AUSTRALIAN ECONOMICS
AUSTRALIAN FEDERAL BUDGET 2012-13

8 MAY 2012

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SHARING THE BENEFITS OF THE MINING BOOM AND REBALANCING OF POLICY

ASSESSMENT

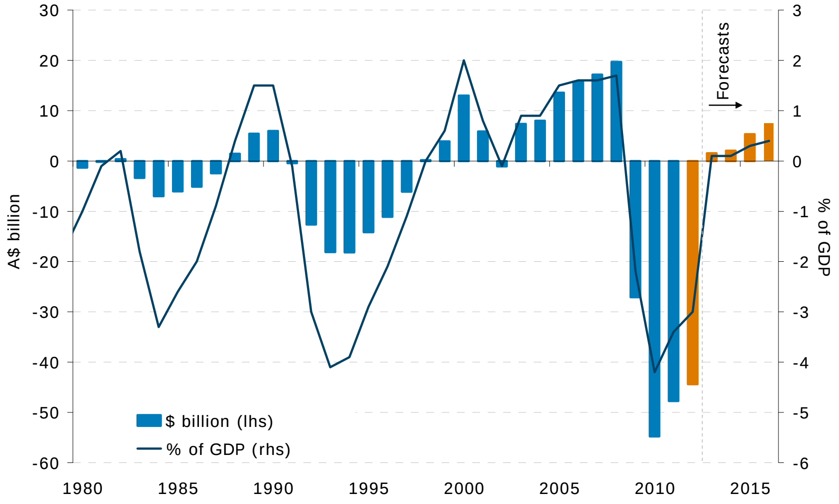
- Our heading summarises the twin aims of tonight's budget. Both themes have a distinct political imperative to rebuild the Government's standing with its traditional voter base, but an imperative that can be viewed as largely aligned with appropriate policy requirements, given current economic circumstances and pressures in the economy. We would expect the media to characterise this as a very pro-Labor voter budget, targeting companies and the very wealthy and redistributing measures and spending priorities (sharing the benefits of the mining boom) towards low and middle income earners and small businesses (ie those being most affected by current economic circumstances).
- As in past years, most details were leaked ahead of the budget. The main surprise was the cancellation of planned (small) company tax cuts with the benefits redirected to families.
- On the economic forecasts, the terms of trade forecasts are somewhat softer than we expected (which is an appropriate risk management practice, given their importance for nominal growth and incomes), while unemployment is expected to drift higher to 5.5% (including 4,000 public sector job cuts). GDP growth is forecast at trend (3.25%) and inflation in the middle of the RBA band, as expected, the latter once allowance is made for the impact of the carbon tax. The somewhat puzzling parts of the economic forecasts included weaker business investment than last year. Weaker mining investment would be a net positive for the budget in current circumstances. The Government is also forecasting flat housing investment, at a time when building approvals are very weak and suggesting outright contraction.
- With revenue growth forecasts continuing to be downwardly revised, cuts in spending have been targeted to allow a strategic rebalancing in policy towards lower interest rates (and presumably hopefully a lower AUD). We expect a significant fiscal drag on growth next year, although at -0.75 to -1 ppts of GDP, this is much less than implied by the 3% turnaround in the budget balance. Weaker GST revenue receipts also flow into reduced GST redistributions to states, which is contributing to further fiscal tightening by state governments.
- This rebalancing of policy trends has been factored into markets recently and probably has some way further to run.

FIGURE 1. KEY BUDGET AGGREGATES

	2010-11 Actual	2011-12 (e)	2012-13 (f)	2013-14 (f)	2014-15 (f)	2015-16 (f)
Underlying cash balance (AUDb)	-47.7	-44.4	1.5	2.0	5.3	7.5
Per cent of GDP	-3.4	-3.0	0.1	0.1	0.3	0.4
Fiscal balance (AUDb)	-51.5	-42.0	2.5	2.6	7.0	9.5
Per cent of GDP	-3.7	-2.8	0.2	0.2	0.4	0.5

