Monday, 19 December 2016

Mid-Year Economic and Fiscal Outlook

Slippage Down The Track

- **The 2016-17 Budget deficit is now expected to be $36.5bn rather than the $37.1bn deficit expected in the May 2016 Budget. However, Budget deficits beyond 2016-17 are expected to slip further into the red.**
- **Softer jobs and wage growth has led to a $2.3bn downward revision to income tax receipts and company tax receipts were revised down by $1.2bn. In total, receipts for 2016-17 are set to be $3.9bn lower than expected.**
- **On the expenditure side, cash payments are expected to be $3.9bn lower in 2016-17 assisted by spending cuts since the election of $0.9bn. The marginal improvement in the 2016-17 budget deficit appears due to adjustments to earnings from the Future Fund.**
- **In Today's MYEFO Treasury lowered its forecasts for real GDP growth and employment growth in 2016-17 and 2017-18, compared to its earlier estimates.**
- **Comments from the three major ratings agencies, S&P, Moody's and Fitch suggest that Australia will maintain its top credit rating for now. However, a downgrade remains in prospect over the near-term. There has been a muted reaction in government bond yields, swap rates and the Australian dollar. Overseas developments are likely playing a bigger role for financial markets.**
- **There are no quick or easy solutions to Australia's Budget situation. If a balanced Budget is to be achieved it will most likely require a reorganisation of taxation and some spending cuts. So far these have been difficult to achieve. The government appears optimistic. We remain a touch sceptical.**

In May 2016 the Treasurer announced an expected Budget deficit of $37.1bn for 2016-17. The deficit for 2016-17 is now expected to be $36.5bn, an improvement of $0.6bn. With little change in the near term, the focus of the MYEFO was on the more distant future. What does this mean for interest rates and the economy in the year ahead?

What happened?

As expected, revenue is now estimated to be weaker than originally outlined in the May Budget and reiterated in the May Pre-election Financial Outlook (PEFO). Softer jobs and wage growth has led to a $2.3bn downward revision to income tax receipts and company tax receipts were revised down by $1.2bn. In total, receipts for 2016-17 are set to be $3.9bn lower than expected.

On the expenditure side, cash payments are expected to be $3.9bn lower in 2016-17 assisted by spending cuts since the election of $0.9bn. The marginal improvement in the 2016-17 budget deficit appears due to adjustments to earnings from the Future Fund.

While the 2016-17 deficit is a marginal improvement on the original Budget numbers, today's MYEFO points to a deterioration in the 'out' years. The estimated and projected deficits for 2017-18 to 2019-20 are larger than expected in the May Budget.

In a nutshell, apart from the current financial year, deficits are now expected to be larger than originally planned. The deficit for 2019-20 was expected to be $6bn, followed by a balanced budget in 2020-21. It is now expected to be $10bn in 2019-20 still followed in 2020-21 by a balanced budget.

The MYEFO document rightly points out the range of uncertainties in looking forward four or five years. Commodity prices are key uncertainty but so too are employment growth, wage growth and company tax receipts. Any slippage in these parameters would be costly for the Budget.

There are no quick or easy solutions to Australia's Budget situation. If a balanced Budget is to be achieved it will most likely require a reorganisation of taxation and some spending cuts. So far these have been difficult to achieve. The government appears optimistic. We remain a touch sceptical.

What does it mean for interest rates?

There was significant media speculation that Australia's AAA credit rating could be downgraded following this Budget update, particularly if the Budget bottom line deteriorated. In July, following the Federal Election, Standard and Poor's placed Australia on negative watch, which implies that there is a 1 in 3 chance of a rating downgrade within two years.

The marginal improvement for the 2016-17 deficit was better than we had expected, however estimates and projections of deficits in following years have been downgraded.

All three major credit ratings agencies have not changed Australia's rating.

Moody's has stated that Australia's fiscal metrics were "broadly in line with other Aaa-rated sovereigns" suggesting that Australia's credit rating will be maintained. However, Moody's also added that "meeting the fiscal targets will be difficult in an environment of weaker nominal GDP growth".

S&P have stated that "the Australian government's mid-year Budget update has no immediate effect on the credit rating or outlook", but that it was pessimistic about the government's ability to return to a balanced Budget by 2021.

