Points of Interest

Baiocchi Griffin Private Wealth

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Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we consider the upcoming federal government budget and the impact the government's weak fiscal position is likely to have on public policy. We also review the current local and global macroeconomic picture.

Executive summary

- Increases in spending and falls in tax revenue have left the federal budget in a weak position.
- For the first time in some years, the tough talk in the lead up to the budget may be matched by tax increases and spending cuts.
- Changes to major expenditure items such as the Age Pension, superannuation concessions and family assistance payments should be expected.
- The ageing population and high cost of the Age Pension looks set to bring about an increase in Age Pension age.
- Global and local economic conditions are relatively favourable, although concerns remain over the extent of credit growth in China

The May 2014 federal government budget

The end of the March quarter marks the lead-up to the unveiling of the federal government budget in May. We discuss a number of the issues which are likely to be addressed through the budget and highlight the economic rationale driving recent government comments regarding the budget.

On the evening of the 13th of May, the Treasurer, Joe Hockey, will cause a temporary spike in TV viewership of the commercial television channels as he spends an hour communicating with the few people who have tuned in to the ABC to watch him deliver the 2014 federal budget. To be fair to Mr Hockey, the budget speech is usually heavy on rhetoric and light on details. By that time the most significant budget items have usually been leaked to the media well in advance of the actual budget speech.

The unveiling of the federal budget tends to follow a well-established pattern: at least six months before the budget, a number of politicians and public servants starting asking rhetorical questions in public along the lines of “Should we increase the GST?” or “Is superannuation too generous?”. These thought bubbles usually target the many sacred cows of public policy – taxes, superannuation, wages, the Age Pension, negative gearing and other topics which tend to generate heated debate. An excessive amount of public approbation and the contentious issue is quietly buried. If the response is less than anticipated, the same issue is usually raised more forcefully after a reasonable space of time. Through this process those ideas most likely to offend (and cost votes) are discarded, while those that don’t bring out the pitchforks and torches eventually find their way into public policy and are unearthed on budget night.

The second phase of preparing the nation for the budget begins with repeated warnings from the Treasurer about the dire state of the government’s finances and the need for drastic change. This is a delicate task – too negative and the Treasurer stands to be accused of talking down the economy; too positive and the public reaction to surprise spending cuts in the budget can be fierce. The trend is for the Treasurer to appear quite despondent in those months leading up to the budget, with frequent warnings of ‘living beyond our means’ and ‘…everyone having to share the heavy lifting…’, statements which leave an expectation of savage cuts. Then, when the budget and associated cuts are announced and turn out to

be far less swingeing than expected, everyone breathes a sigh of relief and feels fortunate to have survived any drastic cuts.

$15 billion

Estimated cost of the family home capital gains tax exemption

Having said that, the 2014 budget may be the first budget for some time to actually live up to the warnings and threats emanating from Canberra. That is, of course, if the current government is willing to make a number of hard choices with regards to spending and taxing. Chart 1 clearly illustrates the need for change. Only in 2015 is government revenue expected to exceed spending, and this outcome requires a number of heroic long term assumptions regarding corporate and personal income tax payments which are unlikely to be achieved.

