

Australian economic and budget update

Economic Research note

14 July 2010

- The government's Economic Statement provides revisions to both economic and budget forecasts. While real GDP growth is expected to be solid at 3% in 2010/11 and 3.75% in 2011/12, this is slightly slower than the previous forecast.
- However, upward revisions to inflation, commodity prices and the terms of trade help drive stronger nominal GDP growth, which feeds through into an improved budget performance.
- The better budget outlook will also help Australia's net debt peak at just 6% of GDP at June 2012, well down on the collective net debt of the advanced economies of 94.2% of GDP in 2015.
- The Economic Statement has also detailed the impact on the budget from the changes to the taxation of resources. While the switch from the proposed Resources Super Profit Tax (RSPT) to the Minerals Resource Rent Tax (MRRT) will cost A\$7.5bn in revenue over the four years to 2013/14, parameter changes (ie. higher commodity price forecasts) will add back A\$6bn in revenue, implying a net cost of just A\$1.5bn.
- The financial market implications from the Economic Statement seem minimal. The bond market is unlikely to be concerned by the higher inflation forecast and the improvement in the budget bottom-line is not significant enough to alter the bond selling program. For equities, the changes to the taxation of resources were previously well signalled.

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Australian economic update:

The Treasurer and Finance Minister have today taken the highly unusual step of releasing a full update of the government's economic forecasts and budget projections. Coming just over two months after the May 2010/11 Budget, today's update is likely a good guide to the closeness of the impending Federal election and the need by the new political leadership to reinforce the relatively positive economic and fiscal outlook for Australia.

Interestingly, today's Economic Statement now forecasts slightly slower real economic growth rates over 2010/11 and 2011/12, but with the unemployment rate still expected to decline. However, both the CPI inflation projections and nominal GDP expectations have been revised higher. These stronger nominal GDP estimates feed through into an upward revision to the Budget numbers, producing lower deficit in 2010/11 and 2011/12 and larger surpluses in 2012/13 and 2013/14. As a result, the Government's net debt position is also improved (see next page for further details).

The Economic Statement also provides details on the fiscal impact of the proposed tax reforms, including the Minerals Resource Rent Tax (MRRT), which is expected to raise A\$10.5bn in 2012/13 and 2013/14 combined.

While the change from the proposed Resources Super Profits Tax (RSPT) to the MRRT is expected to cost the budget A\$7.5bn over the forward estimates to 2013/14, this is expected to be largely offset by parameter changes, ie. higher commodity price and terms of trade forecasts, that are projected to add A\$6bn to the budget bottom-line.

On the economy, the Government has revised down their 2010/11 and 2011/12 growth forecasts to 3.0% and 3.75%, respectively (see table below for details). While the growth estimates are still strong, the downward revisions come on the back of the view that growth in the advanced economies is “weak and uneven” and that the global economic outlook is “increasingly clouded by substantial downside risks.” It is, unfortunately, hard to quibble with this assessment.

The Economic Statement does note, however, that “the robust economy, strong fiscal position, solid banking system, impressive resource endowments and close trade ties with Asia means that Australia is well placed to ride out increased global uncertainties.”

The Government has, however, revised upwards the 2010/11 nominal GDP growth forecast to 9.25%/yr, factoring in a further increase in key commodity prices and the terms of trade. Indeed, Australia’s terms of trade is now expected to rise by 17%/yr in 2010/11 to a new all-time high (see chart over). As discussed below, this has had a positive impact on the expected budget outcomes.

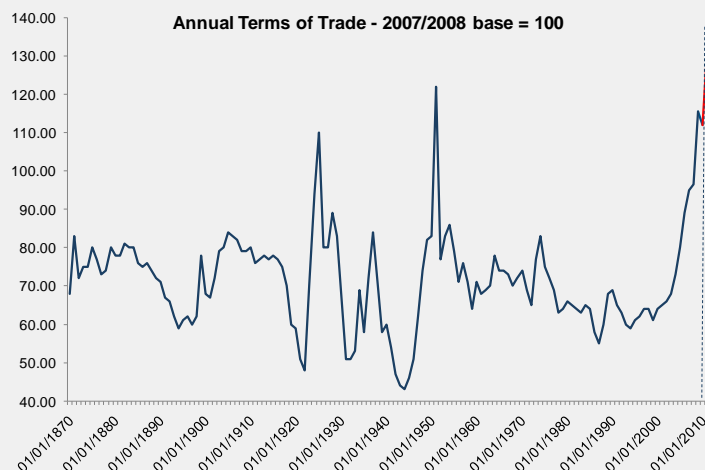
In addition, the unemployment rate is still expected to push down to 4.75% by June 2012. The government has also revised up its inflation forecasts for both 2010/11 and 2011/12 to 2.75%, a forecast much more consistent with the RBA’s view than the previous forecast of 2.5%.

