National Australia Bank

2013-14 Federal Budget

14 May 2013

Comment	What a difference a year makes. Gone is the political rhetoric on the importance of gaining international credibility by getting a surplus no matter what. Rather, the focus is very much on a fairly timid initial approach that doesn't see a balanced Budget till 2015/16 or a surplus till 2016/17. In short, a Budget that is more in line with a "soft economy" – even if the Government doesn't describe it as such. As set out in Medium Term Fiscal Context, the Budget effectively takes nothing from the economy in the near term (compared to detraction from growth of nearly 1½% this year). From a structural viewpoint nearly all of the heavy hitting is from the revenue side and most is done in the out years. That said, the Budget is helping to repair some structural problems via scrapping last year's welfare increases (last year's so called spreading the benefits of the mining boom – around $2.5bn over the estimates) and the baby bonus, increasing the Medicare levy to help fund national disability reform (the largest saving at $11.5bn over the estimates), tightening offshore tax arrangements including Offshore Banking Units (a hefty $4.2bn over the estimates) and acknowledging the lower carbon price ($3.4bn over the estimates). Also, there are measures to reduce funding costs of schooling (out of universities etc at $2.6bn) and measures to introduce PAYG systems for large tax payers. The main expenditure items (within the estimates period) are more infrastructure ($3.1bn) school building ($2.9bn) and disability care ($1.9bn but ramping up in the beyond estimates period). For more details, see Budget Measures – In Brief. NAB's real activity forecasts are very similar to Treasury's – albeit we are a touch weaker in 2012/13 and we also have unemployment a touch higher. Of more concern, we are significantly lower for nominal GDP – which is important because this was the main cause of revenue under prediction in recent years. We are also slightly weaker for the global outlook. For more details, see Economic and Financial Outlook. The real risks to the Budget probably revolve around how much of the package will see the light of day post the election. Also, the Budget expenditures are very much back ended which raises the question of just in what state the economy will be in 2016/17 and beyond. Finally even this modest fiscal retraction will possibly be at risk if election spending fires up. At least in that context Australia's debt position remains very strong in an international context with debt levels very low – albeit they are possibly moving towards the lower end of the remaining AAA economies. For more details, see Bond Issuance and Net Debt. Overall then a budget for a softer economy but one that is very political in nature (as probably was inevitable in present circumstances).
Fiscal Outcome	The underlying cash deficit for 2012/13 is estimated at $19.4 billion (1.3% percent of GDP). The Budget maintains large deficits of $18 billion in 2013/14, and $10.9 billion in 2014/15, before moving into a marginal surplus of $800 million in 2015/16.
Economic Outlook	The Government's economic outlook is broadly in line with recent RBA forecasts, and only slightly stronger than NAB's. However, the Government's outlook for nominal GDP is substantially stronger than ours, at 3¼% in 2012/13 compared to our 2.1%, and 5% in 2013/14 compared to our 4.2%. Over estimating nominal GDP was the reason why revenues were overestimated in recent years – and this is clearly a concern. The Government and Nab both have growth of 2.7% and 3% for 2013/14 and 2014/15. However we are weaker in 2012/13 (at 2.7% v the Governments 3%) largely slower near-term public sector demand and a sharper pace of decline in the terms of trade. The Government expects unemployment to rise to around 5¾% by mid 2014, while NAB expects it to edge towards 6%, reflecting our weaker view on growth. The Government, RBA and NAB share very similar views on the outlook for underlying inflation, which is expected to remain well within the RBA's 2-3% target band over the forecast horizon. Given the structural adjustment occurring in the economy at present, as well as softness in labour market conditions, we still believe the economy would benefit from another 25 bp rate cut this year (November); this would take the RBA's cash rate to 2.50%. However, further deterioration in labour market conditions could see earlier action and possibly more than one cut. For further details, see the *Economic and Financial Outlook.*
Financial Markets	Beyond the economic/fiscal outlook, for bond investors the two main considerations from tonight's Budget are: 1) the Government's debt programme for 2013/14, and 2) any implications for Government's stable AAA credit rating. The market reaction to the Budget was negative, with the $A quickly falling ½ a cent to under 0.9950. The reasoning was less to do with the detail of the Budget and more that investors saw a string of deficits indicating the economy remains weak. The bond market was little moved.

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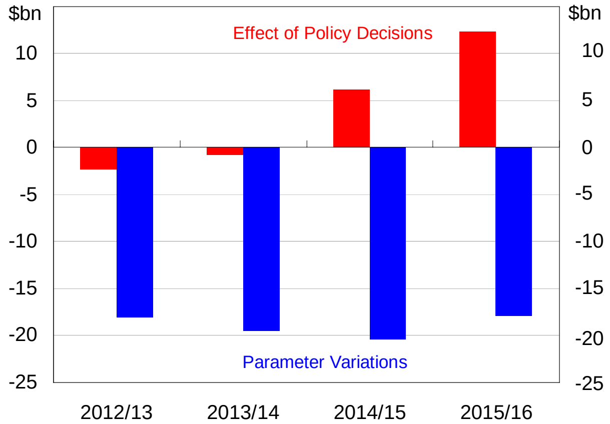
Medium Term Fiscal Context

As noted on our Summary the 2013/14 Budget takes a very different view on the need for fiscal consolidation. The Budget has been hit by the lower returns from nominal incomes and has significantly allowed those parameter effects to flow through to the bottom line. This is perhaps best shown in the following chart which compares these parameter effects with policy responses.

