

PRE-ELECTION ECONOMIC AND FISCAL OUTLOOK

OVERVIEW

The Australian economy is expected to grow by 3 per cent in 2010-11 and 3¾ per cent in 2011-12, although there are substantial downside risks to the world economic outlook.

The underlying cash and fiscal balances are projected to remain in deficit in 2010-11 and 2011-12, returning to surplus from 2012-13. Table 1 provides revised estimates and projections of the underlying cash and fiscal balances for the period from 2010-11 to 2013-14.

Table 1: Summary of budget aggregates

	Estimates		Projections	
	2010-11	2011-12	2012-13	2013-14
Underlying cash balance (\$b)(a)	-40.7	-10.4	3.5	4.5
Per cent of GDP	-2.9	-0.7	0.2	0.3
Fiscal balance (\$b)	-39.4	-8.7	5.1	6.1
Per cent of GDP	-2.8	-0.6	0.3	0.4

(a) Excludes expected Future Fund earnings.

ECONOMIC OUTLOOK

The Australian economy is expected to grow by 3 per cent in 2010-11 and 3¾ per cent in 2011-12, returning to around full capacity over the next year. Fiscal and monetary stimulus is being withdrawn and there are early signs that private sector activity is picking up, although the transition to private sector led activity is proving to be a little slower than expected. Business investment – particularly mining investment – and exports are expected to strengthen over 2010-11 and 2011-12, driven by a substantial boost in the terms of trade and ongoing strong demand for Australian non-rural commodities.

The global economy is continuing to recover although the pace of growth remains uneven, with emerging economies, particularly in Asia, growing much more strongly than advanced economies. The world economy is expected to grow by 4½ per cent in 2010 and 4 per cent in 2011. There are substantial downside risks to the global outlook, including the European sovereign debt crisis, uncertainty over whether the US recovery will gain traction, the challenge in China of addressing overheating and the difficulty across the advanced economies in managing fiscal consolidation in a fragile global environment. The renewed global uncertainty is weighing on financial markets and business confidence.

Despite the heightened global uncertainty, robust growth in the Asian region is expected to continue to generate strong demand and high prices for non-rural commodities. The terms of trade are forecast to increase by 17 per cent in 2010-11, to around record levels, before declining in 2011-12. In line with this, nominal GDP is forecast to grow by 9¼ per cent in 2010-11 and 5¼ per cent in 2011-12, providing a substantial boost to incomes. There are substantial risks around the future profile of the terms of trade, with considerable short-term volatility in spot commodity prices and uncertainty about the timing, pace and extent of their decline as increased global supply capacity comes on line (Box 1).

Employment is expected to grow strongly, with the unemployment rate declining to 4¾ per cent in late 2011-12, around its full-employment level. Inflation is forecast to be 2¾ per cent through the year to the June quarter in both 2011 and 2012. Inflationary risks are on the upside, with the labour market reaching full capacity over the next year and the strong incomes boost from the terms of trade expected to see demand increasingly stretch the economy's supply capacity.

Table 2 presents the major economic parameters used in preparing the Pre-Election Economic and Fiscal Outlook 2010 (PEFO). The PEFO and the Economic Statement are based on the same forecast assumptions and projection methodology.

Table 2: Major economic parameters^{(a) (b)}

	Forecasts		Projections	
	2010-11	2011-12	2012-13	2013-14
Real GDP	3	3 3/4	3	3
Employment	2 1/4	2	1 1/2	1 1/2
Unemployment rate	5	4 3/4	5	5
Consumer Price Index	2 3/4	2 3/4	2 1/2	2 1/2
Nominal GDP	9 1/4	5 1/4	5 1/4	5 1/4

(a) Real and nominal GDP are year-average growth. Employment and the Consumer Price Index are through-the-year growth to the June quarter. The unemployment rate is the rate in the June quarter.

(b) The parameters for 2010-11 and 2011-12 are forecasts and those for 2012-13 and 2013-14 are projections.

Source: ABS cat. nos. 5206.0, 6202.0, 6401.0 and 6345.0, Treasury.

Box 1: The terms of trade

As in the Economic Statement, the terms of trade are forecast to rise by 17 per cent in 2010-11, underpinned by substantial increases in the contract prices of Australia's commodity exports, including iron ore and coal. The terms of trade are forecast to fall by 4½ per cent in 2011-12, a little more than at Budget, as increased global supply capacity starts to weigh on prices of some commodities.

The 17 per cent rise in the terms of trade for 2010-11 is an upward revision from the 14¼ per cent rise forecast at Budget.

