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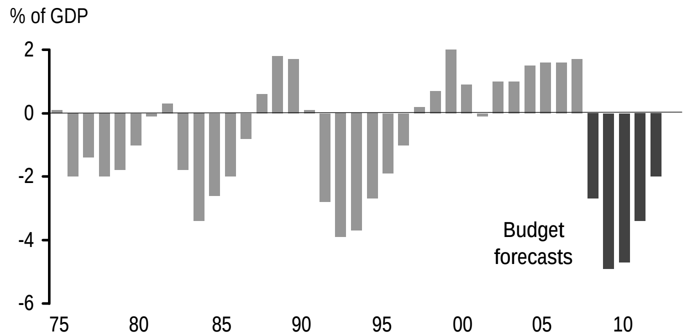
Commonwealth Budget

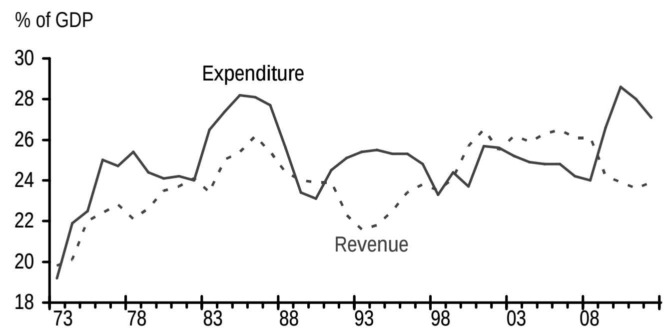
Swan diving into the *Red* Sea

- **Budget deficit of A$57.6 billion (4.9% of GDP) in 2009-10; revenues collapsing as expenditure soars**
- **Government borrowing to blow out to A$301 billion by 2013; bond issuance to balloon**
- **Government belatedly admits that Australia is in recession; GDP to fall 0.5% in 2009-10**

Commonwealth Budget balance



Commonwealth Government revenue and expenditure



Federal Treasurer Wayne Swan tonight delivered his second Budget, with projections of a record deficit and a huge blow-out in borrowing. The Budget was a schizophrenic affair, with the Treasurer delivering on election promises like lowering taxes and boosting infrastructure spending, while simultaneously asking higher income earners to make sacrifices via tougher means tests on welfare payments. As such, the Budget is profoundly different from those delivered in the recent past, when the river of gold from the commodities boom allowed Treasurers to deliver only good news. The recession in Australia, though, means those days of milk and honey are over.

Crucially, the Treasurer's "cross your fingers" strategy for returning the Budget to surplus relies principally (and optimistically) on a return to strong, above trend economic growth, rather than the "hard decisions" he promised. Having softened voters up for a "horror" Budget, the Treasurer effectively pulled his punches.

All the major measures were leaked

The Budget initiatives leaked in recent weeks were delivered broadly as expected. The Treasurer delivered personal income tax breaks, changes to concessional tax arrangements for superannuation (pensions), more onerous means testing of welfare payments, changes to Medicare arrangements, a big rise in spending on infrastructure, a rise in the aged pension, and an extension to the first home owners' grant.

This was a meticulously media-managed Budget, with the bad news "leaked" well beforehand. By definition, therefore, the Budget was unlikely to produce major surprises. And, indeed, the Treasurer failed to pull many rabbits from his hat.

Anything but "temporary" deficits

With government revenues collapsing and ever growing demands on the public purse, the Budget has plunged into what the Treasurer has described as a "temporary" deficit. The Budget's dismal starting point is a yawning shortfall of A$32.1 billion (2.7% of GDP) in the current fiscal year, below our own forecast of a much larger gap. In his first Budget last May, the Treasurer optimistically projected surpluses as far as the eye could see. These, though, have evaporated; revenue has subsided owing mainly to substantially lower company tax receipts, and the government has ramped up spending at the fastest rate since the profligate days of the 1970s.

There is nothing "temporary", however, about fiscal shortfalls stretching out until the middle of the next decade; the Budget indicates that a surplus will not be achieved until 2015-16. The Treasurer expects the deficit to blow out even further to A$57.6 billion in the year ended June 2010, before stabilizing at A$57.0 billion in 2010-11. Even in 2011-12, though, the Budget projects a mammoth gap of A$44.5 billion. These accumulated shortfalls mean government debt will balloon to A$301 billion by 2013; net government debt was zero coming in to the recession.

