



<p>Comment</p>	<p>From a big picture viewpoint, this Budget was very much a big spending affair with surprisingly few “nasties”. The focus was on a number of areas but principally infrastructure – where a total of \$22bn is to be spent (\$3.4bn on roads, \$4.6bn on rail, \$3.5bn on clean energy, \$3.2bn on hospitals, \$2.6bn on universities and \$4.7bn on broadband). Pensions were raised significantly as promised (costing around \$3bn a year), tax cuts delivered, a new carers’ payment was introduced and a paid parental leave scheme introduced from 2011. The first home owners’ scheme was temporarily extended and small business investment allowance increased. As well as taking around \$20bn from the schemes set up under last year’s budget the main savings areas are in tighter rules for superannuation (for the higher paid), increased means testing for middle income welfare, increasing the pension qualifying age and reprioritising defence spending. All this stimulus is estimated to add ¾% to GDP next year and supposedly lowers unemployment by 1½% in 2011 ie. 10% unemployment without the Budget measures.</p> <p>In the near term the deficit blows out to around \$57bn. Budget deficits remain sizeable (\$44bn in 2012/13) and are not eliminated until 2015/16 – and then only if the economy seriously bounces up (4½% per annum) for a number of years post the recession. On the near term forecasts (out to 2011/12) we have few real quibbles. Our issue is that the Government seems to be largely relying on the economy to self correct the problem – our structural deficit in fact sees no noticeable retrenchment over the next 3 years (see Medium Term Fiscal Context on page 2).</p> <p>While the net debt position increases significantly it still looks reasonable compared to most other nations (a peak of 13.8% in 2013/14). Our real concern is that the Budget does not lay out a credible medium term policy to return the Budget to a more sustainable footing. It may well happen naturally but at some point down the track a more aggressive policy stance will probably be needed.</p>
<p>Fiscal Outcome</p>	<p>The underlying cash deficit is estimated at \$57.6bn (4.9% percent of GDP). The Budget remains at broadly similar levels in 2010/11 and is not erased until 2015/16. That improvement, however, is very much related to the impact of the economy recovering strongly from 2011/12. For more details see section on Budget Measures in Brief.</p>
<p>Economic Outlook</p>	<p>NAB has similar forecasts to the Government (and the RBA) out to 2010/11 – as far out as we are reasonably prepared to forecast. At the margin the Government is even more bearish on private investment than NAB, though this is partly offset by stronger public sector demand. We on the other hand have larger falls in exports, commodity prices and hence a larger current account deficit. At the margin we are more bearish on employment but surprisingly have a marginally lower unemployment rate. This may in part reflect timing – we see unemployment rising to 8% by late 2010 and edging higher into 2011 (around 8¼%). The Government’s unemployment forecast rises more steeply, reaching 8¼% by mid 2010. We also suspect the Government is being deliberately conservative in its unemployment forecast (as has been the case in the past). As noted previously, a big issue relates to what happens after 2011/12. It is possible that GDP could sustain rates at or above 4% for some time but one wonders about the wisdom of relying on these types of assumptions as the key means to return the Budget to medium term health.</p>
<p>Financial Markets</p>	<p>With the surplus and key measures largely as expected, currency markets were little moved by the Budget. The AUD was at 0.7656 prior to the Budget numbers hitting the screens, and traded in a narrow 0.7650 – 0.7670 range in the first half hour.</p> <p>On interest rate markets, however, 3-yr and 10-yr bond futures rallied around 7 points in the first half hour, perhaps relieved that the deficit was not higher than expected and the issuance levels were as leaked earlier in the week. Equities were little moved with the SPI 200 futures remaining around 3900 after the release.</p>

Medium Term Fiscal Context

As noted in our overview, this Budget was very much geared to the near term stimulus via infrastructure spending. As the Treasurer said in his speech, a key theme was “nation building for recovery.” In addition there was focus on supporting jobs and addressing social concerns such as pensioner reform, carers and parental leave.