The Budget estimates for the terms of trade discounted the sharp and unsustainable run-up in spot prices of some commodities, particularly iron ore. A sharp fall in the iron ore spot price was anticipated and factored into the forecasts.

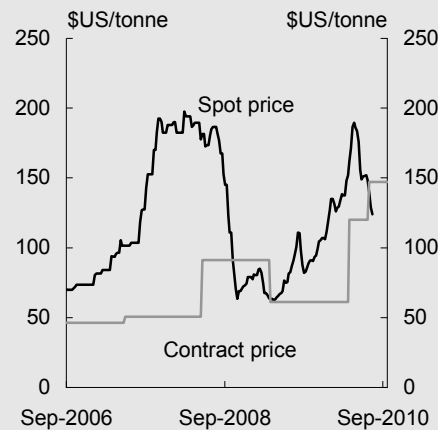
The Budget forecasts assumed that contract prices for bulk commodities would increase substantially – as they have done – but that the increases for iron ore prices would be substantially less than suggested by the prevailing spot prices.

Historically there have been wide divergences between spot prices of bulk commodities at any point in time and contract prices that are subsequently negotiated. These divergences will narrow under the new contracting arrangements for iron ore and metallurgical coal, but they can still be substantial (Chart A).

The Budget estimates were conservative, reflecting the volatility in prices and uncertainty about where they may settle. Subsequent information from industry sources suggested that the estimates for iron ore prices were too low, movements in spot prices notwithstanding, and the current forecasts have been revised accordingly.

The current forecasts are broadly consistent with current spot prices for the bulk commodities, although iron ore spot prices are lower than expected. However, market analysts suggest that part of the reason for this is the seasonal pattern of Chinese demand, which is expected to rebound later in the year when Chinese steel mills look to rebuild iron ore stocks.

Chart A: Iron ore (fines) spot and contract price



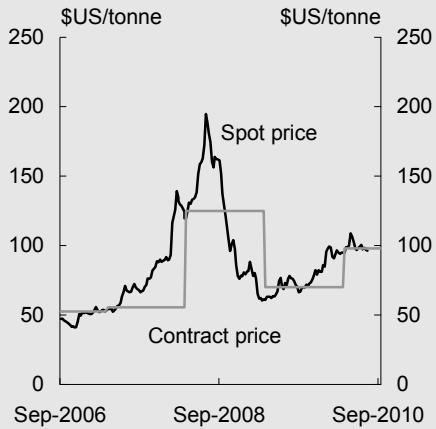
Note: The September quarter 2010 contract price estimate is based on estimates by market analysts. The iron ore spot price includes freight but the contract price does not.
Source: Bloomberg and ABARE.

Box 1: The terms of trade (continued)

Attempts by Indian authorities to limit the sale of iron ore to foreign markets may also provide support for iron ore prices.

Thermal coal and metallurgical coal contract price forecasts are consistent with current spot prices (Chart B).

Chart B: Thermal coal spot and contract price



Source: Global Coal and ABARE.

The medium-term outlook for the terms of trade, and for the commodity prices which underpin them, is uncertain. Empirical evidence produced by the International Monetary Fund suggests that commodity price shocks are typically persistent and that there are often no well-defined, time-invariant averages to which commodity prices return.

There is broad agreement that current high levels of prices are unsustainable and that a supply response will see commodity prices decline to more normal levels over the medium term, but the timing and extent of the expected decline is uncertain.

FISCAL OUTLOOK

An underlying cash deficit of \$40.7 billion (or 2.9 per cent of GDP) is estimated for 2010-11. A fiscal deficit of \$39.4 billion (or 2.8 per cent of GDP) is estimated for 2010-11. The fiscal outlook is for a continuing reduction of underlying cash and fiscal deficits until a forecast return to surplus from 2012-13. This is consistent with the outlook published in the 2010-11 Budget and the Economic Statement.

Table 3 provides a summary of the major budget aggregates.

Table 3: Australian Government general government sector budget aggregates

	Estimates		Projections	
	2010-11	2011-12	2012-13	2013-14
Revenue (\$b)	321.8	358.1	383.0	404.9
Per cent of GDP	22.7	24.0	24.4	24.4
Expenses (\$b)	354.1	362.7	378.8	395.7
Per cent of GDP	25.0	24.3	24.1	23.9
Net operating balance (\$b)	-32.3	-4.6	4.2	9.2
Net capital investment (\$b)	7.1	4.1	-0.9	3.1
Fiscal balance (\$b)	-39.4	-8.7	5.1	6.1
Per cent of GDP	-2.8	-0.6	0.3	0.4
Underlying cash balance (\$b)(a)	-40.7	-10.4	3.5	4.5
Per cent of GDP	-2.9	-0.7	0.2	0.3
<i>Memorandum item:</i>				
Headline cash balance (\$b)	-49.2	-12.6	0.1	3.3

(a) Excludes expected Future Fund earnings.

