

## Managing a deepening deficit

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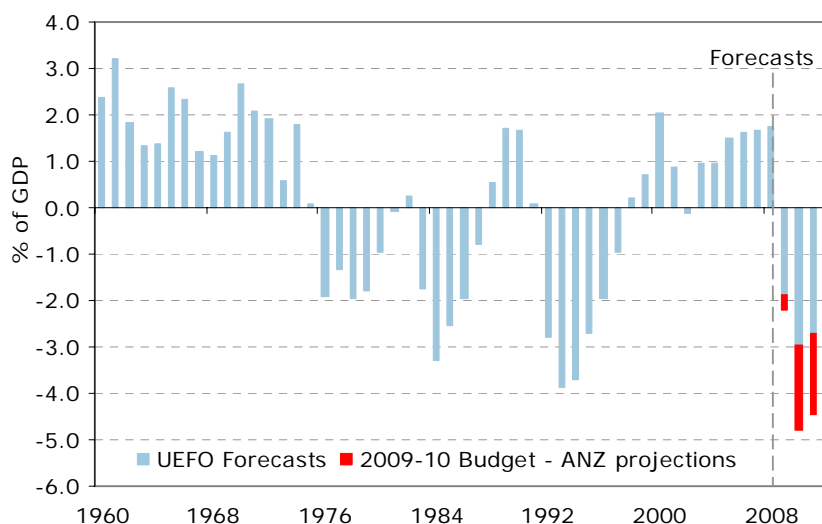
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### Summary

- The 2009-10 Commonwealth Budget is shaping up as one of the most important economic policy documents in over a decade.
- We expect the government to revise down its expectations for the economy, with both real and nominal GDP forecast to contract in 2009-10. The government is unlikely to forecast real economic growth returning to trend before mid-2011.
- We expect that the starting point for the 2009-10 Budget has deteriorated significantly since February's Budget update. Before any new policy announcements are taken into account, a weaker economy is expected to drag the 2009-10 Budget starting point into deficit of around 4% to 4.5% of GDP, worse than the largest deficit in the last recession (1992-93).
- The Government must balance counter-cyclical policy priorities with medium-term productivity enhancing objectives as well as a financial discipline that does not undermine the Commonwealth's credit rating.
- It will not all be good news next week; permanent spending initiatives will need to be offset by permanent savings if the Government is to convince the broader community and the ratings agencies that they are serious about returning the Budget to balance as the economy recovers.
- We expect the Government to announce the largest budget deficit in over 50 years next week. Once new policy decisions are taken into account, we expect the 2009-10 deficit to be at least \$57bn or 4.8% of GDP. Deficits should improve to around 3% of GDP by 2012.
- We expect the focus of government spending to shift away from short-term direct fiscal stimulus towards investment and infrastructure.
- Large deficits will require increased bond issuance. The AOFM will be tasked with borrowing almost all of the deficit next financial year. Including refinancing of maturity debt, the AOFM bond program could approach \$100bn in 2009-10.

**Figure 1: The budget deficit will be at least as big as the 1990s**



Source: Commonwealth Treasury and ANZ

## The strategy of deficits

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The 2009-10 Commonwealth Budget is shaping up as one of the most important policy announcements of the last decade. The Government faces three major challenges in framing this budget.

- The sharply deteriorating economic environment has taken a double-edged sword to the government's balance sheet. It has hit government revenues hard and at the same time demands further fiscal stimulus to be delivered. The size and shape of this 'discretionary' stimulus will be important in shaping the depth and duration of the current recession. There will also be distributional consequences (in terms of economic welfare) from current policy decisions made.
- Of equal importance, the 2009-10 budget strategy is critical to protecting the Commonwealth government's AAA credit rating. The introduction of Commonwealth government guarantees on State government and private bank debt has highly concentrated the credit quality of the Australian economy to the quality of the Commonwealth's AAA rating. A sovereign credit downgrade, or being placed on negative credit watch, would therefore have significant ramifications across the broad Australian economy mainly by putting upward pressure on term rates and potentially reducing the attractiveness of Australian debt to foreign investors. To satisfy the ratings agencies that the Australian Commonwealth is a genuine AAA credit a critical element in this Budget will have to be a clear plan to get the government's finances back into balance over the medium term.
- This budget is particularly sensitive to the political cycle as it will set the starting point for the Government's pre-election 2010-11 budget (with the next election due by 12 April 2011). Importantly, if the Government is contemplating an early election, possibly later this year, then this Budget will be a central platform.

