ECONOMICS & MARKETS RESEARCH
ANZ AUSTRALIAN FEDERAL BUDGET REPORT

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BUDGET BACK TO SURPLUS ON STRONG ECONOMIC OUTLOOK

SUMMARY

- The underlying cash deficit is has improved to A$40.8bn in 2010-11 and to A$13.0bn in 2011-12. **The Budget is now expected to return to surplus in 2012-13, three years earlier than previously projected**.
- The government's outlook for the Australian economy is broadly in line with ANZ (and the RBA's) forecasts. The boost to real (and nominal) GDP over the next two years is largely driven by a 14¼% surge in the terms of trade in 2010-11 on the back of the recommencement of the commodities boom. **Risks around the budget from the global economic outlook are dependent on the terms of trade outcomes.**
- A range of new initiatives were announced focusing on health, savings and border protection. New policy measures have almost been fully funded from increases in taxes.
- The Government's Budget projections (and the return to surplus in 2012-13) are highly dependent on a strong economic recovery across Asia and Australia.
- Most of the new policy measures do not begin until 2011/12, leaving the short-term impact on the economy negligible.
- **Australian net debt is now set to peak at 6.1% of GDP in 2011-12.** This is smaller and earlier than the 9.6% peak in 2013-14 that was previously projected. Australia's net debt contrasts sharply with the expected average net debt position of major advanced economies of 82.4% of GDP in 2011.
- Total bonds on issue are likely to be a little higher than we expected this financial year and next. Consequently, the 2010-11 line has a higher starting point and we now expect the peak around the A$230bn area. **The government now expects net debt issuance of $55bn for 2010-11** with Treasury bond issuance around A$60bn.

FIGURE 1. KEY BUDGET AGGREGATES

	2009-10 (e)	2010-11 (f)	2011-12 (f)	2012-13 (p)
Underlying cash balance				
A$bn	-57.7	-46.6	-31.2	-15.9
% of GDP	2.7	8.9	17.9	19.6

Source: Budget Papers

ASSESSMENT

Warren Hogan
Chief Economist

BORING BUDGET HITS THE MARK

As far as pre-election Budgets go, this one should be regarded as measured. None of the big spending associated with the 2004 or 2007 Budgets. An early return to surplus and on-going commitment to contain real expenditures by 2%, which the government has now extended until a surplus of 1% of GDP is achieved. While there are many small, targeted new policy initiatives within this budget, **the Government remains focused on some key strategies issues**; most importantly in our view, a commitment to support a higher rate of national savings in the future. Tax relief for savings vehicles such as deposits and bonds will have some impact on raising national savings over the years ahead and as the Budget improves the extent of this tax relief can be extended from the modest amounts put forward tonight.

But the centre-piece of the Budget is a quicker than expected return to surplus, which is now forecast to happen in 2012-13, three years ahead of the schedule set out in the mid-year update last November. **All of the improvement in the Budget is due to a better economic outlook, with policy decisions actually working in the other direction**. For example, the move in the 2012-13 budget position from a previous forecast deficit of A$15.9bn to a surplus now of A$1bn comes on the back of a A$19.6bn improvement in the budget due to 'parameter variations' (read changes to the economic forecasts). In the same year new policy decisions detract A$2.6bn from the budget bottom line.

A strong economic outlook underpins this Budget. Growth in real GDP in the coming financial year is expected to be 3.25%, rising to 4% in 2011/12. Over this period the terms of trade is expected to surpass the peak of commodity boom mark I. These expectations are broadly consistent with our own forecasts and also those of the RBA, released last Friday in the *Statement on Monetary Policy*. So strong economic outcomes and a surge in revenues (mainly company income taxes) are the key to the improvement in the Government's Budget. **If we get the strong economic outcomes, we see no reason why the corporate tax take will not follow, as this is exactly what happened in commodity boom mark I**.