There continues to be a high chance of a downgrade occurring over the next six months. Any downgrade would likely to cause the bigger reaction in interest rates than the announcement of today's MYEFO. That said, if Australia's rating were to be downgraded, we would not expect a significant movement in government bond or swap yields. Overseas developments, such as the path of rate hikes by the Federal Reserve, the impact of Trump's new fiscal policies and global inflation expectations would likely have a bigger impact on Australian government bond yields.

Exchange rate reaction

The Australian dollar gyrated between 72.73 and 73.13 US cents this morning, but then settled around 72.95 US cents, unchanged from late Friday. A credit ratings downgrade would likely place the Australian dollar under downward pressure, but movement would be limited. Global developments will play a bigger part in determining the AUD's value including the direction of the US dollar and commodity prices.

The Economic Assumptions

GDP growth was revised down for both 2016-17 and 2017-18. GDP growth for 2016-17 was revised down to 2.0%, from the Budget and PEFO estimate of 2.5%. This is due in part to the impact of the weaker than expected September quarter GDP result. Additionally, GDP growth for 2017-18 was revised down slightly to growth of 2.75%, from the previous estimate of 3.0%. The updated GDP growth forecast of 2.0% for 2016-17 is feasible, if slightly above our own forecast for growth of 1.8%.

Additionally, nominal GDP (unadjusted for inflation), which impacts the Budget's bottom line was upgraded for 2016-17, but downgraded for 2017-18. Stronger than expected commodity prices are supportive of nominal GDP in the near-term, while slower growth in inflation and wages are expected to slow nominal GDP growth next year.

In recent years, the commodity prices used for Treasury forecasts were based on a recent average of commodity prices. At the time of the Budget 2016-17 and the Pre-election economic and fiscal outlook (PEFO), forecasts assumed an iron ore spot price of US$55 per tonne. Since then, commodity prices have risen significantly. Iron ore is currently trading around US$81 per tonne. In a prudent move, Treasury has said it will suspend its methodology of using recent commodity prices and has assumed a phased reduction in prices from recent levels. Treasury now assumes the iron ore price will decline from US$68 per tonne through the March and June quarters of 2017, to reach US$55 per tonne in the September quarter 2017.

The labour market forecasts deteriorated from the Budget and PEFO. Treasury now forecasts employment to grow by just 1.25% in 2016-17, down from an earlier estimate of 1.75%. It expects this to pick up slightly to 1.50% in 2017-18, which is also below the earlier estimate of 1.75%. Estimates for an unemployment rate of 5.5% in the June quarter 2017 and the June quarter 2018 are unchanged. The Treasury's forecasts for wages growth are more subdued, at 2.25% in 2016-17 (down from 2.50% in the PEFO).

The full MYEFO document and the measures in contains can be found at:

http://www.budget.gov.au/2016-17/content/myefo/html/

For Budget forecasts see the following page

Forecasts % Change on Previous Year		
	2016/17	2017/18
MYEFO		
Real Gross Domestic Product (GDP)	2.00	2.75
Nominal Gross Domestic Product (GDP)	5.75	3.75
Terms of Trade	14.00	-3.75
Unemployment Rate (%)**	5.50	5.50
CPI (Headline) ***	1.75	2.00
Wage Price Index	2.25	2.50
Pre-election Economic and Fiscal Outlook 2016		
Real Gross Domestic Product (GDP)	2.50	3.00
Nominal Gross Domestic Product (GDP)	4.25	5.00
Terms of Trade	1.25	0.00
Unemployment Rate (%)**	5.50	5.50
CPI (Headline) ***	2.00	2.25
Wage Price Index	2.50	2.75

*Real GDP forecasts are year average.

**The unemployment rate is for the June quarter.

*** Through the year growth rate to the June quarter

Key Budget Parameters				
	2016/17	2017/18	2018/19	2019/20
MYEFO				
Underlying cash balance ($bn)	-36.5	-28.7	-19.7	-10.0
% of GDP	-2.1	-1.6	-1.0	-0.5
Net debt ($bn)	317.2	343.0	359.0	363.8
% of GDP	18.1	18.9	19.0	18.4
Pre-election Economic and Fiscal Outlook 2016				
Underlying cash balance ($bn)	-37.1	-26.1	-15.4	-5.9
% of GDP	-2.2	-1.4	-0.8	-0.3
Net debt ($bn)	326.1	347.1	356.7	355.4
% of GDP	18.9	19.2	18.8	17.8

*Real GDP forecasts are year average.

**The unemployment rate is for the June quarter.

*** Through the year growth rate to the June quarter

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