

Group Economics



Macroeconomics



Industry & Commodity



Markets

8 May 2007

2007-08 Federal Budget

Comment

The Federal Budget contains both politically targeted give-aways, but also important longer-term reforms, supply enhancing infrastructure spending and unexpected innovations. There are significant personal income tax cuts, worth around \$9b per annum on an ongoing basis, very much targeted at the lower income earners – and a additional one off government superannuation injection – aimed to “incentivate” that part of the workforce. A key unexpected innovation is the establishment of a future fund (\$5b seeded from the 2006/07 surplus) for higher education. Elsewhere, significant additional spending is included for education (and you can see why the Treasurer nominated education as the key focus of the Budget rather than the headline catching tax cuts), additional apprenticeships, medical research, small business export incentives and defence. Large spending on transport infrastructure (but not really significant till 2009/10) was also included as was funding for water (notably the Murray Darling basin). Climate change initiatives will probably await the report of the Government’s Emissions Trading Taskforce later this month. Less impressive (from an economic, if not political perspective) as the special payment to senior Australians.

From a macro policy perspective, the Government has targeted an ongoing Budget surplus of around 1% of GDP. All this spending and yet maintaining a firm structural budget position has been made possible by a stronger economy and higher commodity prices. That is, the additional resources the economy has provided the Government has spent in its entirety – worth around \$12b and \$16b in 2007/08 and 2008/09, respectively (see Medium Term Fiscal Context below). In a structural sense, however, the Budget is relatively neutral – unlike last year, when it added around 1 to 1¼ percent of GDP to the economy. And as such, we do not see it as adding to interest rate pressures. The problem is that this is probably just the first in a two part fiscal stimulus (leading into the forthcoming Federal election). If we get a large additional fiscal stimulus, the Reserve Bank would be much more concerned. It also should be said that NAB agrees with the Government’s economic forecasts supporting these fiscal projections. And hence, NAB does not question the integrity of the medium term fiscal projections.

In many ways, the Federal Budget is better and more innovative than we expected. And one that maintains the structural integrity of the underlying fiscal position. As such, it does not, in itself, lead us to increase the chance of an RBA reaction. However, we are watchful that another round of fiscal stimulus in the months ahead might trigger higher cash rates.

Fiscal Outcome

The underlying cash surplus is estimated at \$13.6b (1.3% of GDP) in 2006/07 falling slightly to around \$10.6b (or 1.0 percent of GDP) in 2007/08. Over the medium term, the cash balance is expected to remain around 1% of GDP. Fiscal balance (on an accruals basis) is similar in the out years. For more details see Budget Measures in Brief.

Economic Outlook

The Government’s economic outlook is very similar to NAB’s forecasts for the next couple of years. Both NAB and the Government forecast real GDP growth of 2½% in the current financial year. For 2007/08, NAB’s forecast is for GDP growth to pick up to 3½% – a bit lower than the Government’s figuring of 3¾% - largely boosted by an assumed return to “normal” seasonal conditions. Like the RBA in its recent Policy Statement, non-farm GDP growth is forecast to be around trend of 3¼-½% in 2007/08. NAB expects underlying inflation to continue to move lower to around 2½% by mid 2008 – the middle of the RBA’s target and headline inflation of almost 2½% during 07/08 - a bit lower than both the Government and RBA forecasts for headline of 2¾% during the next financial year (see Economic and Financial Outlook for more detail).

Financial Markets

Financial Markets were little moved by the Budget. The AUD fell around 15 points to 0.8278, while 3-yr bond futures initially sold off when the Budget was released, but quickly rallied back to 93.91.

