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Global Aging 2010: Australia

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Table Of Contents

Global Aging 2010: Australia

- An aging population, combined with a shrinking workforce, implies escalating pressures on Australia's long-term fiscal position.
- Total age-related spending on health, pensions, and aged care are expected to rise to 14.4% of GDP in 2050, from 9.6% in 2010. Without further reforms to address these mounting spending pressures, net general government debt could increase to 71% of GDP over the period, potentially weakening Australia's long-term credit quality.
- Australia is ahead of many peers in addressing these challenges, through reforms directed at raising productivity and workforce participation; promoting greater health-care system efficiency; pre-funding government employee pension entitlements; and mandating the long-term self-provision of retirement incomes.

Standard & Poor's Ratings Services' analysis of Australia is part of a global study conducted to analyze the cost of aging. We presented our findings in "Global Aging 2010: An Irreversible Truth," published Oct. 8, 2010, on RatingsDirect. The study explores various scenarios--including the no-policy-change scenario--and the implications that we currently believe these different scenarios could have on sovereign ratings over the next 40 years. We included an additional 17 sovereigns in this year's report, which expanded the scope of the study's coverage to more than two-thirds of the world's population. For the 32 sovereigns that we included in the first edition of our global aging special report in 2006, our findings this year provide an update of our analyses--including information on long-term demographic, macroeconomic, and budgetary trends, all in the context of the countries' current fiscal positions. We've also published the methodology of our study, which details the simulation model, assumptions, and data sources we used (see "Global Aging 2010: An Irreversible Truth--Methodological And Data Supplement," published Oct. 8, 2010).

Results For Australia

The analysis suggests that in Australia, the old-age dependency ratio will rise to 40% in 2050, from 21% in 2010 (see table). (The old-age dependency ratio is the number of people 65 and older divided by the number of those 15 to 64.) Overall, unlike many of its 'older world' peers, we expect the population will continue to rise, reaching about 28.7 million in 2050. The share of the working age population is projected to fall, however, to 59.6% by 2050, from the current 67.2%.

In our view, an aging population will likely place substantial pressure on economic growth and public finances. State pensions and demand for publicly provided health care and long-term care services could increase. Without further government reforms (which is our base-case scenario), total age-related public expenditures in Australia are projected to rise to 14.4% of GDP in 2050, from 9.6% in 2010. This 4.8% increase as a percentage of GDP is less than the expected 7.8-percentage-point increase for the median of our 49-sovereign sample. We expect that the bulk of Australia's age-related spending will go toward health-care outlays, followed by pension expenditures (see table). In our view, the increase in age-related spending in Australia will be moderate until the early 2030s, when spending will likely grow at a faster pace as more people enter retirement age.

Our projection of a gradually increasing trend in age-related spending until 2030 suggests a relatively stable budget in the long term. Nevertheless, if unmanaged, the weight of general government spending--including social security--could rise significantly as age-related spending increases, and as the interest bill, deficits, and debt mount.

Our analysis suggests that without further fiscal or structural policy reforms, net debt could rise to 71% of GDP by 2050 in Australia. However, this is still well below the sample median of 245% of GDP.

Our Base-Case Scenario's Expected Impact On The Ratings

Such macroeconomic and fiscal dynamics would nonetheless imply a change to the current 'AAA' long-term foreign currency sovereign rating on Australia. Based on the fiscal projections of our study, we derived hypothetical sovereign credit ratings for Australia (see table). In practice, Standard & Poor's takes a large number of factors into consideration when determining sovereign credit ratings (see "Sovereign Credit Ratings: A Primer," published May 29, 2008). In the very long term, however, prolonged fiscal imbalances and wealth (as measured by GDP per capita) tend to become the dominant factors. Using this approach, our 'AAA' rating on Australia would likely come under increasing pressure in around 20 years. By 2040, we expect that Australia's fiscal indicators will have weakened such that they would be more in line with sovereigns currently rated in the 'AA' category. In our view, the projected improvement in GDP per capita over the period would not be able to offset the potential fiscal deterioration. That said, our analysis implies that Australia and its closest peer, Switzerland, would be the last two 'AAA' rated sovereigns hypothetically moving into the 'AA' and 'A' categories, respectively by 2040.