There are clear risks to the economic outlook that lurk behind this otherwise strong set of core projections. The situation in Europe remains problematic despite recent policy initiatives and of course, much of this economic strength in the forecasts is underpinned by China sustaining a strong economy for many years. **If these international economic risks emerge as likely outcomes, the budget position will be severely affected.**

Our main concern within the economic forecasts is the almost unbelievably well behaved inflation outlook. Despite strong real and nominal growth in the economy and an unemployment rate heading below 5% once again, inflation is projected to stay in the middle of the RBA's target band for the next four years. We don't believe it! Unless the Australian dollar rises another 30% (possible) or wages remain remarkably contained (unlikely and not the Government's forecast), we just can't see inflation holding at this rate. The Budget results are not overly sensitive to changes in the inflation forecast although higher inflation will reduce the surplus (increase the deficit). We doubt this is the motivation for this unusual forecast.

Many economists will argue that there should have been more done to cut back on spending and tighten up fiscal policy. Good luck in an election year! But this does mean that most of **the heavy lifting on leaning into the inflationary effects of commodity boom mark II will be left to the RBA**. And this is probably a position the government doesn't want to have to acknowledge. This is not to say that the Budget is inflationary and thus forcing up interest rates; it is not. But as inflation pressures rise due to the

ASSESSMENT

resources/investment boom currently projected, the Government will need to look to the RBA, rather than its own fiscal settings, to fight-off inflation risks.

But the elephant in the room remains the Resources Super Profits Tax, now firmly entrenched in the government figuring. The first year of operation in 2013-14 will see A$9bn raised from this new tax out of a total corporate tax take of A$109bn. The Treasurer has said that if the RSPT goes, so do the other commitments associated with it (extended super and the cut to other company taxes) and thus the return to surplus is not dependant on the RSPT. Technically correct, but the new package is a big part of the Budget. There is a long way to go on how this new tax will look, if indeed it goes ahead. The uncertainty around this is not helpful and the onus is on the government to get some clarity here.

If this budget is boring, then job well done Treasurer. Boring is good in an environment where many of the wealthiest countries in the world are facing government deficits around or above 10% of GDP. For some countries, tough decisions are imminent. In Australia government debt levels will 'peak' well below previous estimates at just over 5% of GDP, compared to well over 50% for many countries and close to 100% for Greece. **Australia's financial position is strong highlighted by the credit rating being affirmed at AAA following the Budget**. More could be done but in an election year the Government needs to be commended on limiting the waste and remaining focused on some key strategic indicatives.

BUDGET DETAILS

Shane Lee
Senior Economist

THE PATH BACK TO SURPLUS

The Budget shows how the Government expects the fiscal position to move back to surplus by 2012-13. In the 12 months since the May 2009-10 Budget the 2010-11 underlying cash balance has improved from a projected deficit of A$57.1bn to a deficit of A$40.8bn. However, in 2011-12, the Government expects the budget deficit to be A$13bn before returning to surplus (A$1bn) in 2012-13.

The turnaround announced tonight from last year is largely due to better parameter variations (A$17.7bn in 2010-11, A$30.9bn in 2011-12 and A$31.6bn), as the domestic and Asian-led global economic recovery improved top line revenue. Discretionary policy decisions made to support growth are relatively insignificant to the bottom line over the forecast period (Figure 2).

FIGURE 2: RECONCILIATION OF GENERAL GOVERNMENT UNDERLYING CASH BALANCE ESTIMATES (A$BN)

		2009-10	2010-11	2011-12	2012-13
Budget 09-10		-57.59	-57.05	-44.54	-28.15
Parameter Variations	MYEFO 09-10	0.42	8.84	13.00	11.99
	Budget 10-11	2.73	8.89	17.90	19.56
	Total	3.15	17.73	30.90	31.56
No Policy Change Underlying Cash Balance		-54.44	-39.32	-13.64	3.41
Policy Decisions	MYEFO 09-10	-0.516	1.587	0.367	0.256
	Budget 10-11	-2.124	-3.024	0.227	-2.648
	Total	-2.64	-1.437	0.594	-2.392
Budget 2010-11		**-57.08**	**-40.76**	**-13.05**	**1.02**

Source: Budget Papers

In 2009-10 the drag from policy decisions has been more than offset by the positive impact of parameter variations, and in the out years parameter revisions drive the Budget back into surplus.

