Budget 2016-17

Comment

This Budget clearly has a political as well as economic dimension – and in particular is framed against the assumption of an upcoming election. As such it is really an exercise in selected refocusing outlays and receipts to achieve the Governments focus of “growth and jobs” – but achieved within a realpolitik framework of burden sharing and keeping debt at sustainable (AAA) levels. The current environment means there is little scope for large structural reforms. And with a Budget not likely to get back to surplus by 2020/21 – and then only marginally – it clearly remains vulnerable to the vagaries of the economic cycle.

Key measures are largely as “signaled” in recent days. On improving the ‘equity front”: there is the raising of the 32.5% personal income threshold from 80k to 87k (to help offset some effects of bracket creep), tougher rules on top end superannuation (lowering the threshold for the higher tax on super from $300k to $250k and imposing annual and lifetime caps on extra super contributions) and easing the tax treatment of super for lower to middle income contributors. Also on the equity theme is stricter enforcement of multi-national tax (essentially a “Google tax with diverted income to be taxed at 40%)

On the adding to “growth” theme is business tax cuts (from 28.5% to 27.5% for small and middle business (with the turnover threshold raised to $10m). Thereafter the turnover limit is progressively raised till all business gets the rate by 2023/34 and the rate then falls to 25% in 2024/25. There is an extra benefit in that the investment tax right off has been extended for an extra year. That said, the size of the near term cuts are limited (around $5.3bn over 4 years) – and our modeling suggests very small near term benefits. There is also extra money for infrastructure $5bn; extra money for health ($2.9bn); and education ($1.2bn – albeit much less than full Gonski). Also helping to repair the Budget bottom line is the (12½%) increase in tobacco taxation.

Outlays remain under 26% of GDP before moving a touch lower in the long run. By way of context, outlays peaked at around 27% during the GFC stimulus and before that around 23% of GDP. Revenue still does most of the repair job on the budget balance with a combination of policy and economic recovery. Overall net debt peaks a touch higher in 2019 at 19.2% (previously 18.5%) and starts to edge lower thereafter. Rating agencies have been much more guarded in their reaction than usual. As set out in the “Medium Term Economic Outlook” the Budget would represent a slight drag on economy going forward (around ½% per annum) and as such is probably doable.

Of course the Budget may not be the final word on medium term fiscal sustainability given the forthcoming election campaign. Our bottom line is there is not a lot of scope for pulling further “rabbits from the hat”. And that Budget repair will be a long and difficult “slog” given the economic environment. We are more cautious in 2018/19 forecasts

Fiscal Outcome

Estimates of the underlying cash deficit are slightly larger at A$39.9bn (2.2% of GDP) in 2015/16 and $37.1bn (2.4% of GDP) in 2016/17 (slightly below market expectations – but near NAB’s). The projected deficit then moves down through the out-years with an eventual return to surplus in 2021/22.

Economic Outlook

There is little fundamental difference between Treasury’s and NAB’s economic forecasts in the next few years. A sharp increase in commodity export volumes, offset by subdued domestic demand, remains the common theme. However, NAB forecasts shift notably more pessimistic as we move into the forward projections (from 2018-19) reflecting significant headwinds as LNG exports reach their peak band the dwelling construction reduces. Over the forward estimates, expectations for the unemployment rate are similar, easing to around 5½% in the near-term before stabilizing. On the nominal GDP forecasts, NAB and Treasury expectations are similar in 2016-17 (around 4¼%) but the Treasury’s 2017-18 forecasts are more optimistic. A real concern for the Budget repair path.

Financial Markets

There was little discernible market reaction to the Budget. Ratings agencies have been circumspect in their initial reaction to the Budget, and have not provided their typical rubber stamp, most choosing instead to allow more time for analysis.

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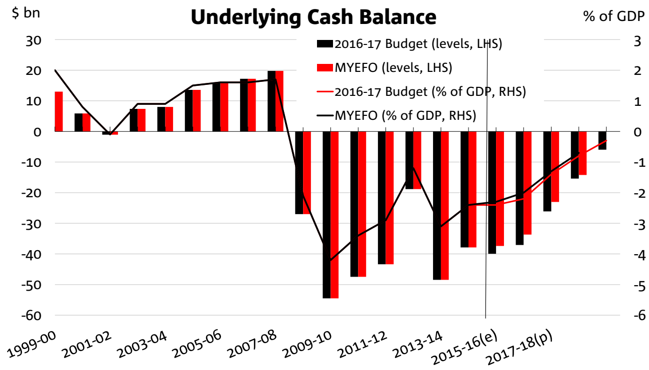
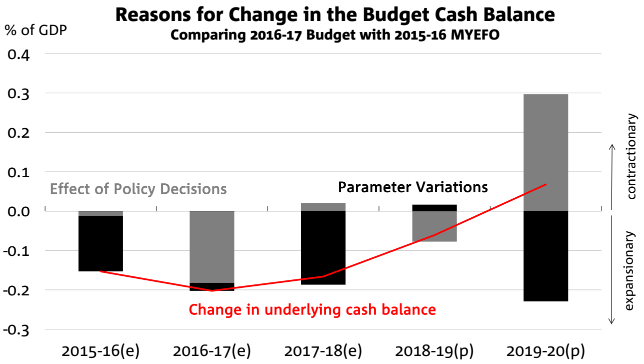
The key metrics

The underlying cash balance deficit is somewhat larger in each year to 2018-19. The 2016-17 underlying cash balance is now expected to be in deficit to the tune of A$37.1bn (2% of GDP), a deterioration of $3.4bn (0.2% of GDP) compared with the mid-year budget update in December 2015. For 2015-16, the expected deficit is now expected at A$39.9bn (2.4% of GDP), compared with A$37.4bn as at December's MYEFO, and up from A$37.9bn (2.4% of GDP) in 2014-15. Deficits for 2017-18 and 2018-19 are also larger at A$26.1bn and A$15.4bn respectively, while the deficit in 2019-20 is smaller at A$6.0bn (0.3% of GDP).

The government now expects a return to surplus by 2020-21 of 0.2% of GDP, as per the mid-year update in December, but one year later than in the previous budget. The surplus then peaks at 0.3% of GDP in 2021-22 before easing gradually and remaining in marginal surplus thereafter. This suggests not much wriggle room in terms of the return to the surplus or the capacity to remain in surplus over the long-term.



Source: Commonwealth Treasury



Source: Commonwealth Treasury

Downgrades over the estimates period are due to parameter variations (changes to actual or forecast economic outcomes) which have largely been allowed to flow through to the budget bottom line. There has been no offset from policy changes out to 2018-19 (in fact policy changes drag $4.2bn over the three years to 2018-19) although policy changes do add noticeably (A$5.9bn) to the bottom line in 2019-20 (see chart above and table below). Parameter variations meanwhile will drag $3.5bn from the underlying cash balance in the three years to 2018-19 and $A4.5bn in 2019-20. (Note that it has not been standard practice in the past to include the extra year in these budget reconciliation tables).

