Australian budget update – still committed to a surplus

Economic research note

29 November 2011

- The Australian Commonwealth government has remained committed to delivering a budget surplus in 2012/13 as part of today's Mid-Year Economic and Fiscal Outlook (MYEFO) release.
- This will involve an aggressive tightening of fiscal policy in 2012/13, at a time when monetary policy has already commenced an easing cycle, opening the door for further easing of monetary policy.
- The economic forecasts contained within MYEFO have been downgraded, however, the budget still assumes around trend economic growth in Australia, unemployment forecasts have been revised higher.
- The larger budget deficit in 2011/12 implies a higher level of net government debt and more bond issuance.
- However when seen in an international context, Australia's government debt level remains very low.
- For financial markets, there is expected to be minimal impact. The main issue remains sovereign debt problems in Europe and the need for decisive political leadership, this also remains the biggest downside risk for economic growth and budget forecasts in Australia.

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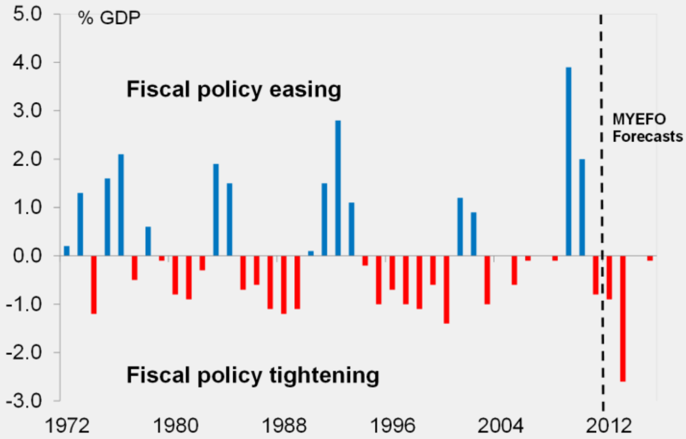
Overview and implications – a significant fiscal contraction for the Australian economy

In the Commonwealth's MYEFO, released today, the government has, as widely expected, significantly revised its budget and economic growth forecasts for both 2011/12 and 2012/13. However the government has remained committed to delivering a budget surplus in 2012/13.

The weaker budget bottom-line and economic growth forecasts have been driven by significant global headwinds from the European sovereign debt crisis. This has contributed to a weaker near-term outlook for the Australian economy with both lower growth and employment growth forecasts announced today.

The turnaround in the government's fiscal position between a deficit of 2.5% of GDP in 2011/12 and a surplus of 0.1% of GDP in 2012/13 represents a substantial fiscal contraction on the economy. Although it must be remembered this contraction comes after a very large GFC inspired stimulus. See chart below for details.

Chart 1: Fiscal policy impulse



Source: Commonwealth Treasury and CFSGAM

This fiscal contraction will occur at a time of much weaker global economic growth and growing downside risks to the broader economic outlook and an already weaker inflation outlook. This tighter fiscal policy stance is now likely to leave room for the Reserve Bank of Australia (RBA) to continue on its path of easing monetary policy. A further interest rate cut in December is certainly a possibility, taking the cash rate to 4.25%. Given the size of the fiscal contraction now expected, and growing downside risks to growth and inflation, further rate cuts beyond December are also possible.

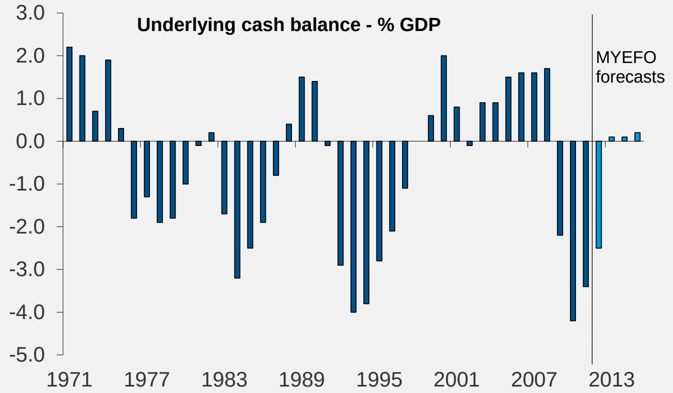
The Treasurers' press release states that "the Australian economy continues to outperform the developed world with solid growth prospects, low unemployment, a record pipeline of resources investment, and strong public finances".

