Comment

As expected, the centrepiece of this Budget is increased infrastructure spending (currently put at 24.5bn over 10 years), reductions in both personal and company tax and the Baby Boomer package (aimed to allow pension aged residents to fund their retirement in their own homes). Also we have the government committing to a tax to GDP ratio of 23.9% (likely to be triggered by around 2021/22). The latter is largely political but probably means that without significant spending restraint (unlikely in our view) future surpluses will be marginal. Hence there is little to no room for the Budget to adapt to any economic downturn while retaining the projected surplus – and indeed little macro policy flexibility.

On infrastructure a long list of projects including: a 50% share in a Western Sydney Airport rail link, Melbourne airport rail, Monash Rail link and finishing the Melbourne ring road, Metronet in Perth, Queensland roads and Adelaide road and rail spending and a congestion fund to address hot spots. Much of this is back ended and some may not go ahead (e.g. the Victorian Government has not committed to matching funding of the $5bn Melbourne to airport rail link).

On personal tax cuts, as expected the cuts begin modestly and are aimed at the lower income levels. Initially this sees a new tax offset at $530 (around $10 per week for lower income earners). Phase two - in 2023/24- sees the bottom two tax brackets increased to $41k (was $37k) and $120k (was $87K) and the old tax offset increased by $200. Phase 3 – in 2024/25- sees the top bracket increased to $200k and the old 37 percent bracket abolished. As such the 2018/19 measures are unlikely to add much to growth. However dropping the Medicare levy increase to fund NDIS is more substantial and should help consumption growth from mid-2019 (albeit that has already been baked into our forecasts). Hence we have not changed our consumption and GDP forecasts out to 2019/20.

The Government continues to try to pass the company tax cuts for firms with more than $50m turnover per annum. Clearly whether this gets through is another matter – with the politics not looking favorable. On the impact of company tax cuts our research based on the NAB Survey very clearly points to the main impact of tax cuts being in the first instance directed to increased investment (See Australian Economic Outlook) but in the short term really involves a switch from corporate to personal taxes (given our imputation system).

Elsewhere the Government is spending much more on a crackdown on the black economy (including outlawing cash transfers above $10k), airport security, the PBS and has extended the immediate asset write off for small business investments of less than $20k..

The government has brought forward its projection of a return to surplus in 2019/20 (really a flat outcome given the uncertainties) and a small surplus in 2020/21. At this stage we remain somewhat sceptical about the projections – if nothing else there is clearly an “election cycle of promises” still to go. In the “Medium Term Economic Outlook” our view is that the Budget implies a further slight weakening of the current structural tightening in the next few years (and we don’t really return to structural - as against a nominal- surplus for some time- i.e. post 2020/21). Put differently revenue continues to be the main driver of the Budget and the medium term surpluses rely on more strict expenditure control than anything we have seen recently.

Overall we don’t see this Budget as a big spending pre-election give away. That means the Budget will provide scope to spend more - and both sides of politics will almost certainly do so. The Contingency reserve is around $21bn.

On the forecasts, there really aren’t a lot of differences between NAB and Treasury – at the margins we are a touch weaker in 2019/20 on growth and nominal GDP but there is not really much in it. Notably the Government is more conservative than the RBA projections – and on unemployment in 2018/19 is closer to our forecasts than the RBA.

Fiscal Outcome

The underlying cash deficit is expected to fall from $33.2bn in 2016-17 to $14.5bn in 2018-19, then achieving a tiny surplus in 2019/20 (ahead of schedule but…) and building to near 1% of GDP in the out years.

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Economic Outlook

As noted above there is little fundamental difference between Treasury's and NAB's economic forecasts - our GDP forecasts are around 2¾% over the next two years moving down to 2.6% in 2019/20 - while the Treasury numbers are 2¾% in 2017/18 and around 3% beyond that. Our profile sees infrastructure spending and business investment (especially for non-mining) adding to growth – as will, in the very near term, LNG exports. However, we still worry about the consumer who we expect will remain very cautious. As noted above we are marginally more cautious on wages and nominal GDP in 2019/20. And hence the surplus result in 2019/20 should really be seen as "flat"- a lot of water has to go under the bridge before we get to the surplus.

Financial Markets

There was little discernible market reaction to the Budget. S&P has so far maintained its negative watch on Australia's AAA rating. Equally it will be interesting to see how much further spending will be rolled out in the election cycle. Already it has been confirmed that there will be a "Women's" Budget in the spring.

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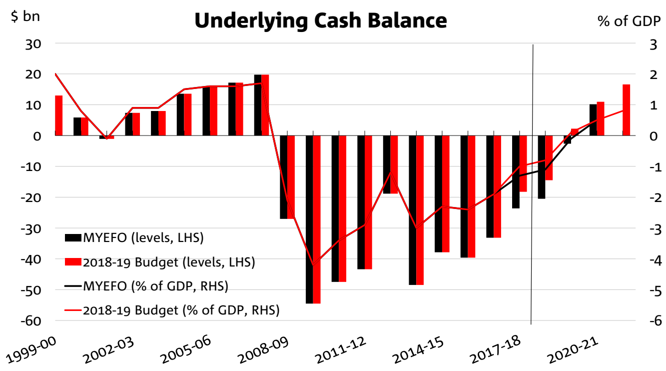
The key metrics

