Australian Federal Budget

2015/16

A report by Westpac Economics

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This issue was finalised on 12 May 2015

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Overview

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Deficit to narrow.

The Government forecasts that the budget deficit will narrow from 2.6% of GDP in 2014/15 to 0.4% of GDP in 2018/19. Revenues are projected to rise by 1.7% of GDP over four years, as expenses decline by 0.6% of GDP. The Government suggests that the improvement in the budget over the four years strikes the right balance between the impact of fiscal consolidation on the economy and sustainable structural reforms. The annual pace of consolidation is 0.5% of GDP.

From higher starting point.

In the current financial year, 2014/15, the deficit is estimated to be $41.1bn, 2.6% of GDP. That is little different from the forecast in the December Mid-Year Economic & Fiscal Outlook (MYEFO), representing a deterioration of only $0.8bn. A $2.2bn downside surprise in revenue has been largely offset by a $2.1bn undershoot on expenditures, while new policies add to spending, costing $0.6bn.

Receipts to build.

In 2015/16, the deficit is $35.1bn, 2.1% of GDP. That is a $3.9bn deterioration on the MYEFO forecast. Revenues are $5.0bn lower than expected, reflecting the weaker economic outlook, while new policies cost $2.2bn. This is partially offset by a $3.3bn undershoot on expenditures. The deficit improves to $25.8bn in 2016/17; moderates to $14.4bn in 2017/18; and then shrinks to $6.9bn in 2018/19.

The deterioration in the budget position since MYEFO is a cumulative $12.5bn across the four years to 2017/18, including a $20bn downgrade of tax receipts. Since the May 2014 Budget, the total write-down in tax receipts is $52bn, of which around $20bn is because of the lower iron ore price (now assumed to be US$48/t FOB, compared to the Budget 2014 profile of US$120/t moderating to $85/t).

Modest new spending fully funded.

Net new policies announced in the 2015 Budget cost $8.8bn over the five years to 2018/19. This is offset by not proceeding with the paid parental leave scheme, saving $10.4bn over these years. In aggregate, the net budget impact is a $1.6bn saving over the five years. The profile of these measures adds to the deficit near term, costing $2.2bn in 2015/16, with savings back-loaded. The 2015 Budget includes a raft of measures, with a focus on child care and small business (detailed discussion below).

A surplus projected in 2019/20 …

The Government sets out a medium-term strategy, with projections to 2025/26. A return to surplus is expected in 2019/20, the same year as in MYEFO. The Government has set itself a target of reaching a surplus of 1% of GDP by 2023/24. However, more work needs to be done, with current projections pointing to surpluses of up to 0.7% of GDP over the remainder of the medium-term.

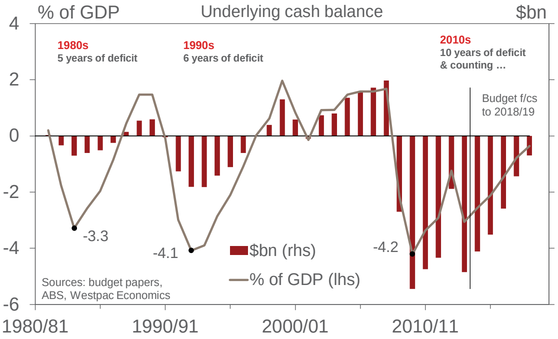
… assuming a period of above trend growth.

The economic forecasts underpinning the fiscal projections appear to be credible. Output growth, real GDP, is below trend in the near-term and then strengthens from 2017/18, supported by an improvement in world growth. See below for a more detailed discussion of the economic outlook.

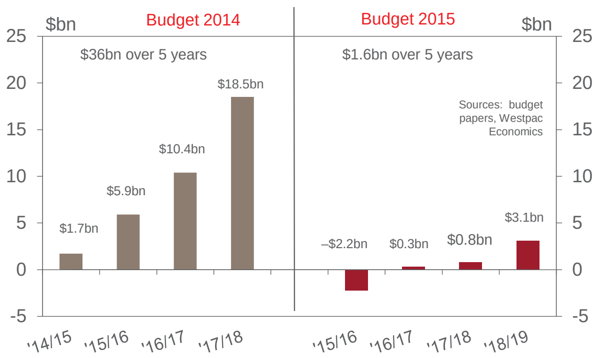
Debt growing but remains manageable.

The Commonwealth Government's net debt position remains manageable. Net debt is expected to rise from 12.8% of GDP at June 2014 to 15.6% of GDP at June 2015, and is forecast to peak at 18.0% of GDP in June 2017, moderating to 16.8% of GDP in June 2019. The stock of Commonwealth Government Securities on issue at June 2015 is expected to be $370bn (unchanged from MYEFO), rising to a forecast $415bn by June 2016 (also unchanged from MYEFO) and then to $500bn by June 2018 (up $16bn from MYEFO).

Federal budget: the long road to surplus



Savings measures: Budget 2014 vs 2015



Budget 2015: the themes

Impact of falling iron ore prices
Since the 2013/14 Budget, the fall in iron ore prices has resulted in a $90bn downgrade to the forecast for the value of iron ore exports contributing to a $20bn reduction to forecast tax collections.

Tax cuts to encourage small business investment and employment
A $5.5bn Jobs and Small Business package, with $5bn in tax relief for small businesses with a turnover below $2mn. Small corporations tax rate will be cut to 28.5% while unincorporated businesses get a 5% tax discount up to $1,000 per year. Small businesses will also be able to get an immediate tax deduction (accelerated depreciation) for a wide range of business assets costing less than $20,000 (up from $1,000).

Assisting the unemployed into those new jobs
Firms will be encouraged to employ job seekers with the simplification of work experience arrangements and the introduction of greater flexibility in wage subsidy payments. There will also be support for early school leavers but with a clear expectation that job seekers will maximise their chances of finding employment. Targeting assistance to those most in need this will result in savings of $3.5bn over five years. Some $1.5bn in savings will come from identifying fraud and non-compliance. Higher Education Loan Programme repayment obligations will now be enforced for Australian residents overseas. The Parental Leave Pay is no longer available to those who receive employer parental leave payments.

