

Few surprises, but medium-term fiscal targets could be optimistic

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## Summary

- The underlying cash deficit has deteriorated to \$57.6bn (4.9% of GDP) in 2009-10 and \$57.1bn (4.7% of GDP) in 2010-11. This is the biggest budget deficit, in dollars and as a % of GDP, since WWII.
- Most of the deterioration in the government's balance sheet has been driven by significant parameter variations, in particular hits to revenue, as a result of the weaker economic backdrop. Discretionary policy spending has also increased, most notably in 2009-10.
- The government is forecasting a relatively mild recession with the Australian economy expected to contract by ½% in 2009-10 and recover to 2¼% growth in 2010-11. In 2011-12 and 2012-13 the government is projecting GDP growth to rebound to well above trend of 4½% p.a.
- The underlying cash balance is not expected to return to surplus until 2015-16. This projection is based on the projection that GDP growth will rebound strongly above trend in 2011-12 and 2012-13, and that this will allow revenues to recover 'naturally'. The optimism around these economic forecasts suggests there is considerable scope for 'slippage' of this medium-term target.
- There were few policy surprises in today's budget. Most spending measures were focussed on investment, particularly infrastructure, as well as additional spending on education and health. Policy decisions directly affecting households had mainly distributional, rather than outright stimulus, consequences. Our estimate is that the budget will add around ¾ppt to GDP growth in 2009-10 and between ¼ to ½ppt to growth in 2010-11.
- Net debt is projected to rise sharply to peak at 13.8% of GDP (around \$205bn on our estimates) in 2012-13. This is well below the peak of 18.5% of GDP reached in 1994-95 and is very low by international standards. The government expects net debt to fall back to 3.7% of GDP by 2019-20. S&P have confirmed the 2009-10 budget has no implication for Australia's 'AAA' credit rating.
- The Government's budget projections suggest a substantial uplift in bonds on issue. A headline cash budget deficit of almost \$60bn for the next two financial years will result in total government securities outstanding rising to well over \$200bn.

Figure 1: Key Budget Aggregates

	2008-09 (f)	2009-10 (f)	2010-11 (f)	2011-12 (p)	2012-13 (p)
<b>Underlying cash balance</b>					
\$bn	-32.1	-57.6	-57.1	-44.5	-28.2
% of GDP	-2.7	-4.9	-4.7	3.4	-2.0
<b>Fiscal balance</b>					
\$bn	-32.9	-53.1	-56.0	-41.8	-30.3
% of GDP	-2.7	-4.5	-4.6	-3.2	-2.2

Source: Budget Papers

## Assessment

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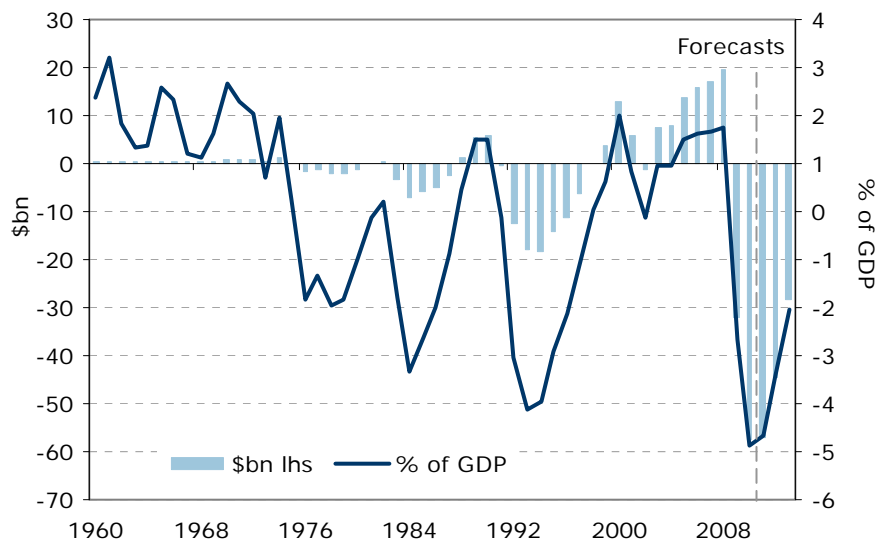
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### Few surprises in the short term

If the Government's intention in 'leaking' nearly all of the major policy initiatives in this year's Budget, most of the key fiscal aggregates and a broad sense of its underlying economic assumptions to the media over the past few weeks was to prompt analysts to conclude that it contained 'no surprises', then they have almost certainly succeeded. The only significant initiative which hadn't been mentioned in pre-Budget media speculation was the increase in the pension age from 65 to 67 between 2017 and 2023. But there was nothing in the Budget Speech or accompanying papers which seems likely to prompt any major reaction from financial markets.

However the Government's success in massaging public and market expectations shouldn't be allowed to obscure how dramatically the Government's fiscal position has changed over the twelve months since the last Budget. The 2008-09 Budget forecast underlying cash surpluses totalling nearly \$80bn over the four years 2008-09 through 2011-12. This year's Budget now envisages cash deficits totalling more than \$191bn over the same period – a turnaround of some \$270bn. Instead of the \$20bn surplus foreshadowed this time last year for 2009-10, the Budget envisages a \$58bn deficit, equivalent to 4.9% of GDP (which exceeds the previous peak of 4.1% of GDP in 1992-93). And the Budget is expected to remain in deficit for a further five years.

### The biggest budget deficit since WWII



Source: Budget papers

Around \$173bn, or just under two-thirds, of this turnaround is the result of factors beyond the Government's direct control – in particular, the impact of the sharp downturn in the global economy (and the associated fall in commodity prices) on taxation revenues. Australia's national income (nominal GDP) will be an average of \$111bn per annum or 9% lower over the next three financial years than had been assumed in last year's Budget.

The vulnerability of the Budget to kind of shock which has occurred since this time last year was greatly increased by the Howard Government's willingness in its last two terms to use windfall revenue gains from the resources and asset price booms to fund permanent reductions in personal income tax and increases in cash payments to households (a practice which the current Government largely continued in last year's Budget).

As a result, there would have been a cash deficit of around \$26bn in 2009-10, rising to \$38bn in 2010-11, even had the Government made no policy decisions at all over the past twelve months. Needless to say, seeking to prevent the Budget from slipping into

deficit would have required swingeing tax increases and spending cuts, which would have in turn exacerbated the economic downturn.

