

The 2001/02 Federal Budget

Comment

This Budget is largely about politics. From an economic viewpoint, it could have been worse – but with the election campaign still to come, ultimately the actual fiscal outcome might well be worse. Basically, the Budget contains ongoing new spending decisions costing around \$2½bn in 2001/02 rising to almost \$5bn in 2003/04. The big ticket items are as expected/leaked: welfare, “older Australians”, rural and regional Australia, health and defence spending. Revenue decisions cost another \$2bn per annum by 2003/04 – mainly reflecting recent “backdowns” in the politically sensitive issues of petrol and beer excise as well as entity taxation.

Despite these sizeable new policy announcements, the somewhat surprising “headline” fiscal surplus for 2000/01 draws substantially on a profit dividend from the Reserve Bank of \$4bn (normally around \$1½bn). While there are sound reasons to spend surpluses in an economic slowdown, the reality is that the “underlying” structural position is now significantly in deficit. From a medium-term perspective, there is now little left of the “headline” cash surplus in the out-years – notwithstanding an expected sharp turnaround in growth during 2001/02 (see page 2 on the Medium-Term Fiscal Context for more details). The medium-term fiscal position is now very susceptible to either: further election “give aways”; or a more protracted slowdown or a less robust bounce in activity in 2001/02. **Overall, probably better politics than economics.....but not a surprise from a “political economy” viewpoint.**

Fiscal Outcome

For 2001/02, the Government is forecasting an underlying fiscal surplus of \$1.5bn (0.2% of GDP) vis-à-vis \$2.3bn (0.3% of GDP) in 2000/01. Total revenue and expenses are expected to fall by about half a percentage point of GDP (to 22.6% and 22.9% of GDP, respectively, in 2001/02) (see section on Budget Measures for more details).

Economic Outlook

For 2000/01, there are no substantive differences in our outlook vis-a-vis the Government’s – although it should be noted that this puts both the Government and the National at the bottom end of forecasts for the near term. For 2001/02, the National is lower on GDP growth (2½% vis-à-vis 3¼%). This mainly reflects our view that the timing of the recovery will be slightly later than expected (hoped for) by the Government – and in particular, business investment will be much weaker. Once the recovery occurs in late 2001, the National appears to be expecting a faster turnaround, and as a result our forecasts through 2001/02 are quite similar (3¾% vis-a-vis 4%). This also means we expect growth to be slightly stronger than the Government’s medium-term scenario (4¼% vis-a-vis 3½% in 2002/03). Elsewhere, it is notable that the Government and the National also agree that inflationary pressures are well contained – a pre-condition for another small easing in monetary policy in the next few months. It is interesting that the Government has a somewhat lower unemployment rate in mid 2002 than forecast by the National. In contrast, we are more optimistic on prospects for the current account deficit (partly reflecting the Government’s assumption of no change in the currency). Finally, it is also noteworthy that the Treasury stresses the uncertainties and the associated downside risks arising from the global outlook – a view we strongly share.

Financial Markets

The markets were very muted in their initial response to the Budget – not surprising given that much of the policy had been leaked. At the margin, the currency fell a touch and interest rates rallied a few basis points (possibly surprised by the Government’s forecasts for the near term). Overall, a big yawn for the markets.

The Medium-Term Fiscal

Context

From the medium-term perspective, one of the stand out features of this Budget is that “give aways” have now reduced the medium-term cash balance to almost nothing.

This means that the Budget will be particularly susceptible to either:

- further “pre-election” give aways; or
- a more protracted slowdown and/or a less robust bounce in 2002.

The following table highlights the erosion in the underlying cash balance that has occurred from the Mid Year Economic Review in November and from last year’s Budget estimates.

Underlying Cash Balance

	2001/02 (\$b)	2003/04 (\$b)
2000/01 Budget Estimates	3.2	14.4
- % of GDP	0.5%	1.8%
Mid Year Review	4.7	12.8
2001/02 Budget Estimates		
Policy Decisions	-3.7	-6.8
Parameters	-0.4	-3.3
ex RBA Abnormal Dividend	-3.2	n.a
Timing Adjustment	0.9	1.4
Published Cash Balance	1.5	4.1
- % of GDP	0.2%	0.5%
Cash Balance – ex RBA	-1.3	4.1
- % of GDP	-0.2%	0.5%