Budget Reconciliation

Underlying cash balance estimates

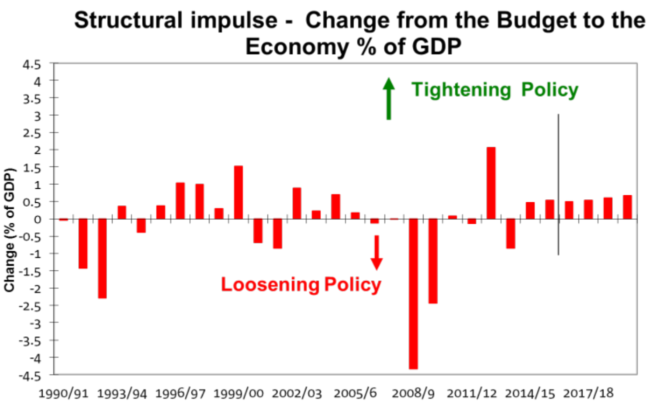
	2015-16(e)	2016-17(e)	2017-18(e)	2018-19(p)	2019-20(p)
Budget 16-17	**-39,946**	**-37,081**	**-26,123**	**-15,406**	**-5,955**
% of GDP	-2.4	-2.2	-1.4	-0.8	-0.3
MYEFO 15-16	**-37,399**	**-33,667**	**-23,021**	**-14,229**	**-7,300**
Effect of:					
Policy Decisions					
Receipts	417	-1,670	225	-209	317
Payments	611	1,400	-158	1,285	-5,578
Total	-195	-3,070	384	-1,494	5,894
% of GDP	-0.01	-0.18	0.02	-0.08	0.30
Parameter Variations					
Receipts	-7,280	-2,373	-3,723	-3,401	-6,475
Payments	-3,985	-1,633	194	-3,098	-366
Total	-2,352	-343	-3,484	319	-4,549
% of GDP	-0.14	-0.02	-0.19	0.02	-0.23
Budget 2015-16	**-35,115**	**-25,836**	**-14,396**	**-6,905**	**1,300**

Source: Budget Papers

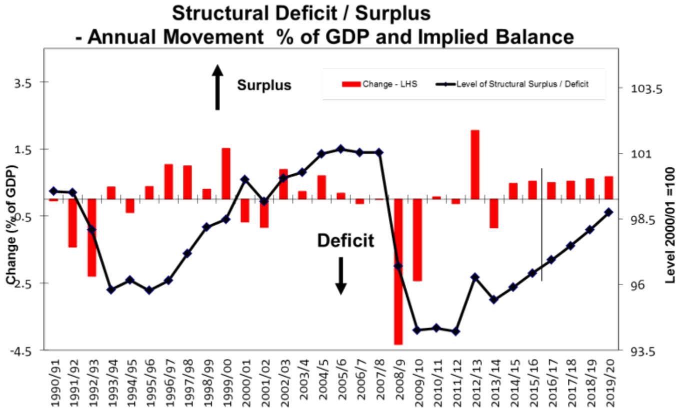
Medium Term Fiscal Context

As noted earlier, the Budget does not involve a fundamental policy tightening compared to the mid-year review or the previous budget. There is however a structural tightening of fiscal policy embedded in the forecasts. Perhaps the best way to show this is using OECD methodology which attempts to show the structural changes of Budget measures by excluding cyclical factors. That is, as the chart below indicates the Budget in the past two years has been subtracting around 0.5ppt from GDP growth, and will continue to subtract 0.5-0.6ppt from GDP in the out years.

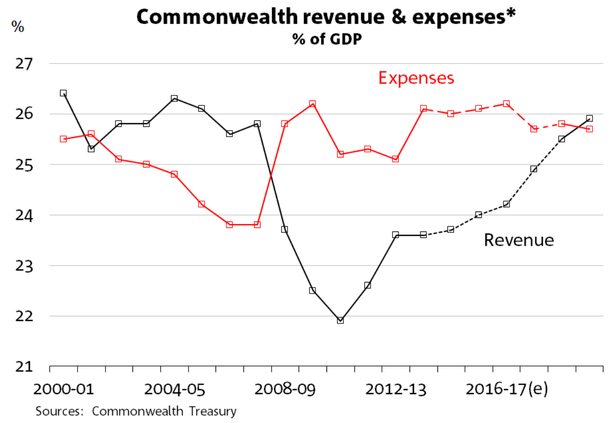
There is some offset to the structural tightening due to the current point in the economic cycle, with the total average annual pace of consolidation across the forward estimates period at 0.4% of GDP per annum according to the Budget papers.



The OECD methodology above shows that the Budget is likely to remain in structural deficit for at least the period of the forward estimates. These estimates look similar to those of the Commonwealth Treasury, which do not show a return to (marginal) structural surplus until 2020-21.

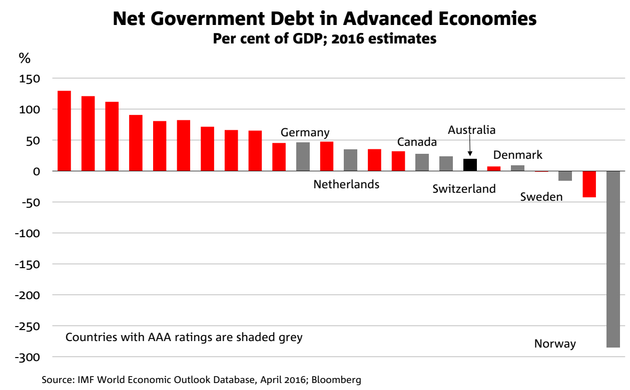


As evident in previous Budgets, the heavy lifting is mostly done from the revenue side, although there is a larger reduction in expenses evident in this year's budget. This is evident if we look at the Budget "jaws" (i.e. revenue versus expenditure as a percentage of GDP). Basically the reduction in the deficit is driven by returning revenues which rise from 24.0% of GDP in 2015/16 to 25.9% in 2019/20 (on an accrual basis). Expenses move from 26.1% of GDP in 2015-16 to 25.7% of GDP over the same period.

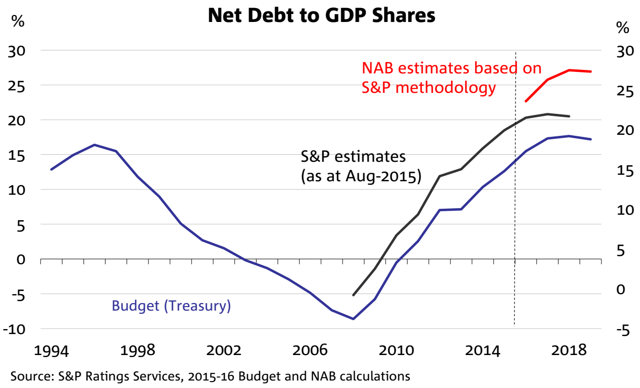


Australia's net debt is now expected to peak a little higher at 19.2% of GDP in 2017-18 compared with 18.5% of GDP in December's mid-year update.

Australian net government debt to GDP is relatively low by international standards, with the OECD average near 70% of GDP. For a AAA rated economy however, Australia is near the middle of the pack (see chart below).



