Federal Budget 2017

Comment

As expected, the centerpiece of this Budget is increased infrastructure spending, a new Housing Affordability plan, Gonski 2.0 and increased emphasis on the "Operating Fiscal Balance" ("good" versus "bad" deficits). What was not expected was the new tax on banks liabilities – and at $6bn over the next four years it is not small. It is too early to say how banks will react.

On infrastructure, key elements include: the second Sydney Airport, the Melbourne to Brisbane rail freight line, Snowy Mountain funding, regional growth connectedness initiatives, and extra spending on hospitals. The package is valued at around $75bn over the next ten years. For smaller business (up to turnover of $10m p.a.) the 20k instant write-off has been extended.

The Housing Affordability Package includes on the supply side: release of more Government land, tax incentives for private investment in affordable housing, establishing a new Government body to provide cheaper finance for community housing, a levy of $5k per annum on vacant foreign owned housing and seniors are allowed to transfer $300kinto super from the sale of family homes to encourage downsizing. First home owners are now allowed voluntary contributions to super ($15k per annum with a cap $30K) as a way of getting a deposit quicker. To the extent these measures are aimed at raising supply, they will clearly help – it is less obvious that boosting FHO's ability to build a deposit will do anything other than add to house price pressures.

Elsewhere the Government has given up on "zombie" measures of over $13bn currently stalled in the Senate. New initiatives in this space include Gonski 2.0 (extra $18.6bn in school funding over the next decade) on a needs-based model; university fee hike of 7.5%; higher repayments on government education loans; 2.5% efficiency dividend on universities.

The Health package includes the phased unfreezing of Medicare rebates for doctor visits and reduced costs for medicines. NDIS is now fully funded via a Medicare levy increase of 0.5ppt to 2.5% in mid-2019. There is now going to be a one stop shop for bank complaints and registration of senior bank executives and possible deregistration together with large fines for bad behaviour.

The government is emphasizing the Net Operating Balance – effectively the Underlying Cash Balance less net investment on the government's balance sheet - which returns to surplus a year earlier in 2019-20. Basically we have no objection separating out the type of government debt into "business as usual" spending from "productivity enhancing investments". The key of course is whether the investment really is "productivity enhancing". That said all debt has to be repaid. We (and the rating agencies) will continue to focus on the Underlying Cash Balance. In the "Medium Term Economic Outlook" our view is that the Budget implies a further slight drag on growth near-term but a sharp drag thereafter.

We are much more cautious on 2018-19 forecasts and beyond. The economy in our view will be running nearer 2½% than 3%+ by then. And we are very sceptical about the wages forecasts – and hence nominal GDP estimates. As such, we don't believe the medium term fiscal projections – and hence the credibility of the fiscal profile. This Budget will be popular but from an economic perspective "if it looks too good to be true, it probably is".

Fiscal Outcome

The underlying cash deficit is expected to fall from $37.6bn to $29.4bn in 2017-18, then rapidly improves to $2.5bn in 2019-20– and achieves a surplus of $7.4bn in 2020-21. The Net Operating Balance is however expected to fall more aggressively (as extra government investment kicks in) to around $10.8bn in 2018-19 and achieves balance a year earlier in 2019-20.

Economic Outlook

There is little fundamental difference between Treasury's and NAB's economic forecasts in 2017-18 – both around 3%. From a slow start in H1 2017 the economy will accelerate as lagged effects of higher commodity prices flow through to profits, LNG export volumes accelerate, and the construction (apartment) cycle peaks. That said domestic demand, remains subdued. NAB's forecasts are notably more pessimistic as we move into the forward projections (from 2018-19) as near term positives start to unwind and the construction cycle turns down. Our expectations for the unemployment rate are similar, stabilizing around 5¾% in the near-term before edging lower to 5 ½% in the out years. We forecast nominal GDP growth of 3.3% in 2018-19 (the Government has 4%). The Government's nominal GDP numbers then accelerate further – heightening our scepticism. The Government's wages growth forecasts in particular, of 3% in 2018-19 and up to 3¾% by 2020-21, appear very optimistic.

Financial Markets

There was little discernible market reaction to the Budget. That said, banks suffered as news of the new tax leaked out earlier in the day. Ratings agencies will clearly be looking at the underlying cash balance projections and their "sustainability". It is equally unclear how they will see the new bank tax and what it means for growth and risk.

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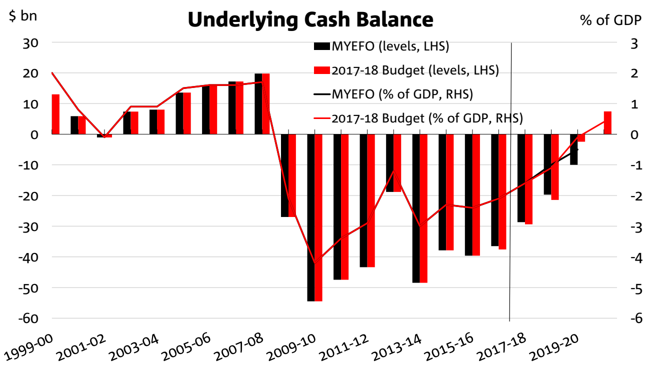
The key metrics

	Estimates						Projections		
	2016-17(e)		2017-18(e)		2018-19(e)		2019-20(p)		2020-21(p)
	MYEFO	Budget	MYEFO	Budget	MYEFO	Budget	MYEFO	Budget	Budget
Underlying cash balance, $bn	-36.5	-37.6	-28.7	-29.4	-19.7	-21.4	-10.0	-2.5	7.4
% of GDP	-2.1	-2.1	-1.6	-1.6	-1.0	-1.1	-0.5	-0.1	0.4
Net operating balance	-37.5	-38.7	-19.2	-19.8	-10.6	-10.8	-1.3	7.6	17.5
% of GDP	-2.1	-2.2	-1.1	-1.1	-0.6	-0.6	-0.1	0.4	0.8
Net capital investment	-4.0	-2.0	-3.1	-0.5	-4.7	-4.8	-5.2	-4.9	-6.0
% of GDP	-0.2	-0.1	-0.2	0.0	-0.3	-0.3	-0.3	-0.2	-0.3
Fiscal balance, $bn	-41.5	-40.7	-22.3	-20.3	-15.3	15.5	-6.4	2.7	11.4
% of GDP	-2.4	-2.3	-1.2	-1.1	-0.8	-0.8	-0.3	0.1	0.6
Net debt, $bn	317.2	325.1	343.0	354.9	359.0	375.1	363.8	374.7	366.2
% of GDP	18.1	18.6	18.9	19.5	19.0	19.8	18.4	18.9	17.6

Source: Commonwealth Treasury

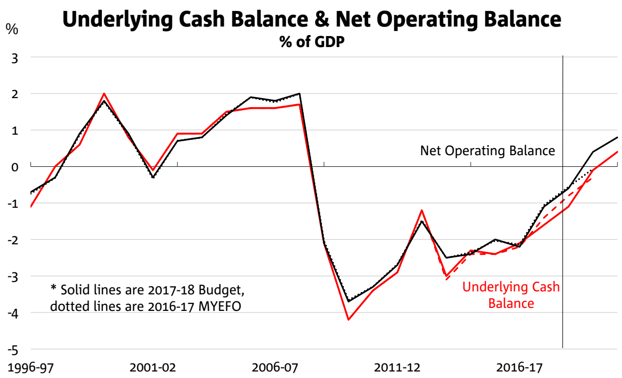
This year's federal budget appears to contain little shift in the government's overall fiscal stance as measured by key budget aggregates over the next couple of years, although it includes a more rapid improvement in the fiscal balance towards the end of the projection period.