In last year's Budget, well before the intensification of the global financial storm and the plunge in prices for Australia's major export commodities, the government forecast seemingly endless Budget surpluses. The long

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Government forecasts

	2008-09(f)	2009-10(f)	2010-11(f)	2011-12(p)	2012-13(p)
Balance - $billion	**-32.1**	**-57.6**	**-57.1**	**-44.5**	**-28.2**
Balance - % of GDP	-2.7	-4.9	-4.7	-3.4	-2.0
Change - % of GDP	*-4.7*	*-2.2*	*0.2*	*1.3*	*1.4*

journey back to surplus will depend heavily on a return to sustained growth in the global economy. A key driver of government revenue in the past has been the strength of the global economy which, other things equal, drives commodity prices and company tax receipts higher.

“Fat cats” making the most sacrifices

The Treasurer said before the Budget that he was prepared to make the “hard choices” necessary to kick-start the Budget on what will be a long, meandering journey back towards balance and, much later, surplus. Also, he hinted that some would be called upon to make a disproportionate share of the sacrifices. In particular, the Treasurer’s “hard choices” on welfare arrangements are mainly at the expense of high income earners; but the Labor government’s beloved “working families” and the elderly are the main beneficiaries.

In net terms, this Budget is stimulatory, in keeping with the government’s belated admission that Australia is in recession. Government officials have for some time been making the case that the economy needed more support. The government already has tugged vigorously on the fiscal policy lever since October, when the first major stimulus package was announced. Officials, though, had made clear that there is scope to deliver more fiscal stimulus, particularly to low- and middle-income earners.

The fiscal boost to the economy from earlier policy announcements already is massive, yet this Budget delivers even more largesse. Based on the projected change in the Budget balance since last year’s Budget, for example, the fiscal pulse is equivalent to around 5% of GDP.

Fiscal black-hole of A$210 billion

The Budget makes clear the extent to which tax revenue has dried up. As a share of the economy, for example, the government’s revenue peaked at 26.5% of GDP in 2005-06. This year, though, the Budget projects that tax revenue will have dropped to just 23.6% of GDP, a 13-year low. This decline reflects, in particular, the sharp drop in company tax receipts owing to the onset of recession.

At the same time, the government, led by Prime Minister Kevin Rudd, has ramped up spending at the fastest rate since the 1970s. As a share of GDP spending will reach (at least) a 30-year high of 28.6% of GDP in 2009-10. Treasurer Swan has admitted there is a A$210 billion revenue shortfall over the four-year forward estimate horizon. Back in February, when the government released the most recent Budget update, the Treasurer candidly estimated the revenue black hole at “only” A$115 billion, relative to earlier forecasts. Back then, he forecast a modest deficit of A$22.5 billion (1.9% of GDP) for the year ended June 2009, and a shortfall of A$35.5 billion for 2009-10.

Budget decisions on personal tax rates

Tax thresholds from 1 July 2009	New tax rates (%)	Tax thresholds from 1 July 2010	New tax rates (%)	Tax thresholds from 1 July 2011	New tax rates (%)
$0 - $6,000	0	$0 - $6,000	0	$0 - $6,000	0
$6,001 - $35,000	15	$6,001 - $37,000	15	$6,001 - $37,000	15
$35,001 - $80,000	30	$37,001 - $80,000	30	$37,001 - $80,000	30
$80,001 - $180,000	38	$80,001 - $180,000	37	$80,001 - $180,000	37
$180,001+	45	$180,001+	45	$180,001+	45

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Government economic forecasts

