

16 June 2009

- Today's NSW budget has recorded a \$1.3bn deficit for 2008-09, better than some initial expectations but in line with recent press reports. The deficit pushes the state's fiscal balance into the red for the first time in 12 years, with a return to surplus anticipated in 2011-12
- The key thrust of the budget is for the Government to spend \$18bn on infrastructure in 2009-10 to support the economy and employment going forward. Such levels of expenditure will see net debt levels rise \$7.7bn to \$15.8bn (3.6% of GSP) over the next four years.
- No significant new savings initiatives were announced. The consolidation of the State Government bureaucracy into 13 super departments, a 2.5% cap on wages, a headcount freeze and a cap on spending growth to 4%p.a. are the main measures.
- Credit ratings agencies affirmed the AAA rating today following the release of the budget. S&P has taken NSW off negative watch. The key net financial liabilities to revenues ratio is expected to peak at 113%, well below the AAA downgrade threshold for the State of NSW of 120/130%
- The gross borrowing program (excluding pre-funding) for 2009-10 has increased significantly to \$15.4bn from the \$8.8bn program over 2008-09. The NSW Treasury Corporation announced that it has done \$5bn of pre-funding leaving the effective borrowing requirement at \$10.4bn in 2009-10. With \$5.5bn of maturities due this leave the NSW State Governments call on markets for new money at a modest \$4.9bn in 2009/10.
- The NSW Budget papers forecast the NSW economy to contract by ½% in 2009-10 followed by below-trend growth of 2¼% in 2010-11.

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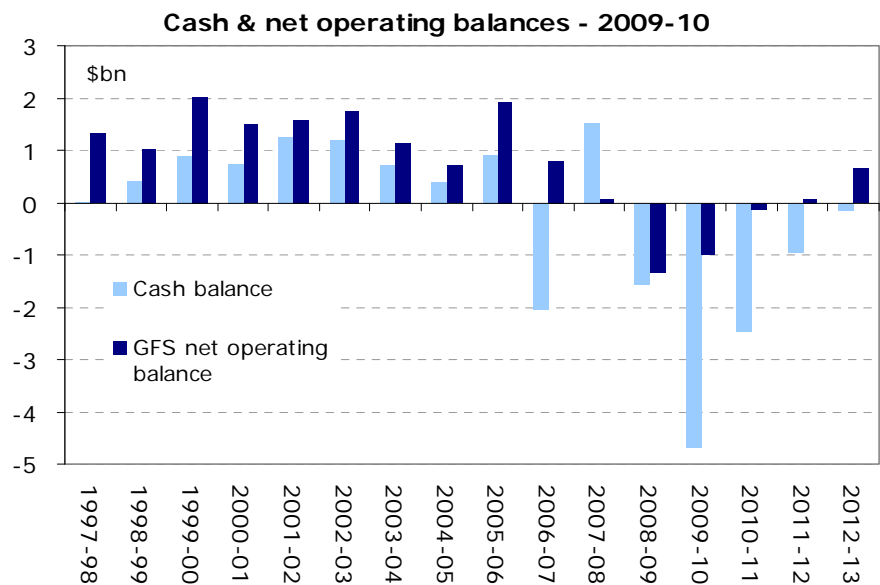
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**Figure 1: Surplus to return in 2012-13**



Source: NSW Treasury

### Budget in deficit for first time in more than a decade

A solid budget was brought down by the NSW Treasurer reflective of the state's still robust financial position. Despite this, the budget has recorded a \$1.3bn deficit for 2008-09 pushing the state's fiscal balance into the red for the first time in 12 years. This is significantly worse than the \$917mn deficit foreshadowed in the Mini-Budget in late 2008. A sharp turnaround in fortunes is expected in 2009-10 with the deficit expected to fall to \$990mn followed by further improvement to \$116mn in 2010-11. The budget is anticipated to return to surplus in 2011-12, recording a surplus of \$86mn pushing higher to \$642bn the following year.

