

AUSTRALIAN ECONOMICS 2011-12 FEDERAL BUDGET PREVIEW

5 MAY 2011

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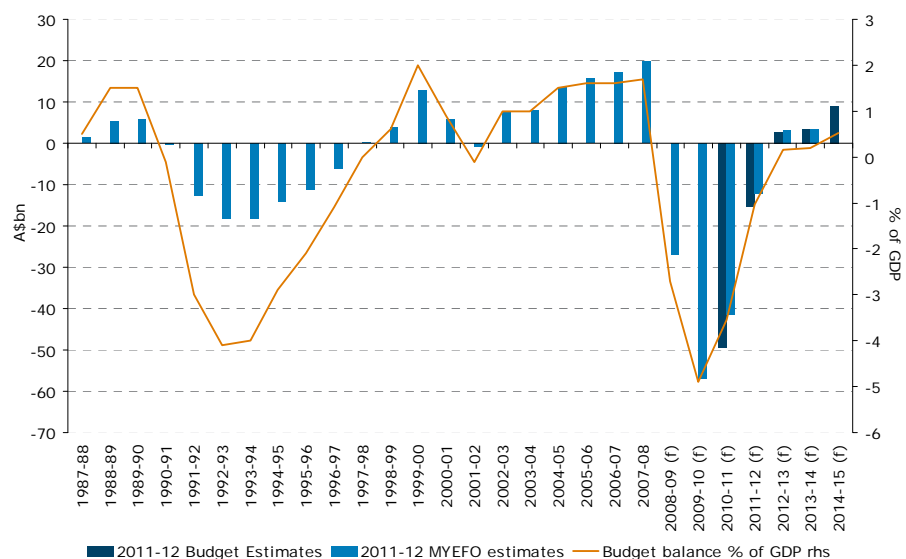
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WEAKER STARTING POINT LIMITS THE POLICY POTENTIAL

- **The Government will be able to maintain the objective of returning the Budget to balance by 2012-13 despite some headwinds over the past year.** ANZ estimates a budget deficit of \$16bn (1.0% of GDP) in 2011-12, a deterioration from the \$12bn deficit expected at MYEFO. A return to Budget surplus of \$2.7bn (0.2% of GDP) is expected in 2012-13, broadly consistent with the \$3.1bn surplus predicted at MYEFO (Figure 1).
- **No further progress on fiscal tightening is expected and thus the structural budget deficit will remain large for many years to come.** On this basis the macroeconomics of this budget should be uninteresting.
- The government treatment of the economic outlook will be critical to framing the overall Budget aggregates. Overall assumptions about growth and inflation for the next few years are unlikely to be controversial. **It is the assumptions about how the terms of trade corrects and the path for the Australian dollar that will be scrutinised heavily.** We hope that budget surpluses in 2012-13 to 2014-15 are not dependent on unrealistic assumptions about these variables.
- **The policy focus will be on microeconomic efforts to prepare the economy for further structural change** as the mining investment boom and the high currency have an impact on the economy. We will be looking for policies that assist, rather than resist, this adjustment process. The focus should be skills, immigration and participation.
- **Government gross debt is expected to peak in the year ahead at just over \$200bn on issue.** On a net debt basis (taking into account our modest 'sovereign wealth' type funds like the Future Fund) the Australian government's net debt position is forecast to peak at around 6.6% of GDP in 2011-12. This compares favourably to a G-7 average of 74.8% of GDP.

FIGURE 1: UNDERLYING CASH BALANCE



Source: Treasury, ABS and ANZ

BUDGET PREVIEW – OVERVIEW

For the Government **the 2011-12 Budget will be all about microeconomic policy initiatives** aimed at addressing the economic challenges of the current environment rather than any substantive new macroeconomic policy efforts. As such, the macroeconomics of the 2011-12 Budget will be utterly dull. There is no reserve of political capital for the Government to draw on to take the big decisions and cut into the structural budget deficit. Instead the Treasurer will focus on the political objective of getting the headline budget numbers back into balance by 2012-13. Though commendable, we see this as a fairly low hurdle.

For the past 8 years the Australian Commonwealth Government has failed to save enough of the financial benefit from what now looks like being a 'once in two hundred year' natural resources boom. Not only does this mean that the Government has very little to financially show for this economic boom, but this lack of financial discipline has added to inflation pressures and imbalances in the economy at various times in the past decade. Fiscal policy played a central role in the surge in inflation in Australia between 2006 and 2008. Inflation pressures are now rising once again and over the next two years will intensify. **Without a substantive tightening of policy settings, the government will leave itself open to the criticism that it added to upward pressures on inflation and interest rates.** Getting the Budget back to balance by 2012-13 is helpful and necessary but we suspect more is needed.

