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Global Asset Management

2017/18 Australian Budget: Resetting the narrative

Economic research note

10 May 2017

- In the 2017/18 Australian Commonwealth Budget, the government reset its Budget and economic narrative to focus on "fairness, security and opportunity", updating its view on the need for good debt.
- Major policy initiatives include an increased focus on transport infrastructure, funded by higher debt levels, but also new revenue initiatives, namely a levy on the five largest banks, an increase in the Medicare levy and a levy on foreign workers to pay for focussed spending initiatives on education, healthcare, small businesses and housing affordability.
- The Budget deficit for 2017/18 is estimated at $A29.4bn (1.6% of GDP), down from the 2016/17 deficit – which is now estimated at $A37.6bn, 2.1% of GDP.
- The return to surplus is now in the projections, in 2020/21, at $A7.4bn, 0.4% of GDP, but will of course rely on the new saving and revenue measures being legislated and economic growth returning to trend.
- Government net debt is expected to rise to $A354.9bn, 19.5% of GDP as at June 2018 and then peak at 19.8% of GDP by June 2019 and be $A366.2bn, 17.6% of GDP, as at June 2021.
- This Budget should help reduce some of the near-term pressure on the AAA rating, but ratings agencies will continue to warn of the dangers and the need for fiscal consolidation.
- The economic forecasts in the Budget look conservative and achievable, with real GDP expected to grow by 2.75% in 2017/18, before rising to 3.0% in 2018/19 and beyond.
- The Budget impact on financial markets is expected to be limited apart from the banking sector. The implications for monetary policy are minimal and we continue to expect the RBA to remain on hold at 1.5% well into 2018.

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2017/18 Australian Budget: Resetting the debt narrative

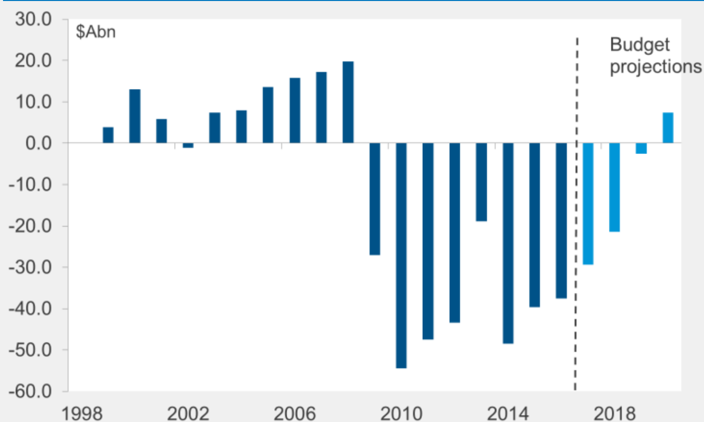
The 2017/18 Commonwealth Budget has been proclaimed by the Federal Government to focus on "**fairness, security and opportunity".** The Government is resetting its Budget and economic narrative, embracing debt to fund infrastructure, using new taxes to fund focussed spending initiatives on jobs, small businesses, health, housing affordability and education, while also addressing the revenue issue evident in recent years. It is worth noting that little has been done on outlay growth, which will average 4.2%/yr over the next four years.

While the overall stance of fiscal policy has tightened marginally, the government has taken the opportunity afforded to it by changing the narrative and the way government debt is recorded to increase direct funding of some (much needed) transport infrastructure projects. This can be viewed as a real positive for the Australian economy and one that has been much needed and called for in recent years.

We see this increased focus on productivity enhancing transport infrastructure, and the use of government debt to fund it, as a positive development and what the economy needs at this point in the cycle.

Overall, the underlying cash deficit for 2017/18 is estimated at $A29.4bn, 1.6% of GDP, down marginally from the now estimated deficit for 2016/17 of $A37.6bn, 2.1% of GDP. As shown in the chart below, the budget deficit is expected to gradually decline towards a small surplus in 2020/21.

Commonwealth Budget surplus/deficit estimates



Source: Commonwealth Treasury, 2017/18 Budget.