	2008-09(f)	2009-10(f)	2010-11(f)	2011-12(p)	2012-13(p)
GDP growth (%oya)	**0.00**	**-0.50**	**2.25**	**4.50**	**4.50**
Change from UEFO [(a)]	-1.00	-1.25	-0.75	1.50	na
Employment (%oya)	**-0.25**	**-1.50**	**0.50**	**2.50**	**2.50**
Change from UEFO	-1.25	-0.75	-0.75	1.25	na
Wages (%oya)	**4.25**	**3.25**	**3.25**	**na**	**na**
Change from UEFO	0.25	-0.25	-0.75	na	na
Inflation (%oya)	**1.75**	**1.75**	**1.50**	**2.00**	**2.50**
Change from UEFO	-0.25	-0.25	-1.00	-0.50	na

(a) Updated Economic and Fiscal Outlook, Feb. '09

With the benefit of hindsight, the previous government pushed the Budget into structural deficit. It did so by consistently handing back skyrocketing cyclical tax revenue derived from the commodities boom in the form of ever more generous welfare payments and personal tax cuts, year after year. Soaring company tax revenues, in particular, masked what became a permanent erosion of the personal income tax base, while generous welfare payments became an ever larger burden on the public purse.

New spending, but more "mean" tests

In keeping with Labor's election promises and more recent commitments to support the economy, the Budget included new spending commitments on big ticket portfolios like defense, health, and education. There will be another boost to spending on infrastructure, mainly on roads, rail, and ports. For low income households, there will be a rise in welfare payments to the elderly, and there was a commitment to training places for the recently unemployed.

The promised tax cuts were delivered, but there was a winding back of middle class welfare arrangements. Also, the 30% rebate of private health insurance costs will be means-tested for higher income earners, there was a rise in the Medicare surcharge (again, only for high income earners), and three major adjustments to the concessional tax treatment of superannuation. The expanded first home owners' grant was extended for six months, but the payment will be scaled back after three months.

Government admits recession ... finally

The Budget provided the perfect opportunity for the Treasurer finally to admit officially that Australia's economy is in recession, and the Treasurer delivered. The Prime Minister made the admission last month, as did RBA Governor Glenn Stevens, but the latest official government forecasts, published in February, showed the economy growing this year and next. Australia's real GDP fell 0.5%q/q in 4Q08, and looks likely to have contracted again in 1Q09. This will confirm the first recession since the early 1990s.

The official Treasury forecasts released with the Budget show Australia's economy projected to contract 0.5% in the fiscal year ended June 2010. This will be after an expectation of no growth 2008-09. The projections, though, show the economy growing above trend beyond 2010-11, in keeping with the patterns observed after Australia's two most recent recessions. The Budget expects employment to fall in 2008-09 and 2009-10 and for unemployment to rise to 8.5% in 2010-11. Our forecast is that unemployment will rise to 9% by the end of 2010.

J.P.Morgan's forecast also is that Australia's economy will not grow at all in 2008-09, but expand slightly in 2009-10. This creates the impression of a remarkably shallow recession but, in reality, the drop in GDP is concentrated in CY09. Indeed, we expect the economy to shrink 0.6% in 2009. Australia's economy should grow 1.9% in real terms in CY10, but this compares unfavourably with average growth of 5% in the year after each of Australia's seven recessions since 1960. Only in 2010-11 do we forecast a material rate of expansion in the economy.

The main reasons for the unimpressive rebound in our forecast is that household debt, which reached an all time high as a multiple of income in 2008, is notoriously slow to decline. Also, business investment, which was at a record share of GDP in 2008, looks likely to fall over an extended period. Both of these factors will cap growth in the economy during the recovery.

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Budget revenue measures

The main *revenue* measures were:

- The personal tax cuts promised in last year's Budget were delivered in full. In particular, the reduction in the middle tax rate from 40% to 38% and the rise in the income thresholds for lower income earners (at a total cost of A$9.8 billion), were delivered as promised;

- There were changes to Medicare arrangements. The Private Health Insurance (PHI) rebate will be progressively reduced for high income earners. The Medicare levy surcharge will increase for singles earning above A$90,000 and families above A$180,000 in order to provide higher income earners with more incentives to take out PHI. These measures will save A$1.9 billion over five years;

- There was a scaling back of the Medicare Safety Net (MSN). The extended MSN benefits will be capped from 1 January 2010, where doctors are charging excessive fees, such as for obstetrics. Benefits will be capped once a patient has met the relevant extended MSN threshold;