The Government has two possible strategies to deal with these challenges.

- First, the Government can act aggressively to try and further limit the depth and duration of the Australian recession by significantly increasing spending. By doing so, the government would likely follow other global governments by going into the biggest deficit since World War II, a move which could directly threaten its AAA credit rating.
- Second, the government can show restraint and keep the budget deficit close to the limits of Australia's biggest post-war deficit experienced during the 1990s recession.

We believe that with Australia's AAA credit rating at risk and the political cycle front of mind, the Government will adopt the second option and choose restraint. Such restraint will not only entail relatively small budget deficits by current international standards but will also require a credible exit strategy to return the budget back into balance over a reasonable time period.

### Already worse than the 1990s

In the last recession the Commonwealth budget deficit peaked at 4.1% of GDP in 1992-93. We expect the Government will be unwilling to significantly exceed this upper limit for the deficit in this recession. In today's terms, a budget deficit of 4.1% of GDP is equivalent to around \$50bn. These 'limits' would impose a significant constraint on funds available for discretionary expenditure, given the severe damage to revenues from the deepening decline in Australian growth.

It now looks like parameter variations (ie. changes in budget revenues and expenses as a result of changes in economic forecasts) alone will drive a starting point for the budget deficit that is worse than the 1990s recession experience. We estimate parameter variations since UEFO in February will drag a cumulative \$50bn off the budget bottom line over the four years to 2008-09 to 2011-12 (see Figure 1 below with details provided in *Parameter Problems* on page 5).

The biggest impact is likely to be in 2010-11 with parameter variations likely to drag around \$17.5bn off the government's bottom line, pushing the deficit (before any policy change) to around \$53bn (4.5% of GDP). The impact in the 2009-10 budget year is almost as bad with parameter variations dragging the deficit down to a new starting point (ie. before policy decisions) of around \$53bn (4.3% of GDP).

We assume the government will allow only minimal slippage in its balance sheet relative to the 1990s experience and so will be unwilling to exceed a deficit of 5.0% of GDP. This significant hit to revenues from the current recession therefore leaves the government scope for just an additional \$15-20bn of expenditure (net of savings) over four years from 2009-10. This is notably smaller than the \$42bn UEFO stimulus package in February but larger than the \$10.4bn stimulus package announced in October 2008. This cash shortfall therefore means the Government will need to find meaningful cost savings over the forward period to try to maximise the size and impact of any direct stimulatory policy it intends to use to fight this recession. Cost-saving will also be vital in prompting a speedy and credible return to budget surplus.

Overall, we now estimate the Government will run a cumulative underlying cash deficit of around \$220bn over the five years from 2008-09 to 2012-13. This will entail deficits in excess of \$50bn per year for the next two years, improving to around \$37bn by 2012-13. For political reasons, we suspect the biggest deficit will occur in 2009-10, to peak at \$57bn or 4.8% of GDP (Figure 2).