With the new focus on separating recurrent versus capital spending, in 2018/19 and the remainder of the forward estimates, cash flow from recurrent activities is expected to be in surplus, which on estimates would be the first time since the GFC. Under the new arrangement to focus on the net operating balance this measure will be expected to be in surplus in 2019/20.

Importantly the government has removed the approximately $A13bn in measures the government could not pass from the 2014/15 Budget, undertaking Budget repair measures instead. This will be seen as a real positive by the credit rating agencies to reset the budget numbers, removing uncertainty and focussing on more realistic numbers going forward. Indeed the Budget papers note "the 2017/18 Budget charts a responsible pathway back to balance."

Key policy initiatives

The key areas of policy announcement in the Budget include:

Infrastructure:

- The budget commits $A70bn from 2013/14 to 2020/21 to fund transport infrastructure across Australia including;
- $A5.3bn for the second Sydney airport through the "Western Sydney Airport Corporation".
- $A8.4bn in funding for the Melbourne to Brisbane Inland Rail.
- An additional $A10bn for a National Rail Program to fund regional and urban rail investments.
- A 50% increase in the generation capacity of the Snowy Hydro Scheme.

Housing Affordability

- First home buyers will be able to build a deposit by contributing up to $A15,000 per year up to a maximum of $A30,000 into superannuation, contributions and earnings can be withdrawn from July 2018.
- Downsizers aged 65 and older will be able to make additional non-concessional contributions to superannuation up to $A300,000 using proceeds from the sale of their primary residence.

- Increase investment in affordable housing by establishing an affordable housing bond aggregator to provide cheaper financing.
- Releasing surplus Commonwealth land, including 127 hectares of Defence land 10km from the Melbourne CBD.
- A 50% cap on foreign investment in new housing developments.
- A housing vacancy tax on foreign investors who leave their properties unoccupied for six months or more each year (existing properties will be grandfathered).
- Foreign property owners will no longer be exempt from capital gain tax on their primary residence.

Foreign workers:

- As earlier announced the 457 visa class will be abolished and replaced with a new “Temporary Skills Shortage visa”.
- Employers who sponsor workers through the new visa will be required to pay a levy of up to $A5,000 per worker to fund apprentices and trainees.

Health:

- A 0.5% increase in the Medicare levy to 2.5% from 1 July 2019, expected to raise $A3.55bn in the first year. The additional revenue will be used to fund the National Disability Insurance Scheme (NDIS).
- The creation of a new Medicare Guarantee Fund to fund the Medicare and Pharmaceutical Benefits Scheme.
- A $A1bn package to unfreeze Medicare rebates for doctor’s visits and medical procedures.
- $A730m for Tasmania’s Mersey Hospital.
- $A1.3bn savings over four years on medicines by encouraging doctors to prescribe generic drugs.

Education:

- An extra $A18.6bn in school funding over the next decade under the Gonski needs-based model; with $A2.2bn of extra funding over the next four years.
- The extra funding will come at the expense of universities, with a 2.5% efficient dividend placed on universities in 2018 and 2019.
- University fees will rise with student contributions increasing 7.5% phased in over 4 years from 2018.
- The income threshold to repay government education loans has been lowered to $A42,000 from $A55,000 while the maximum has been increased to $A119,882 with a repayment rate of 10%.
- From July 2019 all HECS loans will be indexed to CPI instead of Average Weekly Earnings.
- An extra $A428mn for childcare funding.

Company tax:

- A cut in the company tax rate from 30% to 25% for all companies by 2026/27. The cut has already been approved for businesses with annual turnover below $A50m.

Small and medium enterprise:

- The $A20k small business instant asset write-off scheme has been extended for another year. It was due to expire 30 June 2017.

Welfare:

- New integrity measures including stronger financial penalties to persistently non-compliant job seekers and random drug testing.
- New measures to get unemployed persons back to work.
- $A5.5mn anti vax campaign and reduce Family Tax Benefit A for each child who does not meet the immunisation requirement.
- $A260mn one-off energy payment for pensioners, $75 for single pensioners and $125 for couples.

Public sector:

- $A321mn for the Australian Federal Police – 300 extra covert intelligence operators and forensic specialists.

Future Fund:

- Continued to be quarantined until 2026.

Scrapping of zombie 2014 measures:

- Around $A13bn of “zombie” spending cuts from the 2014 budget will be dumped.