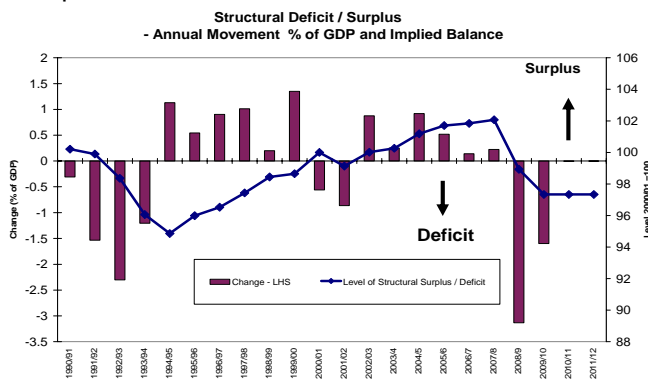
The following table highlights how the Budget has been put together – tracking back to the 2008/09.

Budget Reconciliation

	2008/09 (\$b)	2009/10 (\$b)	2011/12 (\$b)
2008/09 Budget Surplus	21.7	19.7	18.9
- (%GDP)	(1.8)	(1.5)	(1.3)
Mid year review			
- Policy	-11.1	-1.6	-0.8
- Parameters	-5.2	-14.4	-11.3
Govt at Mid year	5.3	3.6	6.9
Updated Fiscal Outlook			
- Policy	-18.0	-18.3	-5.4
- Parameters	-9.8	-20.7	-27.9
Govt at Updated Outlook	-22.5	-35.5	-25.7
Budget 2009/10			
Policy			
- Revenue	0.0	-0.2	-0.6
- Expenses	-4.2	-8.1	-4.9
Parameters	-5.3	-10.1	-11.9
Cash Balance	-32.1	-57.6	-44.5
- (%GDP)	(-2.7)	(-4.5)	(-3.2)

A few themes are apparent in the table. First the impact of parameter changes (i.e. economic conditions) on the Budget, the near term aggressive policy action already delivered prior to the Budget and the limited new revenue measures aimed at clawing back the deficit.

Another way to look at the policy impact of the Budget – rather than what the economy has done to the Budget – is to estimate a structural Budget position. In the following table we have used OECD methodology to attempt to do so.



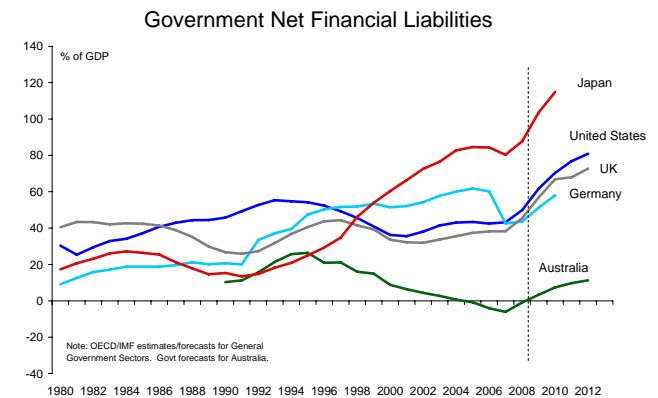
The bars in the chart show the policy stimulus on an annual basis – while the line gives a level of overall structural surplus/ deficit (basing the index at 100 for 2001).

This chart shows that in 2008/09 there was a record amount of policy stimulus used to support growth (approaching 3% of GDP). There is at least another 1½% of GDP stimulus supporting growth in 2009/2010.

From a medium term context what is interesting is that in the following two years the calculation shows no net policy action. That is the moderate decline in the deficit to around \$44bn is purely the result of a stronger recovery.

We have not extended the analysis beyond 2013 because of uncertainty of any economic forecasts that far into the future. However the analysis clearly highlights why it is taking so long in the Treasury’s medium term scenarios to produce a surplus (2015/16). It may well be reasonable to expect another year of 4½% growth but we really don’t know.