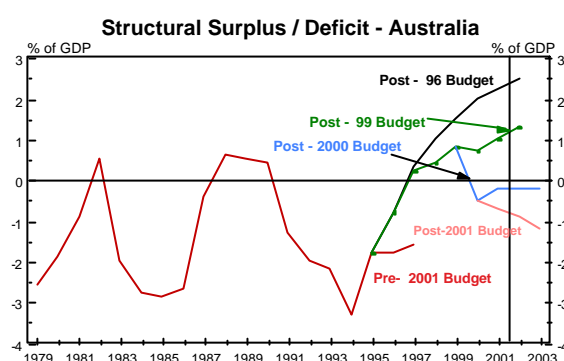
This table draws out that the underlying cash balance for 2001/02 was only able to be reported as a positive because of the increased dividend from the RBA’s profits from its intervention in foreign exchange markets. The Treasurer will rightly argue that this is legitimate current income (and he has not factored it into out years calculations). Equally, it is true that the extra money “nicely” filled a short-term hole caused by the slowing economy – allowing the Government to substantially increase spending in the current year, but still report a cash surplus.

While we would not necessarily argue with the need to spend more in a period of slowing activity, the treatment is somewhat “tricky”, in making out that

the “precious” surplus has still been maintained, when it clearly has not.

The table also highlights the “large” policy adjustments that have been made on an ongoing basis – almost \$7bn per annum by 2003/04 – and that very little is left for whoever wins the next Federal election.

What is equally clear is that the “structural” fiscal position has deteriorated substantially. Drawing on OECD methodology, the following chart shows that we now have a structural deficit approaching 1% of GDP, compared with about 2% before the Government’s 1996 Budget.



Looking at the economic forecasts and assumptions, on which the medium-term fiscal projections are based, we have no fundamental quibbles. At the margin, we would be marginally lower in our growth projections for 2001/02, but probably marginally higher for 2002/03. This relates to our view that the domestic economy may be weaker for a touch longer than expected by Treasury, but then rebound stronger (see more detailed comments in the section on the Economic Outlook below).

That said, the current economic situation is highly fluid. Much depends on global and especially US developments. Here, the Treasury is clearly concerned, and we share those worries.

At the end of the day, the reality is that the fiscal position is “structurally” much less sound than it was even 12 months ago. Any significant departures from the sharp “V”, that both the National and the Government are forecasting, could quickly see the fiscal position fall into substantial deficit.

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Budget Measures

The underlying cash balance is estimated at \$1.5b in 2001/02, marginally lower than \$2.3b in 2000/01, but significantly lower than the Mid Year Review Estimate of \$4.7b last November. Because of differences in the timing of accruals, rather than cash payments (largely related to timing of PAYG transitional payments, where companies can change the timing of actual payments), the actual fiscal balance on an accruals basis is in deficit of \$800m.

The fiscal surplus for 2001/02 projected at the time of the 2000 /01 Budget was \$1.1bn and the subsequent deterioration of \$1.9bn reflects policy changes (subtracted \$4.1 bn) and (net) parameter changes (added \$2.2bn). The latter consists of extra revenue collected from Reserve Bank currency-related profits (estimated at \$2.8bn) largely offsetting the impact of the slowdown in activity underway (subtracted \$0.6bn).

Total revenue is expected to fall significantly as a percentage of GDP in 2001/02 due to a bring forward in the timing of tax under the new PAYG system, boosting tax revenue in 2000/01. Thereafter, total revenue as a share of GDP is broadly unchanged from 2002/03 to be around 22.8% in 2003/04. As noted above, non-tax revenue is somewhat temporarily boosted in 2001/02 by the extra profit from the RBA. Also reflecting the New Tax System, outlays fall further as a percentage of GDP in 2001/02 and thereafter, ease somewhat further to around 22.2% of GDP in 2003/04. As a result, a small surplus – in both headline and underlying terms – is projected by 2003/04.

Outlays

In real terms, outlays are estimated to increase by 0.7% in 2001/02 and a bit faster at about 1.1% pa thereafter.

The main new increases in outlays include:

- the Australians Working Together Package of measures to improve incentives for people to work, assisting people to become job ready and to find jobs (\$1.7bn over the next 4 years). This includes the Work for the Dole Scheme (package \$521m over 4 years) and Job Search Training (\$325 m over 4 years) and helping parents return to work (\$240m over 4 years);
- increases in assistance to older Australians by lifting the tax free thresholds on pensions and more significantly exempting superannuation assets from the pension means test for those aged over 55 but under the pension age (costing \$400m over four years);
- increased allocation and extension of the Natural Heritage Trust (additional \$1bn over 6 years);
- increases in rural and regional assistance – mainly road funding (\$1050m over 4 years);
- additional defence spending – planes, subs and new battalions (around \$5bn over the next four years); and
- increases in support for R&D (\$2bn over 4 years).