When comparing our results for Australia with what we found in 2006 and 2007, it seems that future budgetary challenges now appear to be somewhat more important than they were a few years ago. This is a result of several factors. Two of the main reasons are the worsening of the country's budgetary position since 2006/2007, as well as an increase in health-care spending stemming from nondemographic factors.

Alternative Scenarios Could Result In Drastically Different Economic And Fiscal Prospects

In addition to our base-case, we have considered several other long-term scenarios (see table). One of these scenarios is Australia undertaking radical structural reforms. In this scenario, the government would freeze all age-related spending (as a percentage of GDP) at current levels, while maintaining a balanced budget by 2016. This upside would also include higher economic growth, persistently lower real interest rates, or creditors demanding risk spreads as a function of Australia government debt ratio. Based on this analysis, fiscal indicators in Australia appear to hold up better if the government were to undertake structural reforms to prevent age-related spending from rising or move to consolidate its budget for a sustained period.

Returning to operating surpluses could go a long way in helping to reduce the government's debt burden

Factors that could affect a country's sustainability gap are useful in our analysis to better understand the fiscal burden. The sustainability gap is the difference between the current government's structural primary balance and the one that guarantees the sustainability of public finances. (For more details, see "Global Aging 2010: An Irreversible Truth--Methodological And Data Supplement," published Oct. 8, 2010.) In our base-case scenario, the sustainability gap in 2012 is 3.8% of GDP for Australia, which is well below the median for the advanced economies' sample of 8.5%. As a result, Australia would appear to require an average structural primary balance of 4.3% of GDP from 2010 to 2015 to close its sustainability gap. This compares with our current expectation for Australia to post a deficit of 3.2% of GDP in 2010. In our view, the main factors that determine the sustainability gap is the initial budgetary position, which implies that focusing on consolidating the budget and reforming the social security system would likely have the greatest impact on this measure. Nevertheless, as our upside scenario--maintaining a balanced budget in 2016--shows, fiscal consolidation could significantly contribute to Australia reducing its future debt burden.

The Effects Of Age-Related Spending On Sovereigns' Future Creditworthiness

The base-case scenario is not a prediction. Rather, it is a simulation that highlights the importance of age-related spending trends as a factor in the evolution of sovereign creditworthiness. In our view, it is unlikely that governments would, as a general matter, allow debt and deficit burdens to spiral out of control or that creditors would be willing to subscribe to such high levels of debt. Historically, once governments are confronted with unsustainably rising debt burdens, they usually react by tightening their fiscal stances or reforming their expenditure programs.

Australia's high fiscal flexibility, underpinned by low public debt and strong fiscal discipline, leaves it well placed to respond to the challenges associated with its aging population. Australia is ahead of many peers in addressing these challenges, through reforms directed at raising productivity and workforce participation. It is also investing to expand and improve the efficiency of its health-care system. Longer-term fiscal consolidation will benefit from the continued build-up of assets to fund government pension obligations, of which the central government's unfunded component was well below most 'AAA' rated peers, at about 9.2% of GDP at June 2010. Other structural adjustments to government finances to address spending pressures of an aging population include mandating the long-term self-provision of retirement incomes by individuals and tightening access to publicly funded pensions through means tests and raising the pension age.

In our view, Australia's progress in implementing structural adjustments may drive the momentum for it to maintain its long-term fiscal sustainability and creditworthiness.

