plain-english economics

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Budget surplus now unlikely

The Commonwealth Government has indicated that the budget surplus previously forecast for the current financial year now appears unlikely. In a statement made in late December, the Treasurer, Mr. Swan, suggested that *"dramatically lower tax revenue now makes it unlikely that there will be a surplus in 2012/13."*

Earlier projections made in the Budget statement last May and again in the Mid-Year Economic and Fiscal Outlook statement in late October suggested that the 4 year string of budget deficits commencing in 2008/09 would end with a return to surplus expected in 2012/13. These projections implied a significant tightening in fiscal policy (i.e. a change policy that has a negative impact on demand in an economy due to higher taxation and / or lower spending by the Government). This was planned to be the most significant change in fiscal policy since 2008/09 when a "loosening" of policy saw the Government expand expenditure in order help lessen the impact of the Global Financial Crisis on the domestic economy.

Source: Treasury 2011/12 Final Budget Outcome. Positive numbers are surpluses and negative numbers are deficits.

With economic growth likely to be lower than expected, improvement in the Government's financial position this financial year has become more difficult. Lower economic growth means there is less income being earned by households and businesses from which to generate taxation. In addition, lower economic growth is often associated with higher unemployment, which places increased social security expenditure obligations on the Government.

In addition to the generally subdued state of the local economy, some weakness in the price of commodities, such as iron ore, over recent months has reduced mining sector profits and thereby lowered company tax receipts.

The Government's taxation exposure to mining company earnings was increased in July last year with the introduction of the Minerals Resource Rent Tax (MRRT). Under the MRRT, iron ore and coal based earnings are subject to a tax of 30% on any extraordinary or "super profits" earned. "Super profits" are defined as those earned when a mining project's profitability exceeds a margin of 7% above the government long term bond interest rate. However, low iron ore prices for the majority of the first six months of this financial year are likely to have significantly constrained MRRT receipts.

Hence rather than responding to lower taxation receipts with further cuts to expenditure (which would represent a further tightening of fiscal policy), the Government has decided that any further measures of spending restraint or tax increase would do too much damage to economic growth and employment. These sentiments were expressed in the following statement made by the Treasurer in December:-

"At this stage I don't think it would be responsible to cut harder or further in 2012-13 to fill a hole in tax system if that puts jobs or growth at risk. While the real economy does remain resilient, I think it now has reached a point where it would be difficult to responsibly offset dramatic revenue downgrades with substantial, short term savings. I think that's the bottom line here - it wouldn't be responsible to continue to make up for the revenue hole if that endangered growth or jobs."

Q1: Explain what has caused the deterioration in the Government's financial position over recent months.

Q2: Why isn't the Government prepared to take measures (e.g. expenditure cuts) to achieve a budget surplus in 2012/13 as previously projected?

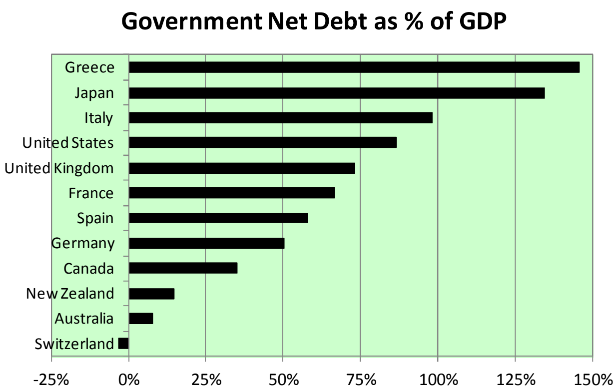
Q3: What was the rationale behind measures to increase Government spending in the 2008/09 and 2009/10 period?

U.S. avoids fiscal cliff for now

Like Australia, the United States (US) has also avoided taking on the full extent of fiscal policy tightening that would be necessary in order to meet previously set targets. In the US, a series of tax increases and spending cuts were due to be introduced at the beginning of 2013. These changes would have changed the US budget position by $US 640 billion or 4% of Gross Domestic Product (i.e. the value of annual production in the U.S. economy). The planned changes to US Government spending and taxation in 2013 were commonly referred to as the "fiscal cliff".