Reasons for Change in the Budget Cash Balance
Comparing 2013/14 Budget with 2012/13 MYEFO

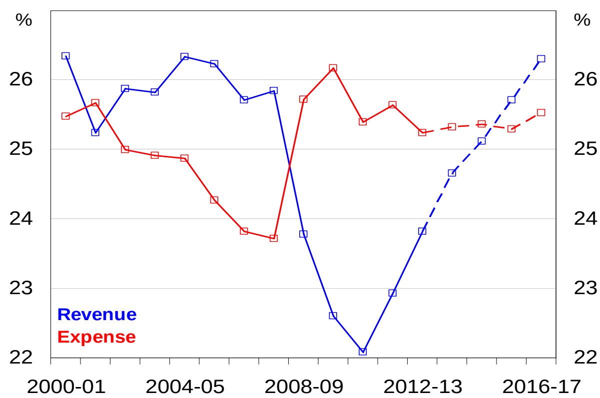


Source: Commonwealth Treasury

The chart also highlights the point that most of the policy responses come later in the estimates period.

Also the heavy lifting has mainly been done from the revenue side. This is also evident if we look at the Budget "jaws" (i.e. revenue versus outlays as a percentage of GDP). Despite some good structural saves in not going ahead with Family tax benefits (the so called spreading the benefits of the mining boom in last year's budget) and cutting the Baby bonus, the real action comes in increasing the Medicare levy at a time when most of the NDIS expenditures are still to come. Also a lot of heavy lifting is also done in the corporate tax area – especially offshore taxing and OBU treatment.

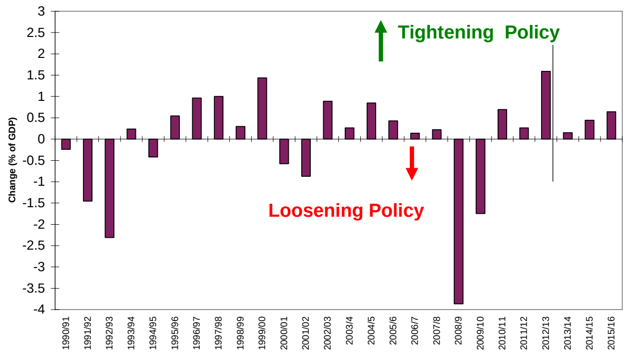
Commonwealth revenue & expenses*
% of GDP



Sources: ABS; Commonwealth Treasury; NAB calculations; RBA
* GST classified as Commonwealth tax & expense

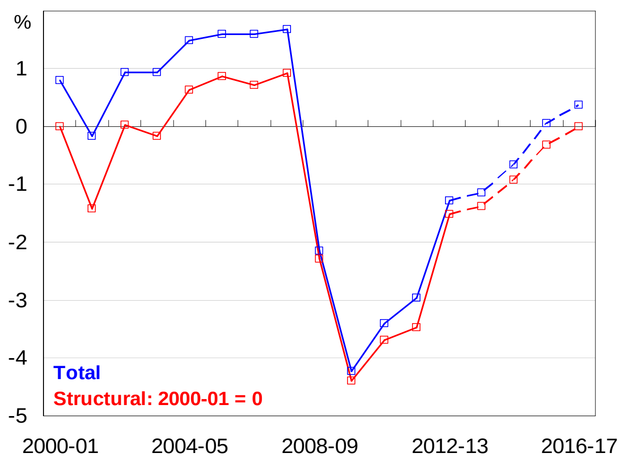
Not surprisingly the fiscal impact of the Budget is in marked contrast to the gains in fiscal consolidation made in recent years – and especially in 2012/13. Using OECD methodology the implication is that the Budget is neutral in 2013/14 and only modestly contractionary in the outer years – building modestly to a contraction of around ½% from GDP in 2015/16.

Structural Impulse
- Annual Movement % of GDP



Not surprisingly, this means that the structural deficit is now estimated at around 1½% of GDP and is now not expected to close till 2016/17.

Underlying cash balance
% of GDP



Sources: ABS; Commonwealth Treasury; NAB calculations; RBA

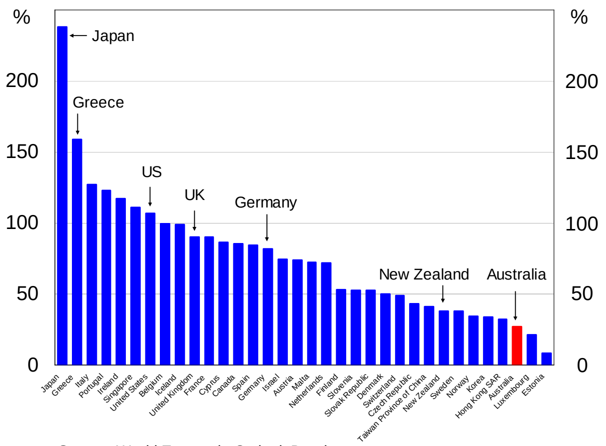
On the credibility of the forecasts, as noted above we are not radically different on the outlook for the real economy in the out years (see *Economic and Financial Outlook*), we are a touch lower in the current year with a higher unemployment profile. From the forecasting side a key difference appears to be our outlook for the nominal economy where we are nearly 2% lower the period 2012/13 to 2013/14. The weakness in nominal GDP was of course a key reason for recent forecasting errors.

On the risks to the medium term outlook, two issues loom large. First what might happen during and post the current election – clearly there is little room to significantly boost spending without corresponding saves. Second, the nature of this Budget is very much back end loaded. That is, the really big spends in the area of Disability and Gonski (Education) are just outside the current estimates period. Clearly, the further out the forecasts the harder it is to judge where the economy will be and what it will do to the Budget.

That said, at least Australia starts from a good fiscal starting point, as highlighted by the following chart of public gross debt to GDP. That is of course not to be complacent but…

Gross Government Debt in Advanced Economies

Per cent of GDP; 2012



Source: World Economic Outlook Database

Budget Measures – In Brief

In accrual terms, the fiscal deficit for 2012/13 is estimated to be $19.4 bn (or 1.3% of GDP). Key highlights of spending and saving measures (those committed within the current Budget period) include:

New Spending Initiatives

Infrastructure:

- Overall $2bn for the next wave of Nation Building , which include $1.8 billion ($350m per annum) for Network Maintenance.

