STATEMENT 4: BUILDING RESILIENCE THROUGH NATIONAL SAVING

The statement discusses Australia's path to building its national saving and the role of Government policy in continuing this transition.

Higher national saving in recent years reflects the maturing of the compulsory superannuation system introduced in the mid-1980s and a rise in household saving, particularly following the global financial crisis. The Government's increase in the superannuation guarantee and structural changes in household saving behaviour mean that high levels of saving will likely be maintained over coming years.

Consistent with the Government's medium-term fiscal strategy, further improvements in government saving are desirable with the economy forecast to grow around trend. In line with this, the Government will return the budget to surplus in 2012-13 and beyond.

Delivering surpluses, along with a further boost to superannuation, will foster fiscal sustainability in the context of an ageing population, and ensure the Government is not contributing to price pressures in the economy, providing scope for monetary policy to respond to economic developments. Higher national saving will also improve economic resilience by reducing Australia's vulnerability to external shocks.

STATEMENT 4: BUILDING RESILIENCE THROUGH NATIONAL SAVING

INTRODUCTION

The compulsory superannuation system has made an important contribution to national saving since it began to be phased-in from the mid-1980s.

More recently, the significant increase in national savings likely reflects a combination of a return to more sustainable rates of consumption growth and cautious households consolidating their financial position — particularly by reducing the pace of their debt accumulation. This increase in saving is important for a number of reasons.

- A higher level of national saving helps moderate price pressures in the economy, providing scope for monetary policy to respond to economic developments.
- While the terms of trade are likely to remain at high levels for some time yet, some portion of our current national income is likely to be temporary and so it is prudent to save more now for the future.
- With the international economic environment more uncertain, borrowing less and saving more makes Australia more resilient to possible external shocks.
- The ageing of Australia's population means that there are benefits to saving more as a country now to support a progressively older population, before the impacts of population ageing become increasingly important from around the end of the decade.

The Government's planned increases in compulsory superannuation contributions will consolidate and build on the increase in national saving in the second half of the 2000s, with the revenue cost of this measure funded from the proceeds of the Minerals Resource Rent Tax. Further, delivering on the Government's fiscal strategy of budget surpluses on average over the medium-term ensures that the Government will make a positive contribution to national saving.

Consistent with this strategy, returning the Budget to surplus from 2012-13 will contribute to national saving and maintain confidence in the strength of Australia's public finances. This will support Australia's capacity to respond to unexpected adverse events.

Delivering surpluses will also improve medium-term fiscal sustainability and macroeconomic stability by helping to manage the challenges of demographic change and the high terms of trade.

THE BENEFITS OF HIGHER SAVING

Households can maximise welfare by using part of their current income to fund increased future, rather than current, consumption; that is, by saving. This is achieved by investing in assets that raise future income and can be drawn on to finance consumption at a later date.

From a household perspective, saving serves three broad objectives:

- allowing consumption to be smoothed over time;
- increasing future consumption possibilities, including for future generations; and
- improving resilience, by providing a buffer against unanticipated adverse events (precautionary saving).

Increasing saving can improve welfare by helping households better manage their consumption over time, including their exposure to risks.

Government policies that encourage saving normally reflect the objectives outlined above. This may require governments to correct for factors that can lead households to insufficiently provide for their retirement and other needs. In this regard Australia's superannuation system is important in improving retirement income adequacy and putting government finances on a sustainable long-term footing. This contrasts starkly with many advanced countries which have failed to put such reforms in place.

Saving undertaken by governments can also help households to achieve these objectives. In particular, prudent fiscal policy focused on fiscal sustainability allows households to maintain stable incomes and assists the private sector in making sound saving and investment decisions by lowering uncertainty. Higher government saving creates a fiscal buffer for uncertain times and, by reducing demand, takes pressure off monetary policy.

Higher national saving has other macroeconomic implications. Higher saving can be expected to raise future national income over the medium-to-long term through some combination of two channels. Higher national saving may lead to higher investment, which underpins higher GDP. Alternatively, higher national saving results in higher investment income being retained in Australia or earned from overseas rather than being paid to foreign investors; that is, it helps reduce our reliance on foreign saving to drive the development of the economy.

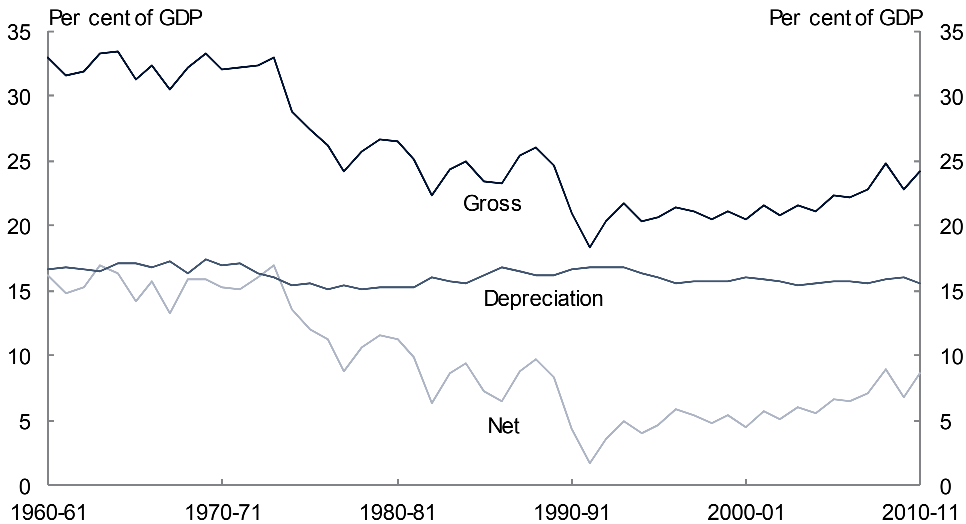
An important example of this occurred during the global financial crisis (GFC) when Australia's superannuation savings provided a funding source which could be drawn on by both the financial and corporate sectors.

BUILDING A HIGH SAVING ECONOMY

Australia's gross saving rate (gross national saving as a proportion of GDP) fell significantly from the mid-1970s to the early-1990s, reaching a low of 18.4 per cent in 1991-92. The gross national saving rate remained broadly steady between 1992-93 and 2004-05 at around 21 per cent, before beginning to rise in 2005-06. The advent of the GFC resulted in a sharp increase in the national saving rate, which reached 24.2 per cent in 2010-11 (Chart 1).

The net national saving rate (which is gross saving less depreciation) has followed the same trend and is currently around 9 per cent of GDP, up from around 5 per cent of GDP in the early 2000s.