However, in order to prevent a significant detrimental impact on economic growth, US Congress agreed to an initiative to make temporary income tax cuts permanent. In addition, it was also agreed that automatic spending cuts would be delayed for two months, allowing time for additional negotiation. The last minute agreement by Congress has meant that changes in US fiscal policy won't be as significant as previous commitments implied. Even so, there will be some policy tightening taking place. For example, temporary reductions in payroll tax are not being continued, with rates reverting back to higher levels.

In addition to negotiations over planned expenditure cuts over the next two months, US politicians will also be discussing the requirement to lift the Government's debt ceiling (US law precludes the Government from taking on additional borrowings once this ceiling is reached). The current debt ceiling of $US 16.4 trillion has now been reached.



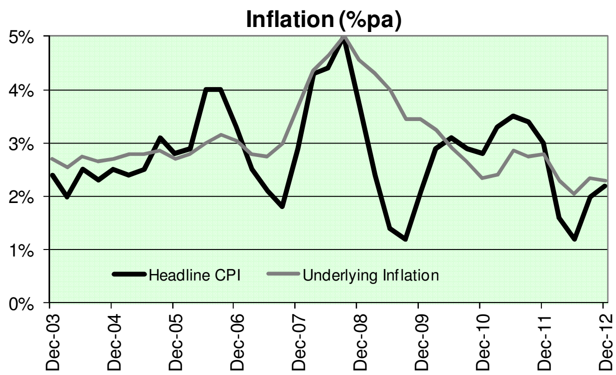
Source: OECD. 2012 Estimates.

The need for the US Government to revisit its debt ceiling is symptomatic of ongoing budget deficits that currently characterise most developed nations. The Global Financial Crisis, and the low rate of economic growth that has followed, has made it difficult for governments to improve budget positions. The chart above shows the net debt levels of various governments expressed as a percentage of GDP. It can be seen that Australia's debt level is minimal in relative terms.

Q4: Why have the governments of the world's major economies continued to run budget deficits despite having high levels of debt?

Inflation remains low

There was minimal inflation in the Australian economy in the final 3 months of 2012 according to the official Consumer Price Index (CPI) measure. The CPI calculates the weighted average level of prices paid by consumers for a fixed basket of goods and services. A small 0.2% increase in the CPI over the December quarter meant that the annual rate of inflation rose marginally from 2.0% to 2.2%.



Source: Australian Bureau of Statistics 6401

One of the contributors to the low quarterly inflation result was a 0.1% fall in food prices. This was impacted by reduced prices for vegetables, where favourable growing and weather conditions boosted supply. Vegetable prices fell by 5.7% over the quarter.

In addition to the drop in food prices, the low rate of inflation is also likely to be indicative of weak demand in the Australian economy. With demand weak, there may be a requirement for local retailers to discount prices in order to maintain sales. Imports, increasingly accessible on-line to consumers and kept cheap by the strong $A, may also be forcing retailers to reduce prices. This price competition may have been apparent in the clothing category, for example, which consists heavily of imports. Over the past year, clothing prices have risen by just 0.6%. Similarly, audio visual and computing equipment, another heavy import orientated category, has recorded a price fall of 14.2% in the last 12 months.

Although the CPI is the predominant measure of inflation, quarterly movements in the Index can be heavily impacted by volatile or "one-off" shifts in prices of specific categories e.g. fruit and vegetables. For this reason, policy makers often review what is known as the "underlying" rate of inflation, using calculations which effectively remove the volatile items from the Index. As at the end of December, measures of "underlying" inflation suggested annual price growth was 2.3%. Hence, underlying inflation is just above the 2.2% unadjusted "headline" CPI annual growth rate.

