Shane Oliver, Head of Investment Strategy & Chief Economist

AMP CAPITAL

2014-15 Aust Budget – heading back to surplus

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Key points

> After a 2013-14 deficit of $49.9bn, the budget deficit for 2014-15 is now projected to be $30bn, down from $34bn in the Mid-Year Economic Fiscal Outlook (MYEFO). For 2015-16 the deficit is projected to be $17bn (from $24bn in MYEFO) and a surplus is now projected for 2019-20.

> Fiscal tightening includes welfare cuts, public sector rationalisation and tax hikes, but with some offset coming from increased infrastructure spending.

> The fiscal cutbacks are modest near term and only really start to impact from 2016-17. As a result, there is unlikely to be much economic impact in the year ahead.

> The impact on the share market is likely to be minimal.

Introduction

With the Government winning the election with a mandate to fix the budget, a bout of fiscal austerity was inevitable. Against this backdrop and the fears of the last few weeks, the Budget is not as tough as feared. Many of the budget savings will only build over time.

Key budget measures

Many of the measures announced in the budget come as no surprise. The key savings measures are as follows:

- a tightening in eligibility for family tax benefits (FTB), eg the income threshold for FTB-B reduced to $100,000 from $150,000 and to end when the youngest child is six;
- pensions to be indexed to inflation not wages, a pause in eligibility thresholds;
- a further increase in the pension age to 70 by 2035;
- a $7 co-payment for GP visits;
- a further 16,500 public sector jobs to go and the merging or elimination of numerous government agencies;
- the resumption of fuel excise indexation from August;
- a 2 percentage point increase in the top marginal tax rate which kicks in at $180,000 for three years;
- reintroduction of the work for the dole scheme;
- moves to increase the cost of higher education;
- the increase in the Superannuation Guarantee beyond 9.5% delayed till 2018; and
- reduced foreign aid spending.

There are several sweeteners though, eg using asset sales to fund infrastructure spending, the start of a new paid parental leave (PPL) scheme, funding for medical research, the planned abolition of the mining and carbon taxes, and a 1.5% cut to corporate tax next year to offset the PPL levy.

The budget bottom line

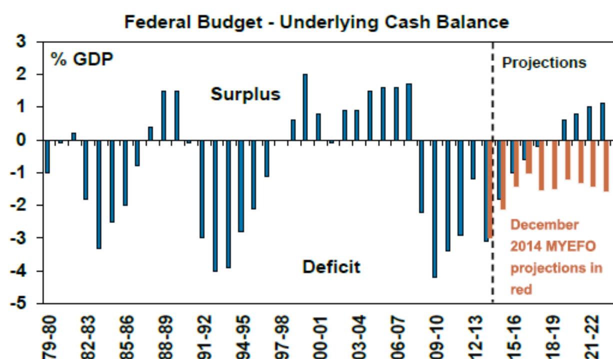
Beyond the projections for the current financial year (which look a bit too pessimistic), the budget deficit projections now look much healthier than those seen in MYEFO, with the budget deficit for 2014-15 now projected to be $30bn, down from $34bn in MYEFO.

Underlying cash budget balance projections

	2013-14	2014-15	2015-16	2016-17	2017-18
MYEFO,$bn	-47.0	-33.9	-24.1	-17.7	-28.0*
%GDP	-3.0	-2.1	-1.4	-1.0	-1.5
Non-policy chgs, $bn	-2.4	+2.4	+1.1	-3.3	NA
Starting point, $bn	**-49.3**	**-31.5**	**-23.0**	**-21.0**	**NA**
%GDP	**-3.1**	**-1.9**	**-1.3**	**-1.2**	**NA**
Policy changes, $bn	-0.5	+1.7	+5.9	+10.4	NA
%GDP	0.0	+0.1	+0.3	+0.6	NA
Budget, $bn	**-49.9**	**-29.8**	**-17.1**	**-10.6**	**-2.8**
%GDP	**-3.1**	**-1.8**	**-1.0**	**-0.6**	**-0.2**