	Estimates						Projections		
	2017-18(e)		2018-19(e)		2019-20(e)		2020-21(p)		2021-22(p)
	MYEFO	Budget	MYEFO	Budget	MYEFO	Budget	MYEFO	Budget	Budget
Underlying cash balance, $bn	-23.6	-18.2	-20.5	-14.5	-2.6	2.2	10.2	11.0	16.6
% of GDP	-1.3	-1.0	-1.1	-0.8	-0.1	0.1	0.5	0.5	0.8
Net operating balance	-18.2	-12.6	-9.9	-2.4	6.8	8.6	20.9	19.6	27.4
% of GDP	-1.0	-0.7	-0.5	-0.1	0.3	0.4	1.0	0.9	1.3
Net capital investment	0.2	0.7	4.8	5.0	5.3	4.9	6.1	6.7	8.0
% of GDP	0.0	0.0	0.3	0.3	0.3	0.2	0.3	0.3	0.4
Fiscal balance, $bn	-18.4	-13.4	-14.7	-7.4	1.5	3.7	14.8	12.9	19.4
% of GDP	-1.0	-0.7	-0.8	-0.4	0.1	0.2	0.7	0.6	0.9
Net debt, $bn	343.8	341.0	363.2	349.9	365.2	344.0	355.3	334.3	319.3
% of GDP	18.9	18.6	19.2	18.4	18.5	17.3	17.2	16.1	14.7

Source: Commonwealth Treasury

This year's budget uses the opportunity provided by an improved revenue outlook partly to accelerate the task of fiscal repair, but also to undertake policy initiatives which have a net cost to the budget.

The government has brought forward by one year – to 2019-20 – the time at which it projects a return to surplus for the **underlying cash balance** (see table above), albeit only a small one. However, the projection for 2020-21 is little changed as the cost of the new policy measures announced since MYEFO starts to ramp up.

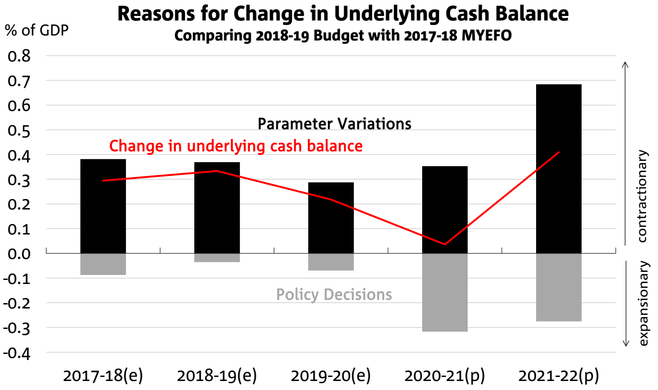


Source: Commonwealth Treasury

Alternative measures of the budget position – the **operating balance** (an accrual based measure of recurrent revenue less expenses, but excluding net capital expenditure) and **fiscal balance** (operating balance with capital expenditure included) show a similar story.

The operating balance is still expected to return to surplus in 2019-20, albeit slightly stronger. Meanwhile, **net capital expenditure** is little changed from MYEFO, but this reflects 'parameter' variations with actual policy decisions adding to capital investment, in keeping with the emphasis on infrastructure in this budget. Nor does this measure capture all infrastructure spending (see key measures below).

The improvement in the underlying cash balance in 2018-19 and 2019-20 is entirely due to parameter changes – principally revenue. This reflects in part the flow on effects of higher commodity prices to mining sector profits, but also more general strength in business activity and employment growth. In contrast, policy decisions detract from the underlying cash balance in each year – initially reflecting increased payments (with policy decisions boosting receipts in 2018-19), but then revenue measures (as the impact of personal income tax cuts and removal of the Medicare levy increase come through) despite efforts to rein in spending in the out years. That said, while the forward estimates have a degree of spending discipline from 2019-20– it is noteworthy that growth in spending in the prior three years is more rapid.



Source: Commonwealth Treasury

Budget Reconciliation
Underlying cash balance estimates

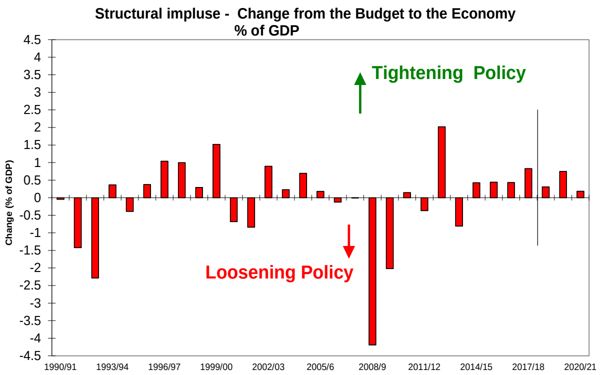
	2017-18(e)	2018-19(e)	2019-20(e)	2020-21(p)	2021-22(p)
Budget 18-19	**-18,238**	**-14,462**	**2,234**	**10,957**	**16,619**
% of GDP	-1.0	-0.8	0.1	0.5	0.8
Policy Decisions					
Receipts	29	674	-950	-6,967	-8,015
Payments	1,620	1,318	599	-24	-2,297
Total	-1,591	-643	-1,549	-6,943	-5,718
% of GDP	-0.09	-0.04	-0.07	-0.32	-0.28
Parameter Variations					
Receipts*	7,615	9,702	7,938	6,357	7,410
Payments	655	3,027	1,517	-1,380	-6,810
Total	6,960	6,674	6,421	7,737	14,220
% of GDP	0.38	0.37	0.29	0.35	0.68
MYEFO 17-18	**-23,608**	**-20,493**	**-2,638**	**10,163**	
Effect of:					
Budget 2017-18	**-29,396**	**-21,422**	**-2,470**	**7,417**	**7,659**