However as explored in the detailed section later in the document, the ratings agencies have been circumspect in their initial reaction to the Budget, and have not provided their typical rubber stamp, choosing instead to allow more time for analysis. This is perhaps because the later return to surplus (as compared to last year's budget) and because using S&P's favoured methodology, Australia's net debt position is nearing the 30% threshold that S&P has flagged as a point of concern for AAA ratings.



Budget Measures – In Brief

In accrual terms, the fiscal deficit for 2016-17 is estimated to be $37.1 billion (or 2.2% of GDP). In this section, we only include spending, revenue and saving initiatives which are newly announced in the 2016-17 Budget. The initiatives include:

New Spending Initiatives

Small and large businesses

As part of the 'Ten Year Enterprise Tax Plan',

- Businesses with annual turnover less than $10m will have a company tax rate of 27.5% from 1 July 2016, at cost of $2.2bn to 2019-20. The company tax rate will be progressively lowered to 25% by 2026-27 for all companies, at a cost of $2.7bn to 2019-20
- A range of concessions already available small businesses with less than $2m turnover (such as lower corporate tax rate, accelerated depreciation and depreciation pooling provisions) will be extended to all businesses with turnover less than $10m from 1 July 2016 (costing $2.2bn over the next four years)
- An increase in the tax discount for unincorporated small businesses with annual turnover of less than $5m from 5% to 16% over 10 years (costing $450m over the forward estimates period)

Agriculture

- $50m over four years allocated to the Australian Grape and Wine Authority to promote wine tourism and Australian wine overseas. However, there will also be a reduction in the Wine Equalisation Tax (WET) rebate cap from $500,000 to $350,000 on 1 July 2017, and to 290,000 on 1 July 2018 and tighter eligibility criteria from 1 July 2019
- $9.5m for the National Water Infrastructure Development Fund, to fund water infrastructure feasibility studies in northern Australia, with the cost

being met by redirecting funds from the Rural Research and Development for Profit program
- $7.1m to fund additional Rural Financial Counsellors who will provide free financial advice to farmers in drought-affected areas

Infrastructure

New initiatives in the Budget include:

- $115m over two years from 2016-17 for preparatory works at the Western Sydney Airport site at Badgerys Creek, including funding for a concept design for provision of a rail link.
- $44m over five years to establish the Northern Australia Infrastructure Facility. The facility is intended to deliver financing to support economic infrastructure in northern Australia.
- an additional $490m in 2015-16 for the Forrestfield Airport Link in Western Australia

Youth Employment

- A new Youth Jobs PaTH (Prepare-Trial-Hire) Programme for vulnerable job seekers aged under 25 who are in employment service that include pre-employment skills training, an internship program for up to 30,000 job seekers each year (with businesses to receive $1,000 upfront to host them), and for employers who hire an eligible job seeker to receive an accelerated wage subsidy of up to $10,000 paid over six months (costing $245m over the next four years)
- $88.6m over four years from 2016-17 to expand the New Enterprise Incentive Scheme (NEIS) and to support self-employment opportunities for young people

Education and Training

- An additional $1.2bn in funding over four years from 2017-18 for government and non-government schools for the 2018 to 2020 school years, although it is contingent upon reforms by the States and the non-government schools sector. Total school funding will be indexed by an education sector specific index of 3.56% rather than the CPI, with an allowance for changes in enrolments.
- An additional $118 million over 2016-17 and 2017-18 for school students with disability

Health

- $2.9bn additional funding between 2017-18 and 2019-20 to support public hospitals, partially offsetting the changes to public hospital funding announced in the 2014-15 Budget

Aged Care

- $137m over four years from 2016-17 to support the operation of the My Aged Care contact centre and $102m over the same period to improve the targeting of the viability supplement for regional aged care facilities

Defence

- An additional spending of $700m to extend existing defence operations (Accordian, Highroad, Manitou, Okra and Resolute)

Revenue Measures

Multinational Company Tax

As part of the 'Tax Integrity Package', a series of measures aimed at tax avoidance:

- A new Australian Diverted Profits Tax that imposes a 40% penalty rate of tax on multinational corporations that attempt to shift their Australian profits offshore through arrangements relating to third parties. It is estimated that this tax will generate revenue of $200 million over 2018-19 and 2019-20.
- $679m for the Australian Taxation Office to establish a new Tax Avoidance Taskforce aimed at avoidance by businesses, multinationals and high wealth individuals, which is expected to raise $3.7bn in revenue

Superannuation

A 'Superannuation Reform package which includes the following measures:

- The lowering of the Division 293 threshold (the point at which high income earners pay addition contributions tax) from $300,000 to $250,000 starting from 1 July 2017. The Government will also reduce the annual cap on concessional superannuation contributions to $25,000 (currently $30,000 under age 50; $35,000 for ages 50 and over). This is expected to raise $2.5bn over the forward estimates period
- Systems changes to defined benefits superannuation schemes estimated to increase revenue by $2.0bn over the forward estimates period
- The introduction of a $500,000 lifetime non-concessional contributions cap which is expected to boost revenue by $550m over the next four years

Tobacco Excise

- An expected $4.7bn increase in revenue from raising the tobacco excise and excise equivalent customs duties by 12.5% per year from 2017 until 2020. The increases will take place on 1 September each year and will be in addition to existing indexation to average weekly ordinary time earnings

Saving Measures

Health

- National Disability Insurance Scheme (NDIS) Savings Fund worth $2.3bn to 2019-20, including $1.4bn from closing carbon tax compensation to new recipients of government welfare benefits, $711.2m over five years from reducing net costs in the NDIS transition agreements reached with states and territories, $109m from aligning backdating provisions for New Carer Allowance claims with other social security payments, $62m by reviewing 30,000 disability support pension recipients each year for three years by assessing their capacity for work; and not proceeding with an advertising campaign

- Savings of $182 million over three years the Health portfolio Health Flexible Funds through extending the indexation pause by two years and reducing uncommitted funds

Aged Care

- Changes to the scoring matrix of the Aged Care Funding Instrument that determines the level of funding paid to aged care providers. There will also be reduced indexation of the Complex Health Care component by 50% in 2016-17. This is expected to generate savings of $1.2bn over four years

Infrastructure

There are savings of $162.7 million from uncommitted project contingency, of which the bulk ($150.4 million) is achieved in 2019-20.