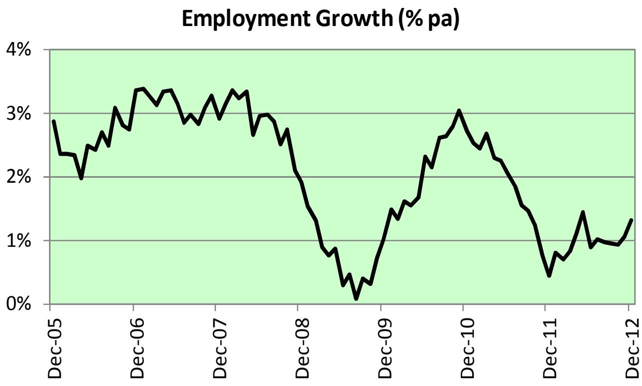
Importantly, underlying inflation has remained well within the Reserve Bank's medium term target range of 2% to 3%. Underlying inflation has been within the target range since mid 2010 after declining from its peak of nearly 5% in September 2008.

Q5: Identify two possible contributors to the maintenance of low inflation in Australia over the past year.

Demand for labour weakens

Indicative of the general weakness in growth throughout the Australian economy has been a low rate of growth in employment. During December, the number of workers employed dropped by 5,500. As a result, the unemployment rate rose from 5.3% to 5.4%.

December's lack of growth in employment represents a continuation of the pattern that has been in place for most of the past two years. The number of workers employed across the economy has grown by an average of just 0.9% per annum over the last 2 years. This is despite the overall adult population continuing to increase at a higher rate than this (approximately 1.6%).

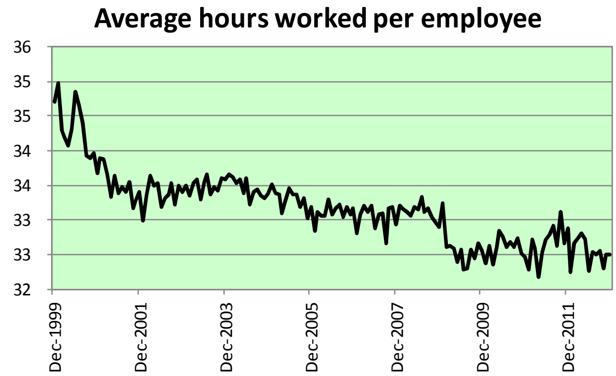


Source: Australian Bureau of Statistics 6202

Due to the lack of growth in employment, the unemployment rate has increased from 4.9% in December 2010 to 5.2% in December 2011 and then to 5.4% last month. A decrease in the participation rate (i.e. the percentage of the adult population that is either employed or looking for employment), from 65.7% to 65.1% over this two year period, has meant that the rise in unemployment has been relatively small.

As can be seen from the chart above, the current lack of growth in employment is in contrast to the conditions that prevailed over 2010 when there was a healthy expansion in the number of workers employed.

In addition to the low rate of growth in the number of workers employed, there has also been a decline in the average hours worked per employee. A 1.2% fall in the average number of hours worked per employee over the past year means there has been virtually no change in the aggregate of hours worked across the economy in the past 12 months. This is reflective of the continued growth in part-time employment and may also indicate that firms are offering less hours to employees due to subdued activity levels.



Source: Australian Bureau of Statistics 6202. (Shows average hours per week).

The overall flattening in employment growth over the last two years is consistent with low rates of growth in many Australian industries. Employment is generally considered to be a "lagging" indicator of economic growth. That is, movements in employment will follow movements in the rate of economic growth. This is because firms often delay making decisions to change employment levels until they perceive the changing economic conditions have a degree of permanency. High costs (e.g. training costs) associated with either increasing or reducing employment are an important factor in creating this "lag".

Although a lagging indicator, the fact that employment growth has slowed significantly over the past two years reduces the prospect that labour shortages will emerge in the future.