The overall budget aggregates are likely to show a deterioration in the deficit in the short-term (2010-11 and 2011-12), but the projected surpluses from 2012-13 are likely to look very similar to what was brought down in MYEFO and last year's budget. The economy is being buffeted by economic and financial forces which make forecasting government revenues and expenditures very difficult. We have seen a further unexpected surge in our terms of trade offset by a weaker domestic economy, soft financial markets and a rapidly rising Australian dollar. The funding of recovery from natural disaster hasn't helped the bottom line despite the temporary increase in the Medicare levy and delays in investment spending announced after the floods.

So where is the government putting its efforts? **It looks like the microeconomic policy announcements will be the most interesting this year.** And on this front the government looks to be on the right track. The economy is being heavily affected by structural adjustments in the face of the commodity boom related relative price changes. This is not a passing fad. Unlike the example of 'Dutch disease' this process will not run its course in a matter of years. As we have been saying for some time now, this upswing in global infrastructure investment and commodity prices will be measured in decades not years.

From a policy perspective we believe the government needs to look at assisting the structural adjustments taking place rather than resisting these industrial changes. **The Government should not look to support industry or businesses but rather assist people that are impacted.** Politically this won't be easy for a left of centre government, even one with a strong economic reform pedigree forged in the golden years of the 1980s. The calls for industry support are widespread and loud, particularly as the Australian dollar rises towards new 30 year highs of US\$1.10.

We expect to see the government focus on improving the effective size and

flexibility of the workforce through new policy measures for training and skills development, immigration and participation policies. Given that the macroeconomic policy elements of this Budget will be somewhat uninteresting, **it will be these microeconomic policies that determine whether the 2011-12 Budget adds or detracts from the current Government's economic policy credentials.**

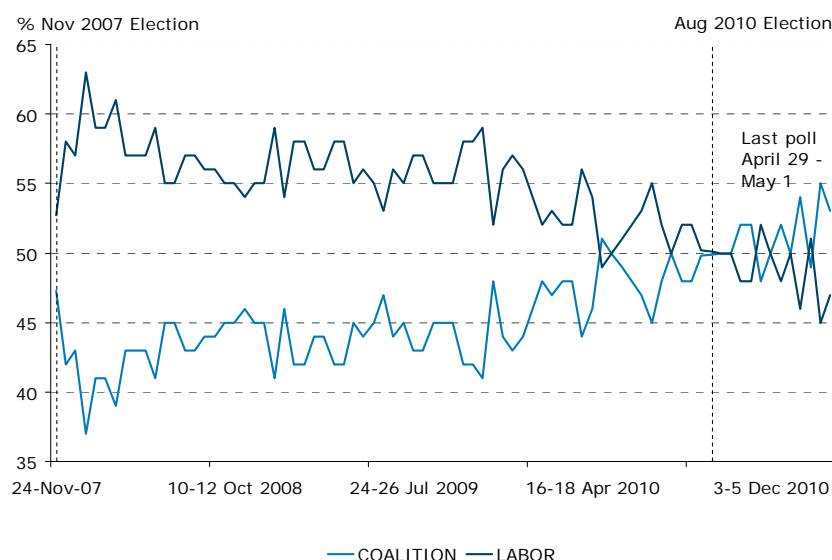
THE POLITICAL CONTEXT: MINORITY STATUS MEANS LESS CERTAINTY

With minority Government, the ALP will face a more difficult than usual task in getting Budget measures that are opposed by the Opposition through Parliament. With just 72 seats in the 150 member House of Representatives, it cannot pass contentious bills without the support of the Greens' Adam Bandt and at least three Independent MPs who often ask for substantial concessions or amendments in exchange for their vote.

From 1 July 2011, the Government will be able to proceed with its Budget measures through the Senate so long as they have support from eight of the nine Greens. The Independents, which until 30 June hold the balance of power, will not be needed to form a majority. There is some possibility however that from 1 July the Greens will fracture and fail to give the Government unified support on some issues.

The Budget will be handed down against a backdrop of poor public support for the Government. Public polling indicates that the Government is well below the Opposition in its primary support. Both the major polls show a Government primary vote at 31 or 33 with the Opposition in the 40's (Figure 2). The Coalition lead in the two Party preferred vote is 56/44 in the Nielson poll and 53/47 in the Newspoll. The Prime Minister's disapproval ratings are higher than approvals in both polls and her lead as preferred Prime Minister has narrowed.

FIGURE 2: TWO-PARTY PREFERRED VOTE



Source: Newspoll, ANZ

BUDGET BALANCE TO DETERIORATE

The Australian Government remains on track to return to surplus in 2012-13. But our estimates suggest a modest deterioration in the underlying

cash balance over the next couple of years relative to previous expectations. This will mean a larger deficit in 2011-12 and a (slightly) bigger surplus in 2012-13 (see Figure 3). A material improvement in the budget seems unlikely before 2014-15, and even then the underlying cash surplus is expected to remain under 1% of GDP.

