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■ Central bankers meet

■ S&P defends rating cut

■ China-US economy tensions

Crisis talks on market turmoil

Adrian Rollins and John McDuling

European bank officials were locked in talks last night amid plans for a conference call of Group of Seven finance ministers to calm financial markets after the shock US debt downgrade and deepening concern about Europe's sovereign debt.

After a week in which \$US2.5 trillion was wiped off the value of global stockmarkets, investors want the European Central Bank to stand behind Italian and Spanish government bonds after Italy brought forward spending cuts to bring its budget into balance in 2013, a year ahead of schedule.

The European meetings came as a row erupted over the unprecedented decision by ratings agency Standard & Poor's to lower the US government's long-term debt rating from AAA to AA+ because of concerns about the ability of the political system to achieve agreement on action to rein in government debt.

Investors are looking to the major governments and central banks to provide leadership on ways to resolve the debt crises on both sides of the Atlantic, but prospects for political co-operation have been dented by a strong attack from China on America's economic management.

Australian markets will this morning be among the first to pass judgement on the historic ratings downgrade, in the first session following a confidence-shattering plunge for the sharemarket on Friday.

"It's uncertain to me how the market will take this downgrade," said Perpetual Investments head of



Nervous investors will be watching to see how the US market reacts to the downgrade.

Photo: BLOOMBERG

equities Matt Williams. "People will probably want to wait and see how the US market reacts to the news. I think European banks' exposure to sovereign debt is what's really driving things."

Senior S&P officials defended the decision to downgrade the US rating because of the inadequacy of the measures agreed to last week as part of the deal to raise the government debt ceiling and scepticism about the

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Surplus vow put at risk

Adrian Rollins
Economics correspondent

Economists have warned that the federal government's pledge to return the budget to surplus in 2012-13 is in "big trouble" after the Reserve Bank of Australia substantially downgraded the nation's short-term growth prospects.

Company tax revenue is likely to have been hit hard by unexpectedly soft economic activity, with the RBA slashing its 2011 gross domestic product growth forecast by 1.25 percentage points to 2 per cent because of big delays in restoring flood-hit coal production and weak consumer spending.

The International Monetary Fund has backed the central bank's revised assessment of activity, matching its forecast for 2 per cent growth this year before a rebound to 3.5 per cent in 2012 because of strong resources-related investment and production that will be sufficient to hold the unemployment rate below 5 per cent during the next 18 months.

Macro-economics director Stephen Anthony said every 0.5 of a percentage point drop in GDP knocked up to \$5 billion from the budget bottom line, and "if that is right, then they [the government] are in big trouble".

Mr Anthony said that the RBA's

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ECONOMIC WOES

'Australia should stand out to global investors as one of the best plays around. Yet there is a potential downside for Australia.'

Alan Mitchell, page 4

'America's economy is sadly lacking self-sustaining growth drivers, while macro-economic policy is badly misaligned.'

David Bassanese, page 17

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Labor's surplus pledge put at risk

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forecast "almost certainly puts the government's target in jeopardy", because even if growth bounces back as anticipated next year, it will be coming from a much lower base than expected, and "it's actually the nominal level of the economy that determines revenues".

In its budget in May, the government forecast the deficit would shrink from almost \$50 billion to \$22.6 billion this financial year before reaching a small surplus of \$3.5 billion in 2012-13, and Treasurer Wayne Swan yesterday reaffirmed the government's fiscal strategy, which was endorsed by the IMF as part of its annual assessment of the economy, released on the weekend.

"The IMF commends the government's fiscal strategy to return the budget to surplus in 2012-13 despite the impact of natural disasters," Mr Swan said. "While the global situation will make things more difficult, the government remains committed to delivering our return to surplus as planned."

But in revised forecasts issued late last week, the RBA warned that the effect of January's floods alone was likely to have subtracted 1.75 percentage points from growth. This, combined with cautious household behaviour, the unwinding of federal stimulus spending, the high dollar and slower population growth, was likely to mean the cumulative rise in GDP in the three years to the end of 2013 would be 1 percentage point lower than it would otherwise have been.