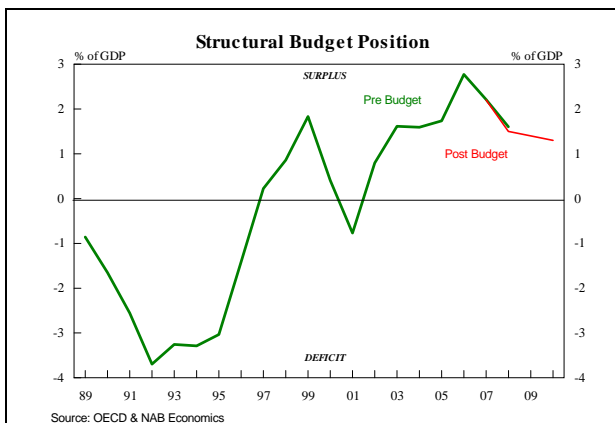
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Medium Term Fiscal Context

While there is a mix of political spending and personal income tax cuts combined with useful economic reforms, the bottom line is that the Government's overall fiscal position is little changed in a structural sense after adjusting for improved economic parameters. See the chart below that draws on OECD methodology for the structural budget position updated by NAB for new announcements in the 2007/08 Budget.



Basically, the Government is targeting a surplus of around 1 per cent of GDP – both in the near term and into the future. This underlying philosophy is (again) achieved via taking the benefits of the resources boom - a strong economy and high commodity returns - and spending it or cutting taxes. Importantly, there have been significant incentives for lower paid workers and a boost for strategic infrastructure. Putting money aside via a future fund for investment in higher education is also a very worthwhile development. Put simply, there could have been worse ways to spend the growth dividend.

The following table summarises the starting point for the Budget as well as new policy decisions and the impact of improved economic parameters on the near and medium term fiscal position. For the current financial year, the starting point Budget looks to have been about \$16.1b. Policy decisions to be implemented in the next few months reduce that by around \$4.2b.

Going forward, relative to the recent MYEFO the strong economy is now expected to produce an additional \$12.4b and \$16.4b in 2007/08 and 2008/09, respectively. Against that, the Budget includes measures that “spend/give back” \$12b

and \$16.1b, respectively. Put differently, if the Government didn't increase spending or cut revenue, the surplus in 2008/09 would have risen to about \$28b or around 2 ½% of GDP, compared to a projection of about \$12bn (1% of GDP).

Table 1: Budget Aggregates

	2006/07 (b)	2007/08 (b)	2008/09 (b)
2006/07 Budget			
- Fiscal Balance	10.3	9.9	10.6
Mid Year Review			
- Fiscal Balance	10.4	9.9	11.9
2007/08 Budget			
Decisions			
- Revenue Decisions	-	-5.6	-8.2
- Outlays	-4.2	-6.4	-7.9
Policy Decisions	-4.2	-12.0	-16.1
Net Investments			
(Asset Sales)	-	+0.3	+0.3
Economic Parameters			
(Economy)	+5.7	+12.4	+16.4
Fiscal Balance	+11.9	+10.0	+11.9
Cash Balance	(+13.6)	(+10.6)	(+12.7)
Implied Fiscal Starting Point	+16.1	+22.3	+28.3

(-ve) sign implies less revenue or more spending (that is it detracts from the fiscal balance)

One of the key questions that will be raised is whether the Budget adds to the risks of further cash rate rises. Based on the above analysis, that is not at all apparent given the broadly unchanged structural long-term budget position. Typically, the Government's personal tax cuts to lower paid people will be spent, as is likely the special one-off payment to senior citizens. But since the underlying economic forecasts are sensible/defendable, the Government will not be adding much in the way of net new stimulus (unlike last year, when there was a significant stimulus). Of course, the Government could have spent the surplus in different ways, but the reality is there are also significant longer term spending on infrastructure and education that will help supply and assist productivity.

On the economic forecasts, NAB does not see any fundamental problems – or at least the Government's forecasts are similar to our own figuring (see details below). While we suspect NAB is more worried about a hard landing in the US, we have not included that in our core forecasts.

However, this is, of course, an election budget with lots in it for voters and we are watchful that there will be a large injection of fiscal stimulus in coming months. Were that to happen, we would be much more concerned about the interest rate ramifications.