FIGURE 3: UNDERLYING CASH BALANCE PROJECTIONS

| | 2010-11 | 2011-12 | 2012-13 | 2013-14 | 2014-15 |
|----------------------------------|---------|---------|---------|---------|---------|
| MYEFO, Nov 2010 | | | | | |
| \$bn | -41.5 | -12.3 | 3.1 | 3.3 | na |
| % of GDP | -3.0 | -0.8 | 0.2 | 0.2 | na |
| ANZ projections, May 2011 | | | | | |
| \$bn | -49.4 | -15.6 | 2.7 | 3.4 | 9.2 |
| % of GDP | -3.6 | -1.0 | 0.2 | 0.2 | 0.5 |

Sources: Treasury and ANZ

The expected deterioration in the budget over the next few years reflects a combination of unfavourable economic developments and higher spending. Higher spending is mostly attributable to reconstruction spending following this summer's natural disasters. This spending is expected to add between \$7bn and \$8bn over the next four years. It will likely only be partly offset by the flood levy (+\$1.8bn) and various other spending cuts/savings. **This disaster relief means the government is unlikely to meet its commitment to cap real spending at 2% p.a. until the budget returns to surplus.** Abstracting from this natural disaster spending, we would actually look for real spending growth of below 2% p.a. in 2011-12 as the government seeks to maximise its chances of returning to surplus.

It is the impact of the economic environment that is the most interesting feature of this year's budget. For despite a strong medium-term economic growth outlook, and despite an upgrade to the terms of trade, the 'parameter changes' are still not that favourable. Partly, this is because of unrealistic assumptions by the Government in the first place. The Government has indicated that lower than expected capital gains tax receipts are hurting the bottom line. This was always likely given the government's previous unrealistic assumption of a quick rebound in the equity market to pre-GFC highs.

Also working against the budget is the negative impact to profits from the sharply higher A\$ and more mixed economic conditions. Moreover, the Government claims that the second stage of Australia's commodity price boom, the investment stage, is eroding mining tax receipts relative to the first stage, given tax breaks for investment spending.

Bigger than expected deficits amidst a higher than expected terms of trade means that Australia's structural budget deficit will likely be larger than previously estimated in the short-term. ANZ estimates that the structural budget deficit will remain close to 6% in 2010-11 and will remain in deficit of around 2% of GDP by 2014-15. This year's budget therefore is likely to provide little reason for Treasury to meaningfully change the estimates, produced late last year showing the structural budget not returning to surplus until 2019-20.

THE CENTRAL ECONOMIC FORECASTS

The softening up process reveals that the Budget is likely to contain the following economic assumptions:

- **GDP growth of around 3¾% for 2011-12**, as the economy bounces back from the natural disasters of early 2011;
- **CPI inflation at the top of the RBA's 2-3% target band** in the next two years. Historically it has been usual for the Treasury not to forecast lower inflation than the RBA. This year the forecasts seem more likely to be in accordance with each other, which may help with the sale of a tight budget when many sections of the economy are already pressured by high interest rates and the high A\$; and
- **An unemployment rate that will fall to 4.5% over the next two financial years**, with around 500,000 new jobs created. ANZ expects a more significant fall in the unemployment rate over the same period to the low 4% mark.
- **A rise in the terms of trade** of around 18% in 2010-11 and 6% in 2011-12.
- **An A\$TWI of 75.7** (the average of the three months to April). This compares with a MYEFO forecast of 74.

TERMS OF TRADE AND A\$ ASSUMPTIONS, NOT POLICY DECISIONS, WILL BE THE CRUCIAL DRIVERS OF THE BUDGET BOTTOM LINE

The projected return to small surplus in 2012-13 can be easily wiped out by a small change in underlying economic conditions. In particular, movements in the terms of trade and the A\$ will play a critical role in driving the budget balance over the forecast period. With both of these variables at extremely elevated levels at present, the Government's medium-term assumptions will play a crucial role in driving the budget balance over the projection period (2013-14 and beyond). **How tempted will the Government be to improve its budget bottom line in the out years by keeping the terms of trade elevated (boosting revenues), but assuming that the A\$ will fall (again boosting revenues)?** In real life, a falling A\$ would unlikely occur in tandem with an elevated terms of trade. We will therefore be watching for consistency in the Budget's treatment of these variables.

