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The 2013-14 Australian Budget – struggling back to surplus

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Key points

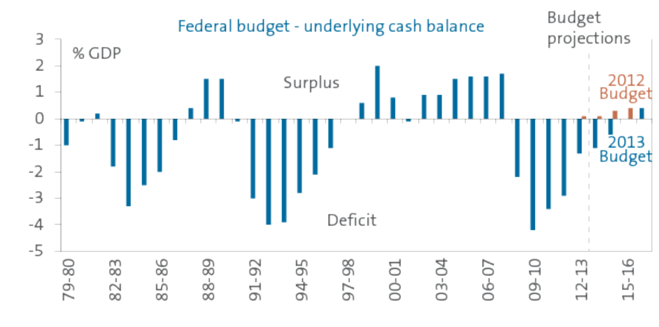
> The positives in the Budget are more for education, disability care and roads together with savings in middle class welfare.
> However, the deficit is worse than expected, with a surplus pushed out at least three years.
> While the Government has announced more budget savings, their impact is zero for the year ahead.
> It's hard to see major implications for investment markets.
> Australia's public finances are benign compared to other advanced countries, but they should be much stronger given the biggest resources boom in our history.

Introduction

The 2013 Budget has seen a big shift in Government policy away from a focus on returning the budget to surplus to send "a strong message of confidence" (quote from last year's Budget) to focussing on "a strong economy". The surplus projection is still there, but thanks to a huge revenue shortfall it has been pushed out three years to 2015-16 and progress towards it will stall in the year ahead. While there will no doubt be lots of interest in the individual budget measures, the lack of a surplus is the key issue.

Key measures

As is well known, last year's Budget projection for a A$1.5 billion surplus this financial year has not been achieved, thanks largely to a circa A$16 billion revenue shortfall and a spending blowout, with the Government now projecting it will be in deficit to the tune of A$19 billion. And with the revenue shortfall affecting the starting point for future years, the Government now expects that a surplus won't be achieved until 2015-16. However, to achieve this it has still had to announce savings, albeit they don't kick in until 2014-15.



Source: Australian Treasury, AMP Capital

The revenue shortfall mainly reflects lower company tax collections, reflecting the combination of lower commodity prices, the strong A$ and apparently various corporate tax loopholes. To plug the gap and push the budget back into surplus in the next few years, the Government has announced net savings of A$28 billion over five years, although these initiatives will not commence until 2014-15. Some of the savings were pre-announced or well flagged and include:

> Various measures to tighten corporate tax loopholes.
> Cancellation of a rise in family benefit payments and replacement of the baby bonus.
> Postponing personal tax cuts that were due in 2015 as the carbon price assumption has been lowered.
> An extension of monthly income tax instalments to large taxpayers.
> An increase in the Medicare levy to fund disability care.
> Superannuation changes as already announced.
> Cuts to higher education funding.
> Cuts to planned foreign aid.

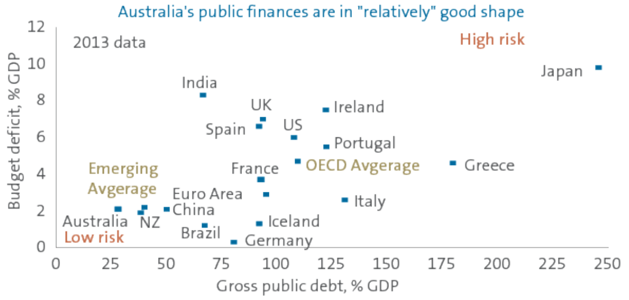
These measures were partly offset by welcomed spending on roads and rail, the move towards a full start-up of disability care in 2018-19 and increased funding for schools.

The budget deficit - the good and bad

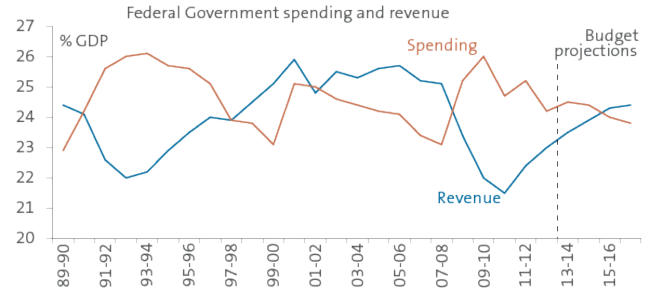
Given the coverage around a continuing budget deficit, it is worth putting it into context. First, some background. Just as with a household, a government's budget deficit is the difference between the amount it spends (on social welfare, defence, infrastructure, health, etc.) and the amount it gets in revenue (from taxes, investment earnings, etc.). It has to be financed by borrowing and to do this, a government issues bonds (to investors such as super funds, insurance companies and foreign investors). The cumulative sum of all such borrowing is its public debt.

While the A$19 billion deficit for this financial year is a lot of money, it needs to be compared to the size of the economy (A$1.5 trillion) to put it into context. This puts it at 1.3% of GDP and as can be seen in the first chart is a big fall from 2.9% of GDP last financial year when the deficit was A$43 billion. This is in fact the biggest reduction in a deficit in modern history. So despite the failure to hit the surplus target (which was always a stretch to achieve anyway) the budget deficit is still going in the right direction.