Revenue

In real terms, total revenue is expected to decrease a further 2.8% in 2001/02, following a fall of over 7% in 2000/01. A pick up in activity is anticipated to see real revenues rise during the following few years.

Following the introduction of the New Tax System in the 2000/01 Budget, there are no major changes in revenue policy – albeit there has been some “roll back”. The Government announced the withdrawal of the entity tax exposure draft due to concerns of small business and farmers (costing \$1.1bn over 4 years). Both petrol and beer excise rates were reduced – costing \$4.6bn and \$0.6bn, respectively, over four years. Finally, an increase in the effective threshold and Medicare levy for older Australians is projected to cost about \$1.5bn over the next four years.

Summary of Budget Aggregates

	2000/01		2001/02			2002/03	2003/04
	\$bn	% of GDP	\$bn	% Real	% of GDP	% of GDP	% of GDP
Outlays (accrual basis)	157.6	23.4	160.9	0.7	22.9	22.4	21.9
Receipts (accrual basis)	161.0	24.0	158.8	-2.8	22.6	22.1	22.1
Tax	150.7	22.4	146.8	-4.0	20.9	20.7	20.9
Non-tax	10.3	1.5	12.1	15.1	1.7	1.4	1.3
Fiscal Balance*	5.4		-0.8		-0.1	-0.2	0.3

* Fiscal balance equals receipts less outlays less net acquisition of non-financial assets.

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Economic Outlook

Following the release of the Government's fiscal outlook, our economic and financial forecasts remain largely unchanged. Assuming global growth recovers in the latter part of the year, we expect to see a significant pick up in domestic activity during 2001/02 – mainly driven by private spending. However, like the Government and the Reserve Bank (RBA), we acknowledge a considerable degree of uncertainty remains regarding the global outlook and any deterioration there will likely impact on domestic activity.

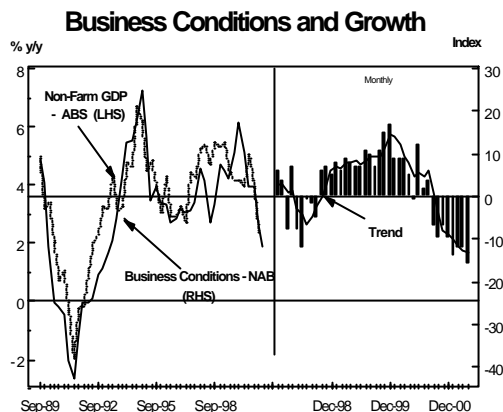
Following an increase of around 2% in 2000/01, we expect GDP growth to pick up to around 2½% in 2001/02. The latter is lower than the Government's 2001/02 forecast for GDP growth of 3¼%. The main difference is due to projected investment. The Government is considerably more optimistic in its outlook for business investment (+5% in average terms versus our forecast of -2%). That said, the Government does point to downside risks to this outlook, should business confidence remain weak.

Inflationary pressures remain well contained. Underlying inflation is expected to pick up through 2001, but to, remain broadly within the Reserve Bank's target range. With limited wage pressures and a strengthening in the currency, underlying inflation is expected to moderate in 2002. Our forecast is for underlying inflation to peak at around 3% in the December quarter 2001, before easing back to around 2% in 2001/02. On a year-ended basis, with the effects of the GST dropping out, headline inflation (currently 6%) will fall to around 2% in 2001/02.

With the slowing in economic activity nearing a bottom, we believe the cash rate is not likely to fall much further. Our baseline is for a further cut of 25 basis points in June – likely to be the last in the current easing cycle. Assuming global growth picks up in the latter part of 2001, the acceleration in domestic activity anticipated should see the Reserve Bank move to a tightening bias in the second half of 2002. Our baseline is for a tightening of around 50 points in the latter part of 2002.

Near term

Following several years of strong growth, economic activity slowed sharply in the latter part of 2000. The National's latest Monthly Business Survey showed that business conditions fell significantly further in April, after stepping down in the March quarter. In our view, economic activity is still slowing and hopes of a "bottoming" may be premature. Results for April are consistent with annual growth in non-farm GDP of around 1½%.



Across sectors, there are signs of a significant shift in the composition of growth. Previously stronger sectors, such as services and transport are deteriorating, while interest-sensitive sectors (such as construction, retail and wholesale) are now recording less negative results. Interestingly, the new monthly export index declined significantly, suggesting an increasing impact from slower global growth.

