National Australia Bank

2 August 2013

Government downgrades outlook: tightens policy

- **The government's economic forecasts now recognise the softness of the domestic economy and the weaker outlook for commodity prices and incomes. In the near term the Budget now looks to be slightly adding to growth (rather than detracting as at Budget time). To get back to surplus (one year later) in 2016/17 however requires a sharp structural tightening in the out years.**
- **In the near term our forecasts are a touch lower than even the revised estimates (NAB 2¼% Government 2½%) which, with similar terms of trade forecasts, translates to lower nominal income and hence downside risk to revenue. Also, domestic demand forecasts for this year appear very optimistic given the state of the economy.**
- **However, Government projections for the out-years appear even more optimistic — especially for the labour market with unemployment falling from 6¼% to 5% in 2015/16. While a technical assumption these have big implications for outlays.**
- **Treasury has revised its global forecasts down as well, still expecting faster growth next year but we have concerns about their China forecasts.**
- **Given the above there must remain serious doubts about the prospect of a surplus even on the new timetable.**
- **The main policy measures were largely as expected / leaked and included: increases to tobacco excise; motor vehicle FBT; the Financial Stability levy; more pressure to cut costs in the public service ("efficiency dividend"); a further delay in the overseas aid schedule and, on the other side, the impact of a lower carbon price.**

Economic forecasts

The latest economic forecasts recognise the reality of the growth slowdown of the past six months, particularly in domestic final demand, and there is now a softer outlook for the terms of trade. As a result, the unemployment track is ½ percentage point higher than at Budget time for this year and next and nominal GDP growth is 2 percentage points weaker by the end of next year. In broad terms, the Commonwealth Treasury outlook looks similar to our own view, except that we are softer on the trajectory of employment and domestic demand this year (see table below). Headline CPI inflation in 2014/15 is expected to be restrained by the expected reduction in the price of carbon (not yet reflected in our forecasts).

The estimates beyond 2014/15 appear unrealistic, with employment growth too weak to reduce the unemployment rate to 5%. While 1½% employment growth in 2014/15 is expected to maintain the unemployment rate at 6¼%, the same employment growth in 2015/16 reduces the unemployment rate to 5%.

The capacity of the non-mining sector to assume the reins of growth as mining investment declines presents some risks to the Government forecasts. It has scaled back its forecast for business investment, but the small decline expected in 2014/15 may prove optimistic.

The softer outlook for the terms of trade reflects the lacklustre pace of global economic expansion. World economic growth has been running well below trend with output expanding by only 3% to 3¼% since early 2012 and there is no clear evidence of a pick-up through the first half of this year. Growth in monthly measures of world industrial output and exports remains less than 2% yoy with softer than expected activity across India, China and several other emerging markets offsetting signs of recovery or a bottoming out in output in the big advanced economies.

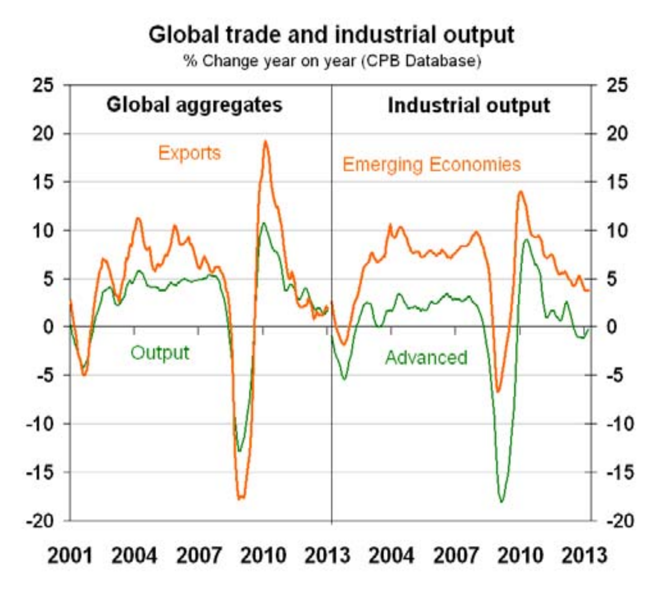
Australian economic forecasts: year average % change unless otherwise indicated

