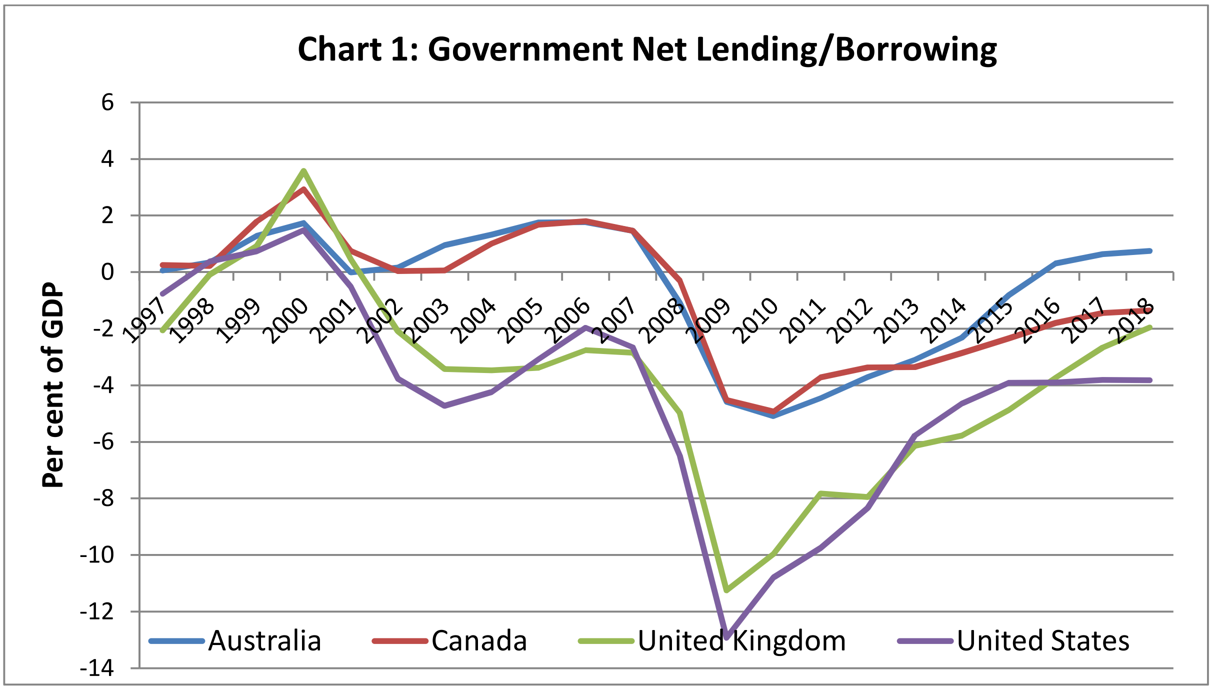
HOW URGENT IS THE NEED FOR THE GOVERNMENT TO RETURN TO A BUDGET SURPLUS?

Comment on Ross Gittins' "Budget a Matter of Timing and Nerve"[1]

Ross Gittins stated the following in his article: "while it's undeniable we need to return the budget to cyclical surplus (and structural balance), this shouldn't happen – and thanks to our still low level of public debt, doesn't need to happen – with any urgency." This comment on the article is intended to focus on that particular statement by comparing Australia's relevant trends with those of Canada, the UK and the USA. These are sometimes referred to jointly as "The Anglosphere."[2]



Source: International Monetary Fund, World Economic Outlook Databases, October 2013. Available at: http://www.imf.org/external/pubs/ft/weo/2013/02/weodata/index.aspx.

Chart 1 (above) shows that Australia and Canada displayed a similar pattern of changes in net lending/borrowing since 1997,[3] and the same is also apparent for the UK and the USA., when viewed as a pair. The display of net lending for Australia and Canada (that is, of

