

Australia & New Zealand Economics Weekly

Australia's exploding budget

Week commencing 11 May 2009

Budget IEDs explode	2
Mr Swan's unspoken problem	2
Australian numbers and the RBA	4
A mild recession, or perhaps no recession at all	4
The strange case of Australian jobs	6
Unemployment up, but so is employment	6
New Zealand's prolonged, mild downturn	7
Not-so-bad jobs numbers	7
Weekly calendar	8
Events & economic releases	8
Monthly calendar	9
Events & economic releases	9

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Budget IEDs explode

Mr Swan's unspoken problem

Australian Treasurer Wayne Swan can't say so but his real problem in Tuesday's Commonwealth Budget is not the downturn in Australian output growth but the fiscal structure he inherited and hasn't so far been able to change. As he rightly says, most of the decline in the fiscal balance from large surpluses to large deficits over the next four years is due to a collapse in expected revenue. The decline would well take Commonwealth net debt from zero today to around \$300bn in five years' time, much the same share of GDP it reached in the mid 1990s. But the mid 1990s deficits arose from a recession deeper than the current downturn is likely to be. And those mid 1990s deficits were on top of 4% of GDP of existing debt, whereas the path from this year is from zero debt. So how come the revenues are expected to deteriorate so quickly to produce such large and persistent deficits and such big net debt?

A glance at Mr Swan's first Budget last May suggests part of the answer. It projected revenue from the actual outcome of 2006/07 through to the final projection year of 2011/12. Revenue from the goods and services tax is hypothecated as grants for the states, so its ups and downs have minimal impact on the fiscal balance. Far and away the biggest remaining sources of Commonwealth revenue are personal income taxes and company taxes. In 2006/07 actual personal income tax revenue was \$118 billion, and actual company tax revenue was half that at \$59 billion. Last year's budget statement showed, however, that by 2011/12 company tax was expected to be 60% of individual income tax. Over the period company tax was expected to increase by 48% and individual income tax by 24%, so they would end up increasing by the same amount — \$28 billion. Company tax would rise by 4% of total income tax revenue, and personal income tax would fall by 4% of total income tax revenue. Take it further back and the substitution of company tax for personal income tax is even more striking, and reflects the decisions of the former government to finance large personal tax cuts with expected booming company tax. In 2001/02 for example company tax was less than one third of personal income tax, compared to half by 2006/07.

The incoming Labor government continued the trend by implementing its commitment to match a further round of personal tax cuts promised by the outgoing Treasurer. This increasing dependence on company tax was an improvised explosive device implanted within the fiscal structure of the Commonwealth. It meant that expected revenues were highly leveraged to profits. The biggest increases in profits were coming from the banks and from mining companies, and both turned down sharply in the second half of last year. As a result the deterioration in Commonwealth revenues is sharper than might be expected given a sensible estimate of the expected deterioration in the economy as a whole. The forward estimates of revenues and receipts published Tuesday night will be strikingly different from the table published this time last year.

Mr Swan was caught on the spending side as well as the revenue side, and again by the change in the fiscal structure in the four or five years before Labor came to power. This is the second IED left in the fiscal structure. As a very interesting Treasury paper published in February last year (and presumably readied for publication as soon as Treasury farewellled its former minister) pointed out, the stunning increase in export prices and the decline in import prices from the middle of this decade had blown out the apparent rate of growth of nominal GDP. From 2003 to 2008 the rate of growth of nominal GDP

doubled, though the average rate of growth of real GDP was little changed. This discrepancy permitted the former government to sharply increase government spending, while showing it little changed as a share of GDP. With the downturn in commodity prices nominal GDP is now falling away, leaving spending high and dry. It will be very difficult for the government to now get spending down as a share of GDP. At the same time and for the same reason – falling commodity prices – revenue is tanking.

Mr Swan won't explain this on Budget night, because it is inconvenient to do so. One reason is that Labor has now become implicated in this defective budget structure by legislating its own personal tax cuts. It might well be said privately that it had no choice but to match the former government's election promise, but it cannot be said publicly. The other and more powerful reason Mr Swan cannot dwell on this defective structure is that remedying it requires very unpopular changes to taxes and spending. It is quite inappropriate to make those changes on Tuesday, in the midst of what it widely thought to be a sharp economic downturn. It will be inappropriate to make the changes in the next budget, because that is an election year. Assuming Labor is re-elected, and assuming he is still Treasurer, Mr Swan's real budget challenge will be in two years' time.