Instead, the Australian Government embarked on a series of discretionary stimulus packages, the third of which is contained in the 2008-09 Budget, seeking to ameliorate the impact of the global downturn and, in so doing, pushing the Budget further into deficit. This was, we hasten to add, absolutely appropriate, and consistent with what governments in most other advanced economies and many emerging economies have also sought to do – even though there is room for argument as to whether the precise form which the various stimulus packages have taken has been optimal. Treasury estimates that without these stimulus packages, real GDP would have been 2¾% lower in 2009-10 and 1½% lower in 2010-11, and that Australia's unemployment rate would have peaked at over 10% in 2010-11 rather than the 8½% which the Budget Papers forecast.

We don't necessarily endorse these calculations, but we don't deny that the stimulus packages have softened the impact of the global downturn.

Nor do we have any concerns about the size of the deficits which the Government envisages incurring over the next few years, or the build-up in net debt which will result from them. Though the deficits are, at least for 2009-10 and 2010-11, large by Australian historical standards, they are almost modest by contemporary international standards, with advanced economies as a group running deficits averaging 7.7% of GDP in 2010 (and the US and UK deficits of over 10% of GDP). Similarly, although the forecast peak in net debt of 13.6% of GDP by 2013-14 is high by Australian historical standards (while falling short of the all-time high of 18.5% of GDP in 1996), it is almost virtuous by comparison with the corresponding figure for advanced economies as a group which, according to the IMF, will reach 107% of GDP by 2013.

These favourable international comparisons reflect Australia's much more advantageous starting point – for which the previous Government is entitled to take credit (even though this analyst believes it could and should have been even more advantageous). But having zero or even negative net debt is not an end in itself, but rather something which is advisable during booms so as to have greater scope to borrow in order to soften the impact of subsequent downturns.

### But risks around the medium-term strategy to return to surplus

This year's Budget seeks to provide a third instalment of fiscal stimulus; to meet some other political commitments which the Government entered into (in particular, to increase pensions, a commitment which it made after last year's Budget); and to lay out a credible strategy for ensuring that the budget eventually returns to surplus over the medium term.

It is with regard to this third objective that this year's Budget may eventually raise some concerns in financial market circles. The medium-term strategy laid out in the Budget relies on three pillars –

- a series of measures aimed at restricting the access of high-income earners to welfare benefits, closing some tax loopholes and reducing the extent of fiscal support for superannuation savings;
- an assumption that economic growth will average 4½% per annum in 2011-12 and 2012-13, and that the 'revenue dividend' from this above-trend growth will be applied to deficit reduction; and
- a commitment to keep real growth in spending to less than 2% pa from 2011-12 onwards.

We have no particular quarrel with the savings measures foreshadowed in this Budget: we believe welfare benefits should, in general, be subjected to means tests, and if it is considered necessary to raise additional tax revenues then it is far preferable to do so by broadening the tax base (eliminating loopholes and concessions) than by raising tax rates. Our only concerns here are whether these measures will get through the Senate; and whether they go far enough. On the latter score, we note that even in 2011-12 and 2012-13, when the economy is supposed to be growing at an above-trend pace and the need for fiscal stimulus has passed, the bottom-line impact of all these savings measures will still be more than offset by new spending measures

contained in this Budget, by over \$4bn and \$2bn respectively. That is, the Budget does not make net savings even three and four years out into the forward estimates period.

Similarly, an analysis of previous cycles supports Treasury's contention that there will probably be a period of above-trend growth after the current recession has ended. Treasury argues that the speed and size of the global policy responses to the financial crisis, together with Australia's exposure to rapid growth in China and India, add 'particular support' to that scenario. Against that, the fact that Treasury is forecasting this recession to be shallower than its two predecessors, and the comparative absence of growth-spurring micro-economic reforms in prospect for the next few years, might argue against growth being as strong as Treasury has assumed.

Third, it remains to be seen whether, as revenue recovers in line with a pick-up in economic growth, the Government really can remain committed to constraining spending growth to less than 2% in real terms, in the absence of further (and more wide-ranging) 'hard policy choices' than the ones contained in this Budget.

In short, while we see no grounds for concern about the foreshadowed deficits and net debt for the period immediately ahead, we suspect that the task of returning the budget to surplus by the middle of the next decade remains unfinished business which will require further attention in future Budgets.

## Budget Details

### How did we get here?

In the 12 months since the May 2008-09 Budget the 2009-10 underlying cash balance has moved from a projected surplus of \$19.7bn to a projected deficit of \$57.6bn. This extraordinary turnaround is largely due to adverse parameter variations (-\$45.3bn), as the weaker global and local economies have 'put a wrecking ball' through revenues. However around 40% of the turnaround, or -\$32bn, is due to discretionary policy measures to try to support growth (see table below).

**Figure 2: Reconciliation of general government underlying cash balance estimates**

	08-09	09-10	10-11	11-12	Sum
	\$bn	\$bn	\$bn	\$bn	\$bn
<b>2008-09 Budget</b>	<b>21.7</b>	<b>19.7</b>	<b>19.0</b>	<b>18.9</b>	<b>79.2</b>
Policy decisions	-11.1	-1.6	-1.0	-0.8	-14.5
Parameter and other variations	-5.2	-14.4	-15.4	-11.4	-46.4
Total changes	-16.4	-16.1	-16.4	-12.2	-60.9
<b>2008-09 MYEFO</b>	<b>5.4</b>	<b>3.6</b>	<b>2.6</b>	<b>6.7</b>	<b>18.3</b>
Policy decisions	-18.0	-18.4	-11.7	-5.4	-53.5
Parameter and other variations	-9.8	-20.8	-25.3	-27.0	-82.8
Total changes	-27.9	-39.1	-37.0	-32.4	-136.3
<b>2008-09 UEFO</b>	<b>-22.5</b>	<b>-35.5</b>	<b>-34.3</b>	<b>-25.7</b>	<b>-118.0</b>
Policy decisions	-4.3	-12.0	-6.0	-7.0	-29.2
Parameter and other variations	-5.4	-10.1	-16.7	-11.9	-44.1
Total changes	-9.6	-22.1	-22.7	-18.9	-73.3
<b>2009-10 Budget</b>	<b>-32.1</b>	<b>-57.6</b>	<b>-57.1</b>	<b>-44.5</b>	<b>-191.3</b>
% of GDP	<b>-2.7</b>	<b>-4.9</b>	<b>-4.7</b>	<b>3.4</b>	<b>-2.0</b>
<i><b>N.B. Since 2008-09 Budget</b></i>					
Total policy decisions	-33.4	-32.0	-18.6	-13.2	-97.2
Total parameter and other variations	-20.4	-45.3	-57.4	-50.2	-173.4
Total changes	-53.8	-77.3	-76.0	-63.4	-270.5