Economic growth forecasts have been lowered to 3.25% in 2011/12 and 2012/13, 0.75 percentage points lower than May budget forecasts, in line with RBA forecasts. The unemployment rate is now forecast to rise to 5.5% at June 2012 and net debt will peak at 8.9% of GDP by June 2012 ($A132.6bn) against the previous estimate of 7.2% and an average of 93% for the major OECD nations.

Some details

For 2011/12 the budget deficit (underlying cash balance) estimate is $A37.1bn or 2.5% of GDP (previous estimate $22.6bn, 1.5%). However, improvement comes in 2012/13 with a surplus estimate of $A1.5bn, 0.1% of GDP, down from $A3.5bn, 0.2% of GDP. For 2013/14 the surplus is estimated at $A1.9bn, 0.1% of GDP (down $A1.8bn) and then to $A3.1bn, 0.2% of GDP in 2014/15 (down $A2.7bn). See chart below for path back to surplus.

Chart 2: Commonwealth budget surplus/deficit estimates



Source: Commonwealth Treasury

Table 1: Budget estimates

Estimates	2011/12 Budget	2011/12 MYEFO	2012/13 Budget	2012/13 MYEFO
Underlying cash balance ($Abn)	**-22.6**	**-37.1**	**3.5**	**1.5**
Percent of GDP	-1.5	-2.5	0.2	0.1
Fiscal balance ($b)	**-20.3**	**-32.4**	**4.0**	**4.7**
Percent of GDP	-1.4	-2.2	0.3	0.3

Projections	2013/14 Budget	2013/14 MYEFO	2014/15 Budget	2014/15 MYEFO
Underlying cash balance ($Abn)	**3.7**	**1.9**	**5.8**	**3.1**
Percent of GDP	0.2	0.1	0.3	0.2
Fiscal balance ($b)	**3.2**	**4.2**	**8.5**	**6.4**
Percent of GDP	0.2	0.3	0.5	0.4

Source: Commonwealth Treasury

The deterioration of $A14.5bn in 2011/12 is split between $A4.9bn in policy changes and $A9.6bn in parameter changes (lower growth forecasts). Tax receipts were revised down by $A4.8bn in 2011/12 due to the weaker economic outlook, particularly lower capital gains tax due to weak equity markets and lower income tax as the labour market has stalled. There does appear to be some front loading of expenses in 2011/12 to aid the return to surplus in 2012/13.

Spending measures were also higher in 2011/12 due to $A2.3bn in funding as part of the Queensland natural disaster rebuild. Higher spending is also due to upfront compensation measures from the Clean Energy Future package and spending on infrastructure projects. However the Clean Energy Future package is expected to detract $A3.3bn over the forward estimates, therefore the total spending cuts identified will not flow through to the bottom line.

Over the forward estimates, tax receipts are forecast to fall more than $A20bn. This is a combination of GST receipts, income taxes, capital gains taxes and resource rent taxes. The government as a result has identified $A11.5bn in net savings. This still may not be enough to achieve the return to surplus in 2012/13 and further spending cuts and revenue raising measures may well need to be announced in May 2012.

Key policy changes

Spending cuts and revenue measures include:

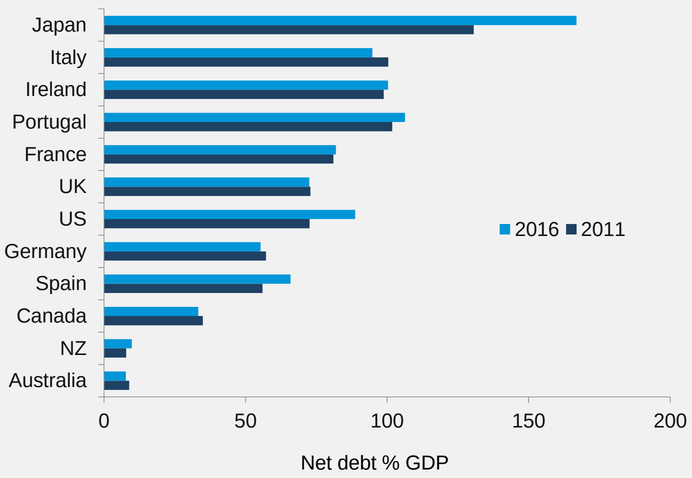
- reduced fuel subsidies
- changes to the living away from home allowances
- alternations to the superannuation co-contribution payment, as well as pausing indexation
- reduction to the baby bonus to $A5000 and pausing indexation
- improved pricing arrangements for visas
- a one-off efficient dividend (ie belt tightening across the public sector).