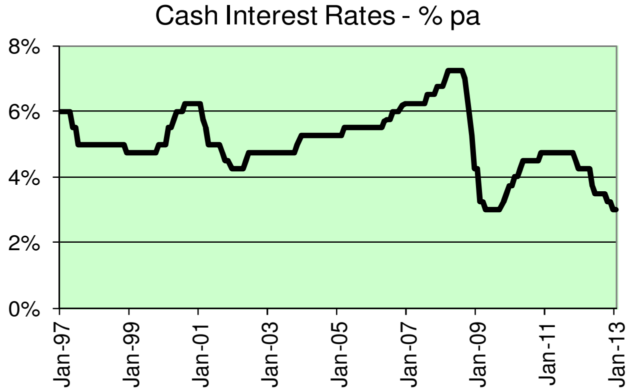
With the reduced prospect of labour shortages, there is less likely to be upward pressure placed on wages and therefore less cost push inflation within the economy.

Q6: Describe how changes in the rate of economic growth would normally affect the level of unemployment.

Q7: What is meant by the term "workforce participation rate"?

Monetary policy eased

The combination of weak employment growth and low inflation has provided an environment that is suitable for the Reserve Bank to ease monetary policy. The primary objective of monetary policy is to achieve an inflation outcome within the target range of 2% to 3% over the medium term. Hence, with underlying inflation near the bottom of the target range, demand weak and little prospect of wages growth being excessive, the Reserve Bank announced in December that it would be lowering the overnight cash interest rate by 0.25% to 3.0%.



Source: Reserve Bank of Australia

The Reserve Bank is able to reduce interest rates by buying Government securities. This increases the supply of cash in the financial system, thereby decreasing the price of cash i.e. the interest rate. This activity by the Reserve Bank to bring about its monetary policy changes is known as Open Market Operations.

By lowering interest rates, the Reserve Bank is attempting to stimulate economic growth. Lower interest rates make it cheaper for individuals and firms to borrow, thereby providing increased incentive for loan funded expenditure. In addition, lower interest rates also provide less incentive for saving, making consumption expenditure more attractive on a relative basis. In this way, an easing in monetary policy can lead to increased spending thereby creating higher economic growth.

December's cut in interest rates extended the program of monetary policy easing that commenced in November 2011 when the cash interest rate was 4.75%. Interest rates have now been reduced to the same level that prevailed in mid 2009 when the monetary policy was eased in order to assist in the management of the Global Financial Crisis.

Whilst the current weak state of spending and employment growth may not be as potentially threatening to future economic growth as was the Global Financial Crisis, the Reserve Bank still saw a need to encourage further demand growth. This is highlighted in the following statement from Reserve Bank Governor, Mr. Stevens, following the December Board meeting:-

"Over the past year, monetary policy has become more accommodative. There are signs of easier conditions starting to have some of the expected effects, though the exchange rate remains higher than might have been expected, given the observed decline in export prices and the weaker global outlook. While the full effects of earlier measures are yet to be observed, the Board judged at today's meeting that a further easing in the stance of monetary policy was appropriate now. This will help to foster sustainable growth in demand and inflation outcomes consistent with the target over time."

During its deliberations over policy settings in early December, the Reserve Bank may have also considered the impact of the expected tightening of fiscal policy given the Government's previous commitment to achieve a surplus in 2012/13. It is possible that the need to accommodate a tighter fiscal policy was one factor that helped justify the additional interest rate cut. Hence the fact that the Treasurer has now announced that additional tax and spending initiatives won't be put in place to achieve a surplus could reduce the need for future interest rate reductions.

Q8: Explain the rationale behind the Reserve Bank's decision to reduce interest rates last December.

Stats on Australia	**Latest**	**Previous Year**
Economic Growth	3.1% (Year to Sep)	2.9%
Inflation	2.2% (Year to Dec)	3.0%
Unemployment	5.4% (Dec)	5.2%
Employment Growth	1.3% (Year to Dec)	0.4%
Wage Price Index	3.7% (Year to Sep)	3.6%
Exchange Rate (TWI)	78.0 (25th Jan)	77.7
Cash Interest Rate	3.0% (Jan)	4.25%
Current Account Deficit	$50.6 bn (Year to Sep)	$32.6 bn
Current Acct (% GDP)	3.4% (Year to Sep)	2.3%
Foreign Debt (% GDP)	50.5% (Sep Qtr)	51.3%

Source: Australian Bureau of Statistics & Reserve Bank