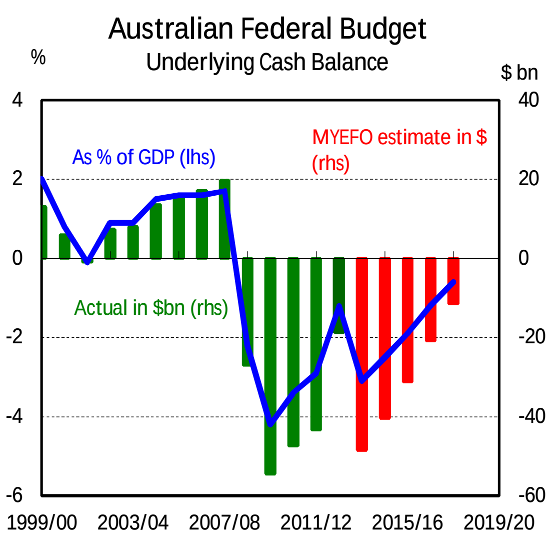
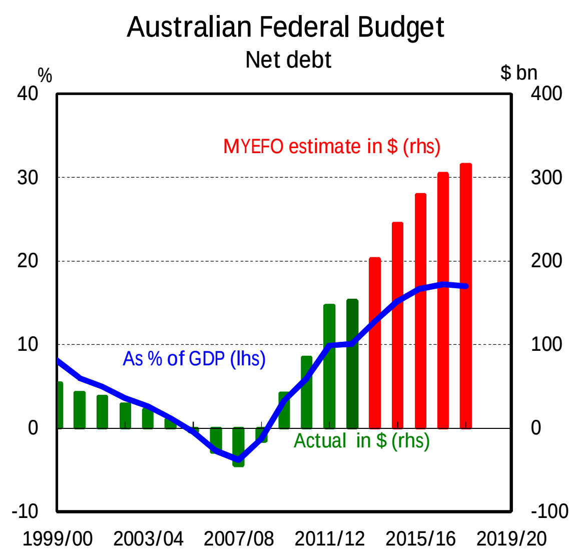
Tuesday, 16 December 2014

Mid-Year Economic and Fiscal Outlook

Budget Blues Continue

- The 2014-15 Budget deficit is now expected to be $40.4bn rather than the $29.8bn deficit expected in the May 2014 Budget.
- Company and individual tax revenue was lower than expected; spending was greater than expected and savings measures assumed in the Budget were not passed through parliament.
- The economic forecasts point towards the RBA cash rate remaining on hold throughout 2015.
- To retain its AAA credit rating, it is likely that demonstrable progress will need to be made, by the Government, on moving the Budget back towards balance. A mix of increased taxation and spending cuts will be required over time.
- The MYEFO economic forecasts, combined with comments made recently by the Governor of the Reserve Bank, point to a weaker AUD over the year ahead. We expect the AUD to be around US75 cents by the end of 2015.





In May 2014 the Treasurer announced an expected Budget deficit of $29.8bn for 2014-15. The deficit for 2014-15 is now expected to be $40.4bn, a deterioration of $10.6bn. Why did it occur and what does it mean for interest rates and the economy in the year ahead?

What went ‘wrong”?

In short, company and individual tax revenue was lower than expected; spending was greater than expected and savings measures assumed in the Budget were not passed through parliament.

A lot has been said about the terms-of-trade and the decline in coal and iron prices. Declines were assumed in the Budget but these fell further than most people expected. These declines contributed to both lower company profits and to slower growth in wages. The flow-on effect was lower company and income tax revenue.

Treasury estimates that for every US$10 per tonne reduction in the price of iron ore there is a 2 per cent decline in the terms of trade and a cut in tax receipts of around $3.6bn over two years. A rebound in iron prices would assist the Budget, however, further declines are assumed.

There are no quick or easy solutions to Australia's Budget situation. If a balanced Budget is to be achieved it will most likely require a mix of higher taxation and spending cuts. Getting such measures through the parliament will be difficult in the current political climate.

What does it mean for interest rates?