Source: Federal Treasury

FIGURE 2. UNDERLYING CASH BALANCE

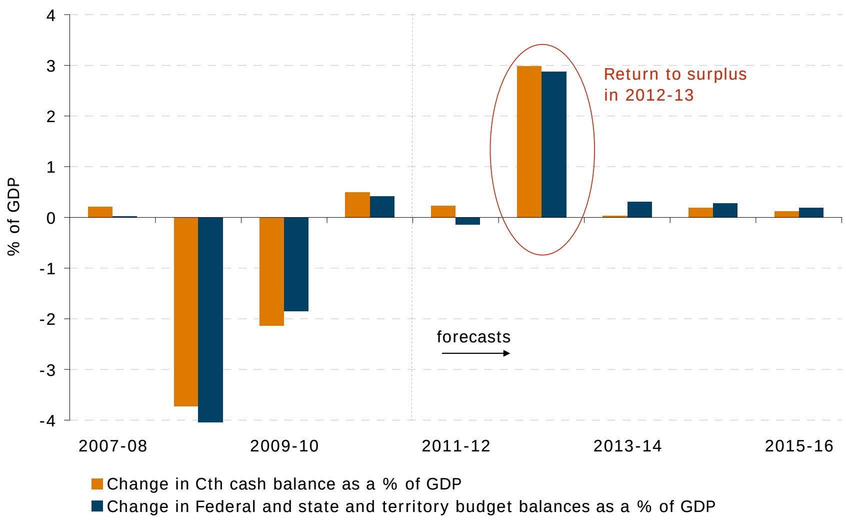


Source: Federal Treasury

THE BUDGET NUMBERS AND FISCAL IMPACT ON THE ECONOMY

As expected, the Federal Government forecast a small budget surplus of $1.5bn (0.1% of GDP) for 2012-13, after a larger than expected ($44.4bn) deficit (–3.0% of GDP) in 2011-12 (see Figure 3). The forecast for the 2011-12 budget this time last year was for a deficit of $22.6bn (1.5% of GDP) and at the November MYEFO (AUD37.1bn).

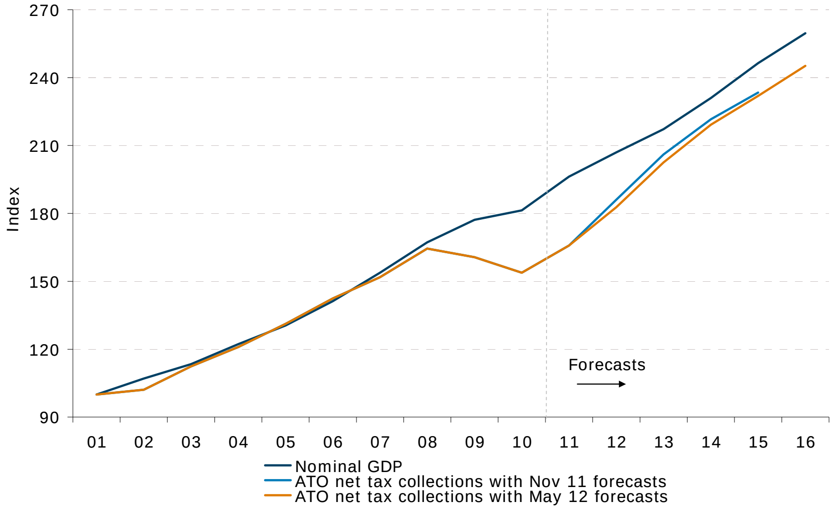
FIGURE 3. CHANGE IN BUDGET BALANCES



Source: Federal Treasury

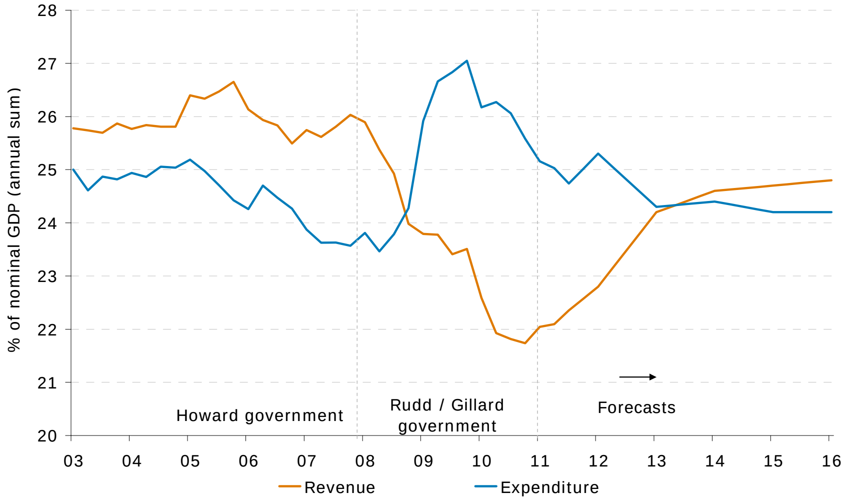
Downgrades to expected revenue growth has been the dominant effect on the budget in all years over the forward estimates (see Figure 4). Weaker-than-expected economic growth, consumer caution, structural change in the economy and the composition of growth (which is seeing stronger activity in mining and transport and utilities, but weaker activity in manufacturing, retail, banking and construction) has restrained growth in company tax, GST and capital gains tax revenues in particular, with revenues a further $28bn weaker over the four years from 2011-12 since last November's estimate.