The deficit comes largely from state-sourced revenues being around \$10bn lower than previously forecast over coming years due to the downturn in the global and domestic economies. Nevertheless, the budget suggests going forward revenue growth should be supported by a gradually recovering economy and ongoing support from the Federal government stimulus package. **No new taxation measures were announced to raise revenues**, with previously announced cuts to payroll tax maintained. Revenue is estimated to come in at \$53bn in 2009-10, \$4.1bn higher than the previous year. However, removing the Federal government support this figure is reduced to \$1.5bn well below long-term average revenue growth for the state. Revenues are expected to rise on average by 5% per annum from 2009-10 to 2012-13.

Expenses are estimated at \$54bn in 2009-10 - a rise of \$3.8bn on the previous year. Of this, around \$1.3bn is spending as a result of the Federal government stimulus package. The budget looks to curtail expenses growth over the forecast horizon by merging the 160 existing state government departments and offices into just 13 and limiting both the size and growth in wages for the public sector (keeping 2.5% wage caps for public servants and the freeze on new staff). Expenses are expected to rise on average by 4% per annum from 2009-10 to 2012-13.

### Debt rises to fund record capital expenditure.

The budget outlines the NSW government's plan, similar to that of other states, to borrow heavily in order to support a marked rise in capital expenditure to fund infrastructure projects as well as to offset weaker revenue growth. Capital expenditure of the general government sector will rise to \$7.7bn in 2009-10, totalling \$25.5bn over the next four years. Total state expenditure will be \$18bn in 2009-10 and \$63bn over the next four years. This is a record level of spending aimed at supporting the economy and boosting employment.

However, such levels of expenditure will see net debt levels rise \$7.7bn to \$15.8bn (3.6% of GSP) over the next four years. As a result net financial liabilities will rise from \$50.3bn in June 2009 to \$55.7bn over the same period. However, given relatively solid rates of economic growth in the second half of the forecast horizon these levels represent a fall from 13.4% of GSP and 12.6% of GSP respectively. Standard & Poor's report the net financial liabilities to revenue will increase to 113% deteriorating significantly from 71% in 2008. However, S&P suggest that a ratio in the vicinity of 120-130% would be required to prompt a re-assessment of the state's credit rating. This allows the NSW government a significant degree of fiscal flexibility should budgetary outcomes not come in as expected.

### Focus on infrastructure spending

The NSW Government plans to spend \$18bn on infrastructure in 2009-10, up 31% from \$13.9bn in 2008-09. The Budget shows, however, that the 2008-09 allocation for infrastructure spending was underspent (revised down) by \$300mn. It also shows 2009-10 will mark a cyclical peak in spending in absolute terms and as a share of GSP (rising to around 4.8% in 2009-10), with annual declines thereafter. Much of the increase in funding in 2009-10 will come from federal government sources and is earmarked for major transport projects:

- Sydney Metro (\$580mn in 2009-10 and \$2.7bn over the next 4 years)
- South West Rail Link (\$804mn over the next 4 years)
- Rail Clearways (\$350mn in 2009-10 and \$935mn over the next 4 years)
- 424 new buses for Sydney public transport operators (\$207mn in 2009-10)

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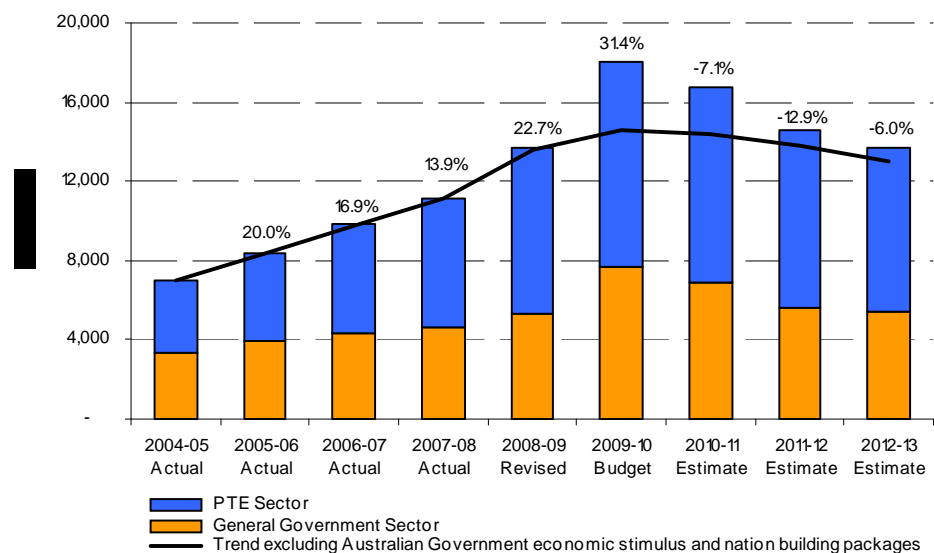
- Pacific Highway (\$3.2bn over the next 4 years)
- Hunter Expressway (\$1.5bn over the next 4 years)
- Southern Hume duplication and bypasses (\$1bn over the next 4 years).

