S&P Global
Ratings

RatingsDirect®

Research Update:

Australia Outlook Revised To Negative On Growing Fiscal Vulnerabilities; 'AAA/A-1+' Ratings Affirmed

Primary Credit Analyst:
Craig R Michaels, Melbourne (613) 9631 2082; craig.michaels@spglobal.com

Secondary Contacts:
Anthony Walker, Melbourne (61) 3 9631 2019; anthony.walker@spglobal.com
Anna E Hughes, Singapore (65) 6216-1080; anna.hughes@spglobal.com

Table Of Contents

Research Update:

Australia Outlook Revised To Negative On Growing Fiscal Vulnerabilities; 'AAA/A-1+' Ratings Affirmed

Overview

- The sovereign credit ratings on Australia benefit from the country's strong institutional settings, its wealthy and resilient economy, monetary policy flexibility, and low government debt.
- The country's high external and household indebtedness, as well as vulnerability to weak commodity export demand, moderate these strengths.
- We are revising the rating outlook on Australia to negative from stable because we believe that without remedial action the government's fiscal stance may no longer be compatible with the country's high level of external indebtedness. We are also affirming the 'AAA' long-term and 'A-1+' short-term sovereign credit ratings on Australia and Efic.

Rating Action

On July 7, 2016, S&P Global Ratings revised its rating outlook on the Commonwealth of Australia to negative from stable. At the same time, we affirmed our 'AAA' long-term and 'A-1+' short-term unsolicited sovereign credit ratings on Australia. In addition, we revised the outlook on Export Finance & Insurance Corp. (Efic) to negative from stable and affirmed the 'AAA' long-term and 'A-1+' short-term issuer credit rating on the company. Efic is wholly owned by the government, which guarantees all of its obligations.

Rationale

The negative outlook on Australia reflects our view that without the implementation of more forceful fiscal policy decisions, material government budget deficits may persist for several years with little improvement. Ongoing budget deficits may become incompatible with Australia's high level of external indebtedness and therefore inconsistent with a 'AAA' rating.

Along with strong institutions, a credible monetary policy, and floating exchange rate regime, Australia's public finances have traditionally been a credit strength for the sovereign rating. Since the global financial recession of 2008-2009 and more recently the end of the mining boom, Australia's fiscal position has continued to weaken with successive governments, delaying an eventual return to budget surpluses. Given the outcome of the July 2, 2016, double-dissolution election, in which neither of the traditional governing parties may command a majority in either house, we believe fiscal consolidation may be further postponed.

The central government's current projection date for a balanced budget in fiscal year 2021 (the year ending June 30, 2021) is now eight years later than the previous government's earlier projection of fiscal year 2013, which it made in 2009; and, if achieved, it would come more than 10 years after the global recession initially pushed the central government budget into deficit.

Since this time last year, fiscal deterioration has continued, albeit to a more moderate degree than in earlier years. The government's budget for fiscal 2017 forecasts that budget deficits to be, on average, 0.5% of GDP weaker each year over fiscal years 2016-2019, compared with its previous budget. This also means that, at the central government level, budget deficits have been little changed over the three years to fiscal year 2016.

While we expect that fiscal deficits will improve over the medium term, we are more pessimistic about the central government's revenue outlook than the government was in its latest budget projections. S&P Global Ratings projects iron ore prices to be close to US$20 per metric ton, lower than the level assumed in the government's budget in the remainder of calendar 2016 and in 2017, although the impact on the mining sector's profits may be partly offset by a weaker currency. Aside from commodity prices, we also consider that there remains downside revenue risk if Australia's inflation and wage growth is weak for longer than the budget anticipates. In addition, there remain government savings decisions, equivalent to 0.1%-0.2% of GDP each year, to which the parliament so far has not assented, and may continue to block post-election.

Our fiscal measures incorporate all levels of local, regional, and central government (the general government). At the state government level, we expect fiscal deficits to re-widen in the next couple of years, after narrowing in recent years, largely as states boost their infrastructure spending plans. This is adding to the outlook for general government sector fiscal deficits, although the impact on debt will likely be tempered by state asset privatizations. Overall, we expect net general government debt to remain low but to peak a little higher than we previously thought, at about 23% of GDP, reflecting our revised fiscal outlook. Low interest rates are also helping keep the general government sector's interest expense burden low at less than 5% of revenues.