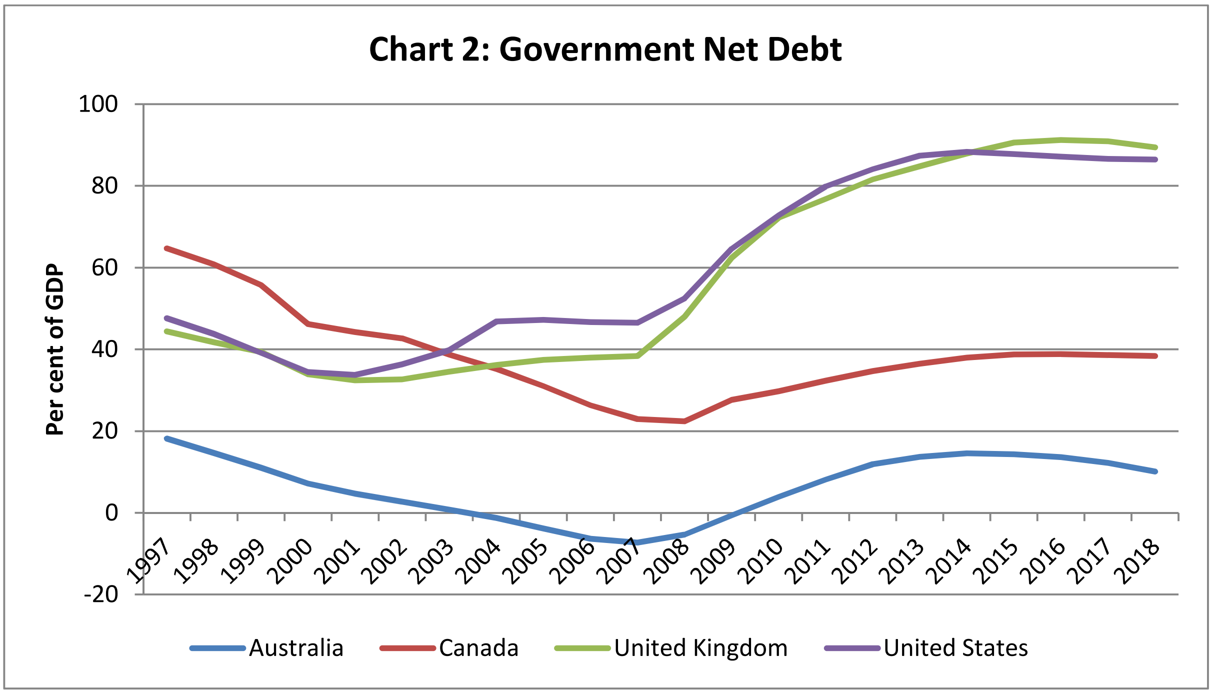
[1] From the *Sydney Morning Herald*, 3 February 3014. Available at: http://www.smh.com.au/business/budget-a-matter-of-timing-and-nerve-20140202-31v2i.html.

[2] A typical application of the name would also include Ireland and New Zealand, while a broader perspective might comprise the British East Indies and South Africa in addition to the others. The four larger ones were used here mainly to simplify the charts.

[3] Net lending/borrowing is obtained by netting out from gross lending/borrowing financial assets that are classified as debt instruments including monetary gold and special drawing rights with the IMF, currency and deposits, debt securities, loans, insurance, pension and standardised guarantee schemes.

positive values in respect of the per cent of GDP) from 1997 to 2008 can be attributed at least partly to their respective resource industries.[4] The ability of these two countries to avoid a budget deficit during that period, in contrast to both the UK and the USA, contributed to a less severe drop in the government deficit in 2010 (of about 5 per cent of GDP for both) compared to deficits of 10 per cent and 11 per cent for the UK and USA, respectively, in that year.

The IMF updated its World Economic Outlook database on 8 October 2013, which is one month after the election of the Abbott government in Australia. Some adjustments may therefore have been made to the IMF projections between 2013 and 2018, but is it likely that the data compiled earlier in 2013 were the main ingredients for the projected figures. The new government's budget plans will be reflected in the IMF's subsequent revisions.[5] If these plans bring substantial changes to the projections that are to be published in April 2014, then new charts will be added to this comment as an addendum.



Source: Same as stated for Chart 1.

Among these four countries, Australia was the best performer in maintaining a lower ratio of government debt to GDP (Chart 2) from 1997 to 2012. Moreover, the projections indicate that for Australia, the peak will be about 14.5 per cent of GDP (in 2014), while the