Source: Budget papers

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In contrast to the total movement since the last budget, since February's Updated Economic and Fiscal Outlook (UEFO), policy decisions do more damage to the 2009-10 budget bottom line than deteriorating parameter variations. While parameter variations wipe around \$10.1bn from the underlying cash balance in 2009-10, policy decisions hurt more, wiping off a further \$12bn. Amongst other things, this supports the Government's claim that the budget is exerting expansionary fiscal policy in 2009-10, a not unreasonable goal given the backdrop of a local recession.

The hit to the budget from policy measures in 2009-10 is largely driven by increased expenses, which in accrual terms will rise by around \$8.5bn this year, mainly reflecting increases to the age, carer and disability pensions, increased defence spending, higher infrastructure spending and the extension of the First Home Owners Grant. These costs have only been partly offset by savings measures (which are largely targeted to greater means-testing of "welfare" benefits).

2009-10 aside, for the forecast period as a whole, most of the deterioration in the deficit is due to parameter variations as a result of the weaker economy. These parameter variations cut around \$38.8bn from the underlying cash balance in the three years to 2011-12. Policy decisions meanwhile cut 'only' around \$25bn from the underlying cash balance over this period (and are largely front-loaded to 2009-10).

The drag from parameter variations is mainly due to weaker revenues which, in accrual terms have fallen by around \$13bn in 2009-10 and by \$47.5bn in the three years to 2011-12. This is largely due to downward revisions to individuals' income taxes, company tax and the GST, which is only partly offset by increased revenue from the Guarantee Scheme for Large Deposits and Wholesale Funding.

### Returning to surplus – the risks

The Government expects the underlying cash balance to return to surplus by 2015-16. This is largely based on allowing tax receipts to recover 'naturally' (ie. without any new policy changes such as tax increases) as the economy recovers from recession which, as we now know the Government expects to happen sharply with real GDP growth forecast to bounce to 4.5%pa in 2011-12 and 2012-13!

The (optimistic) strength of the economic forecasts that underlie this medium-term fiscal strategy suggest there is a significant risk that the government does not return to an underlying cash balance until well after 2015-16. And if the risks around the growth forecasts are heavily skewed to the downside and the Government of the day wants to return the budget to surplus in a sensible time frame, this suggests that at some stage more significant spending cuts or increased taxes will be required.

So, what are the risks? The Government's own sensitivity analysis suggests a 1% fall in real GDP (due to an equal decrease in both productivity and participation) would wipe \$2.5bn off the underlying cash balance in Year 1 and \$4bn off the balance in Year 2.

Let's now consider what will happen if the recession turns out deeper than current government estimates, knocking an extra 1ppt off growth per annum such that the economy contracts by 1½% in 2009-10 and recovers to grow by just 1¼% in 2010-11. Under this scenario, we estimate the underlying cash balance would deteriorate to at least \$60bn (5.0% of GDP) in 2009-10 and at least \$65bn in 2010-11 (5.4% of GDP). Under this scenario, the budget would struggle to improve to \$40bn (3.0% of GDP) by 2012-13 and would struggle to return to balance by 2018-19.

It is also useful to consider the impact if the government's short-term economic forecasts hold but that real GDP growth averages 3.5% in 2011-12 and 2012-13 (which would still be above trend of 3¼%, but below the government's forecasts of 4.5%). Under this assumption, the underlying cash deficit would deteriorate to \$47bn (from \$44.5bn) in 2011-12 and to \$34.7bn (from \$28.2bn). We estimate that this would push out the timing of the return to budget balance by at least 2 years, that is, to at least 2017-18. Under such a scenario net debt would also easily peak above \$200bn.

## Net debt and budget funding

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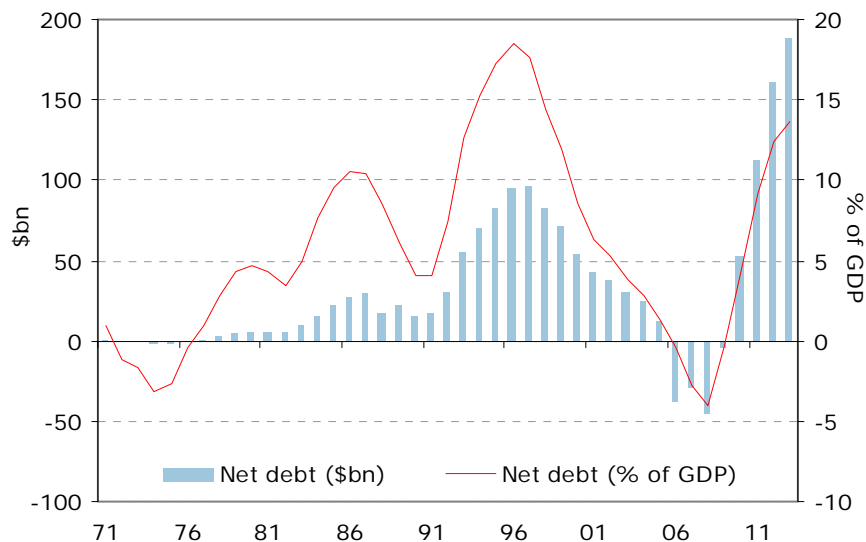
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### Net debt to rise

The deterioration in the cash deficit has caused a significant increase in the government's net debt projections. At UEFO, net debt was forecast to rise to 5.3% of GDP by 2011-12 (which we estimated to be around \$70bn). The government now projects that net debt will rise to peak at 13.8% of GDP, or around \$205bn (on our estimates), in 2013-14. In terms of % of GDP, this would be the biggest net debt position since 1997-98, but is still well below the peak of 18.5% of GDP reached in 1994-95. It is also considerably lower than most other advanced economies (see *International Comparison* below). Interest payments are expected to remain capped well below 1.0% of GDP over the projection period.