The Government's own sensitivity analysis suggests that each 1% change in nominal GDP as a result of a change in the terms of trade adds/subtracts around \$7.2bn to the budget balance over two years. Our rough rule of thumb suggests each 7% change in the terms of trade delivers about a 1% change to nominal GDP growth.¹

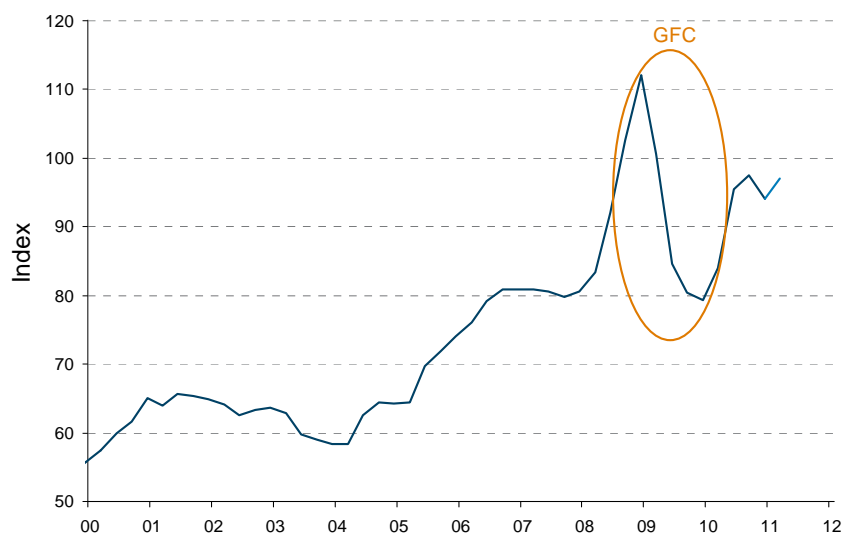
We expect the Government to upgrade its MYEFO terms of trade forecast for 2011-12 by around 10%, which would, all other things unchanged, roughly add \$10bn to the budget balance to 2012-13. But what will the Government assume for its projection period from 2012-13? An assumption, as was adopted in the 2010-11 Budget, that the terms of trade will remain stable at elevated levels in the first part of the projection period before gradually falling would provide a significant underpin to budget revenues out to 2014-15. This would largely assist the predicted material

¹ Note this rule of thumb is highly sensitive to assumptions about the reaction function of the exchange rate and interest rates to changes in the terms of trade.

improvement in the budget by 2014-15. A more cyclical approach to forecasting the terms of trade, in line with ANZ's own forecast for a cumulative 13% drop in the terms of trade from June 2012 to June 2015, would imply much smaller surpluses. We suspect the Government's numbers will fall somewhere in between with modest falls in the terms of trade projected from 2013-14.

The composition of the terms of trade is also very important. The two charts below show why. Firstly, part of the relatively slower than anticipated recovery in revenues and sluggishness in the economy likely reflects an important compositional shift in the terms of trade since the GFC. Figure 4 shows that export prices in A\$ terms have only recently re-achieved the levels reached just prior to the GFC's commencement. As a result, until recently there has not been as much commodity receipt stimulus in the Australian economy as previously. And importantly, this stimulus was previously being recycled broadly through the economy in the form of tax cuts.

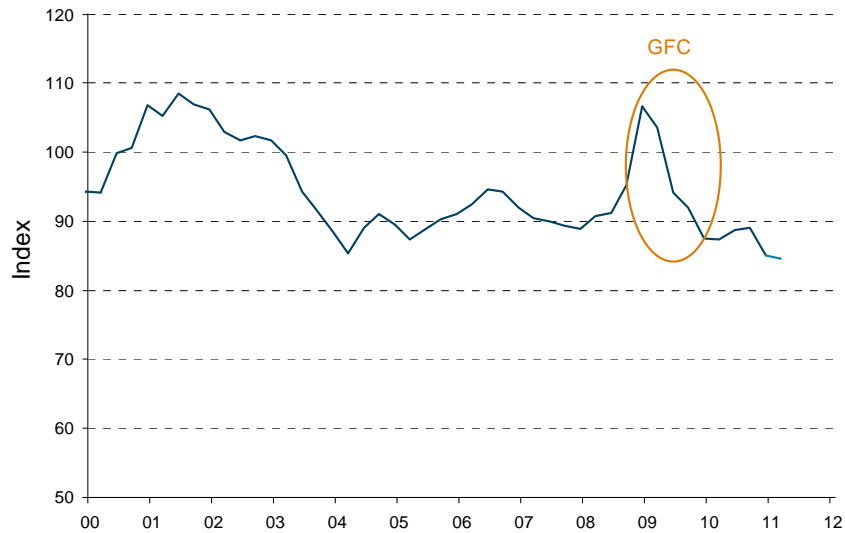
FIGURE 4: AUSTRALIAN EXPORT PRICES



Source: ABS, ANZ

Secondly, more of the recent improvement in the terms of trade reflects (until recently) the falling prices of imports in A\$ terms (a combination of both lower import prices and the higher A\$) (Figure 5). This confers greater purchasing power over imported goods and services (e.g. holidays) to Australians, but drives lower revenues or slower revenue growth for many Australian companies. (The loss of sales overseas to the internet would be another example of this effect).

