2019 FEDERAL BUDGET

more than money nab

Comment

This Budget needs to be seen in its political context. It is more like an election manifesto than a traditional Budget and big questions remain around what parts, if any, will actually be implemented.

Firstly the fact that the Budget is projected to return to surplus is unquestionably a good start. That has largely occurred on the back of expenditure constraint, bracket creep and higher commodity prices (especially iron ore, where the difference between the current and the previous forecast price is – on our estimates – around $7bn per annum). Also the economic forecasts are unlikely to fundamentally change.

As to the Budget itself, a lot of the headlines are about personal income taxes. In the near term the low to medium income tax offset has doubled to a maximum of $1080 per annum and the second tax threshold (of 32.5%) has been raised from 87k to 90k. However the really big tax adjustments don't come till 2022-23. Put differently the near term cost to the Budget is only $700m per annum, whereas $4.5bn of the total spend of $6.7bn in the four years to 2023 comes in the final year. Also a lot more money is given to the Tax office to improve integrity but again is mainly spent in the out years.

The infrastructure package has been boosted by around $25bn to around $100bn in the long-run. However in the next four years the additional spend is around $4.5bn with the big ticket items including the Urban Congestion fund, Victorian fast train (Melbourne to Geelong) and the Road safety program. Also to alleviate the impact of high energy prices the government is also making a one-off tax-free payment to about 3.9 million welfare recipients, mainly age and disability pensioners (singles receive $75 and couples $125). SMEs also get a tax cut to 25% (phased in over 3 years) while the instant asset write off rises to 30k per investment (and $50m of turnover).

It will be interesting to see how Labor responds to the personal tax changes. They have previously refused to support the 2022-23 tax changes. Labor may well keep the near term adjustments but aim to produce bigger and nearer cuts at the bottom end (their current stance is to concentrate tax cuts below the $125k).

Clearly the Budget has been constrained to keep the surplus. The Government has retained the tax to GDP limit of 23.9% of GDP but the surplus really doesn't go much above 0.7% in the next four years. That means as shown in our Medium Term Context Section (see Page 3), that the Budget over the next few years adds little by way of fiscal restraint in the out years. Most of improvement in revenue continues to rely on income taxes (bracket creep) till 2022/23. And the outlays continue to shrink as a percent of GDP (a better performance than in recent years - which may have benefited from NDIS underspend).

As talked about below we also question the "optimism" of the Budget forecasts – especially real GDP and wages. So in our view the Budget is not as stimulatory as it seems to be – or is being sold as. It does not change our view on the economic outlook and how consumers will see their expenditure decisions. Nor would the outlook of the RBA be much affected.

Fiscal Outcome

The underlying cash position is expected to be in moderate surplus in 2019/20 (around $7bn or 0.4% of GDP) and rise gradually in the out years but by 2022-23 is still only around 0.4% of GDP. That is a slim surplus that remains vulnerable to any weaker than expected economic outcome. The Net Operating Balance (which adds back Government investment) rises more strongly – from around 0.5% in 2019/20 ($12.9bn) to around 1% by 2022-23 ($20.6bn).

Economic Outlook

Fundamentally we are a touch more pessimistic than the Treasury on the real economy in the out years. Beyond the current year we see the economy as tracking around 2¼% (the same as 2018/19). Treasury however sees growth around 2¾% in the out years. As a result we see higher unemployment and significantly weaker wages growth. Our profile sees the consumer still struggling with their cash-flow and hence with any discretionary spend. Also house price falls will see construction activity fall another 20% over the next two years. That said infrastructure spending, NDIS spending in public consumption and LNG exports will support the economy. The Treasury is more pessimistic on commodity prices (terms of trade falling by around 5% in each of the out years) leading to lower growth in nominal GDP. Finally we really struggle with any wages growth forecast above 3%.

Financial Markets

There was little discernible market reaction to the Budget. Like most analysts we question whether this Budget will ever be implemented. That said a run of (albeit thin) surpluses is reassuring and will almost certainly be replicated in Labor's alternative.

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Table of contents

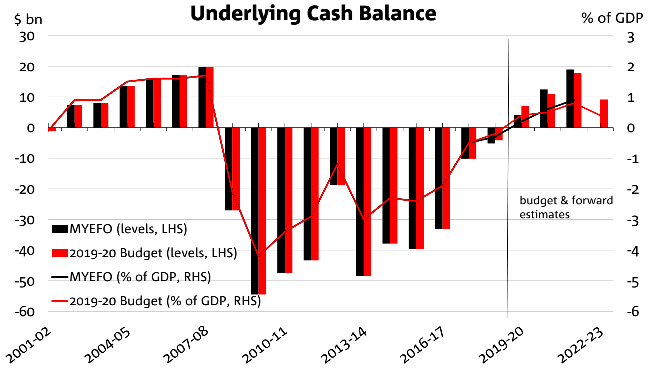
The key metrics

	Estimates						Projections		
	2018-19(e)		2019-20(e)		2020-21(e)		2021-22(p)		2022-23(p)
	MYEFO	Budget	MYEFO	Budget	MYEFO	Budget	MYEFO	Budget	Budget
Underlying cash balance, $bn	-5.2	-4.2	4.1	7.1	12.5	11.0	19.0	17.8	9.2
% of GDP	-0.3	-0.2	0.2	0.4	0.6	0.5	0.9	0.8	0.4
Net operating balance	4.9	8.5	10.1	12.9	20.4	18.2	29.8	28.8	20.6
% of GDP	0.3	0.4	0.5	0.6	1.0	0.9	1.4	1.3	0.9
Net capital investment	6.8	6.5	5.8	4.7	8.1	7.7	9.8	9.7	10.8
% of GDP	0.4	0.3	0.3	0.2	0.4	0.4	0.4	0.4	0.5
Fiscal balance, $bn	-1.9	2.0	4.3	8.1	12.3	10.4	20.0	19.1	9.8
% of GDP	-0.1	0.1	0.2	0.4	0.6	0.5	0.9	0.9	0.4
Net debt, $bn	351.9	373.5	343.4	361.0	329.9	349.5	312.6	333.2	326.1
% of GDP	18.2	19.2	17.1	18.0	15.8	16.8	14.3	15.3	14.4

Source: Commonwealth Treasury

This year's federal budget contains little shift in the government's overall fiscal stance. The budget is still expected to return to surplus in 2019-20 and the average projected underlying cash surplus over the projection period is only slightly higher on average.