FIGURE 4. NOMINAL GDP VS. ATO NET TAX COLLECTIONS



Source: ATO, ABS

FIGURE 5. REVENUE AND EXPENDITURE (% OF GDP)



Source: Treasury

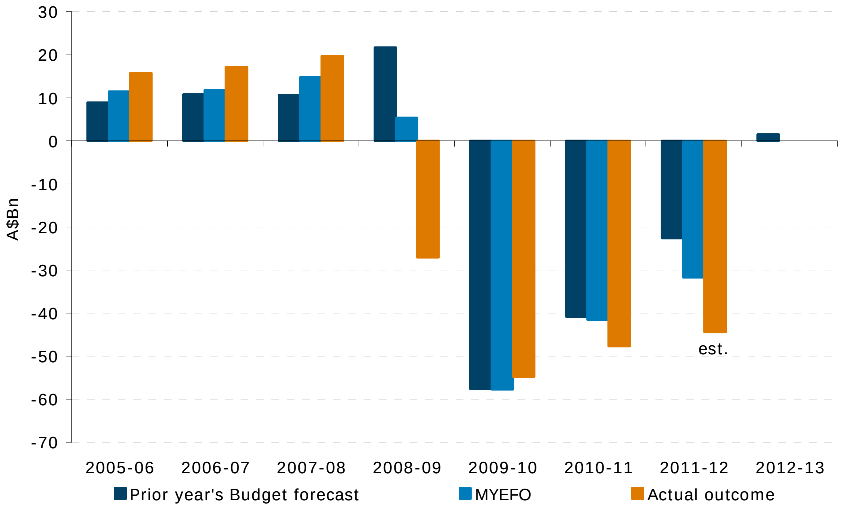
FIGURE 6. RECONCILIATION OF UNDERLYING BUDGET BALANCE

	2011-12 (e) $bn	2012-13 (f) $bn	2013-14 (f) $bn	2014-15 (p) $bn
Underlying cash balance (MYEFO 2011-12)	**-37.1**	**1.5**	**1.9**	**3.1**
Parameter variations	-4.6	-2.9	-3.8	-0.3
Receipts	-6.1	-7.8	-7.8	-7.3
Payments	-1.5	-5.0	-4.0	-7.0
No policy change underlying cash balance	**-41.7**	**-1.4**	**-1.9**	**2.8**
Policy decisions	-2.7	2.9	3.9	2.5
Receipts (a)	0.1	2.0	3.7	4.9
Payments	2.8	-0.9	-0.3	2.4
Underlying cash balance (Budget May 2012)	**-44.4**	**1.5**	**2.0**	**5.3**
% of GDP	*-3.0*	*0.1*	*0.1*	*0.3*

(a) Receipts will differ from the cash receipts reconciliation published in Budget Statement 5 because they exclude Future Fund earnings.