Chart 1: Net and gross saving



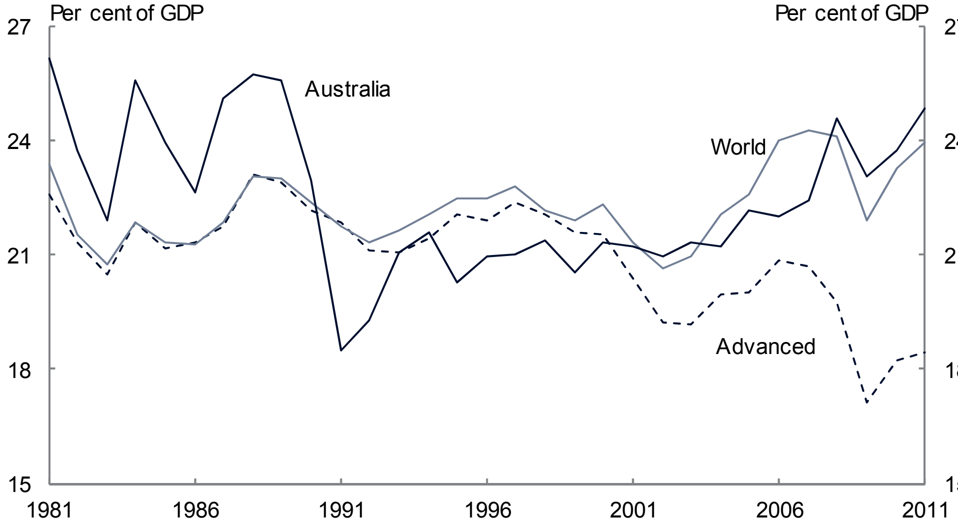
Source: ABS cat. no. 5260.0.

Australia compares well against advanced economies

After being below average for much of the 1990s, Australia's gross national saving rate in calendar year 2011 (24.8 per cent) was significantly above the advanced economy average (18.5 per cent) and slightly above the world average (24.0 per cent) (Chart 2).

The recent decline in advanced economy saving rates largely reflects cyclical economic weakness in other countries since the GFC. It is notable, however, that a significant gap between saving rates in Australia and other advanced economies had already opened up prior to the GFC. This suggests the difference in national saving trends has in part been due to other factors, including the long history of prudent fiscal policy outcomes and the maturation of Australia's compulsory superannuation system.

Chart 2: International comparison of gross national saving



Note: All data based on calendar years.
Source: ABS cat. no. 5206.0 and IMF *World Economic Outlook* April 2012.

The increase in saving has had important benefits for the economy. For example, in the context of an economy with low unemployment and a massive pipeline of mining investment, had the rise in national saving not occurred, tighter monetary policy would have been required to maintain macroeconomic stability.

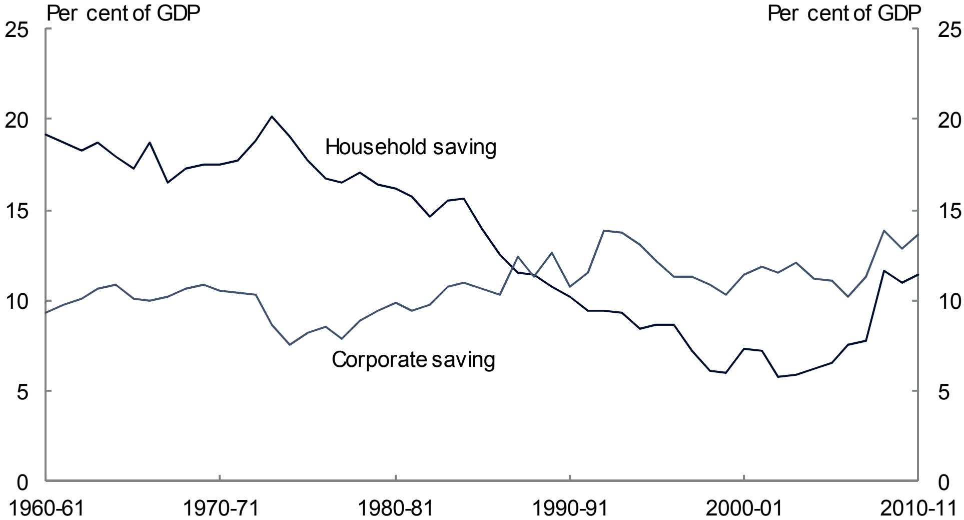
Superannuation and changed household behaviour have driven higher national saving

Saving by households and corporations (which together make up private saving) accounts for the bulk of national saving. In particular, household saving has been the major driver of shifts in national saving over the past several decades. The household saving rate declined steadily from the mid-1970s to the mid-2000s, although this fall was exaggerated by the shift to incorporation of small businesses during this period (Chart 3).

In the second half of the 2000s, the gross household saving rate increased significantly and is currently 11.5 per cent of GDP, up from a low of 5.8 per cent in 2002-03.

The compulsory superannuation system has made an important contribution to household saving since it began to be phased-in from the mid-1980s. More recently, the increase in household saving likely reflects a combination of increased consumer caution following the GFC and a return to more sustainable rates of consumption growth, after a 30-year period in which declining saving rates and strong credit growth meant that consumption grew faster than incomes.

Chart 3: Gross private saving by sector



Source: ABS cat. no. 5206.0, 5232.0, 5204.0 and Treasury.

Superannuation and demographic changes have boosted national saving

The introduction of award-based superannuation in 1985 and Australia's compulsory superannuation guarantee system in 1992 represents a key structural driver of Australia's national saving rate.

The three-pillar structure of the Australian retirement income system — the age pension, compulsory saving through the superannuation guarantee and voluntary superannuation saving — is unique among developed countries, but has considerable strengths.[1] In particular, it provides a system that satisfies the needs of all older Australians, provides the capacity for individuals to enhance their retirement income, and spreads risks between the public and private sectors in a fiscally responsible way (Australia's Future Tax System 2009).

The introduction of the superannuation guarantee required employers to make superannuation contributions on behalf of their employees. The minimum contribution rate was increased gradually from 3 per cent in 1992 to 9 per cent over 10 years. This policy has significantly increased retirement income adequacy for Australian workers and boosted national saving — underscoring the importance of the compulsory superannuation system as a major long-term economic reform (Box 1).

1 The retirement income system in many Organisation for Economic Cooperation and Development (OECD) countries provides a taxpayer or contribution funded retirement income based on a proportion of an individual's pre-retirement income. These countries also provide a minimum retirement income to alleviate poverty for those with a limited working life.