Utilities will also receive a major boost, with \$3.5bn to be spent on infrastructure investment in the electricity sector in 2009-10, including a program of works at power stations, transmission and distribution networks, plus another \$931mn investment in water and waste treatment services.

In health and education, \$1.8bn will come from the Federal Government's economic stimulus package in 2009-10, to be spent on hospital redevelopments (Liverpool, Orange and Royal North Shore Hospitals), education infrastructure upgrades, the 'Digital Education Revolution' and other federally funded projects. Correctional facilities and police stations have also been identified for upgrades.

Smaller projects get very small allocations in this Budget —a \$35mn Community Building Partnership fund and \$200mn Local Infrastructure Fund, which will provide interest free loans to councils. Another \$85mn will be spent on other regional infrastructure (e.g. country halls and libraries) over 5 years.

**NSW State infrastructure investment – actual and forward estimates**



### Focus on housing

As well as direct infrastructure spending, this Budget also aims to boost local construction with measures aimed at public and private housing. It includes:

- 9,000 new social housing dwellings and upgrades of existing homes (\$4.3bn),
- a 50 % stamp duty discount for purchasers of newly constructed dwellings up to \$600,000, excluding first home buyers (worth an estimated \$64mn) and
- an extension for the State-based First Home Owner Supplement to 30 June 2010 (\$3,000 per applicant), as well as continued stamp duty exemptions (valued up to \$17,990) and the \$7,000 First Home Owner Grant.

For non-construction related NSW businesses, the only carrot appears to be a new policy of preferential purchases by government in favour of local businesses, under the 'Local Jobs First' plan.

### Economic Forecasts

The NSW Budget papers forecast the NSW economy to contract by ½% in 2009-10 followed by below-trend growth of 2¼% in 2010-11. The NSW economy is thus expected to perform in line with the national economy in both years (using the Federal Government's latest forecasts). These forecasts seem broadly reasonable; while the NSW economy has been hardest hit by the global financial crisis as Australia's financial centre, it also has a lower exposure to the commodity price cycle than many other states (its exports of thermal coal notwithstanding) and NSW

households are benefiting the most from interest rate cuts given the higher average mortgage size. In anything, the recent stronger-than-expected Q1 GDP outcome suggests there is some upside risk to the government's 2009-10 forecast due to base effects. Growth in 2008-09 is assumed to be ¼%, slightly above the national average of 0% (although recent Q1 GDP figures suggest this estimate for the national economy might be an underestimate).

On the basis of these growth forecasts, employment is expected to decline sharply in 2009-10 (-1¾%) followed by relatively muted growth of ¼% in 2010-11. This will see the unemployment rate increase from 6.4% in May 2009 to an average of 7¾% in 2009-10 and to an average of 8½% in 2010-11. These forecasts are broadly consistent with forecasts for the national economy; the national unemployment rate is projected to reach 8¼% by June 2010 and 8½% by June 2011 (note these are not year average forecasts as for Queensland). This is despite NSW having higher unemployment than the national economy in the previous four years. If anything, recent solid labour market outcomes suggest that the national and NSW employment forecasts may be too pessimistic, although strong population growth and high participation rates will ensure that the unemployment rate still rises significantly from here, even if employment is stronger than expected.