Source: Federal Treasury

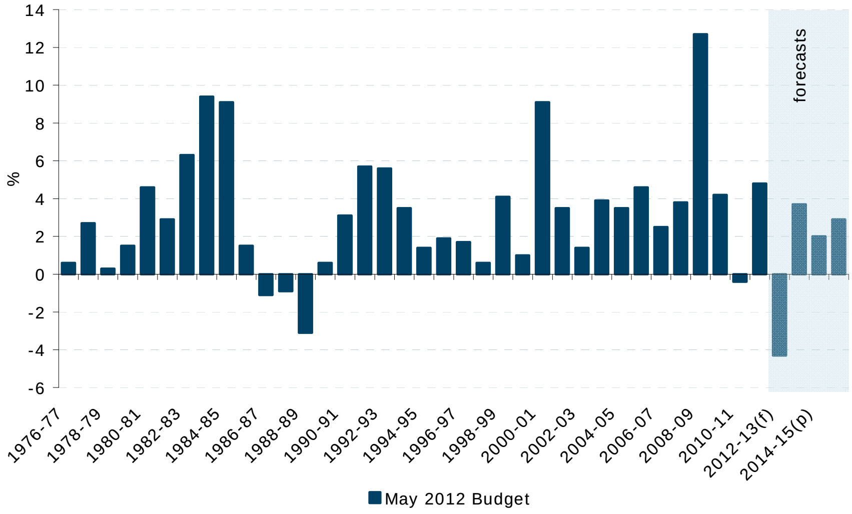
FIGURE 7. ACTUAL VS FORECAST UNDERLYING CASH BALANCE IN RECENT HISTORY



Source: Federal Treasury

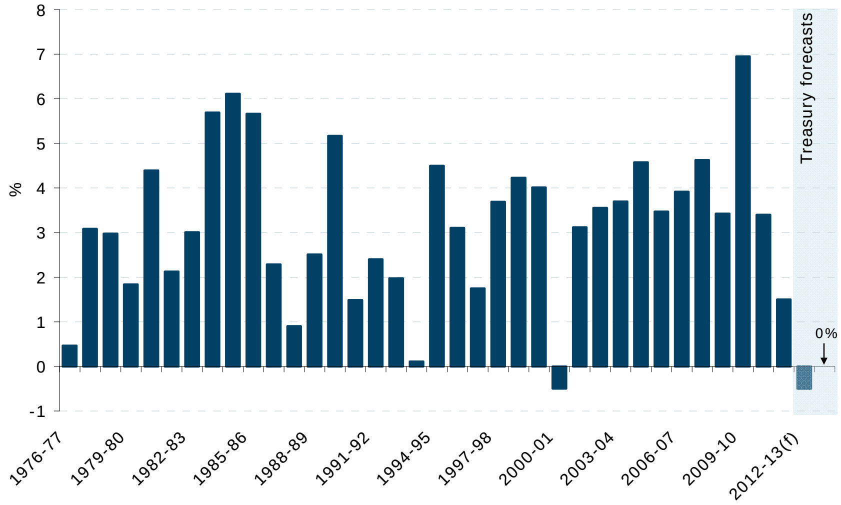
Weaker revenue growth has necessitated significant additional spending cuts and deferrals and some claw back of previous middle-class handouts to achieve the same targeted budget surplus in 2012-13. The Budget papers report an extra $33.6bn in savings over four years. The Budget forecasts a turnaround in the budget position of 3.1ppt of GDP between 2011-12 and 2012-13, and estimated 4.3% cut in real government spending (the largest since we have records in 1970-71). But this overstates the true impact of the budget on the economy in 2012-13 due to the pull forward of some spending measures into 2011-12 and the deferral of other measures beyond 2012-13. (Previously, real spending growth in 2011-12 was estimated at 0.5%, compared to a revised estimated outcome of 4.8%, which appears to largely a pull-forward of spending into that year). Much of the spending pulled forward into 2011-12 will actually translate to an economic impact in 2012-13, such as household compensation payments relating to the carbon tax, and grants to state and local governments.

FIGURE 8. GROWTH IN REAL FEDERAL GOVERNMENT SPENDING



Source: Federal Treasury

FIGURE 9. GROWTH IN REAL PUBLIC DEMAND (ALL LEVELS OF GOVERNMENT)



Source: Federal Treasury

Nevertheless, abstracting from these influences, the Budget tightening will have a significant impact on the economy this year. ANZ estimates that the impact of this budget on the economy in 2012-13 will be around a 0.75–1 percentage point subtraction from GDP growth. The Budget forecast for total public demand growth has actually been revised up since MYEFO to –½% in 2012-13 (from –1¼% previously). Slowing from forecast growth of 1½% in 2011-12, this suggests around a 0.4ppt contraction from growth through public demand in 2012-13. Cuts to household payments would be an additional drag. Overall, Treasury's economic forecasts appear broadly consistent with the lower end of our estimate.

The fiscal tightening is a move designed to nullify consistent criticism by the Opposition of Labor's fiscal credentials. More importantly for markets, it is also designed to attempt to continue an "informal" but real rebalancing of policy: it is hoped that tighter fiscal policy will provide room for the RBA to continue to reduce interest rates, with the possibility that the AUD will also fall somewhat. Together this would ease some pressure on the weakest parts of the economy, families and small businesses and provide the best hope for the Government to achieve some improvement in its standing in the polls.

Markets and most economists remain less convinced of the economic need to return the budget to surplus as quickly as the Government is planning, although this is something of a moot point given the Government is undertaking this course of action. The important implication for markets is that the Government's actions will likely impact on the Reserve Bank's outlook for economic growth and inflation, thereby allowing room for easier monetary policy.

THE ECONOMIC FORECASTS

An important assumption underlying the Government's economic forecasts is that interest rates are assumed to move broadly in line with market expectations. This implies that the RBA cash rate is assumed to be around 75bps lower by the end of 2012, which is in line with our expectations. Global GDP growth forecasts are in line with recent IMF and RBA forecasts and appear reasonable.

The Government's bottom line economic forecasts are broadly consistent with market expectations. GDP growth is expected to be around trend at 3¼% in 2012-13, underpinned by strong business investment (essentially mining investment, with non-mining business investment weak) and exports, and solid consumption growth.