Other notable developments in the April survey included a substantial fall in forward orders and capacity utilisation. Price pressures and labour costs remain moderate. It was encouraging to observe a further modest improvement in business confidence, no doubt, interest rate related.

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The Outlook for 2001/02

International Environment

As already noted above, the international environment – and in particular, the slowdown in activity underway in the US and its flow-on into Asia - will continue to have very important implications for Australian economic prospects and policy.

Indeed, a major downside risk to the Australian outlook relates to overseas prospects, which have deteriorated significantly in recent months. US activity appears to have “stalled” in the first half of 2001. In turn, the US is weighing heavily on Asia, where a “hard landing” is now the most likely outcome.

For the US, the question is whether we can expect to see growth resume toward the end of 2001. On this question, the evidence is still mixed. After substantial falls at end 2000, some of the key business surveys have stabilised recently – albeit business investment is still falling and inventories increasing. While household consumption has been stronger than expected in early 2001, a weakening labour market and lingering wealth effects overhang the outlook. Our central view is that aggressive moves by the Fed and the favourable response of equity markets as well as stimulatory fiscal policy will underwrite a moderate pick up in US activity in late 2001. That, however, would be consistent with US GDP growth falling from 5% in 2000 to a little more than 1% in 2001, before rising to 2½% in 2002.

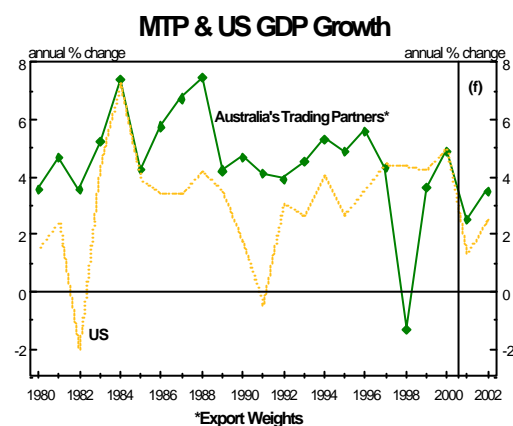
Activity through out non-Japan Asia is slowing sharply. A large part of that story relates to the slowing of US and global demand for high-tech exports. Annual growth in industrial production (ex China) has fallen from around 25 percent in mid 2000 to around 5 percent currently and is likely to contract during the first half of this year. This implies Asian (ex China) GDP growth of only 1½% in 2001, compared with 7% in 2000.

Japan is also looking increasingly fragile with the main drivers of growth - business investment and exports - having stalled. Macro policy options are also limited, with cash rates already low and a

sizeable fiscal deficit. For 2001, we expect Japanese GDP growth of only ½% in 2001 and 1% in 2002.

Europe is looking one of the stronger prospects for 2001, provided the US does not fall further in H2 2001. While the "foot and mouth" outbreak will hurt agriculture and tourism, domestic conditions in the Europe still seem reasonably robust. Overall, GDP growth in both the Euro-area and the UK is expected to slow from around 3% in 2000 to around 2% in 2001

Overall, we expect global growth to slow from 4.8% in 2000 to about 2¼% in 2001, before recovering to 3% in 2002. From an Australian perspective, Australia's major trading partner growth (export weighted) is forecast to be hard hit falling from almost 5% in 2000 to 2½% in 2001, before picking up to 3½% in 2002 – a bit less than the Government's figuring (see next chart).



Domestic Environment

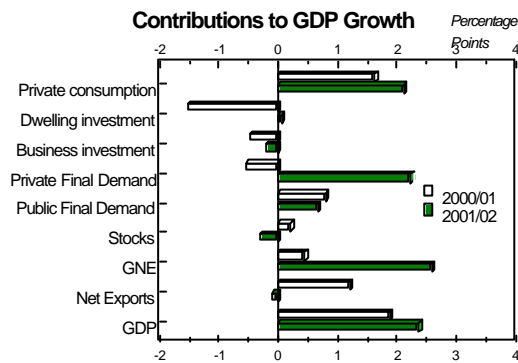
As noted above, domestic demand growth is expected to pick up significantly in the second half of 2001. The aggressive cuts in the official cash rate in the first half of 2001, together with expansionary fiscal policy should see a marked pick up in domestic activity during 2001/02.

On the other hand, net exports are forecast to subtract marginally from overall growth; with a pick up in import volumes offsetting continued – albeit more moderate growth in export volumes.

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The progressive easing in monetary policy is expected to lower the interest servicing burden of households, resulting in a significant increase in consumption spending toward the end of 2001. The outlook for business investment, on the other hand, remains weak in the near term. While current surveys suggest capital expenditure is likely to bottom in the latter part of 2001, business investment is expected to continue to detract from growth in 2001/02. Following the very strong growth in recent years, public expenditure growth is also assumed to moderate slightly in the next financial year.