Chart 1 – Federal government revenue vs. payments

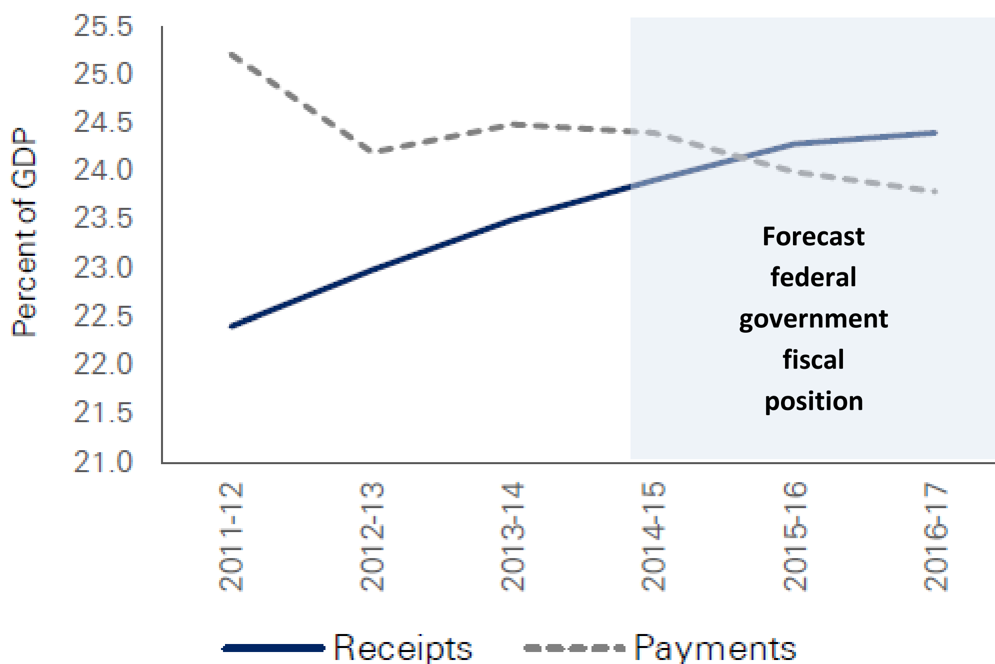


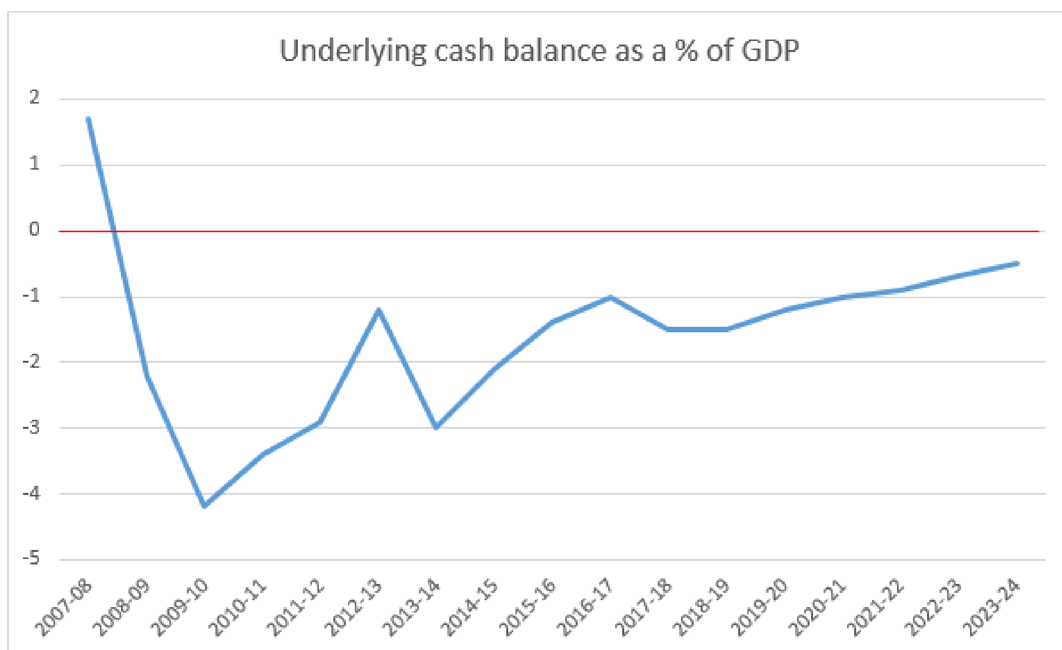
Chart 1 was released as part of the 2013-14 budget, unveiled by the then Treasurer, Wayne Swan, last year. The reality is that corporate and personal tax receipts have not recovered to