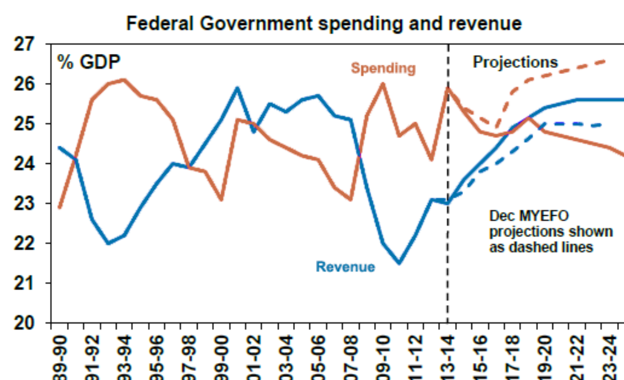
* estimate. Source: Australian Treasury, AMP Capital

Interestingly, despite all the talk of a tough budget, the actual additional policy tightening for 2014-15 is just 0.1% of GDP, but as the spending cuts build the impact rises to 0.6% of GDP by 2016-17 rising dramatically beyond that. See the red rows. Reflecting this, the turnaround in the 2017-18 deficit from 1.5% of GDP to now just 0.2% is substantial. The end result is that the budget is now projected to be in surplus by 2019-20 (versus deficits indefinitely in MYEFO).



Source: Australian Treasury, AMP Capital

Relative to MYEFO, the improvement initially reflects increased revenue and lower spending, but from 2018-19 owes mainly to spending (as savings build, the income tax hikes end and fiscal drag is assumed to be handed back).



Source: Australian Treasury, AMP Capital

Economic assumptions

The major economic assumptions underpinning the Budget are shown in the next table.

Budget economic assumptions

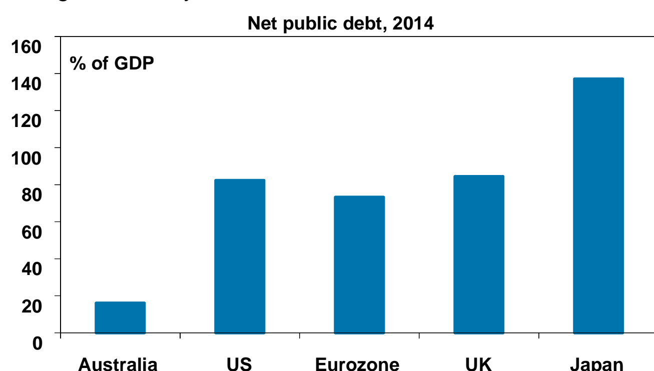
		2013-14	2014-15	2015-16	2016-17
Real GDP	MYEFO	2.5	2.5	3.0	3.0
% year	**Budget**	**2.75**	**2.5**	**3.0**	**3.5**
	AMP	2.75	3.0	3.0	3.0
Inflation	MYEFO	2.75	2.0	2.5	2.5
% to June	**Budget**	**3.25**	**2.25**	**2.5**	**2.5**
	AMP	3.0	2.5	2.5	2.5
Nominal GDP	MYEFO	3.5	3.5	4.75	4.75
% year	**Budget**	**4.0**	**3.0**	**4.75**	**5.0**
Unemp Rate	MYEFO	6.0	6.25	6.25	6.25
% June	**Budget**	**6.0**	**6.25**	**6.25**	**6.0**
	AMP	6.0	5.8	5.7	5.6

Source: Australian Treasury, AMP Capital

There is only fine tuning since the MYEFO forecasts and nominal GDP growth is projected to remain soft as the terms of trade weakens. We continue to think that the 2014-15 growth assumptions are a bit too pessimistic and they remain below the RBA's 2.75% mid-point forecast. This partly explains why we are a bit more optimistic on unemployment.