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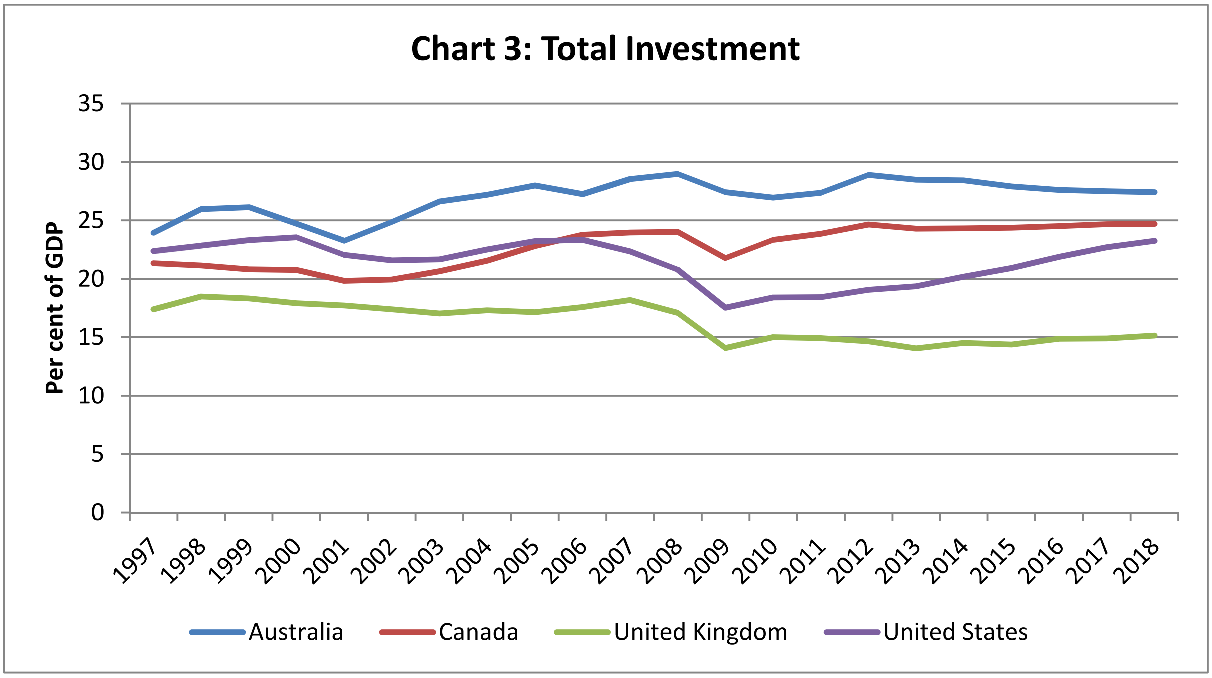
[4] A detailed analysis of the effects of exporting natural resources is available from Ellis Connolly, Jarkko Jääskelä and Michelle van der Merwe, "The Performance of Resource-Exporting Economies", *Bulletin*, Reserve Bank of Australia, September Quarter 2013, pp. 19-29. Available at: http://www.rba.gov.au/publications/bulletin/2013/sep/pdf/bu-0913-3.pdfhttp://www.rba.gov.au/publications/bulletin/2013/sep/pdf/bu-0913-3.pdf

[5] The IMF state: "The World Economic Outlook (WEO) database is created during the biannual WEO exercise, which begins in January and June of each year and results in the April and September WEO publication.

projected peaks for Canada, UK and USA, respectively, are 38.9 per cent, 91.2 per cent and 87.1 per cent. Recent suggestions have been made that economic growth in Australia may be less than the level that was factored in for these projections, so the peak in the debt ratio may not occur until 2015, and it may be higher than 14.5 per cent of GDP, but there is no reason at the moment to suggest that it will be *much* later or *much* higher. As the graph shows the revision would need to result in a doubling of the ratio before Australia is in the same projected position as Canada and would need to expand by 6 times to be in the same position as the UK.

This would seem to be more than ample to add strength to Gittins' statement. Comparisons such as these are important since a major concern associated with high debt-to-GDP ratios is the interest rate the relevant countries must pay to service the debt. This tends to be a based upon a particular country's position compared to the rest of the world. Investors seek higher interest rates on loans to those nations whose debt ratios are substantially higher than the average for otherwise similarly situated countries. This does not apply to Australia at the present time, and an event (or events) that has not occurred in the last decade would be needed to substantially alter this assessment.

