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A message from Peter Munckton:
Chief Economics & Head of Market Strategy

Summary

- A Budget deficit of around $37b is expected for the next financial year, around the same as for this year;
- The Budget is likely to end up being a small plus for the economy next financial year;
- Company tax cuts and infrastructure spending should help boost investment.

Risks to key financial market variables.

Variable	Direction of risk 6 months	Comment
Cash rate	↓	Everyone has been worried about the economy, but that has been better than generally expected. It was the low inflation point in April that led the RBA to move. And the inflation risks means they are probably not done yet.
90-day bank bills	↓	Bill rates are currently about right given the near-term risks for the cash rate. As we progress through the year, bill yields are likely to decline as the cash rate is reduced further.
3-year swap	↓	Financial markets have fully priced in one more 25bp rate cut by year-end. A pickup in global risk aversion would see markets think about even further cuts.
5-year swap	↓	Any renewed concern will see another leg down in longer-term swap yields. Renewed speculation about an imminent rate hike by the Fed would be the most likely cause.
AUS/USD	↓	The $A fell sharply as markets moved to price in the interest rate cut over the past week. But the level of the $A is only around where it was at the end of March. A bigger fall in the currency will take a decline in commodity prices, as well as some further narrowing in interest rate differentials with major overseas economies.

Show me the money

Budget nights are always big news. After all, they influence how much money we have to spend and what goods and services we get provided (such as schools and healthcare). Every year we get a list of Budget ‘winners’ and ‘losers’, those that either get more money (either directly in the pocket or in kind) or those that are likely to get less. In this Budget there is more money for schools, as well as health (dental and hospitals). There is greater spending to help the youth unemployed. The headline budget deficit for the next financial year is expected to be a bit under $40b (about 2.2% of GDP), around what was expected. While a surplus is projected for 2021, forecasted surpluses have had a history of vanishing in recent years. The economic forecasts look reasonable (for both GDP and the CPI), although the risk to the commodity price projections are to the downside. It is again possible that the budget deficit ends up being larger than projected, as has happened regularly in recent years.

This Budget does earn some economic brownie points. We live in a world where there is some uncertainty about economic growth, and interest rates are very low (particularly for governments) as highlighted by today’s RBA rate cut decision. We are also in an economy where there is discussion about improving infrastructure, not the least to help improve the productive potential of the economy. Government debt is also low. All this suggests that Governments should be spending more on infrastructure investment. The state governments that have the most fiscal wiggle room (NSW and Victoria) are likely to be doing the most spending on infrastructure in coming years. The federal Budget announcement that it will be tipping in to help support infrastructure projects is therefore a plus.

Ideally, the economy would also like to see a boost of investment by the non-mining business sector, particularly given the looming slowing of residential construction activity and the ongoing decline in mining capex. The budget should help this happen, with the extension of the company tax cut as well as the depreciation allowances to firms up to $10m turnover (previously $2m). Ideally, all firms would receive the same tax treatment (otherwise there is a disincentive to become big enough to pay more tax). But given the federal government is hardly awash with cash at the moment, giving the incentives to smaller companies gets the maximum economic bang for buck given they are more likely to be cash constrained.

To keep the deficit under control, taxes have gone up to pay for the extra goodies. It helps that each of the major tax rises will likely receive bipartisan political support. It will be interesting to see how much tax each of these initiatives ends up raising, notably the new tax on multinationals. There are also some spending cuts, including a further ‘efficiency dividend’ from the public service. Today’s Budget is likely to mean that fiscal policy will make a (small) contribution to economic growth. That contribution will partially come from taking money from those that are more likely to save (high income earners and big companies) and give money to smaller companies and lower income earners who are more likely to spend.

But some of the important big picture fiscal questions remain:

- Improvements in the tax structure have only been partially addressed in this budget. The proportion of tax the government in Australia receives from income is amongst the largest of developed countries, and the company tax rate is relatively high compared to the rate in many countries. The Government would say that the cut in small company tax rates is the first instalment of a general move lower in company tax. Indeed, the budget notes its 'aspirations' to reduce company tax more generally over time. The government would also point to the changes made in income tax rates (raising those subject to the second top tax bracket from $80,000 to $87,000). But more reform still needs to be done to improve the efficiency of the tax system. And the reform needs to get done while getting political agreement to tackle the size of the fiscal deficit;
- Budget deficits in recent years have been partially run to help support the economy. But the weaker (nominal) economy also causes budget deficits (eg, slower income and profit growth reduces taxes). My take on IMF estimates is that around 20-25% of the budget deficit of the past couple of years can be explained by the economy's weak income growth. But while the deficits now and in recent years are not a big worry, longer-term challenges remain. An aging population means higher health costs. And some of the fiscal presents we gave ourselves during the mining boom good times are now looking extravagant.
- Difficult structural fiscal problems were never going to be fully addressed in a pre-election Budget. But they will need to be an important part of the future economic debate. In fairness, that debate has started over the past year as to whether the reduction in the budget deficit should be done via lower spending or higher taxes. Of course, the end result will be some combination of both. So the debate will be as much around what the community expects the future size of the Government in the economy to be.