Supporting families and accessing care
Introduction of a $4.4 billion Families Package includes $3.5bn over five years for a new Child Care Subsidy, with families earning $65,000 or less to receive 85% subsidy of child care fees. Families with incomes between $65,00 and $170,000 are expected to benefit by some $30 a week. Childcare subsidies will be capped at $10,000 for those earning more than $185,000. From July 2014 a Community Child Care Fund will provide grants for disadvantaged children, children in remote areas and low income families in high cost areas. “No Jab, No Pay” rule will remove all exemptions, except medical, for access to child care payments and Family Benefits Part A. A $250mn “Nannies Trial” will subsidise home based child care for shift workers who find it hard to access traditional childcare.

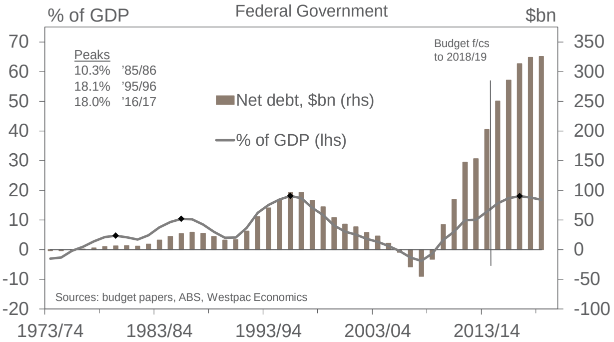
Sustainability of the pension system
The asset thresholds which determine eligibility for the pension (and part pension) have been adjusted, for example: couples who own their own home can now have up to $375,000 in assets and receive the full pension; thereafter they will lose $3 in pension per fortnight for each additional $1,000 in assets. The income test for defined benefit recipients will also be tightened to balance out their treatment versus that of self-funded retirees. Almost $3bn will be saved over the five years to 2018/19.

Tightening the integrity of the tax system
A Multinational Anti-Avoidance Law to ensure foreign businesses don’t escape the Australian tax net; GST to be applied to imported digital products and services; and increased penalties for tax avoidance by large companies. Some not-for-profit organisation employees can access very generous salary packaging arrangements not available to others. These benefits will now be subject to a $5,000 exemption tax.

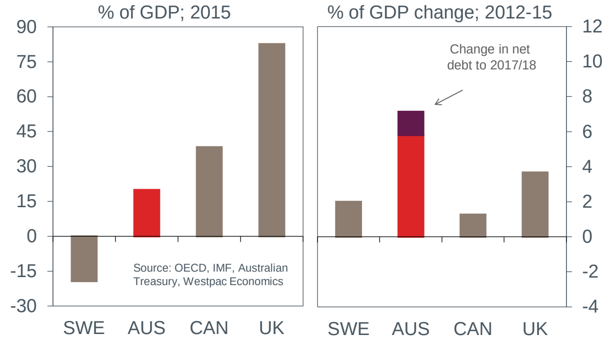
Strengthening foreign investment framework
The ATO has been given responsibility for regulating foreign investment in residential real estate, stronger enforcement of the rules supported by enhanced data matching services, including the introduction of fees for all foreign investment applications.

Strengthening national security
Funding for national security increased by $1.2bn, split across new intelligence measures; improved IT capabilities; and support for the telecommunications industry to implement the Government’s metadata initiative. On defence, $750mn has been provided to fund Australia’s military operations in Afghanistan.

Australia: public net debt



General government net debt: ‘AAA’ countries



Budget 2015: key figures

	2013/14(a)	2014/15	2015/16	2016/17	2017/18	2018/19
GDP	2.5	2.50	2.75	3.25	3.50	3.50
Nominal GDP	4.1	1.50	3.25	5.50	5.25	5.50
Unemployment (Jun qtr)	5.9	6.25	6.50	6.25	6.00	5.75
Cash balance, $bn *	–48.5	-41.1	-35.1	-25.8	-14.4	-6.9
% of GDP	–3.1	-2.6	-2.1	-1.5	-0.8	-0.4
Revenue, % GDP	22.8	23.5	24.0	24.2	24.7	25.2
Expenses, % GDP	25.7	25.9	25.9	25.5	25.3	25.3
% chg, real #	7.8	0.4	1.1	1.0	1.9	3.2
Net debt, $bn	202.5	250.2	285.8	313.4	323.7	325.4
% of GDP	12.8	15.6	17.3	18.0	17.6	16.8

* Underlying cash balance; # deflated by CPI

Sources: ABS, Budget papers, Westpac Economics

Major policy initiatives in Budget 2015

AUDbn	'15/16	4 yrs	Comment
Savings measures			
Social security assets test	0.0	2.4	Taper rate up from $1.50 to $3 for every $1k over the asset free threshold.
Welfare integrity	0.3	2.2	Includes income test for pensions, range of eligibility measures, fraud.
East West link road contribution	0.3	1.5	Still a bone of contention with the new government in Victoria.
Parental leave double dipping	0.0	1.0	Preventing parents accessing both private employer and public support.
Health delivery efficiency	0.1	1.0	Streamlining & rationalising health programs.
Other health initiatives	0.2	1.4	MBS, PBS changes, no jab no pay, child dental, State-Fed duplication "small govt".
Border security related	0.1	0.7	Cost compression on immigration detention management, border protection.
Other	0.1	0.9	"Smaller government" measures ex health, digital transformation, large family supp.
Total	**1.2**	**11.0**	
Revenue measures			**(negative in this instance means revenue foregone)**
Tax cuts for small business	-0.3	-3.3	1.5% cut for unincorporated businesses with revenue under $2mn.
Accelerated depreciation for small business	-0.3	-1.8	Immediate wrote-off for assets <$20,000 bought from now till end June 2017.
FIRB framework	0.1	0.7	Principally charging application fees for foreign property buyers.
Compliance/foreign workers/car expenses/FIFO	0.2	2.4	Range of initiatives aimed at modernizing &/or increasing efficiency of system.
Salary sacrifice meals & entertainment - cap intro	0.0	0.3	Sensible response to an apparently widely rorted allowance.
Total^	-0.3	-1.5	^Total includes residual measures not listed separately.
Spending measures			
Families package - child care and participation	0.1	3.2	Child care subsidy, activity test for eligibility.
Medicare benefits schedule (GP co payment reversal)	0.6	3.0	Unpopular initiative to put an out-of-pocket price on the local doctor, x-rays etc.
Auto industry assistance	0.2	0.8	It isn't cheap keeping the struggling domestic auto industry going.
Families package - Pre-schooling	0.1	0.8	CY16 and CY17, 15h/wk, 600hr/yr, by degree qualified teachers.
Northern Australia	0.0	0.8	Roads for cattle industry, tropical medical research.
WA infrastructure	0.5	0.5	Compensation for collapse in revenues w/out altering GST formula (paid 14/15)
Families package - other	0.5	1.6	Child Care Safety Net, youth employment, more generous youth means test.
Total^	**2.9**	**14.6**	^Total includes residual measures not listed separately