Private Consumption

Consumer spending rose moderately during calendar 2000, reflecting the lagged impact of monetary policy, higher petrol prices and modest increases in the value of household assets. These negative influences outweighed the effects of higher household income flowing from income tax cuts and increases in welfare benefits associated with the New Tax System. We expect consumer spending to pick up in the second half of 2001, as monetary easings lower the interest burden of households. However, consumption is expected to remain well below the levels observed in the latter part of the 1990s. In year average terms, we expect consumption growth at around 3½% in 2000/02 – slightly higher than the Government’s forecast.

Private Investment

Dwellings: Residential construction contracted significantly in the second half of 2000, mainly due to the timing effects of the GST on

construction activity and also higher interest rates and lower house prices. More recently, housing finance approvals for construction picked up significantly in March, signalling a possible turnaround in activity. We expect a substantial pick-up in dwelling investment in the second half of 2001, due to the impact of lower interest rates and the extension to the First Home Owner Grant.

In year average terms, dwelling investment is expected to contract by around 25% in 2000/01 before picking up to around 10% in 2001/02. Here our forecasts are higher than the Government’s forecast of 5% in 2001/02.

Business investment: Following flat growth in calendar 2000, we expect “underlying” business investment to fall in 2001, before picking up in 2002. The current weakness in investment reflects reduced profitability and also uncertainty about the economic outlook. Within the components of business investment, little growth in non-residential construction is expected in the near-term. The downturn in some parts of manufacturing and retailing will see lower investment in industrial and retail property. On the other hand, the outlook for office construction is reasonably strong. Recent surveys of investment plans show a strong recovery in investment plans for mining, machinery & equipment manufacturing and construction. Expenditure on computer software also remains strong, however, is expected to grow at a less rapid pace in 2001/02.

In year average terms, we expect “underlying” business investment to contract by around 2% in 2001/02, following a larger contraction of 4.5% this financial year. This is well below the Government’s forecast of around no change in 2000/01 and a rise of 5% in 2001/02.

Public Demand

Public sector demand is expected to grow around 2% in year average terms in 2001/02, similar to the projected outcome for 2000/01, however - but well below the growth over 1999/00. The more subdued growth in public spending reflects the winding down of spending related to East Timor, start-up costs associated with tax reform, and the

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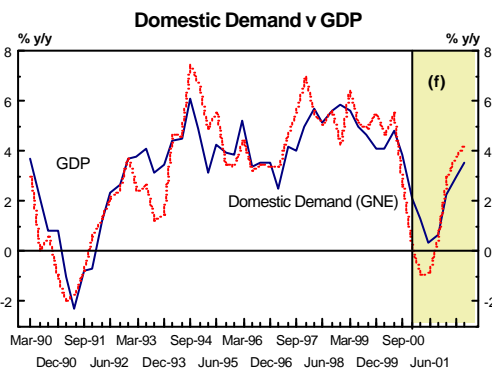
completion of large infrastructure projects in some states (including the Olympics). This has been partially offset by new spending initiatives in 2001/02 on research & development, roads and defence.

Stocks

Private non-farm and public stocks are expected to subtract from growth in 2001/02 after a small contribution in 2000/2001. The unexpected slowing in domestic demand in the latter part of 2001, saw a large build up in stocks in the December quarter. A further significant build-up in stocks is expected in the March quarter 2001, before accumulating at a less rapid rate in subsequent quarters. Overall, stocks are expected to detract about a quarter of a percentage point from GDP in 2001/02.

Domestic Demand (GNE)

Drawing the above together, annual growth in domestic demand (including stocks) or GNE is set to pick up to around 2½% in 2001/02 (see chart below), slightly below the Government's forecast for GNE growth of 3% in 2001/02.



Current Account Deficit

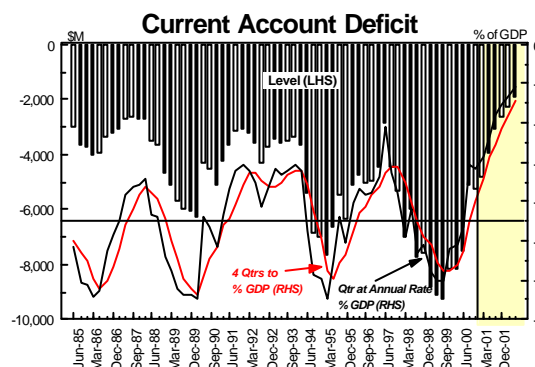
Like both the Government and the Reserve Bank, the National expects a marked improvement in the current account deficit over the next year. However the National's projected improvement is markedly higher than the Government's.