The relatively benign policy impact on the Budget is driven by balancing higher spending with the introduction of new taxes. The new taxes include the Resource Super Profits Tax and the increase in tobacco excise. The Resource Super Profits tax alone is expected to deliver A$3bn to the budget in 2012-13 and A$9bn in 2013-14.

MACRO IMPACT OF THE BUDGET

Katie Dean
Senior Economist

NO SUBSTANTIAL TIGHTENING OF FISCAL POLICY

The change in the Budget balance – the simplest method of measuring the impact of fiscal policy on the economy – suggests that fiscal policy is being tightened quickly and significantly. The A$16bn improvement in the deficit in 2010-11 represents 1.1% of GDP and the A$29bn improvement in 2011-12 is 1.8% of GDP.

This however is likely overstating the impact. Fiscal policy, and thus the change in the budget position, is made up of automatic stabilisers and discreet new policy measures. In our view, it is the budgetary impact of the discreet new policy measures, and the extent to which these blunt or add to the automatic stabilisers, that will tell us the real fiscal tightening.

Assessing this is a little murkier. The government estimates that the withdrawal of its emergency stimulus measures will subtract around 1ppt from GDP growth over 2010 and ¾ppt from growth in 2011. This seems reasonable.

The question for this Budget then becomes whether the Government is using the sharp improvement in the economy since MYEFO to increase this fiscal policy tightening. The numbers suggest barely. Since MYEFO the Government's new spending measures will only just be offset by new savings, delivering a net saving over 2009-10 to 2013-14 of just A$0.5bn (see Figure X below – and note this relies on the passage of the Resource Super Profits Tax in its current form in 2012-13). This relatively small net save suggests the 2010-11 Budget has delivered only a very small tightening of fiscal policy since MYEFO. Moreover, this net save is cumulative. In 2010-11, new spending is $2.3bn higher than new savings. This suggests the fiscal withdrawal may actually be a little smaller than the Government's estimates.

In assessing the effect of fiscal policy on the economy, it is also important to consider the effect of policies on the saving and spending patterns of different sectors of the economy. On this score, the Budget ticks plenty of the right boxes. The redistribution of the proceeds of the mining boom (via the sharp rise in company profits) towards sectors that will promote greater efficiency and capital deepening, including education and infrastructure is commendable. Attempts to promote greater savings in the economy, that will provide an important buffer to future 'shocks', is also welcome.

RBA STILL HAS WORK TO DO

The Government's modest fiscal tightening is appropriate given Australia's solid growth outlook. But in our view it probably won't be enough to mitigate current upside risks to inflation. There is, after all, only so much a budget can do to address the drivers of Australia's upturn. Regulatory uncertainty aside the recovery global economy and strong commodity prices are likely to see Australia again lean on its capacity constraints in the period ahead. We therefore still expect the burden of keeping Australian inflation contained will still fall heavily on the RBA. We therefore would still expect further monetary tightening to be delivered in the upswing of this economic cycle and maintain our forecast for interest rates to rise to 5.25% by end-2010.

ECONOMIC OUTLOOK

Amber Rabinov
Senior Economist

AUSTRALIAN ECONOMIC FORECASTS BROADLY IN LINE WITH ANZ (& RBA) VIEW

The government is expecting the Australian economy to gain further momentum over the next two financial years, and indeed, this is the driving force behind its vastly improved fiscal outlook. Above-trend real GDP growth of 3¼% in 2010-11 and 4% in 2011-12 is expected. For the projection years of 2012-13 and 2013-14 growth reverts to trend of 3%, as per the Government's usual practise.

The government's outlook for the Australian economy is broadly in line with ANZ (and the RBA's) forecasts. The boost to real (and nominal) GDP over the next two years is largely driven by a 14¼% surge in the terms of trade in 2010-11 on the back of the recommencement of the commodities boom.