We consider that Australia's general government sector fiscal outcomes need to be stronger than its peers', and net debt needs to remain lower, to remain consistent with the current 'AAA' rating. This is because Australia's economy carries a high level of net external debt. Several ratios reveal this weakness. Australia's external debt net of public and financial sector assets (our preferred stock measure) is over three times current account receipts (CARs). The current account deficit will reach nearly 5% of GDP this year and only moderate slightly during the forecast horizon to just over 3%. Australia's 2016 gross external financing requirement of US$630 billion is over half of GDP.

That said, Australia's high stock of external debt and structural current account deficits are mostly generated by the private sector and they reflect the productive investment opportunities available in Australia, foreign investor confidence in Australia's rule of law, the high creditworthiness of its banking system, and the positive yield available on highly rated debt. A portion of Australia's external debt has also funded a surge in unproductive household borrowing for housing during the 1990s and 2000s, which was intermediated by the banking sector. Household debt (including debt for small businesses) now stands at more than 180% of household income.

We expect Australia's external borrowers to maintain easy access to foreign funding. We note that the Reserve Bank of Australia (RBA, the central bank) has maintained a freely floating exchange rate regime for over three decades; that the Australian dollar represented 1.9% of allocated international reserves as of March 31, 2016; and that the currency is represented in a comparable percentage of spot foreign exchange transactions.

We consider Australia's banking system to be one of the strongest globally, and assign a Banking Industry Country Risk Assessment score of '2' (on a scale of '1' to '10', with '1' being the lowest risk). Australia's domestic bond market is deep and although external borrowing is high it is mostly denominated in the nation's own currency or hedged.

We also view Australia as possessing a high degree of monetary credibility. This key credit strength helps the country to attenuate major economic shocks—as could come, for example, from a sharp downturn in China's economy or a slump in Australia's property market. The RBA's success in anchoring inflation expectations would, we believe, allow it to lower policy interest rates from their current level of 1.75% to support growth even should the currency weaken further, given the historical low pass-through to inflation.

Australia is a wealthy, diversified and resilient economy, with GDP per capita of an estimated US$51,000 in fiscal year 2016. This high level of wealth derives from strong institutional settings and decades of economic reform, which have facilitated the country's flexible labor and product markets. The economy's resilience and flexibility, we believe, ultimately help cushion government finances from economic shocks and are a major support to Australia's creditworthiness.

Economic growth is now lifting after a period of below-trend economic performance. We estimate headline GDP growth to be around 3% in fiscal year 2016, and the unemployment rate has fallen from last year's cyclical high. Significant currency depreciation is spurring services exports, particularly education and tourism. Low nominal interest rates, coupled with pent-up underlying demand, have been encouraging growth in dwelling investment for some time, and household consumption growth has strengthened. And while resources investment is still falling, resource export volumes keep rising as new capacity is brought on line--even though commodity export prices are much weaker than before. We expect growth to remain firm over our forecast period, and project real per capita GDP growth to average about 1.3% per year over 2016-2019.

The outlook on Efic is reflective of our equalization of the ratings on the company with the sovereign ratings due to the legislative guarantee the government provides over Efic's obligations.

Outlook

The negative outlook on Australia reflects our view that prospects for improvements in budgetary performance have weakened following the recent election outcome, and that general government sector deficits may remain material over our forecast period, with government debt continuing to rise, unless more budget savings measures are legislated or there are improvements in the revenue outlook.

There is a one-in-three chance that we could lower the rating within the next two years if we believe that parliament is unlikely to legislate savings or revenue measures sufficient for the general government sector budget deficit to narrow materially and to be in a balanced position by the early 2020s. We will continue to monitor, over the next six to 12 months, the success or otherwise of the new government's ability to pass revenue and expenditure measures through both houses of parliament.

We could also lower the rating with any further weakening of Australia's external position. This could come from current account deficits remaining at the higher end of the historical range, from a further weakening of terms of trade, or from an increase in the banking sector's cost of external funding.

The ratings could stabilize if new budget savings or revenue measures were enacted that appeared sufficient to reduce fiscal deficits materially over the next few years. A sharp narrowing of current account deficits and external debt due to a favorable export performance could also cause us to change the outlook to stable, although this appears unlikely over the next two years.

