

Surplus has trade hurdle

Forecasts

Adrian Rollins

Falling coal and iron ore prices are set to drag on national income and tax revenue, fuelling doubts over whether the government will be able to achieve its target of a surplus in 2012-13.

While the government has factored in a modest 5.25 per cent decline in the nation's terms of trade next financial year following a rise of 1.75 per cent in 2011-12, several economists believe Treasury has overestimated the extent to which commodity prices and revenues will hold up.

The terms of trade peaked in the September quarter, according to the Reserve Bank of Australia and senior Treasury officials, and prices for both coal and iron ore – which are the major commodity exports – have fallen sharply since by up to 35 per cent.

The extent of the fall has underlined concerns that although the government has factored weaker growth into its budget forecasts, it has not taken sufficient account of the slide in commodity prices. In its mid-year budget outlook the government lowered its real output forecasts for this financial year and next by up to 0.75 of a percentage point to 3.25 per cent.

But while the government expected growth to be slower than anticipated six months ago, it nonetheless left forecasts for nominal gross domestic product – which captures the effects of soaring commodity prices on national income – unchanged at 6.25 per cent this financial year.

This reflected the fact that the terms of trade unexpectedly strengthened during the middle of the year to reach a fresh 140-year high in the September quarter.

But Macroeconomics director Stephen Anthony said the turnaround in the terms of trade forecast for 2011-12, from minus 0.25 per cent in May to 1.75 per cent on Tuesday, was not big enough to justify holding the nominal GDP estimate so high.

Mr Anthony said the government faced a strong imperative to hold nominal GDP up because "it is everything when it comes to forecasting revenue".

Barclays Capital economist Gavin Stacey said it was convenient for the government to have left its forecast for nominal GDP unchanged.

"Usually you would expect that if

KEY POINTS

- A fall in commodity prices will make the government's target of a budget surplus in 2012-13 a lot harder.
- Several economists believe Treasury has overestimated the extent to which commodity prices and revenues will hold up.

real GDP is lowered, nominal GDP would be lowered as well," Mr Stacey said, adding that holding it up could add up to \$5 billion to revenue.

HSBC chief economist Paul Bloxham said it would require a "herculean" effort to achieve the turnaround in government finances forecast on Tuesday, from a deficit of \$37.1 billion this financial year to a surplus of \$1.5 billion in 2012-13.

"It is close to being implausible to expect them to unwind the fiscal position that quickly," Mr Bloxham said. "It is going to be a very big challenge."

The economist said revenue-raising measures like the carbon tax and the minerals resource rent tax would help, but he said history showed it was rare to achieve such a rapid improvement in government finances.

"I am not saying it couldn't happen but it seems like a bit of a stretch to suggest it is the most likely outcome," he said.

But Royal Bank of Scotland economist Kieran Davies said the government had already achieved substantial fiscal tightening in the past two years, cutting the deficit from 4.3 per cent of GDP to 2.5 per cent.

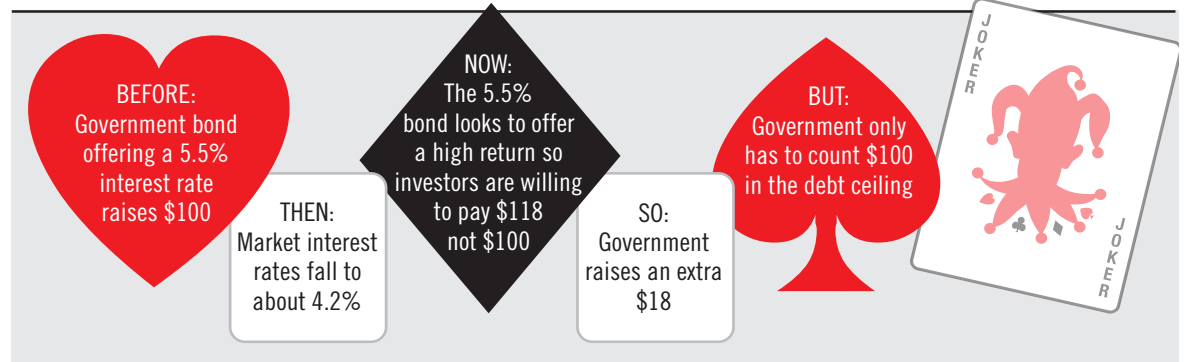
Mr Davies said the size of the fiscal task had been exaggerated by the fact that some spending measures such as the \$1.5 billion in household compensation for the introduction of the carbon tax had been brought forward a year.

"It would be the biggest turnaround since the early 1950s, but you do have fairly strong growth, which should give them a revenue dividend," he said.

