

# Swan May Go Down As Budget Hero

**Macroeconomics** released our Commonwealth and State Budget Bulletin last Friday (27 April 2012) which forecasts the budget bottom-line for the Federal and State Governments. Our Budget model indicates that since MYEFO in November the Federal Budget has deteriorated by around **\$10 billion** in **2012-13** and that most of that deterioration is explained by lower business tax receipts due to:

- slower real activity;
- declining terms of trade;
- GFC inflation of carry forward losses; and
- China boom expansion of depreciation offsets.

Without policy changes (spending cuts or revenue increases), **Macroeconomics** has the bottom bottom-line in cash deficit by around **\$7.8 billion** in 2012-13, compared to Treasurer Swan's surplus estimate of **\$1.5 billion** back in November 2011.

The deterioration in the budget bottom-line over the past six months indicates how difficult it will be for the Treasurer to bring the Budget back into surplus on Budget night. He will have to announce a package of budget cuts / tax hikes worth around **0.5 per cent of GDP** to ensure the political objective of maintaining the surplus is achieved. This represents a total fiscal consolidation of around **2.6 per cent of GDP** to bring the economy back into surplus - following the estimated deficit of around **\$40 billion** in 2011-12.

Is a fiscal consolidation of this magnitude justified in the current economic climate?

The economic case for fiscal consolidation is pretty clear-cut. The 3/4 *or so* of the Australian economy that does not benefit directly from mining activity has been impacted by high domestic interest rates and around a 30 per cent real appreciation in the \$A since 2003-04.

Tightening the stance of fiscal policy leaves more room for the Reserve Bank to cut official interest rates below the current 4.25 per cent which would provide a fillip for business confidence and housing construction activity.

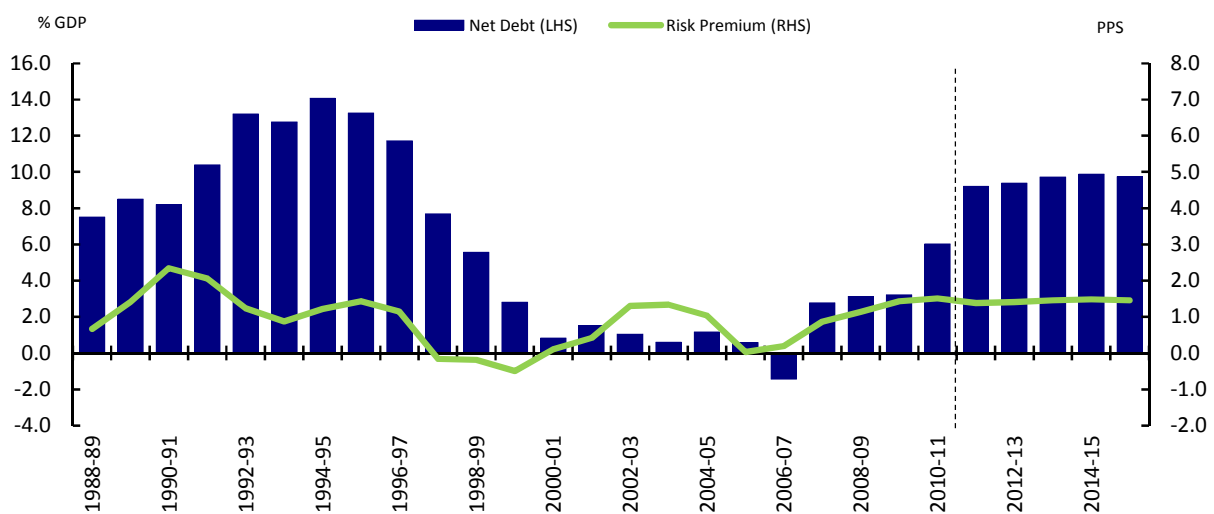
Lower interest rates will bias downward currency markets \$A expectations and assist manufacturing, tourism and other trade exposed sectors.

In addition, Treasury research has shown for each percentage point reduction in debt, longer term interest rates would fall by:

- 30 to 40 basis points in the short term; and
- 5 to 15 per cent in the longer term.

Reducing the risk premium on public debt supports business investment outside the booming mining sector and employment prospects in those regional areas hardest hit by high interest rates and the high \$A.

