ECONOMICS & MARKETS RESEARCH
ANZ BUDGET PREVIEW

6 MAY 2010

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BUDGET STRATEGY:

- Australia's relatively strong economic performance over the past year has set the platform for an improving budget outlook. At MYEFO the Government estimated that the 2009-10 underlying cash deficit would be $57.8bn, but the Government's latest update (released on 19 March) shows that the deficit is now even $6.4bn lower than anticipated in year to date terms (to January) than back then.
- That said, the sticky nature of some government revenues (namely company tax) and unexpected spending pressures (eg. delay in schools building measures, prolonged war in Afghanistan) means a rapid improvement in the budget position will be difficult in the short-term.
- We expect that the budget deficit will be $48bn in 2009-10; $10bn less than the government were estimating at MYEFO. Moreover, in 2010-11 we anticipate the deficit should be around $33bn.
- Significant improvement in the budget will not occur until 2011-12, when the impact of this year's sharp rise in commodity prices hits revenues to reduce the deficit by $15bn to $16bn.
- We expect the budget will return to surplus in 2013-14, two years earlier than previously forecast.
- The short-term challenge for the Government is to wind back last year's aggressive policy stimulus plans given Australia's stronger than expected economic performance and current upward pressure on policy interest rates. Several programs have already been scaled back, such as cuts to promised childcare places. However with the upcoming election front of mind, scope for further spending reductions in the short-term may be limited.
- The medium-term challenge for the Government is to return the budget to surplus and it will need to show how it plans to achieve this in its projections. The Government's commitment to cap real spending growth to 2%pa until the budget returns to surplus will be closely scrutinized and suggests some portion of the upgrade to budget revenues over the next few years will need to be 'banked'.
- There will be little scope for 'big bang' policy initiatives therefore until after the budget returns to surplus (2013-14). The federal-state health reform agreement, which could add costs up to $16bn in the five years from 2014-15, will also reduce policy flexibility.
- The Government has announced some new medium-term savings measures, including this week's proposed tax changes, the deferral of the emissions trading and reported cuts to pharmaceutical prices. But there is nevertheless a risk that real spending will exceed 2%pa once the budget returns to surplus, hampering the improvement in the budget position in the out-years and slowing the reduction in net debt.
- Aside from the focus on health reform, we would also expect some new, 'smaller', medium-term policy initiatives. Further action on the Henry tax review seems likely, such as reducing the tax rate on deposits and measures to simplify business and personal tax reforms. Other policies will likely focus on education, infrastructure and possibly housing affordability.
- The most interesting part of the Government's economic forecasts may well be the longer-term projections for nominal GDP growth. Any upgrade beyond 6.0% could suggest the Government is now officially incorporating a commodity 'super-cycle' into its forecasts. This would raise revenue projections and provide further scope for new discretionary spending pledges.

AN EARLIER RETURN TO SURPLUS

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Senior Economist

Despite a significantly stronger Australian economy, rapid improvement in the budget will be difficult to achieve. Partly, this reflects the timing of budget revenues, with company and capital gains tax collections usually lagging activity by around a year. There has also been some degree of policy slippage in the Government's short-term stimulus measures, with delays to spending on public housing and schools building in 2009-10 likely to push up spending in 2010-11. Further, a range of unexpected costs may well exceed the Government's contingent liabilities, including the prolonged war in Afghanistan and increase in refugees. Recent spending cuts, such as the reduction in planned new childcare places, are likely to only partly offset these higher costs.

We expect the 2009-10 underlying cash balance to improve from -$58bn at MYEFO to -$48bn (Table 1). To be sure, this would require a significant deterioration from the year-to-date underlying cash balance which was $33bn in January. However, we remain wary of extrapolating too much from these monthly figures given: (a) sharp variations in the monthly timing of cash receipts and expenditures; and (b) recent problems at the Australian Tax Office which have seen the payments of many tax receipts to businesses and households delayed to the latter months of 2009-10.

In 2010-11, we look for the underlying cash deficit to further improve by $14bn to $33bn or 2.3% of GDP. This is largely due to the impact of stronger economic activity more than offsetting a small increase in net spending that year.

The biggest boost to government revenues however will occur in 2011-12, when this year's sharp commodity price rises hit the government's company tax collections. This should lead to 'parameter variations' of close to $20bn. Even assuming that the government spends a small portion of this windfall gain, the deficit should narrow to around 1% of GDP, or around $16bn in 2011-12.