Source: Budget Papers
* less Net Future Fund Earnings up to 2019-20

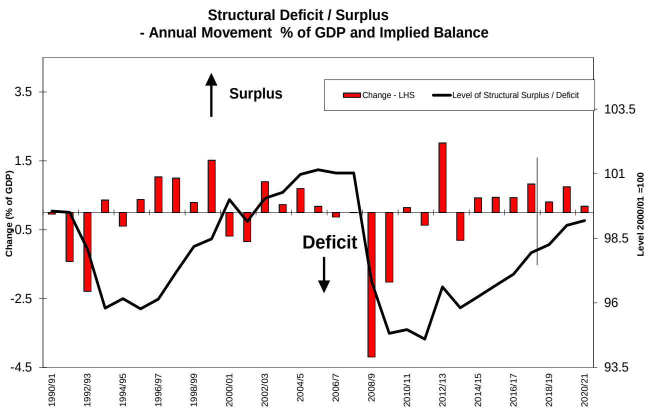
Medium term fiscal context

As noted earlier our figuring suggests that the Budget really only involves a modest loosening in the degree of tightening of the fiscal stance – in 2018/19 and the out years. But to get to a surplus requires a slight tightening in policy in 2019/20.

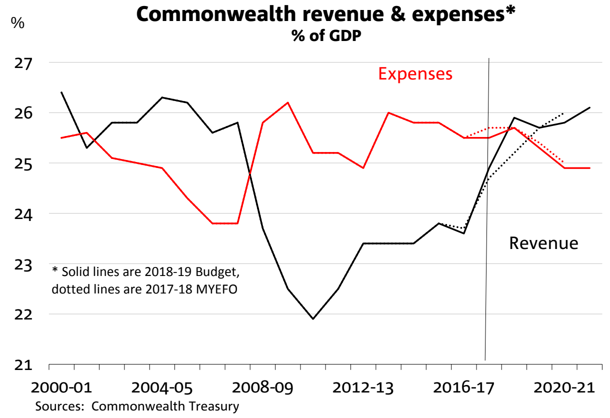
Perhaps the best way to show this is using OECD methodology which attempts to show the structural changes of Budget measures by excluding cyclical factors. That is, as the chart below indicates the Budget had been subtracting around ¼ point from GDP growth in recent years. The 2017/18 kick up in structural tightening really just says that the surge in company tax was larger than expected based on a purely cyclical analysis of the Budget. Put slightly differently corporate profits have been larger than expected given GDP (which lines up with the NAB Business Survey where profits and trading have been strong but business has largely paid down debt rather than funding faster investment). Hence a number of corporates have started to run out of previous tax credits. Going forward, the Budget returns to a very modest structural tightening of around ¼ point of GDP (and indeed a bit less than that in the next 12 months).



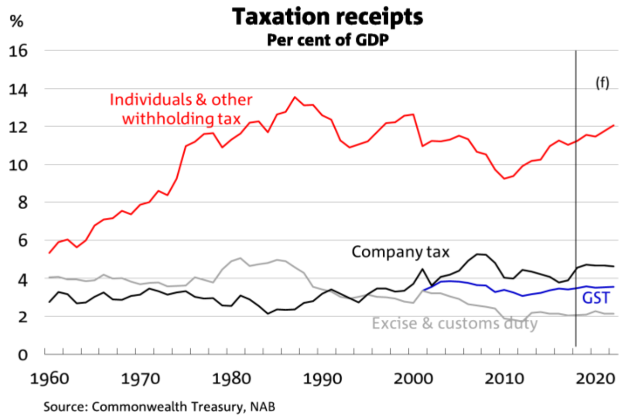
The OECD methodology above shows that the Budget is likely to remain in structural deficit for at least the period of the forward estimates. These estimates suggest that there will be no structural surplus until post 2020-21.



Another way of looking at the Budget is to explore which part of the Budget is doing the heavy lifting. Thus while the Government is headlining the new tax to GDP ceiling, the reality is that to get back to budget surplus, receipts are still doing the majority of the work.

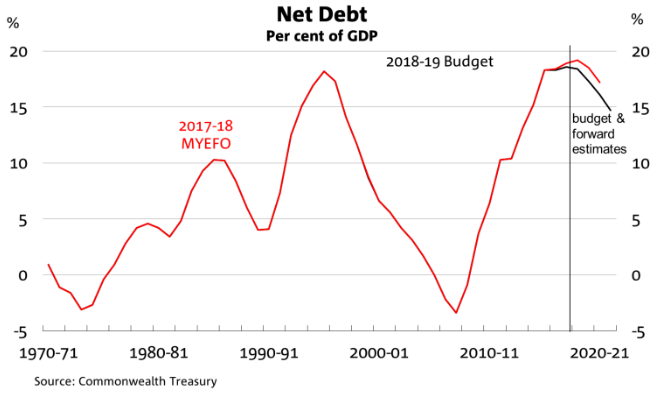


Within revenue, the budget remains very reliant on rising income tax as a percentage of GDP (via bracket creep) till the cap is hit in 2020/21, which exposes the budget to downside risk should wages growth or employment growth disappoint. The chart also shows that the real expenditure constraint in the Budget is from 2020/21 onwards. That is medium term deficits rely on more strict expenditure control than anything we have seen recently.