The government has retained its forecasts for the **underlying cash balance** to return to surplus in 2020-21 (see table above). This is despite slightly higher deficits in the next two years even with the boost from temporarily higher coal and iron ore prices. Compared with the Mid-Year Economic and Fiscal Outlook released in December 2016, the underlying cash deficit is marginally higher up to 2018-19, but then improves more rapidly in 2019-20 and 2020-21, in part as the haul from new revenue measures really starts to kick in.



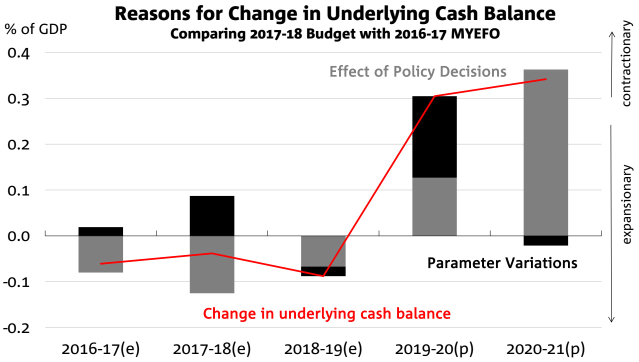
Source: Commonwealth Treasury

In a departure from tradition, the Government is now also emphasising the **operating balance**, which aims to measure recurrent revenue less expenses and removes net capital expenditure (see chart below). It is calculated on an accrual rather than cash basis. The operating balance returns to surplus slightly earlier in 2019-20, compared with a deficit of $1.3 bn at the time of MYEFO. **Net capital expenditure**, meanwhile is weaker than at MYEFO, but this reflects 'parameter' variations with actual policy decisions slightly positive. This measure does not capture all infrastructure spending (see key measures below).



Source: Commonwealth Treasury

Downgrades to the underlying cash balance in 2017-18 are largely due to policy decisions outweighing the beneficial impact of changed parameter variations (economic assumptions, including higher forecasts for iron ore and coal prices given recent history). Policy decisions become more contractionary by 2019-20 and particularly 2020-21, as major initiatives to increase receipts and cut payments kick in. Parameter variations also add significantly to the budget bottom line in 2019-20, perhaps reflecting higher forecasts for nominal GDP (although as mentioned below, we still remain sceptical about the strength of the government's projections for wages growth in particular).



Source: Commonwealth Treasury

Budget Reconciliation

Underlying cash balance estimates

	2016-17(e)	2017-18(e)	2018-19(e)	2019-20(p)	2020-21(p)
Budget 17-18	**-37,600**	**-29,396**	**-21,422**	**-2,470**	**7,417**
% of GDP	-2.1	-1.6	-1.1	-0.1	0.4
MYEFO 16-17	**-36,514**	**-28,694**	**-19,711**	**-9,992**	
Effect of:					
Policy Decisions					
Receipts	73	1,892	3,316	7,038	8,527
Payments	1,502	4,191	4,620	3,910	1,802
Total	-1,429	-2,299	-1,303	3,128	6,724
% of GDP	-0.08	-0.13	-0.07	0.13	0.36
Parameter Variations					
Receipts	-1,699	369	-1,486	-170	-5,992
Payments	-2,025	-1,012	-979	-4,435	-5,601
Total	343	1,599	-407	4,394	-390
% of GDP	0.02	0.09	-0.02	0.18	-0.02
Budget 2016-17	**-37,081**	**-26,123**	**-15,406**	**-5,955**	

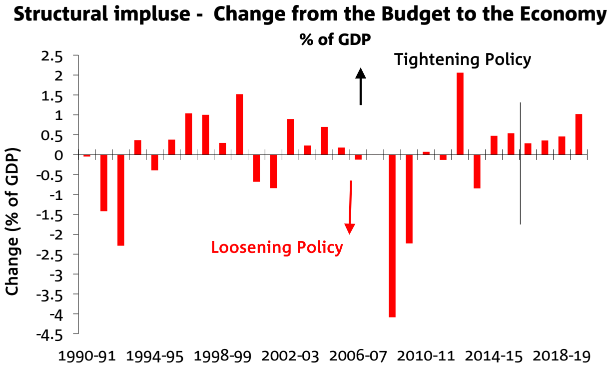
Source: Budget Papers

Medium and long-term fiscal context

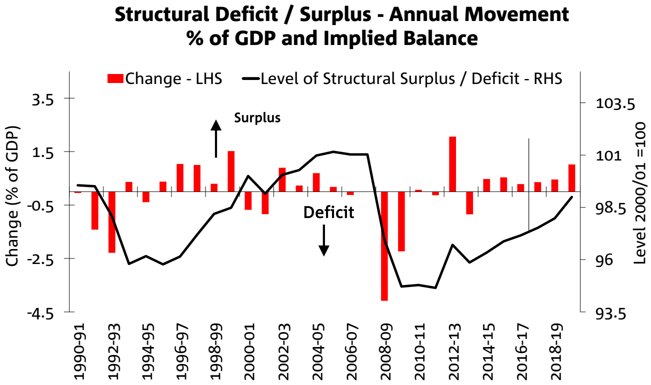
As noted earlier, the Government is putting more focus on the Operational Balance. That makes sense to the extent that investment in productivity enhancing investment should eventually be easier to service given a positive return – as well as helping to plug some doubts on the growth momentum from late 2018. That said all debt needs to be financed and hence we (and Rating Agencies) will continue to look to the Underlying Cash Balance – and any risks to its sustainability.

Our figuring suggests that the Budget really only involves a modest tightening of the fiscal stance – given our 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 has been subtracting around ¼ point from GDP growth, and will continue to do so in 2017/18. Our lower growth profile suggests somewhat higher tightening in the period further out.



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.



The government is spending somewhat more freely in this Budget, projecting growth in **payments** to average 4.2% over the four years to 2020-21 in nominal terms (1.9% in real terms on average); while similar to estimated growth in 2016-17, this is higher than in the two prior years. As a percentage of GDP, **payments** are forecast to rise from 25.1% in 2016-17 to 25.4% of GDP by 2018-19 before moving lower to 25% in 2019-20 (not significantly different, on average, to the 25.2% between 2016-17 and 2019-20 as at MYEFO). By way of context, expenses peaked at around 26% during the post-GFC stimulus in 2009-10 up from around 23% of GDP in the two years prior to the GFC. **Receipts** still do the vast majority of the repair job on the budget balance, rising from 23.4% of GDP in 2015-16 to 25.4% in 2020-21 (compared with the goal of reaching 24.8% in 2019-20 as at MYEFO).