The Budget news was big as always, although getting all the answers to the long-term fiscal challenge remains. An old riddle is, what is always coming but never arrives? Tomorrow is the answer. Hopefully the answer never becomes solving our long-term fiscal challenges.

We live in interesting times.

Key forecasts

Variable	29 Feb	7 Mar	End Jun 2016	End Dec 2016	End Jun 2017
Cash rate	2.00%	1.75%	1.50%	1.50%	1.50%
90-day bank bills	2.28%	2.20%	1.75%	1.75%	1.75%
3-year swap	2.14%	1.94%	1.80%	1.80%	2.00%
5-year swap	2.38%	2.24%	2.00%	2.10%	2.40%
AUD/USD	0.7637	0.7605	0.65	0.65	0.65

Pricing as at 4:30pm, 3 May 2016

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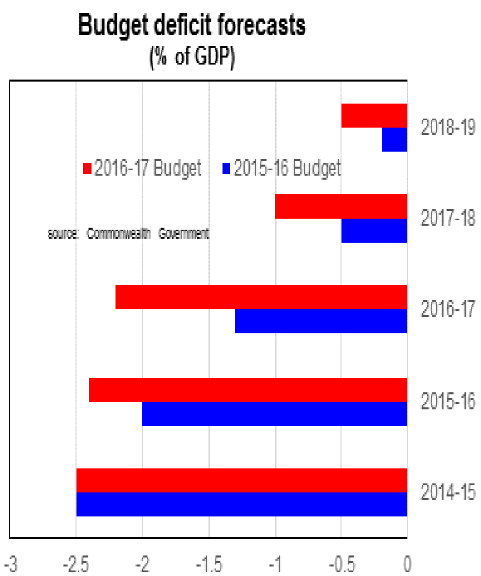
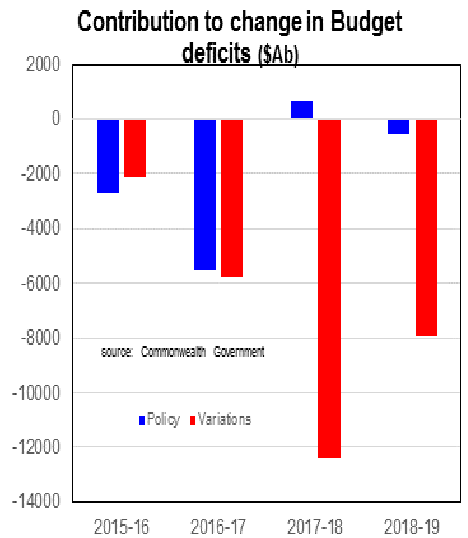
Key economic charts of last week

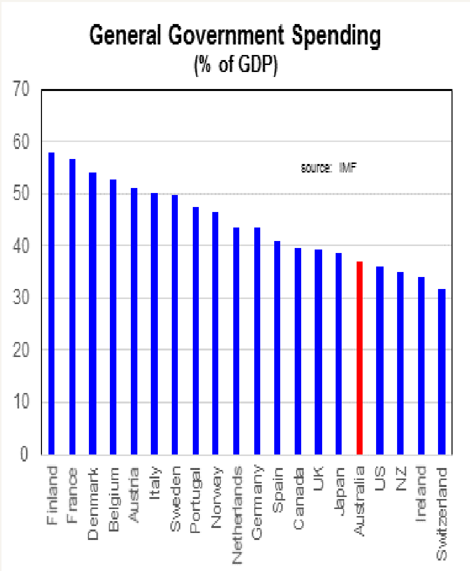
Projected deficits have widened since the last Budget.



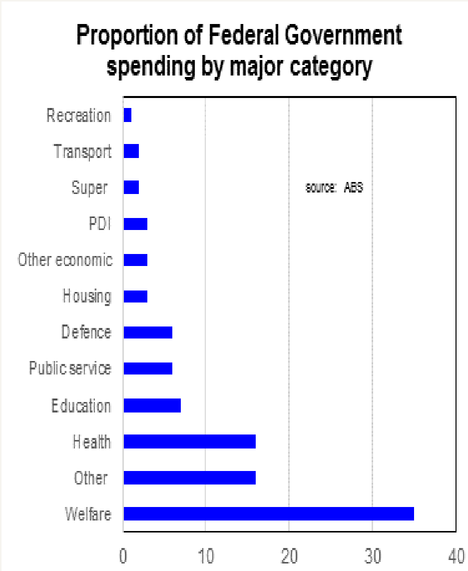
For the next two financial years policy and the economy are equally responsible for the change in deficit forecasts: thereafter it's the economy.



