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Our Vision:

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A sensible approach to supporting growth

- In today's 2009-10 Budget, the Victorian government is forecasting to maintain one of, if not *the*, strongest balance sheet of all of the major States.
- The government expects to record an operating surplus from 2009-10 to 2012-13, partly buoyed by significant Commonwealth government grants as well as forecasts for State economic growth to outperform the national average.
- Victoria's cash deficit has deteriorated significantly, largely due to a record infrastructure spending plan. Nevertheless, at around 1% of GSP, Victoria's cash deficit is smaller than both Queensland and the Commonwealth.
- Record infrastructure spending is the platform of today's budget, with large projects in transportation, public housing, health and schools to be co-funded by the Commonwealth (under December's Nation Building – Economic Stimulus Plan).
- Net debt will rise to \$16 billion by 2013 to fund expenditure measures supporting efforts to shore up economic growth prospects. This is well within the AAA rating criteria. Victoria's AAA credit rating was affirmed by S&P today.
- Overall, the Victorian budget appears to provide a sensible approach to current challenges.
- Today's budget is expected to provide a blueprint for other the other States, with other governments likely to announce significant infrastructure spend, and thus sharply larger cash deficits.

Still operating in surplus

In today's 2009-10 Budget the Victorian Government has delivered a better than expected result and indeed may well be forecasting the strongest balance sheet of all the major States. The Victorian government has been able to deliver on its strategy to maintain an operating surplus of at least \$100mn per year. The government is projecting a surplus of \$165mn (0.1% of GSP) in 2009-10 and \$195mn (0.1% of GSP) in 2010-11, rising to \$562mn (0.2% of GDP) by 2012-13. Since the Government's last Budget Update (December 2008), this is a cut to operating surplus of \$247mn in 2009-10 an average cut of \$246mn p.a. from 2010-11 to 2011-12.

The Victorian government has maintained its operating surplus in contrast to expectations by:

- (a) The help of the Commonwealth's fiscal stimulus package for State services infrastructure spending. Victoria will receive around \$5bn from the Commonwealth's \$42bn Nation Building – Economic Stimulus Plan that was announced in February. Commonwealth funding for service delivery has boosted State coffers and more than offset lower revenues from GST and stamp duty. This is driving an 8.3% rise in State revenues in 2009-10.
- (b) Projecting that revenue streams will be protected by a State economy that, unlike most if not all other states, maintains positive growth in 2009-10 and beyond.
- (c) Keeping some cap on expenses with expense growth expected to be around ¼ppt p.a. lower than revenues growth over the projection period.

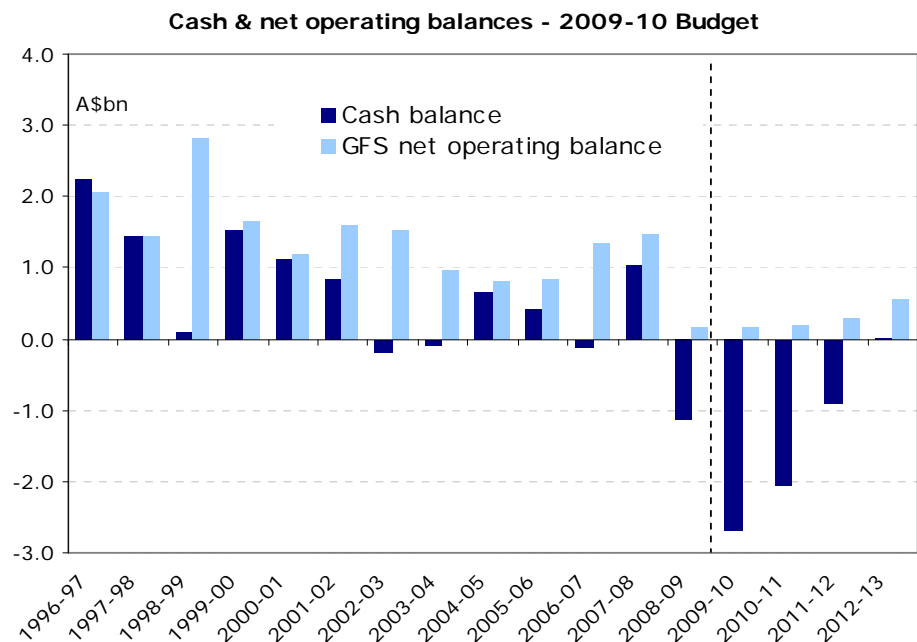
But cash deficit deteriorates significantly

While the Victorian government has been able to protect its operating surplus, its cash deficit (which includes investment in non-financial assets) has deteriorated significantly, nearly quadrupling over the next few years. In 2009-10, the cash deficit is expected to rise to \$2.7bn (c.f. \$703mn forecast in December). This is a deficit of around 1% of GSP, which is much smaller than Queensland's projected deficit (around 2.5% of GSP), as well as the Commonwealth Government's deficit, which is likely to swell above 4% of GDP.