Clearly much will be made of the big kick up in debt. However as the Government correctly notes, the Australian balance sheet – as measured by net financial liabilities will still look very good – see chart below. It should also be noted that the peak of debt on this measure is 13.8% in 2013/2014.



Our real concern is that the Budget does not lay out a credible medium term policy to return the Budget to a more sustainable footing. It may well happen naturally but at some time down the track a more aggressive policy stance will probably be needed.

Budget Measures – In Brief

In accrual terms, the fiscal deficit for 2009/10 is estimated to be \$57.6b (or 4.9% of GDP). Key highlights include:

Spending Initiatives

For the Aged

- An increase in the aged pension of \$32.49 per week for singles and \$10.14 per week for couples, forecast to cost \$3.86b per year.
- Carer's will receive a supplement of \$600 per annum for each eligible person in their care.

First Home Owners Boost Extended

- First Home Owners Boost will be extended for a further six months, 3 months at the full rate before being stepped down to half the rate between 1 October 2009 and 31 December 2009.

Small Business

- Small businesses can claim a bonus tax deduction of 50 per cent of the cost of eligible assets ordered between 13 December 2008 and 31 December 2009 and installed by 31 December 2010.
- \$10 million over two years to fund Small Business Support Line.

Transport

- Road, rail, freight and port infrastructure with the main features being a \$3.2 billion dual rail link from Werribee to Southern Cross Station in Melbourne, a \$365 million light rail corridor in the Gold Coast and \$236 million for a metropolitan Perth rail line.

Broadband

- The Public-Private Partnership to build the National Broadband Network. The government will make an initial investment of \$4.7b, sourced from the Building Australia Fund.

Parental Leave

- Paid parental leave scheme will be implemented from 1 January 2011 for families whose primary carer earns less than \$150,000 a year. Up to 18 weeks leave will be paid at the federal minimum wage of about \$544 a week, costing \$731m over five years.

Education

- \$2.6b over four years for universities and research funded by the Education Investment Fund.

- The cap on the number of university places will be removed from 2012, allowing for an additional 50,000 students. This will be at a cost of \$491 million over four years.
- \$1.5b for the Jobs and Training Compact, targeted at the young, apprentices and retrenched workers.

Environment

- \$3.5b of new funding to develop Carbon Capture & Storage and Solar technologies along with the establishment of Renewables Australia to 'support the development, commercialisation and deployment of new and existing renewable technologies'.

Health

- \$3.2b for hospital infrastructure, cancer care and health research funded from the Health and Hospitals Fund.

Saving Measures

Private Health Insurance

- From July 1, 2010, three new private health insurance tiers will be introduced with the available rebate declining with progression up the income scale. For singles with income of more than \$120,000 (and families earning more than \$240,000), no rebate will be provided.

Aged Pensioners

- The qualifying age to receive the aged pension will be gradually increased to 67 years old (from 65). The qualifying age will increase at a rate of six months every two years, beginning in 2017 and reaching 67 in 2023.

Superannuation

- The cap on concessional superannuation contributions will be reduced from \$50,000 to \$25,000, and the transitional cap (which applies until 30 June 2012 for those aged 50 or over) from \$100,000 to \$50,000.
- Temporary reduction in the government superannuation co-contribution. The co-contribution matching rate will be reduced from 150 per cent to 100 per cent for contributions made between 1 July 2012 and 30 June 2014. Thereafter, the co-contribution matching rate will return to 150 per cent.

Family Benefits

- Threshold incomes for receiving a number of family benefits including dependant tax offsets and the Baby Bonus temporarily frozen before resuming indexation to the Consumer Price Index on 1 July 2012.