Budget Measures – In Brief

In accrual terms, the fiscal surplus for 2007/08 is forecast to be \$10.0b (or 0.9% of GDP) – \$1.9b lower than the estimated 2006/07 Budget outcome. New policy decisions since MYEFO include:

Income Tax and Superannuation

Cuts to personal income tax of \$5.3 billion in 2007-08, and amounting to \$31.5 billion over the next four years.

- From 1 July 2007,
 - The 30% marginal tax rate threshold will be raised to \$30,000.
 - The Low Income Tax Offset will be increased from \$600 to \$750 per year and phase out from \$30,000 – up from \$25,000.
- From 1 July 2008,
 - The 40% marginal tax rate threshold will be raised to \$80,000.
 - The 45% marginal tax rate threshold will be raised to \$180,000.

One-off doubling of superannuation co-contribution for eligible contributions made in 2005-06 to improve savings for low income earners by \$1.1 billion.

Education – ‘Realising Our Potential’ Package

- Perpetual funding for university capital works and research facilities through a \$5 billion Higher Education Endowment Fund, with more investment in the fund to come from future Budget surpluses.
- Other components of ‘*Realising Our Potential*’ amount to another \$3.5 billion over four years – \$530 million of which will be spent in 2007-08.

Child Care

- From 1 July 2007, rates of Child Care Benefit will increase by 10 per cent on top of indexation and the tax rebate will be available as a direct payment shortly after the end of the year – altogether costing around \$1 billion in 2006-07 and 2007-08 and another \$1 billion over the next three years.

Seniors and Aged Care

- Aged care reforms aimed at increasing availability, making fees and charges simpler and fairer, and improving quality and choice – costing \$207 million in 2007-08 and \$1.6 billion over five years.
- Once-off Tax Free Bonus payments to Seniors and Carers amounting to \$1.7 billion in 2006-07.
 - \$500 one-off bonus payment for Seniors
 - \$1,000 bonus payment to recipients of the Carer Payment and recipients of both the Carer Allowance and either the Wife Pension or Veterans’ Affairs Partner Service Pension.

- \$600 bonus to Carer Allowance recipients.

- Those eligible for the Senior Australians Tax Offset will now pay no tax on their annual income up to \$25,867 and \$43,360 for couples.

Health

- \$772 million for improved detection and treatment of chronic and complex conditions.
- \$486 million for medical research infrastructure in 2006-07.

Small Business, Industry and Rural Support

- Small business will receive tax cuts of \$540 million over four years; advisory services will increase and compliance costs reduced.
- Global integration package costing \$1.4 billion over 10 years, with expanded access to the 175% R&D tax concession and other measures.
- Exceptional Circumstances (Drought) assistance will be increased by \$314 million.
- Rural services will be improved will \$342 million and the Agriculture – Advancing Australia initiative will be extended by \$205 million over four years.

Road, Rail and Water Infrastructure

- Road and rail spending of \$22.3 billion will be provided over the five years from 2009-10.
- Water spending of \$10 billion over 10 years, but just \$172 million in 2007-08.

Indigenous Australians

- Increased funding of \$750 million over four years for a range of Indigenous-specific programmes.

Overseas Aid

- Increased aid of \$2.6 billion over four years, \$544 million will be spent in 2007-08.

Defence

- Super Hornets purchase costing \$6.6 billion over 13 years.
- Recruitment and personnel retention initiatives costing \$2.1 billion over 10 years.
- National security initiatives to further safeguard against terrorism, including better e-security, which amount to \$231 million in 2007-08 and \$702 million over four years.
- Military contributions in Afghanistan and Iraq costing an extra \$1.1 billion over four years.

Environment

- Natural Heritage Trust extension of \$2 billion – all in the forward estimates
- Climate change initiatives (including the doubling to \$8,000 of rebates for installation of solar panels) amounting to \$741 million over five years.