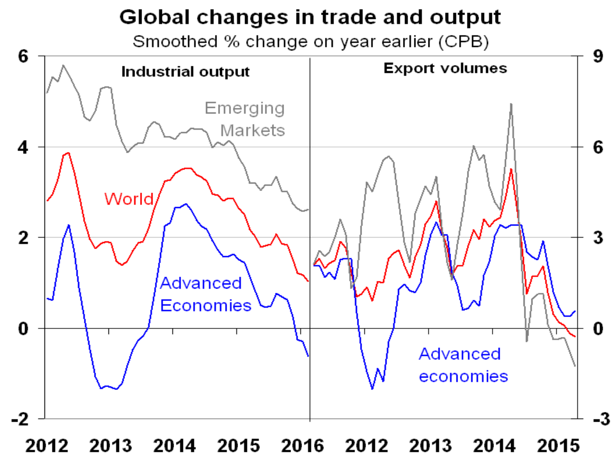
Economic & Financial Outlook

Global outlook

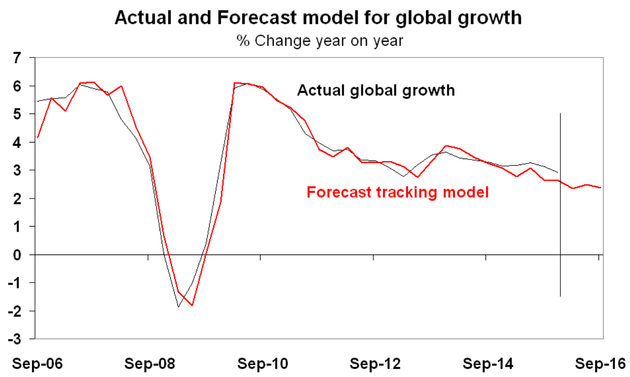
As a small open economy that exports commodities and traditionally relies on inflows of foreign capital, Australia's economy has always been heavily influenced by the global business environment.

While the level of concern about the immediate global outlook has receded since the early months of the year, ongoing sluggish growth perpetuates the risks still hanging over the world economy. In such an international environment, the Federal Government cannot realistically expect another globally-driven lift in commodity prices to help it address its budget difficulties

The latest measures of global economic activity do not show conditions improving through the months leading up to the budget. Global industrial output growth was only 1% yoy in early 2016, well below its long run average. Production in the advanced economies is still well below its pre-GFC level. World trade remains surprisingly weak with exports levelling off through the last few years, a marked break from its previous trend of strong growth. Business surveys for the advanced economies show at best modest growth in the industrial sector continuing through to April but services have fared better. Growth in the emerging economies has been easing with Chinese growth gradually slowing, Brazil in recession and sluggish growth across much of East Asia. In contrast, India has been the standout growth performer.



Our leading indicator of global economic activity does not show any evidence that growth is about to accelerate through the first 9 months of 2016. At best, the global economy should "muddle through" the next few years with sub-trend growth extending right through the forecast horizon. Global growth should reach only 2¾% in 2016, rising to 3¼% in the following two years. The emerging market economies have accounted for the bulk of global output expansion since the global financial crisis and so their slower growth and financial market volatility has had a marked impact on global aggregate numbers.



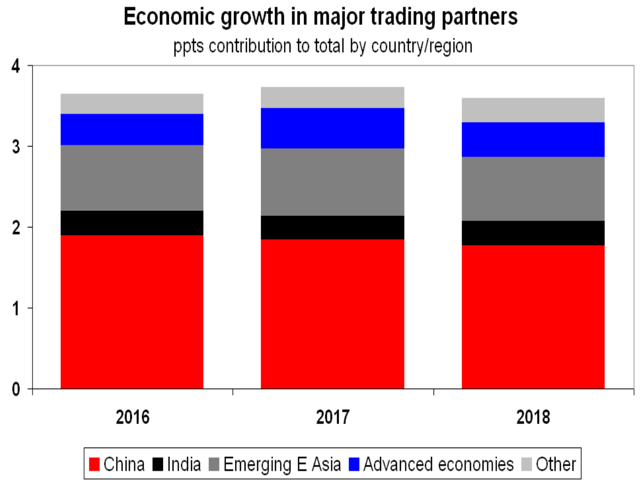
The table below compares our forecasts with those of Treasury and our forecasts are slightly weaker. Unlike Treasury, we have not included an indirect tax hike in Japan and that affects the 2017 numbers.

Comparison of Treasury Budget Forecasts and NAB Forecasts

	2016		2017		2018	
	Treasury	NAB	Treasury	NAB	Treasury	NAB
US	2	1.8	2.25	2.1	2.25	1.9
Euro-zone	1.5	1.5	1.5	1.5	1.5	1.6
Japan	0.5	0.4	0.25	0.7	0.5	0.5
China	6.5	6.7	6.25	6.5	6	6.3
India	7.5	7.6	7.5	7.4	7.75	7.7
Emerging Asia	4	3.5	4	3.6	4.25	3.4
World	***3.25***	***2.8***	***3.5***	***3.2***	***3.75***	***3.2***
Major trading partners	4	3.6	4	3.7	4	3.6

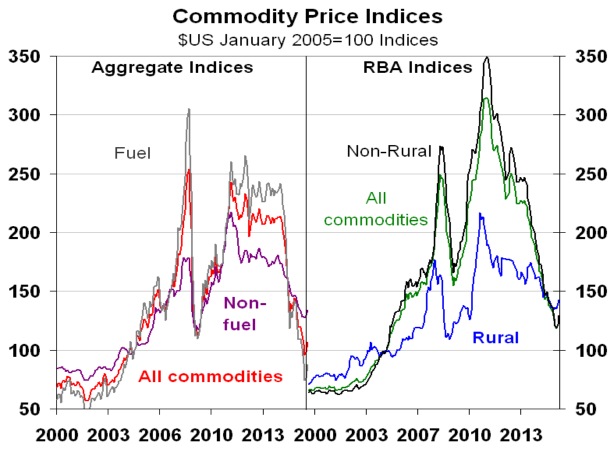
Australian growth remains heavily geared to what happens in the emerging market economies, especially in Asia. Relatively fast Chinese growth and

Australia's high export reliance on that market ensures that China alone accounts for half of our trade weighted economic growth. Advanced economies account for over 40% of global output and Australian exports, but their sluggish growth ensures that they account for only 50 bps out of total trade weighted economic growth of 3¾%.

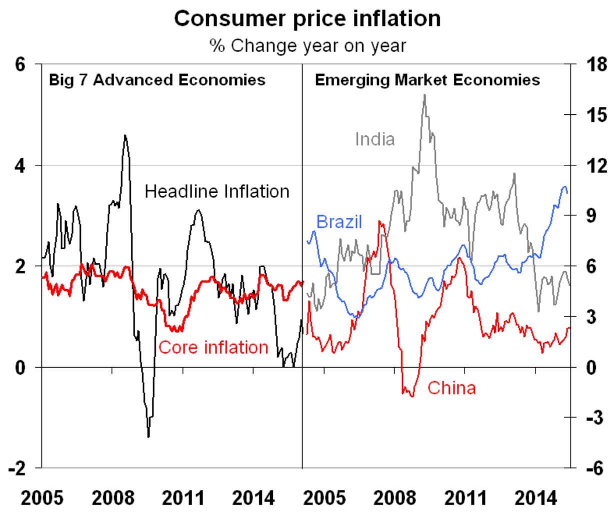


Besides being Australia's biggest export market, buying around one-third of our merchandise exports, China has also become the world's biggest economy with its GDP steadily pulling away from the US. Chinese growth has continued to trend downwards with a particularly marked slowdown in the heavy industries that use Australian resource inputs. Slower Chinese growth has fed into weaker intra-regional trade across the rest of the emerging market economies of East Asia, which buy another fifth of Australian exports. India has overtaken China as the fastest growing big emerging market economy but its imports have been falling in step with lower commodity prices and Australian export earnings from India are well below their 2010 peak.