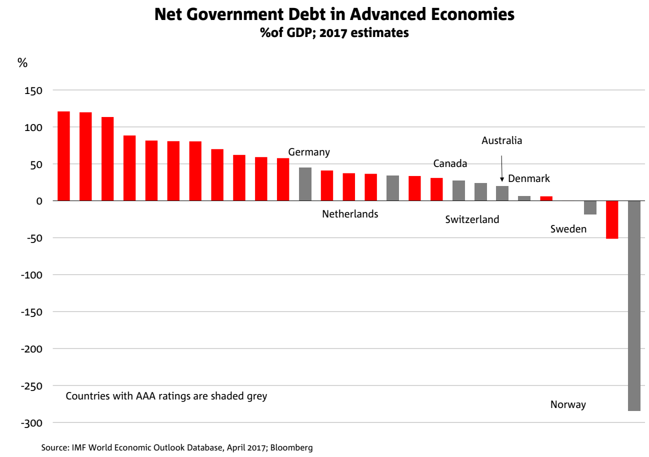


Government debt

Australia's net debt is expected to peak earlier and lower than forecast in MYEFO, with the peak of 18.6% of GDP in 2017-18. Net debt is now expected to fall to 14.7% of GDP by the end of the forward estimates in 2021-22, the lowest share of GDP since 2013-14.



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).



Implications for the bond market and rating

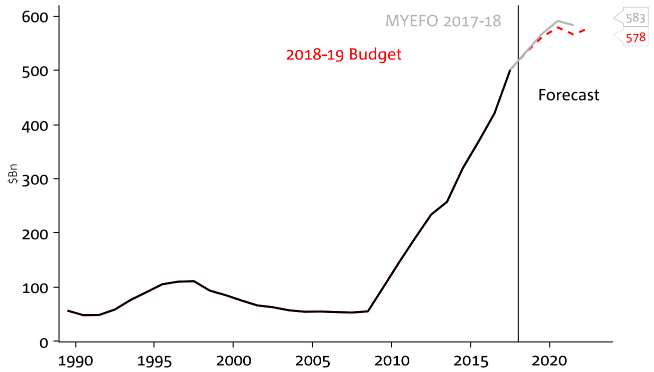
Market implications

There was little reaction in the AUD or Aussie bond futures on the release of the Budget, as is typically the case. Media leaks over the last few days meant the earlier surplus forecast was unsurprising. The Budget points to a lower path for issuance over the next few years. At the margin, this is supportive of ACGBs but the change is relatively modest and we don't see current valuations relative to swap or global peers as especially cheap. Moreover, S&P has said the rating will remain on negative outlook for now and an election before the next Budget means current projections are subject to significant change.

Bond issuance outlook

The Budget projects total CGS on issue will rise from $533bn in 2017-18 to a peak of $579bn in 2019-20 (29.0% of GDP). As the chart shows, the expected peak in the size of the ACGB market is lower than at MYEFO and this time last year a peak of just over $600bn was expected.

Chart: CGS outstanding



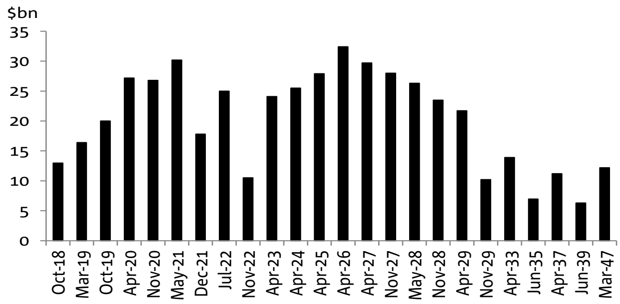
Source: Budget Papers, National Australia Bank, Macrobond

The AOFM will likely announce issuance plans for 2018-19 tomorrow. The Budget projections for CGS suggest net issuance for 2018-19 will be around $28bn. As the table shows, the projected path for net issuance of CGS over the next few years is falling and is around $5-6bn lower than the path suggested at MYEFO. Maturities in 2018-19 are $32bn (nominal and TIBs). Over the next two financial years, there are significant maturities totalling $79bn, so we assume the AOFM will continue buyback activity at a similar rate to the $15bn in 2017-18 (although AOFM recently announced it will cease buyback tenders for the Mar-19 line). We estimate gross issuance will therefore be around $75bn in 2018-19.

In terms of new nominal bond lines, the AOFM has previously said they will look to issue a new May-41 line in the first half of 2018-19. In addition, we see scope for potential new nominal maturities in late 2023 and/or 2030 to help fill future bond basket needs.

	2017-18	2018-19	2019-20	2020-21	2021-22
2018-19 Budget					
Face Value ($bn)	533	561	579	566	578
Implied Net Issuance ($bn)	32	28	18	-13	12
Maturities ($bn, nominal + TIBS)		32	47	57	24
Buybacks (NAB estimate)		*15*			
Gross Issuance ($bn)	32	75	65	44	36
Change since MYEFO					
Face Value Outstanding ($bn)	-1	-6	-12	-17	
Net Issuance ($bn)	-1	-5	-6	-5	

Nominal ACGBs Outstanding



Source: NAB, Bloomberg

Ratings outlook

S&P released a statement immediately after the Budget saying the negative outlook on the AAA rating remains in place for now. The agency acknowledged the improvement in the budget position over the past year, aided by a brighter local and global economic outlook and commitment to fiscal prudence. However, S&P also cited "significant risks to the government's plan for an earlier return to budget surpluses".

Key Initiatives by Sector

There are a wide range of initiatives in this year's Federal Budget. We've broken it down to an overview of what's most important by sector.

Agriculture

This budget contains relatively few changes for agriculture. The $20,000 instant asset write-off has been extended to 30 June 2019, which may help with some equipment purchases. There is $225 million over 4 years for GPS and satellite technology access, which will improve access for some modern agricultural equipment. Further funding is also provided to assist agriculture exporters.

To improve biosecurity, there will be a new levy of $10.02 per 20ft container equivalent and $1/tonne for bulk cargo. This is forecast to raise $360 million (on fiscal balance terms) over the forward estimates.

