Quarterly Economic Report

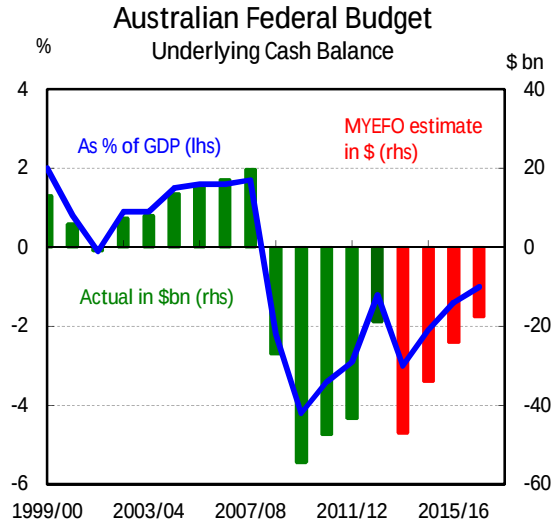
Tuesday, 17 December 2013

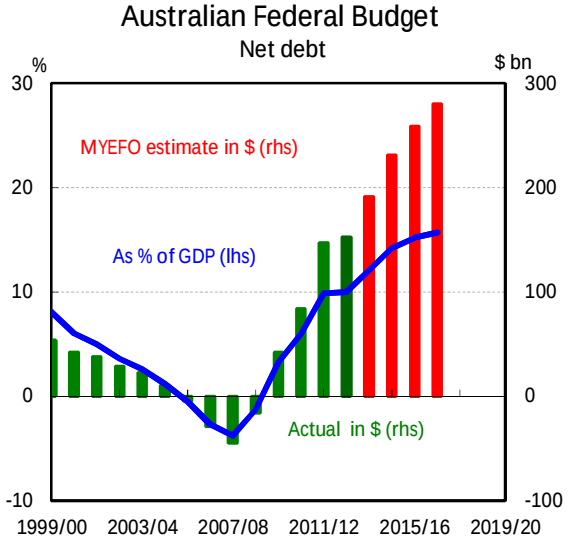
BankSA

Mid-Year Economic and Fiscal Outlook

The Longer Road to Surplus

- Larger budget deficits and a slower path of fiscal consolidation was predictably the key theme in today's MYEFO. The budget deficit expected this current financial year is now $47bn, up from $30.1bn estimated prior to the election in August's Pre-Election and Fiscal Outlook.
- The larger deficits reflect downgrades to the economic outlook and the policy decisions of the





new Government. The revised economic projections reflect expectations that the Australian economic transition from resources-led investment growth will be slower.

- The Government's plans for fiscal consolidation will be delivered with the 2014-15 Budget in May 2014. It should incorporate the findings from the National Commission of Audit, due for release in January and March next year.

The release of the Mid-year Economic and Fiscal Outlook (MYEFO) revealed a sharp deterioration to the Budget's bottom line in 2013-14. A Budget deficit is now estimated to be $47.0bn (-3.0% of GDP), previously estimated to be $30.1bn (-1.9% of GDP) in the Pre-Election and Fiscal Outlook (PEFO) published on 13 August 2013 ahead of the Election.

There is a further deterioration in the bottom-line in the forward estimates. The total underlying cash deterioration over the forward estimates since the 2013-14 Budget is $101.2 billion.

The PEFO projections were for a return to surplus in 2016-17. Today's MYEFO does not indicate

when the government expects to return to surplus. It notes that without any policy changes, the budget is projected to be in deficit in each and every year to 2023-24. It also notes that this is an unsustainable fiscal position and the 2014-15 Budget to be handed down in May 2014 will outline the fiscal strategy to return the budget to surplus and pay down debt. So there will be a significant fiscal drag on the domestic economy in coming years.

Net debt is expected to reach $280.5bn or 15.7% of GDP in 2016-17. Australia's government debt levels remains low by international standards, although it is set to increase beyond the forecast period (2016-17).