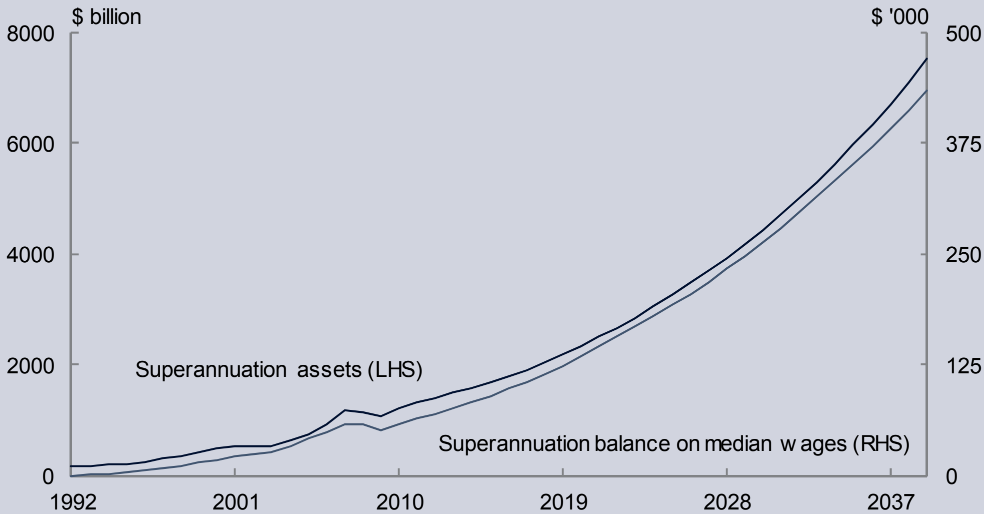
Box 1: Compulsory superannuation — a major long-term economic reform

The compulsory superannuation system has driven a strong rise in superannuation assets through growth in employee coverage and a gradual rise in contribution rates. At the end of 2010-11, total superannuation assets, arising from both compulsory and voluntary superannuation contributions, were around $1.3 trillion, or about 95 per cent of annual GDP.

Australia's superannuation assets as a proportion of GDP substantially exceeded the OECD weighted average ratio of 67.6 per cent in 2009 (OECD 2011). Taking into account changes to the superannuation system, superannuation assets are projected to rise to almost $7 trillion (130 per cent of GDP) over the next 25 years (Chart A).

The accumulation of superannuation by a person on median wages who starts with superannuation guarantee contributions at age 20 in 1992 and who retires at age pension age of 67 in 2039 will have almost $440,000 (in 2011 dollars) when they retire at age pension age (Chart A). The superannuation system is providing a significant boost to retirement incomes for Australian workers.

Chart A: Superannuation assets and superannuation accumulation

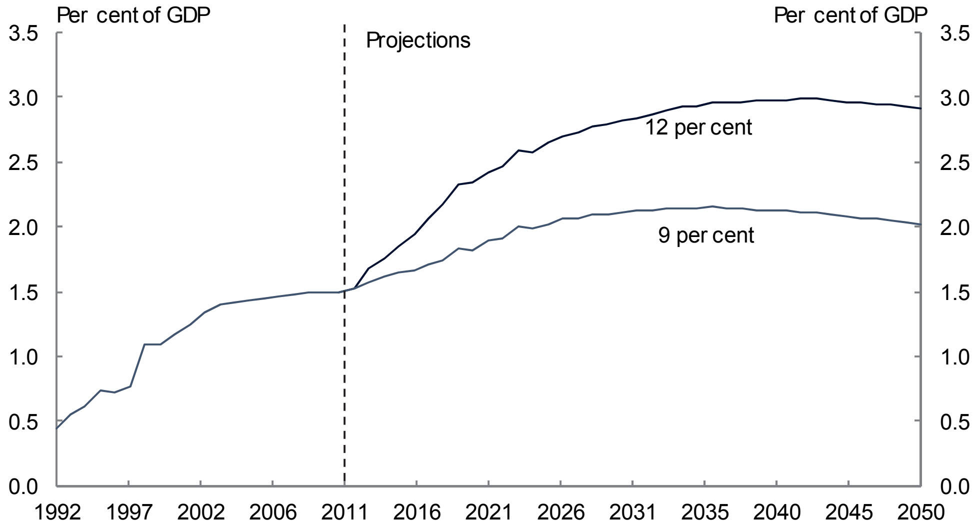


Source: Treasury.

The most recent Melbourne Mercer Global Pension Index, which assessed Australia's retirement income system against more than 40 indicators covering adequacy, sustainability and integrity, found that Australia's system ranked second (behind only the Netherlands) among a range of developed and emerging economies (Mercer 2011).

The Government's decision in 2010 to progressively increase compulsory superannuation contributions from 9 per cent to 12 per cent by 2019-20 will further support the shift in household behaviour towards higher saving. That increase, in conjunction with the maturing of the existing superannuation system, is projected to add 1.5 per cent of GDP to national saving over the next 25 years with most of this increase expected to occur over the next decade (Chart 4).[2]

Chart 4: Estimated contribution of compulsory superannuation to national saving



Note: Estimated contribution in history has been smoothed. Estimated contribution starts to decline approaching mid-century due to the indirect effects of population ageing. The 9 per cent line incorporates the gradual phase-in from 3 per cent in 1992 to 9 per cent in 2002-03, while the 12 per cent line incorporates the gradual increase from 9 to 12 per cent by 2019-20.
Source: Treasury.

Today, Australia's pool of superannuation savings stands at over $1.3 trillion (around 95 per cent of GDP), and is projected to rise to almost $7 trillion by 2037 (around 130 per cent of GDP). This significant increase in Australia's national saving will help build economic resilience by reducing reliance on external financing, and help create room for the terms of trade and investment boom in the resources sector.

The increase of the superannuation guarantee from 9 per cent to 12 per cent, the revenue cost of which is funded from the proceeds of the Minerals Resource Rent Tax, will significantly increase the future retirement incomes for many Australian workers. For example, a 30 year old today earning average full-time wages will have around an extra $118,000 (in real terms) in retirement savings. In this way, government policy is distributing the benefits of the mining boom more equitably.

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2 The estimates assume that governments adhere to the medium-term fiscal objective so that the budgetary costs of superannuation are offset elsewhere in the budget (Gruen and Soding 2011).

Demographic factors are also likely to have contributed to higher household saving over recent years. Most members of the post-war 'baby boomer' generation are currently in the peak life-cycle period for saving as they near the end of their working lives. It is appropriate that household saving be higher over the period before the major part of this group retires and labour force participation starts to fall, which is expected to occur from around the end of the current decade (Australian Government 2010).