Health and aged care

- Transition of Disability Care to the full scheme (1.9bn over six years).
- New listings or amendments to the Pharmaceutical Benefits Scheme ($691m over five years).

Education

- Investment in new school funding model ($2.8bn over four years).
- New funding to promote universal access to preschool under National Partnership ($660m).

Defence

- Additional funding to defence operations and procurement (S$820m over four years).

Saving Measures

Personal income tax

- A 0.5 percentage point increase in Medicare Levy to 2.0% to fund Disability Care ($11.4 bn over three years from 2014-15).
- Phase out the net medical expenses tax offset (NMETO) with transitional arrangements for those currently claiming the offset ($960m over three years).
- Better target work-related self-education expense deductions through an annual $2,000 cap on these expenses from 1 July 2014 ($514m over three years).

Clean Energy Future

- Deferral of Clean Energy Future personal income tax cuts (initially scheduled to commence on 1 July 2015) due to downward revision in carbon price ($1.5bn over 2015-16 and 16-17).

Family

- Not proceeding with the additional increase to Family Tax Benefit Part A ($2.5bn over four years).
- Continuing indexation pauses on upper income limits for family payments and supplements ($1.2bn over three years)

- Increase Family Tax Benefit A to replace the baby bonus from 1 March 2014 ($1.1bn over four years).

Tightening of corporate tax loopholes

- Tightening the international tax arrangement rules to prevent profit shifting ($1.5bn over three years).
- Targeting the deduction for exploration to genuine exploration activity ($1.1bn over four years).
- Closing loopholes in the consolidation regime ($540m over four years).

Monthly Pay-as-you-go (PAYG) Instalments

- Extend the requirement to make PAYG income tax installments to include all large entities such as trust, sole traders and investors ($1.4bn over 2015-16 and 2016-17).

Higher Education

- Apply an efficiency dividend of 2.0 per cent in 2014 and 1.25 per cent in 2015 to all grants provided under the Higher Education Support Act 2003 ($903m over four years).

R&D Tax Incentives

- Limit access to the R&D tax incentive so that it only applies to companies with annual aggregate Australian turnover of less than $20 billion ($1.1 bn over three years).

Official Development Assistance

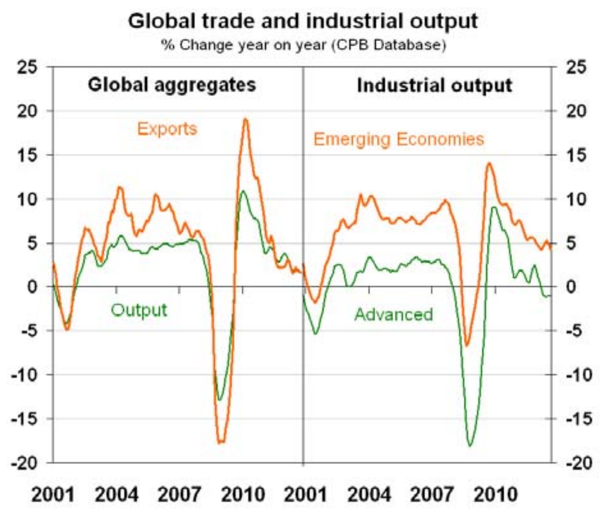
- Deferring Australia's Growth Target ($1.9bn over three years).

Economic & Financial Outlook

Global outlook

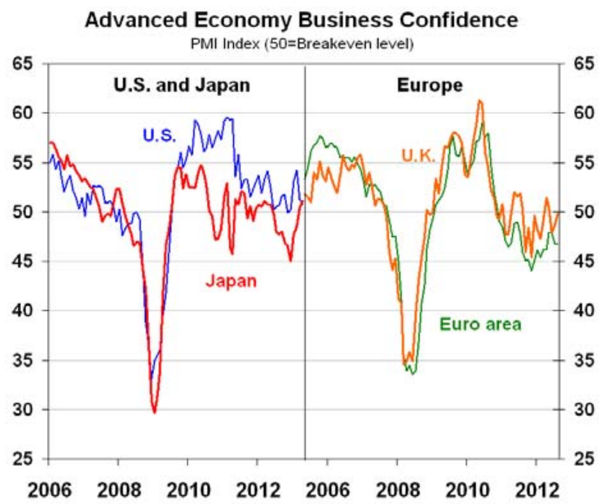
Treasury has forecast global growth of 3¼% in 2013, rising to 4% through both 2014 and 2015 – a consensus view in line with the IMF's recent estimates. The balance of risks for this forecast is seen as tilted to the downside. Our numbers are a little lower at 3% this year, rising to 3¾% in 2014.

Our lower numbers reflect the most recent data on global economic activity which has been softer than generally expected. There has been a clear easing in the expansion of both world exports and industrial output. The industrial slowdown has been broad-based with output falling in the advanced economies and slowing across the emerging markets. There have been several soft patches in global growth through the last few years but they could generally be ascribed to specific events (Euro-zone crises, US budgetary pressures) that undermined business confidence and risk appetites in the financial markets. This time it is harder to identify a clear driver for the slowdown in growth.