Summary of Budget Aggregates

	2006/07		2007/08		2008/09	2009/10	2010/11
	\$bn	% GDP	\$bn	% GDP	% GDP	% GDP	% GDP
Outlays (accrual basis)	235.5	22.8	246.8	22.5	22.8	23.1	22.9
Receipts (accrual basis)	221.6	21.5	235.6	21.5	21.6	21.8	21.8
Fiscal (a)	11.9	1.2	10.0	0.9	1.0	1.2	1.1
Cash (b)	13.6	1.3	10.6	1.0	1.1	1.2	1.0

(a) Fiscal balance equals receipts less outlays less net acquisition of non-financial assets.

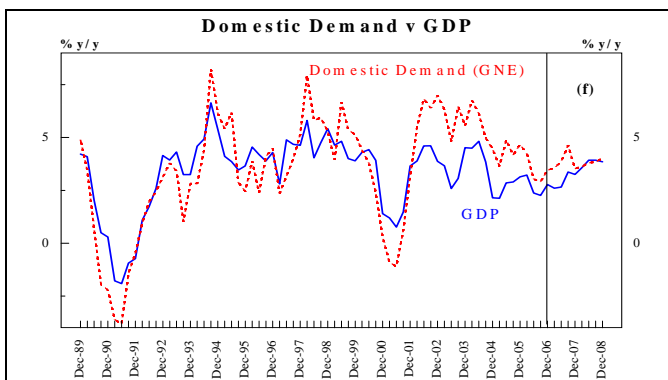
(b) Excludes expected Future Fund earnings.

Economic & Financial Outlook

Following the release of the Government's fiscal policy, NAB's key economic and financial forecasts remain unchanged.

Both NAB and the Government forecast real GDP growth of 2½% in the current financial year. For 2007/08, NAB's forecast is for GDP growth to pick up to 3½% – a bit lower than the Government's figuring of 3¾% - boosted by an assumed return to "normal" seasonal conditions. Like the RBA in its recent Policy Statement, non-farm GDP growth is forecast to be around trend of 3¼-½% in 2007/08.

Underlying the GDP projection is continued moderate growth in domestic demand, while some recovery in export volumes is more than offset by continued strong import volume growth. A sustained rise in the terms of trade is expected to continue to boost nominal income, with a small fall of only 1½% projected in 2007/08.



NAB expects underlying inflation to continue to move lower to around 2½% by mid 2008 – the middle of the RBA's target and headline inflation of almost 2½% during 07/08 - a bit lower than both the Government and RBA forecasts for headline of 2¾% during the next financial year.

International Outlook

Both NAB and the Government expect the world to expand at a strong rate. NAB's global growth of around 4½% p.a. is a bit lower than the Government's projection of about 5% p.a. This positive outlook is supported by strong growth in China, India and other emerging economies, while OECD and in particular US growth eases (see table of NAB's forecasts below). Also like the Government, NAB sees a worse-than-expected US slowdown as the key near-term risk to the world outlook.

Global GDP Forecasts			
% Change	2006	2007(f)	2008(f)
US	3.3	2.1	2.7
Japan	2.2	2.4	2.0
UK	2.8	2.8	2.6
Eurozone	2.8	2.4	2.1
Canada	2.8	2.1	2.4
Australia	2.7	3.0	3.8
New Zealand	1.7	2.6	2.7
China	10.7	10.7	9.9
India	9.1	8.4	7.8
World	5.1	4.6	4.5
Non-Japan E Asia	5.3	4.3	4.2
Latin America	4.7	4.6	4.2

Australian Outlook

NAB's aggregate demand forecasts allow for solid consumption growth, a modest pickup in dwelling investment, continued strong business and to a lesser extent public spending. Net exports, however, are expected to remain a drag on overall GDP growth – subtracting about half a percentage point from GDP in both 2006/07 and 2007/08. Overall, moderate export volume growth reflects a significant pickup in rural and non-rural commodities, but subdued manufacturing and services due to some loss of competitiveness. Consistent with solid domestic demand and a higher \$A, import volume growth remains relatively strong. Largely due to the boost of three-quarters of a percentage point from the assumption of improved seasonal conditions, GDP is forecast to strengthen 3½% in 2007/08 and almost 4% during the year.