Soft global growth dampening commodity demand, the coming on-stream of new supply and $US appreciation have produced the difficult environment facing commodity producing countries. Global commodity prices have been falling for five years, especially for fuels and other resource products. $US export earnings have fallen across a range of commodity economies stretching from Latin America through S Africa to Australia and New Zealand. Depreciations in the local currency have offset some of that price weakness but lower prices on exports to East Asia alone cut Australian nominal GDP by 3½ ppts between April 2014 and early 2016.



Weak commodity prices and sluggish growth have contributed to the very low rates of inflation seen around the world. The OECD's headline rate of consumer price inflation was running at less than 1% yoy by February 2016, well below the 2% or so inflation target set for several central banks. OECD core CPI inflation was then just under 2% yoy, close to the target but weak wage outcomes were making central banks worried that inflation expectations could shift down and drive core inflation further from its target levels. CPI inflation in China is around 2¼% yoy, below the central bank's 3% target, and inflation in India has dropped below 5% yoy, which is below the 6% targeted by January 2016 and within the range of the 4% plus or minus 2% CPI targeted from the FY 2016/17 onwards.

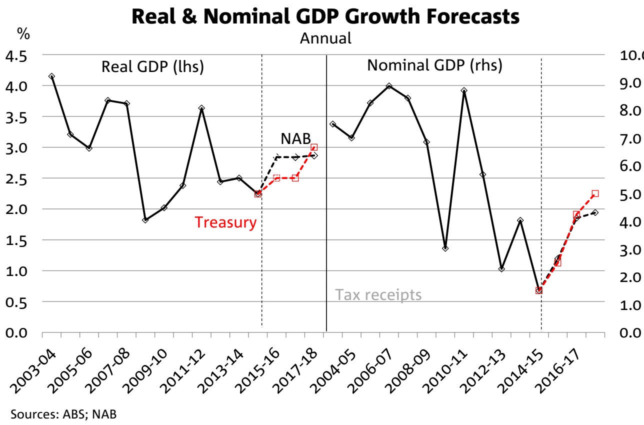


Persistently slow growth and sub-target inflation have already resulted in very low policy interest rates, the increasing use in some economies of non-conventional measures like negative interest rates on commercial bank deposits held at central banks, the expansion in central bank asset buying and media talk about even more drastic measures like "helicopter money". We expect low inflation and policy rates to persist in many countries through the forecast period.

Australian Outlook

The Commonwealth Treasury's Budget papers contain a set of economic forecasts that are slightly softer than NAB's in the near-term, but stronger from 2018-19 onwards.

In the next two years, Treasury are forecasting real GDP growth of 2½% p.a., which compares to NAB's slightly stronger expectation of 2¾% p.a. The difference largely reflects NAB's stronger expectations for dwelling investment and trade.

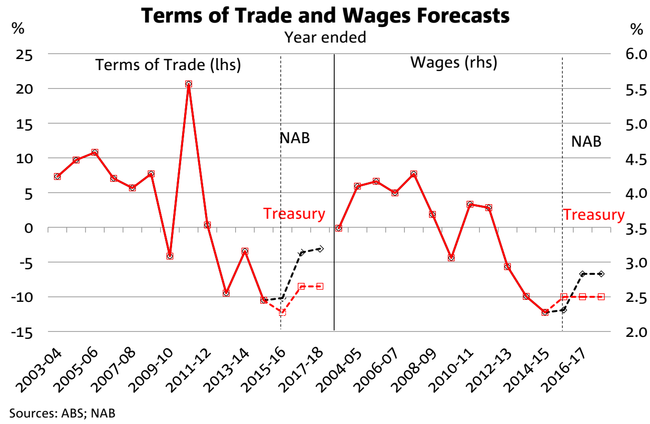


Regardless, both envisage an economy that is gradually transitioning towards non-mining sources of growth against a challenging economic backdrop. While low interest rates and a more competitive currency (despite recent appreciation) are assisting, and LNG exports will support real GDP, a weak global economy and low commodity prices will continue to weigh on national income, corporate profits and government revenue.

In terms of the drivers of real GDP growth, both expect a relatively subdued outlook for domestic demand and support from LNG exports. Moderate consumption growth (but reliant on lower savings rate), sharp falls in mining investment but weak non-mining investment outlook, and support (albeit dwindling) from dwelling investment.

Meanwhile, both NAB and the Treasury envisage employment growth that is strong enough to see further downward pressure on the unemployment rate in the near-term (to around 5½%), before stabilising. This is being supported by low wages growth and the shift towards labour-intensive sectors (largely services sectors), although household income will remain weak, presenting a challenge to government revenue and consumer spending.

In addition, we see some downside risks to the government's forecasts for nominal GDP given our more subdued outlook for iron ore prices (see below), as well as a more conservative estimate of Australia's potential growth. NAB forecasts for the terms of trade are around 10% below Treasury's by 2016-17. Budget sensitivities suggest that a permanent deviation of this magnitude could worsen the cash balance by around $15 billion over 2 years, all else equal – although NAB's forecast for slightly stronger wages provides some offset for nominal GDP (and tax receipts).



Further out, the Treasury's figures are projections, which assume real GDP growth of 3%. These figures do not incorporate the cyclical slowdown to real GDP growth of around 2.5% that we have envisaged for calendar 2018 onwards as the boost from LNG exports and earlier currency depreciation starts to wane, and the dwelling construction cycle turns.

The following provides a detailed discussion of individual sectors:

Household sector

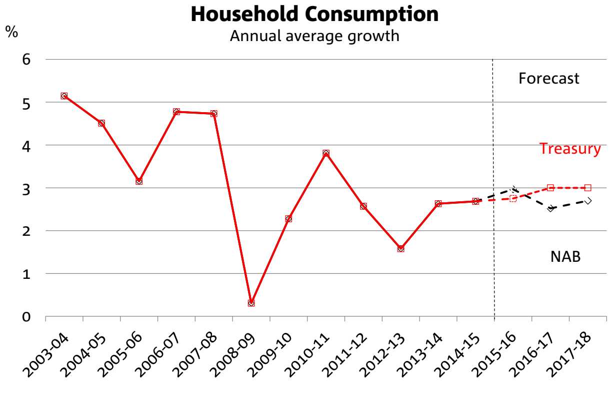
Strong employment over 2015 appeared to have supported household consumption in H2 2015, which grew at a robust average rate of 0.8% per quarter (or 2.9% y/y) despite falling wages growth. Employment growth in the early months of 2016 remained relatively robust, which should offer some support to consumer spending overall, although there are tentative signs that the initial impetus from rising employment and household wealth could be waning. In particular, retail spending has weakened in recent months, although this partly reflects the "two-speed" Australian economy, with weakness in the mining state of WA creating significant drag on the national results.

A cooling housing market could have a negative influence on consumption, although the relationship between the two has been complex. House price growth momentum has clearly slowed, and is expected to be quite modest in 2016 (1½% growth over the year). Price gains in early 2016 have been stronger than expected, but a combination of worsening affordability, rising housing supply and growing constraints on investors are still expected to severely limit further gains. Treasury appear to expect the housing market to hold up a little better than this in the near-term, making reference to support from 'a still strong housing market', although they assume impetus will slow in 2016-17.