Forecasts: the Government & Westpac

The economy

A gradual pick-up

The Government expects the Australian economy to strengthen in coming years but only gradually with growth remaining below trend and incomes under pressure from falling commodity prices near term. The key theme remains a transition from mining-led to broader-based growth with low interest rates, a lower oil price and a lower AUD the key drivers of the pick-up. The transition is now seen as occurring more slowly with additional headwinds from recent sharp falls in commodity prices and a sustained recovery in non-mining business investment now expected to come through a little later in the piece.

... but with sub-trend growth for a little longer ...

Real GDP growth is forecast to lift slightly from 2½% in 2014/15 to 2¾% in 2015/16, moving back to be near trend at 3% in 2016/17. Forecasts for 2014/15 are unchanged from the MYEFO but have been lowered by ¼ppt for 2015/16 and ½ppt for 2016/17. A weaker outlook for business investment and exports are the main sources of the downgrade with the outlook for private consumption unchanged and dwelling investment and government demand a touch firmer.

... and a bigger terms of trade hit to incomes.

The outlook for nominal GDP remains notably weak with the Government forecasting growth to pick up from 1½% in 2014/15 to 3¼% in 2015/16, the latter considerably lower than the 4½% forecast in the MYEFO and well below the long run average of 6%yr. The downgrade reflects both the substantial hit from a falling terms of trade – with a cumulative decline of over 20% now expected between 2013/14 and 2015/16 – and a weaker outlook for wage inflation with the WPI now seen rising at just 2½%yr.

Global backdrop expected to improve ...

Note that the terms of trade outlook is based on key commodity prices holding around current spot levels including an iron ore price of US$48/tonne (FOB). The 'agnostic' assumption of recent spot prices extending across the forecast horizon stands in contrast to last year's Budget forecasts included forecasts of substantial declines in the iron ore price, from a much higher starting position.

... with non-mining led growth to pick up domestically.

The global backdrop is expected to improve with world growth lifting slightly to 3½% in 2015 and 3¾% in 2016. Growth amongst Australia's major trading partners – dominated by the relatively fast-growing economies in Asia – is expected to track about 1ppt above the world average. Notably, China's growth is expected to continue slowing to 6½% in 2015 and 6¼% in 2016. Growth in the US is expected to be sustained at a relatively robust (by its recent standards) 3¼% pace over the same period.

Household savings and business investment key risks

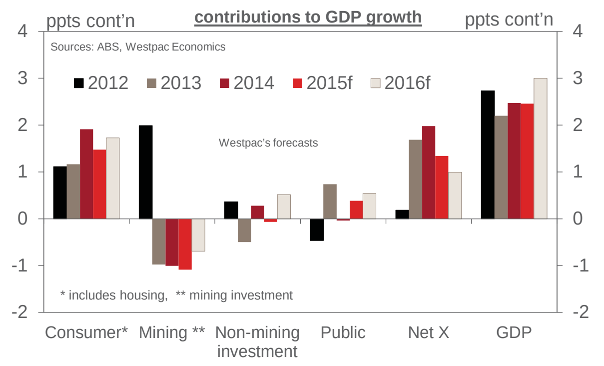
Domestically, the transition towards non-mining led growth is seen as well underway, led by lifts in household consumption, dwelling investment and exports, and supported by lower interest rates, lower petrol and electricity prices and a lower AUD. Growth in consumption is expected to continue picking up, reaching 3% in 2015/16 and 3¼% in 2016/17, spurred by lower interest rates, rising wealth and lower energy costs. A key uncertainty surrounds the extent to which the household savings ratio declines through this period – an unspecified 'modest' decline is forecast.

A similar view to Westpac's but a slightly different mix.

Business investment remains the weak spot in the transition narrative with liaison and survey data indicating that firms in non-mining remain unwilling to commit to major new investment projects. Strong balance sheets, a lower AUD, lower fuel costs, and rising demand from both households and overseas markets are expected to support a modest lift in non-mining business investment in 2015/16 (+4%), strengthening in 2016/17 (+7½%).

How do these forecasts compare to Westpac's? The Government is slightly more upbeat on Australia's growth outlook, particularly around consumption and dwelling investment, but more downbeat than us on the 2015/16 outlook for business investment, exports and Australia's terms of trade. The mix gives similar results for nominal GDP growth and the expected 6½% peak in the unemployment rate.

Australian growth mix



Government & Westpac forecasts: 2015/16

	Government	Westpac
World GDP (2016)	3.75%	4.0%
Aust GDP	2.75%	2.6%
Consumption	3.0%	2.6%
Housing	6.5%	2.3%
Investment	–7.0%	–6.0%
Exports	5.0%	7.0%
Unemployment	6.5%	6.5%