**Figure 2: Underlying cash balance - ANZ projections - \$bn**

	2008-09	2009-10	2010-11	2011-12	2012-13
<b>Underlying cash balance – UEFO, Feb 09 (% of GDP)</b>	-22.5 (-1.9)	-35.5 (-2.9)	-34.3 (-2.7)	-25.7 (-1.9)	na
Parameter variations – impact of revisions to economic projections	-3.5	-17.5	-17.0	-12.0	nf
<b>New starting point for 2009/10 budget (% of GDP)</b>	-26.0 (-2.2)	-53.0 (-4.3)	-51.3 (-4.2)	-37.7 (-2.9)	-34.0 (-2.4)
ANZ estimates for net discretionary spending to be announced	-0.5	-4.0	-4.0	-4.0	-4.0
<b>Underlying cash balance – ANZ projection for 2009/10 Budget (% of GDP)</b>	-26.5 (-2.2)	-57.0 (-4.8)	-55.3 (-4.5)	-41.7 (-3.2)	-37.0 (-2.7)

Source: Commonwealth Treasury and ANZ

The impact to the economy of the budget is likely to be mildly stimulatory in 2009-10. This assessment is based on both the expected (positive) change in the fiscal balance from year to year, as well as the increase in discretionary policy measures. Our estimate is that discretionary spending measures are worth around ¼ppt to (nominal) GDP per annum over the four years from (and including) 2009-10.

### Back to balance

To provide maximum protection to its AAA credit rating, the Government must outline a credible strategy for returning the budget to surplus over a reasonable time period. In large part, the Government will likely argue that most of the deterioration in the deficit is cyclical (ie. due to a weaker economy) and thus that a return to 'normal' economic conditions will allow automatic stabilisers to work and 'naturally' return the budget to surplus.

This appears to be a largely, but not completely, credible strategy. Between the 2008-09 and the 2009-10 budget the Government's balance sheet, on our estimates, has deteriorated by around \$260bn. Of this, around \$180bn, or

70%, will be due to the weaker economy. The remaining \$80bn, or 30%, will be due to discretionary spending increases.

**The question then becomes how many years would it take for cyclical forces alone to return the budget to surplus?** The Government has committed to maintaining real growth in spending to 2% per annum until the budget returns to surplus. This broadly equates to nominal spending growth of around 4% per annum. If we assume nominal revenue growth averages around 6-7%, slightly above trend nominal GDP growth, then our simple estimates suggest that it will take between 7 to 10 years from 2009-10 to return the budget to surplus<sup>1</sup>. That is, we could be running budget deficits until 2020. This contrasts with the 1990s experience when significant asset sales allowed the budget to return to surplus within five years.

We estimate the time to return to surplus could only be reduced by one to two years if, as has been reported, the Government assumes national economic growth rebounds to above trend in 2011-12 (and possibly 2012-13) following the recession. On a best case scenario, we estimate the time taken to 'naturally' return to deficit could be reduced to around 5 to 6 years if for example another commodity price boom allowed revenue growth to exceed expenses growth by 2-3% per annum.

This sort of time frame should be *enough* to satisfy the credit ratings agencies. The strong starting point for the Commonwealth's balance sheet is critical, with net debt below zero last year. But this doesn't mean that government can or should allow a lack of discipline to creep into the execution of fiscal policy. **Indeed, the onus will be on the government to outline a strategy to actively reduce the structural deficit as well as the cyclical deficit over the projection period.** To do so, the government will need to (a) ensure all permanent increases in spending announced in this budget (ie. pension increases) are offset by permanent savings (ie. means-testing Family Tax Benefit Part B) and (b) outline a further combination of permanent savings, most likely through either deferring planned 2010 income tax cuts or broadening current taxes or re-instating past tax rates.