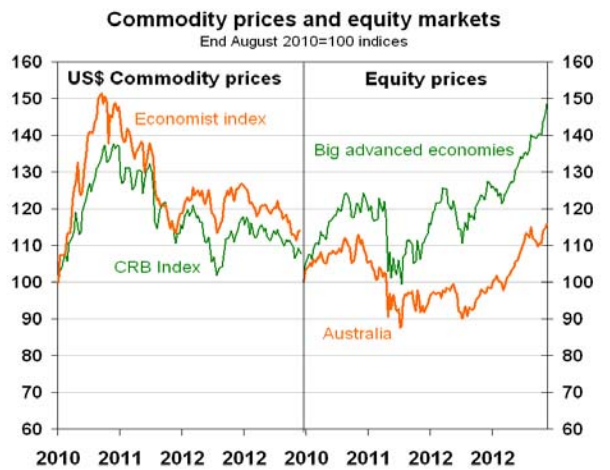
The easing pace of industrial growth has occurred through a period in which several international business surveys and the OECD leading indicators pointed to the likelihood of an impending improvement in business conditions. Global equity markets also turned up, buoyed by increased quantitative monetary easing by major central banks, renewed "risk on" trading and the perception that faster economic growth was likely through the next couple of years. By March 2013, however, global industrial growth had slipped to virtually zero. Continued industrial growth in North America, China and India has been offset by declines in Western Europe, Japan and emerging market East Asia (excluding China). Businesses have probably been disappointed by these outcomes and the latest PMI surveys show a downturn in confidence in some big economies.

There is, however, considerable variation in economic performance between the big economies. The latest business surveys show a solid upturn in confidence in Japan, probably reflecting the change in economic policy and the weaker yen. Survey readings are consistent with continued moderate growth in the US, stabilisation and modest growth in the UK but continued recession in the Euro-zone.



Growth remains much stronger in the emerging market economies than in the advanced economies but it has, nevertheless, still under-performed expectations in the former. The pace of growth has slipped across the biggest emerging market economies – China, India and Brazil. Indian growth has fallen well short of the Government's hopes with the slowest rate of GDP expansion seen since the global recession of 2008/9. Brazil's growth in 2012 slipped to around 1% and data for the early months of 2013 does not look too promising while Chinese growth has remained much more solid but still slowed to 7.7% in early 2013. Monthly data on industrial output and exports also shows a broad-based loss of momentum across East Asia and Latin America through the last few months.

This lacklustre picture for recent growth looks consistent with the downward trend seen in measures of aggregate $US commodity prices, frequently a symptom of sluggish demand. The surge in global equity markets, on the other hand, sits less easily with recent sub-trend global economic growth. It is better explained by central bank liquidity injections into financial systems, "risk on" financial trading as some of the worst downside risks now appear less likely (e.g. Euro-zone disintegration, excessive fiscal tightening in the US) and a consensus expectation that global growth will head back toward trend through the next 18 months.

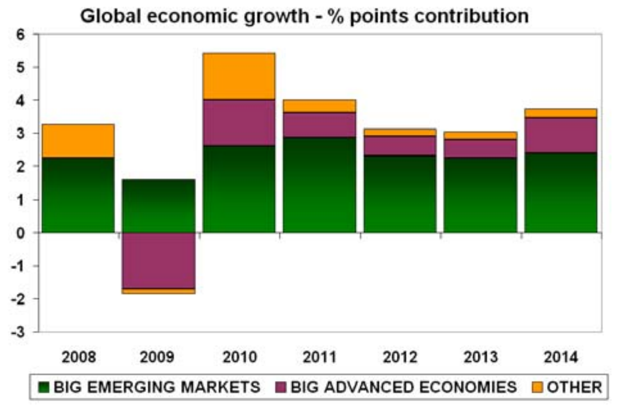


While our forecasts are less optimistic than those of Treasury, we also expect growth to accelerate to around trend by 2014. This pick-up reflects the ending of recession in the Euro-zone, faster growth in the US and India as easier monetary policy boosts demand in each country and a trade-driven upturn in emerging East Asia. As usual, Australia benefits from its concentration of exports in the most dynamic global markets with both Treasury and NAB predicting that growth in our major trading partners will run around 1 percentage point above the headline global figure through both 2013 and 2014. The main differences in growth are in Japan – where NAB expects a stronger 2014 outcome, boosted by yen depreciation lifting exports. As an offset, NAB has lower growth numbers for the Asian emerging market economies where the weaker yen hits their export competitiveness.

Comparison of NAB and Treasury forecasts

	2013		2014	
	Tsy	*NAB*	*Tsy*	*NAB*
China	8	7¾	7¾	7½
India	5¾	5¾	6½	6½
Japan	1¼	1	1	2¼
US	2	2	2½	3
Euro	-½	-½	1	1
E Asia	4½	3½	4¾	4¼
MTPs	4½	4	4¾	4½
Globe	*3¼*	*3*	*4*	*3¾*

The ending of recession in the Euro-zone plus faster growth in the UK, US and Japan combine to alter the balance of global growth. The big emerging economies are still the biggest drivers of world output expansion but advanced economies are forecast to contribute more next year.



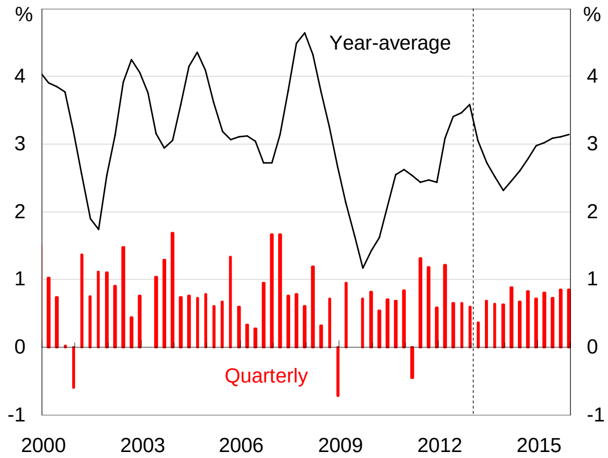
Australian outlook

The Commonwealth Treasury's Budget papers note that while the Australian economy continues to be affected by the enormous structural changes taking place in the global economy, Australian economic fundamentals remain strong and the outlook favourable. The Budget papers highlighted the important transition that the Australian economy is expected to undergo over the forecast period; the transition of the resources boom away from the investment phase and towards the exports and production phase. It also noted the impact that this structural change is having on the economy already, with a persistently high dollar and lower terms of trade having an acute and enduring effect on profits and prices growth across the economy, which is weighing heavily on nominal GDP growth and government revenue.