Sources: Budget papers, Westpac Economics

Economic forecasts – Australia

	Actual		Government (yr average)		Westpac (yr average)	
	2012/13(a)	2013/14(a)	2014/15	2015/16	2014/15	2015/16
Private consumption	1.9	2.2	2.75	3.00	2.7	2.6
Dwelling investment	–3.8	5.1	6.50	6.50	5.7	2.3
Business investment*	4.9	-5.1	–5.50	–7.00	–5.4	–6.2
Private demand*	2.3	0.9	1.25	1.25	1.1	0.9
Government*	–0.9	1.5	1.25	1.50	0.1	1.9
Final demand	1.6	1.0	1.25	1.50	0.9	1.1
Stock contribution ppts	–0.1	–0.3	–	–	0.2	0.1
GNE	1.4	0.7	1.25	1.50	1.0	1.2
Exports	6.0	5.8	6.50	5.00	7.2	7.2
Imports	0.7	-1.9	–3.00	–1.50	–1.2	0.5
Net exports contribution ppts	1.0	1.6	2.00	1.25	1.7	1.4
GDP	**2.5**	**2.5**	**2.50**	**2.75**	**2.3**	**2.6**
Nominal GDP	2.2	4.1	1.50	3.25	1.6	3.2
Employment (Jun qtr)	1.1	0.7	1.50	1.50	1.6	1.7
Unemployment rate (Jun qtr)	5.6	5.9	6.25	6.50	6.3	6.5
Participation rate (Jun qtr)	65.1	64.6	64.75	64.75	64.8	64.8
CPI (Jun qtr)	2.4	3.0	1.75	2.50	1.7	2.4
WPI (Jun qtr)	2.9	2.5	2.50	250	2.6	2.7
Terms of trade	–9.8	-3.5	–12.25	–8.50	–10.5	–6.0
Current account, % of GDP	–3.9	-3.0	–300	–3.50	–2.9	–3.0

* business investment and government spending excluding the effect of private sector purchases of public sector assets.

	Actual	Government (yr average)		Actual	Westpac (yr average)	
	2014(a)	2015	2016	2014(a)	2015	2016
World growth	3.4	3.50	3.75	3.4	3.2	4.0

Macroeconomic variables – recent history

	2014							2015			
Monthly data	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**	**Apr**
Employment ’000	12.2	27.8	–4.7	–3.1	–3.5	49.6	33.4	–4.6	38.0	48.2	–2.9
Unemployment rate %	6.1	6.3	6.1	6.2	6.3	6.2	6.1	6.3	6.2	6.1	6.2
Westpac–MI Consumer Sentiment	93.2	94.9	98.5	94.0	94.8	96.6	91.1	93.2	100.7	99.5	96.2
Retail trade %mth	0.7	0.4	0.1	1.3	0.3	0.1	0.1	0.5	0.7	0.3	–
Dwelling approvals %mth	–3.2	4.1	4.4	–12.6	12.7	5.5	4.9	0.3	–1.6	2.8	–
Credit, private sector %ann	5.1	5.2	5.2	5.4	5.8	5.8	5.9	6.1	6.2	6.2	–
Trade balance AUDbn	–1.75	–1.07	–0.88	–1.96	–0.87	–1.13	–0.65	–1.14	–1.61	–1.32	–

Coast-to-Coast: growth rotates gradually

Australia's gradual growth transition ...

Australia is attempting to navigate the transition from mining investment led growth to strength across the broader economy. This transition will see growth rotate from the mining states of Western Australia and Queensland to the south-east. In WA and Qld the downdraught from the mining investment downturn is clearly apparent. While in the post-GFC era, the south-eastern states face their own challenges, adding to the difficulties of a smooth transition. Here we provide an update on economic conditions Coast-to-Coast, yielding insights masked by the aggregated data at the national level. Our focus is on the timely demand indictors, with state output data only available on an annual basis and with a considerable delay.

... will see growth shift from WA & Qld ....

... to the south-east.

In the second half of 2014, Australia experienced a loss of momentum, a trend that was widespread. Nationally, domestic demand was all but flat over the second half of the year, advancing by only 0.5% annualised. This broadly flat result was matched in Victoria, South Australia and Western Australia; Tasmania's performance wasn't much better at 0.8% annualised, while in Queensland demand contracted sharply. Even in NSW, which is benefitting from a long overdue housing sector catch-up phase, a loss of momentum was apparent with demand growth slowing from 5% annualised in the first half of 2014 to 2.7% annualised in the second half.

Consumer spending is above trend in NSW ...

... but sluggish in Victoria ...

Beginning with the consumer, the picture at the national level is one of a gradual improvement in spending, albeit with growth remaining below trend. However, the disparity at a state level is striking. Spending per capita nationally strengthened from 0.3%yr in 2013 to a still modest 1.2% in 2014, which is well below the long-run average of almost 2%. In the mining states no improvement is evident, with per capita spending in 2014 stalling in Qld and in outright decline in WA. In NSW by contrast, spending per capita accelerated to an above trend 2.5% in 2014. While Victoria is closer to the national average, at a sluggish 0.7% in 2014. No doubt that low interest rates and rising household wealth are providing a strong tailwind. However, weakness in wage incomes is limiting spending power. Pressure on wages is greatest in the mining states and the gains in house prices and household wealth have been modest beyond the Sydney and Melbourne markets. These broad themes are likely to persist into 2015, reinforcing the current growth divide.

... and weak in mining states.

Public demand, which accounts for just over 1/5th of the national economy, remains a key source of weakness. The pressures of fiscal consolidation are unevenly spread across the nation, with state budgets typically pro-cyclical. In short, state government expenditures are closely tied to the fortune of revenues. The WA budget is under considerable pressure from the collapse in iron ore prices. By contrast, in NSW and Victoria, the housing boom is generating a stamp duty windfall. In 2014, public demand national stalled, well short of trend growth of 3%. At the state level, trend public demand advanced only in NSW, was broadly flat in Victoria, and declined materially in the other states. In the broad, these patterns are likely to continue in 2015, although the recent Victorian state budget was clearly expansionary, pointing to a near-term improvement in public spending momentum.

In 2016, growth prospects improve ...

The housing sector is responding to record low and falling interest rates. A supply response is evident, with the forward indicators, dwelling approvals, accelerating to hit fresh record highs. In the six months to March, approvals nationally were 224,000 annualised, up 14% on six months earlier. Strong gains during this period were evident across the eastern states, Victoria +23%, NSW, +21%, Tasmania, +20% and Qld, +17%. However, the upturn has stalled in South Australia, with approvals flat lining, while the cycle is turning down in WA, where the six month sum in approvals fell 7% over the past three months. The absence of upside momentum in home building activity in South Australia and WA will add to the challenges ahead. In NSW, a prolonged period of under building has laid the foundation for an extended and strong upturn in housing investment. Supply and demand are more in balance in the southern states of Victoria and Tasmania, suggesting that the current momentum is unlikely to be sustained into 2016.