Underlying cash balance estimates

Policy decisions taken after the 2010-11 Budget and up to the Economic Statement reduced the underlying cash balance by \$132 million in 2010-11 and by \$5.6 billion over the forward estimates (including \$7.5 billion from changes to the resource tax arrangements).

Policy decisions reported in the PEFO have increased the underlying cash balance by \$24 million in 2010-11 and reduced the underlying cash balance by \$40 million over the forward estimates. This \$40 million reduction includes payments of \$51 million that relate to a decision taken by the Department of Health and Ageing (under delegation from the Minister of Health and Ageing) to list new, and extensions to, medicines on the Pharmaceutical Benefits Scheme (PBS) from 1 August 2010. This policy decision reduces the underlying cash balance by \$51 million over the forward estimates. This decision was taken early in July, and notified to the Department of Finance and Deregulation after the finalisation of the Economic Statement.

Between the 2010-11 Budget and the Economic Statement, parameter and other variations were expected to have a total positive impact on the underlying cash balance of \$10.5 billion over the four years to 2013-14, including \$538 million in

2010-11. Since the Economic Statement, parameter and other variations are expected to reduce the underlying cash balance by \$362 million in 2010-11 and by \$528 million over the four years to 2013-14. These variations are described in more detail below.

Table 4 provides a reconciliation of the underlying cash balance estimates between the 2010-11 Budget, the Economic Statement and the 2010 PEFO.

Table 4: Reconciliation of 2010-11 Budget, Economic Statement and 2010 PEFO underlying cash balance estimates

	Estimates		Projections	
	2010-11 \$m	2011-12 \$m	2012-13 \$m	2013-14 \$m
2010-11 Budget underlying cash balance(a)	-40,756	-13,045	1,016	5,432
Per cent of GDP	-2.9	-0.9	0.1	0.3
Changes from 2010-11 Budget to 2010 ES				
Effect of policy decisions(b)	-132	196	-310	-5,377
Effect of parameter and other variations(c)	538	2,808	2,428	4,748
Total variations	405	3,004	2,118	-629
2010 ES underlying cash balance(a)	-40,351	-10,041	3,134	4,803
Per cent of GDP	-2.8	-0.7	0.2	0.3
Changes from 2010 ES to 2010 PEFO				
Effect of policy decisions(b)	24	-61	1	-4
Effect of parameter and other variations(c)	-362	-282	368	-253
Total variations	-337	-343	369	-257
2010 PEFO underlying cash balance(a)	-40,689	-10,384	3,503	4,546
Per cent of GDP	-2.9	-0.7	0.2	0.3

(a) Excludes expected Future Fund earnings.

(b) Excludes secondary impacts on public debt interest of policy decisions and offsets from the contingency reserve for decisions taken.

(c) Includes contingency reserve offsets to policy decisions.

Fiscal balance estimates

The impact of policy decisions on the fiscal balance is similar to that on the underlying cash balance. Further detail of all policy decisions taken since the 2010-11 Budget and up to the commencement of the caretaker period on 19 July 2010 is provided at Appendix B.

Between the 2010-11 Budget and the Economic Statement, parameter and other variations resulted in taxation revenue estimates being revised upwards by around \$150 million in 2010-11 and by around \$7.5 billion over the four years to 2013-14. A stronger outlook for commodity prices was reflected in expected stronger tax revenues on resource rents and company profits, offset in part by downward revisions in consumption taxes associated with the weaker consumption outlook.

Since the Economic Statement, updated information in regard to 2009-10 outcomes has led to taxation revenue estimates being revised downwards by around \$300 million in

each year of the forward estimates. The lower than previously anticipated collections relate to individuals' income taxes and GST.

Non-tax revenue estimates for 2010-11 were largely unchanged between the 2010-11 Budget and the Economic Statement. Since then non-tax revenue has been revised downward, largely reflecting an expected fall in fee revenue from the Guarantee Scheme for large Deposits and Wholesale Funding of \$120 million in 2010-11 (\$256 million over four years) owing to lower than anticipated outstanding guaranteed liabilities. For 2012-13 and 2013-14, the Reserve Bank of Australia (RBA) dividend estimates have increased by \$717 million. This primarily reflects the impact of a smaller anticipated valuation loss in 2009-10 stemming from exchange rate movements, which is expected to enable the RBA to resume dividend payments a year earlier than anticipated at the time of the 2010-11 Budget.