Banking

- Productivity Commission inquiry into competition and concentration in banking, data sharing initiative.
- Introduction of a major bank levy of 0.06% of liabilities on banks with liabilities greater than $A100bn to raise around $A1.5bn each year, this will impact the big 4 and Macquarie.

Foreign aid

- Foreign aid will be frozen for two years from 2018, saving $A303m.

The key Budget numbers

The Budget forecasts an underlying cash deficit for 2017/18 of $A29.4bn, 1.6% of GDP, slightly higher than market expectations of around $A28bn. It is down from $A37.6bn in 2016/17, 2.1% of GDP. In the out-years the budget deficit will shrink to $A21.4bn, 1.1% of GDP in 2018/19, before a larger reduction to a deficit of $A2.5bn, 0.1% of GDP in 2019/20 with the increase in Medicare levy on 1 July 2019 before the forecast return to surplus in 2020/21 at $A7.4bn, 0.4% of GDP.

For 2017/18, total revenue is projected to increase by 6.9%/yr, up to 23.8% of GDP from a now-estimated 23.2% in 2016/17 (original budget estimate was 23.9% of GDP). This Budget has addressed the weakness in the revenue side of the Budget, through the introduction of a number of new measures, to a total of $A11.9bn over four years to 2019/20 through the increase in the Medicare Levy, bank levy and the new Skilling Australians Fund levy. These gains though have been partially offset (-$A5.5bn) by lower forecasts for income taxes, superannuation taxes and GST revenue.

By 2020/21, total revenue is expected to increase further to 25.4% of GDP, which will be the highest since 2005/06, when the Budget was in heavy surplus territory at $A15.8bn, 1.6% of GDP. Revenue growth increases by 7.4%/yr in 2019/20 on the increase of the Medicare Levy, the timing of this does help return the surplus to Budget in 2020/21.

Outlays by the government in the 2017/18 year are projected to rise by 4.4%/yr, following on from an increase of 4.1%/yr in 2016/17. Outlay growth still averages 4.2%/yr in the four years to 2020/21 with the focus on education and health.

For 2017/18, total spending as a share of GDP is estimated at 25.2% of GDP, from 25.1% of GDP in 2016/17 (originally estimated at 25.8% of GDP).

By 2020/21, total outlays are expected to decline to 25.0% of GDP. The following table provides further details.

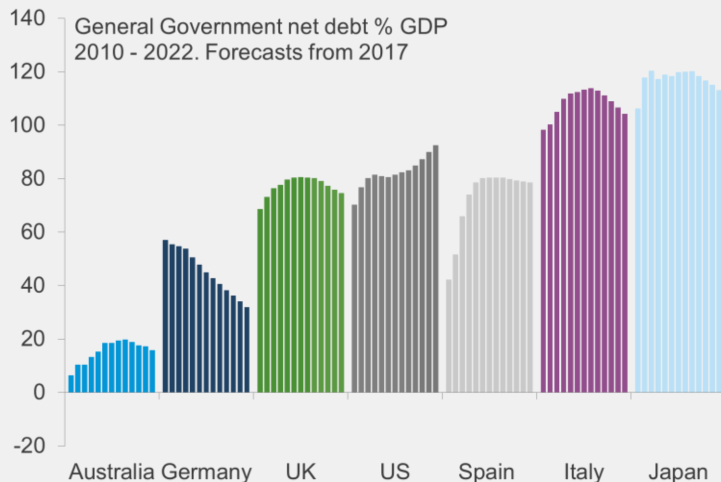
Federal Budget numbers

$Abn	2016/17 Budget	2016/17 Latest	2017/18 Budget	2018/19 Budget	2019/20 Budget	2020/21 Budget
Revenue	411.3	405.7	433.5	462.5	496.9	526.3
% GDP	23.9	23.2	23.8	24.4	25.1	25.4
Outlays	445.0	440.5	459.7	480.4	495.6	518.9
% GDP	25.8	25.1	25.2	25.4	25.0	25.0
Underlying balance	-37.1	-37.6	-29.4	-21.4	-2.5	7.4
% GDP	-2.2	-2.1	-1.6	-1.1	-0.1	0.4
Net debt	326.0	325.1	354.9	375.1	374.7	366.2
% GDP	18.9	18.6	19.5	19.8	18.9	17.6

Source: 2017/18 Commonwealth Budget.