Summary of Budget Aggregates

	2008/09		2009/10		2010/11-P	2011/12-P	2012/13-P
	\$bn	% GDP	\$bn	% GDP	% GDP	% GDP	% GDP
Outlays (accrual basis)	324.4	27.1	338.2	28.7	28.2	27.4	27.0
Receipts (accrual basis)	295.9	24.7	290.6	24.7	24.1	24.7	25.2
Fiscal (a)	-32.9	-2.7	-53.1	-4.5	-4.6	-3.2	-2.2
Underlying Cash (b)	-32.1	-2.7	-57.6	-4.9	-4.7	-3.4	-2.0

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

(b) Excludes expected Future Fund earnings.

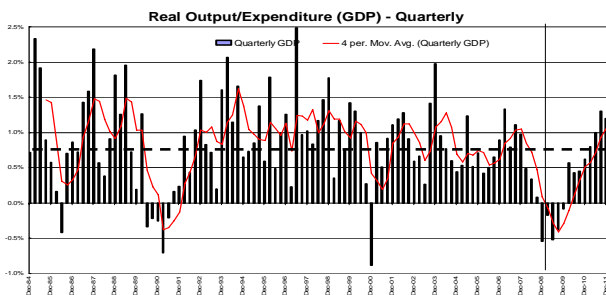
Economic & Financial Outlook

Following the release of the Government's fiscal policy, NAB's key economic and financial forecasts remain unchanged; the sharp increase in the Government Budget deficit has been anticipated for several months. NAB's growth outlook is strikingly similar to the Government's forecasts as well as the RBA's forecasts. That said, there are some compositional differences between NAB's forecasts and those of the Government.

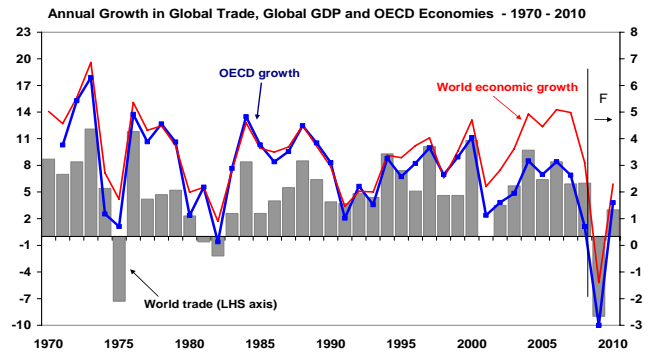
In aggregate, NAB and the Government have the same forecasts, with GDP contracting by $-1\frac{1}{2}\%$ in annual average terms in 2009-10. The main differences are in business investment, the external sector, the size of public sector spending and the pace of deterioration in the unemployment rate.

The Treasury forecasts have a more bearish outlook for investment ($-18\frac{1}{2}\%$ vs -13% for NAB). By contrast, NAB has a greater deterioration in the volume of net exports as well as a sharper contraction in the terms of trade. As a result, the current account deficit share of GDP is -7% in 2009-10 based on NAB's forecasts, compared with $-5\frac{1}{4}\%$ based on Government estimates. The Treasury forecasts a stronger impetus from the public sector, with Underlying Public Final Demand forecast to rise by $7\frac{3}{4}\%$, compared with NAB's $6\frac{1}{4}\%$. Finally, in terms of the unemployment rate, the Government has the rate rising to $8\frac{1}{4}\%$ by June 2010, whilst we forecast a slower progression, rising to $7\frac{1}{2}\%$ by June 2010, and $8\frac{1}{2}\%$ by December, 2010.