Government spending is a smaller part of the Australian economy than most other developed countries.



Welfare spending is the category where most dollars are directed.



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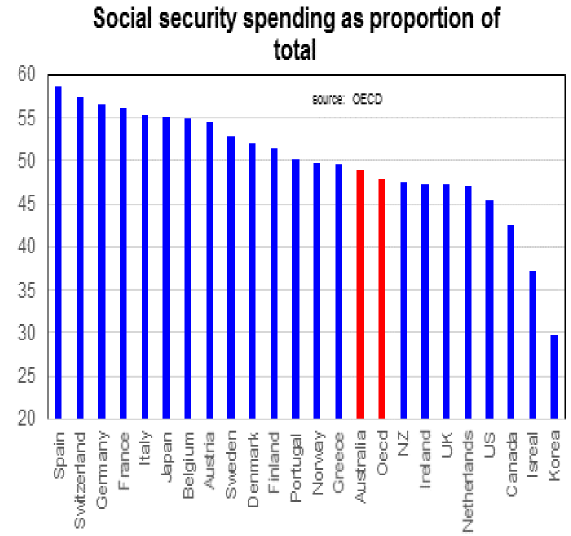
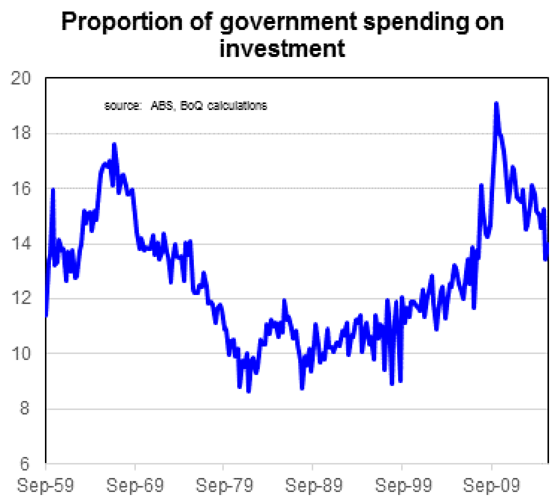
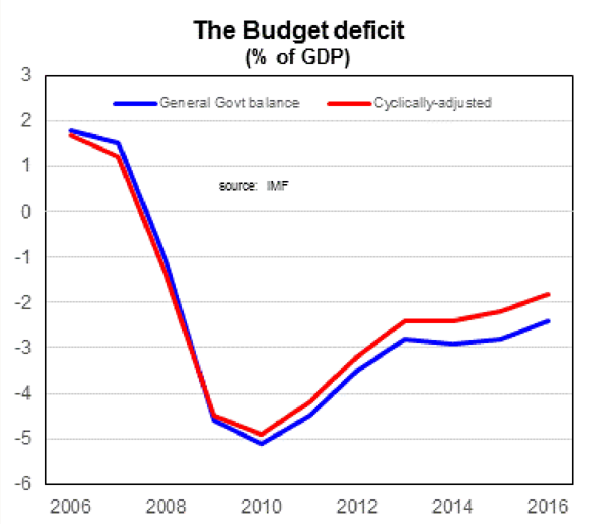
The proportion of money the federal government spends on welfare is around the OECD average.



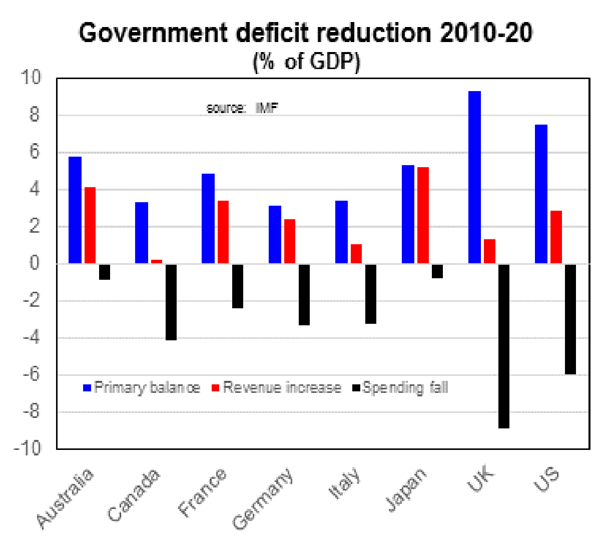
Government spending on investment has become less important recently, one impact of the end of the mining boom.



The size of the budget deficit can be partially explained by the state of the economy.



Australia is projecting a relatively large deficit consolidation task by global standards.



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