The 2013/14 Budget

- The underlying Budget *deficit* for 2013/14 is projected at $18.0bn (1.1 % of GDP), a significant deterioration from the small $2.2bn *surplus* projected in the last official forecasts released in October 2012.
- The 2013/14 deficit is, however, a small improvement on the $19.4bn (1.3%of GDP) deficit now expected for 2012/13.
- And, somewhat surprisingly, the surplus flame continues to flicker with a balanced outcome projected for 2015/16 and a surplus of $6.6bn projected for 2016/17.
- The Government deserves credit for folding on its surplus commitment and taking the resulting political heat.
- An economy expected to run a little below trend for a while is not one that needs aggressive fiscal consolidation.
- But a credible path to return to surplus must be laid out. And here some doubts remain. Implied revenue elasticities are at the high end of the range of the past fifty years but some difficult savings measures have been tabled.
- The implications for financial markets are limited – fiscal objectives and measures were well telegraphed.
- The total size of the CGS market is forecast to grow quickly. From $256bn at June 2013, we expect the market to grow to $282bn by 30 June 2014.

The big picture

The small Budget surpluses previously expected for the next couple of years have evaporated into the ether. Instead, some smallish deficits lie ahead before an eventual creep back to surplus (just) from 2015/16.

The swing from projected surplus to deficit reality is part natural disaster and part man-made.

The "natural disaster" reflects a *real* economy that is in decent shape but where those good real outcomes are not generating income the way that they normally would. *Nominal* GDP, or the tax base, is growing more slowly than real GDP. This divergence is extremely rare. Government tax revenues have suffered as a result. The revenue pain has been compounded by the high AUD (on company profits), the lingering fallout from the GFC (on capital gains) and the collapse in the carbon price.

The "man-made" component reflects the government's desire to push ahead with its signature economic reforms to education and disability insurance at time where the funding backdrop is uncertain. And, with all the clarity of 20-20 hindsight, the failure in earlier Budgets to do any more than was absolutely necessary to keep wafer-thin surplus projections on track has come home to roost.

The Government deserves credit for folding on its immediate surplus commitment and taking the political heat that decision entailed. By letting the economy drive the revenue side of the Budget we have avoided the worst excesses of Eurozone-style fiscal austerity. And by slowing the progress back towards Budget surplus we have avoided the risk of going over our very own "fiscal cliff". The Budget forecasts from last year proposed a reduction in the underlying budget deficit of 3% of GDP in 2012/13 (the US fiscal cliff that preoccupied financial markets for much of 2012 was only slightly larger at 3¼% of GDP). The turnaround in the budget position during the current financial year is now a more manageable 1.6% of GDP. And the further reductions of ¼-½% projected for the next few years look manageable from an economic growth perspective.

It wouldn't be a Budget without some discussion of "smoke and mirrors" or "rubbery" estimates. This Budget is no exception. Savings measures are designed to cover new spending. But the mishmash of spending cuts and tax increases has been cleverly designed to take effect <u>before</u> the back-end-loaded spending really gets going. The budget bottom line benefits as a result. A switch to monthly payments for large PAYG taxpayers gives a transitory timing boost as well.

It is an election year. And the Government again deserves credit for avoiding the go-for-broke mentality that often drives pre-election budgets. The signature policy initiatives will provide plenty of marketing opportunities. But the funding of

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those commitments comes with a degree of economic pain. Deferring tax cuts and taking back some "middle class welfare" is not voter friendly.

The election also represents the elephant in the room. The opinion polls suggest a new government could be in place in September. Any new government will face the same fiscal challenges. But they will have different fiscal priorities as well. The 2013 Budget should be regarded as work-in-progress.

A Surplus: "economic imperative" or "mindless austerity"?

The fiscal debate has moved on. The surplus that was an "economic imperative" last year is now just a reflection of "mindless austerity". The shift is part politics, of course. But it does suggest a maturing in the fiscal debate away from the deficits-and-debt-are-bad view that has characterised the past couple of decades.

A surplus objective remains appropriate, however. An analysis of the funding flows across the economy highlights some key points for policy makers.