... boosted by lower rates, a lower AUD ...

... and a lift in world growth.

The business mood soured in late 2014. That was against the backdrop of disappointing domestic momentum and collapsing global commodity prices. WA and Qld will contend with double digit falls in mining investment over the next couple of years as the sector focuses on cost cutting and as gas, coal and iron ore projects currently under construction are completed and begin exporting. In the non-mining sectors, businesses are reluctant to commit to significant capacity expansion until a durable strong upswing in demand is confirmed. NSW should fare better than other states, given above trend household demand growth and expansionary state fiscal policy. We see prospects for non-mining investment and growth more generally as improving as we head into 2016. World growth is forecast to accelerate to 4.0% in 2016, up from a disappointing and sluggish 3.2% in 2015. In addition, conditions will receive a boost from lower interest rates, with the RBA lowering rates twice in 2015, having been on hold since August 2013. A sharply lower currency against the US dollar will also provide a boost to the trade exposed sectors, including tourism, international education, retail and manufacturing, with all states to benefit.

Coast-to-Coast: growth rotates gradually

Chart 1.

Domestic demand

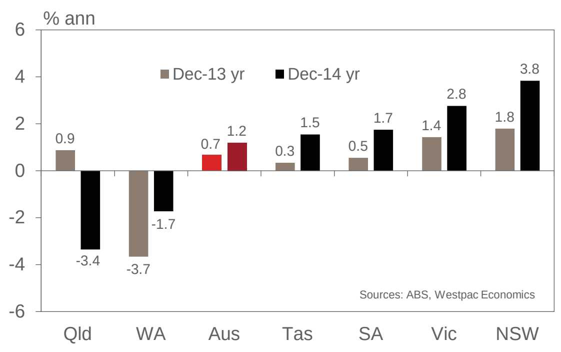


Chart 2.

GSP growth: state government forecasts

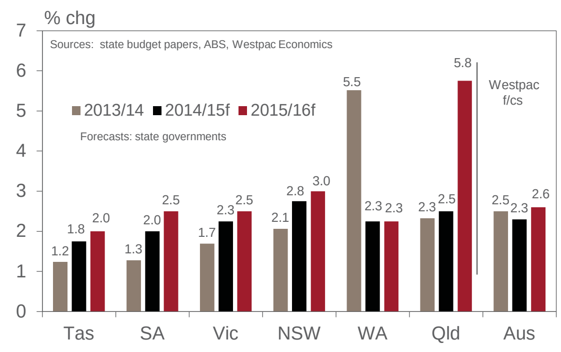


Chart 3.

Consumer spending, per capita: trends diverge

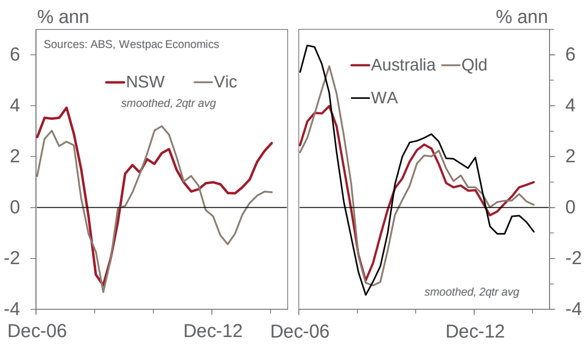


Chart 4.

Population: on the move, as growth shifts

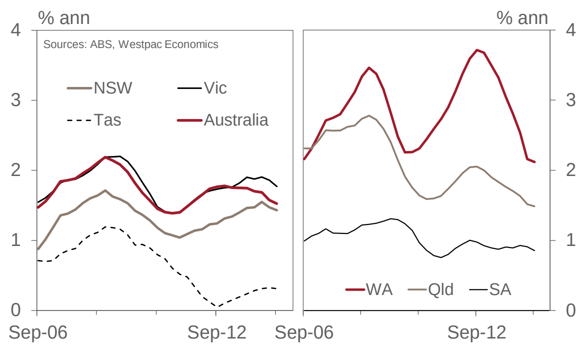


Chart 5.

Dwelling approvals: a building boom

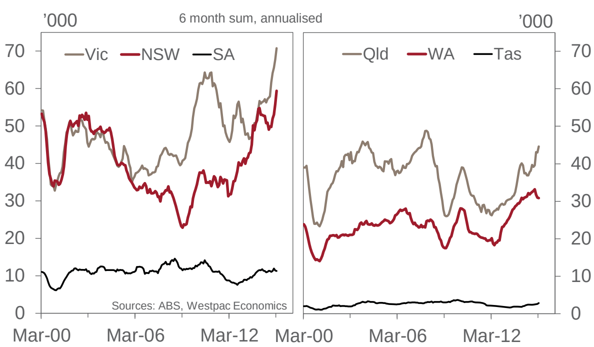
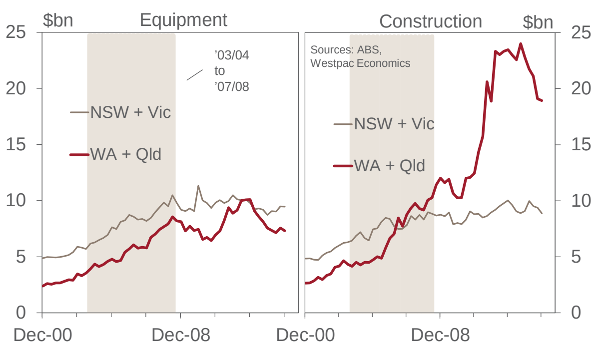


Chart 6.

Business investment: by state



Past performance is not a reliable indicator of future performance. The forecasts given above are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The results ultimately achieved may differ substantially from these forecasts.

Australian interest rates

The May cut brought to a close …

As we had forecast the Reserve Bank Board decided at its May meeting to lower the cash rate by 25bps to 2.00%.

… a difficult forecasting period …

For Westpac this brought to a close a challenging six months in forecasting. Readers will recall that on December 4 last year we changed our view, which had previously been that rates would be on hold over the next year, to expecting that the RBA would cut the cash rate in two 25bp tranches in the first half of 2015 beginning in February. When we made that change we were the only institution on record in the market surveys who forecast that the cash rate would be at 2% by May 2015.