By building a stock of income-producing assets, higher saving will help households maintain future living standards in the face of prospective declines in labour force participation. Combined with the effect of the baby boomers' saving over their remaining working lives, increases in the superannuation guarantee will help maintain retirement incomes at a significantly higher level than would otherwise occur.

The Budget measure reducing the tax concession received by very high income earners on their superannuation contributions is expected to have only a small effect on national saving but will increase the fairness of the superannuation system.

The rise of the cautious consumer

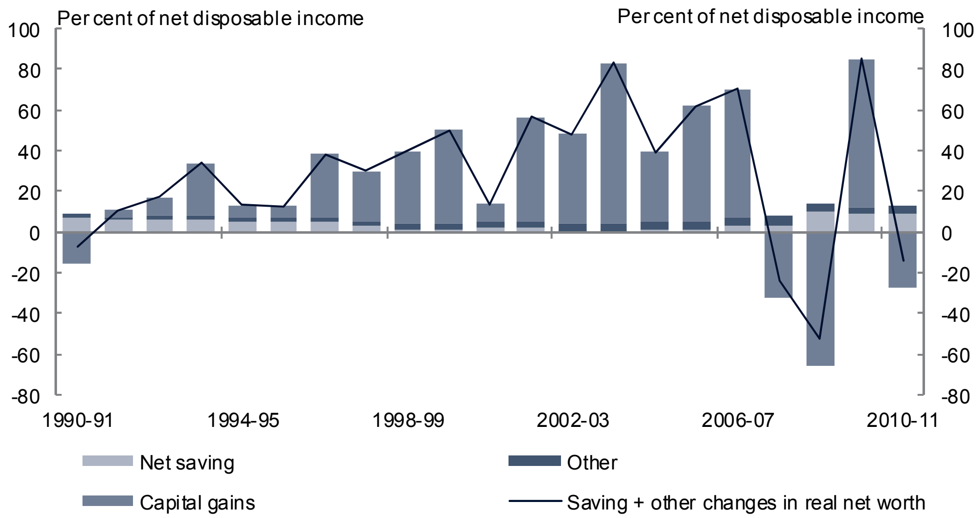
While household saving began to recover in the early-2000s, the largest increase in the saving rate occurred during the GFC, and has been reinforced by ongoing global uncertainty.

During the early to mid-2000s, rapid increases in asset prices, particularly property prices, made households feel wealthier and as a result, they used debt to fund increased consumption (Chart 5). Prior to the GFC, capital gains were consistently positive, albeit much more volatile than net disposable income.

However, the GFC resulted in households suffering capital losses of nearly 100 per cent of annual net disposable income over the two years 2007-08 and 2008-09. Therefore, the recent increase in household saving is likely to reflect an attempt by Australian households to offset the impact of asset price falls on their balance sheets and as a precaution against further external shocks. These wealth losses may also explain households' reluctance to take on debt since the GFC.

As the persistently strong capital gains seen in the pre-GFC period are unlikely to be repeated in the near future, it seems unlikely that households will revert to the very low saving rates seen in the first half of the 2000s (Freestone et. al. 2011). Bouts of global instability and ongoing global uncertainty may continue to reinforce cautious household behaviour for some time. However, if global instability moderates households may begin to feel more secure, which could lead to some decline in household discretionary saving.

Chart 5: Net saving plus capital gains and losses



Source: ABS cat. no. 5204.0 and Treasury.

The high terms of trade has boosted incomes and saving

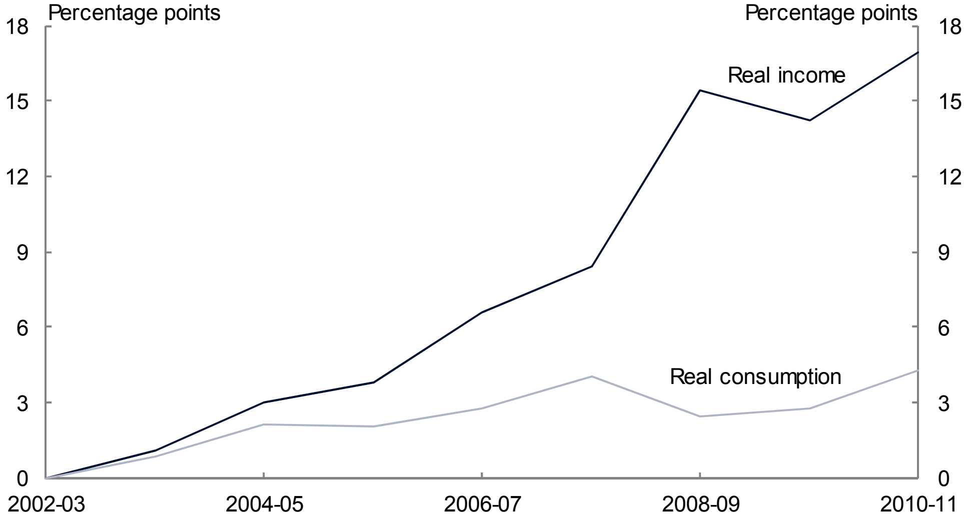
The unprecedented rise in the terms of trade, which began in the mid-2000s, is likely to have also contributed to an increased saving rate. This rise in the terms of trade has boosted Australia's national income and resulted in a period of above-trend growth in household income.

Strong demand from Asia is expected to support the terms of trade remaining at high levels over a long period, however, the terms of trade are expected to decline gradually over time as new sources of supply come on stream here and abroad. As a result, the current boost to income should be expected to raise the rate of national saving for both consumption smoothing and precautionary reasons.

A measure of the income gain from the terms of trade is the difference between cumulative growth in real incomes and cumulative growth in real GDP. Growth in real household disposable income from the start of the mining boom in 2002-03 to 2010-11 has exceeded growth in real GDP by 17 percentage points, while real consumption growth has exceeded real GDP growth by only 4¼ percentage points. This implies a significant proportion of the additional income from the mining boom has been saved (Chart 6).

Part of the rise in saving has also occurred because the high terms of trade have resulted in strong growth in profits, particularly in the mining sector, allowing mining companies to finance high levels of investment through retained earnings. This factor has been largely responsible for the recent rise in the corporate saving rate. With commodity prices expected to fall only gradually across the forward estimates, mining profits should continue to support a relatively high corporate saving rate for some time.

Chart 6: Household real disposable income and real consumption gain



Note: The lines represent the cumulative difference between growth in these variables and growth in real GDP since 2002-03.
Source: ABS cat. no. 5206.0 and Treasury.