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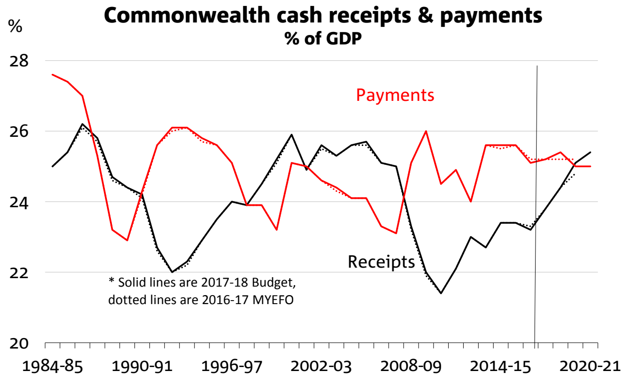
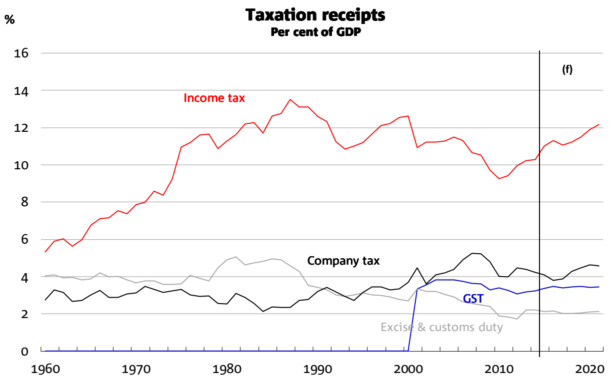
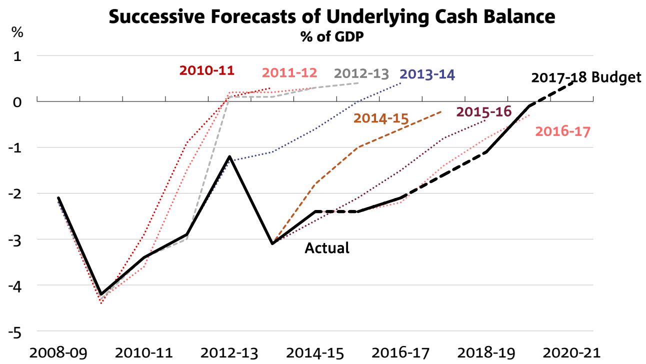


Sources: Commonwealth Treasury

Within revenue, the budget remains very reliant on rising income tax as a percentage of GDP (via bracket creep and the increased Medicare levy), which exposes the budget to downside risk should wages growth or employment growth continue to disappoint, or average hours worked continues to decline. We are also sceptical about the strength of the government's wage price index forecasts, particularly in 2019-20 and 2020-21. Corporate tax is also expected to increase strongly as a percentage of GDP through the four-year estimate period, despite corporate tax rate cuts, with some impetus in the near-term as lagged effect of current (temporarily) higher commodity prices. (The government has taken a sensibly cautious approach to its commodity price forecasts thereafter).



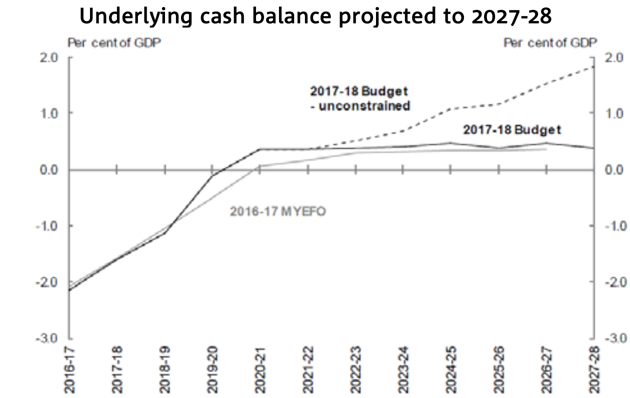
Source: Commonwealth Treasury



Source: Commonwealth Treasury

The longer term

Beyond the four-year estimates period, the underlying cash balance is projected to remain in surplus, peaking at 0.5% of GDP in 2024-25, before moderating to 0.4% of GDP by 2027-28. These projections incorporate tax receipts reaching the tax-to-GDP "cap" of 23.9% of GDP in 2022-23 and then remaining constant. (In the absence of this assumption, the underlying cash balance is projected to reach a surplus of 1.8% of GDP in 2027-28, see chart below).

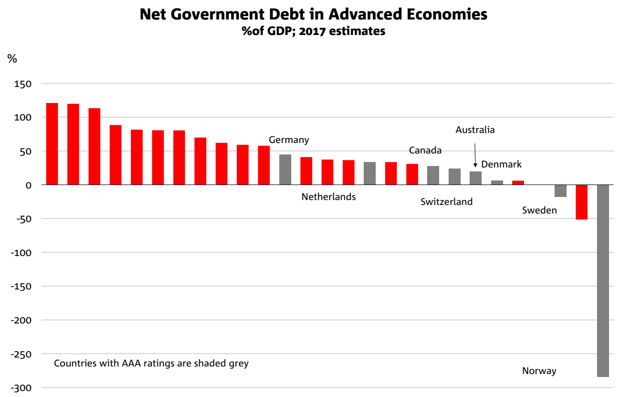


Note: A tax-to-GDP 'cap' of 23.9 per cent is applied to these projections from 2022-23. Net Future Fund earnings are included in projections of the underlying cash balance from 2020-21.
Source: Treasury projections.

Government debt

Australia's net debt is now expected to peak a little higher at 19.8% of GDP in 2018-19 compared with 19% of GDP as at MYEFO. Part, but not all, of the increase in net debt since MYEFO is due to changes in accounting standards (see below for further detail).

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).



Source: IMF World Economic Outlook Database, April 2017; Bloomberg

Despite, all the talk of **"good" and "bad" debt**, pre budget, the emphasis remained on total net debt, but with added focus on the net operating balance. While we agree with the shift in emphasis away from demonising all forms of debt, and agree that the government should take advantage of historically low funding costs, scrutiny over project selection remains paramount and funds must be channelled into productivity-enhancing investments.

Ultimately, all debt must be kept at levels that ensure it remains under control.

Implications for the bond market and rating

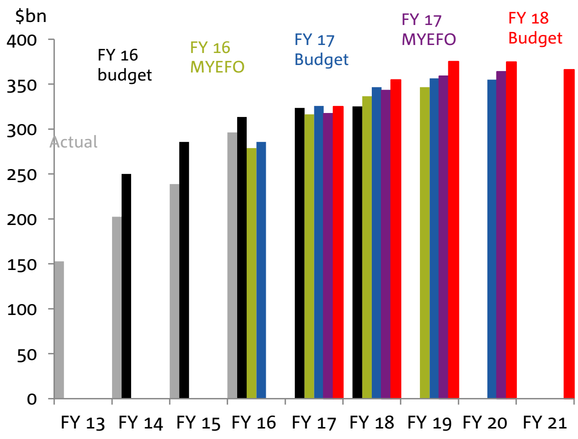
Market implications

There was little reaction in the AUD or Aussie bond futures on the release of the Budget, as is typically the case. Talk of the distinction between "good" debt and "bad" debt ahead of the Budget had raised the prospect of increased issuance for infrastructure. In the event, the CGS forecasts in the budget imply a lower net issuance task for 2017-18 than 2016-17, similar to what was projected at MYEFO. While the headlines focus on a large infrastructure spend of $75bn, funding is partly reflected in budget numbers already and increases in funding for equity injections into new projects are gradual and small in the scheme of things. We don't see this budget tipping S&P towards a reduction to the AAA, but the negative outlook is likely here to stay. Moody's remains comfortable with its Aaa assessment.