Australia--Aging Population Data And Scenario Outputs

	2010	2015	2020	2025	2030	2035	2040	2045	2050
Demographic and economic assumptions									
Population (mil.)	21.5	22.6	23.7	24.7	25.7	26.5	27.3	28	28.7
Working-age population (% of total)	67.2	65.9	64.5	63	61.7	61	60.2	60	59.6
Elderly population (aged over 65; % of total)	14.1	15.8	17.4	18.9	21.0	22.0	22.9	23.4	23.8
Old-age dependency ratio (%)	21.0	24.0	27.0	30.0	34.0	36.0	38.0	39.0	40.0
Real GDP (% change)	3	3.1	2.7	2.7	2.6	2.6	2.5	2.4	2.3
Age-related government expenditure (% of GDP)									
Pensions	4.1	4.1	4.1	4.4	4.6	4.8	4.9	5	5.1
Health care	4	3.9	4.1	4.45	4.8	5.4	5.9	6.5	7.1
Long-term care	0.8	0.8	0.9	1.05	1.2	1.4	1.6	1.7	1.8
Unemployment benefits	0.7	0.5	0.5	0.5	0.5	0.45	0.4	0.4	0.4
Total	9.6	9.3	9.6	10.4	11.1	12.0	12.8	13.6	14.4
Scenario 1: Base-case (% of GDP)									
Net general government debt	11	10	7	7	11	19	32	49	71
General government balance	(3.2)	0.2	0.1	(0.6)	(1.5)	(2.7)	(4.2)	(5.7)	(7.5)
General government expenditure	33.2	33.8	33.9	34.6	35.5	36.7	38.2	39.7	41.5
Interest payments	0.8	0.7	0.4	0.4	0.5	0.9	1.4	2.2	3.2

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Australia--Aging Population Data And Scenario Outputs (cont.)									
Hypothetical long-term sovereign rating	AAA	AAA	AAA	AAA	AAA	AA	AA	A	A
Sustainability indicators									
Initial budgetary position	(0.5)								
Long-term change in budgetary position	4.3								
Sustainability gap	3.8								
Scenario 2: Balanced budget in 2016 (% of GDP)									
Net general government debt	11	10	8	8	12	21	33	51	73
General government balance	(3.2)	0.1	0.0	(0.7)	(1.6)	(2.8)	(4.3)	(5.8)	(7.7)
Hypothetical long-term sovereign rating	AAA	AAA	AAA	AAA	AAA	AA	AA	A	A
Sustainability indicators									
Initial budgetary position	(0.5)								
Long-term change in budgetary position	4.4								
Sustainability gap	4.0								
Scenario 3: No additional age-related spending (% of GDP)									
Net general government debt	11	10	7	5	2	(0.4)	(3.2)	(6.0)	(8.9)
General government balance	(3.2)	(0.0)	0.2	0.3	0.4	0.5	0.7	0.8	0.9
Hypothetical long-term sovereign rating	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
Scenario 4: Lower interest rate (% of GDP)									
Net general government debt	11	10	7	7	10	18	29	45	64
General government balance	(3.2)	0.2	0.2	(0.6)	(1.4)	(2.5)	(3.8)	(5.1)	(6.7)
Hypothetical long-term sovereign rating	AAA	AAA	AAA	AAA	AAA	AAA	AA	AA	A
Scenario 5: Discriminating investors (% of GDP)									
Net general government debt	11	10	7	7	11	19	31	48	69
General government balance	(3.2)	0.2	0.1	(0.6)	(1.5)	(2.6)	(4.0)	(5.6)	(7.5)
Hypothetical long-term sovereign rating	AAA	AAA	AAA	AAA	AAA	AAA	AA	A	A
Scenario 6: Higher growth (% GDP)									
Net general government debt	11	10	7	7	11	18	30	47	67
General government balance	(3.2)	0.2	0.1	(0.6)	(1.5)	(2.7)	(4.1)	(5.6)	(7.4)
Hypothetical long-term sovereign rating	AAA	AAA	AAA	AAA	AAA	AA	AA	A	A

Related Criteria And Research

- Global Aging 2010: An Irreversible Truth, published Oct. 8, 2010
- Global Aging 2010: An Irreversible Truth--Methodological And Data Supplement, published Oct. 8, 2010
- Full analysis: Australia (Commonwealth of), published Sept. 23, 2010
- Australia's External Debt Is A Weakness But The Credit Risk Is Ameliorated, And Here Are Nine Reasons Why, published Sept. 23, 2010
- Australia's Economic Recovery Has Been Strong, But Can It Sustain The Momentum?, published Sept. 14, 2010
- The Australian Economy: Base Metals Fuel Moderate Growth, published March 4, 2010
- Criteria For Determining Transfer And Convertibility Assessments, published May 18, 2009
- Rating Sovereign-Guaranteed Debt, published April 6, 2009

- Sovereign Credit Ratings: A Primer, published May 29, 2008