those levels which were forecast as recently as a year ago. Responsibility lies with the sharp and ongoing fall in mining investment expenditure and continued weakness across much of the non-mining sectors of the economy. Furthermore, government spending has in fact increased, rather than shrinking sufficiently to repair the budget. Both the previous and current federal governments (so far) have tended to make spending decisions as though we are stuck in the early part of last decade. This period, which saw government tax coffers swelled by a boom in tax revenue through higher commodity prices, near full employment and an enormous increase in the level of both corporate and household debt, should be regarded as an aberration, not the norm. Unfortunately starting around 2004 and subsequent years a number of spending initiatives were put in place which will be politically unpopular to unwind. It is this historical trend towards 'vote buying' fiscal policies (of which both major political parties are guilty) which have locked the government into an ongoing deterioration of its financial position.

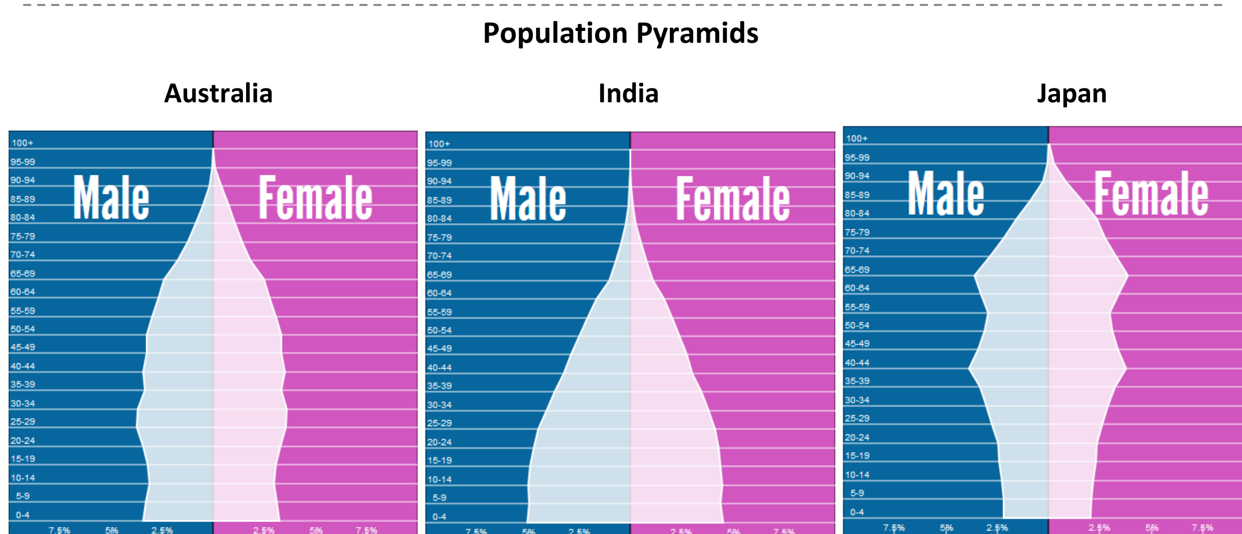
More recent analysis suggests that without some form of action, it may take nearly a decade for tax revenue to reach the level of government spending.

This is detailed in Chart 2, which projects a federal government cash deficit until at least 2023-24.

Chart 2 – Revised government cash deficit to 2023-24 (Released Dec 2013)



While it is not new information, Australia also faces a looming demographics problem which centres on the ageing of our population. As more and more Australians enter retirement, this places pressure on the federal budget, with the Age Pension making up the largest single expenditure item in the budget. Total spending on social security and welfare amounted to just under $140 billion in last year's budget. This was nearly five times the amount of money spent on education. Increased longevity is also partly to blame, with the average Australian's retirement lasting considerably longer than forty or fifty years ago. In this regard it is instructive to examine Australia's population pyramid. This is simply a graphical representation of the age break-down of all Australians. For those countries with a young population, the pyramid is thickest at the bottom, while those countries with an older population tend to have a top-heavy pyramid. The charts below outlines the current population pyramids for Australia, India and Japan.