The government continues to expect that the underlying cash balance will return to surplus in 2019-20, at a modestly higher level than estimated at MYEFO time (see table above). Over 2020-21 and 2021-22 the surplus is still expected to ramp-up, although not as strongly as predicted at MYEFO, before easing in 2022-23 as income tax cuts come through.

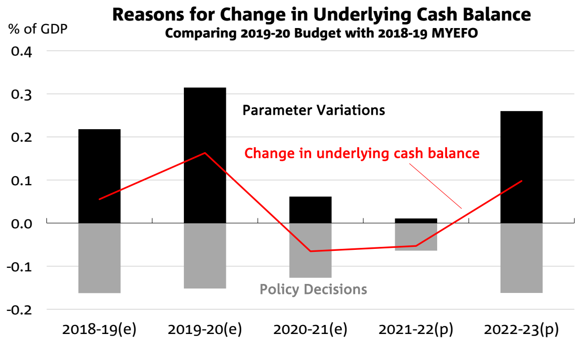


Source: Commonwealth Treasury

The expected improvement in the underlying cash surplus in 2019-20, compared to MYEFO, is despite policy decisions with a net cost of $2.7b (both on the revenue and expenditure side).

This is more than offset by a large reduction in payments due to parameter variations in 2019-20 (and beyond), including lower NDIS payments due to a slow transition of participants to the NDIS, lower debt servicing costs, and lower income support payments due to reduced recipient numbers. GST payments to the states are also lower but this is matched by lower GST receipts.

Moreover, in 2019-20, improved company tax collections (from the strength in commodity prices) more than offsets the negative impact from downward revisions to wages growth and other income on income tax receipts. From 2020-21 onwards, the effect of parameter variations since MYEFO on receipts turn negative. Combined with new policy measures, this results in the slightly lower budget surplus expectations in 2020-21 and 2021-22.



Source: Commonwealth Treasury, NAB calculations

Budget Reconciliation

Underlying cash balance estimates

	2018-19(e)	2019-20(e)	2020-21(e)	2021-22(p)	2022-23(p)
Budget 19-20	**-4,162**	**7,054**	**11,004**	**17,792**	**9,165**
% of GDP	-0.2	0.4	0.5	0.8	0.4
Policy Decisions					
Receipts	52	-1,128	-139	1,717	-2,527
Payments	3,018	1,617	2,699	3,117	842
Total	-2,965	-2,745	-2,837	-1,400	-3,370
% of GDP	-0.14	-0.16	-0.13	-0.06	-0.15
Parameter Variations					
Receipts*	3,031	622	-3,944	-5,498	-6,263
Payments	-3,651	-5,655	-5,320	-5,735	-11,667
Less future fund earnings	2,706	588	na	na	na
Total	3,976	5,689	1,377	237	5,404
% of GDP	0.19	0.32	0.06	0.01	0.24
MYEFO 18-19	**-5,172**	**4,110**	**12,464**	**18,954**	**7,131**
Budget 2018-19	**-14,462**	**2,234**	**10,957**	**16,619**	**6,114**

Source: Budget Papers, NAB calculations

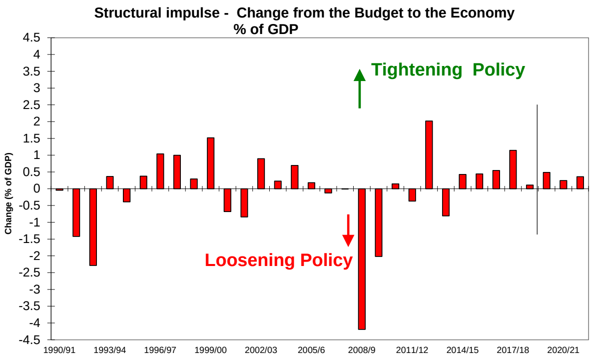
Alternative measures of the budget position - the operating balance (an accrual based measure) and fiscal balance (operating balance but with net capital investment included) - show a similar story but are expected to return to surplus in the current year (2018-19) rather than in 2019-20. However, like the underlying cash balance measure, they are expected to increase out to 2021-22 before easing in 2022-23.

Net capital expenditure, meanwhile is weaker than at MYEFO, but this reflects 'parameter and other' variations with actual policy decisions adding over $400m to investment over the estimates period. This measure does not capture all infrastructure spending.

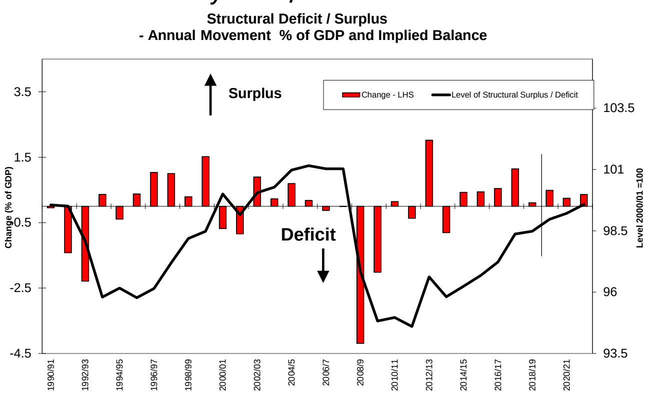
Medium term fiscal context

Our forecasts effectively see little policy tightening in the out years – which is quite a contrast with recent years (albeit that was largely done on the revenue side).

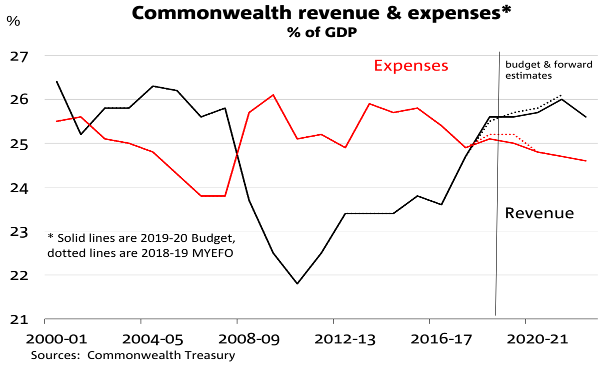
Perhaps the best way to show this is using OECD methodology which attempts to show the structural changes of Budget measures by excluding cyclical factors. That is, as the chart below indicates the Budget has been subtracting around ¼ point from GDP growth, and will continue to do so in 2018-19. Our lower growth profile suggests somewhat higher tightening in the period further out.