Revised economic forecasts

| %/yr | 2010/11 | | 2011/12 | |
|--------------------------|--------------|---------|--------------|---------|
| | Previous f/c | New f/c | Previous f/c | New f/c |
| Real GDP | 3.25 | 3.0 | 4.0 | 3.75 |
| Nominal GDP | 8.5 | 9.25 | 5.75 | 5.25 |
| Employment | 2.25 | 2.25 | 2.0 | 2.0 |
| Unemployment rate | 5.0 | 5.0 | 4.75 | 4.75 |
| CPI | 2.5 | 2.75 | 2.5 | 2.75 |
| Current a/c % GDP | -3.75 | -3.0 | -5.0 | -4.5 |
| Terms of trade | +14.25 | +17.0 | -3.75 | -4.5 |

Source: 2010/11 Budget & Commonwealth Treasury

Australia’s terms of trade to reach all-time high in 2010/11



Source: RBA & Commonwealth Treasury

Australian budget update

The revised terms of trade and nominal GDP forecast have fed through to a generally improved budget profile in the years ahead. While the 2010/11 budget deficit is expected to be little changed from the previous estimate, both the 2011/12 and 2012/13 budget estimates have improved by around A\$2bn-A\$3bn or 0.1%-0.2% of GDP. The table below provides details.

The Government notes that they will stick with their commitment to keep spending increases to 2% real per year until the surplus is at least 1% of GDP, assuming the economy continues to grow at or above trend. The Government has also committed to allowing revenue increases to flow through to the budget bottom-line.

In terms of the budget outlook, it is significant to note that the negative effects on the budget bottom-line from the revisions to the taxation of resources (ie. the move from the RSPT to the MRRT) is estimated at A\$7.5bn over the four year period.

However, this potential revenue loss will be substantially offset by parameter changes of an estimated A\$6.0bn (ie. giving the budget-cost of just A\$1.5bn from the changes to the original tax plans). These positive parameter changes include higher revenue from the stronger commodity prices and terms of trade forecasts, as well as higher company tax receipts. These positive are offset a little, however, by a softer consumer outlook lowering GST receipts (although this effect eventually flows through the states).

The improved budget performance will flow through to the Government’s net debt position, which is now expected to peak in \$A terms at A\$89.7bn at June 2013 (down from the previous estimate of A\$93.7bn) and peak as a share of GDP at 6.0% at June 2012 (down from 6.1%). This compares very favourably to the major advanced economies, with collective net debt for these countries expected to reach 94.2% of GDP in 2015.

Budget and revised deficit/surplus forecasts and general government net debt

| | 2010/11 | 2010/11 | 2011/12 | 2011/12 | 2012/13 | 2012/13 | 2013/14 | 2013/14 |
|--------------------------------|------------|---------|------------|---------|------------|---------|------------|---------|
| | Budget f/c | New f/c | Budget f/c | New f/c | Budget f/c | New f/c | Budget f/c | New f/c |
| Underlying cash balance | | | | | | | | |
| A\$ bn | -40.8 | -40.4 | -13.0 | -10.0 | +1.0 | +3.1 | +5.4 | +4.8 |
| % GDP | -2.9 | -2.8 | -0.9 | -0.7 | +0.1 | +0.2 | +0.3 | +0.3 |
| Net debt | | | | | | | | |
| A\$ bn | 78.5 | 80.8 | 90.5 | 89.2 | 93.7 | 89.7 | 90.8 | 87.0 |
| % GDP | 5.6 | 5.7 | 6.1 | 6.0 | 6.0 | 5.7 | 5.5 | 5.3 |

Source: 2010/11 Budget and Commonwealth Treasury

Financial market implications

There are few direct financial market implications from today's Economic Statement. The revisions to the budget deficit/surplus numbers are unlikely to be sufficiently large to alter the supply of government bonds coming to the markets in the years ahead, while the upward revision to the CPI forecasts just bring the Government more into line with the RBA and the market.

For the equity market, the revenue estimates for the MRRT and other tax changes had already been announced – so no new news there. Markets will remain alive to the fact that there is still likely a long way to go before the government proposed tax reformed pass through Parliament and become law.

For further information

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