Debt and bond issuance outlook

Relative to MEYFO, net debt is projected to increase by $10.9bn over the next 3 years, despite an improvement in the underlying cash balance. However, much of this shift reflects an increase in the market value of CGS because of lower average yields and a change in accounting treatment of development funds. Relative to GDP, net debt is expected to be steady around 17.6-19.8%, before declining towards 8.5% of GDP over the long term.

Net debt



Source: NAB, Commonwealth Budget

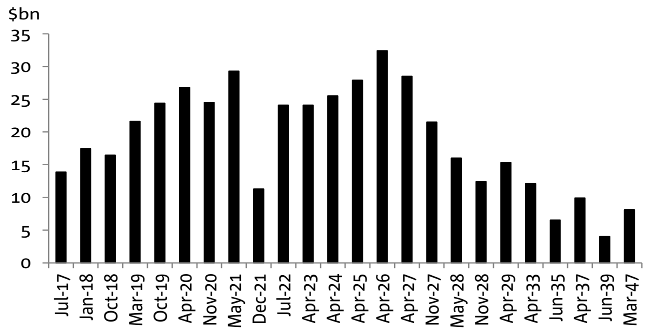
Gross debt and bond issuance outlook

The Budget projects CGS on issue will rise over to over $600bn by 2019-20. Reflecting the expected improvement in the deficit position, the Budget projections for CGS imply net issuance for 2017-18 will fall to $43bn, from $70bn in 2016-17. As the table shows, the projected path for net issuance of CGS over the next few years isn't dramatically different from MYEFO and cumulatively over the next 3 years implies only a $2bn increase.

The AOFM will likely announce issuance plans for 2017-18 tomorrow or in the coming days. As was the case at MYEFO, the gross issuance number may be higher to facilitate expected bond buybacks. There are still some sizable maturities over the next couple of years, although buybacks over the last year have started to smooth this profile. The AOFM's update could also include intentions for next year's new bond lines. There's scope for the AOFM to add a second maturity in 2022 to fill future bond basket needs. The chart below also shows room for the long end of the curve to continue to build over time.

	2016-17	2017-18	2018-19	2019-20	2020-21
2017-18 Budget					
Face Value ($bn)	499	537	579	603	606
Implied Net Issuance ($bn)	73	38	42	24	3
Maturities ($bn)		31	38	51	54
Gross Issuance ($bn)		69	80	75	57
Change since MYEFO					
Face Value ($bn)		-2	3	2	
Net Issuance ($bn)		-2	5	-1	

Nominal ACGBs Outstanding



Source: NAB, Bloomberg

Ratings outlook

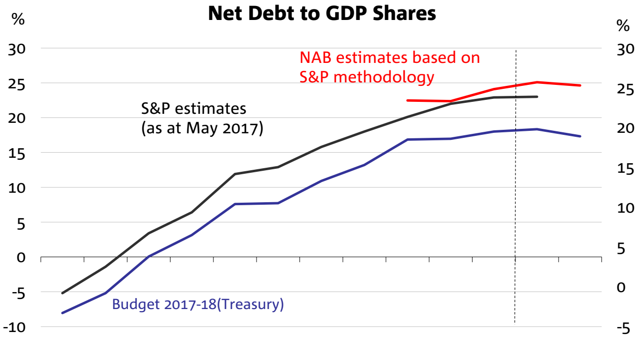
Moody's has commented that the Budget is consistent with Australia's Aaa rating and stable outlook. The Moody's analyst sees the Budget as close to the MYEFO and previous year's numbers and while they are more circumspect on growth and the pace of fiscal consolidation, they still judge fiscal strength as *"very high"*. Fitch notes the faster improvement in the general government deficit is a positive, but they *"will make an assessment of the broader impact of new policy measures on the economy and housing market, factors we have identified as rating sensitivities in our previous review"*.

At the time of writing, S&P is yet to make a comment and they will likely take time to consider the impact of the Budget on their negative outlook to the AAA rating. We think S&P will retain the negative outlook, but we don't think this Budget will serve as the catalyst for an imminent downgrade. We see the following factors as supportive of the AAA being sustained for now:

- the trajectory of the underlying cash balance is a bit better than at MYEFO and preserves a 2020-21 surplus;
- net debt increases in the short term, but the longer term trajectory is similar to MYEFO;

- the removal of $13.6bn of savings measures stuck in the senate should be seen as a positive for credibility and the predictability of fiscal outcomes;
- the willingness to add new revenue and spending measures is also a credit positive;
- the economic backdrop has broadly improved.

Notwithstanding these positives, S&P is likely to remain cautious on a number of fronts. The revenue projections rest on what we believe are defensible growth forecasts, but there is plenty of areas where S&P may remain concerned, such as on wages growth. Restraining expense growth remains an ongoing challenge and much of the improvement in the bottom line reflects revenue changes.



Source: S&P Ratings Services, 2017-18 Budget and NAB calculations

Budget Measures – In Brief

New Spending Initiatives

Infrastructure

- The 2017-18 Budget provides substantial new funding for infrastructure, including Inland Rail, a second Sydney airport as well as further urban and regional road and rail funding. The budget includes an increasing diversity of funding mechanisms for these projects, including equity injections into Commonwealth owned companies and concessional loans in addition to conventional grants to state and territory governments.
- Overall, the budget includes a headline $70b figure for infrastructure investment from 2013-14 to 2020-21 (up from $50 billion last year). This year the budget includes a 10 year allocation for road and rail funding, expected to deliver $75 billion in funding from 2017-18 to 2026-27.
- The two major projects include an equity investment of $8.4b in the Australian Rail Track Corporation (ARTC) to build the Inland Rail and an equity investment of up to $5.3b in a new Commonwealth-owned company, WSA Co, to build the first stage of the Western Sydney Airport at Badgerys Creek.

Education

- The 2017-18 Budget includes a number of new measures for education. While universities will face cuts, schools will receive additional funding. School funding will change under a new plan (*Quality Schools - true needs-based funding for Australia's schools*) that will inject an extra $18.6 billion over the next 10 years and embrace a 'same' funding model for all schools regardless of system.