FIGURE 3: ECONOMIC OUTLOOK, GOVERNMENT VS ANZ

Economic Parameters (%)[a]	2010-11 (f)		2011-12 (f)		2012-13 (p)		2013-14 (p)	
	Budget	ANZ	Budget	ANZ	Budget	ANZ	Budget	ANZ
Real GDP	3.25	3.30	4.00	3.50	3.00	3.60	3.00	3.50
Nominal GDP	8.50	8.80	5.75	6.80	5.50	5.70	5.50	6.30
Headline Inflation[b]	2.50	2.90	2.50	3.00	2.50	2.90	2.50	2.50
Employment Growth[b]	2.25	2.10	2.00	2.20	1.50	2.00	1.75	2.00
Unemployment Rate[c]	5.00	4.80	4.75	4.50	5.00	4.20	5.00	4.00
Terms of Trade	14.25	16.80	-3.75	3.30	-	-1.50	-	2.30
World Growth	4.25	4.25	4.25	4.40	-	4.50	-	4.60

(a) Year-average per cent change unless otherwise stated.
(b) Through the year growth to the June quarter.
(c) Unemployment rate for the June quarter.
Source: Budget Papers, ANZ.

BUT THERE ARE SOME RISKS TO THE FORECASTS

There are two key features of the government's forecasts that strike us as overly optimistic. This raises the risk that these projections will not be met, and thereby threaten the achievement of the government's rapid return to budget surplus in 2012-13.

Firstly, the **expected slowing in headline consumer price inflation from 3¼% in 2009-10 to 2½% in 2010-11 through to 2013-14 is at odds with the strong economic growth numbers projected over the forecast period**. The CPI forecasts are also significantly weaker than both the ANZ's and RBA's expectations, which is particularly surprising given the government's similar views on commodity prices and economic growth. What history has shown us is that when Australia enjoys a commodity boom such as the one that is now occurring, the strong inflow of income that arises tends to bolster demand, and in turn, prices. While the improvement in the government's employment outlook appears to be reflected in its strengthening profile for wages and household consumption, it is curious that this doesn't

ECONOMIC OUTLOOK

feed through into an acceleration in consumer prices, particularly given the capacity constraints that some parts of the economy are already facing. Last week's statements from the RBA showed a central bank that is clearly concerned with an inflation outlook that remains at or above 3% for the next 1½ years, and our analysis concurs with this view. It is thus a surprise to us that the Treasury's forecast has such a flat profile for prices growth.

Note that inflationary pressures are a two-edged sword for the budget. While higher inflation will lift nominal GDP it will also draw the RBA into raising interest rates to try to cool the economy and this may in turn slow both growth and budget revenue growth further down the track.

A second concern is the government's solid outlook for new business investment, with growth of 7% in 2010-11 rising to 12½% in 2011-12. Over the past two weeks, much newsprint has been devoted to concerns regarding the negative impact of the proposed Resources Super Profits Tax on investment in the mining sector as the cost would be greater than under current tax arrangements. While the government purported that the introduction of the RSPT would actually boost investment in the sector, the uncertainty that the proposal has already generated suggests that the mining industry (and related industries such as engineering and infrastructure) may not be as keen to invest over the next few years as the government expects (particularly as the final policy remains uncertain and yet to pass through parliament).[1]

In terms of the broader global economy, the government's solid growth forecasts (like ANZ and the RBA's near-term outlooks) are predicated on a continued strong economic performance in emerging Asia, particularly China. If something did go wrong to cause a sharp slowing in Chinese economic activity (such as a rapid tightening of liquidity and monetary conditions in the face of out-of-control overheating), this would weigh on the Australian growth outlook and likely delay the forecast return to budget surplus in 2012-13.

Finally, while European sovereign debt concerns have yet to make a significant impact on activity in Australia, the impact on risk appetite from persistent volatility on financial markets would pose a downside risk to the global economy, and in turn, Australia.

On the other hand, we do see some upside risks to the Government's projections, which as usual are for growth and employment to return to trend growth in 2012-13 and 2013-14. Our view is that the global and domestic economy will gather steam over this projection period, which in turn could deliver bigger than expected budget surpluses.

[1] Indeed, the government expects that mining-related investment will drive a 19% rise in engineering construction in 2010-11, and a further 20½% increase in 2011-12.

