility is accepted by the Victorian Government.

Victorian Government debt has grown at an extraordinary rate as shown in Chart 1. This was before the latest protracted lockdown which will lift the debt further through additional spending and loss of revenue.

Chart 1: Projected Victorian Net Debt 2015 - 2025



Source: Victorian budgets 2015 - 2021

Government deficits emerge when spending occurs today for the benefit of individuals today. Responsibility for payment though falls on future generations. Deficits which arise through the stabilising feature of spending commitments in a recession may be acceptable. Today, deficits have arisen through Governments imposing draconian controls over activity by Victorians and by unconstrained spending.

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The relevant variables for debt servicing are relatively straight forward.

Only increased private sector activity will drive sustainable higher government revenue. Population growth will drive higher activity. With border controls in place, population growth will be limited, if not negative.

In Victoria, the population has declined by 43,000 since the start of the pandemic. Private sector growth will be limited reflecting business failures through lockdowns, lower employment and negative population growth, lower international student participation and declining tourism.

Interest rates on debt are at historic lows. This will persist as central banks, including the Reserve Bank of Australia, engage in an Australian version of quantitative easing (QE), buying government bonds in secondary markets and therefore indirectly funding government deficits. It is not sustainable.

Negative nominal and real interest rates only persist because of central bank policies of QE. Historically, Commonwealth Government bonds have provided positive real returns. (A real return is the interest rate in excess of inflation.)

At present, the 10-year Commonwealth bond yield is 1.6%. Consumer inflation to June 2021 was 3.8%. Based on this measure, the 10-year bond yield is trading at a real yield of -2.2%. Based on average inflation over the past four years of 1.8%, the real yield comes to -0.2%.

The RBA's inflation target is 2% -3% and yet it is willing to buy bonds at yields well below both the current inflation rate and the inflation rate it is trying to induce.

Real yields on 10-year Australian Commonwealth Government bonds have historically ranged between 1.0%-1.5%. It is expected that the US central bank will end its QE programme by mid-2022, leading to a rise in US Treasury yields and a similar rise in Australia. This should see a rise in local 10-year bond yields back to a range of 3%-4%.

State government bond yields have offered a premium of 0.5% above Commonwealth yields. This indicates interest rates on Victorian government borrowings will increase to 3.5% – 4.5%. Interest rates could be higher should concerns grow about the credit rating of Victorian debt. In its recent downgrading of Victoria's credit rating, Moody's stated the Victoria's debt burden will rise sharply and remain elevated for the remainder of the decade!

Rapidly increasing net debt, rising interest rates and declining credit status for Victoria will result in the interest-to-revenue rate increasing to 7% by 2025. With a previously stated target of 2%, such a rise is indicative of financial irresponsibility.

The inevitable outcome is clear.

A reduction in public sector employment and public services will occur. Asset sales to reduce debt rather than capital recycling will occur. Privatisation of existing infrastructure projects will also be required.

Finally, new or increased taxes will be required. Increased taxes will prompt further shifts of private sector employment from Victoria. This will reduce employment prospects which provides a further disincentive to migrants, perpetuating a cycle of declining populations and declining job opportunities. Higher taxes and other state charges ultimately leads to arbitrage opportunities; responses to Increases in property taxes this year indicate that businesses will shift states.

Government debt does matter. Ultimately a decline in the standard of living, for all Victorians, will occur from irresponsible fiscal management reflected in persistent budget deficits. The level of debt being incurred will impact through a lower standard of living for decades.

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