The Government forecasts that the non-resources economy will grow at below-trend rates of 2% y/y over the next two years, while the resources and related sectors are expected to expand by 9% y/y, on average, over the forecast horizon (accounting for 15-20% of GDP).

- Dwelling investment is forecast to fall by 1% y/y in 2011-12 and be unchanged in 2012-13. We expect larger falls in dwelling investment over this period, notwithstanding some support from lower interest rates.
- Business investment is forecast to increase by a sharp 18% y/y in 2011-12 and 12½% y/y in 2012-13, boosted by very strong mining investment while non-mining investment remains weak. We expect even stronger mining and total business investment growth over the next couple of years. If business investment is stronger than forecast then this would imply lower Government revenue due to higher depreciation deductions.
- As noted above, public demand is expected to fall modestly in 2012-13 but the impact on overall GDP growth relative to the previous year will be minor.
- Net exports are expected to subtract 2ppts from GDP growth in 2011-12 and ¾ppts in 2012-13; the latter is a much smaller subtraction from growth than we expect, but this largely reflects our more robust business investment profile.
- Household consumption growth is expected to grow by 3-3¼% in the current and 2012-13 fiscal years, which is below pre-GFC rates and seems reasonable.
- Inflation is anticipated to be around the middle of the RBA's target band once allowance is made for the carbon tax effect of ¾ppts. The unemployment rate is forecast to rise by around ¼pts to 5½% by end 2012-13 and stay there.
- The terms of trade is forecast to decline by 5¾% in 2012-13 and a further 3¼% in 2013-14, leaving the terms of trade at a relatively high level. How the terms of trade pans out over the next few years remains a crucial and extremely difficult to forecast part of both the Australian landscape and ultimate budget outcomes, given the important influence the terms of trade is having in driving both structural change through the high AUD, but also in sustaining strong rates of income growth and associated high levels of overall tax collections. Australian growth, incomes and government finances in both nominal and real terms, will remain significantly dependent on there being no very sharp fall in the terms of trade.

Overall, our forecasts are broadly similar to those of the Government for 2012-13, however, we are now a little more cautious about our GDP growth forecast, owing to assessed downside risks to consumer spending, housing construction, and activity in a number of sectors dealing with structural change. These assessments are behind our recent decision to forecast an additional two interest rate cuts before the end of 2012 (three in total), taking the cash rate to 3.00% as the RBA seeks to offset the negative impact of structural change and tighter fiscal policy on the economy and labour markets.

FIGURE 10. ECONOMIC FORECASTS

(year-average % change unless stated otherwise)	2010-11	2011-12 (e)		2012-13 (f)		2013-14 (f)	
	Actual	Budget	ANZ	Budget	ANZ	Budget	ANZ
Real GDP	2.0	**3**	2.7	**3 ¼**	2.9	**3**	3.4
Nominal GDP	8.2	**5 ½**	4.8	**5**	4.9	**5 ¼**	6.3
CPI inflation*	3.6	**1 ¼**	1.1	**3 ¼**	3.4	**2 ½**	2.6
CPI inflation (ex carbon price)*				**2 ½**	2.7	**2 ½**	2.6
Employment growth*	2.2	**½**	0.5	**1 ¼**	1.5	**1 ½**	2.0
Unemployment rate**	4.9	**5 ¼**	5.2	**5 ½**	5.4	**5 ½**	5.1
Terms of trade	20.7	**3 ¼**	3.4	**-5 ¾**	-2.4	**-3 ¼**	-1.2
Trade weighted index***	74.0	**77**	76.3	**77**	77.9	**77**	75.6

* Year-ended June quarter, ** June quarter, *** year-average

Sources: ANZ, Federal Treasury

THE MAIN POLICY MEASURES AND SURPRISES IN THE BUDGET

As has become budget practice, most of the policy measures announced in the Budget had been pre-released in newspapers over recent weeks. Many measures were also deliberately pre-released to media outlets a few hours ahead of the Budget speech at 7.30pm. In short, it is a very pro-Labor voter budget package.

The policy measures in the budget were centred around assisting households and small businesses over corporate Australia and high income earners. The Treasurer made much of his "spreading the benefits of the boom" theme. This was highlighted best by the explicit decision of the government not to proceed with its plan to cut the company tax rate by 1ppt to 29% (due in part to blockage in the Senate) and instead distribute the funds to households and small business.

The total sum being paid out to households and small business over the remainder of 2011-12 and 2012-13 will be over $7bn according to ANZ calculations and almost $22bn over the four year forward estimates period due to increases in pensions and other support payments and reduced taxes.