The Budget estimates that Australia’s net government debt will rise to $A354.9, 19.5% of GDP at 30 June 2018 and peak at 19.8% of GDP in 2018/19 and fall to 17.6%, $A366.2bn at 30 June 2021 before declining in the medium term to 8.5% of GDP in 2027/28.

Australian and OECD major nations net debt



Source: Commonwealth Treasury, 2017/18 Budget. IMF, April 2017

At the time of writing, there has been limited news flow from the rating agencies. Moody's has commented broadly, noting that Australia's fiscal strength is very high and supportive of the Aaa rating and there is nothing particularly worrying about the Budget. Fitch still needs to make an assessment of the broader budget impact. S&P has yet to comment but has forewarned that they may not comment on Budget night and nothing should be interpreted from the lack of immediate comments. In July 2016 S&P placed Australia's AAA rating on negative outlook and is therefore the agency that we and the markets will be focussed on.

The credit rating agencies continue to warn that the fiscal consolidation path and the management of debt must remain a priority if the AAA/Aaa credit rating is to remain in place over the medium-term. The good news from this Budget is the removal of the zombie savings measures from 2014 which were not able to be passed through the Parliament, the improvement in the revenue side of the Australian Budget and the forecast of the return to surplus in 2020/21. Crucially the agencies will watch the ability of the government to pass these budget measures and the economic performance versus the economic forecasts contained in this Budget. Labor has already committed to passing the bank levy, one positive for the government already.

The Budget and the economy

In general, **the economic forecasts in the Budget are relatively conservative and achievable**, with the exception of wages growth which is expected to rapidly increase over the forecast horizon, and given the current soft state of the labour market could be a stretch too far.

GDP growth for 2017/18 is forecast at 2.75%/yr, an improvement from the growth rate of 1.75% now expected for 2016/17. In the years ahead economic growth is forecast to return back towards trend at 3.0%/yr till 2020/21. This is largely in line with market expectations. Growth is expected to be driven by household consumption, net exports, public investment and a reduction in the drag from business investment.

Inflation is forecast to remain at the bottom of the RBA's target band for 2017/18 at 2.0%/yr. It is then expected to increase towards the centre of the target range to 2.5%/yr by 2019/20. Again, this is largely in line with market estimates.

The unemployment rate is expected to decline to 5.75% in 2017/18, slightly down from the current 5.9%. It is then expected to gradually decline to 5.25% by 2020/21. Wages are expected to increase from 1.9%/yr currently to 2.0% in 2017/18 and gradually increase towards 3.75%/yr by 2020/21, almost double the current rate. This forecast is likely too optimistic and could lead to a miss on projected income tax revenues and household consumption forecasts.

On the trade side, the current account deficit is forecast to widen slightly to -1.5% in 2017/18 from -0.9% in Q4 16, before increasing to -2% by 2018/19. This is a relatively conservative estimate given the expectation of the first current account surplus in Q1 17.

Other key indicators on the economy to show the expected end of the mining investment downturn with investment forecast to decline by only -3%/yr by 2018/19. Dwelling investment is also expected to gradually decline from 10.6%/yr in 2015/16 to 1.5%/yr by 2017/18 and eventually a drag on growth at -4%/yr by 2018/19.

One concern is the expectations of rising household consumption appears to be underpinned by a forecast decline in the household savings ratio from 5.2% to approx. 3.5%. This could likely lead to household consumption being weaker than forecast.

Iron ore prices are expected to remain around US$66/mt over Q3 17 and Q4 17 before declining to US$55/mt by March 2018. Given recent moves, these forecasts may be slightly optimistic. Metallurgical coal prices are similarly expected to gradually decline from US200/mt to US$120/mt by March 2018.