Infrastructure

There is significant new infrastructure spending, committing up to $75 billion to transport infrastructure over the coming decade of which $24.5 billion is new money. While last year's budget focussed on Commonwealth-owned projects such as Inland Rail and Western Sydney Airport, new spending in this budget is aimed at state government delivered road and rail projects, largely in congested urban areas.

Victoria is arguably the biggest winner, with $7.8 billion earmarked for projects in the state. This includes $5 billion for a rail line to Melbourne Airport (but importantly as an equity investment and contingent on matched funding from the state government), $1.8 billion for North East Link, $475 million for a Monash rail line, $225 million to electrify the Frankston line to Baxter, $140 million for a congestion package, $132 million for Princes Highway in Gippsland and $50 million for Geelong line upgrades.

There may be some tension with the Victorian Government over the airport line, given that the funds may be continent on Commonwealth equity investment and that a final route is yet to be selected (a $10 billion project likely to be the most expensive of potential options). The state has separately commissioned its own study of airport rail route options including Geelong fast rail.

New South Wales will receive an extra $1.5 billion for new projects, including almost $1 billion for Pacific Highway to bypass Coffs Harbour and $400 million for upgrades to the Sydney freight rail network. The Commonwealth will additionally be a 50% partner in the new North South rail link.

Queensland will receive $5.2 billion, including $3.3 billion for the Bruce Highway, $1 billion for the Pacific Motorway and $390 million for railway duplication to Nambour, $300 million for the Brisbane Metro and $170 million for the Amberley Interchange.

Western Australia will receive $2.6 billion including an additional $1.1 billion for Perth Metronet, almost $1 billion for Perth congestion and $560 million for a Bunbury ring road.

South Australia is poised to gain $1.8 billion, including $1.4 billion for the North-South Road and $220 million for Gawler line electrification. Tasmania will receive $461 million for a new Bridgewater Bridge, the ACT will receive a $100 million upgrade to the Monaro Highway and the NT will receive $280 million for road upgrades.

Education and Childcare

There was little for the education sector in this year's budget – with headline spending of an additional $24.5 billion over ten years in needs-based funding already announced in the 2017-18 MYEFO.

Similarly, there were no significant changes to childcare arrangements – with changes to payments and the extension of funding for four year old pre-school already announced.

The Government provided an additional $247 million over four years from 2018-19 to extend the National Schools Chaplaincy Programme.

Health and Aged Care

Public hospitals will receive an additional $30 billion in funding between 2020-21 and 2024-25 (albeit much of this spending is beyond the Budget estimates period). This measure was announced following the COAG meeting in February 2018.

New and amended listings on the Pharmaceutical Benefits Scheme will receive $1.4 billion over five years. The increased use of generic and bio-similar medicine is expected to generate savings of $336 million over this period.

The Government will spend $1.3 billion over 10 years from 2017-18 to support growth in the healthcare sector under the National Health and Medical Industry Growth Plan. The vast majority of this spending is scheduled to occur after 2021-22, with much of the funding coming from the Medical Research Future Fund.

The Government will spend $1.6 billion over the four years from 2018-19to fund an additional 14000 high-level home care packages (from the 6000 packages announced in the 2017-18 MYEFO).

Housing

The Government will spend $550 million over the five years starting 2018-19 to improve access to housing for Indigenous residents in remote Northern Territory. This measure was announced in April 2018 and funding will be matched by the Northern Territory Government.

Business taxation

Extension of instant asset write-off: A further 12 months extension (until 30 June 2019) of the $20,000 instant asset write-off for businesses with aggregated annual turnover less than $10 million. This allows small businesses to immediately deduct eligible purchases of less than $20,000. Assets valued at $20,000 or more can be placed into a depreciation pool and depreciated at 15% in the first income year and 30% in each income year thereafter. The measure will cost $350m in revenue.

The existing 10 year Enterprise Tax Plan was re-confirmed, which would see the company tax rate reduced to 25% at the end of the period. The 27.5% tax rate, which applied to businesses with turnover up to $10 million in the 2017-18 Budget has been expanded to cover businesses with an annual turnover of up to $50 million.

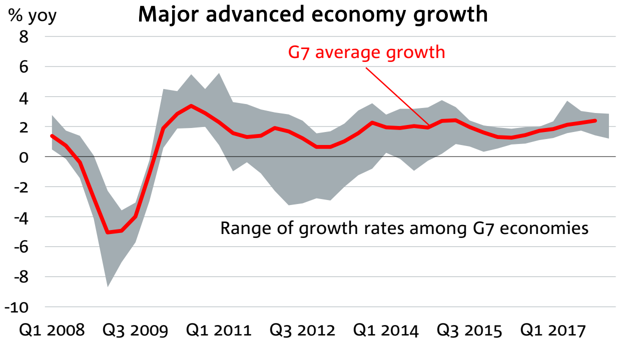
A range of measures have been announced to combat the Black Economy – including addressing fraudulent invoicing, tobacco excise evasion, sham contracting and non-compliant payment deductibility and large cash payments – which will be limited to $10,000 from 1 July 2019.

Changes to research & development tax incentives: maximum R&D expenditure eligible for concessional tax offsets will be increased from $100 to $150 million. Companies with aggregated annual turnover of $20 million or more, the Government will introduce an R&D premium that ties the rates of the non-refundable R&D tax offset to the incremental intensity of R&D expenditure as a proportion of total expenditure for the year.

Further measures have been introduced to tighten thin capitalisation rules which limit the amount of debt deductions multinational entities can claim in Australia. The ability of Management Investment Trusts to apply the capital gains tax discount at the trust level will also be removed and instead be taxed at the investor level as if they had invested in the asset directly. Rules on stapled structures will also to be tightened.