Key Statistics

Table 1

Commonwealth of Australia -- Selected Indicators											
	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
GDP (nominal) (bil.)	1,259	1,297	1,410	1,490	1,524	1,586	1,611	1,644	1,720	1,821	1,913
GDP per capita (US$)	42,733	51,853	62,226	67,606	67,640	62,045	56,362	49,655	51,532	52,808	55,701
Real GDP growth (%)	2	2	2	4	2	2	2	3	3	3	3
Real GDP per capita growth (%)	(0)	0	1	2	1	1	1	2	1	1	1
Chg in GG debt/GDP (%)	5	6	4	6	3	5	4	2	3	2	1
GG balance/GDP (%)	(3)	(5)	(4)	(4)	(3)	(3)	(2)	(3)	(3)	(2)	(1)

Table 1

Commonwealth of Australia -- Selected Indicators (cont.)											
	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
GG debt/GDP (%)	14	19	22	27	29	33	36	38	39	39	39
Net GG debt/GDP (%)	(1)	3	6	12	13	16	18	20	22	23	23
GG interest paid/GG revenues (%)	2	2	3	3	4	4	4	4	4	4	4
Other DC claims on resident non-govt. sector/GDP (%)	148	149	145	149	152	155	165	175	180	182	186
CPI growth (%)	3	2	3	2	2	3	2	1	2	2	2
Gross ext. fin. needs/CAR + use. res. (%)	260	235	214	231	234	231	257	275	269	260	252
Current account balance/GDP (%)	(3)	(5)	(3)	(3)	(4)	(3)	(4)	(5)	(4)	(4)	(3)
Current account balance /CAR (%)	(13)	(22)	(13)	(14)	(17)	(13)	(16)	(21)	(19)	(15)	(14)
Narrow net ext. debt/CAR (%)	237	264	253	236	240	270	273	317	306	295	280
Net external liabilities/CAR (%)	224	243	239	220	211	236	223	276	279	278	273

The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting our independent view on the timeliness, coverage, accuracy, credibility and usability of available information. *Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus non-resident deposits at the end of the prior year plus long-term external debt maturing within one year. Narrow net external debt is defined as the stock of foreign and local currency public and private sector borrowings from non-residents minus official reserves minus public-sector liquid assets held by non-residents minus financial sector loans to, deposits with, or investments in non resident entities. A negative number indicates net external lending. CAR--Current account receipts. CPI--Consumer price index. GG--General government e--Estimate. f--Forecast.

Ratings Score Snapshot

Table 2

Ratings Score Snapshot	
Key rating factors	
Institutional assessment	Strength
Economic assessment	Strength
External assessment	Weakness
Fiscal assessment: flexibility and performance	Neutral
Fiscal assessment: debt burden	Strength
Monetary assessment	Strength

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of S&P Global Ratings "Sovereign Rating Methodology," published on Dec. 23, 2014 , summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with our sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009
- Criteria - Financial Institutions - General: Issue Credit Rating Methodology For Nonbank Financial Institutions And Nonbank Financial Services Companies - December 09, 2014
- Criteria - Financial Institutions - General: Nonbank Financial Institutions Rating Methodology - December 09, 2014
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions - July 17, 2013
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks - May 04, 2010
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks - March 23, 2004
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Rating Sovereign-Guaranteed Debt - April 06, 2009
- General Criteria: Methodology: Timeliness Of Payments: Grace Periods, Guarantees, And Use Of 'D' And 'SD' Ratings - October 24, 2013

Related Research

- "Sovereign Risk Indicators" at http://spiratings.com/sri
- Asia-Pacific Sovereign Debt Report 2016: Borrowing of US$2.5 Trillion Is Likely This Year, Feb. 29, 2016
- Global Sovereign Debt Report 2016: Borrowing To Drop By 2% To US$6.7 Trillion, Feb. 29, 2016
- Asia-Pacific Sovereign Rating Trends, January 2016, Jan. 18, 2016
- Global Sovereign Rating Trends 2016, Jan. 6, 2016
- 2014 Annual Sovereign Default Study And Rating Transitions, May 18, 2015

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the fiscal assessment had deteriorated. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

********************** Australia (Commonwealth of) *********************

Ratings Affirmed

Australia (Commonwealth of)	
Transfer & Convertibility Assessment	
Local Currency |U	AAA
Export Finance & Insurance Corp.	
Senior Unsecured	AAA
Commercial Paper	A-1+

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Australia (Commonwealth of)		
Sovereign Credit Rating |U	AAA/Negative/A-1+	AAA/Stable/A-1+
Export Finance & Insurance Corp.		
Counterparty Credit Rating	AAA/Negative/A-1+	AAA/Stable/A-1+

|U Unsolicited ratings.

This unsolicited rating(s) was initiated by a party other than the Issuer (as defined in S&P Global Ratings' policies). It may be based solely on publicly available information and may or may not involve the participation of the Issuer and/or access to the Issuer's internal documents. S&P Global Ratings has used information from sources believed to be reliable based on standards established in our policies and procedures, but does not guarantee the accuracy, adequacy, or completeness of any information used.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column.