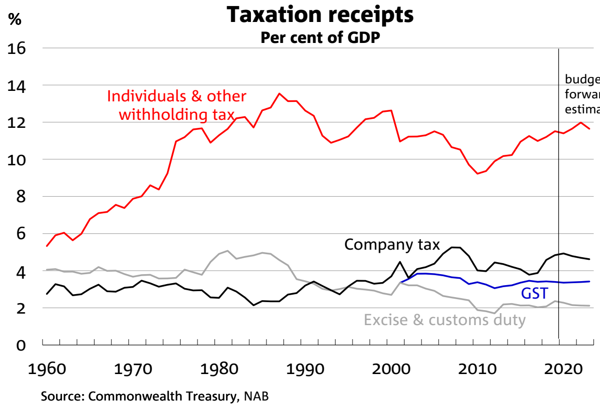
The OECD methodology also shows that the Budget is likely to remain in structural deficit for at least the period of the forward estimates. Indeed it only gets back to neutral by 2021/22.



Looking at the Governments "jaws" it is clear that much of the recovery in the Underlying Cash Balance has come from improved revenues. And that has very much been driven by income tax (bracket creep) while expenses as a share of GDP have remained broadly stable.



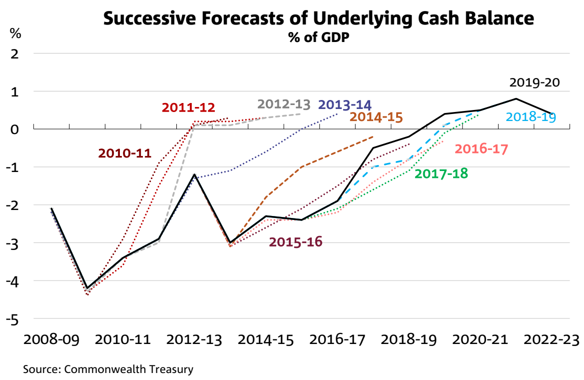
Going forward company tax receipts are expected to weaken a touch (as commodity prices come off). As noted previously bracket creep also continues until the more significant tax adjustments occur in 2022-23.



Finally, it is very marked that, on the expenses side, it is assumed that the Government will be much more frugal than has been the case in recent years.

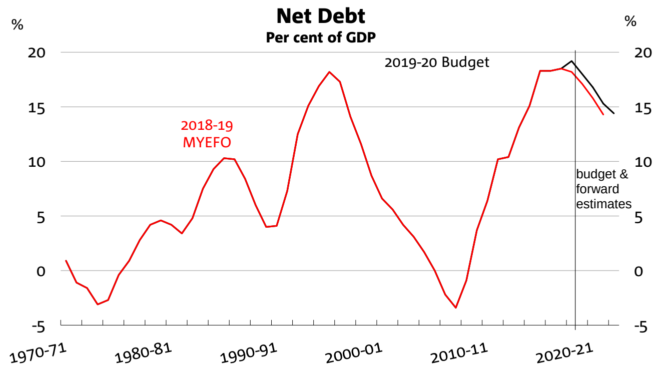
That, together with some doubts about the forecasts in the out years (especially GDP, the labour market and wages), leaves us somewhat sceptical.

In brief, there is very little slack in case things go wrong and unlike in recent years there are signs that the global economy is softening and obviously geopolitical risks are high (Chinese /US trade issues and Brexit). Nor have recent Budget forecasts been a good guide to actual outcomes – albeit the very near term surplus looks reasonable.



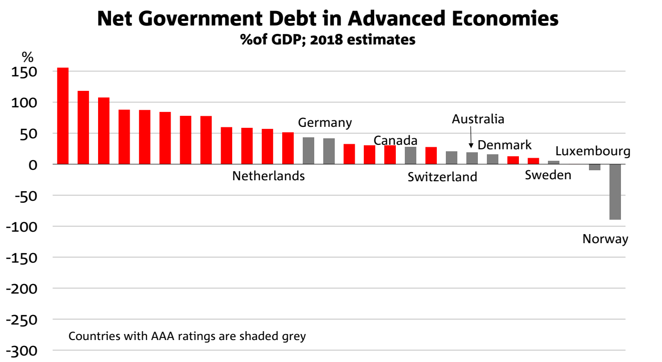
Government debt

Despite the slightly higher (on average) projected cash surpluses over the projection period, general government net debt is now expected to peak a little higher at 19.2% of GDP in 2018-19 (compared to the MYEFO expectation of a 2017-18 peak of 18.5% of GDP, declining to 18.2% in 2018-19). This mainly reflects an increase in the market value of Australian Government Securities due to lower bond yields.



Source: Commonwealth Treasury

Nevertheless, Australian net government debt to GDP is low by international standards. The IMF estimates that in 2018, advanced economies general government net debt was over 70% of GDP. Compared to its AAA rated peers however, Australia is around the middle of the pack (see chart below).



Source: IMF World Economic Outlook Database, October 2018

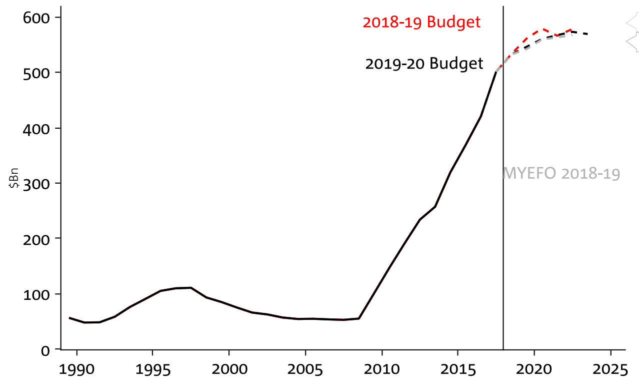
Implications for the bond market

The 2019-20 Budget features a similar debt projection to the MYEFO in December. After nearly a decade of growth amid ongoing deficits, bond supply is now projected to be near its peak. Issuance will largely be focused on refunding of maturities.

As is normal for Budget night, there has been little reaction in the AUD or Aussie bond futures to the release of the Budget papers. There are more important global macro issues to contend with and there is limited surprise value in Budget forecasts or in the policy mix after recent press leaks. Moreover, the polls continue to point to a high likelihood of a change of government at the coming election in May.