What's more, Australia's budget deficit is tiny compared to other advanced countries. At around 2% of GDP across all levels of government, it compares to around 3% of GDP in the Eurozone, 6% in the US and 10% in Japan.



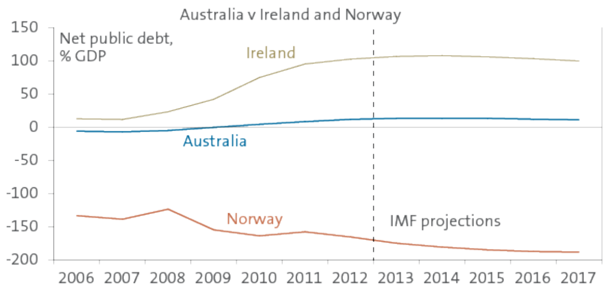
Source: IMF, AMP Capital



Source: Australian Treasury, AMP Capital

Similarly, Australia's gross level of public debt at around 28% of GDP is very small compared to around 95% in the Eurozone, 108% in the US and 245% in Japan.

However, comparing ourselves to a bad bunch is not necessarily wise. First, our level of net public debt (i.e. gross public debt less what the Government is owed) is about where Ireland's was in 2006 before a severe property crash necessitated the Irish Government to bail out its banks which saw public debt skyrocket. This is unlikely in Australia, but the Irish experience highlights just how quickly good times can turn sour. Second, after the biggest resources boom in our history, public finances should be in far better shape. Norway is a good example in this regard. Realising that its North Sea oil reserves would not last forever, it has been running big budget surpluses (around 10 to 18% of GDP) and putting the money into a sovereign wealth fund for use when their boom is over. As a result, Norway's net public debt is negative, i.e. it is owed way more than it owes.



Source: IMF, AMP Capital

Australia is now projected to run budget deficits for seven years in a row, totalling 16% of GDP, which is almost identical to the seven years of budget deficits in the 1990s that totalled 17% of GDP. The problem is that the 1990s episode could be excused on the grounds that it encompassed a deep recession, whereas the current episode has seen no recession and the biggest resources boom in our history!

While the fiscal stimulus around the time of the GFC was justified, Australia ideally should have built up a bigger investment in sovereign wealth funds like the Future Fund in the years before the GFC and then cut back the GFC stimulus much faster. Clearly, the revenue shortfall has played a role but spending should also have been cut back more aggressively through 2010 and 2011 after it surged to around early 1990s highs in relation to GDP, as shown in the next chart.

Implications for interest rates

While there is a fiscal tightening in the Budget, it is actually zero this year and doesn't kick in until 2014-15 at 0.4% of GDP before rising to 0.7% of GDP in 2015-16. This makes it somewhat academic (as it may not even occur) given past experience and is unlikely to have any impact on the Reserve Bank of Australia's (RBA) immediate thinking regarding interest rates. That said, our assessment remains that the RBA will cut interest rates again, taking the cash rate down to at least 2.5%, with the main drivers being the peaking of mining investment at a time when the rest of the economy remains subdued and inflation remains low.

Against this background and assuming that rates are cut further, the Government's growth forecast for 2013-14 of 2.75% is reasonable and in line with our own view. However, its nominal GDP growth forecast of 5% may be a little optimistic and we see unemployment pushing up to 6% as against the Government's 5.75% forecast. Inflation is likely to remain low at around 2.25% as the Government predicts.

Implications for Australian assets

It's hard to see a major impact on Australian assets.

Cash and term deposits – can't see much impact here at all. The RBA is likely to cut rates further which is likely to put more downwards pressure on term deposit rates. Expect term deposit rates to fall below 4% in the months ahead.

Bonds – the delay in a return to surplus is probably not enough to threaten Australia's AAA sovereign rating and continuing low interest rates should ensure bond yields remain low. But the problem remains that with five year bond yields at 2.8%, it's hard to see great returns from Australian sovereign bonds over the next few years.

Shares – while increased spending on roads and rail may help construction and building material stocks, the impact is likely to be minimal. It's hard to see much impact on the share market overall, where we see the broad trend remaining up thanks to reasonable valuations, easy monetary conditions and prospects for stronger profits.

Property – property prices are likely to continue gaining at a modest pace on the back of low interest rates and as domestic growth starts to pick up.

**The A$** – while the initial response to the Budget saw the A$ fall 0.5%, the announcements in the Budget alone are not radical enough to have much of an impact on the A$. In the very short term, the A$ was oversold after last week's sharp fall. However, with the commodity price boom fading, the interest rate differential in favour of Australia falling and the A$ overvalued on a purchasing power parity basis, the trend in the A$ is now likely to be down.

Concluding comments

The good news is that Government has found ways to fund its commendable Gonski education reforms and disability care while superannuation has been left alone beyond what has already been announced. But it would have been desirable to have at least some of the budget savings kick in this year to provide more confidence that a surplus will eventually be achieved. As it turns out, we are now looking at a budget deficit blowout of virtually the same size as that seen in the 1990s despite having a much stronger economy than back then. To be sure, Australia's public finances are in good shape compared to other advanced countries. But having seen the biggest resources boom in our history, we should have been able to put more aside for the inevitable rainy day.

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