Deloitte Access Economics partner Chris Richardson said the weaker growth outlook meant that the federal government's forecast for a return to surplus in 2012-13 was now "fraught with risk".

Mr Richardson said that although the hit to the budget bottom line from slower growth and increased spending was "not big", it increased doubts about whether the government could achieve its target of a \$3.5 billion surplus next financial year.

"The 'must-have' surplus in 2012-13 remains in the lap of the gods, if not the Chinese, in the sense that it's a wafer-thin margin," Mr Richardson said. "It is not important to the economics of this, but it is to the politics."

The economist, who has forecast growth will reach 3.5 per cent this financial year after a weak 1.9 per cent expansion in 2010-11, said that

the hit to growth and company tax revenue from delays in returning Queensland's flood-hit coal industry to full production was essentially a one-off event that would eventually pass.

More concerning, he said, was the drag on activity from weakness in much of the economy outside the booming resources sector, which would have a "more genuine ongoing effect".

Mr Richardson said the country was still receiving a massive boost to income from the soaring terms of trade, but there were "issues afoot" that would affect the government's hopes of achieving a surplus in 2012-13.

"[Reaching the surplus] is fraught with risk, but there is nothing yet that is a killer blow," he said.

Citigroup economist Paul Brennan warned that the government would have to make deeper spending cuts to offset the drop in company tax revenue and increased expenditure on reforms such as the carbon tax compensation package if it were to achieve its surplus target.

Mr Brennan questioned whether it was wise for the government to stick to its target, given the extent of weakness in much of the economy.

In its Statement on Monetary Policy, the RBA noted that an "important factor affecting the outlook is the tightening in fiscal policy", which involved a huge turnaround in the budget position between 2010-11 and 2012-13 of about 4 per cent of GDP.

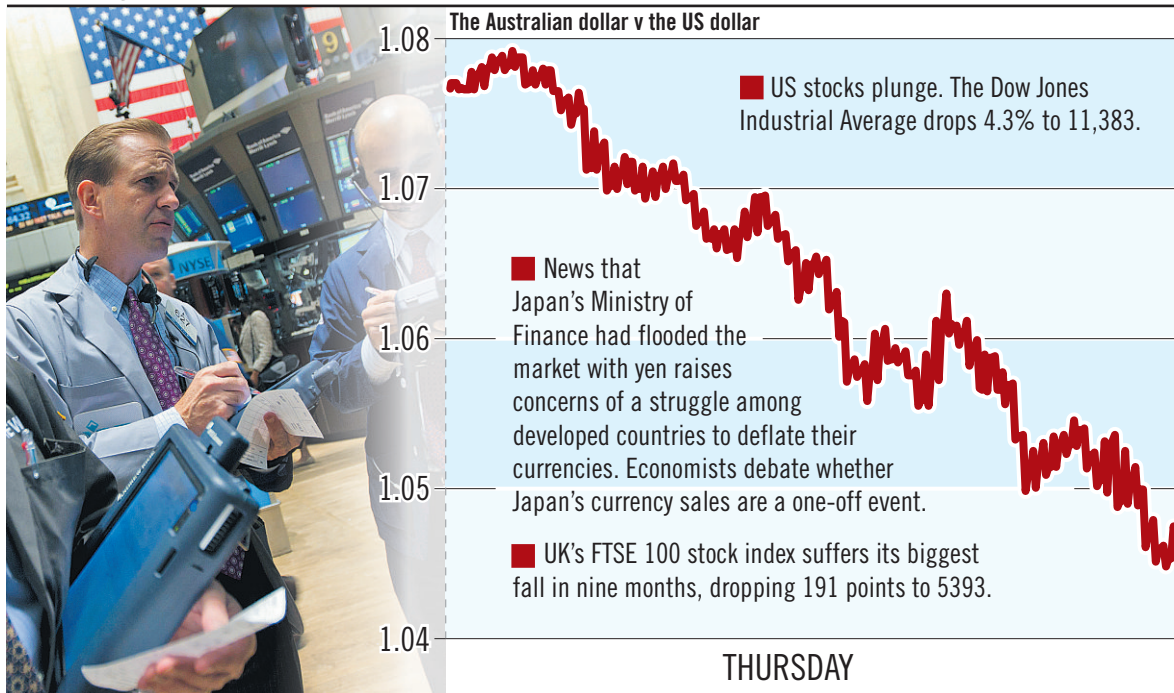
Mr Brennan said the government should reassess its position.