A population pyramid simply shows the proportion of a country's population in each age bracket. It starts at ages 0 – 4 at the bottom and increase by five years for each bracket. At the very top is that proportion of the population older than 100. The general shape of the pyramid shows at a glance the general demographics of a country. The Australian pyramid is reasonably balanced, although the younger generations are outnumbered by those who are older than 30. Nearly 12% of our population is aged between 50 and 69 – people who have either retired or are likely to within the next decade or so. It is this cohort of Australians whom the Treasurer has in mind when he warns of the need for changes to the Age Pension.

India on the other hand, has a very young population. Due to accelerating birth rates, there are more Indians being born now than ever before. Population growth has a positive impact on economic growth, which points to a favourable future for the Indian economy. Japan is the other extreme, with a rapidly ageing population and a relatively small number of births.

In fact the Japanese are dying in greater numbers than they are being born, with the eventual outcome being a significant fall in the total population of Japan (unless unpopular measures such as encouraging increased immigration are put in place).

Given that a nation's demographics tends to be a one-way process (i.e. once a country begins to age it is very difficult to reverse that process), we should accept that Australia is more than likely to have a future population pyramid more like Japan's than India's. This has implications for the federal budget in terms of tax revenue and spending. For this reason we should expect at least some of the following issues to be addressed in the 2014 or future budgets:

- An increase in Age Pension age from 67 to 70 for younger workers
- Less favourable superannuation tax concessions
- Reduced government assistance with medical costs
- Reductions in welfare payments (Family Tax Benefit etc.)
- Stricter Age Pension eligibility requirements
- An increase in the GST and extension to cover areas such as education
- Reduced government assistance to the education sector
- Greater reliance on private funding of infrastructure projects

A number of these measures are most likely too politically sensitive to tackle just yet, although an ongoing deterioration in long-term forecasts of the federal government may ensure that nothing is left off the table when it comes to taxation and spending reform.

Economic update

To a certain extent the first quarter of 2014 was simply a continuation of the set of circumstances which prevailed towards the end of 2013. The Australian economy is still dominated by the ongoing transition from mining-led growth to a more balanced arrangement where a wider proportion of the economy contributes to economic growth. This process will not be an easy one and we have written before of our concerns regarding the low probability of there being a seamless transition.

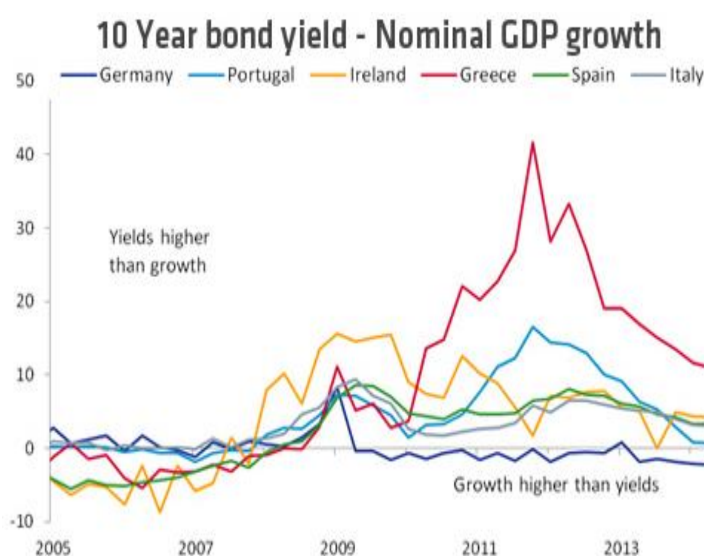
The main thrust of the Reserve Bank of Australia's approach has been to stimulate housing construction, non-mining corporate investment and household consumption as an offset to the slowdown in mining. Of these three areas only housing construction appears to be gaining some traction, with data showing a significant increase in the number of new home construction applications. Non-mining corporate investment and household consumption have not yet reacted as the RBA may have wished, with both companies and households showing relatively little inclination to borrow or spend. With interest rates at historical lows however, this lack of a response is simply a temporary delay and we will eventually see