The Budget projects total ACGBs on issue will rise from $546bn in 2018-19 to a peak of $573bn in 2021-22. As the chart shows, the path for the ACGB outstandings is similar to what was projected at the MYEFO.

ACGBs on issue



Source: Budget Papers, National Australia Bank, Macrobond

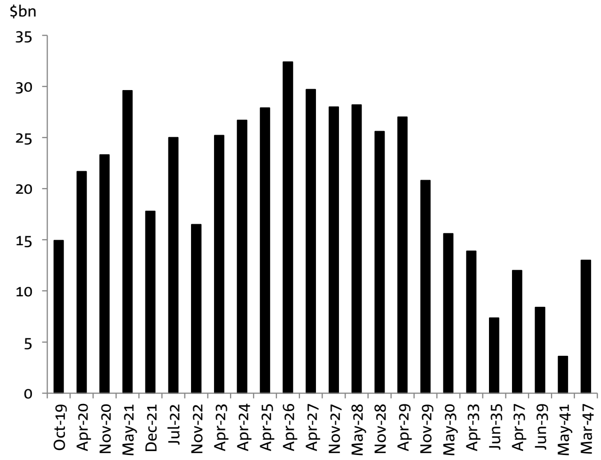
The AOFM will likely announce issuance plans for 2019-20 tomorrow. The Budget figures suggest net issuance for 2019-20 will be around $14bn – about the same as 2018-19 (reflecting the fact the underlying cash balance is in surplus, but the headline balance remains in deficit). As the table shows, the projected path for net issuance of ACGBs over the next few years is projected to fall to negative in 2022-23.There are significant maturities over the next few years, which will likely see the AOFM continue buybacks at a similar rate to the $15bn per annum seen in recent years. For 2019-20, we think the AOFM will project a gross issuance task of around $51bn, or $66bn inclusive of buybacks. We assume the TIB issuance component will remain around $5bn of the $51bn total task.

Bond Supply Projections

	2018-19	2019-20	2020-21	2021-22	2022-23
2019-20 Budget					
Face Value ($bn)	546	560	567	573	569
Implied Net Issuance ($bn)	14	14	7	6	-4
Maturities pre-Buybacks ($bn, nominal + TIBS)		*37*	56	24	67
Buybacks (NAB estimate)		*15*			
Gross Issuance ($bn)		66	63	30	63
Change since MYEFO					
Face Value Outstanding ($bn)	4	1	4	6	
Net Issuance ($bn)	4	-3	3	2	

The diminishing net funding tasks reduce the scope for new bond lines relative to previous years (the AOFM cancelled previous plans to issue new Sep-23 and Dec-30 bond lines after the mid-year review). Still, we think consideration could be given to a new 2031 or 2032 maturity to support 10y futures basket needs over the coming few years, since there is a 3 year gap in the maturity profile between the May-30 and Apr-33. Another possibility would be a new 30 year bond, such as a 2050 maturity.

Current Nominal ACGBs Outstanding



Source: NAB, AOFM, Bloomberg

Budget Measures – In Brief

New Initiatives

Health and aged care

Around $1.1 billion over five years (starting 2018-19) was allocated for primary health care services. This included: a new funding model for chronic disease care for patients over 70 (totalling $448.5 million over three years); promoting quality improvements for General Practices (totalling $201.5 million over five years); and the resumption of indexation for previously frozen GP services under the Medicare Benefits Schedule ($187 million over four years); and $62.2 million for rural generalist training.

Among other initiatives, $736.6 million was allocated over seven years for a range of new mental health and suicide prevention programs – with the largest share ($461.6 million) directed toward youth programs.

Another $724.8 million was allocated over five years (starting in 2018-19) to improve access to aged care services, including: a one-off increase to the basic residential aged care subsidy in 2018-19 ($320 million); a further 10000 home care packages over the five year period ($282.4 million); and an increase in dementia and veterans' home care supplements to support in home aged care ($35.7 million).

$331 million over 5 years for a range of new and amended medications under the Pharmaceutical Benefits Scheme, covering a range of conditions that includes lung cancer, leukaemia, cutaneous T-cell lymphoma and renal cell carcinoma.

$308.9 million to improve access to diagnostic imaging services, including funding for additional Medicare subsided MRI providers, indexation of ultrasound and x-ray diagnostic services from 1 July 2020 and two new items on the MBS for diagnosis of breast cancer.

$245 million over five years (from 2018-19) to support community pharmacies. The largest share of this is remuneration to pharmacies through increased Administration, Handling and Infrastructure fees on PBS scripts. Pharmacy cash flows will also be improved by reducing claims processing times from 9-16 days to 2-9 days.

Education

While pre and post-secondary schools received a funding boost, there were few significant measures for the higher education sector.

Some key measures include:

Recurrent funding for schools is anticipated to reach $19.9bn in 2019, with average Commonwealth funding per student having increased to $5,097 in 2019, a 36% increase over 5 years. This funding will increase to $32.4bn by 2029, a 63% rise over 2019 expenditure. Approximately 60% of the $19.9bn school funding for 2019-20 is to be allocated to non-governmental schools.

The National Partnership Agreement on Universal Access to Early Childhood Education was extended for another year with $453.1m committed over two years to 2020. This will support 15 hours of early childhood education for students attending preschool in early 2020 in preparation for commencing schooling in 2021. In all about 350,000 children should benefit.

While schools have generally been a beneficiary, there does not appear to be any significant measures to boost the Higher Education sector. Some measures announced include:

- A reduction in the HELP (Higher education loan program) - which allows students to defer payment of fees for diploma level and above courses. For example, the fair value of HELP is anticipated around $46.1bn at June 2019, $0.3bn lower than the 201-19 MYEFO.
- The startup and innovation sector has received a setback, with the R&D tax incentive cut a further $1.35bn over forward estimates. The decline in the R&D incentive program over the past 2 budgets has been in excess of $4bn. This will raise the ire of those in the high technology sector who were already upset due to cuts made in last year's budget.

Agriculture

The Budget delivers substantial spending for drought and flood relief, as well as a Future Drought Fund (announced late last year) and an Emergency Response fund.

The North Queensland Flood Recovery Package includes $3.1b over five years – this will support the North Queensland livestock industry to recover from the devastating floods earlier this year. The package has a number of components but the largest three are:

- up to $1.75b for financial institutions to provide interest rate relief for business loans to flood affected primary producers;

- $1b for loans through the Regional Investment Corporation to assist in restocking and damaged crops and on-farm infrastructure; and
- $300m in grants to primary producers (with a cap of $400,000 per producer) to assist in restocking and damaged crops and on-farm infrastructure.

