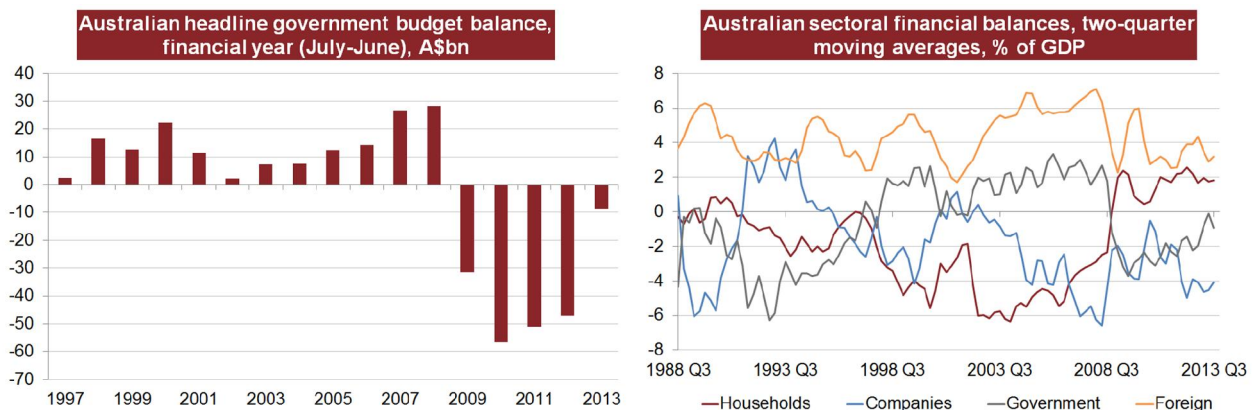


Australian budget surplus pipedreams

- **Australian government still aims for budget surplus**
- **But the private sectors will resist attempts to erode its financial balances**
- **MYEFO rightly points to budget deficits as far as the eye can see**

One of the very first Comments I wrote for Stein Brothers clients (Look beyond the RBA rate cut, 10th October 2012) looked at the Australian sectoral financial balances and pointed out that Australian government forecasts of a return to budget surplus in financial 2012-13 (July 2012 to June 2013) was unlikely to be fulfilled, either in that year or in any other for a long time.

In the event, the Australian budget balance for financial 2012-13 ended with an A\$8.7bn deficit. That was sharply down from the previous year's A\$47bn gap; but still a deficit. Far from narrowing further this year, the deficit has widened sharply again. This issue has come to the fore due to the governments' continued aim of a budget surplus (new government, same target); and the mid-year economic forecast (MYEFO) which has revised up the estimate for this financial year's budget deficit from A\$30bn to A\$47.1bn, 3% of GDP. In addition, the MYEFO is forecasting budget deficits as far as the eye can see (or at least over the next ten years) – much to the consternation of Australian politicians.



This should really not come as a surprise. Australia is unusual among developed economies in that the government ran a surplus for a long time. But, the sum of financial balances for the four sectors in an economy – public, household, corporate and foreign, where 'foreign' is the current account with a reversed sign – must as a matter of accounting identity add up to zero. So, for the Australian government to run a financial surplus, *either* the foreign sector must run a deficit (ie, Australia run a current account surplus), *or* the domestic private sectors (households and companies) must run a deficit of savings over investment; or, of course, a combination of those. Hence, since Australia tends to run a current account deficit, the public sector surplus was dependent on the private sector – households and companies – running a financial deficit.

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

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But, the likelihood of the Australian private sector voluntarily running a financial deficit is currently very low. For households, the financial balance is the net between savings and residential investment. The savings rate has risen sharply since the Great Recession began and has since late 2010 oscillated in a band from 6½% of GDP to 7½%. At the same time residential investment has trended down from over 6% of GDP in the early 2000s to 5.6% in Q3 2007 (one of the starting points for the Great Recession) to a current 4.7%. As a result, the household sector financial balance has gone from a persistent deficit to a surplus of around 2% of GDP. There seems to be little reason for this to change in the near term, a point acknowledged by the Governor of the Reserve Bank of Australia when he told Parliament on 18th December that he cannot force people to spend.

The Australian corporate sector is actually running a financial deficit (defined as business saving less gross fixed capital formation). This deficit averaged more than 4% of GDP in the five quarters from A4 2011 to Q4 2012. The deficit was very much due to a surge in corporate cap-ex beginning as far back as 2001, which took investment from around 12% of GDP to around 16-18%. This is now beginning to wind down. Major infrastructure projects in the resources sector are being completed. Statistics Australia's survey of corporate cap-ex plans shows companies intending to cut spending over the next four quarters for a fourth consecutive quarter in Q3 2013. That is the longest stretch since 1998/99. The corporate sector currently looks more likely to move back into a financial surplus than intending to widen its deficit.

Obviously, there is a difference between ex-ante intentions and ex-post developments. The private sector may intend to run a financial surplus, but end up running a deficit. But, if that occurs, it is likely to resist by increasing its savings or cutting its deficits as Governor Stevens noted. It may not be enough – but it means that activity slows further.

This leaves the foreign sector as the most likely candidate to off-set an increase in government saving. But, Australia as a rule does not run a current account surplus. In fact, since Q3 1959, Australia has only seen a current account surplus in 16 quarters (out of a total of 217), none of them since 1975. In essence, Australia tends only to run current account surpluses in recession, when domestic demand weakens sufficiently. Even in the recent commodity prices boom, arguably the biggest in world history, the current account deficit only rarely and briefly slipped below 2% of GDP. A weaker Australian dollar may help but even when Australia – unusually – ran a trade surplus, eg, for much of 2011, the current account was still in deficit.

Bearing all this in mind, it looks highly unlikely that the Australian government will achieve its budget surplus aim. It is also questionable whether that would be desirable, at least in the near term, since it could probably only be achieved through another investment or housing boom. Medium-term, a shift towards a narrower current account balance should enable the government to move the budget closer towards balance.

But that will almost certainly require a weaker Aussie dollar. Governor Stevens has indicated that he would be happy with the Aussie dollar at 85 cents US, about 5% lower than its current 88-89 cents range. Australian assets should now be attractive, not least bonds, whose yield is more attractive than those of

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

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most other developed markets. But the downward pressure on the Aussie means that the time to buy is not just yet.

Gabriel Stein 2013-12-19

gabriel.stein@steinbrothers.co.uk

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

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