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# Fiscal Policy Update

## Government goes into fiscal overdrive

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## Key Points

- The Government has taken an axe to the official projections for the economy and in the process outlined one of the largest fiscal packages seen in modern times in Australia.
- The government plans to spend around 1% of GDP ($12.7bn) on direct transfer payments to low and middle income earners next month as a short-term jolt to the economy. This will be followed up by a Nation Building program that involves expenditures of $28.5bn over the four Budget out-years. The total fiscal stimulus is worth around $42bn (3.2% of GDP).
- Higher spending and a sharp reduction in revenues has seen the May 2008 estimate of a $21.7bn Budget surplus for 2008/09 is now a deficit of $22.5bn. The deficits don't stop there. The Government is now projecting budget deficits totalling over $118bn between now and 2011/12. As recently as the MYEFO from last November this was expected to be a cumulative surplus of around $18bn. In just three months the government's financial position has deteriorated by over $136bn.
- The government expects economic growth of 1% in 2009. Given that this is in the context of a 2.9 percentage point of GDP fiscal stimulus it is safe to say that without the Government's intervention the Australian economy would experience a sharp recession in 2009.
- Policy should now be aimed a limiting the rise in the unemployment rate. The Government expects the unemployment rate to rise to 7% in 2010. If this is the extent of the rise over the next few years then the Government would have achieved an important economic outcome.

**Figure 1: Key Budget aggregates and economic parameters**

| | 2008-09 (f) | 2009-10 (f) | 2010-11 (f) | 2011-12 (f) |
|---|---|---|---|---|
| **Underlying cash balance** | | | | |
| $bn | -22.5 | -35.5 | -34.3 | -25.7 |
| % of GDP | -1.9 | -2.9 | -2.7 | -1.9 |
| **Fiscal balance** | | | | |
| $bn | -22.4 | -33.3 | -31.5 | -23.9 |
| % of GDP | -1.9 | -2.8 | -2.5 | -1.8 |
| **Economic parameters (% change)** | | | | |
| GDP | 1 | ¾ | 3 | 3 |
| Employment | 1 | -¾ | 1¼ | 1¼ |
| Wage Price Index | 4 | 3½ | 4 | 4 |
| CPI | 2 | 2 | 2½ | 2½ |
| Nominal GDP | 6¾ | 0 | 5¼ | 5¼ |

Source: Budget papers

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## Unprecedented budget stimulus

The Government has taken an axe to the official projections for the economy and in the process outlined one of the largest fiscal packages seen in modern times in Australia. The new fiscal plan has been outlined today in the Updated Economic and Fiscal Outlook (UEFO). The government plans to spend around 1% of GDP ($12.7bn) on direct transfer payments to low and middle income earners next month as a short-term jolt to the economy. This will be followed up by a Nation Building program that involves expenditures of $28.5bn over the four Budget out-years.

The plan involves a fiscal stimulus of around 1.1% of GDP in over the first six months of 2009 (which of course follows the 0.8% of GDP stimulus late last year, most of which has since passed). The rest of the stimulus occurs through the following two years in the form of infrastructure spending and support for business investment and training programs. The total fiscal stimulus is worth around $42bn (3.2% of GDP).

The cost of this new stimulus comes on top of a substantial deterioration in the underlying fiscal position of the Government due to the global economic downturn. The massive downturn in Government receipts was flagged yesterday by the PM in a press conference. As such, the Government's Budget position has been utterly transformed by the global recession. The May 2008 estimate of a $21.7bn Budget surplus for 2008/09 is now a deficit of $22.5bn. The deficits don't stop there. The Government is now projecting budget deficits totalling over $118bn between now and 2011/12. As recently as the MYEFO from last November, this was expected to be a cumulative surplus of around $18bn. In just three months, the government's financial position has deteriorated by over $136bn. The evolution of the Government's fiscal position is presented in Figure 2 below.