Australian numbers and the RBA

A mild recession, or perhaps no recession at all

By the time the Reserve Bank of Australia released its *Statement on Monetary Policy* Friday, Australians were giddy on good news. At 2.75% the increase in Tuesday's March building approvals over the previous month was the highest since a nascent upswing was snuffed out two years ago. It was the fourth successive monthly increase in private house approvals. March retail sales on Wednesday were up 2.2%, recovering the entire decline in the previous month and contributing to a solid 1% gain in volumes for the quarter. Trade numbers out the same day showed exports had not only held the gain of the previous month but improved a little on them, while imports were again down. These numbers were somewhat stronger than we expected, but Thursday's April jobs number was in an altogether different realm. We expected a 25,000 decline in jobs with the unemployment rate increasing from 5.7% to 5.9%, an outcome consistent with what we have thought to be a mild downturn. Instead employment increased 27,000, with 50,000 full time jobs added. The unemployment rate fell to 5.4%, the first check to rising unemployment in eight months.

Agreed, the monthly employment reports are volatile. We don't set much store by a single month. But a sequence of numbers like that last week is quite inconsistent with either a deep recession, or a continuing deterioration. We won't see the March quarter GDP outcome until June 3 and there are many key numbers yet to come. We can now fairly confidently expect, however, that consumption will make a bigger contribution to GDP in the March quarter than to the previous quarter, and that there will also be a useful contribution from net exports. If the decline in business investment is not too startling and the decline in inventories slowed compared to the previous quarter, it is possible the March quarter will record a small gain in GDP overall. It is perhaps only a small possibility, but an interesting one. It would mark the end of a phantom recession – the one Australia thought it had, but discovered it didn't.

The Reserve Bank of Australia emphatically disagrees that a positive outcome in the March quarter is at all likely. Friday's *Statement* discerned signs of a "turning point" in the global economy, noting that IMF forecasts are consistent with a modest increase in global GDP in the second half of this year. The RBA thinks it will likely be a "gradual" recovery with an "extended period of sub-par growth", but the pertinent thing from the point of view of Australian monetary policy is that the RBA now thinks a turning point is at hand. As for the Australian economy, the RBA expects a recovery to be under way by the end of the year "provided global conditions continue to stabilise".

The RBA has revised down its growth forecasts, but the recession now expected is relatively mild. It expects GDP to decline 1.25% through the year to June, an outcome that would be consistent with another 0.5% output fall in the March quarter and a smaller 0.3% contraction in the current quarter. It looks to a through the year decline of 1% to December, implying say a 0.3% contraction in the September quarter and a flat outcome in the December quarter. The subsequent recovery is also mild, with GDP growth through to June 2010 only 0.5%. Unemployment on this trajectory would likely reach or exceed 8%. The RBA now thinks inflation will be quite resilient. On its forecasts headline and underlying inflation do not settle at 2.5% until the middle of next year.

We think the RBA's forecasts will prove too sombre, largely because we think consumption growth will pick up as anxiety wanes, and the "wealth effect" cited by the RBA will prove to have little impact. We

also doubt the decline in the terms of trade will have quite the impact expected by the RBA. Even so, the RBA forecasts do not imply further rate cuts. If the RBA thinks the global economy is now at a turning point and the Australian economy will be growing by the end of the year, it is also likely to think the 3% rate setting is quite appropriate. It is after all, the RBA notes, the lowest since the 1960s, and unlike the case in many other economies the rate cuts flow promptly to households. There is also a major fiscal boost. Of the Commonwealth's \$50bn in additional and discretionary spending to support demand, only a little over two fifths have so far been expended. Given the RBA's views, and even more the run of recent numbers, we doubt there will be a plausible case to cut below 3%.

The strange case of Australian jobs

Unemployment up, but so is employment

It is widely said that there have been large job losses in Australia, which made the April report confounding. It is certainly true that the unemployment rate has increased in Australia, from a more than three decade low of 3.9% in February last year to 5.4% in April this year. It's also true that the number of unemployed has increased over that period, by a substantial 177,000. But in net terms there have been no job losses at all. On the contrary, Australia has gained jobs as unemployment has increased. The gain from February to April is 62,000. Full time jobs have declined – but over that period by only 28,000.