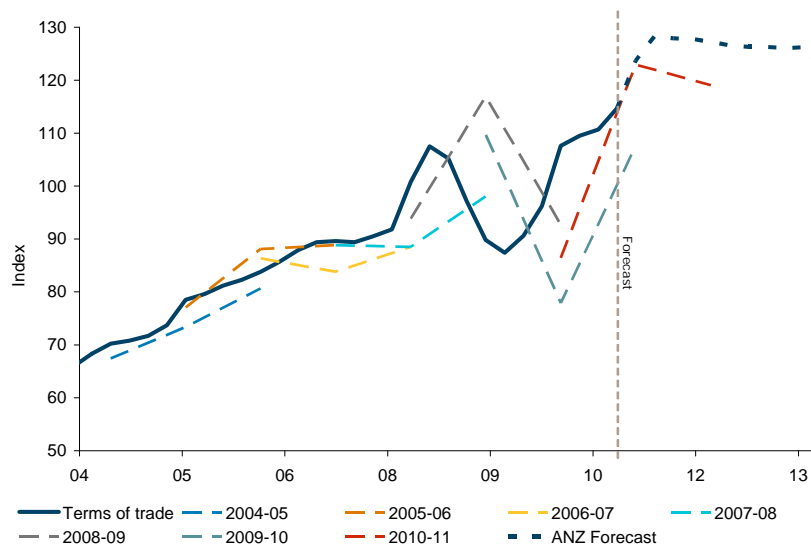
FIGURE 5: AUSTRALIAN IMPORT PRICES



Source: ABS, ANZ

Figure 6 below examines how the Government has fared in its forecasts for the terms of trade in recent budget years. On the basis of how difficult this series is to forecast, this appears a very credible effort. Stay tuned for the Government's forecasts on Tuesday night – and pay some attention to the scenario analysis on the terms of trade, which may be even more important.

FIGURE 6: TERMS OF TRADE FORECASTS



Source: ABS, ANZ

The impact on the budget from the rise in the A\$ is also significant.

Deloitte-Access Economics estimates that each temporary 1 point rise in the A\$TWI subtracts \$900m from the budget balance over four years. The A\$ TWI has averaged 75.7 over the last three months. This is almost 2 points higher than the



MYEFO assumption of 74, and would therefore wipe around \$1.8bn off the budget bottom line out to 2014-15. **The higher A\$ could therefore erase roughly one fifth of the gains to the budget bottom line that arise from the increase in the terms of trade.**

With the A\$ at post-float highs, we suspect the **Government may take the unprecedented step of incorporating a gradual depreciation in the currency over its projected period.** This would be consistent with any assumption of a fall in the terms of trade and indeed would provide a partial positive offset to the budget bottom line from falling commodity prices. While it would be an unprecedented step (that would help to boost the budget bottom line), we think this would be a reasonable assumption.

THE POLICY CONTEXT

The policy context of the 2011-12 Budget and subsequent years' forecasts and projections is likely to be assessed by markets with reference to two main criteria:

- **The appropriateness of the structural setting of fiscal policy given that the Australian economy and budget revenues continue to benefit from a record terms of trade.** Market participants will also be interested in any measures designed to support or assist structural adjustment in sectors affected by the higher A\$; and
- **The extent to which the cyclical fiscal policy setting relieves pressure on monetary policy or otherwise contributes to reducing expected pressures in the labour market** associated with the "execution" of the unprecedented mining investment pipeline anticipated over the next three to four years.

In broad terms, this budget can also be expected to conform to the key elements of the Government's sustainable medium-term fiscal strategy outlined last year, namely:

- **Achieve budget surpluses on average over the medium term** – though it is our contention that this commitment should be expressed in structural rather than underlying terms;
- **Keep taxation as a share of GDP below the level for 2007-08** on average (during which taxation collections measured 23.6% of GDP); and
- **Improve the Government's net financial worth over the medium term.**

In addition, the Government is expected to recommit to constraining real expenditure growth to 2% p.a. until surpluses are at least 1% of GDP and to continue to allow the level of tax receipts to recover with the economy until the budget is returned to surplus.

The broad thrust of each of these themes remains consistent with the medium-term sustainable nature of Australian fiscal settings that has served successive Australian Governments well over an extended period of time. As suggested above, **we expect significant focus to be on the structural position of Australia's Budget**, given the contribution of the strength of the terms of trade (commodities boom) to revenue growth and company tax receipts.