- Reflecting the slow down in domestic demand, import volume growth has slowed in recent quarters. We expect import volume growth to pick up to around 4½% in 2001/02 from -¼% in 2000/01. From a recent peak in

the latter part of 2000, export volume growth is expected to slow through 2001, reflecting the effects of slower global growth offsetting the competitive stimulus from the weak currency. However, export growth is expected to pick up in 2002, as growth for Australia's major trading partners recovers. In year average terms, export growth is expected to rise 4¼% in 2001/02, compared to 5¾% in 2000/01.

- On balance, this means that net exports will be broadly neutral in 2001/02. In contrast, the Government expects net exports to add ¼% to GDP in 2001/02.
- Following a strong improvement over 2000, the terms of trade is projected to improve significantly in 2001/02, to be the highest level since the late 1980s. A strengthening currency should result in a fall in import prices offsetting a modest fall in Australia's export prices. These forecasts are based on the assumption of some recovery in the currency and world growth in the latter half of 2001.

The current account deficit is expected to fall to around \$10bn (or 1% of GDP) in 2001/02, from around \$19½bn (or 2½% of GDP) in 2000/01. Our forecast for 2001/02 is significantly more optimistic than the Government's forecast of -20bn (or 3% of GDP). The difference is mainly due to the outlook for the terms of trade. The usual practice of the Government is to keep exchange rates unchanged, whereas we assume a recovery in the currency over the forecast period.



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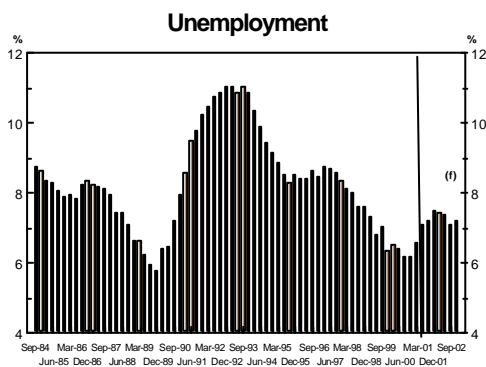
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Labour Market

Following solid gains in employment in recent years, the labour market is weakening on the back of slower activity. The reduced demand for labour has seen the unemployment rate rise by more than half a percentage point to 6.8% from the recent low of 6.0%. The downturn in the labour market has been led by reduced employment for trades persons and labourers, especially in construction. On the other hand, employment opportunities in the service industries remain strong. Most forward-looking indicators point to a further weakening in coming quarters. Both ANZ Job Ads and the National's Business Survey suggest little job growth in the next two quarters.

Employment growth is forecast to slow from around 2% in the current financial year to about 1% in 2001/02 – the Government has a similar forecast. With a small rise in the participation rate, the unemployment rate is forecast to peak at around 7½% in late 2001, before easing back to 7¼% by June 2002. This is higher than the Government's forecast of 7% by June 2002 (with the Government assuming an unchanged participation ratio).

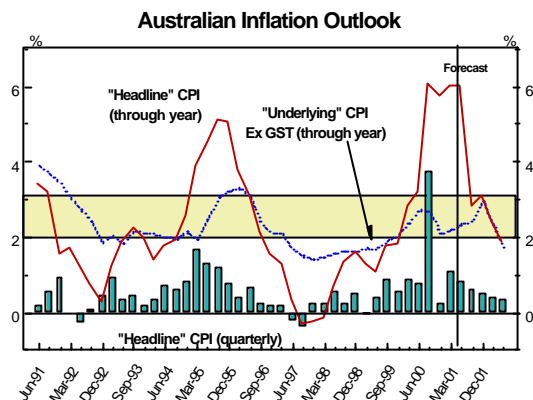
The weakening in the labour market and a moderate inflation outlook point to reduced wage pressures over the next year. On a national accounts basis, average earnings are forecast to remain unchanged at 3¼% in 2000/02 – slightly below the Government's forecast of 3¾%.



Inflation

Underlying inflation (excluding the GST and volatile items) is expected to rise through 2001, however remain just within the RBA's target range. Some flow through of the weaker

currency to retail prices is expected to be partially offset by weaker demand limiting retailers' ability to increase prices. Some recovery in the AUD will see ongoing inflation ease back in 2002. In financial year terms, we expect underlying inflation to ease from 2½% in 2000/01 to 1¾% in 2001/02. The Government provides forecasts of 'ongoing' inflation which excludes GST, however, includes some volatile items such as petrol prices. The Government forecasts are 3¼% in 2000/01 and 2¼% in 2001/02.