Business and government are net borrowers. This borrowing is partly accommodated by households and the shortfall is met by tapping the savings of the rest of world. Australia's net borrowing status leaves us exposed to financial problems elsewhere. The policy implications are:

- households need to remain net lenders – a reason for caution on rate cuts;
- government needs to wind back net borrowing – a reason why a surplus objective is sensible over the medium term;
- household lending, budget surpluses and less business borrowing as the mining capex boom deflates would reduce reliance on tapping the savings of the rest of the world - a handy protection that may ultimately take some of the pressure off the AUD.

Budget GDP growth forecasts for the next couple of years have the economy running a little below trend (3¼%pa). Against that backdrop, the Australian economy is not in need of an aggressive fiscal consolidation. But a credible path to return to surplus must be laid out. The surplus is there on paper. But the projected $6.6bn surplus in 2016/17 at the end of the projection period is of the wafer thin variety again. It does depend on some accounting magic as discussed earlier. But there are also some hard decisions as well that means the Government should be given the benefit of the doubt.

The decision to implement an infrastructure package worth $24bn over the next five years could also be seen as a sign of a more mature fiscal debate. It is always difficult to separate out what is new money in such proposals. But earlier studies concluded that there was a big economic payoff to the private sector to such spending. Low borrowing costs and significant borrowing capacity could amplify the returns. It's time to freshen up the debate.

The economy & the Budget

The forecasts in the May 2012 Budget projected *surpluses* totalling $16bn over the 2012/13-2015/16 period. Parameter and other variations have taken nearly $90bn out of the fiscal equation. Together with net policy changes since the last Budget that improve the bottom line by $26bn, we are now looking at accumulated *deficits* worth $48bn.

The damage to the Budget bottom line is concentrated on the revenue side. Some enduring one-offs, such as the high Aussie dollar, mining-related tax offsets and the collapse in the carbon price, are weighing on revenues. But the main factor is the weakness in incomes or *nominal* GDP growth. Nominal GDP is the revenue base – so nominal GDP forecasts are critical. The Budget projects nominal GDP growth to run at a lacklustre 3¾%pa in 2012/13 before recovering to 5-5¼%pa in the outyears. Revenue forecasters have had a torrid time of late. And we had expected risk-averse forecasters to err on the conservative side as a result. This conservative bias is not apparent. In fact the implied revenue elasticities (ie what sort of rise in revenue do you get from a given increase in nominal GDP) are at the high end of the range of the past fifty years. The risks with current Budget projections may once again be that outcomes disappoint.

Assumptions about the terms of trade are the key for nominal GDP. The Budget notes that a terms-of-trade driven 1% fall (rise) in nominal GDP would ultimately reduce (boost) the budget bottom line by around $6bn. The terms of trade assumptions in this Budget show a 7½% fall in 2012/13 and further ¾% drop in 2013/14. These forecasts seem broadly in accord with expectations for Major Trading Partner (MTP) growth of 4½-4¾%pa over the next few years.

The focus is on downside revenue pressures. But it is important to note that revenues are still growing, quite quickly in some cases. Employment-related taxes are an interesting case in point. Taxes on individual's incomes (PAYG) and payroll taxes are growing at a respectable rate. And the 2013 Budget has Gross PAYG rising by 8.6% in 2013/14 and a further 8.2% in 2014/15. Taxes are hard dollars paid. You don't pay more payroll tax unless you are hiring people. You don't pay PAYG if you don't have a job. The message from the tax data may be that the labour market is in better shape than the official data suggests. Budget forecasts showing the unemployment rate holding around 5¾% may be a touch pessimistic.

The Budget & the economy

Budget forecasts, as noted, have real growth running a touch below trend at 2¾-3%pa over the next couple of years. The consensus agrees - the RBA, the IMF and private sector economists have tabled similar forecasts. Hopefully it is a case of "great minds think alike" rather than "fools never differ". But a number of things need to go right to achieve these sorts of growth outcomes. The most important requirements are:

- nominal growth needs to pick up;
- the mining capex peak needs to be negotiated and the growth transition to the *non-mining* economy needs to succeed;
- confidence needs to recover - policy stimulus will then have its full impact; and
- business must find a way to live with a high AUD - productivity is the key.

The risks to the Budget's economic projections reflect these themes. Scoring the Budget should also reflect the contribution made by fiscal policy to reducing these risks.