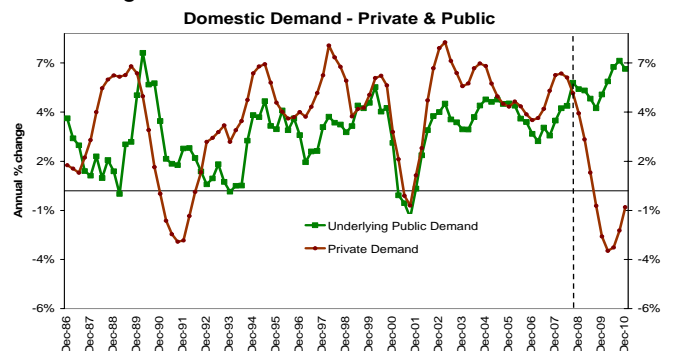
For 2008-09 NAB forecasts growth, in annual average terms, to be a very modest $\frac{1}{4}\%$, followed by a contraction of $-1\frac{1}{2}\%$ in 2009-10. Our forecasts reflect a very weak 2009 and a modest (sub par) recovery in 2010. It is not until 2011 that we return to trend growth. These forecasts reflect the current poor starting point, together with weaker exports and business investment given the global outlook (see below). The extent of recent wealth destruction is likely to see little, if any, growth in consumption.



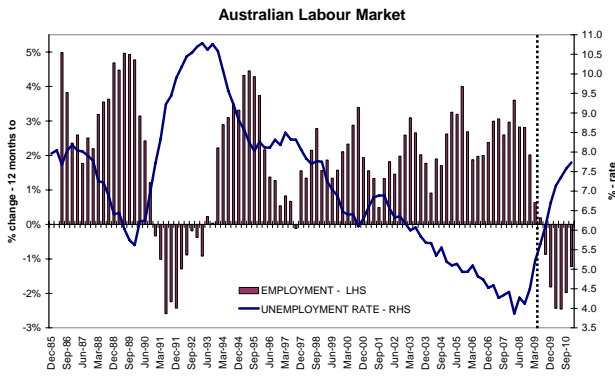
Globally, the world economy continues to struggle with the unprecedented slowdown – currently reflected in key indicators such as global industrial production which fell by -16% in the year to February, 2009. NAB forecasts World economic growth to contract by $-1\frac{1}{2}\%$ in 2009. The Government's forecasts for World growth are identical to NAB's. USA, UK, Japan and the Eurozone will be particularly hard hit. These represent the worst results, by far, for both the big OECD economies and global growth since WW2. The short term outlook for global trade is equally bleak.



There is also concern surrounding Eastern Europe/Russian prospects, and, to a lesser extent, the Asian tigers. The main exception to that is China where GDP and industrial production have strengthened in early 2009 and sentiment has improved. However, aggressive global fiscal and monetary policies (including, in some countries, unconventional measures such as quantitative easing) have had some effect with an improvement in business and consumer sentiment and a slowing in the rate of contraction. However, we still expect the recovery to be modest and protracted, with sub-trend growth in 2010.



Domestic demand is expected to contract in 2009 and experience a sub-trend recovery in 2010. As a result, NAB forecasts domestic demand to fall by $-3\frac{1}{4}\%$ in 2009-10. The private sector is the main driver of this fall in demand with a modest decline in consumption ($-1\frac{1}{4}\%$) and sharp falls in business investment (-13%) resulting from falling orders, declining profits and weak capacity utilisation. By contrast, a strong increase in public sector demand ($6\frac{3}{4}\%$) will help mitigate some of the declines.



Given the weak growth estimates, NAB forecasts a more depressed labour market outcome going forward. The forecasts now see employment falling by -2% in 2009 and moderately further in 2010. Even allowing for significant discouraged worker effects on the participation rate, unemployment moves substantially higher in 2009-around 6¼%. By the second half of 2010 our forecasts would see unemployment rising to 8%. This is considerably lower than the Government's forecasts set out in the Budget papers, wherein the unemployment rate rises to 8¼% by June 2010.