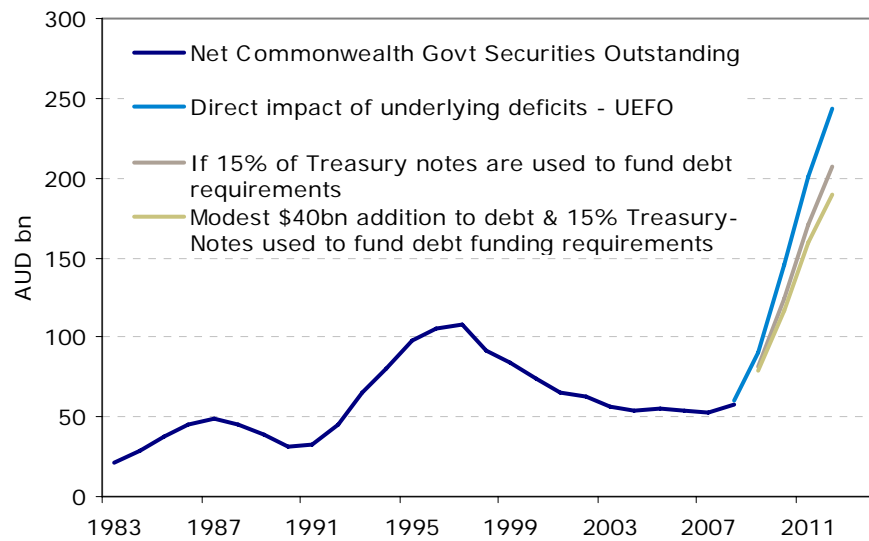
### Net debt to exceed 10% of GDP

Our estimates imply the Government's net debt position could rise from the UEFO estimate of 5.2% of GDP (around \$70bn) in 2011-12 to, as a worse-case, about 10% of GDP (\$130bn). To be sure, this is still low by international standards, but it would nevertheless be the highest level of net debt 1998-99. It is the Commonwealth's strong balance sheet which will be the greatest defence against a ratings downgrade. Prior to the current economic and financial crisis Australia's net debt position was below zero. Even with the guarantee of the banks and the potential for a broad guarantee of the States, the ratings agencies appear comfortable that Australia is a genuine AAA credit.

As per usual, the Government will finance the projected budget deficits by issuing Commonwealth Government Securities (CGS). Based on our estimates, the total deterioration in the budget position will see the Government's total debt funding burden exceed \$200bn by 2011-12 and may approach \$250bn by 2012-13 (see Figure 3). Our analysis implies that the Government will have to contain its additional debt burden to around \$40bn over the projection period to avoid lifting its legislated \$200bn ceiling on debt issuance.

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<sup>1</sup> There are large error bands around these estimates for, given limited access to detailed starting point data on revenues and expenses (which unfortunately were not published in the UEFO) and the (unpublished) sensitivities of different parameter heads to different drivers of the economic cycle.

**Figure 3: Commonwealth Bonds Outstanding – ANZ estimates**


Source: AOFM and ANZ

### Parameter problems

The marked deterioration in the Australian economic outlook, which has weakened markedly since the UEFO was published in February, will be the main drag on the budget bottom line. The Government will now be forecasting GDP to contract in 2009-10, with growth in 2010-11 likely to be well below the UEFO projection of 3%. This will see the Government's forecasts for nominal GDP, the key driver of tax revenues, slashed by at least 1ppt per year over 2009-10 and 2010-11. Moreover, the Government's employment forecasts, a key driver of revenue (via income tax collections) and expenses (via unemployment benefits) are also likely to have been cut substantially (see Figure 4).

Changes to the methodology for forecasting economic parameters will also significantly impact on the budget bottom line, resulting in a greater deficit in 2010-11 but a faster improvement in the budget balance in 2011-12 and 2012-13. Estimates for 2010-11 will now be based on forecasts rather than projections, resulting in a weaker estimate for growth and a larger budget deficit. Estimates for 2011-12 and 2012-13 will still be based on projections, although the government will now assume growth of 1-2% above trend, rather than the previous approach of using trend growth, to account for the "recovery phase" the economy will be in.

We have been deliberately conservative with our economic forecasts for these purposes. This is despite the fact that our figures are less pessimistic than the latest from the IMF (which had growth of -1.4% in calendar year 2009 and -0.6% in calendar year 2010). Nevertheless, it is possible that the government's economic forecasts will be more optimistic than our current estimates, resulting in smaller estimates for the budget deficit.