Health

- The government will also use Medicare levy revenue (along with income tax receipts) to establish the Medicare Guarantee Fund, to meet the funding requirements of the Medicare Benefits Schedule and Pharmaceutical Benefits Scheme in coming years.
- The government will unfreeze Medicare Benefits Schedule (MBS) indexation – the timing varies by items. This measure will cost $1.0 billion over four years.
- increased spending of $1.2 billion over five years for new and amended listings on the Pharmaceutical Benefits Scheme (PBS.

Agriculture

- The Regional Growth Fund (RGF) will invest $472m over the forward estimates in regional infrastructure projects. This includes $272m for grants and $200m to the Building Better Regions Fund.
- The Government will provide $28.5m to establish the Regional Investment Corporation (RIC) to administer $4 billion in concessional loans (already budgeted), including the $2 billion National Water Infrastructure Loan Facility and the $2 billion Farm Business Concessional Loan Scheme.

Revenue Measures

Health

- The Medicare levy will increase from 2.0% to 2.5% of taxable income from July 2019, raising an additional $8.2 billion over the forward estimate period – the National Disability Insurance Scheme will be a major recipient of this additional revenue.

Banks

- The Government will introduce a major bank levy on banks with liabilities greater than $100 billion, raising at least $1.5 billion per year. Additional Tier 1 capital and deposits protected by the Financial Claims Scheme will be excluded from the levy.

Education

- Australians enrolled in universities will pay more to help reduce $52 billion in outstanding student loans while universities are facing funding cuts under a new 'efficiency dividend'.

Business tax cuts

- The government is extending the $20,000 immediate deductibility threshold for a further 12 months to 30 June 2018 at the higher $10 million annual turnover threshold, following the passage of legislation to lower small business taxes
- Despite speculation to the contrary, the budget confirms the Government's Ten Year Enterprise Tax plan, cutting the company tax rate for all companies to 25% by 2026-27.

Saving Measures

'Zombie' savings measures (removed)

- The 2014-15 and 2015-16 budgets included over $13b in savings measures which were blocked in the Senate. Given their continuing rejection by the Parliament, they have been reversed and are no longer included in the forward estimates. However, the impact of their reversal is more than offset by other measures included in this budget.

Education

- The government has abandoned its previous higher education polices , including two key zombie measures first announced in 2014 - full fee deregulation and the 20% funding cut which was still a feature in the 2016 budget.
- The government expects to save $2.8 billion over three years from changes to higher education fees (including higher student contributions, an efficiency dividend from universities, changes to HELP income thresholds, along with other measures).

Health

- A new five year agreement with Medicines Australia will produce cost savings for the Pharmaceutical Benefits Scheme (PBS). This includes a series of agreed price reductions on a range of medicines, with total savings of $1.8 billion over five years

Housing affordability measures

Direct assistance for first home buyers

- Allowing voluntary superannuation contributions of up $15,000 per year to be withdrawn for a deposit, along with associated deemed earnings (withdrawals capped at $30,000).Withdrawals will only be allowed from 1 July 2018. Couples can both use the scheme and combine their savings for a deposit. Contributions and earnings will be taxed at 15% (rather than marginal tax rates) and withdrawals taxed at the individual marginal tax rate less a 30% offset.
- Older Australians (65 and over) will be allowed to contribute downsizing funds into superannuation (up to $300k, in addition to contributions permitted under existing rules and caps). Only applicable to principal residence owned for 10 or more years).

Social/affordable housing measures

- Replace the existing National Affordable Housing Agreement with a new National Housing and Homelessness Agreement with an additional $375m of Commonwealth funding. This will be worked out with the states.
- Establish a National Housing Finance and Investment Corporation (NHFIC) to operate as an affordable housing bond aggregator. Its function will be to provider cheaper and longer term finance for community housing providers by aggregating their borrowing requirements and issuing bonds to wholesale market at lower cost and longer tenor than bank finance.
- Tax incentives for private investment in community housing – increasing capital gains tax deduction to 60% for investment in qualified affordable housing.

Additional supply side measures

- Working with states regarding supply targets and zoning reform
- Establish a $1 billion National Housing Infrastructure Facility (based on the UK model) to work with states and territories to fund deals with local governments to remove infrastructure impediments to developing new homes and apartments on selected sites.
- Releasing Commonwealth government land (namely defence land in Maribyrnong)
- Foreign ownership in new developments will be limited to a maximum of 50% for foreign developers. This cap will be included as a condition on all New Dwelling Exemption Certificates and applies to new applications from 7.30pm tonight.
- Apply an annual foreign investment levy of at least $5,000 on all future foreign investors who fail to either occupy or lease their property for at least six months each year. Again, this applies to applications to acquire property from 7.30pm tonight.
- Legislation to extent APRA's ability to apply controls to the non-ADI sector and explicitly

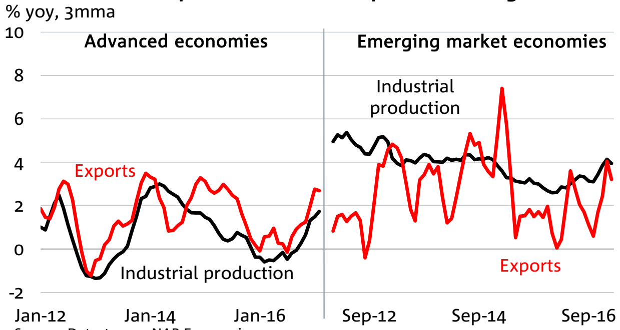
allow them to differentiate the application of loan controls by location.

- Changes to investor deductions – disallowing travel deductions and more stringent requirements for deduction on plant and equipment attached to the property (outlays must be incurred by the investor).

Global Economic Outlook

Global growth began improving through 2016 and the upturn has carried over into the early months of 2017. The pace of growth in global industrial output doubled through late 2016 from its weak mid-year performance and expansion has remained solid in early 2017. World trade, which was also weak in recent years, also picked up through 2016.

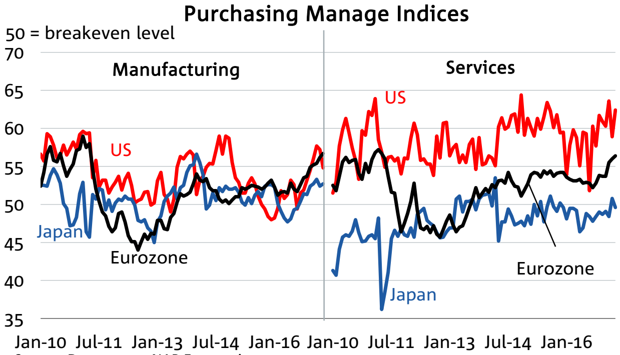
Industrial production and export volume growth



Source: Datastream, NAB Economics

Business surveys in big advanced economies have risen to multi-year highs with a particularly marked upturn in manufacturing, where survey readings have been the highest since 2011. The ramping up in service sector business surveys has been less pronounced but readings are still consistent with a cyclical upturn in economic growth across the big advanced economies.