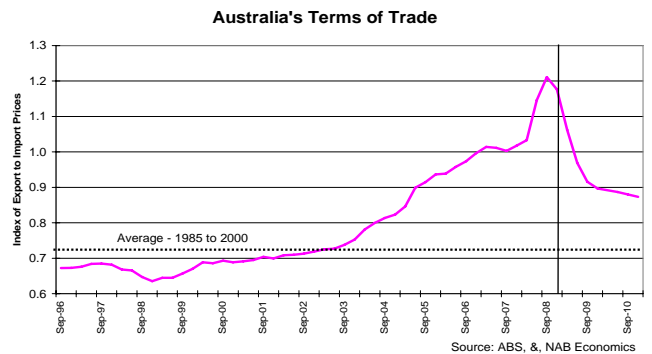
Looking a bit more closely at business investment, we expect sharp falls in non residential construction: offices, shops, warehouses and accommodation are all expected to decline. Against that, investment in social infrastructure (education, health and aged care) is expected to increase, but not enough to counter the falls in office, retail and industrial building construction. Falls in commodity prices and very weak annual capex plans are likely to see a sharp contraction in mining investment in 2010. Besides weak demand, developers also have to contend with stringent credit conditions, with the property and construction sectors experiencing the tightest credit conditions among sectors, according to NAB's March 2009 Quarterly Business Survey.

In contrast to non-residential activity, the dwelling construction sector is expected to benefit from low interest rates and a fundamental undersupply of houses. This should lead to a gradual improvement in dwelling construction activity, with more substantial improvements expected in 2010 and beyond.

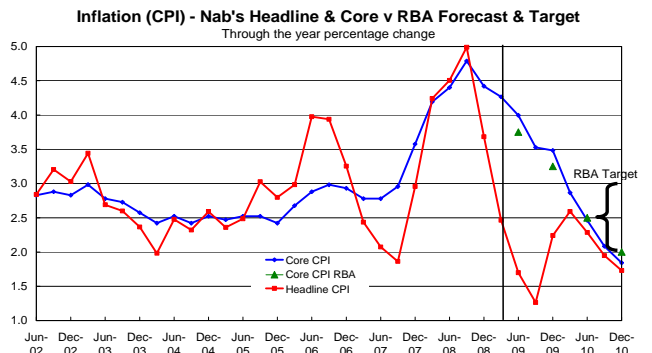
Moving to the farm sector, the significant increase in the winter crop production in 2008-09 is expected to lead to an increase in the volume of farm production, by around 10½% in 2008-09. However, a slight fall in grain and livestock production in 2009-10 will lead to a -1% fall in farm production in 2009-10.

Falls in production in our major trading partners will flow on to weaker export volumes, with exports for 2009-10

falling by -7½% in year average terms. The contraction in domestic demand will also weigh negatively on imports, with the volume of imports falling by -5% in 2009-10.



As well as the volume effects, there are also value effects via falling terms of trade. Our forecasts have commodity prices falling by around 28% in 2009 and by another 7% in 2010. This will push the terms of trade, in annual average terms -18¼% lower in 2009-10. Such a sharp fall in the terms of trade will inevitably impact the current account balance. The current account deficit is expected to deteriorate to 7% of GDP in 2009-10, compared with 5% in 2008-09.



Finally, on inflation, our most recent Monthly and Quarterly Surveys continue to point to very weak demand and sharply slowing levels of capacity utilisation and wage growth. In that environment, we see core inflation returning to the RBA's target by early 2010 (reflecting the relatively high March quarter outcome due to the sharp rise in import prices stemming from the exchange rate depreciation in late 2008) and moving sharply lower over the course of the year.

Indeed, inflation targeting dictates that interest rates should be adjusted according to where inflation is expected in 12 months time, and here it is worth noting that our (and the RBA's) forecasts have inflation at the bottom of the target range – and moving further down (see chart above).

The Government has a slightly faster rate of decline in both the underlying and headline measures of CPI. For example, the Government forecasts underlying CPI of 1¾% over 2009-10, compared with NAB's (and the RBA's) 2½%.