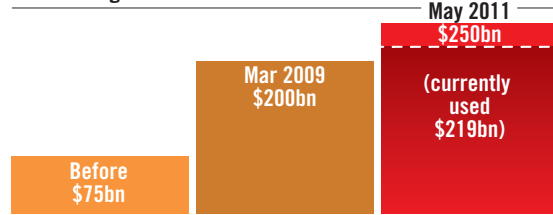
JP Morgan chief economist Stephen Walters said the government's surplus target looked "very, very heroic", warning that "all the risks are to the downside".

He said the dramatic consolidation of government finances being considered was driven by a political obsession with returning the budget to surplus in 2012-13, an outcome that was "not a big deal" for markets.

How the bond deal works

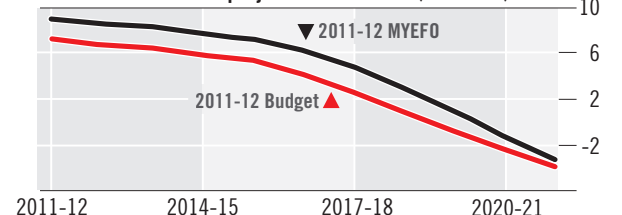


Debt ceiling



NB: Figures may vary

Government net debt projected to 2021-22 (% of GDP)



SOURCE: FINANCIAL REVIEW, MYEFO

Labor dodges debt ceiling

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years. UBS interest rate strategist Matthew Johnson estimated the government would need to issue \$18 billion in bonds this financial year to keep pace as well as \$9 billion, \$6 billion and \$4 billion in the subsequent three years.

Added to the \$219 billion in bonds on issue at the moment, that would take the debt to about \$256 billion and breach the debt ceiling.

But sources familiar with the Australian Office of Financial Management say it is issuing bonds in a particular way that could keep the face value of the bonds below the cap, sparing Labor from a political fight.

The AOFM is reportedly choosing to issue bonds that will minimise the face value – or the amount of debt ceiling used – by taking advantage of the fall in bond yields as investors around the globe have raced into the safety of bonds. Global central banks have been attracted to Australian bonds given the relatively low debt position of the government.

An example was yesterday's tender of \$700 million of April 2023 bonds with a nominated interest rate of 5.5 per cent. The recent fall in bond yields around the globe means that investors were attracted to the bonds and were willing to pay \$789 million for those bonds. Only \$700 million will count towards the debt ceiling.

The debt ceiling triggered a political row earlier this year when Labor passed legislation to raise the cap to \$250 billion, thinking that would be sufficient for future bond issues.

A spokesman for Mr Swan said it

would not be necessary to raise the debt ceiling again because it was determined by the face value rather than the market value of the bonds.

Government sources insisted there was no instruction to the AOFM to adjust the way it issued securities and that any change in the impact of the bond program was the result of a shift in the market, with strong demand for Australian sovereign debt.

Another factor behind the AOFM issuance decisions was to take advantage of the lower yields, for instance by issuing a 12-year bond at an interest rate of 4 per cent. "You'd be mad not to do it," said one person familiar with the bond market developments.

Opposition finance spokesman Andrew Robb said yesterday any move to raise the ceiling would trigger a policy debate in Parliament over Labor's deficit and debt.

"Crashing through the debt ceiling, or nearly crashing through it, amply demonstrates that Labor has lost control of Australia's finances," he said.

"This would be a board's worst nightmare if they had a chief executive running amok like this, making predictions which aren't realised."

"To be this close to the wind within five or six months of bringing down the budget and raising the debt ceiling beggars belief."

Mr Robb said he would confer with his colleagues about whether to vote for or against any further increase in the cap, but said he was mindful of the responsibility to keep funding available for government operations.

UBS's Matthew Johnson said that in recent bond issuance, the government was raising \$118 in cash for \$100 of face value or debt ceiling. But he cautioned that the AOFM's practice involved issuing bonds with long maturities, which meant that it would pay a higher interest rate on the debt than it would if the bonds matured between 2013 and 2015.

"They are in the short term raising the average cost of debt by doing this," he said.

"But I happen to think it's cheap insurance. I think it's worthwhile having a longer maturity profile than a shorter one."

He said that amid fears about contagion from Europe, it made sense to issue bonds with long maturities.

"This is one of those happy occasions when the politics are driving them to do something sensible," Mr Johnson said.

But Westpac chief interest rate strategist Damien McColugh said one of the roles of the AOFM was to meet the demand of those banks that served as market makers that ensured a liquid and functioning bond market. Demand for yesterday's bond issue was the lowest since 1996.

"I think global investors are going to want commonwealth government securities regardless, but there is a definite preference for shorter maturities which are preferred to long-term bonds."

The most popular bond the AOFM has issued this year has been January 2018, which it has tendered at auction seven times since July 1, raising a total of \$4.9 billion.



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