Global Economic Outlook

Global economic conditions remain at their strongest for several years – reflecting a synchronised upturn in the major advanced economies and an improvement in trends for major emerging market economies as well. The net effect is a global economy growing faster than its long term trend (at around 3.5% a year since 1980).

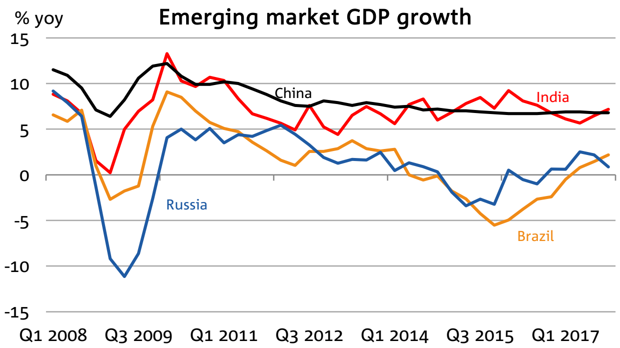


Source: Datastream, NAB Economics

Major advanced economies have recorded an upturn in growth since the middle of 2016, growing more consistently together as the average rate has risen from 1¼% in Q2 2016 to almost 2½% in Q4 2017. The main outlier is the United Kingdom, where growth has slowed as Brexit related constraints have impacted (along with poor weather in Q1 2018).

It is worth noting that growth in many of these economies (such as the United States, major European economies and Japan) has been running ahead of its potential – possible only in the short term as they erode the excess labour and production capacity that was built up in the post-GFC period. As these constraints begin to bite and central banks wind back stimulus, we anticipate higher levels of inflation and weaker growth in coming years – with growth heading back towards potential.

Inflation in advanced economies has been stronger compared with the weak levels in the first half of 2016, however the acceleration seen in the early part of 2017 has not continued – despite rising oil prices and tighter labour markets. With consumer price growth below 2% on average (and core inflation even lower), most central banks can be conservative in raising interest rates.

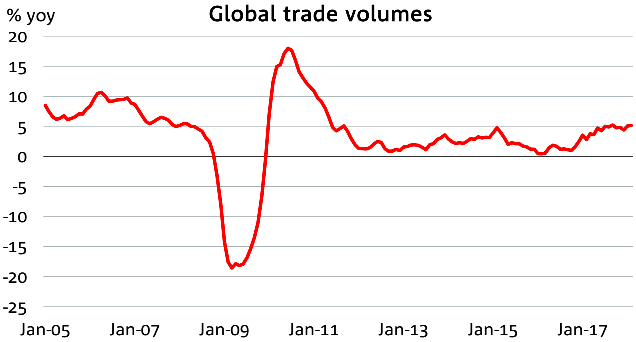


Source: Datastream, NAB Economics

Emerging market economies account for the largest share of global growth. Recent trends for the major emerging markets have been improving – driven by a rebound in growth in India (which has overcome the negative impacts of tax changes and the demonetisation program) along with recoveries from recession for Russia and Brazil.

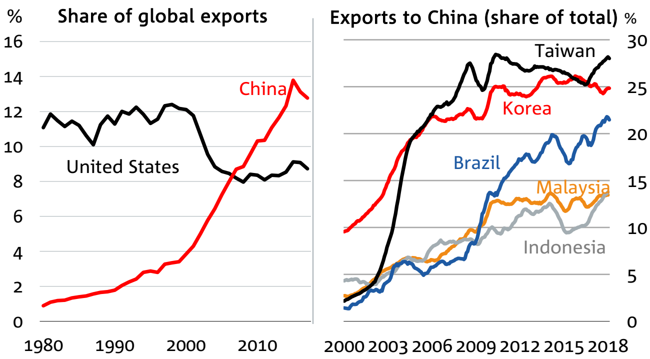
China – the world's largest economy and Australia's largest trading partner – has maintained its stable growth path since late 2015. That said, the continued transition towards consumption led growth and its ageing demographic profile point to softer economic growth in coming years – down to 6½% this year and 6% by 2020.

Growth in international trade volumes accelerated from weak levels in late 2016 to around 5% yoy in mid 2017 – a rate that has generally been sustained ever since. It is worth noting that this growth rate is weaker than pre-GFC trend levels.



Source: Datastream, NAB Economics

The escalation of trade tensions between the United States and China in recent months presents a key risk to the global economic outlook over the shorter-to-medium term. Since the start of March, trade tensions between the United States and China have ebbed and flowed, as a series of tariff proposals, exemptions and concessions have been announced by both countries. The future global trading environment remains uncertain, given the scale of these economies in global markets and potential impact on trading partners.



Source: WTO, Datastream, NAB Economics

The direct impact from a major US-China trade dispute would be limited for Australia, as the bulk of Australia's exports to China are consumed within its domestic economy (rather than as inputs to exported goods). However, lower Chinese income could impact demand for commodities and key services exports (such as tourism and education).

The majority of survey indicators – which provide more rapid indications of economic conditions than official data – remain positive. PMI measures in major advanced economies are off recent peaks in early 2018, but remain near their post-GFC highs. Similarly, forward looking indicators in advanced economy industrial surveys are a little weaker than 2017 peaks, but these were the highest readings since the early 1990s.

Our leading indicator suggests that economic growth has already peaked and will decline across the remainder of this year. Weaker trends in international air freight are the main contributor to the slowing in our measure.

The table below compares NAB's global economic forecasts with that of the Treasury. Overall, we see a gradual deterioration in global growth, whereas Treasury see a flat profile out to 2020. We see similar growth for China and Japan, our outlook is slightly stronger for the Euro-zone, while Treasury forecast stronger growth the United States, India and Other East Asia.