Purchasing Manage Indices

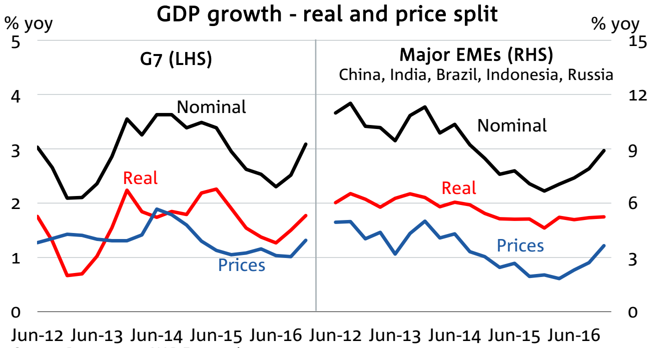


Source: Datastream, NAB Economics

Forward looking indicators in the latest advanced economy industrial surveys have lost a little of their earlier strength but remain positive. Our leading indicator confirms the acceleration in global growth continuing to mid-2017, followed by a modest slowing as weaker industrial metals prices foreshadow a possible slowing in industrial growth in the latter half of the year.

While the upturn in growth and inflation is most evident in the big advanced economies, the emerging market economies drive the bulk of global output expansion. While China (the largest global economy) and India (third largest) continue to grow rapidly, emerging market growth has stagnated overall. This reflects weakness in Russia (the sixth largest) and Brazil (the eighth biggest). The pick-up in world trade is feeding through to an industrial upturn in export-led economies such as Taiwan and South Korea in East Asia, a region which contains many of Australia's most important trading partners.

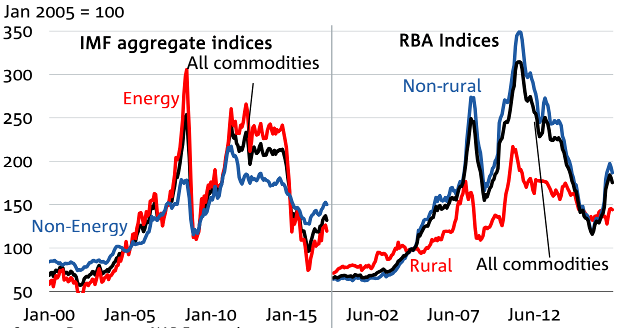
GDP growth - real and price split



Source: Datastream, NAB Economics

Part of the lift in global inflation reflects the impact of higher commodity prices lifting the cost base. Global non-energy prices are almost 20% above early 2016 lows but remain around 20% below early 2013 highs. Australian commodity export prices have shown an equally marked price cycle - higher iron ore and coal prices have contributed to a solid price lift since early 2016 but this is forecast to fade.

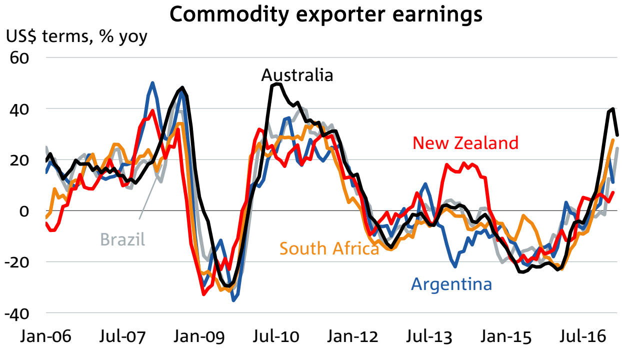
Commodity Price Indices (US$ terms)



Source: Datastream, NAB Economics

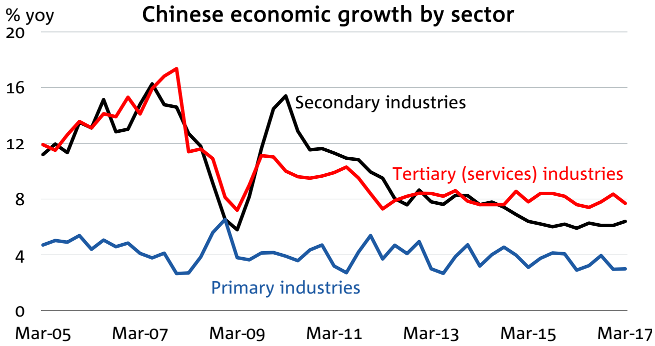
Higher commodity prices underpin the lift in export receipts across Southern Hemisphere primary exporters. Differences in export mix mean countries vary in the extent to which exports have increased during this global reflation with Australia faring especially well.

Commodity exporter earnings



Source: Datastream, NAB Economics

China is the dominant consumer in global commodity markets and Australian growth remains heavily geared to what happens in that market. After a solid start to 2017, we expect the trend slowdown in Chinese growth to continue. Chinese growth slowed from 11¼% in the 5 years to 2011 to 7¾% in the 5 years to 2016 with sub-7% growth in 2015 and 2016. Chinese growth should slow from 6¾ in 2016 to 6½% this year and 6¼% next year. The composition of Chinese growth is also shifting as the government seeks to lift household incomes and spending power, a transition reflected in the growing importance of consumption in driving demand growth and service industries in driving increases in supply. This change in the mix of growth will lift opportunities for Australian agri-business and service exporters while it puts a ceiling on the growth in Chinese demand for industrial commodities.



Source: Datastream, NAB Economics

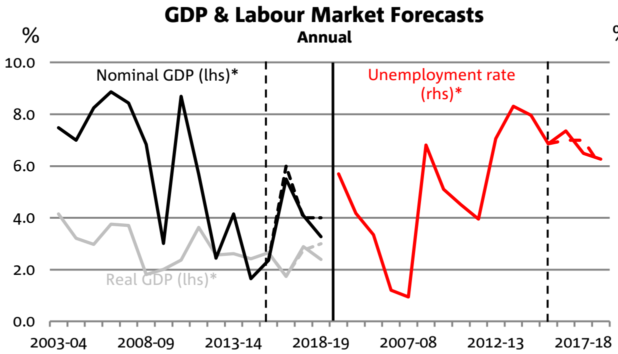
The table below compares our forecasts with those of Treasury and our forecasts are broadly similar. We have the same growth profile for China as Treasury, we are stronger on Japan and the Euro-zone through the forecast period but weaker on India and the Asian emerging market economies for 2018 and 2019.

Comparison of Treasury Budget Forecasts and NAB Forecasts						
	2017		2018		2019	
	Treasury	NAB	Treasury	NAB	Treasury	NAB
US	2.3	2.1	2.3	2.3	2.3	2
Euro-zone	1.3	1.9	1.3	1.8	1.3	1.5
Japan	0.8	1.2	0.5	0.9	0.5	0.7
China	6.5	6.5	6.3	6.3	6	6
India	7	7.4	7.8	7.2	7.8	7.4
Emerging Asia	4	4	4.3	4	4.3	3.9
World	***3.3***	***3.3***	***3.5***	***3.5***	***3.8***	***3.4***
Major trading partners	4	4	4	3.9	4	3.7

While we expect the global upturn to gather speed through the next couple of years, as always there are risks. Despite the numerous geo-political risks hanging over the global economy in the last couple of years, growth has persisted – Brexit did not lead to a UK recession, China did not experience an economic hard landing, President Trump's nationalist trade policy has not led to any trade wars and the Euro-zone has not fragmented despite the rise of populist parties. This capacity to keep growing through geo-political and financial stresses suggests that global growth has rested on stronger foundations than many feared.