Real GDP has grown by 0.6% in each of the three quarters up to end-2012; that is, a sub-trend annual rate of 2.5%. While private underlying business investment grew robustly in the December quarter, weakness in the underlying public component reflecting the continued tightness of fiscal policy combined with subdued household consumption – not helped by a falling terms of trade – meant domestic final demand growth was fairly tepid. The external sector made a positive contribution to the growth outcome, largely reflecting volumes of metals and minerals exports.

More recently, signs have emerged that the economy is responding to historically low borrowing rates; in the early months of this year, retail spending has strengthened and asset prices have risen, despite labour market conditions remaining a little subdued. However, the NAB monthly business survey continues to highlight the difficulty in business conditions, which remained challenging in April, while business confidence stumbled into negative territory. Furthermore, persistent weakness in forward indicators of demand – including capacity utilisation, forward orders and employment conditions – combined with tight fiscal policy settings, imply little improvement in near-term activity. Consistent with this, we see GDP growth remaining below trend over 2013 (but appearing to slow in 'through the year' terms as last year's strong Q1 reading drops out), led largely by a pull back in business investment as the economy transitions from the mining investment phase to the exports phase. GDP growth will not be sufficient to prevent the unemployment rate edging up towards 6% by the end of 2013.

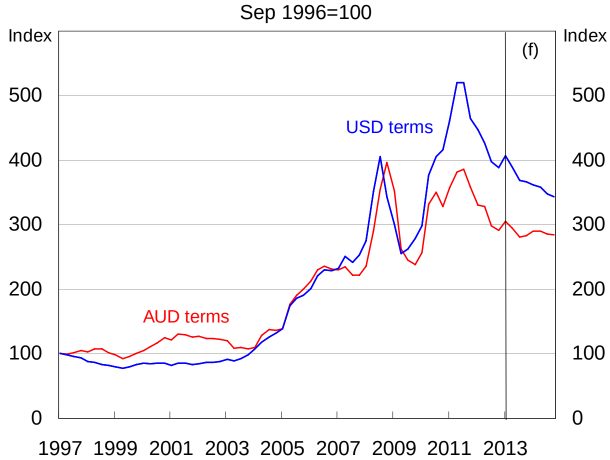
Gross Domestic Product Growth



Sources: ABS; NAB

NAB Non-Rural Commodities Price Index

Sep 1996=100

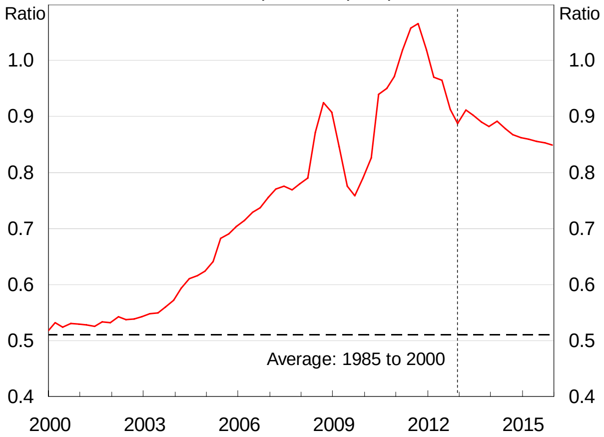


Sources: ABARES; ABS; Bloomberg; NAB; Thomson Datastream

Prices of most of the minerals & energy commodities declined over 2012, reflecting the soft demand environment in major advanced and emerging economies. Central bank stimulus in the US, Japan and Europe and supportive fundamentals have limited price declines, but the effect on Australia's terms of trade has been marked. While prices of coking and thermal coal and some of the industrial metals fell further in the March quarter, spot prices of iron ore recovered from relatively low levels at the end of 2012, which together are expected to contribute to a modest and temporary rise in Australia's terms of trade. But with supply fundamentals set to loosen as global commodities supply increases, we expect minerals and energy commodities prices to ease further, contributing to a 10% decline in the terms of trade in 2012/13, and a further 2% decline in 2013/14. Given the associated contribution to Australian domestic income, NAB expects GDP growth to ease from 3.4% in 2011/12 to a modest 2.7% in 2012/13, before softening to 2.6% in 2013/14.

Australia's Terms of Trade

Index of export to import prices

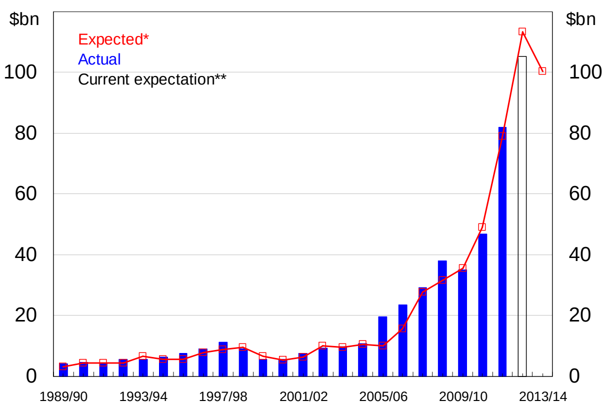


Sources: ABS; NAB

The ABS New Private Capital Expenditure Survey showed a pull back in total capital expenditure of 1.2% in the December quarter. Of particular interest in this survey was the first estimate of mining capital spending for 2013/14. Using five year average realisation ratios, the December quarter survey implies that mining capex is expected to increase by 12.5% in 2012/13, which is lower than the 17.6% expected in the September quarter survey. Combining December quarter actual data with short-term expectations for the 2013 March and June quarters implies that last year's expectation for mining capex in 2012/13 was optimistic. Overall, this outcome suggests that mining investment will remain reasonably buoyant in 2013/14, but the numbers look superficially positive and mask considerable downside risk.