The results are mixed. The terms-of-trade, for example, is outside government control but fiscal restraint is a factor weighing on domestic prices and incomes. Households need to play a greater role – via residential construction and consumer spending - in shifting growth to the non-mining economy. Surveys show that many households worry about the perceived pressures on their personal budgets. So spending and revenue initiatives in this Budget won't help. On our figuring, the increase in the Medicare levy, deferred tax cuts, cancellation of the FTB Part A payments and other miscellaneous measures are equivalent to 2¼% of household income over the next four years. Budget forecasts showing unemployment creeping up to 5¾% may keep job security fears alive. Households could favour savings over spending as a result.

There is little that fiscal policy can do in a direct sense to influence the currency. Indeed, the soundness of Australian public finances relative to other countries is part of the strong Aussie dollar story. But some measures will assist productivity growth. And higher productivity is the only permanent solution to taking the pain away from a strong currency. Education spending and the NDIS are worthy reforms in their own right. But from the cold-hearted perspective of an economist they come with the added benefit of boosting productivity and participation over time.

Fiscal settings feed into RBA deliberations. And current cash rates contain an allowance for the pressures of fiscal consolidation. The abandonment of the surplus commitment for this year has reduced, at the margin, the importance of fiscal settings in the rates debate. Further fiscal consolidation looks manageable from a growth perspective. Nevertheless, the RBA has room to move and has illustrated a willingness to use that room. We have a 25bpt cut pencilled in for August, taking the cash rate down to 2½%.

The Budget & financial markets

The Government's 2012/13 Budget has not affected prices in Australian fixed income markets. The 2012/13 and 2013/14 deficits were a little larger than expected, but the surpluses forecast for the following two years were a slight surprise (though leaked earlier in day). There were no policy initiatives affecting the overall level of debt.

Government forecasts show that the value of government securities on issue is now expected to be $67bn higher in 2015/16 than previously forecast. That equates to an additional 4% of GDP of gross debt (forecast to peak at 20.6% in 2014-15), which is not enough to challenge the AAA rating. Both major agencies affirmed the AAA immediately after the Budget.

However, the credibility of the estimates is an open question. Revenue growth of 7.7% in 2013-14 is above the 6.0% average for the past ten years. It rests on a recovery in nominal GDP growth to 5.0% from 3.25% in 2012-13, which reflects a small 0.75% slip in the terms of trade after this year's 7.5% drop. That is arguably defensible, but perhaps not conservative enough given the sheer uncertainty surrounding the global growth outlook and volatility in commodity prices. The current account deficit is expected to be quite stable, averaging around 3.5% a year and hence no decline in the stock of national debt. If households respond to low interest rates by borrowing heavily, but the slowdown in mining capex delivers sub-par growth (and keeps the pressure on for further rate cuts), the ingredients may fall into place for ratings pressure down the track.

The total size of the CGS market is forecast to grow quickly. From $256b at 30 June 2013, we expect the total size of the CGS market to grow to $282bn by 30 June 2014. The main growth will be in nominal bonds. The Government forecasts the total size of the Nominal bond market to grow from $233b at 30 June 2013 to $260bn at 30 June 2014, with $50bn of new issuance offset by $23bn of maturities. That issuance is only $3.7bn lower than the expected result for 2012/13, where some digestion problems have arguably started to emerge. There is no guidance as to whether AOFM will continue to extend the tenor of the Government yield curve.

The Government expects to issue $4b of linker bonds, taking the total outstanding to $22bn. The Budget Papers appear to assume the entire borrowing requirement will be funded using long-term debt, which allows the use of Treasury Notes to fall to zero. This assumption allows any unexpected shortfalls to be met by issuing Treasury Notes without impacting the bond forecasts.

We expect the relative improvement in the US economy versus Australia to help narrow AUS-US bond spreads under 100bp over the next year or so. The AAA rating will help that process. However, we can no longer confidently predict demand to outstrip supply of government paper. With a 2.4% cash rate already being discounted, we can't see an argument for a further immediate contraction in the spread. Together with some back up in US Treasury yields, this suggests Aussie 10Y bond yields may head back toward 3.5% in coming weeks.

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