Comparison of Treasury Budget Forecasts and NAB Forecasts

	2018		2019		2020	
	Treasury	NAB	Treasury	NAB	Treasury	NAB
US	2.8	2.7	2.5	2.3	2.0	1.7
Euro-zone	2.0	2.3	1.8	2.1	1.5	1.9
Japan	1.3	1.3	1.0	0.9	0.8	0.7
China	6.5	6.5	6.3	6.3	6.0	6.0
India	7.5	6.8	7.8	7.2	7.8	6.9
Other East Asia	4.3	4.2	4.3	3.9	4.3	3.7
World	3.8	3.8	3.8	3.7	3.8	3.5
Major trading partners	4.3	4.4	4.3	4.2	4.3	3.9

Above trend growth is expected to persist across 2018, however this year is likely to be the peak of the cycle as constraints begin to impact growth (particularly in advanced economies). This should bring growth back to trend levels by 2020. There remain a number of risks to this outlook. These include the risk of escalating trade tensions into a full scale trade war, the impact of out-of-cycle fiscal stimulus in the United States and the challenges related to removing monetary stimulus and normalising central bank policy rates. The long period of emergency monetary policy in the post-GFC period has contributed to high debt levels (government, corporate and household) and elevated asset prices around the globe, leading to increased risks as interest rates begin to rise.

Australian Outlook

There is little fundamental difference between Treasury's and NAB's economic forecasts in 2017-18 – both around 2¾%. Thereafter the differences are also marginal – Nab 2 3/4% to 2.6% Treasury around 3%.

Our profile sees infrastructure spending and business investment (especially for non-mining) helping growth going forward – as will in the near term LNG exports. However, we still worry about the consumer who we expect will remain very cautious. As noted above we are marginally more cautious on wages and nominal GDP in 2019/20. And hence the surplus result in 2019/20 should really be seen as "flat"- a lot of question marks remain

Fundamentally, post this Budget we have not changed our core activity and financial forecasts.

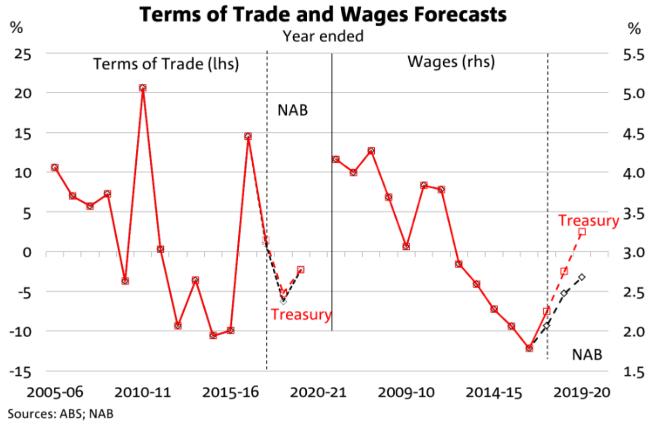
After a somewhat disappointing 2017, we continue to expect growth to gain more momentum during 2018 – with GDP increasing by around 3% through the year or 2.8% in year average terms. That is very much reflecting increased infrastructure spending by governments (underlying public investment up 7%), some continued improvement in non-mining business (up around 6%) and the increased impact of LNG exports (net exports adding 0.6 percentage to GDP during 2018).

However we see little pick up in the speed of consumption growth (around 2.7% in 2018). Recent strength in consumption was very much driven by one-offs and an apparent run down in savings. While retail has been reasonable in recent months consumers are more inclined to buy services than discretionary goods. Going forward we see limits on how much more consumers will be willing to run down savings. As a result we still see consumer caution in the face of higher electricity prices, low wages growth, stalling/ falling house price wealth and high debt levels. Tax cuts in this Budget don't really become significant until the latter years of the forward estimates.

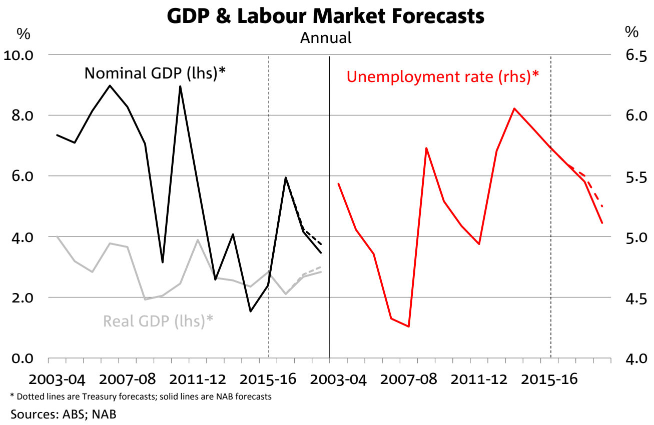
We also see consumer caution continuing into 2019 – with GDP growth of around 2.7% (as net exports fade) and nearer 2.8% in 2020 as higher wages growth eventually feeds into higher consumption growth and domestic demand accelerates above 3%. The negative impact of lower terms of trade (falling commodity prices) should also ease in 2020.

While business conditions remain at very high levels (trend conditions of around +19 vis long run averages of +5.5) business continues to use better profits to pay down debt and balance sheet strengthening – with any spare cash then being directed into investment spend (business credit in that environment is very subdued). Against that the Business Survey continues to point to a strengthening labour market – with growth in jobs around 24k (or more) for at least the next 6 months. As a result we continue to see unemployment falling to around 5 per cent by year's end. That of course depends on the participation rate not continuing its "puzzling rise".