Our sensitivity analysis suggests that the budget will return to a small surplus in 2013-14, two years earlier than the Government's previous projection of 2015-16. This mainly reflects the improvement in economic activity, although the just-announced tax changes will add $2.6bn in that year. The proposed delay in the Carbon Pollution Reduction Scheme (CPRS) to 2013 could also boost coffers by up to $1.5bn in 2013-14. The return to surplus also rests primarily on the assumption that any major spending announcements are funded largely by new revenue-raising efforts. This includes finding savings to offset the cost of the federal- state health reform agreement, which requires at least $15.6bn to be paid to the states from 2014-15 to 2019-20. Reported cuts to pharmaceutical prices (which will reduce drug subsidy costs), the deferral of CPRS and this week's proposed tax changes will only partly offset these higher health costs.

If the government does announce major new spending (or adopt a more conservative set of economic forecasts), the positive impact of the Government's just-announced tax changes should still ensure the budget returns to surplus by 2014-15, one year earlier than previously projected. A return to budget surplus *before* 2013-14 seems unlikely as it would reduce the Government's flexibility to announce additional fresh policy initiatives in the lead up to the election.

FIGURE 1: UNDERLYING CASH BALANCE – ANZ PROJECTIONS - $BN

	2009-10	2010-11	2011-12	2012-13
MYEFO Nov-09 **(% of GDP)**	-58 (-4.7)	-47 (-3.6)	-31 (-2.3)	-16 (-1.1)
Parameter variations – ANZ estimates	8	17	19	12
New Budget starting point	-50	-30	-12	-4
Net discretionary spending $bn	2.0	-3.0	-4.0	-5.0
2010-11 Budget **(% of GDP)**	**-48** **(-3.6)**	**-33** **(-2.3)**	**-16** **(-1.0)**	**-9** **(-0.6)**

Source: Commonwealth Treasury and ANZ

OUTLOOK FOR BOND ISSUANCE

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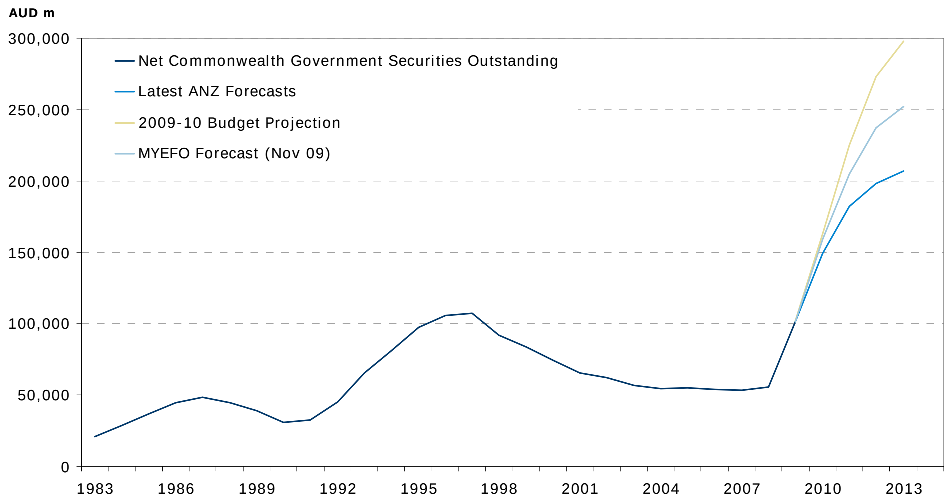
The improvement in the projected supply of Commonwealth Government Securities is a direct function of the improvement in the underlying cash balance. We had originally projected that total bonds on issue would rise towards $300bn at the time of the Budget last year. We then saw an improvement in the projections at November's mid-year review. And based on our estimates for a further improved Budget position over coming years we can now see a peak in the volume on issue around the $200bn level in 2012-13. This is still more than triple the size of the market in June 2008. An eventual return to surplus would see the supply profile start to head lower.

According to the AOFM Commonwealth Government Securities on issue at the end of April was $138.5bn, made up of $116.4bn of A$ benchmark bonds, $10.8bn of Index-linked bonds and $11.3bn T-Notes. The AOFM has issued around $44bn of bonds so far this fiscal year compared to an original borrowing requirement estimate of $54bn at the time of the Budget last year and an amended borrowing program above $50bn indicated at MYEFO last November.

FIGURE 2: PROJECTIONS OF COMMONWEALTH GOVERNMENT SECURITIES ON ISSUE



Source: AOFM and ANZ

We assume the AOFM will maintain around $12bn of T-Notes on issue over coming years (their current commitment is to keep at least $10bn on issue) and we also assume a more modest rise in CPI indexed-linked bonds on issue towards $18bn in 2011-12.

Even though 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), the comparison of this debt profile with other advanced countries is striking. Australia's sovereign credit profile is set to improve further in the out years barring a major economic downturn.