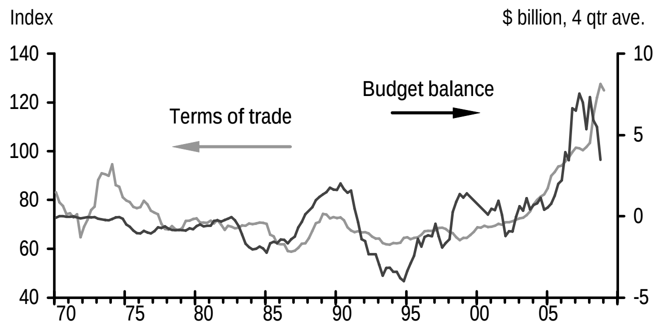
- To limit growth in payments made to higher income families, the CPI indexation of upper income eligibility thresholds will be suspended for three years, saving A$1.4 billion. This will affect eligibility for Family Tax Benefit-B (FTB-B) and dependency tax offsets for families earning over A$150,000 a year;

- Family Tax Benefit-A (FTB-A) will be indexed by the CPI only and the link to pension indexation will be removed. The maximum rate for children aged under 16 will no longer be linked to the couple pension rate. This measure will save A$1.0 billion over four years;

- The small business tax break for investment was expanded (at a cost of A$141 million), to 50% for items purchased before December 2009. The ATO will receive A$168 million to assist small businesses; and

- There were three main changes to superannuation provisions. The Budget announced that it would reduce the cap on concessional superannuation contributions from A$50,000 to A$25,000. Second, there also was a change to the "transition to work" provisions in which those soon to retire can collect a pension while still working - the transitional cap for those over 50 was lowered from A$100,000 to A$50,000. Third, the Government will temporarily reduce the superannuation co-contribution matching rate from 150% to 100% for contributions made in 2009-10 to 2011-12, and to 125% for 2012-13 and 2013-14.

Budget balance and the terms of trade



Budget expenditure measures

The main *expenditure* measures were:

- There was a rise in the aged pension by A$32.50 per week for single pensioners and A$10.15 for couples, costing a total A$14.2 billion. The qualifying age will be progressively increased to 67, starting in 2017, and the aged pension will be withdrawn at a rate of 50 cents in the dollar (previously 40). Half of the first A$500 of fortnightly employment income will not be part of the income test. There will also be a carer supplement of A$600 per year;

- The A$1.5 billion Jobs and Training Compact will provide training supplements of $41.60 a fortnight. There also was an increase in the unemployment safety net, amid expectations of a sharp rise in the unemployment rate. The government doubled the liquid asset test threshold, and included A$299 million to give retrenched workers access to employment services, costing a total A$438 million;

- The Treasurer announced a delay in the promised implementation of Government-funded paid maternity leave until 2011, although there is a firm commitment on its start date of 1 January 2011. The scheme, amounting to A$731 million over five years, is capped at incomes of A$150,000 for the primary carer;

- The Budget introduced unspecified, but more onerous means tests on so-called middle-class welfare. From 1 July 2009, higher income thresholds will be applied to "certain family payments";

- There was more spending on infrastructure, particularly on roads, rail, ports and hospitals, much of which covered initiatives already proposed, including the National Broadband scheme. One aim here is to boost employment to assist the "working families" who helped Labor win the last election in November 2007. The big items were roads (A$3.4 billion), ports (A$390 million), and rail (A$4.6 billion). Hospitals attracted an extra A$20 billion over four years, with A$2.4 billion of this dedicated to health workforce reform;

- The government's education revolution involves a A$14.7 billion investment in Australian schools, aimed at primary schools, and the construction of science laboratories;

- Another beneficiary of the broad infrastructure spend was environmental reform. The A$4.5 billion clean energy initiative will promote investment in low-emissions technology. The Carbon Pollution Reduction Scheme was delayed until 1 July 2011;

- The Treasurer announced an extension of the expanded first home owners' (FHB) grant beyond June 30, 2009 by six months at a cost of A$539 million. From 1 October 2009, the boost (excess above A$7,000) will be halved to give a total of A$10,500 for those FHBs purchasing established homes, and A$14,000 for those purchasing new homes.