The Government will also establish a $3.9b Future Drought Fund, although this is was already announced in MYEFO in December. The fund will use $3.9b in uncommitted funds from the Building Australia fund, with the value of these invested funds expected to grow to $5b over the next decade. $100m in disbursements will be available from the fund per year from 2020/21.

In addition there will be a $3.9b Emergency Response Fund, to fund natural disaster recovery. Up to $150m will be available from the fund annually from 2019/20. There will also be $130.5m over the forward estimates to reduce the risk and impact of disasters.

There will also be $29.4m to improve industry access to export markets as well as $18.3m to continue the war on fire ants.

Infrastructure

The budget announces $100b of infrastructure spending over the next 10 years, although it appears that a good deal of the money is either scheduled beyond the forward estimates period or already committed from the previous budget, which committed to around $75b of infrastructure spending.

The government will provide an additional $3b for the Urban Congestion Fund (of which $1.6b will be provided over the budget and forward estimates period), bringing the total commitment to $4b.

New South Wales is forecast to receive an additional $6.1b, with projects including $3.1b for the Western Sydney North South Rail Link (already provided by government), $1.6b for the M1 Pacific Motorway, $405m for the M12 Motorway, $400 for the Newell Highway and $200m for an additional Hawkesbury River crossing. There will also be $496m for the state under the Roads of Strategic Importance initiative and $253.5m, under the Urban Congestion Fund. The *Infrastructure Investment Program – New South Wales infrastructure investments* expense line shows $266.5m of additional funding over the budget and forward estimates period.

Victoria is forecast to receive an additional $2.8b, including $1.1b for suburban roads, $700m for the South Geelong - Waurn Ponds Rail Upgrade, $360m for the Western Highway, $300m for the Dandenong Ranges, $208m for the Shepparton Bypass and $110m for the Wellington Rd Duplication. There will also be $490m under Roads of Strategic Importance, $396.3m through the Urban Congestion Fund and $162m under the Victorian Congestion Package. The government has also committed $2b to Geelong fast rail under the *Population Package*, although almost none of the money is in the forward estimates and the Victorian government has been very critical of the project. The *Infrastructure Investment Program – Victorian Infrastructure investments* expense line shows $266.5m of additional funding over the budget and forward estimates period.

Queensland is forecast to receive an additional $2.6b, including $800m for the Gateway Motorway, $500m for the M1 upgrade, $425.4m for the Bruce Highway, $320m for the Warrego Highway, $287.2m for the Cairns ring road, $170m for the Cunningham Highway, $100m for the Gladstone Port access road. There will also be $1b for the state under the Roads of Strategic Importance initiative and $378.8m under Urban Congestion Fund. The *Infrastructure Investment Program – Queensland infrastructure investments* expense line shows $1.2b of additional funding over the budget and forward estimates period.

Western Australia is forecast to receive an additional $932m, including $348.5m for the Tonkin Highway, $207.5m for level crossing removals, $140m for the Albany Ring Road, $121.6m for the Bunbury Outer Ring Road and $115m for the Freemantle bridge. There is $535m under Roads of Strategic Importance and $121.8m under the Urban Congestion Fund. The *Infrastructure Investment Program – Western Australia infrastructure investments* expense line shows $443m of additional funding over the budget and forward estimates period.

South Australia is forecast to receive an additional $1.8b, including $1.5b for the North-South corridor, $260m for rural roads and $40m for local roads. There is $341m through the Urban Congestion Fund and $220m through Roads of Strategic Importance. The *Infrastructure Investment Program – South Australia infrastructure investments* expense line shows $134.8m of additional funding over the budget and forward estimates period.

Tasmania will see an additional $68m for freight rail modernisation – all provided within the forward estimates. There is $210m under Roads of Strategic Importance and $35m under the Urban Congestion Fund.

The Northern Territory will see an additional $60m in the forward estimates for Tiwi Island road upgrades, $492.3m under Roads of Strategic Importance and $70m for road infrastructure for Kakadu. The ACT will see an additional $50m, of which $35m is in the forward estimates period.

Road safety will see $2.2b in additional funding, although only $800m of this will be provided over the budget and forward estimates period.

Energy

The budget provides $3.5b over 15 years for the Climate Solutions Package, although most of the spending will be beyond the forward estimates period. This includes $2b for the Climate Solutions

Fund (previously the Emissions Reduction Fund) over 15 years, $1.4b equity investment in government-owned company Snowy Hydro for Snowy 2.0, and $56m for a feasibility study into the Marinus Link project in Tasmania. This will give Tasmania a second interconnector with the mainland and allow the state's extensive hydro generation assets to be used as a "Battery of the Nation". There is also $79.2m for new energy efficiency measures.

Beyond Climate Solutions, there is an additional $3.5m for underwriting new generation and $284m for one off payments to 3.9m Australians to assist with their power bills.

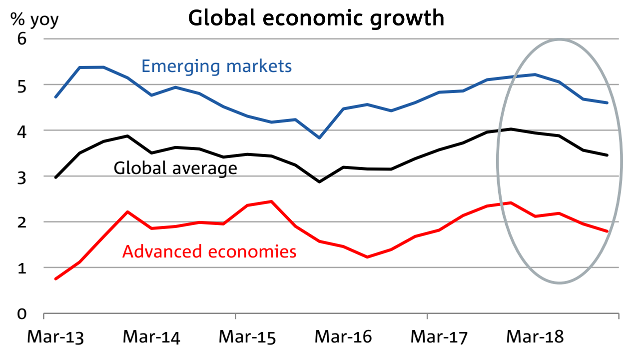
Taxes for business

The instant asset write-off - which allows businesses to write off assets (such as tools or equipment) against their taxable income - has been extended and expanded. It will now cover purchases under $30,000, up from $25,000, and can be used by businesses with annual turnover of under $50 million, up from a $10 million limit previously. Medium sized businesses will welcome this new access to the scheme. The threshold applies on a per asset basis so businesses will be able to instantly write off multiple assets. Around 22,000 additional businesses employing around 1.7 million people will now be eligible for the tax write-off with the changes projected to cost the budget $400 million over four years. These changes will apply from April 2019 to 30 June 2020 - not the permanent scheme business had hoped for. In total these changes will benefit around 3.4 million businesses employing around 7.7 million workers. The Government's decision to increase and extend the instant asset write should help alleviate cash flow pressures for SMEs and help them with their expansion plans.