The structural adjustment to financial deregulation and low inflation may have come to an end

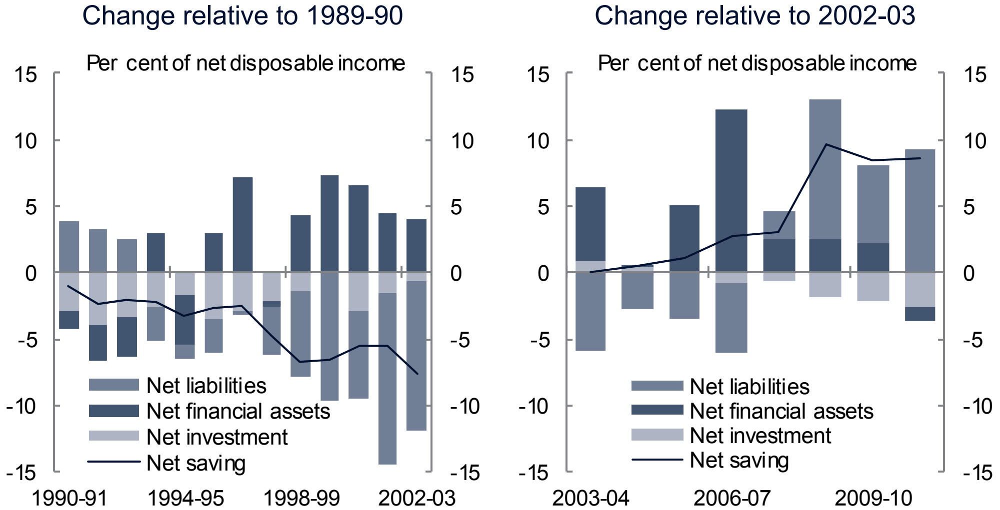
The fall in household saving up to the mid-2000s reflected primarily a prolonged, but ultimately one-off, structural adjustment to financial deregulation from the early-1980s and the transition to a low inflation and interest rate environment from the early-1990s.

The combination of these two factors led to greater access to credit, rising house prices and high levels of confidence, all of which allowed households to borrow more, both to finance purchases of housing and financial assets, and to bring forward consumption.

As a consequence, from the early-1990s up until the mid-2000s, households increased their accumulation of debt (Chart 7), which was used in part to help fund strong growth in consumption. This led to a significant fall in the household saving rate (net household saving as a share of disposable income) from around 5.5 per cent in the early-1990s to 0.5 per cent by the mid-2000s.

This adjustment to financial deregulation and lower borrowing costs is likely to have been a significant structural driver of change in household saving. From the second half of the 2000s, however, households began to slow their accumulation of debt, and as a result the household saving rate began to rise. With its likely completion, households in aggregate can be expected to consolidate their financial position over coming years by returning to more normal levels of saving and borrowing (Stevens 2011). However, government policy plays an important role in securing this transition.

Chart 7: Contributions to changes in household net saving



Note: Components may not add to net saving as errors and omissions are excluded. Increased net incurrence of liabilities is shown as a negative.
Source: ABS cat. no. 5204.0 and Treasury.

HIGHER NATIONAL SAVING IMPROVES MACROECONOMIC RESILIENCE

Increases in national saving help improve the economy's resilience to economic shocks. Part of the recent rise in saving, especially by households, is likely to represent a response to increased risks in the post-GFC economic environment.

Higher saving can help increase macroeconomic resilience by reducing financial vulnerability to adverse shocks. This vulnerability can arise from three main sources:

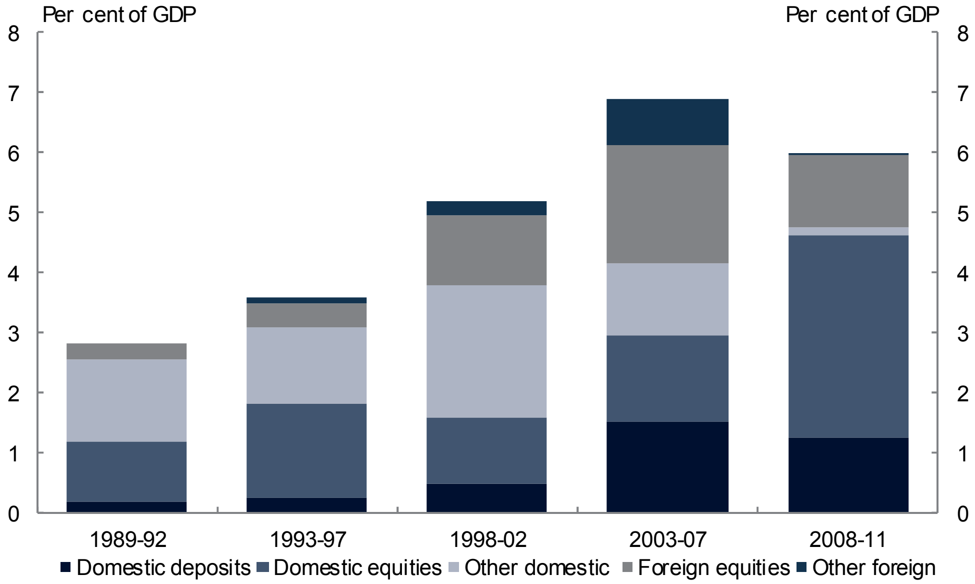
- financing risk — the risk that the ability to issue new debt or roll over maturing debt is disrupted and forces a sharp contraction in spending;
- debt servicing risk — the risk that debt cannot be serviced in the event of a fall in incomes, resulting in defaults and forced asset sales; and
- balance sheet risk — the risk (magnified by leverage) of wealth losses due to falls in asset prices, resulting in falls in spending.

Superannuation is a growing source of domestic finance

Superannuation is an increasing source of financing to the rest of the economy, which has helped to reduce financing risks, particularly since the GFC. By contributing to higher national saving, superannuation also increases national income either through higher investment or by earning more investment income for Australians.

Since 2008 there has been a substantial shift in superannuation funds' asset acquisition away from foreign equities and debt securities towards domestic equities (Chart 8). Around 50 per cent of net equity financing for both banks and non-financial corporations over this period has come from superannuation funds. Holdings of domestic deposits by superannuation funds have also increased since the early-2000s. This has helped Australian banks and non-financial firms shift toward safer forms of financing in an environment where debt financing is less readily available and is seen as more risky than prior to the GFC. This was particularly important when global debt markets were impaired during the GFC.

Chart 8: Superannuation funds' net acquisition of financial assets



Note: Years ending 31 December.
Source: ABS cat. no. 5206.0, 5232.0 and Treasury.