KEY POLICY MEASURES

Tom Kenny
Senior Economist

TAXATION

A number of corporate tax measures were introduced, including:

- Introduction of a Resource Super Profit Tax (RSPT) applicable to non-renewable resource projects. This is expected to raise A$12bn in revenue starting in 2012-13;
- The company tax rate will be cut to 29 per cent in 2013-14 and then to 28 percent from 2014-15. This will cost the government around A$2.3bn;
- Small business will be entitled to the reduced corporate tax rate of 28 per cent from 2012-13. In addition, they will be allowed to write off assets valued at under A$5,000 immediately, up from A$1,000. The cost to the Budget is A$1.6bn over the forward estimates.

Personal income tax returns will also become optional.

SAVINGS

A 50 percent discount on up to A$1,000 of interest income earned directly by an individual or indirectly a trust or managed investment scheme. This is expected to cost A$950 million over the forward estimates.

A number of measures to boost retirement incomes (costing A$2.4bn over the forward estimates), including:

- lifting the Superannuation Guarantee from 9 per cent to 12 per cent over the period 1 July 2013 to 1 June 2019;
- increase the maximum age for superannuation contributions from 70 to 75 from 1 July 2013;
- the government will introduce a superannuation contribution tax rebate (up to a maximum of A$500) for low income earners (up A$37,000); and
- a higher cap for concessional superannuation contributions up to $50,000 for people aged over 50 and with a superannuation balance of less than A$500,000.

HEALTH

The government will invest A$7.3bn in the National Health and Hospitals Network (HNHN) over five years. This includes an additional A$2.2bn, from previously announced A$5.1bn, to be spent on: improving after hours access to GPs; establishing an Individual Electronic Health Record system; and more training for health professionals.

The government will provide the states and territories at least A$15.6bn between 2014-15 and 2019-20.

The excise on cigarettes has been increased by 25% and will provide an extra A$5.0bn in customs and excise revenue over five years. This money will be used to meet the additional costs associated with the HNHN.

Reforms to pricing medicine under the Pharmaceutical Benefits Scheme are expected to yield savings of around A$1.9bn over five years from 2010-11.

SKILLS

An investment of A$661.2m in a *Skills for Sustainable Growth* strategy. This will involve spending in the following three areas: skills for recovery; a training system for the future; and foundation skills.

KEY POLICY MEASURES

INFRASTRUCTURE

A$1bn will be invested in the Australian Rail Track Corporation for upgrades to major rail networks.

A new infrastructure fund will be established – the *State Infrastructure Fund* – which will invest more than A$5.6bn over the next decade. This will be funded by some of the proceeds of the Resource Super Profits Tax. The Infrastructure Fund will be seeded with A$0.7bn in 2012-13 and will grow over time.

STRENGTHENING OUR BORDERS

An additional A$1.3bn will be provided to support the defence force in Afghanistan in 2010-11.

ENVIRONMENT

The Carbon Pollution Reduction Scheme has been deferred. This is estimated to yield savings of A$652.6m over five years from 2009-10.

Establish a Renewable Energy Future Fund that will invest A$0.7bn over four years. The fund will provide support for the development of renewable energy projects.

PLAN TO CONTINUE TO CAP REAL SPENDING GROWTH

The government will continue to cap annual (real) spending growth under 2% until the Budget surplus is at least one per cent of GDP and also on the proviso that the economy is growing at trend.

NET DEBT AND BUDGET FUNDING

Tony Morriss
Senior Strategist

NET DEBT NOW SMALLER

Australian net debt is now set to peak at 6.1% of GDP in 2011-12. This is smaller and earlier than the 9.6% peak in 2013-14 that was projected at MYEFO. As the Government points out, Australia's net debt contrasts sharply with the expected average net debt position of major advanced economies of 82.4% of GDP in 2011.