**Figure 4: Main economic parameters – annual average % change\***

		2008-09	2009-10	2010-11	2011-12
Real GDP	UEFO	1	$\frac{3}{4}$	3	3
	ANZ	0	$-\frac{1}{4}$	$1\frac{3}{4}$	3
Employment	UEFO	1	$-\frac{3}{4}$	$1\frac{1}{4}$	$1\frac{1}{4}$
	ANZ	1	$-1\frac{1}{4}$	$\frac{1}{4}$	$1\frac{1}{2}$
WPI	UEFO	4	$3\frac{1}{2}$	4	4
	ANZ	$4\frac{1}{4}$	$3\frac{1}{2}$	$3\frac{3}{4}$	4
CPI	UEFO	2	2	$2\frac{1}{2}$	$2\frac{1}{2}$
	ANZ	3	2	$2\frac{1}{2}$	$2\frac{1}{2}$
Nominal GDP	UEFO	$6\frac{3}{4}$	0	$5\frac{1}{4}$	$5\frac{1}{4}$
	ANZ	$6\frac{1}{2}$	-1	4	$5\frac{1}{2}$

\* All parameters except the CPI are year average percentage changes. The CPI is through the year growth to the June quarter.

Source: Commonwealth Treasury and ANZ

### Discretionary spending and saving measures

The Prime Minister has confirmed a third spending package will be included in the Budget. We estimate the package will be worth between \$30bn and \$35bn, offset by savings of \$10bn to \$15bn.

Most spending will be concentrated on infrastructure spending (much of which will likely be funded out of existing nation-building funds including the Building Australia Fund) and increases to transfer payments, particularly for pensioners and perhaps the unemployed and disabled.

Because these spending measures will have a permanent impact on the budget, this will most likely be partly offset by permanent savings measures to minimise the impact on the structural deficit. The most likely are cuts to "middle class" welfare through imposing income limits on a number of benefits and amending (or eliminating) the first home owners' grant. Deferring planned income tax cuts from July 2010 is also a possibility, which would add back \$11bn to the budget bottom line in 2009-10 alone.

The main **spending initiatives** are likely to be:

- Major infrastructure spending on road, rail, port, irrigation and recycling infrastructure. 30 projects will reportedly receive funding and will include more community and regional infrastructure funding. Funding will come from the \$10bn Building Australia Fund created in last year's Budget.
- Increase in aged pension rate by at least \$30 per week.
- Increase in unemployment and disability benefit rates.
- More support for small business to stem declines in business investment, including a possible extension of the small business investment tax break.
- Implementation of paid parental leave, although this may not commence until 2010-11 at the earliest and could be phased in gradually.
- Increased spending on higher education, although this is likely to be delayed until at least 2011.

Key **savings measures** are likely to be:

- Savings identified by the Razor Gang, such as reducing government spending on consultants, creating government-wide contracts for buying products, cutting back on travel and streamlining arrangements for leasing office space.
- Reducing "middle-class" welfare by reducing or implementing income limits (most likely of \$100,000 per year for individuals and \$150,000 per year for families). Areas to be targeted include:
  - The Medicare Safety Net
  - Family Tax Benefit Part B

- The Childcare Benefit
- The Private health insurance rebate of 30%. There may also be a cutback to the range of "ancillary" items eligible for the rebate scheme.
- High income superannuation tax concessions. At present, individuals can invest up to \$150,000 of their pre-tax salary into superannuation and earn significant tax breaks.
- Changes to (or abolition of) the first home owners' grant to favour new building.
- Abolition of a loophole allowing hobby farms, holiday homes and lifestyle assets which are listed as businesses for tax purposes to be claimed as tax deductions.
- Streamlining taxation on alcoholic beverages by removing anomalies in the way different alcoholic drinks are taxed.
- Increase in tobacco tax.

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