Australian Outlook

We take no issue with the government's economic growth estimates for 2016-17 and 2017-18, but we see downside risks to the projected 3% p.a. growth between 2018-19 and 2020-21. This rate of growth is higher than Treasury's own estimate of potential growth for Australia of ~2¾% p.a. (although the government may argue that investment in infrastructure and education in this budget will be shifting that dial). Part of the divergence may also reflect a stronger expectation for global growth in the out years. NAB's forecasts see real GDP growth of 2.9% in 2017-18 (similar to the Government's 2.75% estimate) but only 2.4% in 2018-19, before growth reverts to our (lower) long-run growth estimate of ~2½% p.a. The government has sensibly taken a prudent approach to their forecasts for key commodity prices such as iron ore and coal, and hence the terms of trade. The government's unemployment rate forecasts of 5¾% in 2016-17 and 2017-18 appear reasonable, although the government's wage growth forecasts in the out-years of 3% to 3¾% continue to look overly strong.



* Dotted lines are Treasury forecasts; solid lines are NAB forecasts
Source: ABS, NAB Economics

Both NAB Economics and the Federal Treasury anticipate economic growth to rebound in H2 2017, following a temporary slowdown following disruptions relating to Cyclone Debbie. NAB Economics anticipates that growth will accelerate for the rest of 2017 (picking up to near 3% through the year), due to LNG exports and lagged commodity price effects. However, the longer-term outlook for the economy is where differences in views become more apparent, with NAB Economics seeing growth returning to more subdued levels, while Treasury have maintained their view for growth to remain above estimates of the economy's potential growth rate in the out years – Treasury estimate for potential growth are at 2.75% (slightly higher than NAB's estimate of 2.5%).

	2016-17 (f)		2017-18 (f)		2018-19 (f)		2019-20 (p)	2020-21 (p)
	Budget	NAB	Budget	NAB	Budget	NAB	Budget	Budget
Real GDP	1¾	1.7	2¾	2.9	3	2.4	3	3
Nominal GDP	6.0	5.5	4.0	4.1	4	3.3	4½	4¾
Employment	1.0	1.2	1½	1.6	1½	1.3	1½	1½
Unemployment rate^	5¾	5.8	5¾	5.6	5½	5.6	5½	5¼
Consumer price index#	1¼	1.8	2	1.8	2¼	2.0	2½	2½
Wage price index	2.0	1.8	2½	2.1	3	2.3	3½	3¾
Terms of trade	16½	14.8	-2¾	-1.9	-4¼	-5.4	n.a.	n.a.

* Annual average data unless otherwise specified

^ As at June quarter

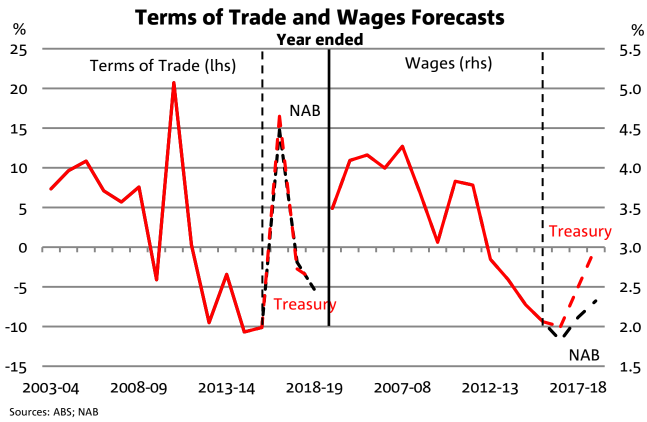
\# Through the year growth to the June quarter (y/y %ch)

Source: NAB and Commonwealth Treasury

NAB economics expect growth to soften through 2018-19, to 2.4%, as dwelling construction and LNG exports both peak. Household spending will remain subdued amidst low household income growth, although business investment will start to recover and solid government spending (particularly government infrastructure investment at the state and federal level) will provide an offset. Meanwhile, the stronger outlook held by the Federal Treasury is largely underpinned by a more optimistic view on consumption and wages (discussed below). Despite the more optimistic outlook for consumption, the contribution from net exports in the Budget is larger, in part due to softer growth in imports. Both NAB and Federal Treasury expect further dissipation of the long-running drag on investment and the labour market from the mining sector, although NAB's forecasts for business investment are notably higher – reflecting encouraging improvements in the NAB Business Survey.

Despite the relatively benign outlook for growth, NAB's expectation for a moderate recovery in domestic demand over the forecast horizon is helping to put downward pressure on unemployment -- gradually easing to around 5½% in 2017-18 and 2018-19. Treasury have taken a similar view, but are assuming further improvement to 5¼ by 2020-21. While the improvement is expected to be gradual, timely labour market indicators have been quite upbeat of late, suggesting somewhat faster employment growth than has been reported in official ABS statistics – although the official data have strengthened (partially closing the gap) very recently. In April, the employment conditions index from NAB's Monthly Business Survey pointed to annualised job creation of around 245k, which is more than sufficient to see the unemployment rate improve (assuming no change in the participation rate).

Our divergence in views on real GDP (and Australia's potential growth rate) is partly underlying differences in nominal GDP forecasts from 2018-19. Both sets of forecasts anticipate a continuation of only modest inflationary pressures, while Treasury have taken a relatively cautious stance with their commodity price forecasts, and by extension, the terms of trade – a wise approach in our view. NAB forecasts for the terms of trade are only around 2% below Treasury's by 2018-19. Budget sensitivities suggest that a permanent deviation of this magnitude could worsen the cash balance by around $1½ billion over 2 years, all else equal.



Of more significance, we are somewhat sceptical about the optimism Treasury have around wages growth – bolstering revenue projections – although they have taken a more conservative view on corporate profits. While employment growth has started to improve, helping aggregate measures of incomes (compensation of employees), wages growth has been very subdued and appears set to remain so – both NAB and Treasury expect the unemployment rate to remain above NAIRU (albeit improving) in coming years. There is also little indication of an imminent turnaround in record high underemployment, which appear to have a structural element to it, while the shifting composition of employment – towards lower paid (largely services based) occupations – is likely to continue, suggesting a structurally lower rate of wages growth going forward as well. NAB is forecasting wages growth to remain around 2% over the forecasts horizon, which compares to Treasury projections reaching 3% in 2018-19. Importantly, Treasury see a return of wages growth to 3¾% in the out years of the projection period, which is above historical averages and seems unlikely in the context of the aforementioned structural headwinds. Consequently, we see some downside risk to projections for income tax receipts and nominal GDP growth in the out years.

Further out, the Treasury's figures are projections, which assume real GDP growth of 3%. These figures do not incorporate a return to a slower potential growth rate, as we would envisage by the end of the forecast horizon.

