

Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates

1 June – 3 June 2010

Question: BET 342

Topic: Unemployment & the Terms of Trade

Hansard Page: Written

Senator EGGLESTON asked:

1. In last year's budget you produced estimates of the structural budget balance of below -4 per cent, under certain assumptions about the unemployment and terms of trade.
 - a) How would a decrease in the expected unemployment rate and an increase in the expected terms of trade affect the structural budget balance?
 - b) Would it increase or decrease the structural budget balance?
 - c) Has the Treasury done further work to estimate the structural budget balance?
 - d) Given you produced these figures, why weren't updated estimates produced for this budget?
 - e) To the best of your knowledge, would the structural budget balance be above or below the actual underlying cash balance at the moment?
 - f) That is the structural element of the budget expansionary or contractionary?
 - g) Do any other organisations produce structural deficit estimates?
 - h) If so, what do they say has happened to Australia's structural deficit over the past year?

Answer:

a), b), c), d), e), g) and h) Dr Gruen and Mr McDonald answered these questions at the Senate Estimates (see below answers in Hansard, pages E39, E40 and E41).

Senator BUSHBY—I have a few questions about the structural budget balance. In last year's budget you produced estimates of the structural budget balance, estimated at below negative four per cent, using certain assumptions about unemployment and terms of trade. I am referring in particular to the 2009-10 Budget Paper No. 1 at page 4-17. How would a decrease in the expected unemployment rate affect the structural budget balance if the underlying cash balance remained unchanged?

Dr Gruen—It would depend on whether you regarded the change in the unemployment rate as a structural change or a cyclical change. It would depend on that. If it were a cyclical change, you would get a different answer than if you thought that the decline in the unemployment rate was structural.

Senator BUSHBY—If it were structural, would it increase or decrease the structural budget balance?

Dr Gruen—Hang on, this is getting tricky. So the underlying cash balance has not changed and you want to know what would happen to the structural balance if you thought the structural rate of unemployment was lower; is that the question?

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Senator BUSHBY—Yes.

Dr Gruen—I will do my best. The structural budget balance would be improved if the structural rate of unemployment fell, but if the actual underlying cash balance had not moved that would be a structural deterioration, assuming that the structural rate of unemployment was now lower. I think that is right.

Senator BUSHBY—I think that is what I needed.

Dr Gruen—I should add that we do not think there has been a structural decline in the unemployment rate.

Senator BUSHBY—You said it might well be different if there had been a cyclical decrease in the unemployment rate.

Mr T McDonald—Because the structural budget balance is based on a series of structural assumptions. If you take the position that the structural rate of unemployment is unchanged then if the actual unemployment rate is lower then any movements in the budget balance as a result of that would be assumed to be cyclical. So a reduction in the unemployment rate would be expected to result in an improvement in the underlying cash balance both through higher revenues and lower outlays. Then if the observed result was that the actual budget balance did not change despite the cyclical improvement in the unemployment rate then you would assume that the structural budget balance would have deteriorated.

Senator BUSHBY—That is what I expected. How would an increase in the expected terms of trade affect the structural budget balance if the underlying cash balance remained unchanged—would it increase or decrease the structural budget balance?

Mr T McDonald—This is perhaps even a trickier question than the one on the unemployment rate. What is quite difficult with things like the terms of trade is knowing exactly whether an improvement is because of cyclical factors or structural. Indeed, there are going to be cases where you get a little bit of both. If you were to assume that all of an increase in the terms of trade was cyclical in those circumstances then you would expect that increase in the terms of trade to result in a higher level of revenue and, therefore, an improvement in the underlying cash balance. If the result was in fact no improvement in the underlying cash balance that would imply a deterioration in the structural budget balance.

Senator BUSHBY—Has Treasury done any further work to estimate the structural budget balance as it currently stands? It was in the papers last year but I do not know if it is this year.

Mr T McDonald—We have done some work since last year's budget to refine, extend and monitor structural budget balance measures. We have not done the calculation based on this year's budget numbers.

Senator BUSHBY—Why is that?

Mr T McDonald—As you will recall, in last year's budget papers the analysis of the structural budget balance did not occur in isolation but rather occurred as part of a broader assessment of fiscal sustainability. In the discussion you had with Dr Gruen earlier about the chart that is in this year's budget I think Dr Gruen noted that that was one piece of evidence. I think we see a structural budget balance measure as being one part of evidence in a broader assessment of fiscal sustainability.

One thing we tried to do in last year's budget papers was highlight just how dependent these measures are on the assumptions that are made, in particular, as you referred, to the terms of trade. In the budget papers last year we said:

Alternative assumptions around the equilibrium terms of trade—that is, assumptions around the extent to which movements are structural rather than cyclical—can result in significantly different structural budget balance estimates.

Despite that, one of the things I keep learning with the experience is that, no matter what you put in words, people pay far more attention to figures. Historically we have resisted publishing structural budget estimates for the very reason that there is excessive focus on point estimates rather than taking—

Senator BUSHBY—You published it last year. As you note, people focus more on figures than they do on the words. It was to some extent used for political purposes last year. This year it is not

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published. I am curious why—not that I am suggesting that Treasury would be complicit in any political activities. Is there the potential for this year to show that it has got worse and it is not there because of the potential to be used for political purposes again?