… in which we took the lead.

The most surprising aspect of the Governor's May statement is that he had not chosen to indicate a 'soft' easing bias. In fact, the explanation behind the decision indicates renewed optimism in the economy with the obvious implication that rates are likely to be on hold for some time. Specifically, he commented: "The Board judged that the inflation outlook provided the opportunity for monetary policy to be eased further, so as to *reinforce recent encouraging trends* in household demand". [My emphasis].

The Bank's $A concerns persist …

Despite the lack of an easing bias, the language around the Australian dollar was among the most strident we have seen. Not only does the Governor predict that a further depreciation seems likely, he also labels it as "necessary". It must have been a disappointment for the Governor to see that the Australian dollar lift to around US 79¢ (from 78.5¢) in the aftermath of the decision. This is clearly the market responding to the final paragraph which signals an end, at this stage, to the easing cycle, thus encouraging them to 'look through' the attempt at jawboning the exchange rate.

… but its policy bias points to …

Those doubting that a cut would be delivered in May placed most emphasis on risks in the housing market. The Governor addresses that issue by pointing out that outside Sydney trends in the housing market have been varied. Once again he emphasised the macroprudential tools that the Australian Prudential Regulation Authority (APRA) is now enforcing within the banking system. It is our view that these guidelines will have a cooling impact on housing markets. For example industry data shows that banks have now increased their lending in the investor segment by 11.5% over the year. Banks are already setting out new tighter guidelines for lending in that space with the likely effect of dampening activity in the sector to some degree.

… 2% being the 'resting place'.

In our previews to the meeting we emphasised that we expect that the Bank will lower its growth forecasts for 2015 and 2016 due to a weaker outlook for business investment, both mining and non-mining. The Governor clearly highlights business investment as the key drag on private demand. This decision has been confirmed in the revised forecasts which have been released in the May Statement on Monetary Policy. Forecast growth in 2015 has been revised down to 2.5% from 2.75% and growth in 2016 has been revised down from 3.5% to 3.25%. These forecasts are based on an assumption of "market pricing" for interest rates. Markets are currently assessing the probability of another cut of 25bps by year's end as 60%. It probably suits the Bank to "frank" that assessment given its concern about the market's response to the closing remark in the Governor's post-meeting statement.

The Fed is a major factor.

For the first time in this cycle the Governor also chose to speculate on the policy of the Federal Reserve, with the expectation that the Fed will be tightening later this year. Clearly that will provide an important contribution to the Governor's expectation that the Australian dollar will depreciate further. Westpac shares that view, with our current expectation that the Fed will begin tightening in September with a follow up move in December.

The evolution of the 2016 GDP forecast …

We have consistently argued that 2% will be 'the resting place' for this easing cycle. The Bank will now take time to assess the sustainability of their current forecast that economic growth in 2016 will exceed 3%. The decision to lower the forecast in the current Statement on Monetary Policy is not an encouraging sign. That is still above trend growth and consistent with stability and an eventual fall in the unemployment rate. For our part the next significant date will be the November Board meeting. Market flirtation with a cut in the September quarter seems premature. By November the Bank will have sufficient information around the momentum in the economy through 2015 for it to assess whether its relatively positive outlook for growth in 2016 can be sustained.

… will determine the next policy phase.

Our current forecast is that despite an ongoing drag from mining and non-mining business investment there will be a sufficient momentum in household demand (both consumption and dwelling investment) to justify a 3% growth rate in 2016. However, with weak income growth, fragile confidence and ongoing headwinds from fiscal policy the risks to this outlook are to the downside. In addition, Australia's ongoing yield advantage over other countries could frustrate the Bank's ambitions to see a substantially lower currency. For the RBA, the Fed's September meeting looms very large.

Australian interest rates

Chart 1.

RBA cash rate, 3 year swap

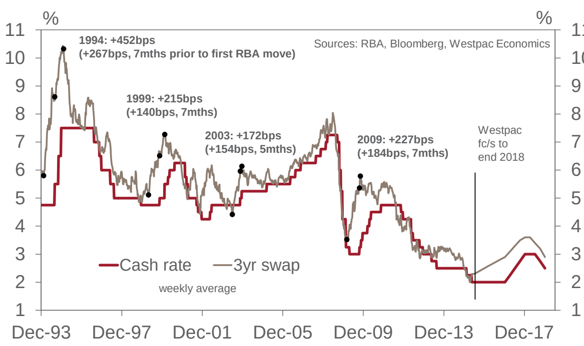


Chart 2.

GDP growth outlook will affect rate policy

% ann	2014	2015	2016
RBA, Nov	2.50	3.00	3.50
RBA, Feb	2.50	2.75	3.50
RBA, May	2.50	2.50	3.25
Westpac	2.50	2.50	3.00

Source: ABS, RBA Statement on Monetary Policy, Westpac Economics

Chart 3.

Confidence: consumers & business

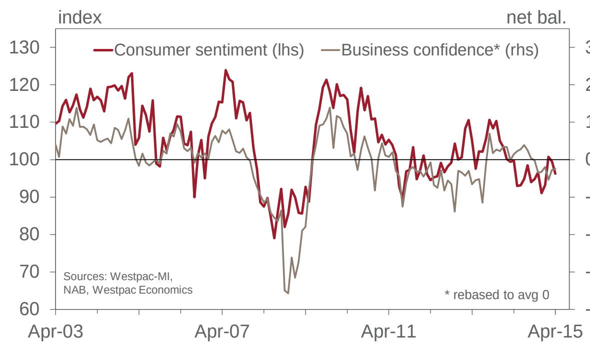


Chart 4.

Core inflation: at 2.4%yr in Q1

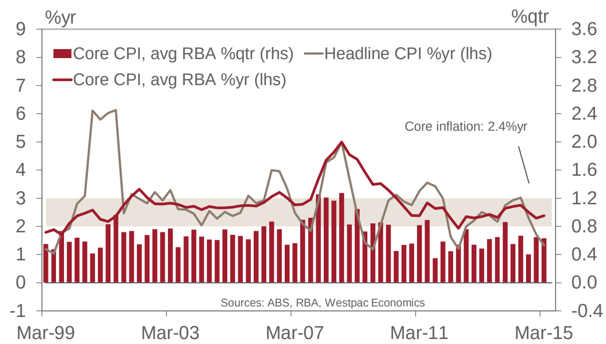


Chart 5.

