Why China remains our best hope to repair budget woes

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Wayne Swan couldn't do it. Joe Hockey has tried and failed. Getting the budget back in black is proving to be mission impossible. But it could be a whole lot worse. The Commonwealth Government's bottom line has been getting a boost from an unappreciated source. That source is China.

These days China is more often painted as a villain in the budget saga. Take the Mid-Year Economic and Fiscal Outlook (MYEFO) released last month as an example. It forecast a A$10.6 billion worsening in the deficit this financial year, and a total of A$43.7 billion out to 2017-2018.

The finger was pointed at an unexpected slump in iron ore prices. The budget in May assumed that iron ore prices would stay at $95 per tonne. The MYEFO revised this down to $60 per tonne.

We all know which country consumes most of our iron ore. Activity in China's real estate sector, a big consumer of iron ore, has been sluggish.

But let's get this straight – as far as the budget goes, China is still making the numbers look good.

Commentators in Australia have long talked up the link between iron ore prices and the budget balance. But we've never really known just how strong the link is. Until now that is.

Tucked away in an attachment in the MYEFO is a simulation performed by economists at the Commonwealth Treasury. It shows the impact on the budget of a 4% fall in the terms of trade due to a permanent reduction in the price of non-rural commodity exports – think iron ore. That's roughly how much the terms of trade fell between when the budget was released and the MYEFO.

The result is a A$2.7 billion dollar hit to the bottom line this financial year, followed by A$5.6 billion in 2015-2016. These numbers aren't trivial. But take a look at the size of the forecast deficit - A$40.4 billion this financial year and A$31.2 billion the next. It's clear that most of our budget problems are home grown.

Then there's the stubborn belief that it's been Chinese demand driving iron ore prices lower. A quick look at demand and supply conditions in the iron ore market and you'll spot the flaws in this story. According

to the Bureau of Energy and Resources Economics (BREE), in 2014 China's imports of iron ore are expected to have risen by 14.4%. That's even faster growth than in 2013, and it came off a higher base.

What is true is that demand from the world's other major iron ore importers – the European Union, Japan and Korea – has flatlined. China stands out as the exception.

The real culprit behind falling iron ore prices is rapidly expanding Australian supply. While BREE expect that China's demand for imported iron ore jumped by 118 million tonnes (mt) last year, this was more than matched by a 139 mt jump in our exports.

Another gem found in the MYEFO was estimates of how the budget responds to the volume of goods and services we produce. Treasury found that if real GDP was 1% higher from 2014-2015, the budget would be better off by $3.5 billion this financial year and $4.4 billion the next.

So what impact is China having on our real GDP?

Looking at the value of our exports to China won't tell you the answer. Non-rural commodity exports make up around 70% of the total. With iron ore prices falling, values could be sagging even if volumes are up.

To get a clear look at the volume story we need to adjust values for these price changes. The Reserve Bank of Australia keeps measures of prices that are up to the task.

Run the numbers and this is what you'll find. In the year to November, the volume of Australian exports to China jumped by around 17%.

Think about that for a moment. According to the Australian Bureau of Statistics, in the year to September the volume of output produced by the Australian economy as a whole grew by 2.7%. In roughly the same period, the volume of our output consumed by China grew at more than six times that pace.

That trend is set to continue. On Wednesday the World Bank announced it was expecting growth of 6.9% in China to continue out to 2017. That's down from 7.4% now but is still more than three times the forecast pace of growth in high income countries.

The MYEFO gave up any hope of returning the budget to surplus by 2017-18. We'll be leaning heavily on Chinese demand to get us there sometime after that.

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