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Economic Update

Global financial crisis wipes $61bn from budget bottom line over the next four years

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Key points

- **The 2008-09 Mid-Year Economic and Fiscal Outlook (MYEFO) forecasts an underlying cash surplus of $5.4bn (0.4% of GDP) in 2008-09**, some $16.3bn lower than envisaged at Budget just six months ago. Over the next four years, surpluses are now expected to total $18.3bn, a staggering $61bn less than previously forecast.
- **The downgrade to the fiscal outlook reflects the impact of the global financial crisis**. The automatic effect of the weaker economic environment (slower growth, falling share prices, lower commodity prices) on government revenues and expenses (so called 'automatic stabilisers') has reduced the cash balance by $46.4bn over the four-year outlook period. Government policies – most notably the fiscal stimulus package announced in October – have reduced the budget bottom line by a further $14.5bn over the same period, with the bulk of this in 2008-09.
- Worryingly, **the government's bottom line may deteriorate even more than implied by the MYEFO estimates**, given the relatively optimistic economic assumptions underpinning it.
  - The government's revised forecast for real GDP growth of 2% in 2008-09 (from 2¾% previously) still sits at the top end of market expectations. We expect growth to come in closer to 1½%.
  - The government has also painted a very optimistic view for the labour force; its forecast for the unemployment rate to rise to 5¾% by mid-2010 looks to be a best-case scenario given the very sharp deterioration in the recent leading indicators for employment (including ANZ job ads). We expect unemployment to be around 6¼% of the labour force by this time.
  - Perhaps most importantly, forecasts for the terms of trade, and thus nominal GDP growth (which drives budget revenues), now look to be too optimistic. The government has only modestly downgraded its terms of trade forecasts to 10¾% growth in 2008-09, from 16% at Budget. This is well above our estimate for the terms of trade to rise by just 6% this year. The government's budget forecast for nominal GDP growth has thus been only modestly downgraded to 7¾% for 2008-09 (from 9¼%), compared with our expectation for growth of around 6%.

Key MYEFO forecasts

	08-09	09-10	10-11	11-12
Underlying cash balance ($bn)	**5.4**	**3.6**	**2.6**	**6.7**
% of GDP	**0.4**	**0.3**	**0.2**	**0.5**
Real GDP (% ch.)	2	2¼	3	3
Employment (% ch.)	1¼	¾	1¼	1¼
Wages (% ch.)	4¼	4	4	4
CPI (% ch.)	3½	3	2½	2½
Nominal GDP (% ch.)	7¾	3	4¼	4¼

Source: Mid-Year Economic and Fiscal Outlook

- **An additional source of downside surprise to the MYEFO aggregates is the potential for further discretionary policies** – not currently budgeted for – to be announced. If the extraordinary policy interventions of the past month highlight anything, it is the lengths with which the government is prepared to go to soften the impact of the economic slowdown already in train and guard against the risk of something much more severe. With this in mind, and with the bulk of the economic weakness still to come, it seems a better-than-even-bet that the government will seek to do more beyond the current year.
- While not a pressing concern, **the downgrade to the fiscal outlook has raised some uncertainty around the government's medium-term infrastructure agenda**, which revolves around three key funds announced in this year's Budget – the Building Australia Fund, the Health and Hospitals Fund, and the Education Endowment Fund. These funds were intended to be at least partly funded from the 2007-08 and 2008-09 Budget surpluses. While the 2007-08 surplus turned out to be around $2.5bn higher than forecast at Budget time, the $16.3bn downgrade to the 2008-09 surplus leaves a $13.8bn shortfall over the two years, relative to that expected in May.
- The massive downgrade to the economic and fiscal outlook was well anticipated, and indeed, when all is said and done, we expect **the key budget numbers will probably end up looking worse that what has been presented in the 2008-09 MYEFO**.
- **There is nothing wrong with this**. In the current extraordinary circumstances, with economic conditions and risks deteriorating markedly, it is entirely appropriate that the government allow the budget's 'automatic stabilisers' to work, and implement prudent, discretionary fiscal policy to stimulate economic activity, even if that means allowing the budget to move into deficit in the short term.
- **The remarkable thing about the MYEFO numbers is the extraordinary capacity that remains for the government to further pump prime the Australian economy, should the need arise**. And we suspect that it will.

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