The government also announced that the corporate tax rate for companies with annual turnover of less than $50 million will fall from 27.5 per cent to 26 per cent next year and 25 per cent starting in 2021-22. This is some five years earlier than previously planned and is expected to benefit around 970,000 companies. The Government will also increase the unincorporated small business (up to $1000) tax discount rate from 8% in 2019-20 to 13 per cent in 2020-21 and 16% in 2021-22.

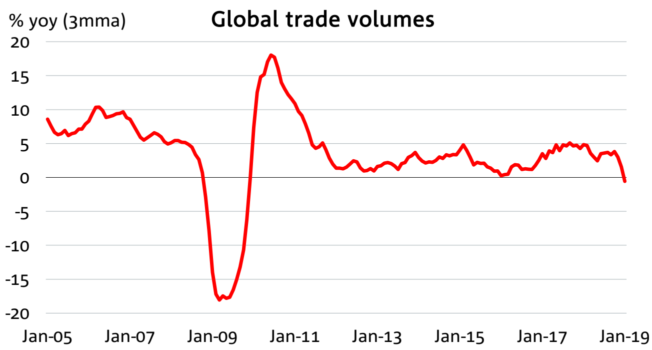
Global Economic Outlook

Global economic conditions gradually deteriorated across 2018, and early indicators for 2019 show continued slowing. Much of the slowdown is evident in manufacturing indicators – reflecting both weakness in global trade and domestic demand in advanced economies outside the United States. In contrast, services sectors have performed a little more strongly.



Source: Datastream, NAB Economics

Growth in global trade volumes slowed considerably in the second half of 2018 – from an average around 4.0% yoy in 2017 and H1 2018, to -0.6% yoy (on a three month moving average basis) in January. This trend goes beyond US-China trade tensions, with imports falling noticeably in the Euro-zone and in other advanced economies (excluding the US and Japan).



Source: CPB, NAB Economics

That said, the US-China trade relationship remains a key uncertainty. The scheduled increase in US tariffs (due at the start of March) was indefinitely deferred in February 2019, and there are signs that the US and China may reach a deal which would lift sentiment. However, there remain doubts around the likelihood of a lasting agreement between the two countries.

Growth in the major advanced economies slowed across 2018, down to 1.8% yoy in Q4 2018 (compared with 2.4% yoy in Q4 2017). This was particularly the case outside the US – with downturns in Japan, Germany, France and Italy being the main drivers. We expect the slowing trend to continue in 2019, as US growth eases due to the fading impact of last year's fiscal stimulus and the lagged impact of earlier monetary policy tightening. The ongoing confusion around Brexit adds some uncertainty for the United Kingdom and European Union.

The current weakness in global trade will impact emerging markets more significantly than advanced economies. Growth in these economies has also slowed, with weaker growth from the two largest markets – China and India.

China's weaker growth has been driven primarily by tightening credit conditions, as authorities have attempted to address high corporate debt levels, rather than trade tensions with the United States.

The scope of stimulus in 2019 presents considerable uncertainty to China's economic outlook – which we forecast will continue to slow.

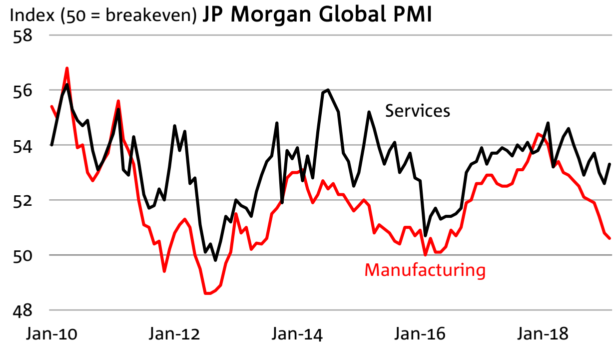
There are a number of challenges for India's economy in 2019, including an increase in unemployment, volatility in the exchange rate and political uncertainty given upcoming elections. That said, business surveys have been improving, suggesting growth is holding up for now.

Despite supply side constraints and rising wage growth (primarily in advanced economies, particularly the United States), inflation remains muted.

The combination of subdued inflation and weaker growth has led to a change in the policy stance of some major central banks. The US Federal Reserve has moved from signalling rate rises at the end of 2018 to indicating that it be patient and remain on hold through 2019. Similarly, the European Central Bank has delayed the date from which it will consider rate rises. The tightening cycle evident in emerging economies through 2018 also appears to have come to an end.

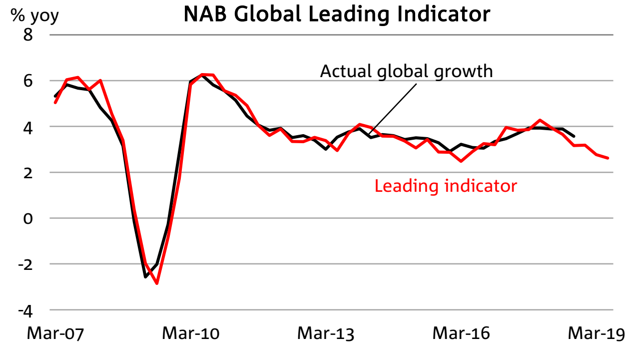
Changing monetary policy and economic growth expectations are evident in bond markets, where the 10 year government bond yields for major advanced economies have declined by between 25 and 110 basis points since peaks in October 2018.

A range of survey indicators – which provide more up to date signals around economic conditions than official data – have deteriorated since early 2018. Global manufacturing PMIs have fallen since late 2017 and are now near neutral levels, while services PMIs have also softened but remain in expansionary territory. Forward looking indicators in advanced economy industrial surveys have returned to trend levels, having been elevated above these levels since early 2016.



Source: Datastream, Markit, NAB Economics

Our global leading indicator suggests that growth could slow considerably through to the middle of 2019, implying some downside risk to our forecasts, however we expect that the move towards a more dovish monetary policy should stabilise growth later in the year.