Capital survey year-ahead expectations and actuals

Mining industry, financial year



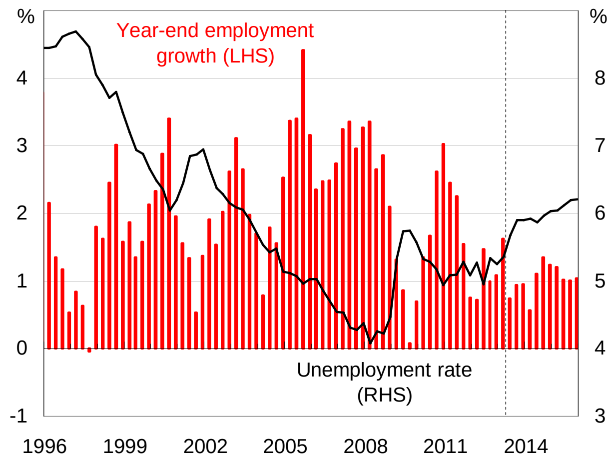
* Estimate 1: 12 months expectation as reported in Jan-Feb survey of previous financial year
** First 6 months are actuals, second 6 months are expections from estimate 5
Source: ABS

Indeed, mining sentiment has deteriorated significantly over recent months, with the NAB monthly business survey measure of mining confidence slumping to a four year low of -39 points in April, with this industry by far the most pessimistic. While the pipeline of work yet to be done on minerals projects remains large, it has been in decline for the past year and no mega projects have commenced over the same period. The resource boom is clearly undergoing a transition, from the labour intensive investment to the capital intensive exports phase, and mining employment demand is already being reduced as a consequence.

Offsetting the impact of a slowing in mining investment will be a strengthening in net export volumes, which are expected to gain momentum over the next two years as major resource projects (particularly LNG) begin to deliver. Overall commodities exports will benefit from a gradual strengthening in demand from Australia's major trading partners. Overall, we expect exports to grow by around 7% in 2012/13, and around 8¾% in 2013/14. With the AUD expected to soften modestly over the forecast horizon, we expect imports to rise only marginally – with growth of just 1½% in 2012/13 and 2% in 2013/14.

Low borrowing rates, gradually increasing house prices and better rental yields appear to have encouraged an increase in dwellings investment from the end of last year. The outlook for relatively easy borrowing conditions to be maintained for some time should encourage dwelling investment plans over the next year or two, but ongoing fiscal restraint and the likelihood that higher unemployment will affect job security may work to partly offset this. Overall, we expect dwellings investment to rise by around ½% in 2012/13, before rising by around 2¾% in 2013/14.

Australian Labour Market

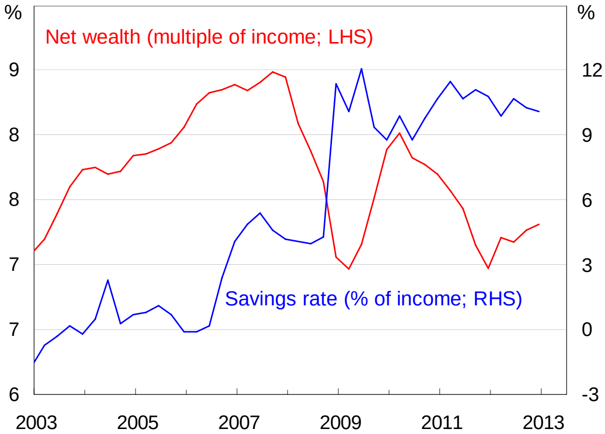


Sources: ABS; NAB

Official data suggest that labour market conditions have held up reasonably well over recent months given the soft state of the domestic economy. However, forward indicators point to a degree of weakening in the labour market, which is likely to weigh on growth over the next year or so. The recent upwards shift in trend employment growth has been somewhat surprising given the relative softness in activity; however, the unemployment rate – probably a more realistic reading of the state of the labour market – has also trended higher since the beginning of this year. As the mining transition intensifies, we would expect to see labour market conditions worsen. The unemployment rate is expected to lift to around 5¾% by the middle of this year, before gradually rising to around 6% by mid 2014 and remaining around this level for the remainder of the forecast horizon. While the weakening in the labour market will cause a softening in income growth, which may result in households becoming more anxious about their spending and borrowing decisions, low borrowing rates and rising asset prices should provide some offsetting support.

Household savings rate & wealth

Per cent of net household disposable income

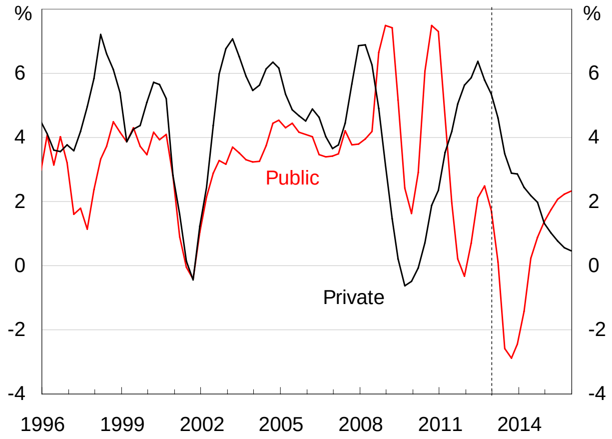


Source: ABS

While consumption growth weakened in the second half of 2012, growing by just 0.9% at an annualised pace, activity indicators suggest that growth strengthened considerably into early 2013. Since the beginning of this year, consumer confidence has risen to above average levels, helped by historically low borrowing rates, rising asset prices and a sense that the global financial system has been repaired, which has encouraged consumers to spend again. A sharp increase in retail trade in January and February, which was partly unwound in March, suggests consumption growth accelerated in the March quarter. While 'green shoots' appear to be emerging in the consumer dependent sectors, the NAB business survey shows that conditions in these industries – retail, wholesale etc – are still challenging, albeit less subdued than at the end of last year. A declining terms of trade and a still high AUD are likely to weigh adversely on these sectors. We see consumption growth of around 2½% in 2012/13, before softening to around 2¼-2½% in 2013/14.

