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SE Commentary

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The chances of an easier budget next year are diminishing along with iron ore prices

One can scarcely blame Tony Abbott for wanting to put this year's budget behind him, but he risks being mugged by the same reality that destroyed the former Labor government's reputation for economic management if he believes that the major task of repairing the government's finances has been accomplished.

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Baring his breast before the media on Monday, the Prime Minister declared last May's budget had "got the fundamentals right" and it should not be assumed there would be further large savings in next year's budget. Although the government was always on the lookout for "sensible savings", there was no case for further "massive" cuts. "I think that the fundamental decisions were made in this budget and this gives us the foundation on which we can build," he said.

The government would not chase falling commodity markets seeking additional spending cuts every time iron ore prices dipped. Abbott said it was too soon to conclude the sharp fall in the terms of trade (the average price fetched for exports compared with import prices) was permanent. We might just be seeing a "cyclical" downturn in commodity markets — a critical difference to the budget.

The terms of trade has a big influence on national income and hence on tax revenue. If the downturn is merely cyclical commodity prices will eventually rise, delivering a recovery in taxes and removing the need to cut government spending to a permanently lower level. But if what we're seeing is commodity prices dropping to the long-term average that prevailed for most of the 50 years before the China boom, the savings task has barely begun.

Treasury and the host of private economic forecasters have been wrong with every prediction about the terms of trade for the past 10 years. In the final four years of the Howard government, these forecasting errors brought a bounty with every budget, as revenue far exceeded expectations. It was a largesse treasurer Peter Costello distributed in family benefits and tax cuts with still enough in budget surpluses to eliminate public sector debt. Economists draw on history when making forecasts and there was no precedent for the dramatic growth in China's demand for minerals from 2002 onwards.

Not only did the economists fail to anticipate it, so did mining companies. This left acute shortages as it was at least five years before new investments started yielding increases in production.

There was a honeyed moment when Treasury believed this would last into the distant future. In the 2007-08 budget, Treasury thought it would take 10 years for resource prices to decline by 20 per cent. By 2011-12, this had stretched to 20 years. In 2011, though, the commodity boom cracked. Just as economists underestimated the size of the boom, they consistently underestimated the speed and size of the fall.

Mining companies have, too. Until last year, they were holding to forecasts that China's steel production would continue rising at a healthy if not breakneck pace, to hit a billion tonnes a year by 2020. As China's steel production has fallen and prices have dropped, the big miners have responded by redoubling efforts to lift output in an effort to reduce the cost for every tonne of iron ore they ship.

Nobody predicted this, and it has sent prices into a downward spiral. We have never been here before. Nothing about these markets looks cyclical.

At the beginning of the year, Treasury conducted major research into its terms of trade forecasts. It accepted there would be a period of falling prices as new mines came into production with supply and demand coming into balance in 2017-18. The terms of trade would fall by about 13 per cent over that period and then remain stable indefinitely about 40 per cent above the long-term average. Since Joe Hockey wanted the budget to be prudent, the forecast fall over four years was raised to 19 per cent but this is already looking far too optimistic. If prices keep falling at the rate of the past nine months, the four-year forecast will be met next year.

A report from the Parliamentary Budget Office last week shows how much is at **stake**. A 10 per cent fall in the terms of trade adds $7 **billion** to this year's budget deficit and $12.4bn to the deficit by 2023-24. Public debt would be $75bn higher. A 30 or 40 per cent fall taking prices back to their long-term average would be catastrophic for the budget.

Doing nothing is not an option. A spokesman for ratings agency Standard & Poor's said on Monday corrective action was needed in next year's budget if commodity prices remained weak. This matters, not because it is S&P or because Australia's AAA credit rating may be in jeopardy but because it reflects the view of global financial markets, our creditors, and demands a response.Hockey likes to mock his predecessor Wayne Swan for having declared in the past tense that "we have delivered a surplus", only to have falling revenue render the claim ridiculous. Abbott's "mission accomplished" stance on budget repair on Monday leaves him similarly exposed.

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