

Economics Report

3 May 2010

Caton's Corner May 2010

Fix it dear Henry

April was a mixed month for share-market investors. The **ASX 200** fell by 1.4% in the month, while the **US market** moved ahead by 1.5%. Markets around the world continued to worry about Greece and other nations with perceived sovereign debt issues. While I have no perfect insight as to how these issues will be resolved, and while the countries involved (particularly Greece) are likely to bear considerable costs for many years as they struggle to get their fiscal books back into balance, it is difficult to see the world economic recovery being derailed by these issues. The US market made forward progress in the month because its current earnings season has continued to excel. And this is the fundamental point: so long as economic growth continues, earnings will grow and the fundamental value of shares should continue to rise.

On 2 May, the much-awaited so-called "Henry Review" of Australia's tax system was released, along with the Government's reaction to it. I can't possibly do justice to the full length and breadth of the report here. Note that there were 138 separate recommendations made.

The media coverage of the government's response to the Review has, of course, already been extensive. For those keeping score, the Government intends to act immediately on fewer than 10 of the recommendations. 19 have been confined to the "when hell freezes over" category, leaving more than 100 in the "maybe later" basket. This should not be a surprise, even though it may be a trifle disappointing. Such reviews often leave several slow-burning fuses. Several key recommendations of the Asprey review of the tax system, in the mid-1970s, were not implemented until 10-25 years later.

Perhaps of most interest to my readers (both of them!) are the moves related to superannuation. The Government has announced that the Superannuation Guarantee levy will be increased from the current 9% to 12%, with the increase being phased in between 2013 and 2020. Note that this was not a recommendation of the Review! In addition, low-paid workers will get a "top-up" to their accounts, while those over 50 with less than \$500,000 in their accounts will be permitted to contribute up to \$50,000 a year, rather than just \$25,000. And the maximum age for a worker to receive employer payments will be raised from 70 to 75. Good news for my younger brother! All up, the superannuation measures are estimated to add \$85 billion to retirement savings over the next 10 years.

Other measures with investment implications include a phased reduction of the company tax rate (by just 2 percentage points; the Review had recommended 5), and the establishment of an infrastructure fund, worth \$700 million in 2012/13 and growing thereafter. This will facilitate the initiation of major infrastructure projects by State governments.

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There is, of course, always a catch. **All of the above is said to be contingent on the Federal Government's new 40% "resource super profits tax" to be introduced in 2012.** Resource companies won't like this, of course, so there will be much bleating and public brouhaha for some time. The States won't be missing out; they will keep their existing royalties, and companies will get a credit for these in assessing their Federal liabilities.

Implementation of such a tax raises several issues. I'm sure it's more complicated than this, but I see it as recognition that the stuff in the ground belongs to us all, and the tax is a way of fairly allocating the benefits of the new mining boom, which threatens to be around for some time. The detractors will presumably argue, inter alia, that the sector is very capital intensive, and that imposition of such a levy will reduce the attractiveness of the sector, particularly for foreign investors, not only by reducing the rate of return but also by adding to uncertainty.

Meanwhile in other news—how high are interest rates going?

One of the consequences of the dramatic turnaround in commodity prices is that the mining sector is set to grow rapidly again. For some time, we have been told that interest rates need to get back to normal because the Australian economy is getting back to normal. With the unemployment rate already down to 5.3% -- it has been lower for only about four years in the past 35 -- the mining sector can grow fast enough only if growth is slower than otherwise in other areas of the economy.

In addition, we were reminded last week that inflation is coming down only slowly. It's certainly not a problem right now, but we wouldn't want to be starting a new upward trend from here. So the Reserve Bank clearly has more work to do yet. This monthly is always published a day or two before the Reserve Bank's monthly decision, so you get to find out quickly how wrong I can be. I'm not sure what I think about early May; my suspicion is that the Reserve Bank will sit tight for a month, but Terry McCrann is leaning the other way, and he has had a good record lately. Let's just say that the RBA will hike again in May or June!

And then, of course, there's the Budget, to be brought down on the evening of 12 May. After the Government's reaction to the Henry report, there can't be too many surprises left on the tax side. Unusually for an election year, the Government will be focussed on fiscal rectitude. Last year's Budget was released in a crisis atmosphere. Short-term emergency measures needed to be taken with little regard for their long-term consequences. The crisis has now past. So it is imperative that the Government show that it has not strayed to far from the path of fiscal righteousness. It will need to spell out a scenario whereby Budget balance is regained fairly quickly, probably by 2014/15 if not earlier. Given all we now know about the tax side, this implies a focus on, and fairly austere approach towards, spending growth next Tuesday evening.

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