Domestic Demand

Annual-average growth

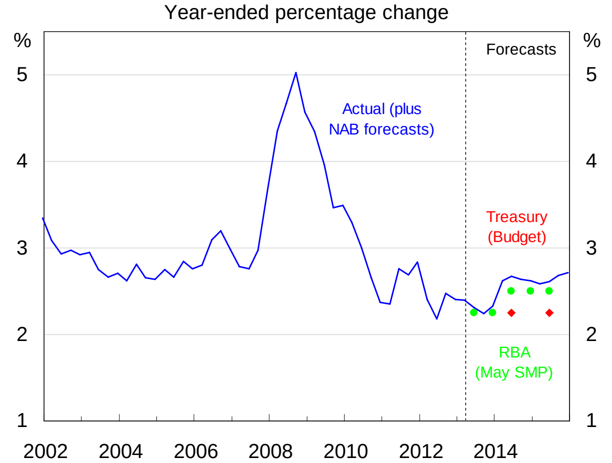


Sources: ABS; NAB

The huge turnaround in the Government's underlying cash balance from a $43.4 billion deficit in 2011/12 to an estimated deficit of $19.4 billion in 2012/13 has taken a toll on the economy. While public consumption growth has remained reasonably robust given the Government's determination to get the Budget back into the black in 2012/13, the degree of tightening in public investment growth over 2012 has been fairly marked, reflecting a clear pull back in infrastructure projects following the post-GFC stimulus programs. Treasury expects public final demand growth to ease by around ½%, over 2012/13 and to be unchanged in 2013/14. However, our expectations are for more weakness in near-term public spending due to the large scale of fiscal tightening that has already taken place over 2012, and will continue to occur over the remainder of the forecast horizon.

Underlying Consumer Price Inflation

Year-ended percentage change



Sources: ABS; NAB; RBA; Commonwealth Treasury

Based on our analysis of the state of the economy and our expectation for activity to soften over the year ahead, we believe there is still room for further monetary easing by end 2013. Underlying inflation is expected to remain well within the RBA's comfortable range of 2-3%, helped by weaker labour market conditions, fiscal tightness and persistent consumer caution, and will not be a barrier to further rate reductions. While the RBA is likely to wait and see how the economy responds to previous rate cuts, including the most recent 25 bp reduction on 7 May, we believe the economy will weaken as the mining sector transition intensifies, and another rate cut will be necessary by late 2013 (possibly November). Of course, timing remains fluid and a faster than anticipated worsening in labour market conditions could bring forward a rate cut and increase the number of cuts required. Beyond 2013, monetary policy is likely to remain very accommodative for sometime as the full impacts of stimulus take effect.

Australian Economic and Financial Forecasts – National v Federal Budget (a)

End Period	**2012-13 (f)**		**2013-14 (f)**	
Annual % Change	**NAB**	**Budget**	**NAB**	**Budget**
Private Consumption	2.5	2½	2.4	3
Private Investment – Dwelling	0.4	½	2.7	5
Underlying Business Fixed Investment	10.5	10½	-1.7	4½
Underlying Public Final Demand	-2.6	-½	0.2	0
Domestic Demand	**2.5**	**3**	**1.4**	**2¾**
Stocks – Contribution to GDP	-0.1	0	-0.1	0
GNE	**2.4**	**3**	**1.3**	**2¾**
Exports	-4.4	7	7.8	6½
Imports	2.4	5	4.2	6
GDP	**2.7**	**3**	**2.6**	**2¾**
- Non-Farm GDP	2.9	**3**	2.6	2¾
- Farm GDP	-8.0	-8	1.7	4
Federal Budget Deficit (fiscal balance, $bn)	**-20.3**	**-20.3**	**-13.5**	**-13.5**
Current Account Deficit: % of GDP (-%)	-3.6	-3½	-2.9	-3¾
Terms of Trade	-10.1	-7½	-2.0	-¾
World GDP (b)	3.0	3¼	3.7	4
End Period				
Wage Price Index	3.3	3½	3.5	3½
Employment	1.0	1¼	0.9	1¼
Unemployment rate	5.7	5½	5.9	5¾
Total CPI	2.4	2½	2.2	2¼
Underlying CPI	2.3	n.a	2.7	2¼
Official Cash Rate	2.75	n.a	2.50	n.a.
10 Year Govt. Bond Yield	3.15	n.a	3.85	n.a.
US cents/$A	1.03	n.a	0.96	n.a.
Trade Weighted Index	79.9	n.a	75.6	n.a.

Forecast Comparisons

GDP	**Dec 2012**	**Jun 2013**	**Dec 2013**	**Jun 2014**	**Dec 2014**	**Jun 2015**
NAB	3.6	2.7	2.3	2.6	3.0	3.1
RBA	3.6	3	2¾	2-3	2¼-3¼	2½-3½
Treasury		3		2¾		3
CORE INFLATION*						
NAB	2.4	2.3	2.3	2.7	2.6	2.6
RBA	2½	2¼	2¼	2-3	2-3	2-3
Treasury				2¼		2¼

(a) Year-average percentage change
(b) Year-ended percentage change

Bond Issuance and Net Debt

The Debt Programme in 2013/14.

To fund larger deficits the Government will clearly need to issue more debt. The Budget papers provide a broad indication of the Government's debt programme for the year ahead but, as is usual, the Australian Office of Financial Management (AOFM) will follow up in the next few days with more detail.

My comments at this point would be: 1) net CGS issuance likely to be a larger than expected $30bn; 2) AOFM will continue to term out their debt as much as they can (so they will run Treasury notes as low as possible); and 3) a larger $4bn of net issuance of indexed linked bonds has been signalled in 2013/14.