The following table provides details:

Australian economic forecasts

%yr	Est. 16/17	F/c 17/18	F/c 18/19	F/c 19/20	F/c 20/21
Real GDP	1.75	2.75	3.0	3.0	3.0
Nominal GDP	6.0	4.0	4.0	4.5	4.75
GNE	1.75	2.5	2.75	-	-
Net exports % cont.	0.5	0.5	0.25	-	-
Terms of trade	16.5	-2.75	-4.25	-	-
Current acc. % GDP	-1.5	-1.5	-2	-	-
Business investment	-6.0	0.0	3.0	-	-
Unemployment rate %	5.75	5.75	5.5	5.5	5.25
CPI	2.0	2.0	2.25	2.5	2.5
Wages	2	2.5	3	3.5	3.75

Source: Commonwealth Treasury Budget Paper No.1 2017/18.

The Budget and the markets:

The bond market

For the bond market, the Budget is unlikely to have a significant impact with an incremental path back to surplus over the coming four years that is not significantly different from MYEFO.

In terms of debt/bond issuance, the Australian Office of Financial Management (AOFM) has noted that Gross Treasury Bond issuance in 2017/18 is expected to be around $A80bn. After accounting for maturities of $A31bn and buybacks of around $A15bn of Treasury Bonds maturing in future financial years, this represents net issuance of $A34bn.

This will be accounted for by $A75bn in Treasury bond sales and another $A5bn in Inflation-Linked bonds.

The Budget estimates that the face value of total CGS on issue is projected to rise to $A540bn in 2017/18 to $A606bn by the end of the forward estimates. Gross debt is projected to continue to rise to around $A725bn by 2027/28.

One key element for the bond market will be the AAA rating. This has been on negative outlook with S&P since July 2016. While the government has stated they aim to keep the AAA there is expected to be little downside to bond yields if the AAA is lost.

Monetary Policy implications

The 2017/18 Commonwealth Budget is unlikely to have a significant impact on the monetary policy outlook. The RBA is likely to welcome the greater commitment to infrastructure investment – as long as the projects serve to support productivity in the economy.

As detailed following last week's RBA Board meeting, our view remains that the RBA will hold monetary policy steady at 1.5% well into 2018. This outlook is based on the view that the RBA will continue to believe that a balanced approach is required for i) on-target inflation, ii) softness in the labour market and iii) strength in the residential property market on the east-coast.

The equity market

If the Budget focus on infrastructure, jobs, growth and productivity bears fruit, then this should be supportive for the equity market. Over time, the renewed focus on infrastructure investment could lift potential economic growth in Australia, helping support the equity market. This Budget recommits the plan to cut the corporate tax rate for all companies to 25% by 2026/27, keeping Australian companies competitive in an environment where corporate tax rates are falling. Currently this is only legislated for companies with a turnover under $A50mn so if the legislation is passed, it will be a positive driver of equity markets.

There are some clear sector specific consequences from the Budget, with the Banking sector the hardest hit with the introduction of a 0.06% bank levy from 1 July 2017, although rumours of the new bank levy did see bank share prices fall ahead of the Budget release.

Increased transport infrastructure lend should support a range of sectors including building materials, transport, developers and contractors, some support for first home buyers and affordable housing should also support these sectors.

Changes to healthcare, particularly lifting the freeze on Medicare rebates for doctors and medical procedures could also be supportive for the sector.

The Australian dollar

The Budget has had a minimal impact on the Australian dollar, with some initial weakness on the release but then recovery after. In terms of the credit rating, it seems at this stage this Budget does enough to maintain the AAA rating, despite the increase in net debt and Commonwealth Government Securities on issue.

More importantly for the outlook, the real influence for the remainder of 2017 is likely to come from offshore factors. Delays are now expected to US Dollar strength in 2017, due to push back in President Trump's fiscal stimulus plans, which may now not be legislated until early 2018 given the renewed focus on Healthcare with legislation passed in the House of Representatives this week. The Senate is now expected to take its turn at the legislation, delaying focus on tax reform. Also two further rate rises are expected by the US Federal Reserve this year by us, and this is now well priced in financial markets with limited USD strength expected on these announcements.

On the local front, a better-than-expected external trade position Australia is currently enjoying, with the lowest Current Account Deficit in 40 years, and potential Current Account Surplus on the cards, are likely to mean that the AUD/USD exchange rate will remain around current levels into end 2017.

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