The government projects that net debt will begin to improve as the budget approaches surplus, to quickly drop to 3.7% of GDP by 2019-20. Following these projections, we would not expect to see net debt eliminated until 2011-12 at the earliest. Despite the rise in debt, Standard & Poor's have confirmed tonight's budget is consistent with Australia's 'AAA' long-term foreign and local currency sovereign credit rating.

**Figure 3: Net debt projections**



Source: Budget papers

While net debt was quickly reduced in the 1990s, this was partly helped by large scale asset sales, which this time the government doesn't have at its disposal. Therefore, the robustness of the government's net debt projects rely crucially on the robustness of the underlying economic assumptions, which we have already outlined look optimistic. There is thus a risk that not only will net debt peak above the projected 13.8% of GDP (to more like 15% of GDP, to approach \$250bn), but that it will also take longer than forecast to return to more 'desirable' levels.

### Government bonds on issue will double in 2009!

The Government's projections for the Budget deficit over the next five years suggest a substantial uplift in bonds on issue. A headline cash Budget deficit of almost \$60bn for the next two financial years will result in total government securities outstanding rising to well over \$200bn. The government has flagged the increased bond issuance in the Budget papers stating that most of the borrowing requirement will be met through issuance into existing benchmark bond lines. The Treasury-Note (T-Note) program will maintain a minimum issuance level of \$10bn. The Budget Papers also suggest that the Australian Office of Financial Management (AOFM) will look into the possibility of issuing inflation linked bonds once again.

The table below shows the Government's forecast for the headline cash balance and our estimate of what that will do to Bonds and Notes outstanding at the end of each period. We assume a lift in minimum T-Note issuance to \$15bn in 2010-11 and an indexed bond program of \$6bn a year from next year. There is currently \$6bn of index

bonds outstanding. On these numbers, it is expected that the volume of government bonds on issue will roughly double in calendar 2009. After starting the year with approximately \$55bn of government securities outstanding, this is forecast to be \$95bn in June and around \$125bn by the end of 2009.

The Papers also indicate that the AOFM will issuance a new 2022 bond this coming year but have made no comment on longer securities such as 30 year bonds, common in other government markets. The AOFM is expected to announce an updated borrowing program at midday on 13 May 2009.

**Figure 4: Estimates of Commonwealth Government Securities Outstanding**

	2008-09	2009-10	2010-11	2011-12	2012-13
<b>GFS Cash Balance</b>	-32.1	-54.7	-54.2	-41.8	-25.4
Net Cash flows from investments in financial assets for policy purposes*	-7.4	-5.1	-4.8	-6.8	0.3
Plus Future Fund Earnings	3.6	2.9	2.9	2.8	2.8
<b>Headline Cash Balance:</b>	-35.9	-59.8	-58.9	-48.5	-25.1
<b>CGS Outstanding (end period)</b>					
\$A Benchmark	79.0	133.0	182.0	226.0	245.0
T-Notes	10.0	10.0	15.0	15.0	15.0
Index Bonds	6.0	12.0	18.0	24.0	30.0
<b>Total CGS Outstanding (end period):</b>	95.0	155.0	215.0	265.0	290.0

Source: Budget papers and ANZ

### Funding the National Broadband Network

The Government recently announced that it will establish a company to roll-out at National Broadband Network (NBN). The initial estimate for the cost is \$43.7bn of which the government is hoping just under half will come from the private sector.

The Government will provide an initial equity injection into the holding company of \$4.7bn. This money will be raised through the issue of regular government bonds and the interest cost accounted for in the Budget. In 2009-10 the Government expects to inject \$750m rising to \$3.7bn in 2010-11.

The rest of the Government money will come from the issuance of Aussie Infrastructure Bonds (AIBs), the interest cost of which will be funded through the Building Australia Fund. Although the Government hasn't given exact numbers we are assuming that there will need to be between \$15 and \$20bn of AIBs issued if the proposed strategy is followed through.

## Macroeconomic impact of the budget

### A modest fiscal stimulus

Assessing the impact of fiscal policy on the economy is a complicated task still argued over by economists to this day. The simplest expression is the change in the Budget balance. On this measure, fiscal policy is extremely accommodative with the Budget position swinging from a surplus of \$19.7bn in 2007-08 to a deficit of \$32.1bn in 2008-09. This \$51.8bn swing in the Budget position represents 5.1% of GDP. On this basis, further fiscal stimulus is at hand with deterioration in the Budget position to \$57.6bn in 2009-10. This simplistic methodology surely overstates the stimulus, but it does suggest that the bigger fiscal stimulus has occurred in 2008-09 than in 2009-10.

In essence, counter-cyclical fiscal policy is made up to two distinct components, the automatic stabilisers and discreet new policy measures. Since the last Budget the effect of a weaker economy on the Budget position, the so-called impact of 'parameter

variations' (a proxy for the automatic stabilisers), has been to reduce the 2007-08 surplus to an expected surplus of \$1.3bn in 2008-09 and an expected deficit of \$25.6bn in 2009-10. While allowing the automatic stabilisers to work, that is, not to resist the impact by cutting spending or raising taxes, is a commonly accepted approach to fiscal policy, the real fiscal stimulus is in the discreet changes to policies.

Of the \$25.5bn swing in the budget position between 2008-09 and 2009-10, approximately \$20bn or 1.8% of GDP has been due to the previously announced fiscal stimulus packages and other policy changes made by the Government over the past year. Over the year ahead to 2010-11 this number is less although still substantial at \$12.6bn or 1.1% of GDP. Quantifying the impact for fiscal policy on the underlying economy is difficult and requires judgement around how these different forces will work to affect growth and employment outcomes in the economy. Our assessment is that the fiscal stimulus from the 2009-10 budget has been worth approximately 0.8% of GDP in 2009-10 and 0.25 to 0.5% of GDP in 2010-11

## Monetary Policy Implications

### RBA on hold for now, but reduced fiscal flexibility means rates on may still fall further

Fiscal stimulus is playing a critical counter-cyclical policy role in Australia at present and will continue to do so for sometime. This takes pressure off monetary policy in attempting to cushion the effects of the global economic downturn and financial crisis on the economy. But just as we have little room for further monetary stimulus with a cash rate at 3%, so too tonight's Budget highlights that we are running out of fiscal bullets as well.