Source: NAB Economics

The table below compares NAB's global economic forecasts with that of the Commonwealth Treasury. Overall, we see a downturn in global growth this year – to a sub-trend 3.4%, before recovering marginally to the long term trend of 3.5% in 2020 and 2021. Generally Treasury appear to be a little more optimistic in its outlook – with stronger rates of growth in the out years for India and Other East Asia, along with stronger growth for the United States in 2019 and 2020.

Comparison of Treasury Budget Forecasts and NAB Forecasts

	2019		2020		2021	
	Treasury	NAB	Treasury	NAB	Treasury	NAB
US	2.3	2.1	2.0	1.8	1.8	1.8
Euro-zone	1.3	1.2	1.5	1.5	1.5	1.4
Japan	1.0	0.3	0.8	0.6	0.8	0.9
China	6.0	6.3	6.0	6.0	5.8	5.8
India	7.5	7.1	7.8	7.2	7.8	7.1
Other East Asia	4.3	3.8	4.3	3.7	4.3	3.6
World	3.5	3.4	3.5	3.5	3.5	3.5
Major trading partners	4.0	4.0	4.0	3.9	4.0	3.9

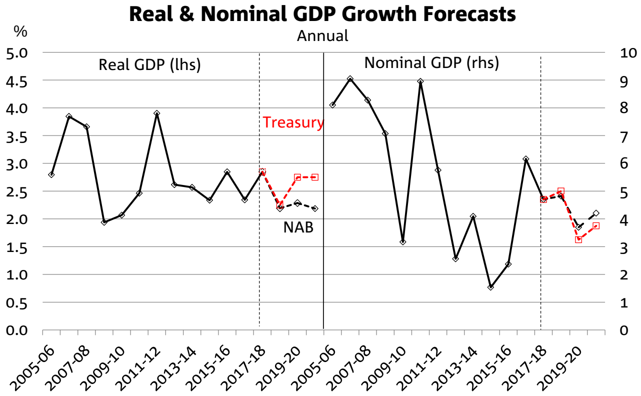
There remains considerable uncertainty around the outlook. The extent of stimulus in China (in response to slowing growth in late 2018) remains far from clear (in part due to the country's already high debt levels), while ongoing uncertainty around US trade policy beyond China, the Brexit negotiations, further financial market and energy price volatility and shifting expectations regarding monetary policy could impact economic growth going forward.

Australian Outlook

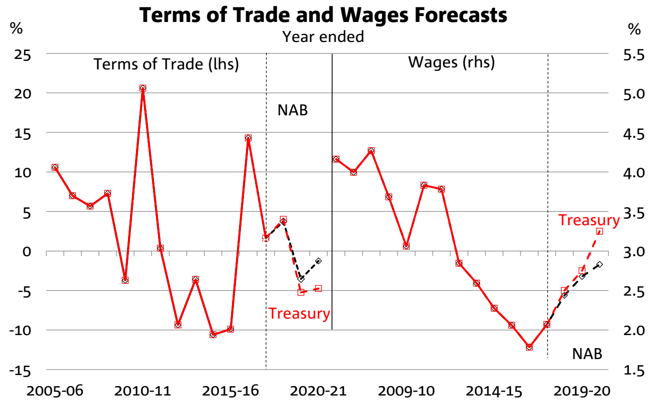
Our forecasts for real GDP growth are a little weaker than those included in the budget. For 2018/19 there is little difference in the forecasts – with the recent run of weakness having been factored in. In the out years, Treasury expects growth of around trend 2¾% (close to the Treasury's estimate of potential output growth), whereas we expect weaker growth of around 2¼% which is around ¼ppt below our estimate of potential output. Treasury expects stronger consumption growth, a faster ramp up of LNG exports and a gentler decline in dwelling investment. Our expectations for underlying business investment are broadly similar to those of Treasury, while we expect slightly stronger growth in underlying public investment.

On the other hand, Treasury appears to have taken a conservative approach to forecasts of nominal GDP with a weaker outlook for the terms of trade. Treasury expects nominal GDP growth of 5% in 2018/19 (similar to our forecast of 4.8%) before slowing to 3¼% in 2019/20, then rising to 3¾% in the out year. We expect slightly stronger nominal GDP growth with a less conservative outlook for the terms of trade.

In general, the budget embodies a more optimistic outlook for the labour market than our own, with employment growth of 1¾% (around ½-¾% stronger than NAB forecasts) and an unemployment rate of 5.0% in each year of forecasts – compared with our expectation of a gradually rising unemployment rate (reaching 5.3% by the end of 2020/21). The budget forecasts of wage growth are broadly similar to ours for the current and next financial year, before strengthening in 2020/21 and returning to average growth of 3.5% beyond that.



Sources: ABS; NAB



Sources: ABS; NAB

We have not fundamentally changed our forecasts with the release of this Budget. We do not see a significant shift in the stance of fiscal policy, and while there are a series of tax cuts, they are largely on the back of a bigger than expected revenue take, with commodity prices having been higher than expected. They are also small – at least in the near term.

The Budget comes after a sharp slowing in growth, driven by a pull-back in household spending from the better-than-expected outcome in the first half of 2018 and the beginnings of a relatively sharp fall in the residential dwelling construction cycle. Mining investment has also continued to decline as the construction phase of the last large LNG projects winds down.

Offsetting some of this weakness in the private sector has been ongoing strength in spending by the public sector. Government consumption – related to NDIS rollout – has grown strongly over the last year. Government spending on infrastructure has also supported growth. Overall growth has slowed from an annualized pace of 3.8% in the first half of 2018 to only 0.9% in the second half of 2018. The NAB NAB Monthly business survey and consumption indicators suggest that there has been little improvement in growth in the first quarter of 2019.

Alongside the slowing in economic growth, inflation has remained generally weak with both a series of one-off factors weighing on headline over the past year, and weak global inflation pressure combined with weak growth in domestic labour costs (despite some increase in wage growth) weighing on core measures. Housing rents have also weighed in some markets with rental vacancy rates having increased.

Over the next couple of years we see economic growth supported by ongoing increases in public sector investment (both infrastructure and NDIS related), rising business investment, and in the near term, a lift in LNG exports. Further, the drag from falling mining investment is expected to wane, and sustaining capex will settle at a new higher level with the now larger capital stock in the sector.