Our reliance on external debt has fallen

The rise in national saving has also reduced Australia's reliance on external financing to fund domestic investment. In Australia, most of this external financing has historically come in the form of debt, so higher national saving can reduce aggregate financing risk. After rising from around 42 per cent of GDP at the start of 2002, Australia's net foreign debt (public and private) has remained flat at around 52 per cent of GDP since the start of 2008.

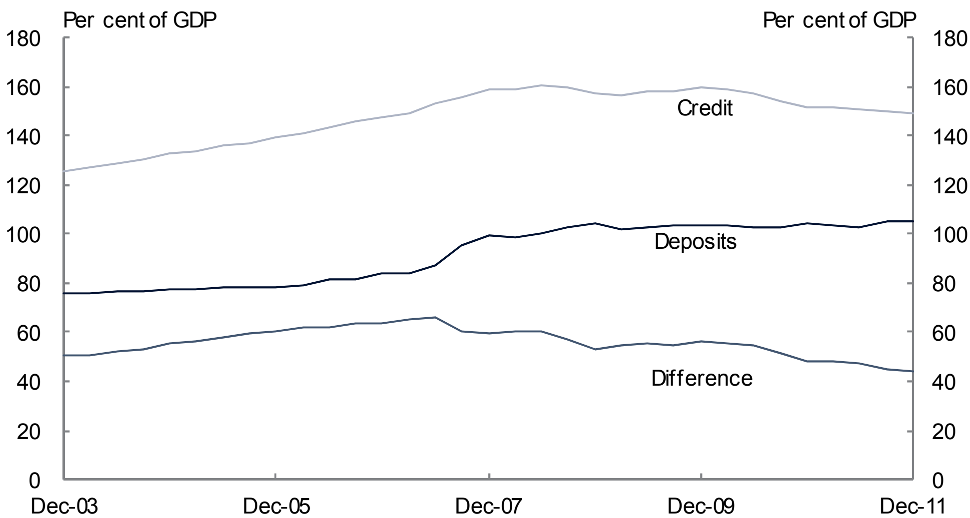
Had private saving behaviour remained unchanged, Australia's exposure to international financial shocks would have increased at a time when global financial markets have become much more volatile.

Moreover, it is likely that any additional external borrowing would have been channelled primarily through the banking system, as was the case before the GFC.

While Australian banks are amongst the strongest in the world, the GFC demonstrated starkly the risks seen in other countries from an excessive reliance on short-term funding from wholesale debt markets.

Since the GFC, Australian banks and other depository institutions have substantially reduced their reliance on short-term funding. The recent change in household saving behaviour has made an important contribution to reducing this exposure, through both reduced household demand for credit and increased deposit saving. As a result, the gap between credit and deposits — representing the requirement for market funding — has fallen by around 20 per cent of GDP since 2007 (Chart 9).

Chart 9: Authorised Deposit-taking Institution deposits and credit

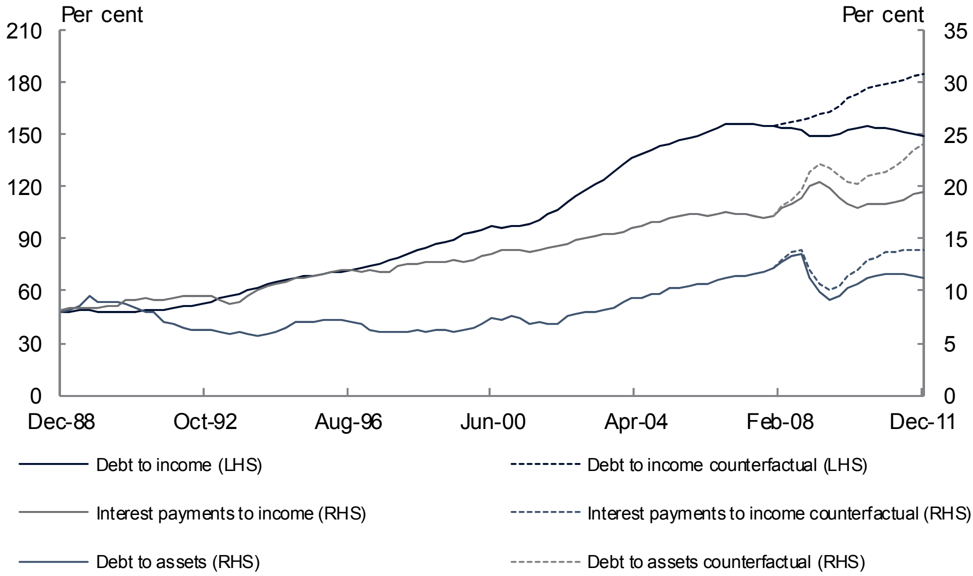


Note: Deposits exclude intra-group deposits.
Source: ABS cat. no. 5206.0, APRA, RBA and Treasury.

The reduction in debt accumulation that has underpinned the recent recovery in household saving is also reducing households' vulnerability to adverse developments, reducing debt servicing and balance sheet risks.

While the household debt-to-income ratio has fallen only modestly from a peak of 156 per cent to 150 per cent (Chart 10), this ratio would have continued to rise in the absence of a change in household behaviour. For instance, if household net borrowing had continued at the average rate seen from 2002 to 2007, the household debt-to-income ratio would currently be around one-quarter higher at 185 per cent, with commensurate increases in both debt servicing and gearing ratios.

Chart 10: Household finance ratios



Source: RBA and Treasury.

Another aspect of the increase in household saving that assists in reducing vulnerability to macroeconomic risks is that around one-half of households with mortgages have been making substantial repayments in excess of the minimum required. Indeed, excess repayments, on average, have been almost as large as the required debt-servicing payments, implying that these borrowers have sizeable buffers to draw on should their incomes fall (RBA 2012).

GOVERNMENT SAVING PROMOTES MACROECONOMIC STABILITY AND FISCAL SUSTAINABILITY

Fiscal policy plays an important role in helping to stabilise the economy through the operation of the automatic stabilisers and during exceptional circumstances where monetary policy alone may not be able to respond with sufficient speed and force. The Government's fiscal stimulus during the GFC is a prime example of this important role. The Government stepped in to support aggregate demand when the private sector retreated, with a credible strategy for returning the budget to surplus as the economy recovered to trend growth.

Another crucial objective of fiscal policy is fiscal sustainability. Maintaining fiscal sustainability is particularly important at this time of ongoing global economic uncertainty and when fiscal deficits and high national debt have been a proximate cause of distress in many countries around the world. Fiscal sustainability is essential to maintaining macroeconomic stability, reducing economic vulnerabilities, and achieving sustained growth in living standards.

