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2012-13 Budget – back to surplus. The great fiscal, monetary switch

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Key points

> The Australian Government's Budget forecasts a $1.5bn surplus for 2012-13, with savings focussed on defence, foreign aid, the public service, large companies and high income earners via a doubling of the contributions tax on super but handouts for low to middle income earners.

> By sticking to the surplus timetable, the Government will further boost foreign investor confidence, provide flexibility for a future fiscal stimulus if needed and further enhance the ability of the RBA to cut interest rates.

> The negatives in the Budget are the abandonment of company tax reform and more changes to superannuation.

> On balance the implied policy switch towards tighter fiscal policy and easier monetary policy is a negative for the $A, but probably a positive for Australian shares.

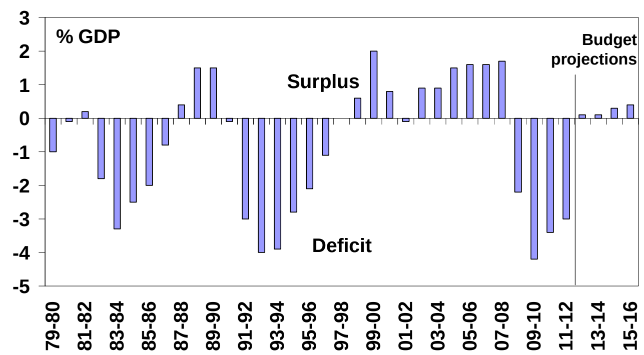
Introduction

The 2012-13 Federal Budget is about one thing: returning the budget to surplus on schedule and doing it in a way that minimises the negative impact on the economy and doesn't alienate the Government's key constituency of low to middle income voters. And this is what the Government has done. The Budget is projected to be in surplus to the tune of $1.5bn – wafer thin but still a surplus. The main issues relate to the economic impact: is returning a surplus good or bad for the economy and what does it mean for interest rates?

Key measures

After four years of hefty deficits starting in 2008-09 in order to combat the GFC and more recently partly because of greater than expected weakness in revenues, the budget is projected to be back in surplus in 2012-13

Federal Budget - Underlying Cash Balance



Source: Australian Treasury, AMP Capital

A return to surplus for 2012-13 has been foreshadowed since 2010, but owing to chronic revenue shortfalls the Government has had to rely on a combination of smoke and mirrors (shifting spending into 2011-12 and revenue into 2012-13) and net budget cuts to the tune of $11bn over five years. The key savings were well flagged & include:

- The cancellation of the 1% cut to the company tax rate.
- A doubling in the superannuation contributions tax rate for those earning more than $300,000 to 30%.
- Tougher targeting of welfare and health spending.
- Reduced depreciation write-offs for large companies.
- Reduced living away from home allowances.
- The cancellation of the cut to the company tax rate.
- Cuts to defence, foreign aid and the public service.

These measures were partly offset by more payments to low and middle income households, including a "school kids bonus", spending on aged care and disability insurance, more skills training, allowing companies to carry back losses and spending on the Pacific Coast highway in NSW.

This is not a good budget for high income earners (given the extra tax on super contributions on top of the means testing of the private health insurance rebate) and large companies. But it is good for welfare recipients and low to middle income earners who will benefit from carbon tax compensation payments and the school kid bonus (totalling nearly $2bn over May and June) and tax cuts from July.

But is the surplus justified?

Budget cutbacks are risky with the economy slowing and there may not be a huge difference economically between running a small deficit in 2012-13 and a small surplus as long as the trend towards a surplus remains in place. However, we think the Government has done the right thing:

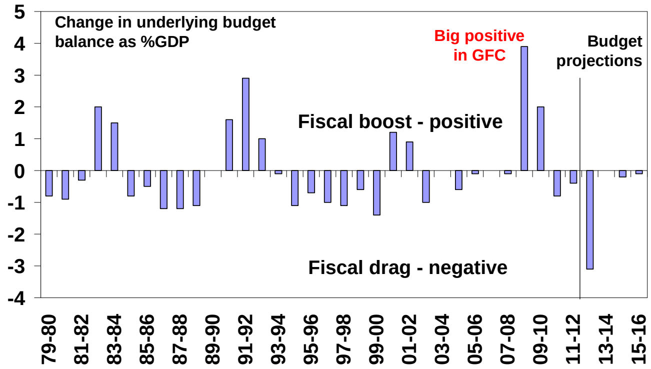
- The economic backdrop is not so bad that we need further fiscal stimulus.
- If we can't get back to surplus when unemployment is 5.2% and commodity prices are high when will we?
- A return to surplus and additional fiscal austerity will add to the scope for the RBA to cut interest rates further.
- Tightening fiscal policy & easing monetary policy is often a dampener for a country's currency and so may help relieve some of the pressure on the Australian dollar.
- A surplus will add to confidence in the minds of foreign investors – who now own 75% of Commonwealth Government bonds - regarding Australia's underlying economic strength at a time when most other countries are still struggling to bring deficits under control.
- It will start to put the public finances back into the position where fiscal policy can provide another bout of stimulus should the global economy take another negative turn

While it's true that fiscal and monetary policies are moving in opposite directions our assessment is that in times of extreme shock to the economy, the heavy gun of fiscal policy should be used to help stabilise the economy. But in times like now when fine tuning is required, its monetary policy that's best placed to do that. The problem in Australia is that interest rates have been too high for too long.