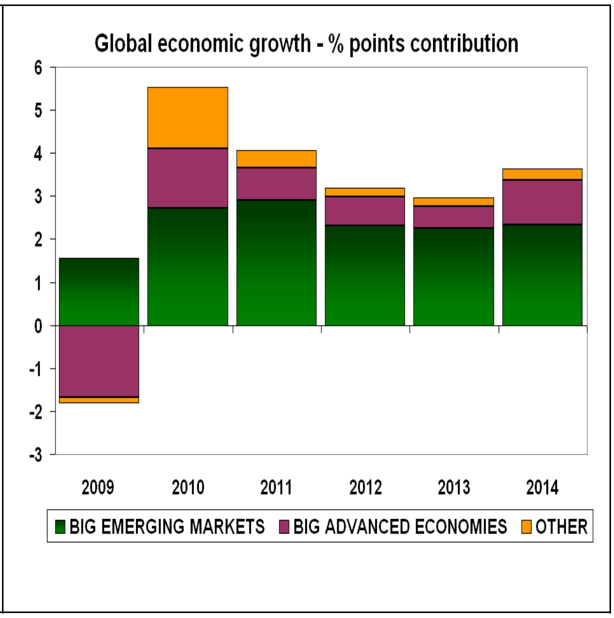
		2013-14	2014-15	2015-16	2016-17
GDP	Commonwealth	2½	3	3	3
	NAB	2.3	3.2		
Domestic final demand	Commonwealth	2	2	n.a.	n.a.
	NAB	0.5	1.1		
Headline CPI	Commonwealth	2½	2	2½	2½
through-the-year	NAB	2.3	2.5		
Employment	Commonwealth	1	1½	1½	1½
through-the-year	NAB	0.3	1.0		
Unemployment rate:	Commonwealth	6¼	6¼	5	5
end of period	NAB	6.3	6.4		
Terms of trade	Commonwealth	-5¾	-3¾	-1½	-1½
	NAB	-6.0	-3.0		
Nominal GDP	Commonwealth	3¾	4½	5¼	5¼
	NAB	3.1	4.8		

Treasury expects global economic growth of 3% in 2013, rising to 3¾% in 2014 and 4% in 2015 – a downward revision from the 3¼% predicted at budget time for 2013 and the 4% for 2014. The Treasury's view that the global economy will soon accelerate is broadly in line with that of the big international organisations. The IMF expects global growth to reach 3.1% in 2013, rising to 3.8% next year while the OECD is also expecting things to finally get better with an end to recession in Western Europe helping drive an upturn in OECD area growth from 1.2% in 2013 to 2.3% in 2014. At the same time the OECD expects growth outside its region to also rise from 5.5% this year to 6.2% in 2014.

Our global forecasts follow much the same pattern but we are less optimistic on the growth outlook. Continued moderate expansion in the US, a resumption of growth in Western Europe and the stimulus from Abenomics in Japan lead to a rise in advanced economy growth from 1% in 2013 to 2¼% in 2014 on our numbers – much the same as the OECD's estimates. However the slowdown in China and ongoing structural problems in India underpin our view that the upturn in emerging market growth will be modest with growth rising from 5¼ this year to 5½% next year. The main risk in the Treasury's global forecasts is their decision to only lower their Chinese forecast growth by ¼ percentage point in 2014 and 2015, keeping predicted growth at 7½% through both 2014 and 2015, whereas many others (including us) expect it to slow to around 7% over that period. This optimism is countered by Treasury pessimism on Japan where, unlike us, they do not seem to expect Abenomics to boost growth by much after this year.

As the emerging market economies have been driving much of what growth there has been in global output through the last few years, our more pessimistic view on their prospects has quite an impact on the global growth bottom line. Overall, therefore, we expect a less marked ramping up of growth through the forecast period with world growth rising from 3% in 2013 to 3.6% next year and 3.7% in 2015.