Employment growth is expected to be sustained at 2½% in 2007/08. The participation rate is expected to continue to rise and the unemployment rate remains at around a 30 year low of 4½%. Government forecasts allow for a marked pick up in productivity and a slight rise in the unemployment rate to 4¾% in mid 2007 and 5% by mid 2008. The tight labour market and stronger growth means wage pressures bear watching. Wages growth is expected to be around 4% p.a., however, with pressures localised in mining, infrastructure & related sectors.

The current account deficit remains at around 5¾% of GDP in 2007/08 – as net export volumes remain a drag on the trade account and export prices fall slightly, while the net income deficit is also largely unchanged.

Similar to the Government, NAB would note that the main domestic risks to the Australian economy are the lagged impact of higher interest rates during 2006 on highly leveraged households, the breaking of the drought and ongoing effects of current low water storage levels on irrigated agriculture. The lack of spare capacity and its potential to constrain

growth and place upward pressures on wages and prices as well as potential volatility in commodity prices are also risks.

A comparison of the Government's and NAB's economic and financial forecasts is detailed in the next table.

Economic and Financial Forecasts – NAB v Federal Budget (a)

Annual % Change	2006/07 (f)		2007/08 (f)	
	NAB	Budget	NAB	Budget
Private Consumption	3½	3½	3¼	3½
Private Investment – Dwelling	2¼	2½	-¼	2½
– Underlying Business	3	4	8¼	7½
Underlying Public Final Demand	5¼	4	3½	3¾
Domestic Demand	3½	3½	3¾	4
Stocks (b)	-	-	¼	¼
GNE	3½	3½	4	4¼
Exports	4¼	3	5	5
Imports	9¼	8½	7½	6½
GDP	2½	2½	3½	3¾
– Non-Farm GDP	3¼	3	3¼	3½
Current Account Deficit – \$b	-59	-58¼	-63	-65¾
– % of GDP	-5¾	-5¾	-5¾	-6
Terms of Trade	7	6	-1½	-1½
Non-farm GDP deflator	4¾	4¾	2½	2½
Wage Price Index	4	4¼	3¾	4¼
Total CPI	2¾	2¾	2	2½
Underlying CPI	2¾	n.a	2½	n.a
Employment	2½	2½	2½	1½
End Period				
Participation Rate	65¼	64¾	66	65
Unemployment Rate	4½	4¾	4½	5
Official Cash Rate	6¼	n.a	6¼	n.a
10 Year Govt. Bond Yield	5¾	n.a	5½	n.a
US cents/\$A	82	n.a	78	n.a
Trade Weighted Index	67	n.a	63	n.a

(a) Percentage change on previous year, unless otherwise indicated

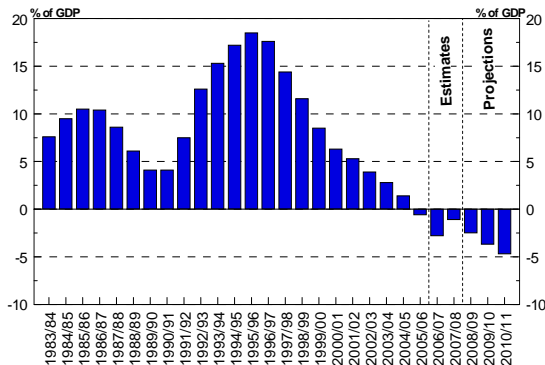
(b) Contribution to GDP growth (f) Forecast

Net Debt, Future Fund & Debt Issuance

The Government's net debt is expected to remain below zero (ie. net surplus) in 2007-08, but there will be some reduction in the financial assets included in net debt as the Future Fund progressively moves its assets out of cash and fixed interest securities, which are included in the net debt calculation, into equities, which are excluded.