Consumers' unemployment fears extreme

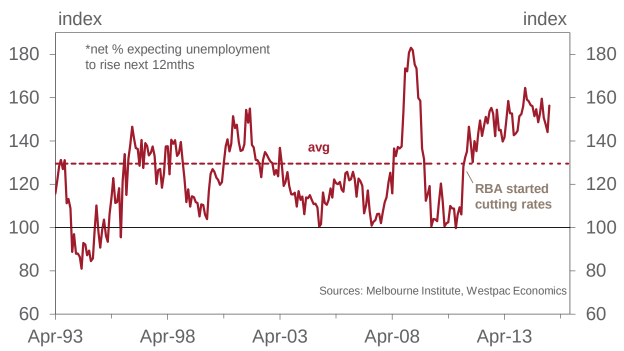
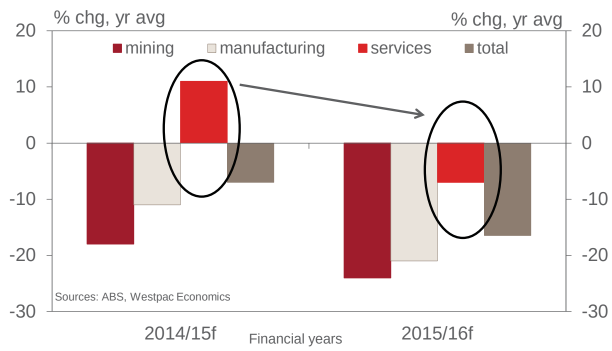


Chart 6.

CAPEX plans – even services looking weak



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Australian dollar

Aussie dollar trading above "fair value" …

We expect that the Australian dollar will fall from its current level of around USD 0.79 to USD 0.72 over the course of the next year. This substantial forecast fall may even be on the conservative side.

A number of factors point towards AUD weakness over the course of the next year. Interest rates, commodity prices and the general movement in the US dollar stand out.

Our own fair value models are pointing to an AUD of around USD 0.70.

… which is US70¢ on our estimates.

An indicator of the "catch-up" required by the AUD to the weakness in commodity prices over the past few years can be gauged by the decline in Australia's basket of commodity exports since the beginning of 2013. Over that period, Westpac's index of Australia's commodity exports has declined by around 45% in USD terms. Over the same period, the AUD has fallen by around 25% against the USD. Now, not all Australia's exports are commodities denominated in USD's. We estimate that around 70% of Australia's exports are denominated in that way.

AUD to fall to US72¢, in a catch-up move.

For the movement in the AUD to fully offset the decline in commodity prices, from an export price perspective, it should have fallen by around 31%. That would see and AUD at around USD 0.72. Now, such a fall would not fully neutralise the impact on the terms of trade from the slump in commodity prices because there will be an increase in import prices associated with the drop in the AUD. Import prices are not as heavily weighted towards the USD as are exports, however, so a fall in the USD value of the AUD would ameliorate some of the impact on the terms of trade of the precipitous fall in commodity prices.

RBA in SoMP indicates "mild" easing bias.

A key reason why the AUD has not adjusted further to the slump in commodity prices is because Australian interest rates are still very attractive to international investors. For example, in March we saw the second largest inflow of capital from Japan in recent years. The markets also "wasted" the recent rate cut from the RBA. Going into the announcement of the May rate cut the AUD was trading at around USD 0.785. With the RBA on the day failing to give any forward guidance markets assumed that the Bank had decided that rates had now bottomed out. Surprisingly markets have not responded to a strong change in stance from the RBA in its Statement on Monetary Policy that was released on May 8. In that Statement the Bank noted that "the Board will continue to assess the outlook and adjust policy as needed". This statement indicated a preparedness by the RBA to move rates if necessary.

We see RBA on hold … but risks to the downside.

Even more importantly, the RBA lowered its growth forecast for 2015 and, in addition, lowered the forecast for underlying inflation to be in the bottom half of the policy target range (2–3%) in 2016. We have not seen the Bank provide such confident medium term guidance for inflation in previous Statements and while our current view is that rates are likely to be on hold throughout the remainder of 2015 and through the course of 2016 the risks are firmly pointing to the downside. To us that is a "mild" easing bias but currency markets are yet to adjust.

For currency markets, US Fed cycle key …

Our view on rates is that while the RBA continues to expect growth in 2016 of 3.25% it is unlikely to see the need to cut again. Our own forecast is for 3% growth – the tipping point from a rate policy perspective. If momentum in the economy, particularly around the household sector, starts to slow through the second half of 2015 then the Bank will find it difficult to maintain its above trend growth forecast and will have to begin cutting rates again. However the likely move would be a total of two cuts, to, say February next year.

… we expect initial move in September …

Perhaps the most important likely development that will impact the AUD over the course of the next year will be the policy of the US Federal Reserve. Markets are currently too complacent about the FED. They are not expecting the FED to begin raising rates until December this year with only two further hikes expected throughout the course of 2016. We expect that the first move will be in September. The US unemployment rate is now in the "full employment" range of 5–5.5% (5.4%) and there is recent evidence that wage pressures have intensified.

… and 150pbs of tightening in 2015, 2016.

Our forecast is that the FED will lift rates twice in 2015 (September and December) and on four more occasions in 2016. Under such a scenario, even with a steady policy from the RBA, the short term yield differential between Australia and the US will narrow from 1.875% to 1.375% in 2015 and 0.875% by mid – 2016. A combination of the market being surprised at the pace of FED hiking, which will lift the USD outright, and a sharp narrowing of the yield differential with Australia, is likely to see the Australian dollar move back towards a level which is more consistent with the commodity price environment.

Australian dollar

Chart 1.