Given the excess capacity in the labour market currently, wages growth is likely to remain tepid, thus not likely to fill the gap left by the absence of housing wealth impetus. The equity market, which has been hit by large commodity price falls in the past year, should also gain a firmer footing this year as commodity prices stabilise.

As such, the fundamentals for household consumption are mixed amidst solid employment growth but subdued wages and lesser wealth creation prospects from housing. A decline in the household savings ratio remains necessary to satisfy our moderate household consumption forecasts. Treasury hold a similar view of the labour market and wage growth, requiring the household savings rate to drop to around 6% in 2017-18 (from 7.6% currently) to support consumption growth.

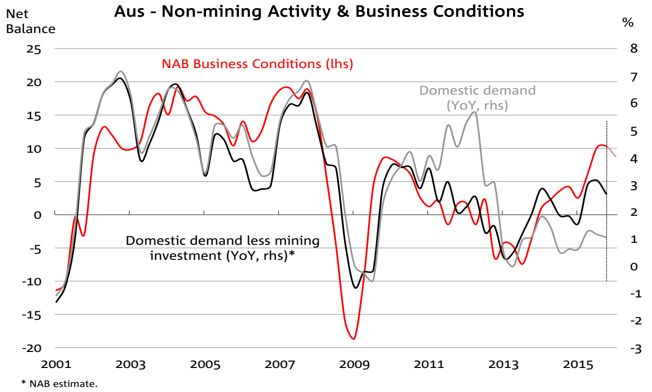
We generally see the Budget as not fundamentally changing consumers' tentative behaviour and confidence levels, although the promised tax cuts for mid-to-high-income earners and changes to individual tax thresholds could have some positive effects at the margin. We expect consumption growth of around 2.9% in 2015/-16, before moderating to 2.5% in 2016-17 and then rising modestly to 2.7% in 2017-18. This is a little softer that Treasury forecast, reflecting NAB's stronger anticipated headwinds from the housing market. We do, however, agree that deviations in the projected household savings rate pose a significant risk to the outlook.



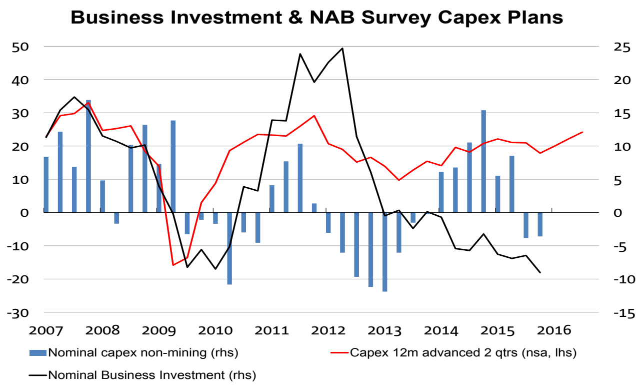
Sources: ABS; NAB

Business sector

Turning to the business sector, the NAB Monthly Business Survey has confirmed a continuation of the favourable business environment that has helped to underpin the non-mining recovery. We continue to look for signs that the recovery is broadening, and while evidence of that has been mixed, solid results for manufacturing and transport – as well as a bounce-back in retail conditions – are encouraging. Low interest rates and a more competitive currency (even given recent strength) remain key to ongoing improvement, especially in the context of global economic uncertainty (see [NAB Monthly Business Survey – April 2016]() for more details).



Despite a clear improvement in business environment, there remains a great deal of uncertainty around the outlook for business investment – namely, whether non-mining capital expenditure (capex) will pick up sufficiently to offset ongoing (large) declines in mining investment. According to Treasury, non-mining businesses in their liaison programme have yet to commit to significant new investment plans. This is similar to the very weak investment expectations reported in the ABS capex survey, which are pointing to further declines in non-mining investment. We remain somewhat more optimistic about the investment outlook for the non-mining sector, however, given some of the recent trends seen in the NAB Business Surveys. As acknowledged in the Budget, capacity utilisation has improved considerably. Additionally, firms in the NAB Survey are reporting relatively solid expectations for investment in the next 12 months. Limitations on the ABS Capex Survey – especially its coverage – partially help to explain the stark differences in outlook.



The Budget is unlikely to have a material impact on our expectation for private business investment in the near-term, although a lower tax burden (especially for small business) and additional infrastructure commitments will all be supportive of our anticipated recovery in non-mining capex. For 2015/16 we expect core business investment to fall by 12.1% and a further 8.4% in 2016/17 and down

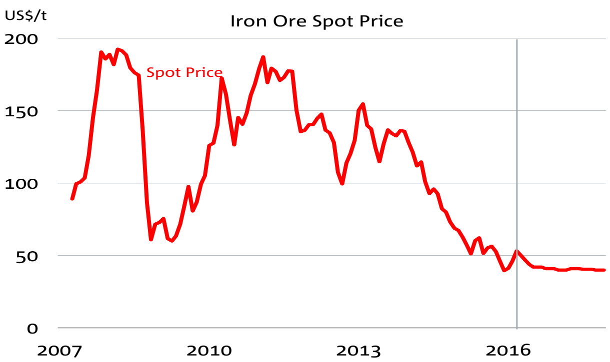
3.2% in 2017-18. The budget also has large falls for business investment, albeit slightly more moderate.

Similarly, with no changes made to negative gearing or capital gains tax provisions in this Budget, our outlook for dwelling investment is unchanged. Dwelling construction will continue to make a positive contribution to growth in the near-term – although the profile will remain volatile given the large share of apartment construction. However, given the state of market over-supply, approvals should remain soft, suggesting that overall contribution of dwelling investment to GDP will begin to diminish over the course of 2017. NAB forecast therefore anticipate a much larger drag on growth from dwelling investment in 2017-18 than is provided in the Budget.

Public sector

As part of the gradual improvement in the size of the fiscal deficit, we are expecting relatively moderate contributions to growth from public sector demand. In 2015/16 underlying public demand is likely rise moderately (up 2.5%), increasing a further 2.3% in 2016/17 and around 2½% in the out year. As part of that, public consumption is expected to grow faster than investment (excluding sales to the private sector) in the near term, but both will increase 2½-3% in the out years.