"The comments by the RBA suggests to us that they see [the budget turnaround] as adding to the downward pressure in the weak parts of the two-speed economy, and you have to ask whether that is a sensible thing to do," he said.

But the IMF has urged the government to stick by its budget plans, arguing that strong growth prospects in resources-related parts of the economy mean the pressure on inflation will build and that "macro-economic policy should continue to make room for a strengthening economy and not compound the emergence of capacity and price pressures".

Far from abandoning the surplus target, the IMF said, the government should set more ambitious goals for fiscal consolidation, and it called for average surpluses of more than 1 per cent of GDP beyond 2013-14.

Four days which shook the world



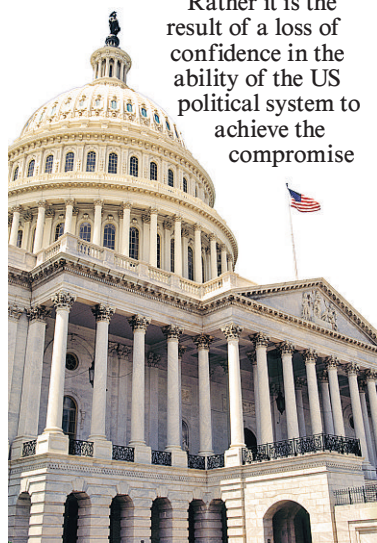
Lessons in vulnerability

The US downgrading is also a wake-up call for politicians in Europe and our own region, writes **Alan Mitchell**.

"The political brinkmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed," Standard & Poor's said on Friday.

Its decision to downgrade the US government debt is not primarily about the results of its hotly disputed number crunching.

Rather it is the result of a loss of confidence in the ability of the US political system to achieve the compromise



necessary for responsible economic management.

It is that loss of confidence in the political process that changes the debt ceiling agreement from "a first step," as President Barack Obama sees it, to insufficiency in the eyes of Standard & Poor's.

America's system of separated power frequently requires the two major parties to share responsibility for the government of the country while simultaneously contesting the political field.

It is a model that relies on a largely shared vision, and a willingness to observe the unwritten rules of the political cartel. The emergence of the Tea Party has broken that comfortable consensus.

Now, a horrified Standard & Poor's says, the statutory debt ceiling and the threat of default have become political bargaining chips and politicians "remain wary of tackling the structural issues required to effectively address the rising US public debt burden in a manner consistent with a triple-A rating".

If American investors, businesses and consumers come to share that loss of confidence, the impact on the US economy will exceed the technical increase in the cost of public borrowing.

This is a wake-up call not just for the US political establishment, but for politicians in Europe and our own region. The Americans' reliance

on growth to make their public debt sustainable is being undermined by Europe's failure to resolve its sovereign debt crisis. That, in turn, will rebound on the Europeans, since they too are relying heavily on global growth.

Europe, which was rebuilt and kept secure by the generosity of the American taxpayer, must now pull its weight.

China, which is criticising the US for its addiction to debt, conveniently forgets its own contribution to the problem. Fortunately for Australia, China has the capacity to generate its own growth in a period of prolonged global weakness, just as the US did in the last decade.

Julia Gillard's government rightly points to the strength of the Australian economy and its public finances. Australia should stand out to global investors as one of the best plays around. Yet there is a potential downside for Australia in the form of softer commodity prices, weaker global equity markets, and perhaps a heightened sense of the risk of investing in a small, capital-importing, commodity-dependent economy.

The crisis in Europe and the US downgrade should be a reminder to the federal government of how little it has done to correct Australia's woefully weak productivity growth, and how dependent we are on one country's boom.