Further out, the NSW government has adopted the same approach as the Federal Government and is using above-average growth projections for the "transition years" of 2011-12 and 2012-13. In NSW, trend growth is assumed at 2¾% and growth is expected to be 1½% above this in both years at 4¼%. The same logic is applied; economic recessions are usually followed by periods of above-trend growth as underutilised capacity (of both labour and capital) is brought back into production. While we do not dispute this reasoning, we are a little cautious about the degree at which growth is expected to be above trend. After all, recoveries following financial crises and recoveries following highly-synchronised recessions across economies (both of which apply in this instance) tend to be less pronounced than in other circumstances.

**Table 1 NSW economic forecasts**

	2007-08	2008-09 (f)	2009-10 (f)	2010-11 (f)	2011-12 (p)	2012-13 (p)
Real gross state product (GSP)	2.8	¼	-½	2¼	4¼	4¼
Real state final demand	4.4	1	-1	2½	na	na
Employment	2.4	0	-1¾	¼	2¼	2¼
Unemployment rate	4.6	5¾	7¾	8½	na	na
Sydney CPI (a)	4.3	1¾	2	1½	2½	2½
Wage price index	3.8	3¾	3½	3¼	3½	3½

All forecasts year-average with the exception of the CPI (a) year-ended

Source: ABS, NSW Treasury

### NSW maintains AAA rating, outlook stable from negative.

We learnt from other recent Budgets that increased pressure on fiscal balances or breaks of key financial ratios does not necessarily result in automatic downgrades. The maintenance of NSW's AAA and change in the outlook to stable from negative is good news for the State and follows positive news from NZ, Tasmania and SA.

The re-prioritisation of the capital investment program in light of the failure to sell electricity generation assets, Budget discipline and help from Canberra on the infrastructure load were key elements in the change to the ratings outlook back to stable. Most of NSW's \$6bn increase in capital spending since the mini-Budget in November has been covered by increased funding from the Commonwealth.

NSW Treasurer Roozendaal was active in managing the expectations of the ratings agencies ahead of the release of the Budget. Considering negative developments on

the growth and pressure on spending this is a very good outcome for the State and for the performance of NSWTC bonds.

The maintenance of the rating will obviously save the State significantly in terms of interest costs, ensure costs are managed within a disciplined framework, should help to bolster confidence and will clearly be some welcome political news for the government. This might even mitigate some of the **legislative risk** for NSWTC bond spreads in light of the time is taking to pass the government guarantee legislation in Canberra.

This could be debated in the House of Representatives as soon as today and then move to the Senate by Thursday. There is clearly a risk that it could be held up by a backlog of other legislation and may not be passed during the current winter session (which ends on Thursday 25<sup>th</sup> June). If not, the next opportunity for the Senate to consider it would be the week starting August 11<sup>th</sup>.

There still looks to be a good chance that it will pass. There appears to be support in principle from the opposition, though they do say they want an amendment that increases transparency as to who is buying these bonds. NSW stands alone of the States in already making it clear it will take up the offer of a guarantee to cover both existing and new debt.

### NSWTC borrowing

The borrowing program for 2009-10 has increased significantly to \$10.4bn from the \$5.3bn program over 2008-09. The full program would have been \$15.4bn but for \$5.0bn of pre-funding as TCorp has taken advantage of improved debt market conditions. The program includes \$5.5bn of maturing liabilities as the '09 bond will mature in October. This leaves a modest \$4.9bn call on markets for new monies in the coming financial year.

The rating action is a positive outcome, there is a still a decent yield pick-up and this will also improve liquidity for NSWTC paper but this is a marked increase in borrowings considering there is around \$28bn in domestic benchmark bonds on issue at present. And we will get another update on Queensland's borrowing program later today.

It is not clear if there is much scope for NSW spreads to contract relative to ACGB in the near-term on the back of this Budget. We have highlighted the uncertainty over the timing of the legislative program above and spreads have narrowed significantly already – see the chart below. While we see some scope for further narrowing of these spreads over coming months - especially if the guarantee is passed - but would expect to see some consolidation around current levels.

**Figure 1: NSWTC bond spreads to ACGB**



Source: ANZ & Bloomberg

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