Between the 2010-11 Budget and the Economic Statement, parameter and other variations reduced the estimates of expenses for 2010-11 and across the forward estimates. In 2010-11, this primarily reflects:

- a reduction in GST payments to the States and Territories (consistent with the forecast reduction in GST collections) of \$1.0 billion (\$3.0 billion over four years to 2013-14); and
- a reduction in expected interest expenses of \$514 million (\$4.2 billion over four years).

These variations are partly offset by:

- an increase in a range of grant and other program expenses of \$857 million (previously included in the estimates for 2009-10); and
- increased costs flowing from revised economic parameters of \$61 million (\$651 million over four years).

Since the Economic Statement, parameter and other variations have increased expenses by \$179 million in 2010-11 largely reflecting the recognition of \$243 million of expenses for road infrastructure that was previously expected in 2009-10 and a forecast increase in Child Care Rebate expenses of \$56 million (\$249 million over four years). These increases are partially offset by a forecast further reduction in GST payments to the States (consistent with GST revenue collections) of \$90 million in 2010-11 (\$440 million over four years).

The Contingency Reserve includes an allowance for the tendency for estimates of expenses for existing Government policy to be revised upwards in the forward years (the conservative bias allowance). This allowance is unchanged from the 2010-11 Budget. The Contingency Reserve also contains provisions for future increases in Australia's Official Development Assistance yet to be allocated to specific aid

programs (\$2.8 billion over four years), the continuation of existing exceptional circumstances drought relief (\$145 million in 2010-11), the ICT Business as Usual Reinvestment Fund (\$447 million over four years) and for future equity investments in the National Broadband Network (\$13.6 billion over three years to 2013-14).¹ The Contingency Reserve also contains a number of items that cannot be disclosed for commercial-in-confidence or national security reasons.

Table 5 provides a reconciliation of the fiscal balance estimates.

Table 5: Reconciliation of 2010-11 Budget, Economic Statement and 2010 PEFO fiscal balance estimates

	Estimates		Projections	
	2010-11 \$m	2011-12 \$m	2012-13 \$m	2013-14 \$m
2010-11 Budget fiscal balance	-39,598	-12,093	1,960	6,325
Per cent of GDP	-2.8	-0.8	0.1	0.4
Changes from 2010-11 Budget to 2010 ES				
Effect of policy decisions(b)	-130	725	-247	-5,325
Effect of parameter and other variations(c)	773	2,973	3,022	5,344
Total variations	643	3,698	2,774	20
2010 ES fiscal balance	-38,955	-8,395	4,735	6,345
Per cent of GDP	-2.7	-0.6	0.3	0.4
Changes from 2010 ES to 2010 PEFO				
Effect of policy decisions(b)				
Revenue	0	0	0	0
Expenses	-24	61	-1	4
Net capital investment	0	0	0	0
Total policy decisions impact on fiscal balance	24	-61	1	-4
Effect of parameter and other variations(c)				
Revenue	-321	-242	361	-286
Expenses	179	47	5	-26
Net capital investment	-8	-8	-8	-8
Total parameter and other variations impact on fiscal balance	-491	-281	364	-252
2010 PEFO fiscal balance	-39,422	-8,738	5,101	6,088
Per cent of GDP	-2.8	-0.6	0.3	0.4

(a) A positive number for revenue indicates an increase in the fiscal balance, while a positive number for expenses and net capital investment indicates a decrease in the fiscal balance.

(b) Excludes secondary impacts on public debt interest of policy decisions and offsets from the contingency reserve for decisions taken.

(c) Includes contingency reserve offsets to policy decisions.

¹ The profile of expenses in the contingency reserve for Official Development Assistance is \$155 million in 2010-11, \$233 million in 2011-12, \$668 million in 2012-13 and \$1,702 million in 2013-14. The profile for the ICT Business as Usual Reinvestment Fund is \$40 million in 2010-11, \$118 million in 2011-12, \$114 million in 2012-13 and \$177 million in 2013-14.

Net debt and net financial worth

Net debt for the Australian Government general government sector is estimated to be \$80.6 billion (or 5.7 per cent of GDP) in 2010-11, which is broadly consistent with the forecast in the 2010-11 Budget and the Economic Statement.

Net financial worth is estimated to be -\$166.8 billion (or -11.8 per cent of GDP) in 2010-11 in line with the Economic Statement. In the 2010-11 Budget net financial worth was estimated to be -\$160.6 billion (or -11.4 per cent of GDP).