With the deficit at \$57.6bn already the worst (in both nominal terms and as a percentage of GDP) since WWII, we doubt the government has much scope to intentionally take the Budget further into deficit over the year ahead. The government is already struggling to come up with a credible plan to put the Budget back into balance.

In terms of the Commonwealth, we think that the bulk of discretionary fiscal measures have now been announced. Only in the most dire of economic circumstances (such as those affecting the US and UK and various other parts of Europe) would the government risk undermining the government's financial position any further. In this case, we would likely see a double whammy to the budget deficit of a further deterioration in the automatic stabilisers combined with more discretionary policy announcements.

This puts the onus on the RBA to react to any disappointment on prospects for the economy over the year ahead including a more anaemic recovery than currently forecast. While the Budget will have limited implications for monetary policy in the short-term, which we believe is comfortably on hold for the next 3 months or so, the lack of fiscal flexibility suggests it is too early to call an end to the easing cycle, let alone near term rate hikes.

Our forecasts are that further disappointment on the economic forecasts, particularly around business investment and potentially the labour market, will see the RBA cut rates further later this year. We expect a low for the cash rate of 2% to 2.5% in the current cycle.

## Economic forecasts

### Australian economic forecasts sound, at least in the near term...

The government is expecting a mild recession for the Australian economy in the coming year, followed by gradual rebound 2010-11 and above-trend growth in both 2011-12 and 2012-13 as the recovery gathers steam.

While slightly above our forecasts, the government's figuring for economic contraction of ½% in 2009-10 seems broadly reasonable. 2¼% growth in 2010-11 is consistent with our view that the recovery will be gradual in 2010-11. We are a little less sure about the government's projections for 2011-12 and 2012-13 (and hence the ability of the government to return the budget to surplus by 2015-16). The government is projecting growth of 4½% in those out years, well above trend growth of between 3

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and 3¼%. To be sure, above-trend growth is common when economies come out of recession. For instance GDP did grow by 4.2% on average for two years following the early 1990s recession and by an average 4.8% for three years following the early 1980s recession.

#### Government Forecasts – Major Australian Economic Parameters

	GDP	Employment	Wage Price Index	CPI	Nominal GDP
Forecasts:					
2008-09	0	-¼	4¼	1¾	5¾
2009-10	-½	-1½	3¼	1¾	-1½
2010-11	2¼	½	3¼	1½	3¾
Projections:					
2011-12	4½	2½	np	2	6¼
2012-13	4½	2½	np	2½	6¾

<sup>(a)</sup>Through the year growth to the June quarter  
Sources: Budget Papers and ANZ

However, there are also some important differences in this cycle; the recession in the early 1980s was much deeper than during the current cycle. There is thus less potential for a strong bounce in this cycle, although growth admittedly will stay below trend in 2010-11. In addition, the recovery following the early 1990s recession was aided greatly by productivity increases due to microeconomic reform, including financial system reform and deregulation. In this cycle, we are unlikely to see the same productivity advances and in fact will face a significant productivity challenge stemming from the ageing of the population.

#### Rising unemployment and falling inflation

Slower growth is forecast to lead to a sharp rise in the unemployment rate in the coming two years. The unemployment rate is now forecast to rise to 8¼% by June 2010 and to 8½% by June 2011. The rise in unemployment will be slightly less pronounced than in the previous two cycles in which unemployment rose by 5ppt and 5.3ppt. This time the trough to peak change in the unemployment rate will be around 4.6ppt. Nevertheless, this will mean that almost 1mn Australians will be out of work by June 2011. The government expects above-trend growth to reduce the unemployment rate quickly in 2011-12 and 2012-13, with the unemployment rate expected to fall by 1ppt per annum back down to 6½%.

Weaker growth and lower employment will also take pressure off inflation, with the government expecting headline and underlying inflation to ease to 1½% by 2010-11. This is broadly consistent with RBA forecasts released this week.

#### Falling commodity prices limited to 2009-10

While the Government has a more pessimistic outlook for growth in the global economy and amongst Australia's commodity-importing trade partners than we do (see below), its outlook for Australia's terms of trade does not appear to be overly dire. The Government is forecasting a 13.25% decline in Australia's terms of trade in the coming fiscal year. This is likely roughly in line with the 20% fall that both ANZ and the RBA are forecasting over the 2009 calendar year - although our global growth forecasts are somewhat more optimistic.

In the years following 2010, the RBA estimates that the terms of trade will settle around 40% above the long-term average level while the Government is estimating 45% higher than in the decade prior to the commodity boom, so the assumption appears to be that any falls in commodity prices will be limited to this next fiscal year. The recovery of the Australian domestic economy after 2011 to an above-trend rate of growth appears to be the primary driver of a return to stronger budget revenue growth, rather than a focus on any changes to gross domestic income arising from the longer-term evolution of the commodity boom.

## Key drivers of growth

In 2009-10, the downturn will largely be driven by substantial falls in business investment (-18½%), particularly non-dwelling construction (-26%), and exports (-4%) in response to both weaker global and domestic demand. Lower household consumption (-¼%) will also weigh on growth, as household income growth slows from here in line with weaker labour market conditions (lower interest rates and cash handouts primarily boosted incomes in 2008-09). Public investment is expected to be the main contributor to growth, with public investment rising an unprecedented 25%.

The key drivers of recovery in 2010-11 are expected to be dwelling investment and exports. Household consumption and business investment are expected to recover gradually.