Some of this is newly announced (such as the Schoolkids bonus and the company loss carry back measure) but the majority is compensation for the carbon tax package. The savings, however, are made almost entirely from the corporate sector and the public service, particularly defence. Of course most of the revenue increases from 2012-13 will come form the implementation of carbon pricing and the Minerals Resources Rent Tax. Discretionary spending cuts and revenue increases will come from superannuation, rolling back fringe benefits and reducing foreign aid. There were two major measures removing tax concessions on superannuation for the wealthy and allowances for living away from home, targeted particularly at executives.

There were substantial increases in payments for the vulnerable with extra aged care funding, funding for the national disability health insurance scheme and dental, particularly for low income earners. The nature of the policy changes, which redistributed from the corporate sector to households with high marginal propensities to consume, will help the Government deliver a surplus without impeding domestic demand as much as if the cuts had been imposed evenly across sectors.

FIGURE 11. MAJOR SAVINGS MEASURES

Measure	Description	Saving in 2012-13 AUDbn	Saving over 5 years to 2015-16 AUDbn
Carbon price*	Introduction of a carbon pricing regime, with fixed price then floating from 2015-16	7.70	24.50
Minerals Resource Rent Tax*	Revenue from taxing bulk commodity production	3.70	10.60
Defence	Deferring acquisitions and seeking capital efficiencies	0.97	5.50
Company tax rate	Decision not to proceed with measure to cut to 29% from 30%	0.40	4.60
Foreign aid	Delay target expenditure (of 0.5% of GNI) to 2016-17, from 2015-16	0.45	2.90
Standard tax deductions	Reversal of decision to give a standard deduction for work related expenses and tax ma	0.00	1.60
Public sector efficiency dividend*	Cut to departmental spending	0.50	1.50
Superannuation	Deferral to Jul 2014 of higher super concessional contributions cap for 50+s with super	0.58	1.40
Finge benefits	Limiting access to living away from home tax concessions	0.05	1.00
Superannuation	Reduce higher tax concession for contributions of very high income earners	0.00	1.00
Extended medicare saftey net	Improved targeting	0.01	0.95
Delay 50% discount on interest income	Delay a measure to cut by half tax on interest income to after the planned 1 July 2013	0.01	0.80
Parenting payment eligibility	Aligning eligibility for those receiving parenting payments before July 1 2006 to others	0.10	0.69
Apprenticeship payments	Reducing the payment for those not on the National Skills Needs List	0.06	0.35
Family Tax Benefit A eligibility	Change in eligibility to FTB A to the under 18s	0.03	0.31
Dental	Cut Commonwealth Dental Health Program	0.94	0.29
PBS	Price savings agreed with drug companies	0.03	0.10
Heavy vehicle road user charge	Increase from 23.1 to 25.5 cents per litre from July 1 2012	0.17	0.07
Bring forward local council grants	From 2012-13 to 2011-12	1.10	0.00

Source: Federal Treasury *Previously announced

FIGURE 12. MAJOR SPENDING MEASURES

Measure	Description	Increase in 2012-13 AUDbn	Cost over 5 years to 2015-16 AUDbn
Carbon tax compensation*	Tax cuts for those earning under $80,000: treble the tax free threshold from $6k to $	3.35	8.04
Carbon tax compensation*	Increase in pensions allowances and family payments	0.75	6.90
Pacific Highway	Increased funding	0.00	2.60
Schoolkids bonus	Twice yearly payments - replacing education tax rebate	-0.11	2.40
Increase in Middle East Defence Opera	Increase in defence capability	1.00	1.40
Disability insurance	Stage one of the National Disability Insurance Scheme from July 2013	0.08	1.00
Increase in Family Tax Benefit A	Increase in payment	0.15	2.90
Company loss carry back	Allowing businesses to carry back losses so they receive a refund against tax previous	0.00	0.70
Dental Health	Reduce public dental wait lists and increased funding for dental workers	0.09	0.52
Post-entry quarantine facility	To improve biosecurity systems	0.07	0.37
Aged Care	Means-testing of aged care but increase in home care packages and funding to institu	0.06	0.28
Medicare levy	Increasing the low-income threshold to $19.4k for individuals and $32.7k for families	0.05	0.09

Source: Federal Treasury *Previously announced

SMOKE AND MIRRORS

As well as the MYEFO measures, the budget has brought forward some further payments into 2011-12 to lower 2012-13 expenses.