The Government gives effect to promoting fiscal sustainability through its objective of achieving budget surpluses on average over the medium-term. Government saving is the difference between revenue and recurrent spending. This means that investment financed from current revenue adds to government saving, even though it does not add to the underlying cash balance. As a result, a surplus objective implies a larger positive level of gross government saving.

As well as directly affecting fiscal sustainability, the overall budget position can affect expectations and confidence. Public finances that are viewed as unsustainable generate uncertainty, as governments are expected to act to secure finances by reducing expenditure or increasing taxes, or face the risk of default. A credible strategy to maintain fiscal sustainability, therefore, provides a positive foundation for long-term decision-making by households and businesses.

Fiscal sustainability is also important because of the longer-term challenges arising from population ageing and climate change. These challenges result substantially from decisions made by preceding generations from which they benefitted: in the former case, establishing spending programs with unsustainable future fiscal costs; in the latter case, burning of fossil fuels with unsustainable future environmental costs.

Responsible fiscal policy requires the budget to be returned to surplus

Under the Government's macroeconomic policy framework, the primary objective of fiscal policy is to maintain the budget in a sustainable position from a medium-term perspective. Monetary policy has primary responsibility for managing the level of demand to keep the economy on a stable growth path consistent with low inflation over the medium-term.

There are circumstances in which fiscal policy needs to support monetary policy in managing short-term changes in demand, beyond the automatic stabilisers. This may be either because the effectiveness of monetary policy is impeded or, as occurred during the GFC, adverse shocks affecting the economy are sufficiently large, and arrive sufficiently quickly, that a monetary policy response alone would be insufficient to respond to them. Outside of these circumstances, fiscal policy should revert to its medium-term focus.

In current circumstances, fiscal policy should be concerned with restoring the budget to a position consistent with the Government's objective of achieving budget surpluses on average over the medium-term. With the economy forecast to grow around trend, a low unemployment rate and commodity prices still close to historical highs, it is appropriate to bring the budget back to surplus in 2012-13.

By returning to surplus at this time, the Budget recognises that in normal circumstances, with fiscal policy focussed on the medium-term, monetary policy should play the primary role in managing demand to keep the economy stable.

Importantly, the Budget forecast of around-trend growth takes account of the impact of the substantial fiscal consolidation in 2012-13. Returning the budget to surplus ensures that monetary policy has scope to respond to economic developments, as appropriate and consistent with the medium-term inflation target.

Against a backdrop of continuing global uncertainty, it is also prudent to strengthen the government's balance sheet while economic conditions remain favourable to support Australia's capacity to respond to future adverse shocks.

Returning the budget to surplus will also help maintain confidence in the strength of Australia's public finances as reflected in Australia's AAA credit rating by all three major rating agencies. Financial markets and international organisations are strongly focused on fiscal credibility, which places a premium on meeting the commitment to return the budget to surplus and adhering to the medium-term fiscal strategy.

Return to surplus achieved despite revenue weakness

However, the return to surplus has been made more difficult by the weakness in revenues. In the years prior to the GFC, rapidly rising commodity prices provided a major boost to company profits and wage growth in resources and resources-related industries. Combined with strong asset price growth, a maturing capital gains tax system, and strong household consumption growth, this resulted in robust growth in tax receipts. However, tax receipts are now expected to remain well below their mid-2000s level relative to GDP over the forward estimates. This lower tax take reflects both the ongoing impacts of the GFC and structural factors such as the investment intensive nature of the current phase of the mining boom (see Statement 5 for more details).

Despite these challenges, the Government is returning the Budget to surplus in 2012-13, with surpluses growing over the forward estimates. The return to surplus is being achieved by the Government making net savings and lower payments than expected at the *Mid-Year Economic and Fiscal Outlook 2011-12* (see Statement 3 for more details).

In total, the Government's fiscal consolidation is expected to improve total government saving by around 3 per cent of GDP over the next three years.

Government saving is important for managing demographic challenges

Higher government saving over the medium-term, consistent with the medium-term fiscal strategy, will also mean the government is better placed to deal with the budgetary pressures arising from population ageing by ensuring that public finances start from a strong position.

The *2010 Intergenerational Report* projected that with unchanged policies Australian government spending on health, age-related pensions and aged care would increase by 5.3 per cent of GDP over the following 40 years. To avoid exacerbating these pressures, it will be important to maintain fiscal discipline while demographic influences remain favourable.

Government saving will help in managing the high terms of trade

Government saving can also play a role in ensuring that the benefits of the high terms of trade are sustained over a longer period, as well as helping to manage its immediate macroeconomic impacts.

A key lesson from Australia's experience during the initial phase of the mining boom is the importance of increasing government saving as revenues increase due to the impacts of high commodity prices. The period prior to the GFC saw very strong revenue growth, but rather than being saved, these revenues were in substantial part channelled back into the economy, which fed into increased household spending (Box 2).

In an economy that entered the boom with relatively limited spare capacity, this added to demand pressures associated with the massive expansion in mining investment. This contributed to the significant rise in inflation that occurred in 2007-08. It also meant that monetary policy had to be significantly tighter than otherwise.

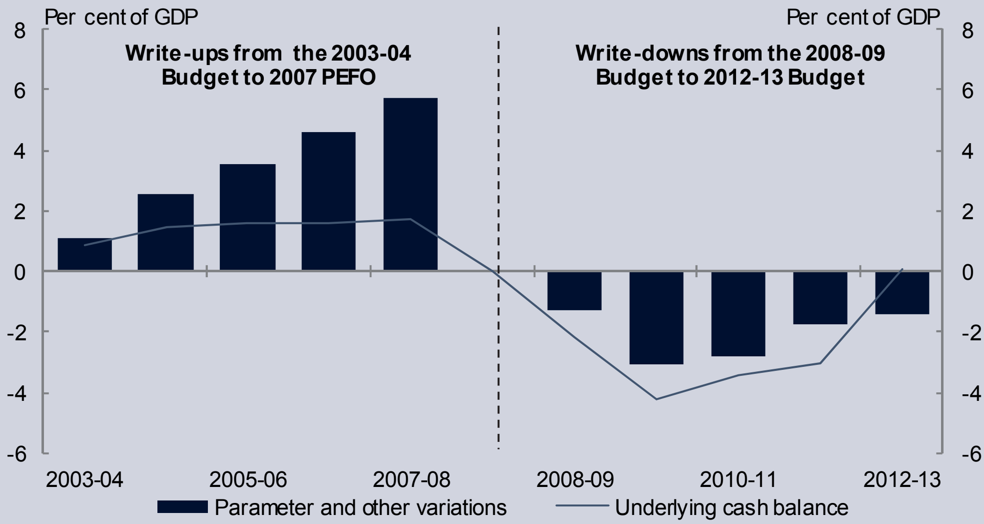
The Government's fiscal strategy is consistent with ensuring a further rise in government saving in the event that the high terms of trade support strong economic activity and incomes over the medium-term. This would continue to reduce pressures on interest rates and temper the pace of structural adjustment.