Global economic forecasts: year average % change unless otherwise indicated

	2013		2014		2015	
	Treasury	*NAB*	*Treasury*	*NAB*	*Treasury*	*NAB*
US	1½	1.5	2½	2.7	2½	2.9
China	7¼	7.5	7½	7.2	7½	7
Japan	1¾	2	1	2.3	1	1.8
Euro-zone	-¾	-0.6	¾	1.1	1¼	1.9
E Asia	3¾	3.7	4¾	4.1	5	4.3
India	5	5.5	6½	6.2	6½	6.6
World	3	3	3¾	3.6	4	3.7
Trading partners	4	4.1	4½	4.4	4¾	4.3

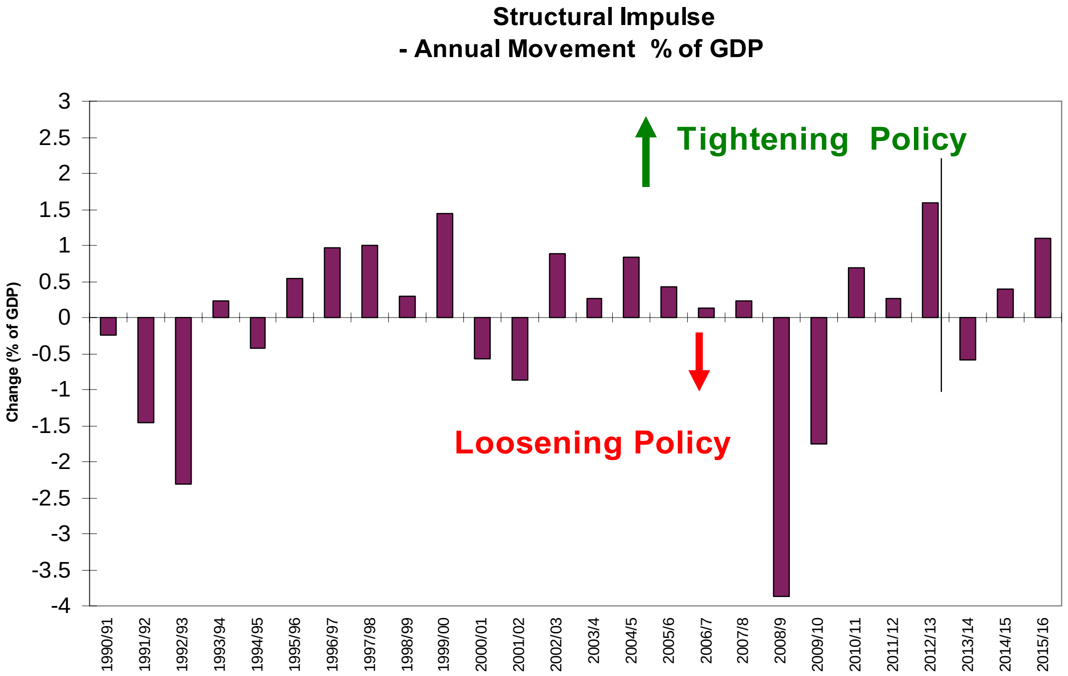
New policy measures

New policy measures include:

- Phased increases in tobacco excises over three years commencing 1 December 2013.
- Restricting the motor vehicle FBT exemption to vehicles actually used for business purposes.
- A levy on bank deposits commencing 1 January 2016 to establish a Financial Stability Fund to help defray any future claims on the bank deposit guarantee scheme.
- The early termination of the fixed carbon price and commencement of the ETS will reduce revenue but will be more than offset by savings measures (including the FBT changes).
- The $2000 cap on work-related education expenses has been deferred until 1 July 2015.
- More pressure to cut costs in the public service (“efficiency dividend”).
- A further delay in the overseas aid schedule.

Implications for government finances

Overall, the policy decisions since the Budget are estimated to be broadly neutral this year but to be slightly contractionary in 2014/15. Our own estimates of the structural budget position suggest that the Budget's impact is slightly stimulatory in structural terms this year but increasingly contractionary in the later years (see chart). This means more of the heavy lifting will devolve to monetary policy.



The underlying cash balances for 2013/14 and 2014/15 have deteriorated by $12 billion and $13 billion respectively, with the achievement of a surplus now deferred until 2016/17. Most of this deterioration is attributed to the weaker economic environment. However, unrealistic economic parameters must place a question mark over whether this will be achieved within the expected time frame.

Underlying cash balance

		2013-14	2014-15	2015-16	2016-17
Underlying cash balance	Economic statement	-30.1	-24.0	-4.7	4.0
	Budget	-18.0	-10.9	0.8	6.6

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