But what will be the economic impact?

The swing from a $44.4bn deficit in 2011-12 to a $1.5bn surplus in 2012-13 will be the biggest fiscal turnaround on record, with $46bn or 3.1% of GDP being taken out of the economy.

Fiscal thrust to be strongly negative in 2012-13



Source: Australian Treasury, AMP Capital

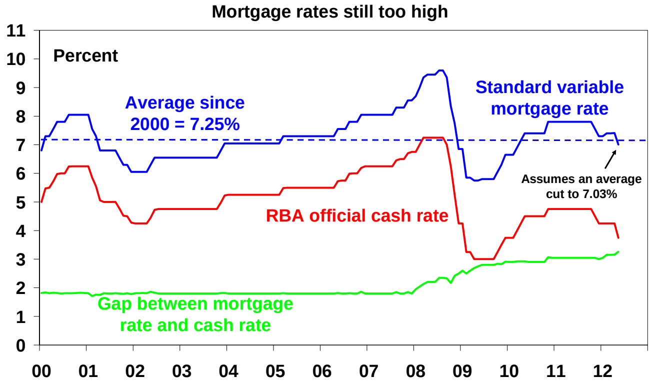
Of course the real contractionary impact on the economy from the Budget won't be this big. The bulk of the turnaround is due to the assumption of stronger economic growth boosting revenues, the loading of spending into May and June exaggerates the economic impact of the turnaround in the budget between this year and next and some of the savings may have little impact on the economy, eg the cut to foreign aid. The actual contractionary impact on the economy is more likely to be around 1% of GDP.

Given this and given recent weak economic data, we regard the Government's growth forecast for 2012-13 of 3.25% as optimistic, but provided interest rates are cut further then 3% growth should be achievable. We also see unemployment coming in around 3.75% compared to the Governments forecast of 3.5% and see inflation (ex the carbon tax) around the same level as the Government's 2.5%.

What does all this mean for interest rates?

There is no precise relationship between changes in fiscal policy and monetary policy. But the scale of the fiscal turnaround and the additional budgetary cuts for 2012-13 and beyond add to the case for lower interest rates. Our assessment is that interest rates are still too high.

Mortgage rates still too high



Assumes ANZ cuts to 7.03% = avg of NAB, CBA & WBC. Source: RBA, AMP

Mortgage rates have now fallen to around 7% which is below their longer term average of 7.25%, but in an environment of household caution the "neutral" mortgage rate has probably fallen to around 6.75%. Normally borrowing rates need to fall below neutral levels to spur a pick up in demand. So with borrowing rates still too high, economic uncertainty likely to persist for several months as unemployment rises, problems in Europe and the US persisting and the budget set to detract from growth (after a short term boost to household finances over the next few months) further interest rate cuts are likely to be required before we start to see a decent and sustainable acceleration in the economy. This will likely take the cash rate down to 3-3.25% by year end and average standard variable mortgage rates down to around 6.5%.

Implications for Australian assets

It's hard to see a major impact on Australian assets.

Cash and term deposits – to the extent the Budget allows the RBA to cut interest rates further it is a negative for returns from cash and bank term deposits.

Bonds – the return to surplus will only enhance Australia's AAA sovereign rating and along with lower interest rates ensure bond yields remain low. The problem of course is that with ten year bond yields at a 61 year low of 3.4% and five year bond yields at just 2.9% it's hard to see great returns from Australian sovereign bonds over the next few years.

Shares – retailing stocks might see a short term boost from payments and tax cuts for low to middle income families (although higher gas and electricity bills will be a counterweight). The real boost from the Budget might come from lower interest rates as high rates have been a drag on Australian shares over the last two years. Shares are vulnerable to a further correction over the next few months (on worries about Europe, a soft patch in US economic data and normal seasonal weakness) but should end the year higher thanks to attractive valuations and falling rates.

Property – property should benefit from lower interest rates and if domestic growth starts to pick up. However, it may not be till later this year before this is evident.

Concluding comments

Obviously there are numerous risks to the Budget. Given the need for the support of independents or the Greens, key aspects of the Budget may not pass through Parliament. Revenue may continue to lag projections. And there could be more global shocks.

The Budget also contains two weaknesses. First, continuously hitting high income earners (flood levy, means testing of private health rebate, doubling of super contributions tax) and large corporates to fill budget holes or finance more welfare spending risks damaging incentive and long term growth. Second, continuously tinkering with superannuation risks damaging faith in it. The last five years have seen short term savings (via bank deposits) surge at the expense of long term savings (via superannuation). This could potentially damage Australia's long term health.

But one thing is clear. Australia's public finances are in good shape and the Government is doing the right thing to make sure they stay that way

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