### Australian economic forecasts<sup>(a)</sup>

	2008-09		2009-10		2010-11	
	Govt	ANZ	Govt	ANZ	Govt	ANZ
<b>Demand and output</b>						
Consumption	1	¾	-¼	¼	1¾	2
Dwelling investment.	-2½	-2¾	0	-¼	11½	11½
Business investment <sup>(b)</sup>	2½	4¾	-18½	-17½	3½	-7¼
<i>Non-dwelling</i>	½	5	-26	-21¼	3	-11½
<i>Machinery and equipment</i>	3	4¼	-16½	-17¾	4	5¾
Private demand <sup>(b)</sup>	½	1	-4	-3¾	2¾	1
Public demand <sup>(b)</sup>	5	3¼	7¾	4	-½	5¾
Changes in inventories <sup>(c)</sup>	-1½	-1½	¼	½	¾	½
GNE	¼	0	-1¼	-1½	2½	2½
Net exports <sup>(c)</sup>	¼	¾	¾	½	-½	½
<i>Exports</i>	-½	½	-4	5¼	4½	2¼
<i>Imports</i>	-1½	-2½	-6½	-6¼	6½	5
<b>GDP</b>	<b>0</b>	<b>¼</b>	<b>-½</b>	<b>-¾</b>	<b>2¼</b>	<b>2¼</b>
<i>Non-farm product</i>	<b>-¼</b>	<b>0</b>	<b>-½</b>	<b>-¾</b>	<b>2¼</b>	<b>2¼</b>
<i>Farm product</i>	<b>13</b>	<b>12¾</b>	<b>1</b>	<b>3</b>	<b>0</b>	<b>3¼</b>
<b>Nominal GDP</b>	<b>5¾</b>	<b>5¾</b>	<b>-1½</b>	<b>-2</b>	<b>3¾</b>	<b>4½</b>
<b>Other indicators</b>						
CPI <sup>(d)</sup>	1¾	3	1¾	2	1½	2½
Employment	-¼	1	-1½	-1¼	½	¼
Unemployment rate (%) – year ended June qtr	6	5¾	8¼	8	8½	8¼
Wage price index	4¼	4¼	3¼	3½	3¼	3½
Terms of trade	8¾	8¼	-13¼	-17¼	0	-1½
Current account (% of GDP)	-3	-3	-5¼	-6½	-5¾	-7¼

(a) Year-average per cent change unless otherwise stated.

(b) Excluding transfers of second-hand asset sales from the public sector to the private sector.

(c) % point contribution to growth in GDP.

(d) Through the year growth to the June quarter for 2006-07 and 2007-08. 2008-09 is year-average.

Source: Budget Papers and ANZ

## Risks to the forecasts

While we are relatively comfortable with the government's 2009-10 and 2010-11 forecasts, there are two key downside risks worth noting:

- The forecast recovery in business investment appears to occur quite quickly given that demand conditions will remain difficult and given what we know about the long lead times involved in most large projects. Indeed, we (and the RBA) are not expected a recovery in business investment until calendar year 2011. According to the government, the 2010-11 business investment recovery will be led by engineering construction due to a high number of resource projects due for commencement. However, even the government admits that there are significant risks around this *"given the possibility of delays or cancellations in light of reduced demand and significantly lower commodity prices."*
- The government is assuming a large fall in the household savings ratio from 8.5% in the December quarter 2008 to an average 6¼% for 2008-09 as a whole and remain there. This assumes the savings rate will fall to 7.5% in the next two quarters and continue to ease through 2009-10. In our view, there is a significant risk that households will retain their recent more cautious approach and continue to improve their balance sheet position, thus posing significant downside risks to household consumption in the near term.
- On the flipside, the government's forecasts for global growth are very conservative, implying a deep global contraction and a very tepid recovery (see table below). The forecasts for growth among Australia's trading partners is in line with forecasts that the RBA used in last week's Statement on Monetary Policy, where Australia's major trade partners are expected to contract by 2% this year (weighted by merchandise export shares). Our forecasts outline a more optimistic scenario for the recovery in the US over the next few years, and a less disastrous collapse in Japan this year. As a result, we don't anticipate quite as bad a year for Australia's major trade partners in aggregate as what has been incorporated into the Treasury's global forecasts. This suggests upside risk to the government's export forecasts for 2009-10.

### Comparison of International Economic Forecasts

	2009 (est)		2010 (f)		2011 (f)	
	Govt	ANZ	Govt	ANZ	Govt	ANZ
United States	-3	-2 ¾	¼	1 ½	1¾	2 ¼
Euro area	-4	-3 ¼	0	¼	1 ¼	1 ¼
Japan	-6	-3 ¾	½	½	¾	¾
China	6 ¼	6 ½	8	8 ¼	8 ½	9
India	4	5	4 ¾	6 ½	5 ¾	8
Major Trading Partners	-2	-1	2 ½	3	3 ¼	4
World <sup>1</sup>	-1 ½	-½	2 ¼	2 ¾	3 ½	3 ¾

Source: Budget Papers and ANZ

<sup>1</sup> Includes Hong Kong, Korea, Singapore, Taiwan, Indonesia, Malaysia, the Philippines, Thailand and Vietnam.

## Business and Industry Impacts

### No big surprises for business, but the devil is in the timing

As expected, the importance of this Budget for business lies mainly in infrastructure spending projects, which will provide a short-term activity stimulus and hopefully, a long-term productivity gain. There are also a few very small sweeteners in the form of bigger business investment tax concessions. Industry-specific decisions will mainly affect healthcare, childcare, residential construction, superannuation funds and education and training providers.

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### Infrastructure dollars for transport, telecomms, schools and hospitals

Last year the Government announced it would identify priority projects for immediate funding from the \$10bn Building Australia Fund, which was created in last year's Budget for national infrastructure. This Budget allocates \$5.6bn of this Fund to specific transport projects over the next 5 years (see table below). Much of this spending however, will be slow to trickle through, with the majority allocated to the latter years of the outlook period. New transport projects show a heavy emphasis on metro rail, presumably in order to address urban commuter congestion. New road funding is concentrated on 'Network 1', the freight route along the eastern seaboard from Melbourne to Cairns.

For the National Broadband Network (NBN), the Government expects the total investment will eventually cost \$43bn, with significant contribution from the private sector. The initial government investment will be just \$53mn in 2009-10 to kick start the establishment of the investment vehicle, with another \$250mn to immediately address the more serious regional blackspots. The switch to digital television will cost \$26mn in 2009-10, doubling to \$51mn in 2010-11.

The other major infrastructure spending beneficiaries are public schools and hospitals, which will see a much needed \$2.5bn and \$2.9bn worth of capital improvements respectively over the 5 years, paid from their respective Funds.

The 'Clean Energy Initiative' components of the Budget are less clearly targeted at infrastructure spending and are more about R&D. About half is allocated to 'carbon capture and storage' research and demonstration plants (for coal-fired power sites) with the remainder going to solar power demonstration plants and a smaller portion to other renewable energy research projects.

