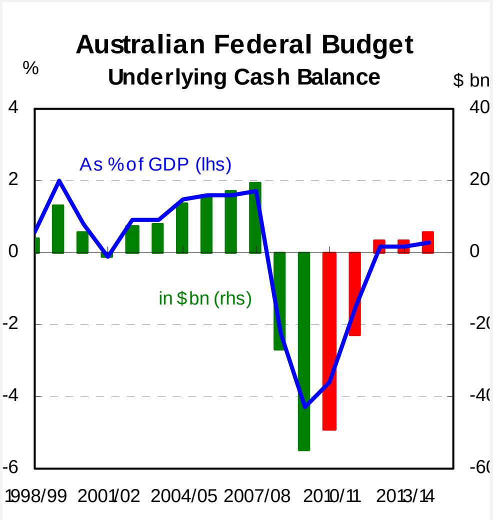
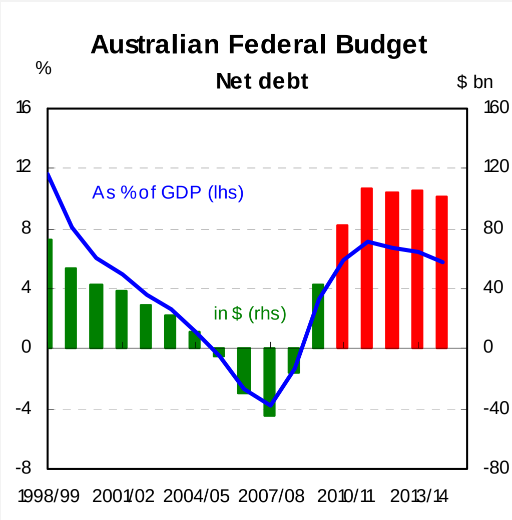
FEDERAL BUDGET

2011/12

Wednesday 11 May, 2011

- The budget deficits are now predicted to be larger in 2010/11 and 2011/12 but a return to surplus is still forecast for 2012/13. Whether the surplus will be delivered in the committed framework assumes there are no nasty surprises in the economic growth projections and little slippage in the spending initiatives.
- The near-term deterioration in the budget deficits means the peak in net debt is now forecast to be a little higher at 7.2% of GDP in 2011/12 before falling back to a projected 5.3% at the end of the forecast horizon. This level of debt remains manageable and low by international standards.
- The economic parameters in the Budget are similar to that of the Reserve Bank. The Government are factoring in an acceleration of growth in the economy after a predicted weak outcome in 2010/11. The economic forecasts appear reasonable but on balance, we believe the risks lie to the downside in the out years.
- The Budget initiatives focussed on mental health services, regional Australia and improving workforce participation. These initiatives are a step in the right direction. But there are other current issues in Australia that received little attention.





Underlying Cash Balances:

The Government stuck to its well known objective of returning the Budget to surplus in 2012/13, estimated at $3.5bn (or 0.2% of GDP).

There are fiscal repair measures of $22bn over four years to ensure this surplus is met by the targeted date.

However, the deficits for 2010/11 and 2011/12 are now predicted to be larger. The underlying cash deficit is now expected to be $49.4bn, from $41.5bn predicted in the Mid-Year Economic and Fiscal Outlook (MYEFO) in November last year and $22.6 bn for 2011/12 from $12.3bn predicted in the MYEFO.

The near-term deterioration in the budgets are caused by weaker economic growth expected in the near-term, natural disasters and lower revenue. These factors have cost the government $16bn in the bottomline. The Budget bottomline over the outyears (i.e. the four years to 2014/15) is around $10bn worse than expected last year in the MYEFO.

Whether the surplus will be delivered in the committed framework assumes there are no nasty surprises to economic growth projections, no slippage in the cost of existing policies and no net new policy decisions. This budget also did not take into account the carbon tax in its figuring, which means there are likely to be revisions in the future.