Australian government debt outlook

Net debt for the government is now forecast to peak at 8.9% of GDP in 2011/12, higher than previously anticipated of 7.2% at $A132.6bn. This is due to changes in the market value of existing Commonwealth Government Securities and an increase in issuance of bonds expected in 2011/12 due to the weaker fiscal outlook.

However the net debt position for Australia still remains low by international comparison. The average net debt position of the major advanced economies (G7) is projected to reach 93% in 2016. See chart below for details.

Chart 3: Government net debt as percentage of GDP



Source: IMF and Commonwealth Treasury

Economic outlook

In the MYEFO the Government has, as widely expected, made downward revisions to its economic growth and employment forecasts for both 2011/12 and 2012/13. The weakened outlook for the domestic economy follows the recent deterioration in global economic and financial conditions, mainly stemming from the European sovereign debt crises. Conditions in the domestic economy are expected to remain un-even, with the weaker international environment exacerbating the existing pressures felt by the non-mining sectors of the economy.

Real GDP growth is now forecast to grow 3 ¼ per cent in both 2011/12 and 2012/13 – a downward revision of ¾ a percentage point and ½ a percentage point respectively.

Employment growth is now expected to ease to 1 per cent in 2011/12 and to 1 ½ per cent in 2012/13. The unemployment rate, while still remaining low, is expected to drift up slightly to 5 ½ per cent for both 2011/12 and 2012/13 while inflation is expected to remain well contained. Despite recent volatility in commodity prices, the terms of trade have been revised up for 2011/12 to 1 ¾ per cent, but are now expected to decline by 5 ¾ in 2012/13.

In aggregate, the Australian economy is expected to grow at around its trend rate, underpinned by the record pipeline of resource investment and strong growth in commodity exports. However, the non-mining sector, namely manufacturing, retail and wholesale trade, road transport and non-resource related construction sectors will continue to feel the pressures of the high Australian dollar and cautious household spending – which is expected to be magnified by easing employment growth and recent falls in equity markets.

The intensification of the European debt crises and a weaker than expected US economy has led to a further deterioration in the global economic outlook. World GDP is now expected to grow 4 per cent in 2011/12 and 3 ½ per cent in 2012/13, compared to previous Budget forecasts of 4 ¼ per cent and 4 ½ per cent respectively. The uncertainty surrounding the situation in Europe poses significant downside risks to global growth – and the European economy, which is now expected to return to recession in 2012. The US recovery is expected to remain weak and susceptible to external shocks. The US housing and labour market remained depressed, albeit recent economic data indicating a modest pick-up in growth. Despite slowing, growth in China is expected to remain strong and continue to support global growth. China, and other trade-exposed emerging economies, remain vulnerable to further deteriorations in external conditions.

Table 2: Economic Forecasts

Estimates	2011/12		2012/13	
	Budget	MYEFO	Budget	MYEFO
Real GDP growth	4	3 1/4	3 3/4	3 1/4
Employment growth	1 3/4	1	1 3/4	1 1/2
Unemployment rate	4 3/4	5 1/2	4 1/2	5 1/2
Headline inflation	2 3/4	2 1/4	3	3 1/4
Nominal GDP growth	6 1/4	6 1/4	5 3/4	5

Projections	2013/14		2014/15	
	Budget	MYEFO	Budget	MYEFO
Real GDP growth	3 1/4	3	3 1/4	3
Employment growth	1	1 1/2	1 1/2	1 1/2
Unemployment rate	5 1/2	5	5 1/2	5
Headline inflation	2 1/4	2 1/2	3 1/4	2 1/2
Nominal GDP growth	6 1/4	5 1/4	5	5 1/4

Source: Commonwealth Treasury

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