**Figure 2: Reconciliation of general government underlying cash balance estimates**

| | 008-09 | 2009-10 | 2010-11 | 2011-12 |
|---|---|---|---|---|
| | $mn | $mn | $mn | $mn |
| **2008-09 Budget** | **21,703** | **19,669** | **18,996** | **18,870** |
| Policy Decisions | -11,093 | -1,634 | -966 | -810 |
| Parameter and other variations | -5,244 | -14,440 | -15,390 | -11,371 |
| Total changes | -16,337 | -16,074 | -16,357 | -12,181 |
| **2008-09 MYEFO** | **5,365** | **3,595** | **2,640** | **6,689** |
| Policy Decisions | -18,037 | -18,365 | -11,655 | -5,435 |
| Parameter and other variations | -9,816 | -20,753 | -25,314 | -26,937 |
| Total changes | -27,853 | -39,118 | -36,970 | -32,372 |
| **Budget Update** | **-22,487** | **-35,524** | **-34,330** | **-25,683** |

Source: Budget papers

## *Mostly* good economic policy

Most of the decisions taken by the Government today generally meet a range of criteria which can be described as good economic policy. The stimulus is not permanent and thus will allow the Government to return the Budget to balance as economic conditions improve. The moves have been decisive and pre-emptive thus giving policy the best chance of minimising the damage to employment from the downturn in the global economy. This should help support spending and confidence across household and business. The bulk of the stimulus (ie. the investment component) will be on activities that should raise the medium-term productivity of the economy. The magnitude of the stimulus is significant. The fiscal stimulus in 2008 was worth 0.8% of GDP and this will rise to 2.5% of GDP in 2009 as the full impact of the global financial crisis hits the economy.

Some criticism can be directed to the nature of the payments to households. Delivering a large one-off payment as the unemployment rate rises runs the risk that households may be more likely to save, than spend the extra income. If this is the case, the support to growth and jobs is minimal. Smaller individual payments distributed over a longer-period of time (ie. $950 over a couple of months) may well have been more effective in delivering some *sustainable* support to spending and the economy. Indeed, it could be argued that the timing and size of the one-off payments, which will hit household pockets in April, was designed by the government precisely in an attempt to avert Australia from experiencing a 'technical' recession (two consecutive quarters of negative growth).

## Taking pressure off the RBA?

Government fiscal stimulus has so far not prevented the RBA from delivering aggressive interest rate cuts. Indeed, the RBA today explicitly acknowledged that the Board had taken into account today's fiscal package in deciding to deliver a further 100bps cut, to bring the cash rate to 3.25%, this afternoon. Clearly, the RBA is determined to remain 'ahead of the curve' as the best hope of averting a deep local recession.

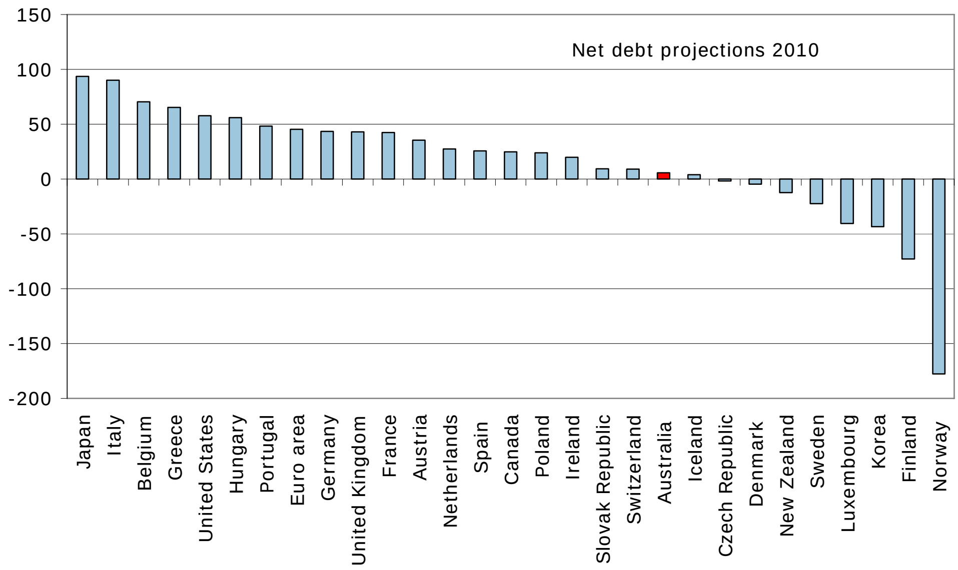
However, the Government's announcement today, in particular the second large short-term term stimulus to households in a matter of months now argues for a slowing in the rate of monetary ease. With official interest rates clearly stimulatory (at near 40-year lows), the RBA may now like to see the impact of this stimulus before deciding to deliver further out-size rate cuts. While we expect to see further rate cuts in short-order, to bring official interest rates down to 2.5%, we are not anticipating more outsized moves. This would potentially be a significant shock to the market, which expects the RBA to remain aggressive and is currently pricing in a further 75bps rate cut in March and an end-point of around 2% by mid-2009.