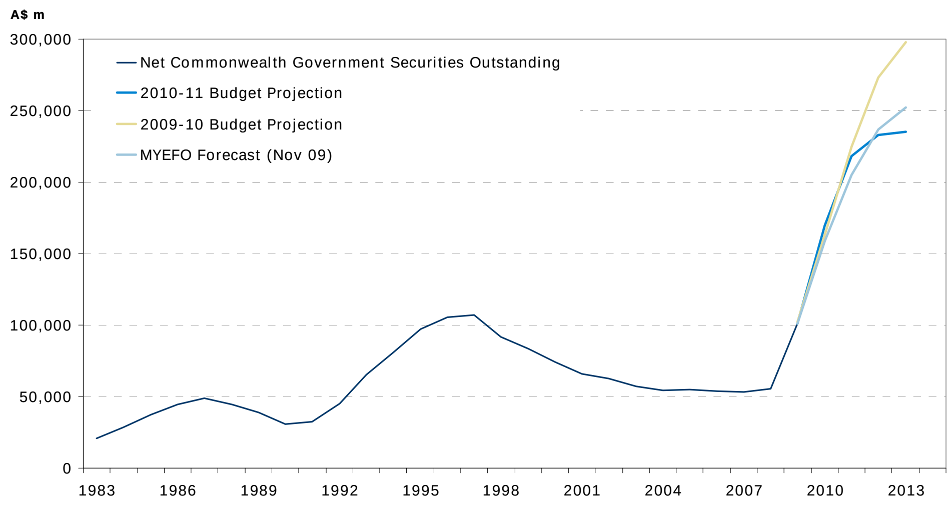
OUTLOOK FOR BOND ISSUANCE

The Budget projections put a peak in sight for Commonwealth Government Securities (CGS) on issue and the international comparisons with other major economies in terms of net debt ratios, as noted above, are impressive. The peak in CGS on issue can be seen in the chart below.

But total bonds on issue are likely to be a little higher than we expected this financial year and next. Consequently, the 2010-11 line has a higher starting point and we now expect the peak around the A$230bn area. The government now expects net debt issuance of $55bn for 2010-11 with Treasury bond issuance around A$60bn. The Budget papers now say that CGS bonds on issue will rise to $169.9bn at the end of June 2010, up from A$111.9bn at the end of June 2009.

They have also flagged a new 2022 ACGB benchmark bond that will be issued to support the 10-year bond futures contract**.**

FIGURE 4: INITIAL PROJECTIONS OF COMMONWEALTH GOVERNMENT SECURITIES ON ISSUE



The projections are based on the numbers below, and the breakdown between benchmark, T-Notes, Indexed and other bonds.

NET DEBT AND BUDGET FUNDING

FIGURE 5: RECONCILIATION OF GOVERNMENT BOND PROJECTIONS (A$BN)

	09-10	10-11	11-12	12-13	13-14
GFS Cash Balance	-54.3	-37.8	-10.2	3.9	8.5
Net Cash flows from investments in financial assets for policy purposes*	-4.9	-10.2	-4.5	-6.1	-4.4
Plus Future Fund Earnings	2.8	2.9	2.9	2.9	3.0
Headline Cash Balance:	-59.2	-48.0	-14.6	-2.2	4.1
CGS Outstanding (end period)					
$A Benchmark	133	181	196	198	194
T-Notes	15	15	15	15	15
Index Bonds and Other	22	22	22	22	22
Total CGS Outstanding (end period):	170	218	233	235	231

Source: Budget Papers, ANZ.

We had assumed the AOFM maintains around $12-15bn of T-Notes on issue over coming years (their current commitment is to keep at least $10bn on issue) However, the government has signalled it will explore the use of other financing instruments, such as Treasury Indexed Bonds. We had assumed a more modest rise in CPI Indexed-linked bonds on issue, but the figures in the Budget suggest this program could rise substantially.

And we are also unsure of the mix of bonds that will make up the expected total of A$111.9bn CGS at the end of June. If there are A$79bn bonds and around A$17bn of T-Notes then this would mean around 16bn of other bonds. Index bonds on issue currently total around A$11bn.

INFRASTRUCTURE BONDS

The government has signalled that Australian Infrastructure bonds (AIBs) will be issued to fund (in part) the National Broadband Network. But there are no further details provided. We would have thought the total bonds issued would not reach much more than around $20bn. If so it is difficult to get up to the $300bn CGS total mentioned above.

Overall, and despite the question over the exact peak in total CGS, we are still looking at a significant rise in bonds on issue which will ensure a deep and liquid bond market for investors for the foreseeable future. And the comparison of this debt profile with other advanced countries is striking.

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