A tighter labour market, consistent with a falling underutilisation rate (as employers continue to report increasing difficulty in finding skilled labour) should see some modest improvement in private sector wages growth (to around 2¼% by late 2018). The Budget cuts in the Budget in the near term are modest and unlikely to boost consumption much over the next 12 months. However the dropping of the Medicare levy to fund NDIS is more substantial and should help consumption growth from mid-2019 (albeit that has already been baked into our forecasts). Hence we have not changed our consumption and GDP forecasts.



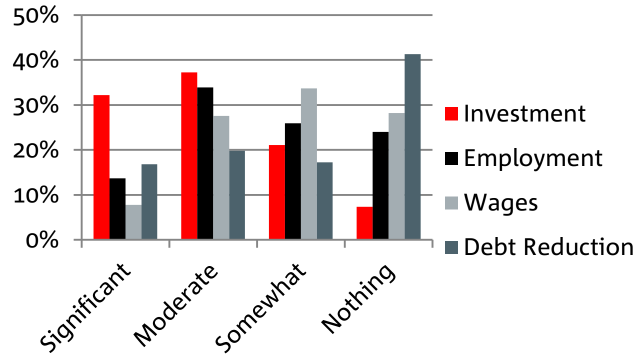
We continue to see further strength in domestic demand – together with above trend global growth (see Global Outlook) – as consistent with the RBA gradually withdrawing emergency low monetary policy settings from late 2018. However nothing will happen until wages growth accelerates and even then the RBA will be very cautious and data driven in its rate making decisions. Overall while tax cuts will help incomes growth, it is only marginal in the next year or so. And as such we do not see the current Budget as fundamentally changing the RBA's policy approach.



Finally it is worth remembering that tax cuts – were they to get up politically – would not necessarily provide a large initial boost to activity and or wages. As noted earlier Nab recently used its Business Survey data base to explore the likely impact of a company tax cut. Key findings were as follows

- o Typically the smaller the business the larger the tax cut sought (less than 100 employees 7.4 points, 100-200 employees 6.7 points and above 200 employees 6.1 points). By industry, manufacturing, mining, and construction suggested the largest cuts while service industries suggested smaller cuts.
- o In terms of where the tax cuts would be used, those businesses who considered a tax cut would improve their outlook pointed to the most significant impact being increased business investment. Those pointing to a tax cut having a significant positive impact, by category, are as follows (see chart below left hand column):
  - o Investment growth 32%
  - o Paying down debt 17%
  - o Employment growth 14%
  - o Wages growth 8%

What Would Business Do Significantly More With A Tax Cut



Thus while the focus would initially be on increasing investment – with second round impacts via employment and to a lesser extent wages – that is not the full impact on the broader economy.

That is because under our imputation system tax cuts to the corporate sector – without subsequent changes to the top marginal income tax rate – largely involve a switch between corporate tax and personal tax. Hence in many macro models the impact of corporate tax cuts on domestic demand are generally found to be relatively small – with the main impacts coming on capital inflows/ outflows. And with the Budget not really doing much in the top two tax brackets the impact could be quiet small and very much delayed. Indeed to the extent that other countries do cut tax rates the impact of not doing anything for a long time could actually be a headwind as Australia becomes a less favourable place to invest.

Budget economic forecasts table

	2017-18 (f)		2018-19 (f)		2019-20 (f)	
Annual % Change	**Budget**	**NAB**	**Budget**	**NAB**	**Budget**	**NAB**
Private Consumption	2 3/4	2.9	2 3/4	2.4	3	2.7
Private Investment – Dwelling	-3	-3.9	1 1/2	-2.6	0	-0.9
Underlying Business Investment	4 1/2	6.0	3	4.5	4 1/2	5.8
Underlying Public Final Demand	4 3/4	4.6	3	3.4	2 3/4	3.9
Domestic Demand	n.a	**3.1**	n.a	**2.5**	n.a	**3.0**
Stocks – Contribution to GDP	- 1/4	-0.2	0	0.0	0	0.0
GNE	3	**2.9**	2 3/4	**2.5**	3	**3.0**
Exports	2 1/2	3.6	4	5.5	2 1/2	3.4
Imports	5	6.1	2	3.9	2 1/2	5.1
Real GDP	2 3/4	**2.7**	3	**2.8**	3	**2.6**
- Non-Farm GDP	n.a	2.9	n.a	2.9	n.a	2.7
- Farm GDP	n.a	-7.9	n.a	1.0	n.a	2.0
Nominal GDP	4 1/4	**4.2**	3 3/4	**3.5**	4 3/4	**4.4**
Federal Budget Deficit (fiscal balance, $bn)	**-13.4**		**-7.4**		**3.7**	
Current Account Deficit: % of GDP (-%)	-2 1/4	-2.7	-2 3/4	-3.8	-3 1/4	-4.7
Terms of Trade	1 1/2	1.0	-5 1/4	-6.3	-2 1/4	-2.3
World GDP (b)	3 3/4	3.8	3 3/4	3,7	3 3/4	3,5
End Period						
Wage Price Index	2 1/4	2.1	2 3/4	2.5	3 1/4	2.7
Employment	2 3/4	2.8	1 1/2	1.8	1 1/2	1.6
Unemployment rate	5 1/2	5.5	5 1/4	5.1	5 1/4	5.1
Underlying CPI	n.a	1.8	n.a	2.1	n.a	2.3
Official Cash Rate (%) (c)	n.a.	1.5	n.a.	2.0	n.a.	2.3
10 Year Govt. Bond Yield	n.a.	2.8	n.a.	3.4	n.a.	3.7
US cents/$A	0.77	0.78	0.77	0.76	0.77	0.74
Trade Weighted Index (d)	63.0	64.4	63.0	61.7	63.0	60.6

(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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