

ECONOMICS: AUSTRALASIAN PERSPECTIVES—JUNE 11, 2010

# Australia and New Zealand: From Crises and Austerity to Fiscal Paragons

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In contrast to the fiscal woes of Greece and other peripheral euro-area countries, the budgetary positions of Australia and New Zealand tell a tale of fiscal prudence—as highlighted by the national budgets released last month.

After spending big on fiscal stimulus programs to avert the worst consequences of the 2008–2009 crisis, both countries expect their budget positions to improve dramatically in the next few years. Australia is forecasting a return to a small surplus in 2012–2013 (**Display 1**), three years ahead of schedule and, by the government’s own reckoning, before any other major advanced economy will return to the black. Next year’s deficit is expected to come in at just under A\$41 billion—more than A\$16 billion less than forecast a year ago.

New Zealand will take slightly longer to return to surplus (it forecasts deficits until 2015–2016 (**Display 2**), but its fiscal outlook has already begun to improve following decisions in last year’s budget to restrain growth in government spending.

If the budget forecasts are realized, Australia’s net debt will peak at slightly more than 6% of GDP in 2012—half the level projected at the last budget—and New Zealand’s will level out at 18% (**Display 3, next page**). These figures are

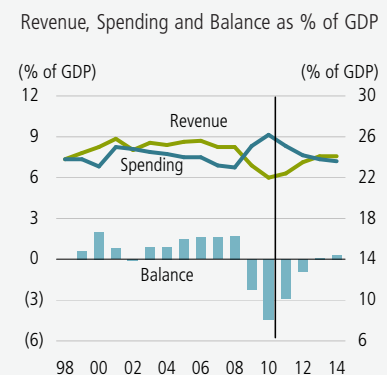
light years away from comparable forecasts for the UK, Europe, US and Japan.

What lies behind the Australasian countries’ improving budget positions? Both can thank their geographical proximity to, and strong trading links with, Asian countries—especially (even more especially in Australia’s case) China. China’s continuing demand for commodities is expected to contribute, again, to a substantial rise in Australia’s terms of trade, which the government expects to rebound by around 25% by mid-2010.

This underpins a positive growth outlook which, in turn, drives a rapid cyclical improvement in the budget bottom line.

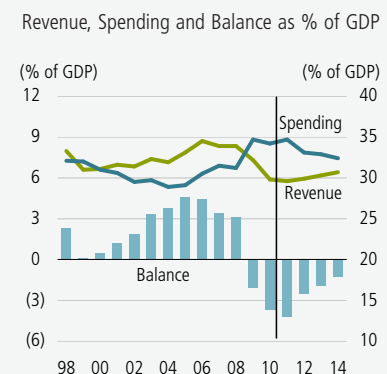
This economic good fortune is only one contributory factor, however. Another is the hard work that Australia and New Zealand put into salvaging their fiscal positions after financial crises in the mid-to-early 1980s, which resulted in sovereign rating downgrades for both countries. The experience led to reforms which transformed both economies,

Display 1  
Australia’s Budget Return to Surplus



Source: Australian Government Budget Papers

Display 2  
NZ’s Budget Heads Towards Balance



Source: New Zealand Government Budget Papers

making them more open and competitive, and which imposed fiscal discipline that resulted in sustained budget surpluses.

Without these measures, neither country would have been as well prepared as it was to insulate itself, through fiscal and monetary stimulus measures, from the worst effects of the global crisis. The experience of both countries is testament to the fact that fiscal austerity can—admittedly at the cost of some short-term pain—pay dividends well into the future.

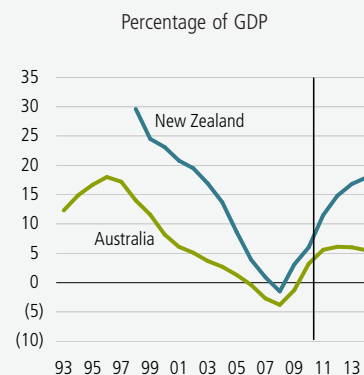
That's not to say, however, that these budgets have failed to provide their share of excitement.

In New Zealand, following a comprehensive review of the tax system, the government announced a major shift in the tax structure away from direct tax towards indirect taxes. Rates for both personal income tax (from October) and corporate income tax (from April 2011) are being cut. And the Goods and Services Tax (GST) rate is being raised from 12.5% to 15% from October 1. The latter, of course, will have a marked impact on headline inflation. The Reserve Bank of New Zealand (RBNZ) estimates that the rise in

GST (along with the impact of higher tobacco excise and the Emissions Trading Scheme) will push annual CPI inflation to 5.4% by June 2011; excluding the impact of these policy changes, inflation would be running at 2.6%. This tax change was highlighted by the RBNZ in its decision to begin increasing rates (the RBNZ tightened by 25 basis points on June 10 to take the Overnight Cash Rate to 2.75%). While the RBNZ is, for now, comfortable in assuming minimal feed-through of this rise in headline inflation to inflation expectations, this clearly provides an extra degree of concern for the RBNZ, making it marginally more hawkish.

Australia conducted a tax review, too, but the government accepted only a small portion of its recommendations for immediate implementation. But that portion is causing a massive amount of indigestion. The announcement of a new tax on the resources sector—the so-called Resource Super Profits Tax or RSPT has met—with very vocal opposition from the mining sector (not surprisingly) and from other quarters, and has been blamed for all manner of ills from the cancellation of mining projects to the collapse in the Australian dollar. In our view, the impact

Display 3  
Net General Government Debt to GDP



Source: Australian and NZ Government Budget Papers

claimed for this new tax is significantly exaggerated. But the perception created—on top of a number of policy back-flips and instances of program mismanagement—has led to a sharp slide in the polls for the Labor government, to the extent that the Liberal/National opposition is now marginally ahead. With an election only months away\* we suspect that the government is close to announcing a compromise on this issue, placating some of the objections raised by the mining industry. ■

\*The Labor Government won office in November 2007, but parliament did not actually start sitting until early 2008. The maximum term a government can run is three years from the first day of sitting of the new parliament, so the latest possible date for an election is April 16, 2011. In normal circumstances, the earliest date this election could be called is August 7, 2010, but the government could have called an election at any time in recent months because it has what is known as a "double dissolution trigger"—effectively it can argue that the upper house has been blocking essential legislation, so parliament is not working, and needs to be dissolved and new elections held. In other words, an election can be held at any time in the next nine months.

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