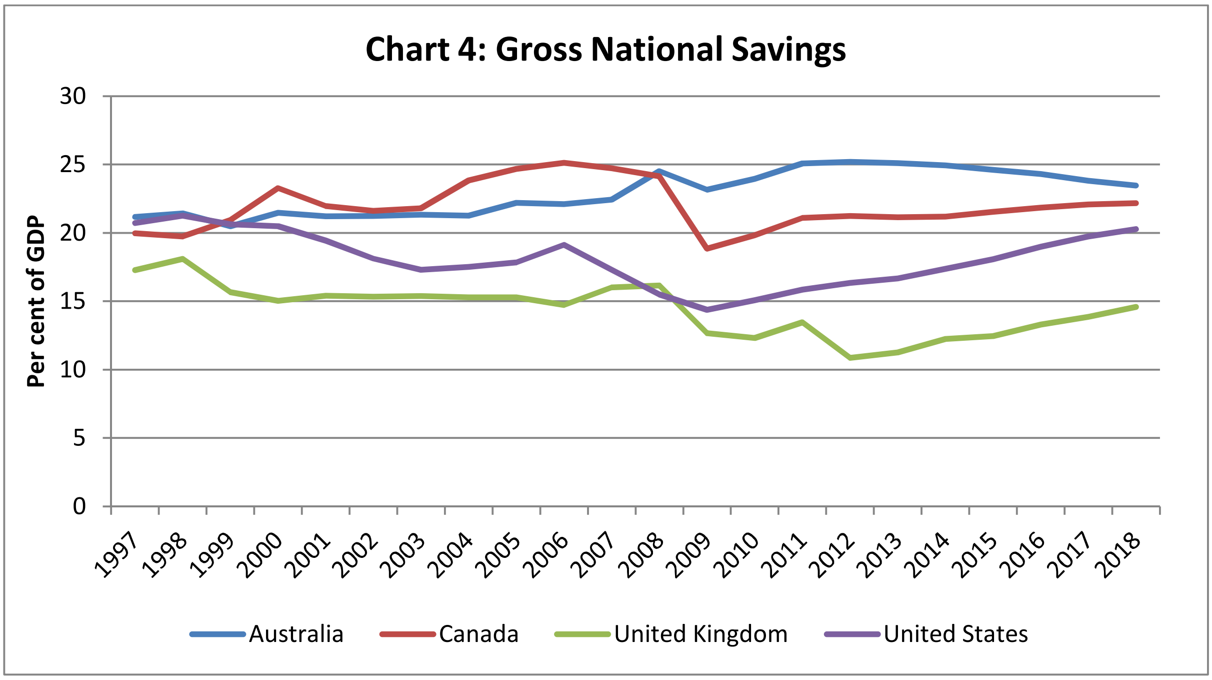


Source: Same as stated for Chart 1.

We briefly examine three additional factors that have an indirect effect of the notion of urgency. The first is total investment, which, for Australia, rose from 23.2 per cent of GDP in 2001 to 29.0 per cent of GDP in 2008. A major part of this can be attributed to the sharp rise in the terms of trade that occurred during the period and much of which was fuelled by the rising prices of Australia's mineral exports.[6] A second peak occurred in 2012 (28.9 per

[6] Tim Atkin, Mark Caputo, Tim Robinson and Hao Wang, "Macroeconomic Consequences of Terms of Trade Episodes, Past and Present," Research Discussion Paper 2014-01, Reserve Bank of Australia, January 2014, especially section 3.1. Available at: https://www.google.com.au/?gfe_rd=ctrl&ei=xgbvUoDbBMyN8Qe1hoCoCQ&gws_rd=cr.

cent) and the IMF projections indicate a decline is likely to occur after planned mining projects are completed. The dip that occurred between 2008 and 2012 could be due to an initial slowing down of the work on these projects, as well as on non-mining projects, during the global financial crisis. Even if these projections turn out to be optimistic, Australia's total investment position in 2018 will almost certainly be better than that of the UK, which is shown in the chart as clinging to the 15 per cent level. Canada's investment in unconventional oil extraction, primarily from the Alberta oil sands, increased substantially during the past 10 years. Similarly, extraction of gas trapped in shale formations in the US has only recently begun and is rapidly making that country self-sufficient in LNG.[7] No equivalent resources development exists at the present time for the UK, so other means must be found to enhance total investment.