- First up ‘Schoolkids Bonus’, costs $1.3bn in 2011-12, but reduces costs by $105m in 2012-13 because of the timing of payments.
- Bringing forward $1.1bn in grants into 2011-12 for local councils and lowering them by the same amount in 2012-13.
- Bringing forward $50m for Northern Territory roads into 2011-12.
- Export Finance and Insurance Corporation to pay a “special dividend” of $200m in 2012-13
- Australian Reinsurance Pool Corporation to pay a “special dividend” of $100m in 2012-13 as well as the regular $75m dividend.
- Assuming a $1.1bn increase in cash receipts (over four years), by increasing ATO funding by $106m to help it collect outstanding tax and superannuation guarantee charges.
- Assuming a $1.1bn increase in cash receipts (over four years), by funding GST compliance activities to promote voluntary compliance.

CARBON PRICING

The budget papers specifically recognise the fall in carbon prices traded on international markets, as for the first time Treasury must make an estimate of the price of carbon in a flexible Australian market. The floating stage of the regime begins in 2015-16, which is now within the forward estimates. Treasury notes that international carbon prices have fallen due to the European debt crisis and the unsettled world economic outlook.

Treasury have chosen to stick to their previously modelled price assumption of $29 a tonne in 2015-16, which would be $6 a tonne higher than fixed starting price of $23 on 1 July 2012.

The budget papers note that there will potentially be changes in international policy and regulatory regimes especially in the EU trading scheme, with the possibility of increases in the EU ETS prices.

Carbon pricing is expected to raise $24.7bn over the forward estimates. Treasury notes that the associated expenditures; jobs and competitiveness program and permit-based assistance under the Energy Security Fund will move in line with the carbon price. Household assistance however would not and is permanent.

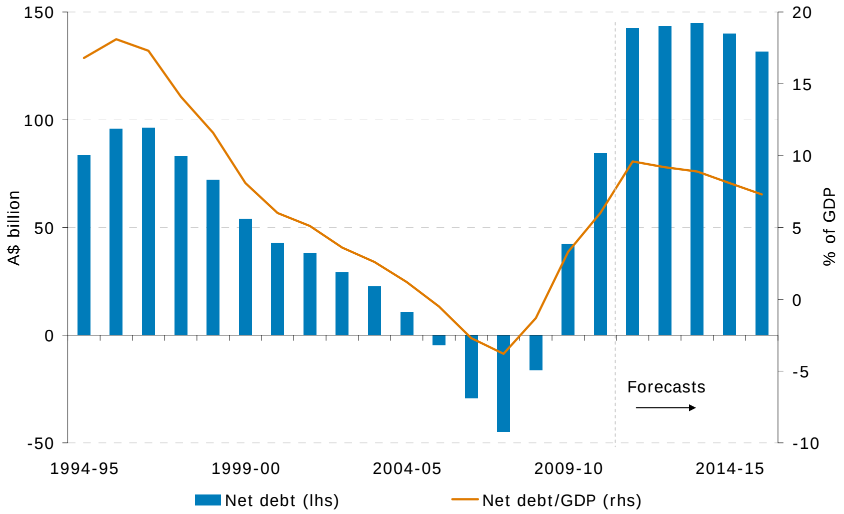
FINANCIAL MARKETS IMPACT

Arguably much of the financial markets impact of this budget has occurred in recent weeks as the market digested the Government's intention to maintain its aggressive timetable to return to surplus in 2012-13 in spite of weaker than expected growth, inflation and revenue outcomes. Together these imply the potential for a lower path for interest rates and possibly the AUD too.

The Budget underlines the strength of Australia's AAA rating, despite a forecast rising stock of debt on issue. The metrics around the profile of net debt and strong global demand for AAA bonds means that Commonwealth Government Securities (CGS) will remain sought after and this will keep the entire yield curve low.

Net debt is expected to peak around 9.6% of GDP before falling towards 7.3% over the forward estimates. This is an AAA metric by any standard.

FIGURE 13. GOVERNMENT NET DEBT



Source: Federal Treasury

Investors will be encouraged by the Government's decision to maintain relatively high levels of CGS on issue even though the budget projects the fiscal balance to be an AUD2.5bn surplus in 2012-13 and an AUD2.6bn surplus in 2013-14. In 2014-15, the fiscal surplus is expected to rise to AUD7.0bn and then increase to AUD9.5bn in 2015-16.

The budget figures and accompanying statements provide some information on the Government's borrowing for FY 2012-13, but the Australian Office of Financial Management (AOFM) will release more detail tomorrow. Total issuance is expected to be AUD235bn by June 2012, but it will rise again in 2012-13. At this stage we expect the increase to be around AUD10bn over the year ahead to a little less than AUD245bn.