Interest and Exchange Rates

Official interest rates are close to a bottom in this current cycle – albeit National's view is heavily dependent on developments overseas and in particular, US activity.

Although some upside inflation risk remains as retailers attempt to recover profit margins, subdued domestic demand may limit their ability to do so. Wage pressures are also expected to remain moderate due to the weak labour market. Accordingly, we believe inflation is expected to remain within the Reserve Bank's target zone.

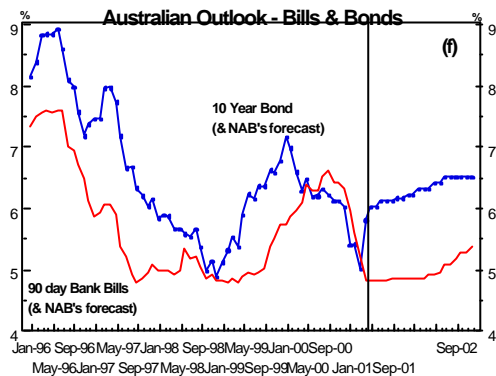
The May Statement on Monetary Policy suggests the Reserve Bank is optimistic about domestic conditions, however remains on an easing bias due to downside risks. The main risks identified by the Reserve Bank are a further deterioration in the labour market and the outlook for the external environment. We believe the Reserve Bank is likely to cut rates by a further 25 points in the next couple of months, largely in response to the deteriorating labour market. However, given its upbeat assessment of the economy, this is likely to be the last cut for this cycle, unless global growth

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deteriorates further. By mid/late 2002, we expect to see the start of an unwinding of the current expansionary monetary policy.

Longer term interest rates have risen considerably recently, in anticipation of stronger growth globally and domestically. We expect this trend to continue, with the rate on 10 - year Government bonds likely to reach 6½% by June 2002.



After reaching a low of 47.8 US cents in early April, the currency has recovered significantly and is currently trading at around 52.7 US cents. The weakness of the AUD in recent months has been due to several factors, including continued USD strength, falling commodity prices as world growth forecasts have been revised lower, the sharp slowing in domestic activity relative to world growth and also political uncertainty. The recent recovery in the AUD has been due to some unwinding of USD strength, a reassessment of domestic growth prospects and an impending improvement in prospects for world growth. The recent sell-off of USD largely reflects a reduction in the nervousness of financial markets and their flight into USD assets as prospects for global growth have picked up.

We retain the view that the currency is trading significantly below fundamentals. After allowing for a structural break in early 2000, we would put fundamental value of the \$A/\$US at between 57-60 US cents. We expect fundamentals to gradually reassert and expect the currency to be around 57 US cents by year's end. The key factors underlying our forecast are a strengthening in the global outlook (positive for commodity prices), a favourable interest rate differential and continued unwinding of USD strength.

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Table: Economic and Financial Forecasts

	2000/01 (f)		2001/02 (f)	
	National	Budget	National	Budget
Private Consumption	2¾	2¾	3½	3
Private Investment – Dwelling	-24½	-25	10	5
- U/lying Business	-4½	0	-2	5
Underlying Public Final Demand	2½	2¼	2	2¼
Domestic Demand	¼	½	3	3¼
Stocks (a)	¼	¼	-¼	-¼
GNE	½	½	2½	3
Exports	5¾	6	4¼	5
Imports	-¼	0	4½	4
GDP(A)	2	2	2½	3¼
- Non-Farm GDP	2	2¼	2¼	3
Current Account Deficit - \$b	-19½	-20½	-10	-20
- % of GDP	-3	-3	-1½	-3
Employment	2	2	1	1
Major Trading Partner Growth (b)	2½	2¾	3½	3½
Terms of Trade	5½	4	4	-¾
End of Period				
Average Earnings (Nat Accs)	3¼	3	3¼	3¾
Total CPI	5.9	5¾	2	2
Underlying CPI	2½	3¼*	1¾	2¼*
Unemployment Rate	6½	6¼	7¼	7
Official Cash Rate	4¾	n.a.	4¾	n.a.
10 Year Govt. Bonds	6	n.a.	6½	n.a.
US cents/\$A	53	n.a.	63	n.a.
Trade Weighted Index	50	n.a.	54	n.a.