The changes between the PEFO and MYEFO largely reflect downgrades to underlying economic forecasts and policy decisions by the new Government.

As usual, the budget outcome is largely dependent on forecasts which are subject to variability. On this front, the Government sees the economy growing more slowly than expected. That means less revenue than expected from income tax and less revenue than expected from company tax.

While the Government continues to expect the Australian economy to transition from resources-investment led growth to broader sources of growth, it now expects this transition to be slower than previously estimated. These expectations were reflected in the economic forecasts.

Real GDP forecasts are unchanged from the time of PEFO for 2013-14 but revised lower in 2014-15 from 3.0% to 2.5%, consistent with the middle of the RBA's forecasts published in its quarterly Statement on Monetary Policy in November.

The net income injection from a rising terms of trade is over. The forecast decline in the terms of trade has been revised from a fall of 12% over four years to 20% over the same time period. So while real GDP forecasts were unchanged for 2013-14, income forecasts were cut; this is reflected in a lower forecast for nominal GDP (see table below) in 2013-14. A more substantial 1ppt cut to nominal GDP is made for 2015-16.

To cut government spending by the full extent of the decline in revenue would place economic growth at risk at a time when the economy is growing below trend. Likewise, to lift taxes in a bid to gather new revenue would have a similar impact. What the government has chosen to do is a limited amount of extra taxes and a limited amount of spending cuts. The net result is a Budget deficit in 2013-14 far larger than originally anticipated. The outcome would have been worse if no changes were made.

Forecasts % Change on Previous Year	2013/14	2014/15
Real Gross Domestic Product (GDP)	(2.50) 2.50	(3.00) 2.50
Nominal Gross Domestic Product (GDP)	(3.75) 3.50	(4.50) 3.50
Terms of Trade	(-5.75) -5.00	(-3.75) -5.00
Unemployment Rate (%)**	(6.25) 6.00	(6.25) 6.25
CPI (Headline) ***	(2.50) 2.75	(2.00) 2.00
Wage Price Index	(3.25) 2.75	(3.25) 2.75

*Real GDP forecasts are year average.

**The unemployment rate is for the June quarter.

*** Through the year growth rate to the June quarter

Forecasts from the PEFO in August are in brackets

In terms of policy decisions, one of the more important impacts came from the decision to give a grant of $8.8bn to the RBA for the purpose of rebuilding its reserve fund to a level deemed prudent by the RBA board.

Policy decisions around the national disability insurance scheme and the education program also have an impact. The cost of the previous government's national disability insurance scheme and education program, to which the current government is largely committed to, is bigger than previously estimated. An additional $1.2bn of funding has been provided for States that are yet to sign up to the National Plan for School Improvement.

The savings of $5.2bn from cutting headcount of 12,000 in the public service will not proceed, affecting the bottom-line of the budget.

Moreover, the total impact of the repeal of the carbon price and associated measures also gives a net deterioration in the budget of $7.4bn over the forward estimates period. This cost reflects, in part, the Government's decision to retain the personal income tax rates while abolishing the carbon price, and to maintain the increases in fortnightly pensions and benefit rates that were introduced with the carbon tax.

National Commission of Audit

A Commission of Audit is due early next year, and is to be released in two phases. The first is due by the end of January and the second is due by the end of March. The Commission is aimed at identifying efficiency and productivity improvements across all areas of federal spending and to recommend savings measures to assist in delivering a surplus of at least 1% of GDP by 2023-24.

The 2014/15 Budget to be delivered in May 2014 is the first opportunity for the new government to implement the recommendations. We expect the details of the Government's plans for fiscal consolidation will be released in the May. Today's MYEFO did not contain that detail. We would expect Australia to maintain its AAA sovereign credit rating, but it could be at risk if the Government does not provide a viable strategy to get back to surplus over the medium term.

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