Dr Gruen—I will not comment on that, but I will make the point that the IMF and the OECD publish structural budget balances. Certainly the OECD have been making the point for a while that for a country like Australia the level of the terms of trade—the standard way of doing structural budget balances is not to talk about issues to do with terms of trade but to cyclically adjust—

Senator BUSHBY—Australia is a little different in that respect.

Dr Gruen—Exactly. So the OECD had issued a working paper sometime ago making the point that for commodity exporting countries like Australia it becomes extremely important what assumptions you make about the structural level of the terms of trade because that has very substantial implications for your revenue estimates, as everyone around this table would be aware. We had been doing some of this work ourselves, but we thought there was heightened interest in this issue, partly because the OECD drew attention to it and partly because the terms of trade had moved so much. There was a long period of time when small movements in the terms of trade were regarded as the norm, but obviously in the past six years or so the terms of trade have changed by an amount that we have not seen since the Korean War. The issue of the implications of a very different structural assumption for the terms of trade were front and centre. We did some work in the budget last year and we published that work. But, as Mr McDonald says— and perhaps we should have been clearer—these assumptions are extremely sensitive to the detailed assumptions you make for the structural level of the terms of trade, and we would still make that claim.

Senator BUSHBY—In estimating last year's structural deficit, what value did you use for the terms of trade? What did you assume was the natural level?

Mr T McDonald—The value for the terms of trade was the same as the end point of the medium-term fiscal projections. The easiest way to look at this is to refer to the *Intergenerational report*, because it is equivalent to where the terms of trade finishes in the *Intergenerational report* projections.

Senator BUSHBY—Does it have a figure?

Mr T McDonald—It does have a figure. One of the slight complications is that the terms of trade figures from year to year are comparable but need to be adjusted because the ABS rebases the national accounts to a different year because it is an indexed number.

Senator BUSHBY—You would have had to assume a figure as the normal terms of trade to do a structural deficit calculation.

Dr Gruen—We could take it on notice and give you an answer.

Senator BUSHBY—I do not know whether you can tell me this: is the terms of trade now higher or lower than last year's assumption?

Mr T McDonald—It is higher.

Senator BUSHBY—If you take that other question on notice it would be very good.

Dr Gruen—The question you would like the answer to is what the level was assumed to be here and what it is now in the comparable period.

Senator BUSHBY—And also what you would consider the normal level is now, yes. You are saying it would be adjusted. With structural deficit calculations you assume capacity and normally that is your growth and your unemployment rate, but in Australia, because it is a commodity country, we also do terms of trade. I want to know what the assumption is for the purpose of last year and whether that has changed.

Dr Gruen—Yes, indeed.

Mr T McDonald—I guess on the first part of that, what we said in last year's budget was that the terms of trade assumption that we used was consistent with the end point of the medium-term projections outlined in per cent from the end of the medium-term projection periods by 2022-23. That end point, when we reach it, is later now. But that end point is consistent with the equivalent

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end point in the *Intergenerational report* for the terms of trade. I believe there is a chart that has that. We can take it on notice to see what extra we can provide.

Senator BUSHBY—I have a couple of final questions on this. You mention you had done some work on the structural budget deficit this year. Would the structural budget balance be above or below the actual underlying cash balance for 2009-10 and 2010-11—that is, is the structural element of the budget expansionary or contractionary?

Dr Gruen—We may need to take that on notice because it will depend on the assumption you make, particularly for the terms of trade. Obviously the unemployment rate is much closer to our assumed full employment rate than we had thought it would be. We would have to take it on notice.

Senator BUSHBY—Are you aware of whether any other organisations produce structural deficit estimates for Australia?

Dr Gruen—I think the OECD does.

Mr T McDonald—The OECD and IMF do and Access Economics also does. Just one thing on the Access Economics estimates, I think they are in the *Budget monitor*. One of the things that the most recent *Budget monitor* has done is make a significant adjustment to the assumption that they make for the underlying or structural terms of trade estimate—quite substantially, as far as I can understand. That has an impact on their estimates as well.

Senator BUSHBY—Bearing in mind that impact, what do those other organisations say has happened to Australia's structural deficit over the last year?

Mr McDonald—Again there are questions of timing on this. I do not have the latest OECD ones because they have only just come out last week. The IMF estimate—

Senator BUSHBY—Can you take it on notice to provide the latest ones that came out last week?

Mr McDonald—Yes. The most recent ones from the IMF, which predate the budget and so are not necessarily directly comparable, are moving from in 2008 -0.6, 2009 -0.4ⁱ, 2010 -4.9 and 2011 -3.5. That is covering all levels of government, state and federal and acts as a percentage of potential GDP, I think. Access Economics estimates—these are in financial years, starting in 2008-09—are -2.3, 2009-10 -3, 2010-11 -2.3, 2011-12 -0.8 and 2012-13 -0.6. I guess the point to note there, though, is that a key element, as you are saying before, of a structural balance budget estimate is what your estimate of the underlying cash balance is. Access Economics, and again this budget monitor predated the budget, including the savings features in the budget, had an actual underlying cash balance of -0.5.

f) The question of whether a budget position is expansionary or contractionary is independent of the level of the structural budget balance in any given year.

ⁱ Note that the IMF estimate for 2009 should be -4.0 per cent of potential GDP, rather than -0.4 recorded in the Hansard.