The MYEFO forecasts ongoing modest growth and a lift in the rate of unemployment. These are not the hallmarks of an economy that will bear an increase in its interest rate structure. We therefore expect the Reserve Bank to keep its cash rate on hold throughout 2015. Only if there is a significant deterioration in the outlook for economic growth would we expect the cash rate to decline.

Ongoing Budget deficits are expected to lift the Government's net debt position over the next five years. Debt to GDP is expected to peak at 17.2% in 2016-17. While rating agencies still rate Australian Commonwealth debt as AAA, this is based on the assumption that the government is actively pursuing and achieving a path towards a balanced budget.

Spending cuts were announced in the MYEFO. The foreign aid budget has been cut a further $3.7bn over four year and savings of a $0.5bn are expected from cuts to a 175 government agencies on top of the cuts to 76 agencies announced in the May Budget.

Working in the opposite direction were increases in spending on national security and spending on military action in Iraq.

Given the political climate and the vagaries of the global economy, maintenance of a AAA rating cannot be taken for granted and if it were lost there could be upward pressure on bond yields as offshore investors reassess their risk premiums.

What does it mean for the exchange rate?

The MYEFO itself assumes lower commodity prices and increased debt. These alone suggest potential downward pressure on the currency. With the US now showing signs of a fairly robust recovery, we expect the AUD to continue to slide against the USD with a target of US 75 cents for the end of 2015.

The Economic Assumptions

Real GDP forecasts were unchanged from the Budget, but nominal GDP (unadjusted for inflation), which affects the budget's bottom line, was revised sharply lower for 2014-15, from 3.0% to 1.5%. This largely reflects a much larger expected decline in the terms of trade (ratio of export prices to import prices). The terms of trade is now expected to fall 13.5% in 2014-15, down from a 6.75% decline assumed in the Budget. The labour market is also now expected to be weaker. The unemployment rate has been revised upwards in both 2014-15 and 2015-16, while wage growth has also been revised lower.

The terms of trade will be the main source of uncertainty over the budget estimates. Much of its sharper-than-expected decline is due to weaker prices for iron ore. Treasury forecasts assume that the price of iron ore to be little changed at around US$60 a tonne. However, there remain considerable risks surrounding these forecasts. Treasury approximates that a US$10/tonne decline in the spot price of iron ore will result in a 0.5% reduction in nominal GDP by 2015-16, and result in a decline in tax receipts of $0.8bn in 2014-15 and $2.8bn in 2015-16.

The full MYEFO document and the measures in contains can be found at:

http://www.budget.gov.au/2014-15/content/myefo/html/index.htm

Forecasts % Change on Previous Year		
	2014/15	2015/16
MYEFO		
Real Gross Domestic Product (GDP)	2.50	3.00
Nominal Gross Domestic Product (GDP)	1.50	4.50
Terms of Trade	-13.50	-3.75
Unemployment Rate (%)**	6.50	6.50
CPI (Headline) ***	2.50	2.50
Wage Price Index	2.50	3.00
Budget 2014-15		
Real Gross Domestic Product (GDP)	2.50	3.00
Nominal Gross Domestic Product (GDP)	3.00	4.75
Terms of Trade	-6.75	-1.75
Unemployment Rate (%)**	6.25	6.25
CPI (Headline) ***	2.25	2.50
Wage Price Index	3.00	3.00

*Real GDP forecasts are year average.

**The unemployment rate is for the June quarter.

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

Key Budget Parameters				
	2014/15	2015/16	2016/17	2017/18
MYEFO				
Underlying cash balance ($bn)	-40.4	-31.2	-20.8	-11.5
% of GDP	-2.5	-1.9	-1.2	-0.6
Net debt ($bn)	244.8	279.6	304.4	315.8
% of GDP	15.2	16.7	17.2	17.0
Budget 2014-15				
Underlying cash balance ($bn)	-29.8	-17.1	-10.6	-2.8
% of GDP	-1.8	-1.0	-0.6	-0.2
Net debt ($bn)	226.4	246.4	261.3	264.2
% of GDP	13.9	14.4	14.6	14.0

*Real GDP forecasts are year average.

**The unemployment rate is for the June quarter.

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

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