Household sector

Recent data on consumer behaviour has remained quite downbeat, pointing to very soft consumer spending growth during Q1 2017. While some of this weakness has been driven by temporary factors – such as the disruption from Cyclone Debbie (evidenced by particular weakness in Qld spending) – there are signs of a more fundamental slowdown in spending. Retail conditions in the NAB Business Survey have been especially soft, showing the weakest trend of any industry, and our survey of consumer behaviour tends to suggest that consumers remain reluctant to spend on discretionary items, despite some reduction in anxiety levels. Consequently, we generally see the Budget as not fundamentally changing consumers' (cautious) behaviour and confidence levels, although measures such as the increase in the Medicare levy (affecting the out years) and changes to family tax benefits and higher education fees could further dampen sentiment. We expect consumption growth of around 2% in 2016/-17 and 2017-18, before seeing only a modest improvement to 2.2% in 2018-19. This is notably softer than Treasury forecast, mostly due to NAB's weaker wages growth outlook, but also reflecting our expectation for higher levels of consumer caution – prompted by very elevated levels of household debt. Treasury's consumption forecasts rely on further declines in the household savings rate to 3¼% (currently 5.2%) in 2018-19 – its lowest level since the GFC.

Business sector & dwelling investment

Turning to the business sector, the NAB Monthly Business Survey has continued to post strong outcomes, showing that both business conditions and confidence are sitting at multi-year highs. Additionally, with the possible exception of retail, the improvement in business conditions appears to have become more broad-based, with even the mining sector showing a notable improvement in recent months. This is consistent with our expectation for the economy to strengthen in the near-term (through H2 2017). Part of this is the anticipation of an ongoing recovery in non-mining investment, while mining investment will also pose much less of a drag on the economy.

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 and additional infrastructure commitments will all be supportive of our anticipated recovery in non-mining capex. For 2016/17 we expect core business investment to fall by 6.8%, before recovering by 4.7% in 2017/18 and 5.7% in 2017-18. The budget is somewhat more downbeat on private business investment, but still shows a stabilisation, then gradual recovery, over the forecast horizon.

Measures designed to encourage additional housing supply could have some positive implications for dwelling investment, although given the potential for capacity constraints in the construction industry, the upside risk is more likely to elongate the current construction cycle. However, given the size of the construction pipeline to date (with a big focus on apartments), which has responded to the strength in the residential property market, the scope for major new developments may be limited. As a result, we continue to expect the current housing cycle to peak in the relative near term. That is consistent with the recent pull back in residential building approvals, although they do remain at historically elevated levels. NAB forecast have dwelling investment rising 3.7% in 2016-17 and slowing to 1.1% in 2017-18, before showing a modest contraction of 2.6% in 2018-19. This is similar to the Budget expectation, which has dwelling investment contracting at an even faster pace of -4% in 2018-19.

As expected the Housing Affordability Package included: use of Government land to increase supply, additional funding measures for public sector housing, penalties for unused properties (more expensive for foreigners and aimed to increase supply), and favourable tax treatment of savings (voluntary superannuation contributions) for FHO deposits. There are also tax benefits for the elderly to sell their family homes, along with a number of other initiatives. To the extent these measures are aimed at increasing supply, they will clearly help – it is less obvious that boosting FHO ability to build a deposit will do anything other than add to house price pressures.

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 2016/17 underlying public demand is likely to rise moderately (up 2.7%), increasing a further 2.7% in 2017/18 and around 3½% in the out year. As part of that, the focus on infrastructure and 'good debt vs bad debt' is expected to see public investment grow much faster than public consumption over the forecast horizon. Public consumption is expected to rise around 2% in both 2017-18 and 2018-19. Meanwhile, underlying public investment is forecast to increase 5.1% in 2017-18 and 6.9% in 2018-19.

External sector

The trade sector is expected to continue to add to GDP growth in 2017 as large scale LNG projects ramp up production and exports. In the short-term, however, Cyclone Debbie has caused damage in Queensland, negatively impacting coal exports and tourism. Net exports are then expected to be neutral for growth in 2018-19 as LNG exports flatten off. Similar to the RBA, Treasury have a slightly different profile for resource exports, making a stronger contribution in 2018-19 than what NAB is forecasting.

Monetary policy outlook

We do not see much in the Budget that would affect our forecasts for the RBA to maintain the cash rate at the current 1.5% for an extended period, before hiking late in 2019. Announced measures designed to address housing affordability will on balance be welcomed by the RBA, but is unlikely to be enough for them to put aside concerns around balance sheet risks – meaning additional cuts to raise underlying inflation or lower unemployment quicker are still highly unlikely. On the same token, rate hikes are off the table in our view given forecasts (the RBA's and our own) which see the unemployment rate somewhat elevated for a considerable period, and for underlying inflation to remain below or just on the bottom of the target band.

Budget economic forecasts table

	2016-17 (f)		2017-18 (f)		2018-19 (f)	
Annual % Change	**Budget**	**NAB**	**Budget**	**NAB**	**Budget**	**NAB**
Private Consumption	2½	2.4	2¾	2.1	3	2.1
Private Investment – Dwelling	4½	3.7	1½	1.1	-4	-2.6
Underlying Business Investment	-6	-6.7	0	4.8	3	5.6
Underlying Public Final Demand	4	4.4	2½	2.7	3	3.1
Domestic Demand	**n.a**	**1.9**	**n.a**	**2.4**	**n.a**	**2.3**
Stocks – Contribution to GDP	0.00	0.2	0	-0.1	0	0.0
GNE	**1¾**	**2.0**	**2½**	**2.3**	**2¾**	**2.4**
Exports	5½	5.3	5	6.4	4	3.7
Imports	3	4.2	3	4.3	3	3.8
Real GDP	**1¾**	**1.8**	**2¾**	**2.9**	**3**	**2.4**
- Non-Farm GDP	n.a	1.4	n.a	2.9	n.a	2.4
- Farm GDP	n.a	22.0	n.a	4.2	n.a	2.0
Nominal GDP	**6**	**5.5**	**4**	**4.0**	**4**	**3.2**
Federal Budget Deficit (fiscal balance, $bn)	**-40.71**		**-20.3**		**15.5**	
Current Account Deficit: % of GDP (-%)	-1½	-1.4	-1½	-1.8	-2	-2.9
Terms of Trade	16.50	14.8	-2¾	-1.9	-4¼	-5.4
World GDP (b)	3¼	2.9	3½	2.9	3¾	3.2
End Period						
Wage Price Index	2	1.6	2½	1.8	3	2.0
Employment	1	1.3	1½	1.7	1½	1.3
Unemployment rate	5¾	5.9	5¾	5.5	5½	5.5
Underlying CPI	n.a	1.8	n.a	1.8	n.a	2.0
Official Cash Rate (%) (c)	n.a.	1.5	n.a.	1.5	n.a.	1.5
10 Year Govt. Bond Yield	n.a.	2.8	n.a.	3.2	n.a.	3.2
US cents/$A	0.76	0.8	0.76	0.7	0.76	0.7
Trade Weighted Index (d)	65.0	65.9	65.0	62.6	65.0	62.1

(a) Percentage change on previous year, unless otherwise indicated (b) Calendar year (c) Budget assumes profile similar to market pricing
(d) End of period (f) Forecast

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