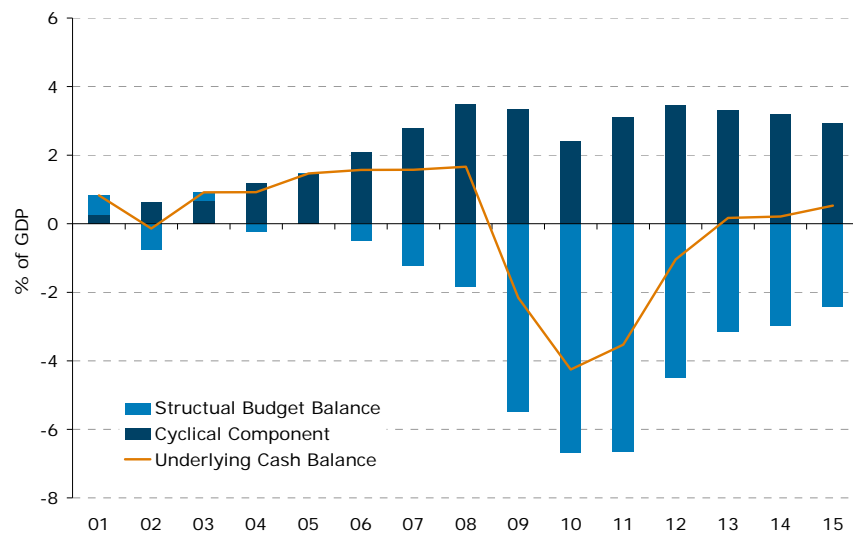
ANZ Research's estimates of Australia's structural budget deficit (Figure 7) show:

- A significant deterioration in the structural setting of the Budget of around 2 percentage points of GDP from 2004-05 until 2007-08 (i.e. before the GFC) as

the Coalition Government used the surge in revenues to cut income taxes and to boost many forms of (principally) non means-tested welfare; and

- The discretionary fiscal stimulus packages introduced during the GFC drove a further sharp deterioration in the structural deficit. But, even once the majority of these measures have expired, the structural deficit is still found to have deteriorated by around 2.5 percentage points of GDP between 2007-08 and 2011-12.

FIGURE 7: STRUCTURAL BUDGET BALANCE – ANZ ESTIMATES



Source: Treasury, ABS and ANZ

It is disappointing that Australia has slipped into structural deficit at a time when the economy and revenues are being boosted by the once in a lifetime boom in the terms of trade and associated tax receipts. Similarly, it can be argued that the forecast return to structural balance is unusually timid given the prospective strength of the domestic economy. And indeed a reasonable question is whether Australia should be aiming to have a structural surplus to position itself for the inevitable next deterioration in economic conditions or turn in the terms of trade. The forecast slow return to structural budget surplus can similarly be judged to be relatively disappointing on a local basis rather than on a global comparison.

A related, but distinct question relates to **the extent to which the change in fiscal policy measures announced on Tuesday night acts to further tighten policy and reduce some of the cyclical pressure on the RBA to raise rates.** Expected related measures to increase participation in the workforce, upgrade skills or to boost migration can similarly be viewed as assisting to relieve some pressure on monetary policy.

POLICY TO FOCUS ON MICROECONOMIC REFORM

With tight spending parameters this year, the Government won't have much (if any) room to offer expensive or vote-winning policies in this Budget. This is the most likely point in the political cycle for such an approach; given this is the first Budget in the current election cycle. Wayne Swan has publicly 'vowed' to go ahead with a company income tax cut (from 30% to 29% in 2013-14

and 28% in the following year), but revenue pressures and more immediate needs are likely to win out over further tax cuts, at least until new revenue measures (such as the MMRT) are firmly bedded down. That said, the Government will be keen to leave its mark. **We expect to see this Budget focus on three key policy areas:**

1. **Flood recovery.** This will include the one-off Flood Levy, to be paid by higher-income households, and associated payments to State Governments and various other agencies, mainly located in Queensland. \$2bn has already been paid to Queensland and will appear as expenditure in the current year, but the remainder of the expected \$7bn is yet to be allocated.
2. **The 'three P's of economic growth, mostly relating to the labour market:** population, participation and productivity. This policy group is likely to include a variety of relatively small sticks and carrots to encourage higher labour force participation from women and older workers (e.g. changes to childcare, superannuation arrangements and single parent benefits), education and training measures (e.g. access to education for single parents), workforce mobility and flexibility measures (e.g. a revamp of relocation allowances for jobseekers or changes to skilled migration and temporary entry migration programs). Some of this is likely to be co-funded by the private sector.
3. **Tightening up of 'untargeted' welfare programs and payments.** We expect to see a raft of small changes to existing welfare payments, aimed at saving expenditure and better targeting the national welfare system. This will include introducing means testing for some programs and tightening eligibility for others. Likely targets are the private health insurance rebate (which Labor has unsuccessfully tried to cut in the past), the baby bonus (already shifted from a one-off bonus to fortnightly payments), upfront HECS discounts for university students, childcare rebates and other family benefits. Payments related to childcare and maternity leave will be problematic, as any cuts could be counter-productive to the Government's stated aim of improving workforce participation. While each measure in this policy group is likely to be small, their cumulative effect could be significant, both for the Government's coffers and for the individual households affected.