The Australian dollar: actual versus fitted

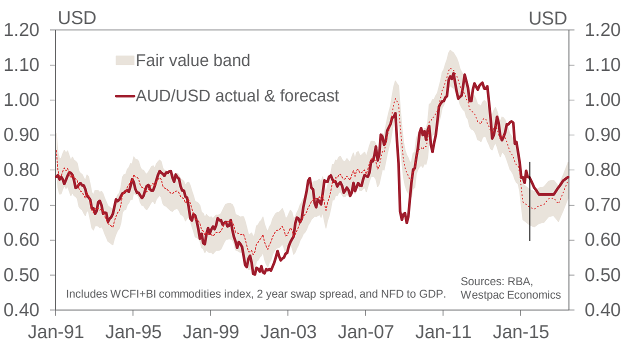


Chart 2.

AUD remains elevated against commodity prices

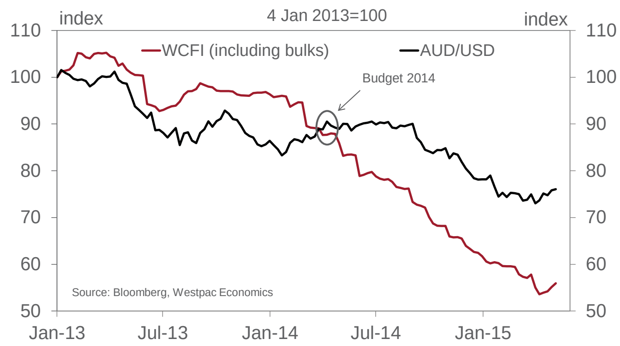


Chart 3.

The US dollar dominates the AUD's direction

Chart 4.

US nearing full employment – range of rate hikes

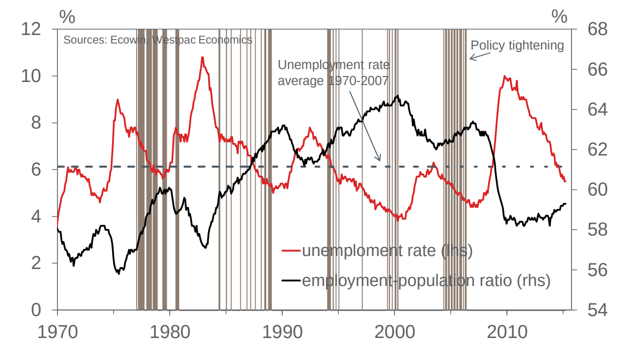


Chart 5.

FOMC normalisation: a long, slow process

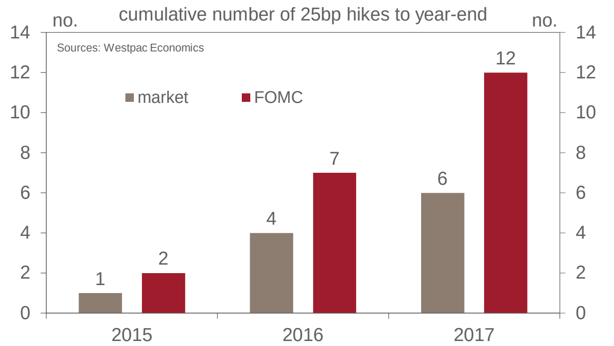
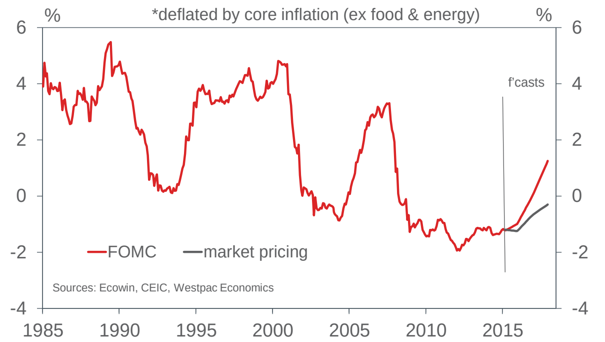


Chart 6.

US real policy rate: FOMC versus the market



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Financial forecasts – Australia

Interest rate forecasts

	Latest (12 May)	Jun–15	Sep–15	Dec–15	Mar–16	Jun–16
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.16	2.20	2.20	2.20	2.20	2.20
3 Year Swap	2.33	2.40	2.50	2.60	2.70	2.75
10 Year Bond	2.84	2.90	2.90	3.00	3.10	3.30
10 Year Spread to US (bps)	70	70	60	50	40	30

Sources: Bloomberg, Westpac Strategy.

Currency forecasts

	Latest (12May)	Jun–15	Sep–15	Dec–15	Mar–16	Jun–16
AUD vs						
USD	0.7910	0.78	0.75	0.73	0.73	0.73
USD forward^	**na**	**0.79**	**0.79**	**0.78**	**0.78**	**0.77**
JPY	94.90	94	92	91	91	91
EUR	0.7059	0.72	0.72	0.72	0.72	0.72
NZD	1.0619	1.04	1.02	1.02	1.02	1.02
CAD	0.9579	0.98	0.98	0.98	0.98	0.98
GBP	0.5124	0.52	0.52	0.51	0.50	0.49
CHF	0.7304	0.74	0.75	0.76	0.77	0.78
DKK	5.2687	5.35	5.33	5.34	5.36	5.36
SEK	6.5701	6.68	6.72	6.73	6.73	6.73
NOK	5.9242	6.08	6.06	6.04	6.01	5.98
ZAR	9.5164	9.36	9.27	9.21	9.21	9.21
SGD	1.0523	1.05	1.01	0.98	0.98	0.97
HKD	6.1330	6.05	5.81	5.66	5.66	5.60
PHP	35.28	34.87	33.90	32.50	32.50	32.39
THB	26.53	26.36	25.51	24.62	24.62	24.50
MYR	2.8472	2.82	2.73	2.64	2.64	2.63
CNY	4.9100	4.84	4.68	4.53	4.53	4.50
IDR	10372	10335	9987	9656	9656	9618
TWD	24.27	24.76	23.40	22.58	22.58	22.47
KRW	861	857	830	800	800	795
INR	50.71	50.31	48.83	46.93	46.93	46.68

*Nominal trade weighted index, with latest data compiling the base. Weights from Reserve Bank of Australia. A reading above (below) 100 indicates a rise (fall) in the AUD.
^Approximate market forward price for AUD/USD, not a forecast. Sources: Bloomberg, Westpac Economics.

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