**Risk Premia on Commonwealth Net Debt**



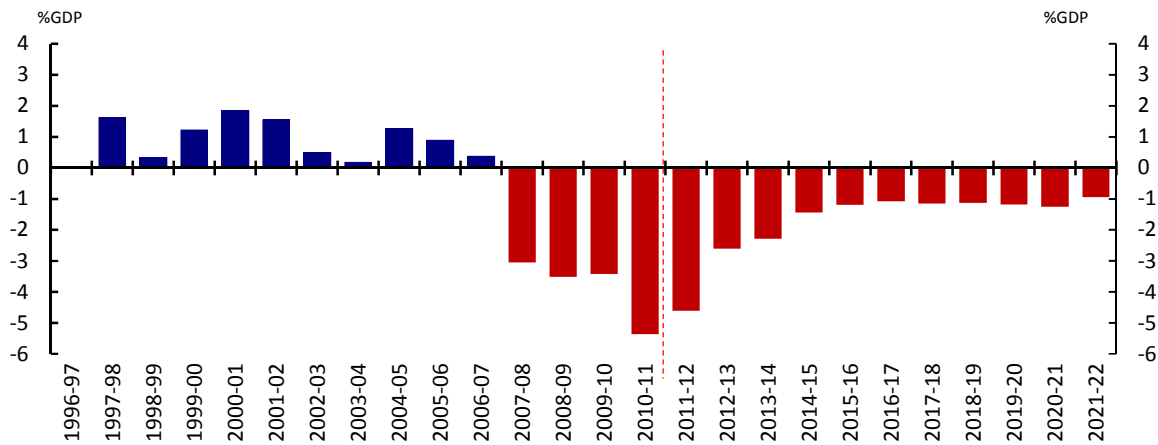
Source: ABS 5202.0, RBA Bulletin and Macroeconomics' estimates.

So is this fiscal contraction OK or too much tightening? Currently the national unemployment rate sits at 5.2 per cent, but output is still below trend on our measure. Everything should still come up roses provided anticipated mining investment eventuates. This will be worth around **9-10 per cent** to GDP in 2012-13. Real GDP growth of between  $2\frac{3}{4}$  and  $3\frac{1}{4}$  is feasible in 2012-13, even with the anticipated budget consolidation. Of course, another significant external shock from the financial sector or elsewhere would put a spanner in the works. But, the Reserve Bank has plenty of room to loosen monetary policy if that occurs. And anyway, tight fiscal and loose monetary policy is a better assignment of macroeconomic policy to support output and jobs growth.

Well constructed and sensible driven budget cuts can also contribute to growth in the short to medium term by eliminating waste and unproductive activities.

The institutional case for spending cuts is perhaps more clear cut. The Rudd-Gillard Government has become too comfortable with a mediocre fiscal strategy performance. Since coming to office it remains a net spender in discretionary policy terms (even adjusting for the GFC) and has never achieved a budget surplus. Tightening the fiscal strategy now and locking in future budget surpluses of the order of **1 per cent of GDP** would help inoculate the Australian economy from the 'North Atlantic Flu'; sending a clear signal to global markets that this country lives within its means. It is also necessary given that any surplus that the Gillard Government runs in 2012-13 will only be due to windfall revenues from the terms of trade, whilst **Macroeconomics** estimates the structural budget deficit at around **\$40 billion** (2.6 per cent of GDP) in 2012-13.

### Structural Balance Estimates



Source: Budget Papers and Macroeconomics estimates.

Are there obvious targets for spending cuts? Federal spending on social security has risen by around 10 percentage points over the last thirty years. This was exacerbated by the Howard Government's tendency to play entitlement politics gifting benefits to certain interest groups without a strong policy case. So target the first home-owners grant, the baby bonus, abolition of petrol excise and the tax-free status of retirees/and other superannuation largess for the well-off.

Whilst the Government may have given itself no other option than to seek to run a surplus in 2012-13, tightening the stance of fiscal policy is a far sighted decision, which **if** achieved, will help to underpin growth and employment in the Australian economy over the medium-term. Whilst we have criticised Wayne Swan before for taking short steps on fiscal policy, achieving a surplus in 2012-13 via sensible budget cuts would be praiseworthy, especially given the criticism of those who would argue he should *do nothing* or *spend even more*.

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