Separate to these policy areas, Treasurer Swan has said there will be an increase from 1.25% to 1.5% in the 'efficiency dividend' to be imposed on the public service in 2011-12 and 2012-13. This will save \$465m. Usually invisible to most Australians, this 'dividend' is shorthand for cuts to public sector payrolls and running costs.

Some of the current policy debates we won't see finalised in this Budget are:

- **The proposed carbon pricing scheme.** The carbon pricing scheme, which is still slated to start in July 2012, will not be included in this year's Budget. Details of the scheme, which the Government has stated will be revenue neutral, will instead be included in the mid-year review (around December). Climate Change Minister Greg Combet has said that more than half of the revenue raised by the carbon pricing scheme would be used for permanent assistance to households. The other 50% would support jobs in emissions-intensive, trade-exposed industries and measures to encourage the transition

to cleaner energy. At this stage it seems likely that the compensation payments attached to the scheme are likely to be aimed at individuals rather than at businesses or industries.

- **Widespread tax reform and a full response to the Henry tax review.** This was originally scheduled for release in the first half of the year, but has been delayed until October to allow for further business consultation.
- **Infrastructure development**, much of which is tied to the yet-to-be seen MRRT legislation and carbon tax (apart from flood-related reconstruction). The Future Fund and Infrastructure Australia are set up and running (although the latter may be overhauled), but significant bottlenecks are still evident across Australia's publicly-owned physical infrastructure, including in transport links, ports, water management and other utilities. An increased focus on infrastructure is necessary due to ageing infrastructure, technology changes, population increases and the impending demands of a 'lower-carbon' future. The main policy initiative relating to infrastructure to be leaked so far involves taxation and regulatory changes to encourage superannuation funds to invest in infrastructure projects.

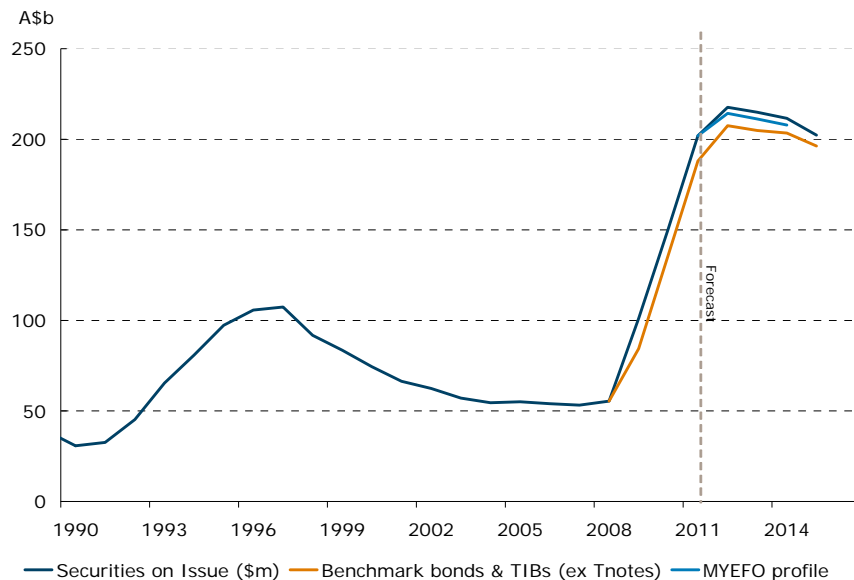
BOND MARKET IMPLICATIONS

The projection of a Budget surplus is a major contrast with other developed economies. The debt ceiling remains a major issue in the US, and Europe remains in the midst of a sovereign debt crisis across several EU peripheral countries. Australia's AAA rating was upheld by Moody's earlier this week.