Treasury Bonds on issue are expected to increase from AUD200bn to AUD214 by June 2013 and Treasury Indexed Bonds on issue are expected to increase from AUD16bn to AUD18bn. The Government has stated that it will keep the level of Treasury Notes on issue at a minimum of AUD10bn going forward to keep the market liquid. Treasury notes on issue are expected to be AUD15bn at the end of June 2012.

There are two bond maturities in 2012-13, with around AUD9bn of the 15-Nov-12 and AUD16.7bn of the 15-May-13 set to mature. Pressure on revenues over the year ahead may also require a modest increase in short-term financing.

The Government will issue AUD1.7bn of Aussie Infrastructure bonds to partly fund its AUD2.1bn equity investment in the National Broadband Network. In 2012-13 all of the Government's AUD5.8bn investment will be funded by issuing these bonds.

The increase in CGS on issue addresses some concerns investor may have had about liquidity of the market, given the projected return to surplus. Strong global demand for higher yielding AAA markets has driven overseas ownership of the CGS market to 75%.

There was no specific mention of a commitment to maintain a certain level of bonds on issue in this budget, but last year's budget stated that it would keep bonds on issue at around 12-14% of GDP.

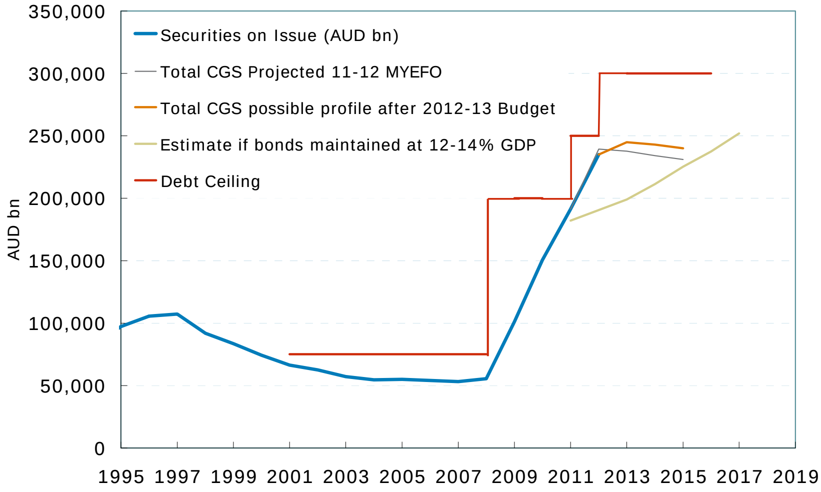
The global shortage of higher yielding AAA bonds and reduction in net issuance of CGS further out will also probably mean that the yield curve will be flatter than could be expected during periods when the Reserve Bank of Australia (RBA) is easing policy.

We expect the RBA to ease by a further 75bps this year and this will go some way towards normalising the yield curve as yields out to the 5-year maturity are trading well below 3.0%. We expect ongoing investor demand for longer-dated bonds to keep yields low further out the curve. This also means that the discount rate on the Government's unfunded super liabilities will put upward pressure on liabilities.

The Government will seek to amend the Commonwealth Inscribed Stock Act 2011 to increase the legislative limit on securities on issue to AUD300bn. This would seem prudent given the Government's intention to maintain AUD10bn in Treasury notes on issue and fund the Government's National Broadband Network equity investment. In practice, we expect this limit to be successfully raised, although the politics around this could be difficult.

In addition tonight, there was no mention of the AOFM looking to reduce some of its holding of residential mortgage backed securities (RMBS). By 1st May 2012 it had invested AUD14.9bn in RMBS. The Treasurer has set the limit on this investment at AUD20bn. The Government advised that it would monitor conditions in the RMBS market and adjust its investment as it sees fit.

FIGURE 14. COMMONWEALTH GOVERNMENT SECURITIES ON ISSUE



Sources: Treasury, ANZ

In the wake of tonight's budget announcement interest rate markets, the AUD and share price futures were remarkably unchanged.

The AUD's stability likely reflected participants having received and factored in most of the relevant information over the last few weeks. The budget has been cited as a factor behind the depreciation of the AUD, as tighter fiscal policy and looser monetary policy combined to ease pressure on local interest rates, and reduce the yield available to international investors. Looking ahead the budget is not expected to adversely affect the currency in the overnight session. More important will be the ongoing reaction to European voter anti-austerity and how this may affect fiscal unity, integration, and the EUR moving forward. The release of Chinese data this Thursday during the Asian session is the focus for the AUD. In the short term, a correction cannot be ruled out. But if Chinese data continue to demonstrate a soft landing as we expect, the risks will build for a rally.

IMPORTANT NOTICE