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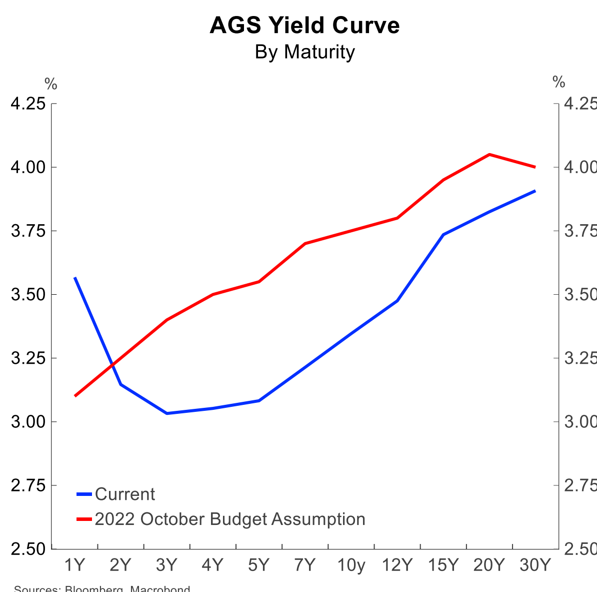
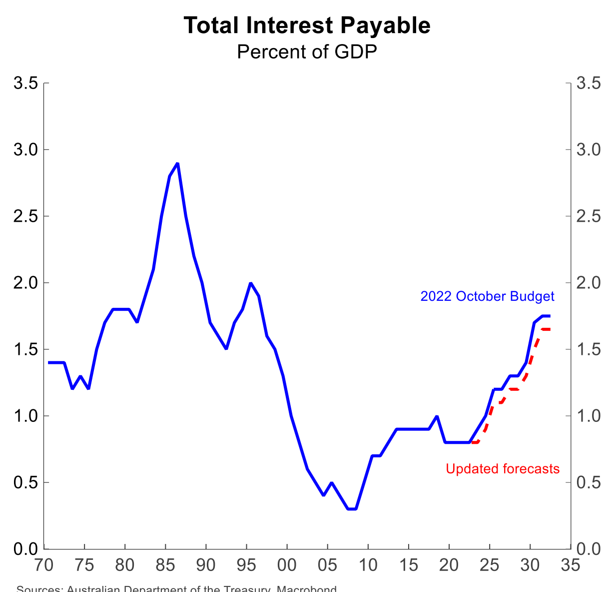
Fiscal Insights

Losing Interest

- **One of the key drivers of the forecast deterioration in the budget bottom line back in the October 2022 Federal budget was higher government bond yields, which lifted the debt servicing expenses for the government's public debt.**
- **Fast forward seven months and the economic and fiscal backdrop has dramatically shifted. So much so that the Federal Treasurer has a 'good news story' to tell on interest expenses.**
- **Interest payments should drop by around $6 billion over the 4 years to the end of 2025-26. Over the 10 years to the end of 2032-33, the fall in interest expenses should be $40 billion (or around 0.2 percentage points of GDP lower in 2032-33).**
- **The lower interest bill is because the prevailing 10-year government bond yield that the government will do new borrowing at will be a lot lower, about 50 basis points lower in fact compared with October's Federal Budget!**
- **Outstanding government debt that is due to mature and roll over will be financed at these lower government bond yields. We estimate that 20% of outstanding Australian government debt will roll over and be refinanced in 2023-24. That share is expected to rise to 50% by 2025-26 and 95% by 2032-33. So, the impact of the recent trends in longer-dated government bond yields will have a bigger impact further into the future.**
- **Does this vastly improve the medium-term fiscal position, which is needed to deliver a stronger public balance sheet and the capacity to better respond to future shocks? While the lower bond yields make inroads in reducing the structural deficit, it's not enough on its own to close the substantial gap that is expected to materialise.**
- **News reports suggest the Federal Treasurer is set to announce today a budget surplus for 2022-23 - the first surplus in 15 years.**





Debt and interest dynamics

A larger stock of public debt increases the amount of revenue that needs to be earmarked to service the debt. In addition, a larger stock of public debt means that public finances are more susceptible to changes in government bond yields (that is, interest rates).