The impact on the expected profile for Commonwealth Government securities (CGS) on issue as a result of our forecasts of the underlying cash balance is presented in Figure 8 below. This highlights that we are close to the peak of CGS on issue, considering the return to surplus expected for 2012-13. **Bonds on issue should then start to move lower from mid-2013 given the larger surpluses we are now expecting in the out years.**

We see total securities on issue peaking at around A\$218bn next financial year from a current level above A\$185bn, before easing towards A\$202bn in 2014-15. Assuming T-Notes on issue are held at around A\$10bn, this implies that total benchmark and Treasury-Indexed bonds on issue will ease below A\$200bn in the out years from a peak near A\$210bn next financial year (see Figures 8 and 9). On our forecasts, gross CGS on issue as a percentage of GDP will peak at around 14.5% of GDP this current financial year (or 6.1% in terms of net debt). This is up from around 8% of GDP in 2001-02. Compare these numbers with current gross debt of 140% for Japan and around 90% in the US. US net debt is around 60% of GDP.

FIGURE 8: COMMONWEALTH GOVERNMENT SECURITIES ON ISSUE



Source: AOFM, ANZ

A return to surplus does raise questions over what might be an optimal size of the bond market over time. In order to ensure the smooth functioning of the futures market and undistorted price-signalling mechanism of a risk-free curve, we are still looking at the maintenance of relatively liquid CGS market for a few years yet (at least by Australian standards).

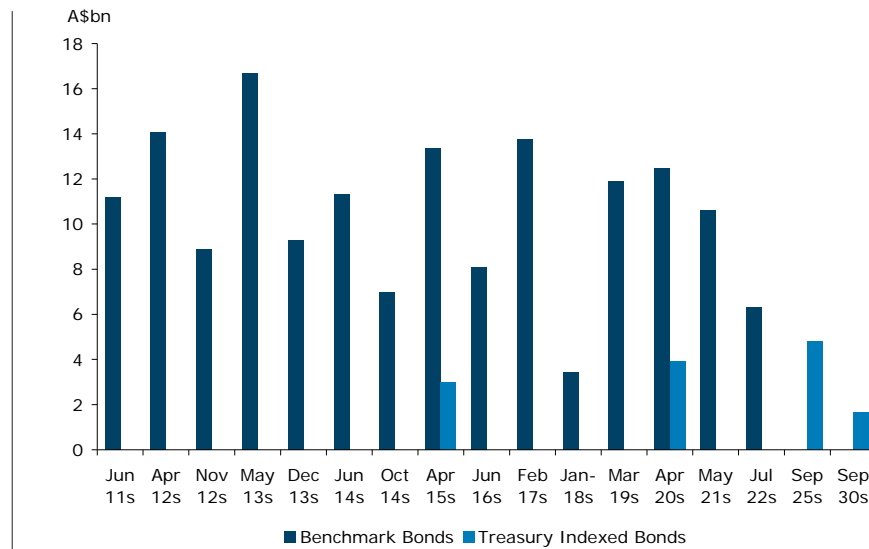
The industry engaged in debate over whether to maintain national debt in the face of surpluses early in the 2000s. Maintaining bonds on issue of just over A\$50bn after that period was probably too low. But with only modest surpluses likely to be posted over coming years, the size of the bond market is likely to remain close to A\$200bn at least until 2015. Any substantial reduction is only likely in the years beyond that and will depend on the maintaining of significant Budget surpluses.

Even so, **there will still be too few A\$ Government bonds on issue to fulfil new liquidity requirements under the Basel III accords that are due to fully implemented from 2015.** This is just when total bonds on issue are expected to start receding. And consider that the extended ascent of the A\$ and ongoing diversification from the US\$ has helped to drive a sharp rise in the overseas ownership of CGS above 70% according to RBA data. As we do not expect a major correction for the A\$ anytime soon, CGS are likely to retain scarcity value.

We are still waiting on the issue of a new 2025 benchmark bond from the AOFM. This is due to be launched before the end of the financial year and would be expected to absorb investor demand around the maturity of the June 2011 bond. The current maturity profile is highlighted in Figure 9 below.

The AOFM clearly has a good deal of flexibility over the composition of debt in coming years. We have assumed T-Notes will be maintained at around A\$10 bn over coming years before starting to edge lower while benchmark bonds on issue are likely to shrink gradually from next year (See Figure 10 below).

FIGURE 9: MATURITY PROFILE OF CGS



Source: AOFM, ANZ

FIGURE 10: COMMONWEALTH GOVERNMENT SECURITIES ON ISSUE

| | 2008-09 | 2009-10 | 2010-11 | 2011-12 | 2012-13 | 2013-14 | 2014-15 |
|---|------------|------------|------------|------------|------------|------------|------------|
| A\$ Benchmark | 78 | 125 | 174 | 194 | 191 | 190 | 184 |
| T-Notes | 17 | 11 | 14 | 10 | 10 | 8 | 6 |
| Indexed Bonds | 6 | 11 | 14 | 14 | 14 | 13 | 12 |
| Total CGS Outstanding (end period) | 101 | 147 | 202 | 218 | 215 | 211 | 202 |

Sources: AOFM, ANZ

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