The sharp deterioration in Victoria's cash deficit is largely due to the Government's (sensible) decision to pull-forward a record infrastructure spend. Infrastructure investment is now projected to reach a record \$7bn in 2009-10 and average \$4.4bn p.a. from 2010-11 to 2012-13. This infrastructure spend will be funded primary by the Commonwealth's fiscal stimulus package, as well as historically high levels of State investment. Most spending will be focused on transport, schools and social housing.

The government has front-loaded its infrastructure spend to this and next fiscal year. This will help buffer Victoria from the (likely) sharp slowdown in private demand (consumption and investment) and indeed may be the primary reason behind the government's positive growth forecasts for 2009-10 and 2010-11. This strategy also allows the government to formulate a credible debt reduction strategy, with state debt (as a share of GDP) expected to commence falling by 2012-13 as infrastructure investment is wound back.

Figure 1: Government continues to forecast a surplus



Source: Department of Treasury and Finance

Debt rises to fund spending measures

Net debt will rise to from 0.8% of GSP (\$2.2bn) in 2008-09 to peak at 5.3% of GSP (\$15.7bn) in 2012-13. Net debt is expected to commence easing, to 5.1% of GSP (\$16bn) in 2013-14. This is up from only. Net debt rises sharply in the short-term before levelling out in latter years of the forecast period. It is in these years when the government expects the economy to recover and infrastructure spending wound back reducing the need for significant additional debt. Combined with rises in superannuation liabilities the jump in net debt in the forecast period will see net financial liabilities levels more than double from the period 2008 to 2013. However, it is encouraging that the government expects that net debt levels will stabilise and decline within 5 years. But as highlighted, the projections rely on no further significant increases in infrastructure spending from 2012. And on revenues recovering quickly and solidly as the economy recovers.

Given the government budget numbers, S&P have released a statement that supports Victoria's AAA credit rating. In their statement, S&P suggest that the Government net financial liabilities to operating revenue ratio will rise to 119% by 2013. This is well short of the 130% level that would prompt a rating review. That being said S&P also state that *"The rating could be put under pressure if the broader economic downturn is deeper and longer than forecast and the state's operating position and balance sheet deteriorate further"*

Economic Forecasts

The Department of Treasury and Finance forecast Victorian gross state product (GSP) growth to slow to ½% in 2008-09 and only ¼% in 2009-10 before recovering to something like trend growth rates in the following two years. This relatively optimistic outlook forms the basis of the state's improving financial position in the latter years of the forecast period. With the Australian economy expected to have zero growth in 2008-09 and contract by around ¼% in 2009-10 the Victorian forecasts represent the state economy as a significant outperformer. The economic forecasts in the Federal Budget released next week will likely bring this into sharp focus. Despite the fact that we do agree that the Victorian economy will outperform most other states through this period, our point forecasts are less optimistic. On our current reckoning Victoria's GSP growth will most likely be zero or slightly negative in 2009-2010 with a more moderate recovery in 2010-11.

The relative strength, compared to other states, of the Victorian building sector supported by very solid population growth should continue to be a positive for the economy. However, slumping business investment and non-residential building will pose significant challenges to economic growth in coming years. A significantly higher unemployment rate peaking at 7¾% in 2010-11, where it remains through the remainder of the forecasts period, is broadly in line with what is expected at the national level. Ongoing strong labour force participation, combined with solid population growth may provide some upside risk to the unemployment rate forecasts. Inflation and wage prices are expected to ease in line with a slowing economy.

Table 1 Victorian economic forecasts

	2007-08 Actual	2008-09 Forecast	2009-10 Forecast	2010-11 Forecast	2011-12 Forecast	2012-13 Forecast
Real GSP	3.2	0.50	0.25	2.25	3.0	3.0
Employment	2.7	0.25	-1.00	0.5	1.5	1.5
Unemployment rate	4.5	5.00	7.00	7.75	7.75	7.75
Inflation	3.6	3.25	2.00	2.25	2.5	2.5
Wage price index	3.8	4.25	3.75	3.25	3.5	3.5
Population	1.8	1.80	1.6	1.50	1.4	1.4

Source: ABS, Victorian Department of Treasury and Finance

The Budget does highlight significant downside risks to its forecasts that include a greater impact on the domestic economy from the global downturn, financial market volatility, low confidence and high unemployment. Upside risks include stimulus from monetary policy, federal government fiscal policies and the state's own spending measures.

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