Against this, we see the household sector as a continuing drag on growth. A substantial fall in dwelling investment alongside the ongoing cooling in the housing market will detract from growth over the next couple of years as the dwelling construction cycle turns down. Household consumption, which accounts for over 50% of GDP, is also expected to only grow modestly at around 2¼% (compared with 2¾-3% in the budget) over the next few years, which will further restrain growth in overall output. We see the confluence of weak wage/income growth, high debt levels and stretched budgets continuing to weigh on consumer confidence and restrain household spending decisions for the next couple of years. In contrast, Treasury sees a more optimistic outcome for consumption with incomes lifting as wage growth increases and also some support from the included tax cuts in this budget. Falling house prices are another risk to consumption – though at this point we have not factored in a large 'wealth effect' – where ongoing sharp price falls could.

With a below trend growth outlook, we expect little improvement in the unemployment rate from here before it rises a little in the out years. With a slight deterioration in the labour market we also see only a very gradual increase in wage growth over the forecast period.

Further in the absence of a significant pickup in global inflationary pressure, and a material deterioration of the exchange rate combined with the ongoing weak growth in domestic wage pressure sees core inflation only in the bottom quarter of the RBA's target band over the next couple of years.

Housing

The cooling in the housing market continues to be an important factor for the macro outlook going forward. Residential property prices have continued to decline, led by weakness in the two largest capital cities with Sydney now 13.9% below its peak in mid-2017 and Melbourne down 10.3% from its peak in November 2017. While the pace of decline has moderated slightly in recent months, the falls have become more broad-based across market segments and regions. Overall, we continue to expect a peak-to-trough decline in national dwelling values of around 10% with declines of around 15% in Melbourne and Sydney (though the latter may decline a little further).

We see the decline in prices as having been driven by weaker investor demand, waning foreign demand, increases in supply in some areas and tighter credit conditions.

The decline in prices has seen some spill-overs to the activity side of the market. Residential building approvals have declined relatively sharply over the past year, and appear to have already flowed into construction activity, with dwelling investment falling sharply in late 2018, despite a relatively large pipe-line of work yet to be done. We expect a large decline in dwelling investment over the next few years (around 20%).

For now we see the adjustment in the housing market as having occurred in an orderly fashion and overall a healthy correction after an extraordinary period of house price growth. With both unemployment and rates low, we do not see a disorderly correction occurring. That said, there are risks of a bigger than expected 'wealth effect' to the household sector, despite prices remaining well up on 2012 levels. Further, the decline in activity may spill over to other construction-related industries.

Business Sector

A key outlook for forecasts over the next couple of years is relatively strong growth in business investment. Investment in the non-mining sector rose over the second half 2018 and we expect solid outcomes for growth from here. Indeed, the ABS capex survey (while not a complete picture) suggests that non-mining investment is expected to increase over the next year or so. Further, the decline in mining investment is expected to fade as the last mega-projects are completed. Further, there is the potential of some new investment with commodity prices having held up.

However, a significant risk to this outlook is the deterioration seen across a range of variables in the NAB Business survey. Business conditions are currently around their long-run average, after dipping to below average levels in recent months. This comes after a significant trend decline in the second half of 2018 – though from a high starting point. The decline in conditions has been broad-based across all states and industries and at face value signals a slowing in momentum in the business sector.

Further, forward looking indicators suggest little improvement from here with confidence having been below average since October last year and other forward indicators such as forward orders and capacity utilisation having trended down. Measures of cash-flow and capex have also eased.

Monetary Policy

This budget is unlikely to shift the stance of monetary policy. Inflation has been persistently weak, primarily a result of weak growth in labour costs and with a weaker growth outlook seeing little further improvement in the labour market we see the RBA moving to cut rates twice in 2019, taking the cash rate to 1% from already very stimulatory levels. With little constraint from inflation risk, and the opportunity to do better on the growth and labour market front, we see this as the path of 'least regret'. The mooted tax cuts in this budget will provide a welcome boost to household incomes, at a time of weak income growth and weaker consumer confidence resulting from high debt levels and other budget constraints. But while these measures are welcome and help at the margin, they are small and hence are unlikely to impact significantly upon the household sector dynamic.

Budget economic forecasts table

	2018-19 (f)		2019-20 (f)		2020-21 (f)	
Annual % Change	**Budget**	**NAB**	**Budget**	**NAB**	**Budget**	**NAB**
Private Consumption	2 1/4	2.2	2 3/4	2.2	3	2.3
Private Investment – Dwelling	1/2	-0.4	-7	-9.7	-4	-5.4
Underlying Business Investment	1	-1.3	5	5.1	4 1/2	4.3
Underlying Public Final Demand	5 1/2	6.0	3 1/4	4.7	3	4.5
Domestic Demand	n.a	**2.4**	n.a	**2.2**	n.a	**2.6**
Stocks – Contribution to GDP	0	0.0	0	0.1	0	0.0
GNE	2 1/2	**2.4**	2 1/2	**2.3**	2 3/4	**2.6**
Exports	3 1/2	3.0	4	3.1	1 1/2	1.9
Imports	1 1/2	1.2	3	3.2	2 1/2	3.7
Real GDP	2 1/4	**2.2**	2 3/4	**2.3**	2 3/4	**2.2**
- Non-Farm GDP	n.a	2.4	n.a	2.4	n.a	2.2
- Farm GDP	n.a	-7.9	n.a	-3.4	n.a	1.9
Nominal GDP	5	**4.8**	3 1/4	**3.7**	3 3/4	**4.2**
Federal Budget Balance (fiscal balance, $bn)	**2.0**		**8.1**		**10.4**	
Current Account Deficit: % of GDP (-%)	-1 3/4	-1.6	-2 3/4	-2.3	-3 3/4	-3.0
Terms of Trade	4	3.7	-5 1/4	-3.5	-4 3/4	-1.3
World GDP (b)	3 1/2	3.4	3 1/2	3.5	3 1/2	3,5
End Period						
Wage Price Index	2 1/2	2.4	2 3/4	2.7	3 1/4	2.8
Employment	2	2.4	1 3/4	1.1	1 3/4	1.2
Unemployment rate	5	5.0	5	5.1	5	5.3
Underlying CPI	n.a	1.6	n.a	2.3	n.a	2.0
Official Cash Rate (%) (c)	n.a.	1.5	n.a.	1.0	n.a.	1.0
10 Year Govt. Bond Yield	n.a.	1.9	n.a.	2.0	n.a.	2.1
US cents/$A	0.71	0.70	0.71	0.77	0.71	0.77
Trade Weighted Index (d)	61.0	59.7	61.0	62.5	61.0	61.6

(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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