	Budget Aggregates				
	2010/11	2011/12	2012/13	2013/14	2014-15
Government Forecasts in 2011-12 Budget:					
Underlying cash balance, $bn	-49.4	-22.6	3.5	3.7	5.8
% of GDP	-3.6	-1.5	0.2	0.2	0.3
Fiscal Balance, $bn	-45.7	-20.3	4.0	3.2	8.5
% of GDP	-3.3	-1.4	0.3	0.2	0.5
Net debt, $bn	82.4	106.6	104.6	105.3	100.9
% of GDP	5.9	7.2	6.7	6.4	5.8
Forecasts Before Announcement of Budget:					
Mid Year Review (MYEFO):					
Underlying cash balance, $bn	-41.5	-12.3	3.1	3.3	n.a.
% of GDP	-3	-0.8	0.2	0.2	n.a.
Consensus:					
Underlying cash balance, $bn	-48.0	-16.0	2.0	n.f.	n.f.
% of GDP	-3.6	-1.1	0.1	n.f.	n.f.
St George Bank:					
Underlying cash balance, $bn	-50.0	-20.0	4.0	n.f.	n.f.
% of GDP	-3.6	-1.4	0.3	n.f.	n.f.

Net Debt:

The deterioration in the near-term budget deficit figuring means the peak in net debt is now slightly higher and forecast to peak at $106.6 bn or 7.2% of GDP in 2011-12 (from 6.1% predicted in the MYEFO). Net debt has risen from $42.3 bn or 3.3% of GDP in 2009/10. Net debt is expected to fall to 5.8% of GDP at the end of the forecast horizon period.

This level of debt is still manageable and compares favourably with international standards. The average net debt level in the major advanced economies, measured for all levels of government, is projected to be around 80% of GDP in 2011 and reach an average of around 90% in 2016.

Bond Issuance:

There's a modest rise in total bond issuance, reflecting the larger deficits expected in the near-term years. Debt outstanding is now forecast to peak at $239bn versus $221bn previously expected in the MYEFO. However, there is a drop off in gross debt issuance in the coming year, from $53bn to $33bn; $51bn of that will be in coupon bonds, lifting outstandings to $198bn. The remainder $2bn is made up of index-linked bond issuance.

The Budget noted that a panel of experts that reviewed the Commonwealth Government Securities (CGS) market suggested a CGS market should be maintained around its current size – that is, of around 12-14% of GDP over time. The Government notes it is clarifying its objectives with regard to the future of the CGS market, stopping short of explicitly endorsing this recommended size. However, we believe the Government is likely to stick close to this recommended target, so in this respect, the recommended size is a positive for the bond market over time.

With issuance expected to be maintained at around 12-14% of GDP and with net debt forecast to decline over time, there is likely to be a large build up of financial assets over time.

Further, the Government reaffirmed its commitment in maintaining liquidity in the CGS market to support the 3-year and 10-year bond futures market as its continuing primary objective.

In addition, the Government said it will support liquidity in the Treasury Indexed bond market by maintaining around 10-15% of the size of the total CGS market in indexed securities and continue to lengthen the CGS yield curve incrementally.

After the release of the Budget, the credit rating agencies, S&P and Moody's, reaffirmed Australia's AAA rating by saying that the Budget had no impact on these ratings.

Economic Parameters

The economic forecasts are broadly similar to those of the Reserve Bank published in last week's Statement on Monetary Policy.

The Australian economy is forecast to grow at an above-trend rate over the next two years, driven by a surge in private business investment, notably in the resources sector.

Economic growth in 2010-11 is forecast to be 2.25%. Economic activity is then expected to accelerate with GDP growth of 4% expected in 2011-12 and 3.75% in 2012-13.

Government Forecasts (% Change on Previous Year)			
	2010/11	2011/12	2012/13
Demand and Output:			
Household consumption	3.00	3.50	3.50
Private Dwelling Investment	2.50	1.50	3.00
Private Business Investment*	4.50	16.00	14.50
Private Demand*	3.00	6.00	6.00
Government Spending*	3.50	1.25	-1.25
Final Demand	3.00	4.75	4.50
Inventories Contribution (ppts)	0.00	0.00	0.00
Gross National Expenditure	3.25	4.75	4.25
Exports	4.00	6.50	5.50
Imports	9.00	10.50	8.50
Net Exports Contribution	-1.00	-1.00	-0.75
Real Gross Domestic Product (GDP):			
GDP	2.25	4.00	3.75
Nominal GDP	8.00	6.25	5.75
Other Selected Economic Measures:			
Terms of Trade	19.25	-0.25	-3.00
Current Account Balance, % of GDP	-2.00	-4.00	-5.25
Unemployment Rate (%, June Quarter)	5.00	4.75	4.50
Consumer Price Index**	3.25	2.75	3.00
Wage Price Index**	4.00	4.00	4.25

* Excludes second-hand asset sales from the public sector to the private sector ** Through the year growth rate to the June quarter

The strong surge in private business investment has been spurred by a huge lift in the terms of trade. The terms of trade is at a 140-year high and is giving a boost to national incomes, thereby benefiting government revenues. The terms of trade is expected to ease modestly in 2011/12 and 2012/13.