(a) Contribution to GDP growth (b) Calendar year (f) Forecast *Ongoing inflation

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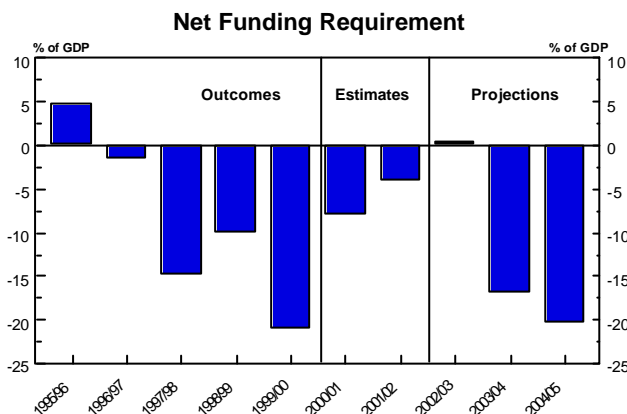
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Financial Markets

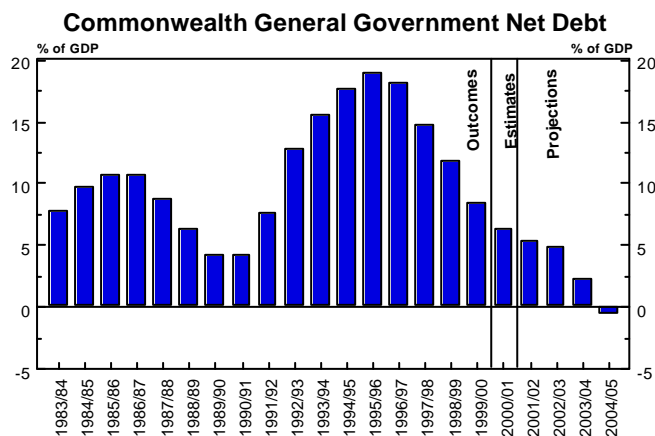
Debt Reduction Remains A Priority

The Government remains committed to the debt reduction programme it commenced in 1996, and expects to be in a net surplus position by 2004/05. That however, depends critically on the assumption that the remaining 51% of Telstra is sold in 2003/04 (see below).

The net funding requirement of the 2001/02 budget – which in recent years has been the surplus funds remaining to reduce net debt after the budget has been financed – is estimated to be a \$4.1bn surplus. The total amount of funds forecast to be available to reduce net debt over the 2001/02 to 2004/05 period total \$40bn.



The Government has not been a net borrower since 1995/96, and in 2001/02 it expects to reduce government net debt by a further \$5.1bn. This includes not only the net funding surplus above, but incorporates non-equity policy advances and the revaluation of selected financial assets and liabilities. This would mean that net debt has been reduced by almost \$60bn since 1996 (helped by the sale of 49% of Telstra over that period), leaving the Government with a net debt balance of \$37.7bn (or 5.4% of GDP) by the end of 2001/02.



The Government expects the rate of debt reduction to fall slowly over the next couple of years, reflecting lower projected underlying cash surpluses, before a significant reduction in 2003-04 when the remaining share of Telstra is sold. **That said, the prospect of a sale at this stage seems unlikely, given the difficulty of passing the legislation through the Parliament.**

Debt Issuance Programme

The Government again stated that the reduction in net debt would “continue to be managed in line with the objective of maintaining the viability of the Commonwealth Government Securities (CGS) market.” Surplus budget proceeds not used to redeem CGS would continue to be held as financial assets, while a modest gross issuance programme is planned for 2001/02.

The Government has around \$6.5bn in CGS maturing in 2001/02 (\$2.6bn in November 2001 and \$3.9bn in March 2002). One further bond tender is expected in the current financial year, while gross new Treasury Bond issuance in 2001/02 is expected to be around \$2-3 bn, again weighed toward the long-end of the curve.

Indexed bond issuance of \$200m is planned for 2001/02, following the tender for the issue of \$75m on 24 May 2001.

Market Reaction

Although the underlying surplus of \$1.5bn was above market expectations and therefore allays some fears that the Government was potentially going to compromise its fiscal responsibility for political gain, the markets appear to be sceptical of a surplus that requires an additional \$2.8bn injection from the RBA.

Pre-Budget, the AUD was trading at 0.5262 US cents, and lost about 10 pips in the subsequent half-hour, before some strong selling 45 minutes after the release saw the currency heading down towards 0.5230.

Bonds remained unexcited by the Budget, barely moving after the release. The international ratings agency Standard & Poors said the Budget is unlikely to have any ratings impact, given the Government is continuing to reduce its already low level of debt.

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