Indeed, one of the key drivers of the forecast deterioration in the budget bottom line back in the 2022 October Budget was higher bond yields. Expected debt servicing payments were revised up by $12 billion over the four years to 2025-26. The medium-term impacts (out to 2032-33) were even more significant – around 0.7% of GDP by the end of the medium term.

The Government, through the Australian Office of Financial Management (AOFM), has hedged against some of this interest rate risks by issuing low yielding debt with a longer term to maturity and locking in interest rates for a fixed period.

Changes since the October Budget – what's the delta?

As it turns out, the economic and fiscal backdrop has shifted rapidly since October 2022 and the Federal Treasurer will likely be telling a 'good news story' on interest expenses next week.

On Budget night in October last year, interest rate markets were expecting the Reserve Bank (RBA) to continue hiking the cash rate to a peak of around 4.20% towards the end of 2023. Now, financial markets believe we have seen the peak in the cash rate at 3.85%.

What financial markets expect for the inflation and growth outlook impacts the level of longer-dated government bond yields. The Australian cash rate influences these outlooks. Longer-dated yields are also highly influenced by US bond yields. The US central bank has indicated it might be at the end of its hiking cycle. Longer-dated US yields are sharply lower compared with October 2022 because markets also anticipate the US will tip into a recession.

The cash rate also sets the structure of all bond yields across the government bond yield curve. So, a different outlook for the cash rate impacts interest rates, including the prevailing yield on government bonds. For example, when Treasury was finalising its numbers around the time of the October 2022 Budget, the 10-year government bond yield was around 3.80%. Over the past month the 10-year government bond yield has averaged around 3.30% (ranging between 3.20% and 3.40%) - that's a 50-basis point reduction.

When projecting future interest payments in the Budget, we assume issuance over the Budget year and the following 3 years of the forward estimates will be raised at the prevailing 10-year government bond yield. This is consistent with Treasury's methodology.

The Government only pays interest at the rate prevailing at the time new debt is issued and a large share of the current stock of debt was raised while interest rates were exceptionally low during the pandemic. As existing bonds mature and need to be rolled over, the Government will need to issue more bonds at the prevailing rates.

Based on Budget and AOFM debt issuance data, we estimate that in 2023-24 around 20% of outstanding AGS will roll over and need to be financed at the new rate, which is expected to increase to around 50% by 2025-26 and 95% by 2032-33. This is a key reason why the impacts of changes in bond yields are relatively small up front but become larger further into the future.

We have recently discussed the huge Budget windfall expected to be reaped from higher-than-expected commodity prices, the strength of domestic economic conditions and asymmetric fiscal rewards from surging migration. These are short-term and likely one-off upgrades to the Budget bottom line***. However, the windfall will reduce the expected budget deficit and the amount the Government needs to borrow, or the Government's ongoing financing task.***

What do these changes mean for expected interest payments?

This ultimately means that when Treasury re-estimates expected interest costs in next week's Budget using a lower bond yield, the amount of interest expected to be paid on debt will be lower. The question is how much lower?

Based on the flatter government yield curve and the expected financing task, interest payments are forecast to decline by around $6 billion over the four years to the end of 2025-26, which includes a saving of $3 billion in 2025-26.

Over the ten years to the end of 2032-33, interest payments are forecast to be around $40 billion lower – or 0.2 percentage points of GDP lower by the end of the medium term (2032-33). The impacts are more significant further out because the Government needs to roll over a greater share of debt at the new interest rates.

Does this vastly improve the medium-term fiscal position?

Unlikely!

The Government's structural budget deficit was forecast to settle at around 2% of GDP back in the 2022 October Budget. While the lower bond yields make inroads in reducing the structural deficit, it's not enough to close the substantial gap that has emerged.

But it does show that the Budget is more susceptible to changes in bond yields, especially if the stock of debt becomes larger.

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