Assessment and risks

Australia does not really have a 'budget emergency': the budget deficit has not come anywhere near the 10% of GDP plus levels that sparked concern in the US, parts of Europe and Japan. Net public debt at 16% of GDP is a fraction of what it is in the US (82%), the Eurozone (73%) and Japan (137%); ratings agencies are not downgrading our AAA rating and bond yields remain low.



Source: IMF, AMP Capital

That said, the budget is always about balance and Australia does have a budget problem. After the biggest boom in our history, the budget should be in far better shape. Comparing ourselves to a bad bunch is not necessarily wise. In 2006 Ireland's net public debt was close to where Australia's is now and yet it skyrocketed when its boom turned to bust. Given our (albeit shorter) resources boom but 20 plus years with no recession we should be much closer to Norway which is running huge surpluses and negative net public debt (-205% of GDP). This was a major and valid criticism of the last few years' budgets.

Against this backdrop, the 2014-15 Budget is a step in the right direction with the measures put in place to control spending growth over the medium to long term likely to put it on to a sustainable path. The Budget also gets a tick in terms of its focus on boosting infrastructure, reducing public sector duplication and renewed privatisation – all of which should help boost productivity over the long term.

There are three main risks though. First, the tax hikes and welfare cutbacks could drag on consumer spending. Fortunately, the Government has not front-loaded its savings and partly offset them initially by infrastructure spending.

Second, taking the top marginal tax rate to 49% (which will put it as the world's 15th highest and way above our neighbours, eg NZ 33%, Singapore 20%, HK 15%) is a backward step in terms of incentive and trying to discourage tax minimisation efforts. However, I have sympathy with the fairness rationale (although there would have been better alternatives such as reducing the capital gains tax discount).

Finally, there is a big risk that many of the budget measures will not pass through the Senate.

Implications for interest rates

While the fiscal tightening in the year ahead is less than feared at about 0.1% of GDP, it comes on top of 0.3% of tightening already in train from the previous Government (mainly the 0.5% NDIS levy). In addition, the scaling back of welfare access and the public sector could negatively impact confidence. So while we still see the RBA raising interest rates around September/October, there is some risk that rate hikes may be delayed into next year.

Implications for Australian assets

Cash and term deposits – the ongoing fiscal tightening means that interest rates will remain pretty low (even when they do eventually start to rise). Expect term deposit rates to remain at 4% or below in the months ahead.

Bonds – the measures to bring spending under control and provide confidence the budget will be returned to surplus will help ensure Australia's AAA rating remains secure. This, plus additional fiscal tightening, albeit spread over time, and the risk rate hikes will be delayed till next year should help ensure bond yields remain low. But with five year bond yields at 3.2% it's hard to see great returns from Australian sovereign bonds over the next few years.

Shares – the fiscal austerity in the Budget is only a minor headwind for profits. And against this, the increase in infrastructure spending, the reform inherent in public sector downsizing and privatisation and putting the budget on a sounder footing are long term positives and the Budget will help keep interest rates down. Overall, its impact is unlikely to be huge. Construction and building material stocks are likely to benefit, whereas it's a slight drag for retailers.

Property – property prices are likely to continue gaining on the back of low interest rates, although momentum may slow a bit from last year's surge in Sydney and Melbourne.

The $A – the announcements in the Budget alone are not radical enough to have much of an impact on the Australian dollar. Affirmation of the AAA rating is a positive while the dampening impact on long term growth from fiscal austerity is a drag. Not much in it really though. With the commodity price boom fading, the interest rate differential in favour of Australia having fallen and the Australian dollar overvalued on a purchasing power parity basis, the trend in the Australian dollar is likely to remain down.

Concluding comments

The 2014-15 Budget goes a fair way to getting the budget heading back towards surplus without going overboard with fiscal austerity for the next financial year. Better to start down the path though before any crisis hits, so when it does we will have greater fiscal flexibility.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital

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