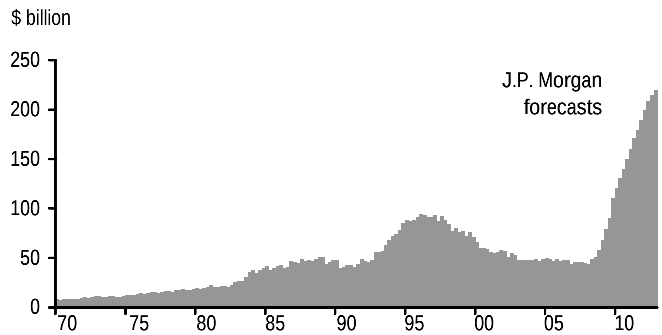
- On health care, there was a paring back of the 30% Government rebate on the cost of private health insurance for higher income earners. The scheme will remain as is for singles earning less than $75,000, or $150,000 for families, but will be progressively reduced above these amounts. Also, A$134 million was dedicated to rural health, primarily attracting medical practitioners to rural areas;

- There was a A$1.3 billion boost to funding to enhance border security and combat people smuggling;

- An extra A$4.6 billion boost in funding to indigenous reform, targeted at schemes such as early childhood development and health as announced by COAG in 2007; and

- A$20 billion of costs savings were announced across the Defence portfolio until 2030. These savings will accommodate new funding of A$1.7 billion for military operations in Afghanistan, East Timor and the Solomon Islands.

Gross Commonwealth Government Bond (CGS) issuance



Inflating a balloon—CGS issuance to soar

- Issuance next fiscal year will amount to $60 billion. In an annualized context, this is a slower pace of issuance than seen this year. We would expect at least 15% (around $11 billion) of this will directed at the new 2022 maturity. Another $6 billion should be directed at the 2021 line, with the remaining $47 billion spread over the other nine issues (around $3.5 billion each). This suggests each bond line will reach at least $10 billion-$11 billion by June 2010.

- Taking the Government's fiscal forecasts, we think that Treasury bonds on issue should reach around $230 billion by June 2013. In the Budget, the Government noted that total Commonwealth Government securities on issue by June 2013 would total around $301 billion. This suggests that the remaining $70 billion will be taken up by T-Notes, Aussie Infrastructure Bonds (used to partially fund the National Broadband Network) and other financing instruments (such as indexed linked bonds).

Government doing heavy lifting for RBA

For the first time in many years, the Federal Budget has important implications for monetary policy. In the boom years when commodity prices were soaring, and when there was no pressing need for big increases in CGS issuance, the release of the Budget often failed to move markets. Already, though, by delivering a significant boost to the economy since last October, fiscal policy has done a substantial amount of the heavy lifting required to prevent Australia from plunging into an even deeper recession. GDP fell in 4Q despite massive government "handouts" to families. Without these payments, the plunge into recession would have been even more abrupt.

It follows that without the fiscal boost, more of the hard yards would have had to be covered by the RBA. This has

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been hinted at by RBA officials, who repeatedly have indicated that one reason they slowed the pace of official rate cuts from the outsized 100bp reductions last year and earlier this year is because they wanted to see how the stimulus was playing out in the economy. There was, for example, considerable uncertainty over how much of the fiscal handouts would be saved.

The government's swift action to boost the economy by red-lining the fiscal engine has left the RBA with plenty of ammunition in reserve for use at a later date, if necessary. Equally, by delivering significant cash payments to low and middle income households, the government has supercharged the stimulus likely ultimately to be derived from the largest reduction in the official cash rate in living memory.

Sanguine RBA officials in no hurry

RBA officials appear in no rush to deliver more stimulus. In particular, they want to see the impact of the latest cash payments to low income families and, of course, this Budget. Also, they are anxious to retain monetary ammunition in the event that unemployment rises more quickly than the official forecasts.

We forecast a 25bp reduction in the cash rate in August, once officials have had a chance to gauge the impact of the Budget, and the previous stimulus packages, on the economy. We anticipate another modest 25bp reduction in the official cash rate later in the year, probably in Q4. This will take the cash rate down to 2.5%, which we estimate will be the terminal rate for this cycle.