Box 2: Revenue changes and the underlying cash balance

The initial phase of the mining boom delivered a surge in tax revenue that was in substantial part channelled back into the economy. This led to increased household consumption, adding to demand pressures associated with the terms of trade boom and contributing to the significant rise in inflation that occurred in 2007-08.

The revenue surge increased each year from the beginning of the mining boom and reached almost 6 per cent of GDP by 2007-08. Over this period the underlying cash balance rose from 0.9 in 2003-04 to 1.7 per cent of GDP (Chart A). Had the entire surge been saved, the underlying cash balance, and therefore government saving, would have increased substantially more over the period.

Chart A: Revenue write-ups and write-downs and the underlying cash balance



Note: Revenue write-ups and write-downs reflect parameter and other variations and exclude GST.
Source: Treasury.

In contrast to the around 18 per cent of GDP revenue write-ups (parameter variations only) in the five years prior to the GFC, revenue write-downs since the GFC have amounted to around 10 per cent of GDP.

Proposals for saving through a sovereign wealth fund

With the return to surplus, the Government's first priority is to strengthen its balance sheet by reducing net debt from already very low levels.

The Government is committed to maintaining a liquid and efficient Commonwealth Government Securities market. This means that continued surpluses will require the Government to accumulate financial assets in some form once gross debt is reduced sufficiently, while continuing to reduce the level of net debt outstanding.

Some commentators have argued that ensuring the benefits of the high terms of trade are sustained, as well as managing its immediate macroeconomic impacts, may be best achieved by investing some portion of government revenues arising from the high terms of trade in financial assets through a sovereign wealth fund that operates at arms-length from government, thereby quarantining these revenues from spending.

What matters in this regard is not the establishment of such a fund *per se*, but whether national (and not just government) saving rises in response to unusually high resource revenues. From the perspective of the government balance sheet, establishing a sovereign wealth fund without a change in fiscal objectives would not alter either current or future levels of government saving and net financial worth, as accumulating financial assets has the same effect as repaying borrowings (Garton and Gruen 2012).

There are two broad types of sovereign wealth funds. The first involves building a stock of financial assets for long-term saving. This is the type of fund established in Norway, which has invested all government petroleum revenues in its sovereign wealth fund since 1996.

Superannuation performs the function of a long-term savings fund

The superannuation system already serves as a decentralised means of accumulating financial assets on a large scale.

Australia's compulsory superannuation system has some similarity to Norway's sovereign wealth fund as they both involve increasing saving via the accumulation of financial assets over a long period of time. As a share of GDP, Australia's superannuation assets are of a similar order of magnitude to Norway's sovereign wealth fund and private pension assets combined, and are set to increase further with the increase in the superannuation guarantee from 9 per cent to 12 per cent. Instead of saving through a centrally managed fund, however, superannuation assets are kept in individual retirement accounts that cannot be accessed until individuals reach their preservation age.

There are also a number of important differences between Australia's circumstances and those of Norway (Garton and Gruen 2012). First, the remaining life of Norway's oil and gas reserves is much more limited than for reserves of Australia's key commodities (iron ore and coal). Second, Norway's economy and government revenues are far more dependent on revenues from the resources sector than is the case in Australia. Finally, Norway faces greater long-term fiscal challenges than Australia. This implies a stronger case for Norway to save these revenues to smooth consumption over time and for intergenerational equity.

In terms of intergenerational equity, the Minerals Resource Rent Tax is central to the Government's plan to spread the benefits of the mining boom and help ensure the gains provide benefits for generations to come. In particular, revenue from the Minerals Resource Rent Tax will help fund critical investment in roads, bridges and other infrastructure, relieving capacity constraints particularly in mining regions. Furthermore, revenue from the tax will also contribute to funding the revenue cost of the increase in the superannuation guarantee.

Australia's fiscal rules and institutions mean a stabilisation fund is not warranted at this time

The second type of fund is a stabilisation fund that involves setting aside revenues in a fund during periods in which commodity prices are unusually high, which can then be drawn down to support the budget in the event that commodity prices fall. The purpose of this type of fund is to enhance the government's capacity to implement counter-cyclical fiscal policy, thereby helping to moderate the macroeconomic impacts of commodity price fluctuations. This type of fund has been in place in Chile since 2000.

The Government's fiscal rules mean that it is able to implement counter-cyclical fiscal policy without the need for a mechanism of the kind adopted in Chile. The medium-term fiscal strategy provides the Government with scope to increase government saving during periods of steady economic growth while allowing government saving to fall during economic downturns, as it did to support demand and jobs during the GFC.

Government saving over coming years will occur through a combination of debt repayment from already very low levels, accumulation of financial assets and investments in infrastructure. The Government will also contribute to national saving through its superannuation policies. As decisions are made over coming years on how to use the proceeds from continued high terms of trade, it will be important to consider which allocation of saving between these forms will best contribute to maintaining prosperity into the future.

CONCLUSION

Since the mid-2000s there has been a significant increase in Australia's national saving rate. Australia's system of compulsory superannuation has made a substantial contribution to national saving since its introduction in mid-1980s. More recently, national saving has been boosted by a marked shift to more cautious saving and borrowing behaviour by households, particularly since the GFC.

This represents a reversal following a long period in which household saving declined and household borrowing rose. As this period of household debt accumulation appears to have come to an end, much of the recent increase in saving is likely to be sustained for some time to come, with the boost to the superannuation guarantee progressively from 9 to 12 per cent helping to secure the gains in national saving.

The increase in the superannuation guarantee, the revenue cost of which is funded by the Minerals Resource Rent Tax, helps ensure the benefits of the boom are spread fairly across the economy.

In the period prior to the GFC very strong revenue growth was in substantial part channelled back into the economy, rather than being saved. This fed into increased household spending, which added to demand pressures and contributed to a significant rise in inflation that occurred in 2007-08 and significantly tighter monetary policy than otherwise.

Returning the Budget to surplus from 2012-13 will add to national saving, ensure fiscal policy is not generating price pressures in the economy and will continue to provide monetary policy with scope to respond to economic developments. It will also maintain confidence in the strength of Australia's public finances.

Delivering surpluses, along with further improvements to superannuation will foster fiscal sustainability which will assist in managing the high terms of trade while helping meet the challenges of population ageing. Higher national saving will also improve economic resilience by reducing Australia's vulnerability to adverse shocks.

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