**Figure 5: Budget 2009-10: Major new infrastructure spending allocations**

\$mn	2008-09	2009-10	2010-11	2011-12	2012-13	Total
(Road) Network 1	742.0	75.0	424.0	624.0	526.0	2,391.0
Metro rail	263.0	196.0	469.7	834.6	1,143.4	2,906.7
Public transport	32.0	30.0	79.0	65.0	74.0	280.0
Clean Energy	0	400.0	300.0	300.0	300.0	1,300.0
Education fund	68.0	595.4	935.4	650.6	317.1	2,566.5
Hospitals fund	186.0	465.7	847.5	813.2	643.0	2,955.4
Total new infrastructure spend	1,291	1,762.1	3,055.6	3,287.4	3,003.5	12,399.6

Source: Budget 2009-10

As well as these big-ticket headline items, there is the usual list of small one-off capital works projects. In 2009-10 the list is very small indeed. It will include: \$15mn to expand the national crisis coordination facility (at attorney-general's); \$14mn to the ABC for capital improvements; \$250mn for regional blackspots in the national broadband network; \$12mn to fit out offices for the new Dept of Climate Change; \$16.7mn for a new office for FaHCSIA in Tuggeranong; \$6mn to redevelop the Villawood Detention Centre (but costing a total of \$141.7mn to 2012-13); and \$12.6mn for security upgrades to Australian embassies.

A major area of omission in these infrastructure plans seems to be water and drought reform (a major focus of last year's Budget), which were apparently overlooked in this year's list of projects. The only additional allocation appears to be accelerated funding for water rights buy-backs for the Murray-Darling Basin.

### Housing and construction

Residential construction will benefit from a much-anticipated extension to the popular First Home Owners Grant for 3 months (to 31 Sept 2009), phasing down to \$14,000 for new homes and \$10,500 for established homes until 31 Dec. This will cost an additional \$486.2mn in 2009-10. The old FHOG of \$7,000 will continue thereafter. No means testing or other limits have been applied.

The residential construction industry will also benefit from increases in funding for public and defence housing. The Defence department will also provide an indirect boost through an estimated \$100mn in defence land sales, which will provide a boost to local land available for redevelopment in some locations.

Some residential energy efficiency programs are being enhanced, but others - such as the phase-out of inefficient light bulbs, the 'Green Loans Program' and efficient appliances - are being cut or phased out. In the longer term, less favourable tax treatment for holiday homes and hobby farms could be detrimental to residential demand in some regional locations.

### Health and aged care

There is little or no new direct funding for health services in this Budget. Instead, the \$3.2bn Health and Hospitals Fund established last year will be used to invest in hospital infrastructure projects 'of national significance', cancer care and research. \$465mn of this Fund will be spent in 2009-10, rising to \$847mn in 2010-11 and \$813mn in 2011-12. Health spending cuts have been made across a wide range of health and ageing portfolio programs, most notably by imposing new pricing caps on items paid by the Medicare Safety Net. This will save \$198.5mn on Safety Net payments for obstetrics services over the 5 year Budget period and \$261mn on other Safety Net funded items. Depreciation allowance changes for diagnostic imaging and pathology equipment will also net savings of around \$65mn p.a. from 2011-12.

Other Budget measures affecting the health sector — and especially private health services — will be the changes to the government subsidy for health insurance, which will now be means tested (cutting out at \$75,000 for individuals and \$150,000 for families) and to the Medicare surcharge levy.

### Business-wide and miscellaneous measures

Business taxation:

- Small business tax deductions on eligible investment assets increased to 50% upfront for goods ordered between 13 Dec 2008 and 31 Dec 2009.
- All other business investment will remain eligible for the 30% tax rebate.
- Hobby farms and holiday homes no longer allowable as loss-making business deductions for tax purposes for high income individuals.

Industry assistance:

- a one-off \$50mn boost to the Export Market Development Grants (up from \$150mn) in 2008-09, to cover an estimated extra 1,800 businesses with eligible costs, due to over-subscription to this popular scheme.
- \$10mn p.a. for a new small business support line and online program.
- a new 'Commercialisation Institute' to support small business R&D.

For farms and rural industries:

- Confirmed additional exceptional circumstances assistance for 2009-10 (\$194mn extra), but no additional spending beyond that date.
- Axing the 'Land Water Australia' program, saving \$46mn over 5 years.

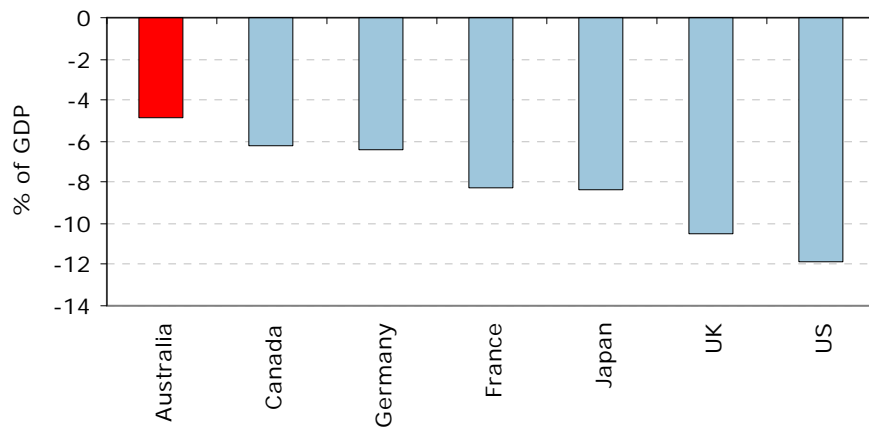
## International comparison

### Still a (positive) standout amongst global peers

Despite the sharp deterioration, the Australian government balance sheet remains solid by international standards. Partly this reflects Australia's relatively better "starting position", with the government running an underlying cash surplus and negative net debt going into this global recession. Just as importantly, it highlights Australia's stronger economic performance relative to those nations at the epicentre of the global financial crisis. It also highlights the relative health of Australia's banking system, which has not been the drag on the Commonwealth's balance sheet that it has in other countries, like the US and the UK.

At 4.9% of GDP, Australia's underlying cash balance will be less than half of that in either the UK or US (12 to 13% of GDP) in 2009-10.