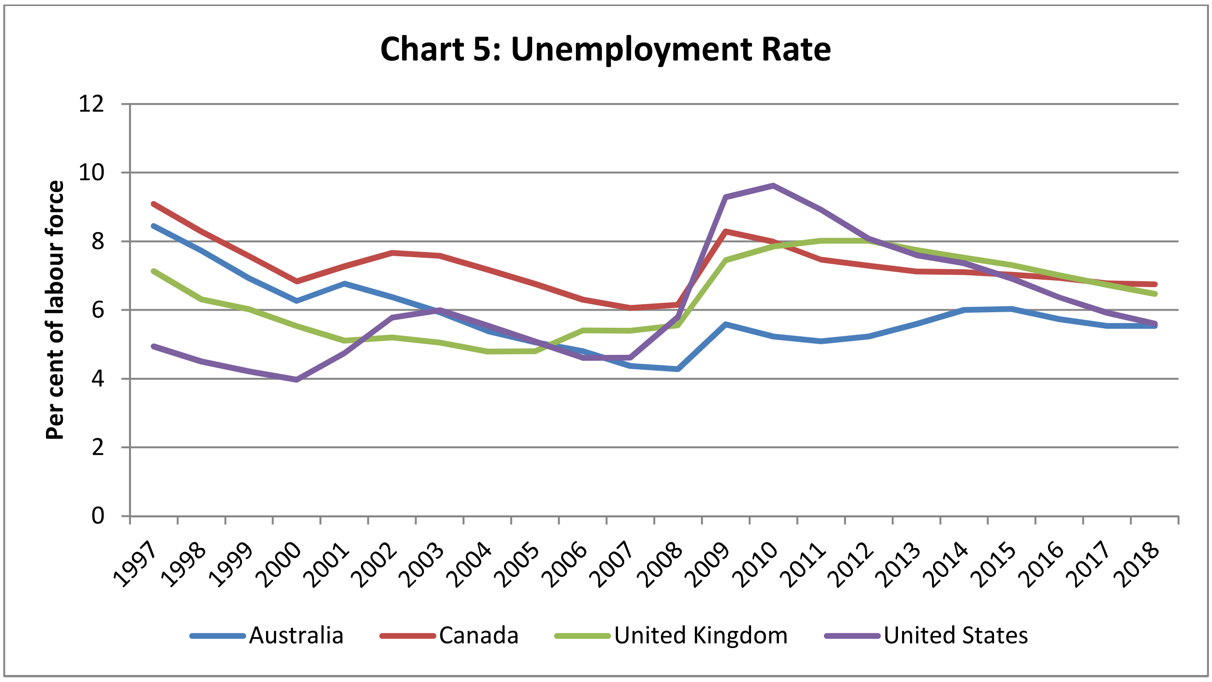


Source: Same as stated for Chart 1.

Total investment is related to gross national savings (Chart 4) and the two will vary with the amount of foreign direct investment, indicating how much of total investment is funded by the savings of other nations. Canada's gross national savings rate peaked at slightly more than 25 per cent of GDP in 2006, and then fell as asset prices went into sharp decline following the global financial crisis. It rose again in 2009. Australia's gross national savings rate reached a projected peak of 25.1 per cent of GDP in 2013 as a result of households deleveraging to restore asset values that existed prior to the crisis. The national savings rate in the US declined sharply between 2000 and 2003, then rose before falling again in 2006. Although the second episode was influenced by the negative wealth effects of the global financial crisis, the different pattern for the US is partly explained by a tendency for over-

[7] Ellis Connolly, Jarkko Jääskelä and Michelle van der Merwe, *op. cit*. (footnote 4), p. 22.

consumption.[8] In Britain, recessionary conditions continued between 2008 and 2012, resulting in a delay in restoring household wealth by paying off debt that had accumulated earlier. Thus, all four economies are in the process of returning to trend rates in the saving ratio and Australia would seem to be as well placed, or better, than the other three countries to achieve this objective. This supports the lack of urgency in restoring a budget surplus.



Source: Same as stated for Chart 1.

Finally, the unemployment rate for both Canada Australia was relatively high in 1997 (more than 8 per cent of the labour force (Chart 5), but fell in both cases until 2008. Australia clearly emerged from the financial crisis with few bruises and continued to display the lowest unemployment rate among the four countries examined here. Greater detail on this and other aspects of Australia's recent performance is available in speeches by Glenn Stevens, Governor of the Reserve Bank of Australia, during 2012.[9] There is reason for optimism, but not complacency, and there is no reason to panic.

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[8] This is said to occur when relatively high levels of consumption continue after cyclical rises in incomes cease or perhaps even fall. Refer to Jean-Philippe Cotis, Jonathan Coppel and Luiz de Mello, "Is the US Prone to 'Over-Consumption'?" Federal Reserve of Boston Economic Conference, Chatham, Massachusetts, 14-16 June 2004. Available at: http://www.oecd.org/**unitedstates**/35910313.doc.

[9] The Lucky Country," speech to the Anika Foundation Luncheon, Sydney, 29 July 2012. Available at: http://www.rba.gov.au/speeches/2012/sp-gov-240712.html. "Producing Prosperity," speech to the Committee of Economic Development of Australia Annual Dinner, Melbourne, 20 November 2012. Available at: http://www.rba.gov.au/speeches/2012/sp-gov-201112.html.