A STRONGER, SMOOTHER ECONOMY

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Since the MYEFO was released in November 2009, we have seen a continued improvement in economic momentum, most notably in the domestic economy but also in Australia's major trading partners. For next week's Budget, the main implication is a much smoother trajectory for forecast economic growth than the sharp downturn and then strong recovery previously forecast. That is, growth will be revised up in the short-term and down in the medium-term. This will represent a marked improvement on MYEFO, particularly in projected income flows to Australia on the back of the recommencement of the commodities boom that will provide a major boost to the Federal budget's bottom line in the out years.

We expect the Government will deliver a similar set of economic forecasts to our own (Figure 3). We look for nominal GDP growth (the key driver of budget revenues) to be upgraded to around 3¼% in 2009-10 and upwards of 8.0% for 2010-11. The Government will probably then forecast nominal GDP growth to return to trend of around 6.0% from 2012-13.

The most interesting part of the economic forecasts may well be the Government's longer-term projections for nominal GDP growth. Any upgrade beyond 6.0% could suggest the Government is now officially incorporating a commodity 'super-cycle' into its forecasts. This would raise revenue projections and provide further scope for new discretionary spending pledges.

FIGURE 3: MAIN ECONOMIC PARAMETERS – ANNUAL AVERAGE % CHANGE*

		2009-10	2010-11	2011-12	2012-13
Real GDP	MYEFO	1.50	2.75	4.00	4.00
	ANZ	2.40	3.30	3.50	3.60
Employment	MYEFO	0.25	1.50	2.25	2.00
	ANZ	1.20	2.30	2.10	2.10
WPI	MYEFO	3.25	3.50	na	na
	ANZ	3.00	3.20	3.50	3.80
CPI	MYEFO	2.25	2.25	2.25	2.25
	ANZ	2.90	2.90	3.00	2.90
Nominal GDP	MYEFO	1.25	5.50	6.25	6.25
	ANZ	3.10	8.80	6.80	5.70

* All parameters except the CPI are year average percentage changes. The CPI is through the year growth to the June quarter.

Source: Commonwealth Treasury and ANZ.

DISCRETIONARY FISCAL POLICY - ALL QUIET ON THE BUDGET FRONT

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Senior Economist

In the weeks preceding the release of the Federal Budget there is generally a steady trickle of leaks about any major new spending or revenue initiatives the government intends to announce. This is partly owing to the government's desire to assuage financial markets fears about surprises. This time there has been very little forthcoming. This doesn't imply the government has a surprise install; it's more likely this will be a modest Budget in the lead up to an election in late H2 2010. It makes little sense for the government to entice the electorate just now. It is far more strategic to save some goodies for closer to the election. That said, there is limited scope for the government to offer sweeteners, as it is committed to restoring the Budget to surplus after injecting a sizable stimulus in response to the global financial crisis.

There is another more compelling reason behind the absence of leaks: the government has been too busy on other things. Indeed, over the past month the government has released two major policy packages: *"Stronger, Fairer and Simpler: A Tax Plan for Our Future"*; and *"National Health and Hospitals Network"*. Both of these are significant reform measures and it would have been difficult to frame a Budget without knowing just how they would play out. The introduction of these reforms also highlights the fact that the Budget is no longer (and hasn't been for some time) regarded as a vehicle for the government to deliver major policy initiatives.

Key policy developments that have occurred since the 2009-10 MYEFO include:

- To get the states to jump on board its national health plan the government has committed itself to an additional $5.3bn on health expenditure (more new doctors, additional aged care beds, Federal takeover of primary and age care) over the next four years. This will be financed by a 25% increase in the tobacco excise. This is expected to raise an additional $5.0bn over the next four years. The government will also provide (at least) an additional A$15.6bn, in the five years from 2014-15, to fund public hospitals. Details of how this will be funded should be outlined in the Budget.
- Implementation of the *"Stronger, Fairer and Simpler"* tax package isn't expected to impact on the Budget bottom line in a meaningful way until 2012-13. In that year, the government coffers are expected to be boosted by $635mn, rising to $2,595mn in the following year.
- The decision by the Rudd government to push back its emissions trading scheme (ETS) until at least 2013 will yield some savings in the short term –up to $1.1bn by 2012-13 and $2.8bn if it is delayed past 2013-14. As the government is likely to forecast an exchange rate similar to its 2009-10 MYEFO forecast (around USD0.90), the overall cost of the Carbon Pollution Reduction

Scheme should be little changed from the MYEFO estimate. If the government forecasts a higher exchange rate than MYEFO, this would result in less revenue collected (so higher overall cost) as the carbon permits are set in US dollar terms.

- The government is proposing to cut the price of prescribed medicines. This is expected to yield the government A$2.0bn in savings from its Pharmaceutical Benefits Scheme over the next four years.

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