In terms of the outlook for interest rates:

- We now see the RBA in data watching mode, having delivered the bulk of the emergency cuts.
- Cuts going forward will be data dependent and will be delivered in 25bp moves. The RBA now requires bad, and possibly worse than expected data to move lower.
- Overall, however, we still see the RBA as needing to respond to further falls in the GDP and sharp rises in unemployment. It is also noticeable that the RBA forecasts imply a significant undershoot of their inflation targets through 2011.
- As a result, we have maintained cuts in November and December in 2009, bringing the cash rate to a low of 2½% in December 2009.
- Finally, we still see the RBA as keen to re-establish more 'normal policy settings' once recovery becomes entrenched. Hence we continue to expect to see the cash rate rising to around 3% by end 2010 – continuing into 2011.

There are both downside and upside risks to our forecasts. The downside risks include: increasing strains in the financial systems in Europe and the US; an increase in precautionary savings by both firms and businesses, limiting the effectiveness of stimulatory fiscal and monetary policy; China's recent improvement does not turn out to be durable. Conversely, the recent stabilisation in economic conditions as well as the recent rally in equity markets may lead to stronger business and consumer confidence, leading to higher investment and consumer spending, and thereby economic growth.

Overall this budget does not change our inflation or interest rate outlook. Clearly the RBA is also concerned about growth. However once recovery comes, a still stimulatory fiscal position could well add to demand pressures causing the RBA to tighten more aggressively in the medium term.

A comparison of the Government's, NAB's and the RBA's economic and financial forecasts is detailed in the tables on the following page.

Australian Economic and Financial Forecasts – National v Federal Budget (a)

End Period	2008-09 (f)		2009-10 (f)	
	NAB	Budget	NAB	Budget
Annual % Change				
Private Consumption	½	1	-½	-¼
Private Investment – Dwelling	-½	-2½	½	0
– Underlying Business	4	2½	-13	-18½
Underlying Public Final Demand	4¾	5	6¼	7¾
Domestic Demand	1¾	1½	-¾	-1¼
Stocks – Contribution to GDP	-1	-1½	½	¼
GNE	¾	¼	-¼	-1¼
Exports	¼	-½	-7¼	-4
Imports	¼	-1½	-5¼	-6½
GDP	¼	0	-½	-½
- Non-Farm GDP	-¼	-¼	-¾	-½
- Farm GDP	10½	13	-1	1
Current Account Deficit: % of GDP	-5	-3	-7	-5¼
Terms of Trade	5¼	8¾	-18¾	-13¾
World GDP (b)	-1½	-1½	2¼	2¼
Wage Price Index	4	4¼	3	3¼
End Period				
Employment	½	-¼	-2½	-1½
Unemployment rate	5¼	6	7½	8¼
Total CPI	1¾	1¾	2½	1¾
Underlying CPI	3½	1¾	2½	1¾
Official Cash Rate	3	n.a	2½	n.a
10 Year Govt. Bond Yield	4¾	n.a	5¼	n.a
US cents/\$A	73	n.a	80	n.a
Trade Weighted Index	55	n.a	62½	n.a

(a) Percentage change on previous year, unless otherwise indicated (b) Calendar (f) Forecast

NAB'S forecasts vs RBA forecasts

GDP	Q2	Q4	Q2	Q4	Q2	Q4
	2009	2009	2010	2010	2011	2011
NAB	-1.2	-1.2	½	2	3	4¼
RBA	-1 ¼	-1	½	2	3¼	3¾
Core Inflation						
NAB	4	3½	2½	1¾	1½	1½
RBA	3¾	3¼	2½	2	1½	1½