## Government likely to come to the bond market by mid-year

The Australian Government general government sector net debt is estimated to be -$16.2bn (-1.3% of GDP) in 2008-09, growing to around $76bn (5.2% of GDP) in 2011-12. The Government has recognised the need to go to the capital markets to raise the funds to pay for the deficit over the next few years. We expect the Government to begin issuing bonds for the purpose of raising new monies before the end of the current financial year. Due to the buffer they have built up via deposits with the RBA and the establishment of various funds (that will no doubt be tapped to pay for the stimulus announced today) the call on capital markets will be less than that implied by the size of the budget deficit projections. That said, the size of the projected surpluses, totalling almost $120bn over the next four years overwhelms the current financial assets that the Government current has which we estimate to be around $35bn. We therefore expect the Government bond market to gradually increase in size from around $60bn current to something closer to $140bn over the years ahead.

It should be noted that despite the return to net debt, the Australian government's financial position remains in much better shape than most other countries (Figure 3). This should mean that an increase in net government debt should have little implication on Australia's sovereign credit rating. It should also mean that Australia continues to maintain some advantage in the comparative price of sovereign debt.

**Figure 3: Net debt projections for 2010, OECD countries**




Source: Commonwealth Treasury, OECD and ANZ

## The policy details

The government is attempting to deliver a significant short-term boost to growth through delivering $12.7bn in payments to low-and middle-income Australians (larger than the $8.7bn payment delivered to low-income earners in December) over March and April. This includes:

- $8.2bn to eligible taxpayers as a tax bonus. These payments are means-tested and will begin from April 2009.
- A $1.4bn Single-Income Family bonus ($950 one-off bonus payment to families eligible for FTB-B), starting from March 2009.
- A $2.6bn Back to School bonus ($950 one off bonus per school age child to families eligible for FTB-A).
- A $20.4nmn Farmer's Hardship Bonus ($950 lump sum payment). Commencing in March 2009.

These one-off payments will boost aggregate household disposable income growth by around 3ppts in the June quarter, a similar stimulus that was delivered in the December quarter from the government's first Economic Security Stimulus Package. Tomorrow's retail sales data is expected to confirm anecdotes that these one-off payments translated into a significant stimulus to consumer spending at the end of last year. Even though the unemployment rate will be higher, and the propensity to save these handouts will be higher, we would still expect *some* short-term boost to consumer spending from these government payments over Q2. As already mentioned, we suspect the government has chosen this timing in the hope that this boost to consumption may allow Australia to avert a 'technical' recession (two consecutive quarters of negative growth).