Since February last year there has been no net change in the participation rate. All of the increase in unemployment has come from new entrants to the workforce, which increased by a little over 2% in the fourteen months to April. The apparent dramatic worsening of Australia's jobs market is mostly the result of faster population growth combined with a slowdown in the rate of creation of jobs. If the pattern persists it will be quite possible to get to an unemployment rate of 7.5% in the middle of next year with almost no net job loss. In the upswing, the high rate of growth in the workforce will be one of Australia's most valuable economic assets. These reflections do not mitigate the problem rising unemployment poses, but they do change the policy prescriptions and the economic implications. It's no surprise that workers aged between 15 and 24 account for a little under half of the total increase in unemployment from the trough to April. If so many of the unemployed are new entrants to the workforce a useful response is to encourage young Australians to remain in the education system a bit longer by providing generous additional and temporary incentives to continue formal post-school training. The Commonwealth is moving in exactly this direction.

It is frequently said that the Reserve Bank of Australia will have to cut rates even below the very low level of 3% as unemployment rises through this year. But the RBA is looking at the same numbers we are, and will also be noting the significant difference between an economy experiencing a mass jobs shake-out, and an economy which is not creating jobs fast enough to absorb new entrants to the workforce.

New Zealand's prolonged, mild downturn

Not-so-bad jobs numbers

Like Australia's, New Zealand employment last week surprised on the upside. Employment fell 25,000 or 1% during the first quarter of this year, a mild enough decline given that it was the fifth quarter of GDP contraction. Unemployment increased but even so only got to 5% - not bad after 15 months of recession. All up, taking the whole recession from the beginning of last year to the end of the first quarter this year New Zealand has lost just 4,000 jobs. It is surely closer to the end of the recession than to the beginning, but the rest of the world is not giving RBNZ Governor Alan Bollard much help. His dramatic decision late last month to not only cut the cash rate 50bp but also announce it would stay low for some time checked the increase in term funding and the New Zealand dollar, but not for long. Last week wholesale term rates were moving up again, and late last week the New Zealand dollar was reaching towards USD0.60. The only positive things one can say of these developments is that they remove any concern that another couple of 25bp cuts (which we now expect) will cause a sudden loss of confidence in the New Zealand dollar.

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Weekly calendar

Events & economic releases

Week commencing Monday, 11 May 2009

Country/ region	Event or economic release	Period	HSBC	Market consensus	Actual previous
Monday, 11 May					
AU	NAB Business Confidence (11:30)	Apr			-13
Tuesday 12 May					
AU	Home Loans (11:30)	Mar	7%		0.40%
AU	Commonwealth Budget (19:30)	May 12			
Wednesday 13 May					
AU	Westpac Consumer Confidence (10:30)	May			8.30%
Thursday 14 May					
Friday 15 May					
NZ	Retail Sales (08:45)	MoM	Mar	0.30%	0.20%
NZ	Retail Sales Ex inflation (08:45)	QoQ	1Q	-1%	-0.60%
During the week					

Notes:- p= preliminary, r = revised, nf = not forecast, nsa = not seasonally adjusted, ann = annualised, bn = billion, m = million
Source: Dow Jones, Reuters, Bloomberg

Monthly calendar

Events & economic releases

Month commencing Monday, 18 May 2009

Monday 18 May	Tuesday 19 May	Wednesday 20 May	Thursday 21 May	Friday 22 May
NZ Producer Prices – Inputs QoQ 1Q NZ Producer Prices- Outputs QoQ 1Q	AU RBA Governor Stevens Speaks in Sydney MAY 19	AU Wage Cost Index YoY 1Q		

Monday 25 May	Tuesday 26 May	Wednesday 27 May	Thursday 28 May	Friday 29 May
	NZ Trade Balance APR	NZ Annual Budget MAY 27	AU RBA Deputy Governor Battellino Speaks in Sydney MAY 28 AU Private Capital Expenditure 1Q NZ NBNZ Business Confidence MAY	NZ Building Permits MoM APR AU Private Sector Credit MoM% APR

Monday 1 June	Tuesday 2 June	Wednesday 3 June	Thursday 4 June	Friday 5 June
AU Company Operating Profit QoQ 1Q AU Retail Sales s.a. MoM Apr AU Inventories 1Q	AU Building Approvals MoM Apr AU Current Account Balance 1Q AU RBA Cash Target Jun 02	AU Gross Domestic Product QoQ AU Gross Domestic Product YoY	AU Trade Balance Apr NZ ANZ Commodity Price May	

Monday 8 June	Tuesday 9 June	Wednesday 10 June	Thursday 11 June	Friday 12 June
	AU NAB Business Confidence May AU ANZ Job Advertisements MoM	AU Westpac Consumer Confidence Jun	NZ RBNZ Official Cash Rate Jun 11	NZ Retail Sale MoM

Disclosure appendix

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