credit growth and consumption levels improve. It's just a matter of 'when', not 'if' – assuming no major external negative events such as an outright war between Russia and the Ukraine.

The wider international macroeconomic picture remains reasonably positive. The US economic recovery is still underway, despite a very cold winter which was so severe it actually managed to temporarily dent the economy. Retail sales, as important in the US as a driver of economic activity as it is in Australia, nose-dived in the face of the freezing weather. Shopping for shoes or meeting for cake and coffee at an outdoor café seems somewhat unattractive when the thermometer falls to -20 degrees Celsius (as it did in upstate New York in February).

Europe continues to recover from the government debt-induced crisis of 2012, although many of the issues which the sparked have not been fully resolved. For an indication of the improvement in the fortunes of Europe however, you need not look further than Greece. A the height of the European crisis, Greece was paying an interest rate of over 30% on government debt, an indication of how reluctant investors were to lend money to the Greek government. More recently however, Greece was able to issue new debt at an interest rate at just 4.95%.

Chart 3 – Key European Government Borrowing Costs



Importantly, it is not just Greece which has seen an improvement in its fortunes – all of the struggling European nations have seen significant falls in government borrowing costs. Of course, the excessive debt hasn't disappeared; it's all still there, it's just that it's now much cheaper for those governments to pay the interest on their debts. This trend is shown in Chart 3, which shows falling borrowing costs for those European nations with the most significant debt issues (Germany is included as a point of reference).

The news in China is less promising, with a continuation of the slowing in economic growth, a process which commenced over a year ago. After many years of breakneck economic growth, some moderation in Chinese economic growth rates was inevitable, but this is scant comfort to Australia's important mining sector. Unresolved issues in China still pose a threat to its stability and hence a large proportion of the Australian economy. Chief among these is

the significant level of outstanding local and state government debt. This has been augmented by the development of a 'shadow banking system', where unregulated lending is funnelled to borrowers of questionable creditworthiness. At some point the credit binge in China will need to be dealt with, an event we expect to cause a considerable level of economic and market volatility. Overall however, the global economy is better positioned than perhaps at any time over the past six years, notwithstanding our concerns over too much debt in China.

Portfolio Folders

We hope that by now you have received your Portfolio Folder for 2014. This is a new initiative on our part, designed to assist you in managing the paperwork generated by our portfolio administration services. If you happen to fill the folder part-way through the year, simply contact our office and we will be happy to send you any additional folders as required.

As we have communicated to you, from this point forward we will provide you with a new Portfolio Folder each year, allowing for easy chronological record-keeping for your portfolio.

We hope you have enjoyed this edition of our quarterly newsletter. As always, should you have any queries, questions or feedback, please do not hesitate to contact us.

With kind regards,

Justin and Ray

Facts & Figures at a Glance

	Rate/Value	Change from last reading
Australian inflation rate	2.7% (December)	+0.5%
Australian unemployment rate	5.8%	**0.00%**
RBA Cash rate	2.50%	**0.00%**
ASX 200 Index	5,394	+0.78%
MSCI World Index (ex-Australia)	1,656	-1.19%
Australian $ vs. US $	$0.9273	+3.87%
Australian $ vs. UK £	$0.5562	+3.26%
Australian $ vs. Euro €	$0.6732	+3.88%

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This newsletter provides general information only. Before making any financial or investment decisions, we recommend you consult a financial planner to take into account your particular investment objectives, financial situation and individual needs.