The broad parameters are on the table below:

Debt Programme 2013/14

June Years - $bn	Exp 2012/13	Forecast 2013/14
Budget outcome	-19.4	-18.0
Net Debt - $bn	162	178
Net Debt - % GDP	10.6	11.1
Net Funding $bn - face value		
ACGB	28	27
Linkers	2	4
T Notes	-8	0
Net new funding	22	31
Gross CGS - $bn	54	50
Gross Government Debt - $bn Face Value		
ACGB	233	260
Linkers	18	22
Treasury Notes	5	5
Total	256	287

Source: Budget papers and NAB calculations

- Government bonds (ACGBs) - Outstandings to be $233bn by June 2013, rising to $260bn by June 2014. This is net issuance of $27bn and after accounting for $23bn of maturing bond means gross ACGB issuance will be $50bn. This is more bonds than the consensus estimate for gross issuances of $42bn. Budget papers indicate a preference to keep issuing into longer maturities as they have done through 2012/13.
- Inflation index bonds – outstandings to rise from $18bn at June 2013 to $22bn by June 2014. This net issuance of $4bn steps up the pace of issuance from recent years.
- Treasury notes – AOFM use Treasury notes for within year financing and do not have a specific target outstanding in mind. It does reiterate the point it made in October last year that there is no floor for issuance and at times there could be zero notes on issue.
- Total Commonwealth Government Securities (CGS) – The Budget papers forecast total outstandings to be $256 by June 30 2013 but do not give us a total number for June 2014 – the uncertainty being Treasury Note outstandings. If we assume Treasury Note outstandings remain unchanged, total CGS outstandings would be around $285-$290bn.

Debt Ceiling OK for now – The Treasurer and AOFM are bound by a debt ceiling which is currently $300bn. Our calculations suggest that total CGS will rise to $285-$290bn by June 2014. So it is possible the Government will not need to raise the ceiling in the 2013/14 fiscal year. But certainly in the years beyond it will need to be lifted. The Budget papers say the Government will "legislate to increase the limit as it becomes necessary".

Australia's AAA credit rating secure for now, but Australia at the weaker end of the remaining AAA countries.

Both Moody's and S&P have come out immediately after tonight's Budget to affirm the Government's AAA stable credit rating. They cite the low level of Government debt as a key rating positive and do not seem too perturbed by the delayed return to surplus. Both rating agencies note that projected deficits are quite modest although I would comment that a structural Budget deficit remains even in the out years.

With the AAA stable credit rating secure, this leaves Australia in the last eight unquestioned AAA Governments[1].

That said, it is fair to point out that Australia is at the weaker end of eight.

The major positive for Australia from a ratings perspective remains the modest levels of net debt. The chart below plots Government net debt as a share of GDP by the end of 2013 for a number of advanced countries. Even with substantial slippage in recent years, the Australian Government's net debt is expected to be 11% at the end of 2013 and peak at 11.4% in 2014/15. This is a modest amount of debt when compared to the 91.5% for all advanced countries. As the chart below also shows, Australia's 11% of GDP net debt is near the middle of the remaining AAA countries.

Government debt, however, is not the only criteria rating agencies use to assess Government's credit worthiness. They also look at a country's institutional and political arrangements, economic and fiscal flexibility, and also potential contingent

[1] Unquestioned in that they are rate AAA stable by all major credit rating agencies. The last eight AAA stable countries are: Australia, Norway, Canada, Sweden, Denmark, Singapore, Finland, and Switzerland.

liabilities from the likes of State Governments and even households and banks.

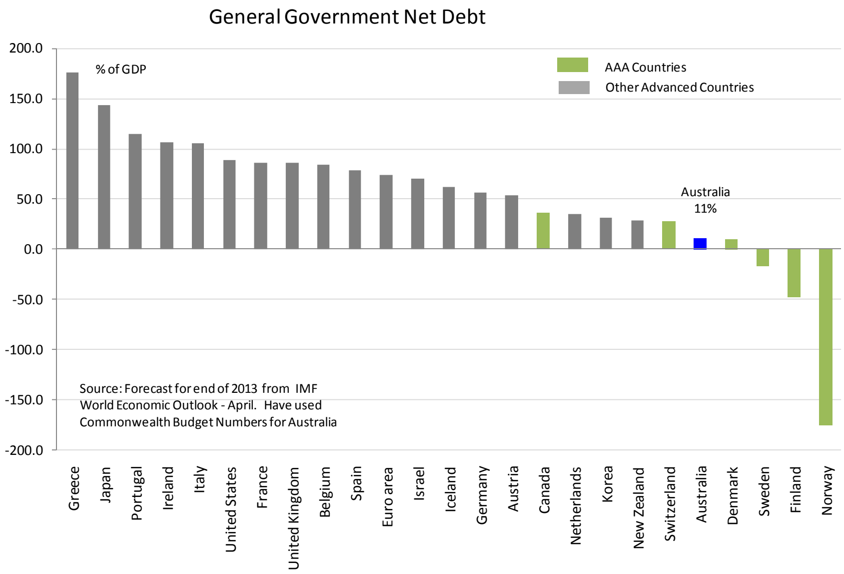
Against these criteria, Australia does have the very substantial rating positives of a flexible economy with a relatively high potential growth rate, a floating exchange rate, an inflation targeting central bank, a well capitalised banking sector, a stable government, and high quality public and private institutions. But then so do most of the other AAA countries.

The comparative weaknesses for Australia remain: 1) external indebtedness as Australia continues to run a current account deficit when most of the other AAAs are creditor nations; and 2) associated with this Australian households are comparatively highly indebted.

On this basis it is fair to conclude that Australia is at the weaker end of the remaining AAAs.

Tonight's Budget, with only a slow crawl back to surplus, has not improved the relative positioning of Australia amongst the eight.

Australian Government Debt still relatively modest.



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