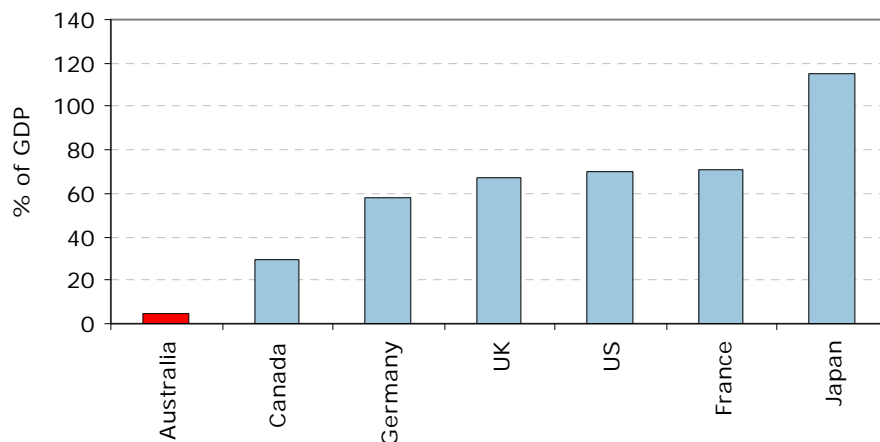
**Figure 6: General government financial balances, 2010**



Source: Budget Papers and OECD

Australia's general government net debt position, at 4.6% of GDP in 2010 and projected to rise to 13.8% of GDP in 2013-14, is also much lower than most other developed countries. US general government net debt for example is projected to be around 70% of GDP next year while in Japan it is likely to swell to 115%. Even as Australia's net debt position continues to rise over the next 3 to 5 years, it will remain very low by global standards.

**Figure 7: General government net debt positions, 2010**



Source: Budget papers and IMF

This better starting position means that Australia stands a much better chance than most other developed economies, over the medium-term, of returning its budget position to surplus and eliminating its net debt burden. It doesn't mean it will be an easy task and really highlights just how diabolical the fiscal situation is turning out to be in many other countries. For the medium-term economic outlook, this suggests Australia has a better chance of avoiding any erosion to productivity growth from the substitution of private capital (and investment) by public spending and debt.

## Market Reaction

### No surprises limits the market reaction

For this much-anticipated budget, it appeared to be a case of sell on the rumour, buy on the fact. Over the past few weeks, the negative rhetoric of the Rudd government highlighting a return to significant deficits and the need for tough budgeting truly prepared the market for the numbers that were eventually released. Since the start of last week, we have seen Australian 3yr and 10yr government bond yields rise by 40

bps and 25 bps, respectively, as the need to issue bonds to fund fiscal expenditure was priced into the market.

In the event, the estimate for an underlying cash deficit of \$57.6bn for the coming fiscal year was pretty much on the consensus forecast and thus proved to be no surprise. Neither were estimates that the government would aim to issue roughly \$60bn in government bonds in the coming fiscal year. Though the forecast for a potential rise in net debt to 13.8% of GDP by 2013/2014 - potentially in conjunction with a need to raise the Commonwealth Government debt ceiling - was the kind of negative surprise that bond bears would have been looking for, the time horizon appeared to be sufficiently long into the future that market participants felt such possibilities had already been priced in.

In the hour following the budget announcement, we saw government bond yields fall by about 5 bps across the curve, as did 5-year swap rates. Equity market futures were essentially unchanged, while the Australian dollar initially drifted just a touch higher before drifting off again as offshore investors turned their attention to a mixed open of the European equity markets. An announcement by S&P only 10 minutes after the budget was released stating that Australia's sovereign rating would be unaffected by the budget sealed the markets' initial reaction that there was nothing further to be done.

## Key policy measures at a glance *(Alex Joiner and Daniel Bae)*

### Infrastructure

- Nation building infrastructure spending of \$22bn, including:
  - \$3.4bn for roads
  - \$4.6bn for metropolitan rail systems
  - \$389mn for ports and freight infrastructure
  - Partnering with the private sector to build the \$43bn National Broadband Network

### Families and Older Australians

- A pension increase of \$32.49 per week for singles and \$10.14 per week combined for couples on the full rate worth over \$14bn over four years
- Additional support of \$1.8bn to Australia's 500,000 carers
- 18 weeks of Paid Parental Leave from 2011, worth \$731mn over four years
- Limiting growth in Family payments made to higher income families, pausing CPI indexation of upper income eligibility thresholds for three years, saving \$1.4bn over four years.
- Reducing the cap on concessional superannuation contributions, saving over \$2.7bn over four years. The reduction in the rate of Government co-contributions will save \$1.4bn over four years

### Education

- A boost of \$2.7bn in funding for tertiary education, research and innovation
- \$2.6bn in projects focused on universities and research from the Education Investment fund, including:
  - \$901mn for 21 research projects in space, marine, climate and nuclear science
  - a further \$750mn for future funding rounds from the Education Investment Fund
  - \$934mn for 11 teaching and learning projects, 8 research-based projects, and 12 vocational education and training projects around the nation
- \$1.5bn for the Jobs and Training Compact, providing education and services to support young people, retrenched workers and local communities

### Health

- \$3.2bn focused on hospitals and health infrastructure from the Health and Hospitals Fund, that includes:
  - \$1.4bn for hospital infrastructure, \$1.2bn for cancer care and \$430mn for Translational health research
- From 1 July 2010, the private health insurance rebate will be reduced on a means tested basis for higher income earners, saving \$1.9bn over four years.
- Increasing the Medicare Levy Surcharge. The levy will be pushed up from 1% to 1.5% for singles earning above \$90,000/couples \$180,000, single income earners above \$120,000 will pay the full surcharge of 1.5%

### Housing

- Extending the first home owners boost for an extra six months costing \$540mn in the next three years (including three months at the 'full' rate, before stepping it down being scaled back to \$10,500 for existing homes and \$14,000 for new homes)

### Business

- A 50% small business tax break for eligible assets, worth \$242mn over four years

### Environment

- A \$4.5bn for the Clean Energy Initiative including:
  - \$2.0bn investment in carbon capture and storage (CCS) projects
  - a \$1.5bn Solar Flagships program to demonstrate large-scale solar technologies
  - a new independent body, Renewables Australia, with \$465mn seed funding, to support renewable technology research and development

### Plan to return to budget to surplus

- Budget savings of \$22.6bn over four years, including through structural reform
- Containing real spending growth at 2% per annum as the economy recovers and returns to above trend growth

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