The government's attempts to support medium-term prospects is via the **'Building prosperity for the Future'** package, which will deliver $28.8bn of investment funding over the four years from 2008-09 to 2011-12. Most of this spending will occur in 2009-10 ($15.7bn or 1.3% of GDP) and 2010-11 ($9.8bn or 0.8% of GDP). Most of the spending is focussed on new construction, in the education and housing sector and also on roads. This spending should boost both GDP growth and jobs as well as the longer-term productivity of the economy. Investment in these sectors also makes it less likely that the Government will 'crowd-out' private investment. Key measures announced under this policy include:

- $14.7bn over three years to the education sector. Most of this spending is for school building and maintenance (including the new Trade Training Centres)
- $6bn over two years to build another 20,000 new public houses, 802 new defence houses plus repairing another 2,500 existing public housing
- $507mn over three years to provide free insulation for 2.2mn homes ($1,600 per owner occupied house and $1000 per rented house) (there is no detail over whether this will be means-tested). The solar hot water rebate will increase to $1600 and the means-test on this will be removed.
- $2.7bn of temporary tax breaks for small business asset purchases. Eligibility for these tax breaks will be at 30 June 2010.
- $20mn in 2008-09 and $60bn in 2009-10 of additional funding for the black spots for regional roads & rail crossings program.
- $150mn in 2008-09 to repair regional roads across Australia.
- $500mn over two years to fund local government infrastructure.

## The economic outlook

After much criticism following the Government's forecasts in MYEFO in November, **the new set of forecasts look much more reasonable and realistic** (key figures presented on page 1)**.** After incorporating the impact of today's fiscal policy announcements, **real GDP growth** in 2008-09 has been halved to 1% and growth in 2009-10 has been downgraded to ¾% from 2¼%. This is broadly in line with our current view. The aim of the government's stimulus package today seems to have been to avoid a 'technical recession' or two consecutive quarters of negative growth; these forecasts imply flat or slightly positive growth in the next few quarters.

The cash handouts in particular are expected to support household consumption in immediate few months. There has only been a slight downward revision to **household consumption** in 2008-09 to 1¾% from 2% at the time of MYEFO. These consumer spending forecasts still look pretty optimistic to us. Not much recovery in household consumption in anticipated for 2009-10 however, with the unemployment rate now to rise consistently through the period.

The government's **labour market** forecasts have been revised heavily. Employment is now expected to fall outright in 2008-09 and to show no growth in 2009-10. With the participation rate falling due to the discouraged worker effect, the **unemployment rate** is foreshadowed to deteriorate to 7% by June 2010, notwithstanding the government's claims that today's fiscal package will support 90,000 jobs. This is a smaller rise than in previous recessions, but more in line with forecasts from market economists.

**The largest contribution to growth is expected to come from public spending**, with public final demand forecast to increase by 5½% in 2008-09 and a massive 7¼% in 2009-10, the strongest rate of growth since the recession in 1990-91. As mentioned above, much of this will be driven by construction activity as part of the 'Building prosperity for the Future' package.

This should help offset a sharp 15½% in **private business investment** in 2009-10, notwithstanding measures announced today to help stimulate capital expenditure by small businesses.

Today's estimates also incorporate a large downward revision to the **terms of trade**, with acknowledgement that the global recession and the developing slowdown in China has brought an abrupt end to the commodities boom. **Global growth** for 2009 has been revised down to just ½% from 3% and major-trading partner growth is now expected to be flat compared with 3% growth at MYEFO. This is broadly in line with the latest IMF forecasts. As a result of this deterioration, the government now acknowledges that the price of Australia's key bulk commodity exports (coal and iron ore) are "expected to lose much of their gains of recent years." The terms of trade is now expected to fall 12¾% in 2009-10 following a 9% improvement in 2008-09 (largely due to price rises earlier in the year). For calendar year 2009, the terms of trade drop is estimated at 20%.

The projected fall in the terms of trade, together with weak economic growth more broadly, will have large implications for corporate profits and Australia's national income**. Corporate profits** are expected to drop 9¾% in 2009-10. This is a key driver of downward revisions to nominal GDP (nominal rather than real GDP is important for estimates of government revenue and expenses). There is now expected to be no growth **in nominal GDP** at all in 2009-10. Also interesting to note here are the upward revisions to nominal GDP growth in 2010-11 and 2011-12**. It seems the Government is relying on a more substantial recovery in these years (no doubt on the assumption of a recovery in global growth and commodity prices) to help drive an improvement in its fiscal position.**

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