The Government expects to be in a net surplus position of \$28.4bn by the end of June 2007 (2.8% of GDP), falling to \$12.0bn by June 2008 (1.1% of GDP) but then rising back to \$28.4bn by June 2009 (2.5% of GDP)

Commonwealth General Government Net Debt



Net worth (a broader measure that incorporates the Government's non-financial assets, such as land assets and accrued employee superannuation liabilities) is expected to strengthen with future Budget surpluses and earnings from the Future Fund. Currently net worth is -\$10.9bn, falling to -\$0.6bn next year, and it is projected that the Government will have a positive net worth of +\$14.1bn by 2008-09 and +\$29.1bn in 2009-10.

Future Fund Earnings

The Government established the Future Fund in 2005-06 with \$18bn in seed capital. Since then it has added \$13.6bn from the 2005-06 Budget surplus and \$17.6bn from the Telstra sale, raising the total expected balance (with earnings) to around \$52bn by June 2007.

In 2007-08, the Government will consider a transfer to the Fund from the 2006-07 Budget surplus once it is realised, and there will also be another contribution from the second instalment of the Telstra sale which is due in 2008.

Higher Education Endowment Fund

The Government will establish a perpetual Higher Education Endowment Fund (HEEF) with an initial investment of \$5bn funded from the 2006-07 surplus. The capital component of the HEEF will be managed and invested by the Future Fund Board of Guardians, while the income earned will be distributed by the Minister of Education, Science and Training to tertiary institutions for capital works and research facilities.

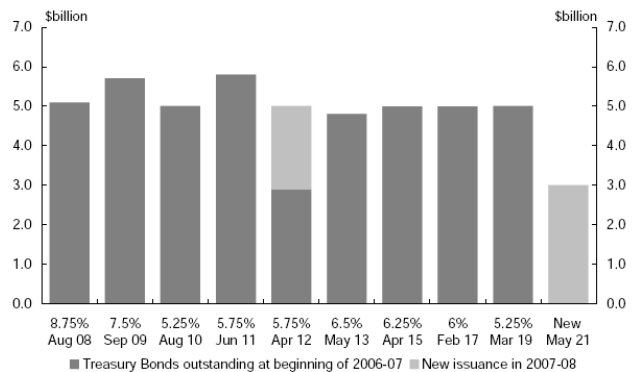
Debt Issuance

The Government remains committed to maintaining sufficient CGS on issue to support the Treasury bond futures market, and there has been no change to the issuance strategy, which is to launch new 5-year and 13-year Treasury Bonds in alternate years, with total issuance over two years of around \$5 billion per bond line.

In 2007-08, the Government intends to issue a further \$2.1bn of the April 2012 Treasury bond to bring total issue for this bond line to \$5bn. Also, a new May 2021 Treasury Bond will be issued to support the 10-year bond futures contract. The Government plans to issue \$3.0 billion of this bond during 2007-08, with a further \$2.0bn issuance undertaken in the first half of 2008-09.

All up, total issuance in 2007-08 will be \$5.1 billion, while scheduled maturities during this period will be \$2.9 billion. Hence the total stock of Treasury bonds on issue, net of Australian Government holdings, will be around \$49.4 billion at 30 June 2008.

Benchmark Bonds Outstanding as at 30 June 2008



(a) Treasury Bonds on issue are net of Australian Government holdings. Source: Australian Office of Financial Management and Treasury estimates.

Market Reaction to Budget

The AUD was at 0.8292 when the Budget was handed down at 7.30pm, and fell to a low of 0.8278 in the half hour after the release, but was back at 0.8284 by 8.30pm.

On interest rate markets, June bill futures were little changed, while the 3-year bond futures rallied 2 basis points in the first half hour to 93.91.

For equities, the SPI 200 futures index fell around 10 points to 6,300 in the hour after the Budget release.

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