External sector



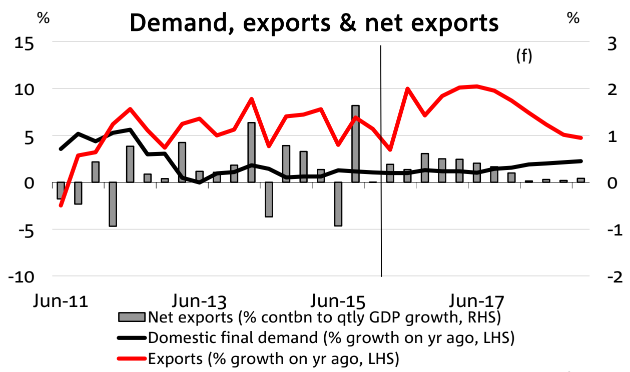
Source: BREE, Bloomberg, NAB Economics

Iron ore prices have rallied recently, which has been reflected in a more favourable price assumption within the Budget over the forecast period. However, much of this has been underlined by temporary factors, suggesting that weaker fundamentals will again see the iron ore price fall – NAB is forecasting prices to fall to around the low US$40s per tonne (FoB) by late 2016 and remain around these levels (compared to a current spot price around US$64.5 per tonne CFR). While this will be partly offset by further anticipated AUD/USD depreciation – reaching 69c by late 2016, before returning to 75c over FY18 – the terms of trade are expected to fall a further 3.6% in 2016/17 and 3.1% in 2017-18. This compares to the Budget assumption for iron ore prices to remain around US$55 (FOB) over the forward estimate. Based on sensitivities provided in the Budget, the difference between NAB and Budget price forecasts could contribute up to an additional $15 billion to Government revenue over a couple of years.

The outlook for resource production is key to the forecast for Australian exports and GDP. The ramp-up in output from several large scale LNG projects will contribute most to Australia's total export growth (forecast to grow by 7.4% in 2016, with more than half of that growth coming from LNG exports). Despite some recovery and a short rally in iron ore prices, our iron ore export forecasts are largely unchanged, growing at 6.2% in 2016 and 4.4% in 2017. Similarly, coal export growth is to remain weak, as a result of slowing global demand. Non commodity exports have been gaining support from AUD depreciation – especially services such as tourism – and this is expected to continue going forward, although the impetus from currency depreciation will gradually diminish.

In the medium term, exports are forecast to grow strongly while import growth will remain moderate. Overall, net exports are expected to contribute 1.5, 1.7 and 1.2 ppt to total GDP growth in FY16, FY17 and FY18 respectively. This is stronger than Treasury forecasts, owing to both stronger exports – partly a reflection of our lower exchange rate assumption – and weaker imports (reflecting weaker consumption and private business investment.

For rural commodities, dry weather across much of eastern Australia has pressure on cattle restocker interest and dented expected wheat yields, especially in Victoria. Meanwhile, good pre-planting rain in Western Australia and parts of South Australia bodes well for wheat growers. With global prices subdued for many agricultural commodities, the higher Australian dollar this year has dented local prices. However, the anticipated AUD depreciation in H2 2016 will provide some relief.



Sources: ABS, NAB forecasts

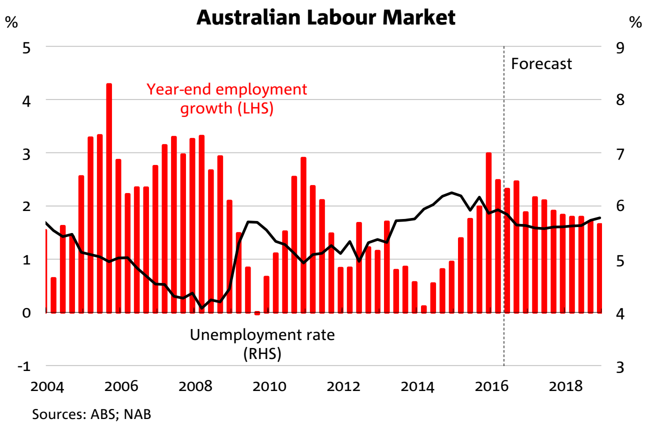
The labour market

The early months of 2016 continued to witness further improvement in the labour market, characterised by moderate employment growth and a falling unemployment rate to 5.7% in March, the lowest since mid-2013. While employment growth has clearly slowed compared to 2015, this is likely to be a reflection of a return to more sustainable levels of growth from the incredibly strong official numbers witnessed prior.

Forward indicators of the labour market continue to be positive, with job ads and vacancies trending higher and the employment index from the NAB survey's employment series reaching the most elevated level since 2011. The latter, which leads official statistics by around 6 months, is currently suggesting employment growth of around 15 to 20k a month – a level sufficient to see unemployment edge down over the course of 2016.

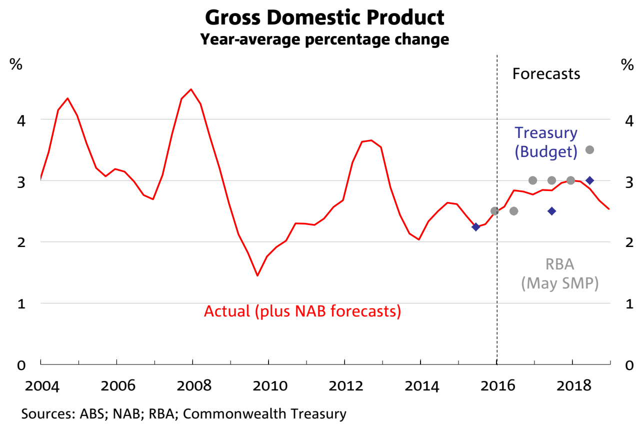
Overall wage growth remains tepid despite the pick-up in employment. Wages growth is either slowing or remaining weak in most industries, reflecting the dominance of part-time jobs in employment growth since late 2014. We expect the gap between the growth in part-time jobs and full-time jobs to narrow as the non-mining recovery broadens, creating a positive impetus for wage growth going forward.

Short-term risks aside, our expectation remains that employment growth will continue to grow moderately on the back of low wages and a shift towards labour-intensive jobs. Our forecasts see the unemployment rate easing gradually to 5.6% by end-16 and stabilising, before returning to 5.8% by end-18. Slowing population growth (currently 1.3% y/y, down from 1.6% at the start of 2014) also suggests a slightly lower rate of job creation will be necessary to keep up with population growth. Budget expectations for both wages and the unemployment rate are very similar.

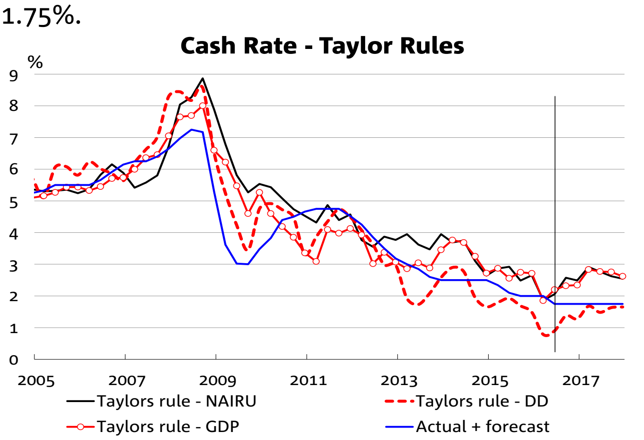


The outlook for growth and monetary policy

Weighing up all these factors, we see GDP growth remaining below 3% in the near-term as subdued domestic demand is largely offset by strong increases in resource exports. Positive contributions from dwelling investment will be counterbalanced by significant weakness in mining investment and somewhat disappointing non-mining investment growth. However, dwelling investment is expected to drag on growth in the out year – a weaker outlook than suggested by Treasury. Nevertheless, Treasury forecasts are somewhat weaker in the near-term (at 2½%), reflecting a softer outlook for net exports and near-term dwelling investment.