In the near term, that is the 2010/11 financial year, economic growth is expected to be held down by natural disasters. The Budget expects the combined disasters in Australia and overseas to detract around 0.75% of a percentage point from Australia's real GDP growth in 2010/11. Rebuilding efforts are expected to boost growth in 2011/12 and beyond.

Returning the budget to surplus in 2012/13 assumes these economic growth projections don't disappoint. We believe the balance of risks to these forecasts however modestly lie to the downside; our own GDP forecasts for 2011/12 and 2012/13 are slightly lower.

Major Policy Initiatives:

The Budget encompasses net savings of $21bn over the four years to 2014/15 and a $2bn call on the contingency reserve. The main saving measures are outlined in the table below.

Major Policy Initiatives (Over 4 Years)		
Spending Measures:	$bn	
Families	2.2	Changes to low income tax offset; increasing the Family Tax Benefit Part A for teenagers; disabilities support
Defence	1.5	Reflects funding decisions from the 2009 Defence White Paper
Regional Australia	1.5	Putting mining tax revenues to work on regional hospitals and healthcare, infrastructure, schools and higher education
Mental Health Services	0.9	Community mental health services; youth mental health services; prevention, early intervention & care; provide single point of contact for those with severe mental illness; improved access to primary health care
Education	0.8	Bonuses for outperforming teacher; learning initiatives for children with a disability; extension of education tax refund
Workforce Initiatives	0.6	National Workforce Development Fund a centrepiece: improved access to education & training; mentoring for apprentices to lift completion rate; increasing incentives to work; increased income test threshold for working seniors
Small Business	0.4	First $5k of a vehicle scrapped off immediately from 2012/13; immediate write off for other assets costing under $5k, $34bn to mfg to better service resource projects
Savings Measures:		
Natural Disasters	4.1	Mix of temporary levy, deferred projects & redirected funding for rebuilding public infrastructure; addressing skills shortages in affected areas.
Tax Reform	3.2	FBT changes on cars - flat 20% rate irrespective of distance travelled; phasing out of dependant spouse offset; income-splitting incentives reduced
Defence	2.5	Capital investment reprogrammed; increased efficiencies, especially in corporate and support functions
Family Payments	2.0	Pause indexation of Family Tax Benefit supplements for three years and pause indexation of upper limits and thresholds for a further two years
Efficiency Dividend	1.1	Previously Government held real growth in spending at 2%, this will be lowered to an average 1% over the forward estimates
Healthcare	0.7	Funding pathology service efficiencies; redirecting mental health with rationalisation of GP mental health services
Carbon Program Cuts	0.6	Reduction and deferral of funding for carbon capture; cessation of green start loan programmes
Other Initiatives	7.0	A range of minor savings measures that add up to $7bn over 4 years

The Budget initiatives focussed on mental health services, regional Australia and improving workforce participation. The measures for mental health are well overdue and addressing skilled shortages are steps in the right direction. The measures to increase labour force participation included an increase in the skilled migration intake of 16,000, which essentially reverses one of the cuts made to migration after the global financial crisis.

Some other big policy issues received little attention; these include the chronic shortage of housing and significant reform to the tax system. While the government has introduced a few recommendations from the Henry Tax Review, they have failed to implement any significant changes, such as those that would make the tax system much simpler.

Implications for Interest Rates:

The underlying budget position moves from a deficit of 3.6% of GDP in 2010/11 to a deficit of 1.5% of GDP in 2011/12 and to a surplus of 0.2% in 2012/13. That indicates that fiscal policy is heading in a contractionary direction. This will work in conjunction with monetary policy settings which are contractionary.

We do not expect that this Federal Budget will significantly alter the Reserve Bank's outlook on the economy and therefore its decision on the interest-rate settings. We still expect two rate hikes from the RBA this year and we cannot rule out the next rate hike coming as soon as June.

Reaction in Financial Markets

Many initiatives were flagged in advance of the actual Budget announcement. It was also well flagged that the Government intended to stick to its commitment of returning the budget to surplus in 2012-13. As such, financial markets had largely priced in the fiscal tightening. If anything, the Government was slightly less "tough" than markets were perhaps expecting.

As such the reaction in financial markets in the wake of the Budget announcement was largely limited. Bank bill prices and the Australian dollar showed little reaction to the Budget itself.

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