Both NAB and the Treasury see a subdued inflation outlook over coming years, although the Budget forecast for headline inflation is even weaker in the near-term. NAB expects core inflation will only gradually rise to 2% over the forecast period – the lower bound of the RBA inflation target. Weak growth in labour costs, low fuel prices, strong competition in the retail and supermarket space, lower rental growth and a weak global inflation backdrop all suggest that inflation will struggle to pick up substantially from here.
With the May cut to the cash rate to 1.75% indicating that the central bank remains a committed inflation targeter, the RBA will retain an easing bias going forward. This could be acted upon should inflation continue to undershoot. In that context the next live meeting is probably August. Of course should the non-mining recovery show signs of fragility the RBA would not hesitate to cut again. The path of the AUD will also be important, as this could pose a threat to the hitherto robust non-mining recovery. That said for the foreseeable future, NAB expects the RBA to remain on hold at 1.75%.



Market Reaction, bond issuance, and rating agencies

Market Reaction

With the fiscal parameters and forecasts largely as expected there was no discernible market reaction to the Budget. The most likely market reaction would have come from elevated concerns about the fiscal stance from ratings agencies – the immediate headlines from both Standard and Poor's and Moodys have been non-committal saying they will review the Budget in more detail in the weeks ahead.

The Debt Programme in 2016-17 – record debt issuance.

The Budget papers indicate that Government debt is expect to keep rising in the years ahead, with net debt now forecast to peak at a higher 19.2% of GDP in 2017-18 from an estimated 17.3% of GDP in 2015-16. The Governments gross debt continues to rise through the entire forecast profile.

In terms of the 2016-17 debt programme, commonwealth government stock (GS) on issue is projected to rise from $425bn at June 2016 to $497bn at June 2017. The implied net issuance of $72bn is more than the net issuance in the current year. Along with maturities of about $21bn in the next financial year, this would imply gross CGS issuance of around $93bn. This would be a record.

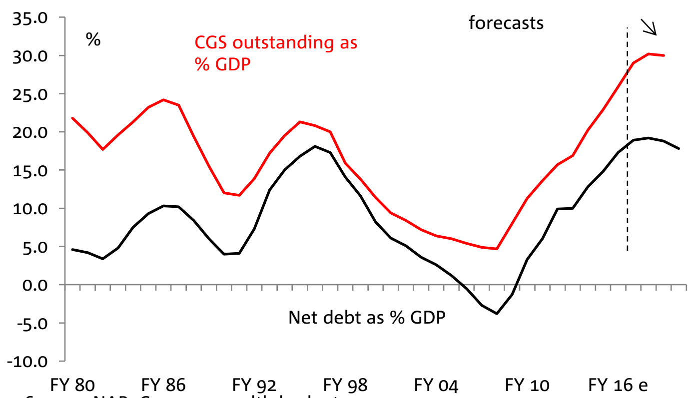
So long as Australia remains an AAA country and retains yields above most other countries this debt funding task should be manageable. The Government's debt management arm (AOFM) normally gives the detail of expected issuance in the days ahead.

Table 1 – Projections of CGS Debt Outstanding

A$bn	Actual 2014-15	Estimate 2015-16
2016-17 Budget (May 2016)		
Face value - end of year ($bn)	367	425
Implied net issuance		58
Face value - within-year peak ($bn)	368	437
Face value - within-year peak (% of GDP)	*22.9*	*26.5*
Changes since MYEFO		
Face value - end of year ($bn)		-1
Face value - within year peak ($bn)		-8

Source: Commonwealth Treasury, National Australia Bank

Net and Gross Debt



Source: NAB, Commonwealth budget

Credit Rating Agencies non-committal

Ratings agencies reactions have been a bit circumspect in their initial reaction to the Budget. Rather than rush to rubber stamp the Budget as meeting its AAA criteria – as they have generally done in prior years – Standard and Poors said in a brief statement that "We will look through the details of the budget over the coming weeks. As we've previously highlighted, improving budget balances remain important to the rating to offset Australia's high vulnerability to shifts in offshore financial market sentiment."

Moody's highlighted the Government's commitment to fiscal consolidation as a positive but they did highlight that deficit forecasts have again deteriorated while also questioning the Governments nominal GDP forecast, where they see more muted growth - and presumably a related more muted recovery in tax revenues. They finish saying the "slower pace of fiscal consolidation will leave public finances vulnerable to negative shocks"

We have previously highlighted that rising debt and successive years of Governments pushing out the date when the Budget recovers has means Australia is pushing close to the boundaries for a AAA country. Our sense is the Budget has done enough to avoid a more stringent warning from the ratings agencies but a change in rating outlook is not out of the question.

Budget forecast table

	2015-16 (f)		2016-17 (f)		2017-18 (f)	
Annual % Change	**Budget**	**NAB**	**Budget**	**NAB**	**Budget**	**NAB**
Private Consumption	3	3.0	3	2.5	3	2.7
Private Investment – Dwelling	8	8.5	2	2.2	1	-1.9
Underlying Business Investment	-11	-12.1	-5	-8.3	0	-3.2
Underlying Public Final Demand	2¼	2.5	2¼	2.3	2	2.6
Domestic Demand	**n.a.**	**1.0**	**n.a.**	**1.2**	n.a	**1.7**
Stocks – Contribution to GDP	0	0.0	0	0.1	0	0.0
GNE	**1**	**1.1**	1¾	**1.3**	2½	**1.8**
Exports	6	6.5	5	9.2	5½	8.0
Imports	0	-0.5	2 1/2	1.6	3	3.6
Real GDP	**2½**	**2.8**	**2¾**	**2.8**	**3**	**2.9**
- Non-Farm GDP	n.a	2.9	n.a.	2.9	n.a	2.9
- Farm GDP	n.a	-2.6	n.a.	0.4	n.a	2.0
Nominal GDP	2½	2.6	4¼	4.2	5	4.3
Federal Budget Deficit (fiscal balance, $bn)	**-39.4**		**-37.1**		**-19**	
Current Account Deficit: % of GDP (-%)	-4¾	-5.0	-4	-4.2	-3½	-3.9
Terms of Trade	-8¾	-10.4	1¼	-3.4	0	-3.1
World GDP (b)	3¼	2.9	3½	2.9	3¾	3.2
End Period					0	
Wage Price Index	2¼	2.3	2½	2.8	2¾	2.8
Employment	2	2.3	1¾	2.1	1¾	1.8
Unemployment rate	5¾	5.8	5½	5.6	5½	5.6
Underlying CPI	n.a.	1.6	n.a.	2.0	n.a	1.9
Official Cash Rate	n.a	2.00	n.a.	2.50	n.a.	3.50
10 Year Govt. Bond Yield	n.a	2.75	n.a.	3.45	n.a.	3.45
US cents/$A	n.a	0.74	n.a.	0.70	n.a.	0.75
Trade Weighted Index	n.a	63.6	n.a.	61.2	n.a.	63.8

(a) Percentage change on previous year, unless otherwise indicated (b) Calendar (f) Forecast

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