Bond Issuance and Net Debt

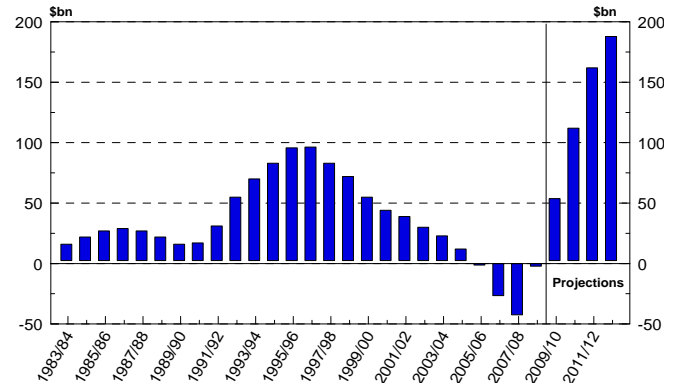
Debt Issuance in 2009-10

Gone are the days of the Australian Government issuing just \$5 billion over two years to offset maturing bond lines. By end-June 2009, the Government projects that there will be \$79 billion in Treasury Bonds on issue, up from around \$49 billion at end-June 2008. In 2009-10, the Government intends to issue around \$60 billion in Treasury Bonds, with the stock of Treasury Bonds on issue projected to be around \$133 billion after allowing for maturing stock.

The bulk of the issuance in 2009-10 will be into existing bond lines, but at least one new Treasury Bond line (maturing in 2022) is planned to be issued in 2009-10. Meanwhile, the volume of Treasury Notes on issue is expected to be around \$17 billion at end-June 2009, and issuance in 2009-10 will depend on short-term funding needs. However at least \$10 billion of Treasury Notes will be kept on issue at all times to maintain a liquid market.

Net debt, which does not include accrued employee superannuation liabilities, is estimated to be in net surplus of +\$4.7 billion as at June 2009, but deteriorates to a net deficit of \$53.7 billion in 2009-10 (4.6% of GDP) and rises to \$188.2 billion (13.6% of GDP) by 2012-13. Beyond 2013, net debt is projected to improve gradually as a percentage of GDP, with net debt returning to just 3.7% of GDP at the end of the medium-term projections in 2019-20.

Australian Government Net Debt



Net Financial Worth to deteriorate sharply

The Rudd Government has focussed on net financial worth when stating its assets and liabilities, as opposed to net debt and net worth which was preferred by the Howard Government.

The Government's net financial worth, defined as total financial assets less total liabilities, includes government borrowing, superannuation and all financial assets, but excludes illiquid non-financial assets such as land.

Net financial worth is estimated to be at -\$82.3 billion at June 2009, deteriorating to -\$136.0 billion (11.5% of GDP) in June 2010. At the end of the projection period, 2012-13, it will be up to a huge \$268.7bn, 19% of GDP. The projected deterioration in net financial worth is driven by future budget deficits, as the Budget is not forecast to return to surplus until 2015-16.

Nation Building Funds & The Future Fund

In 2008 the Government planned to establish three new nation building funds, the Building Australia Fund (\$20bn), the Education Investment Fund (\$11bn) and the Health and Hospital Fund (\$10bn). The funding for these was to come from the 'planned surpluses' of 2007-08 and 2008-09.

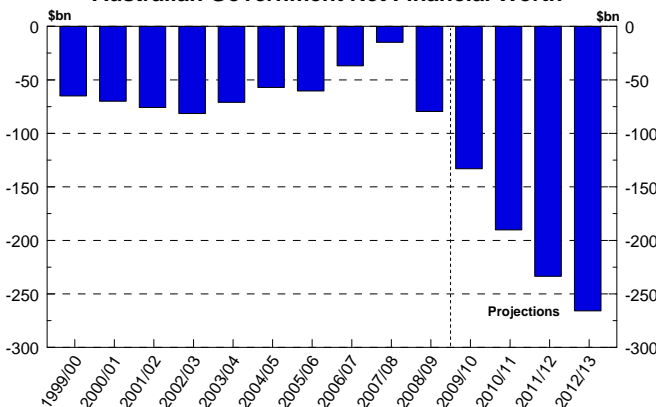
The Government has committed to transfer the realised 2007-08 surplus of \$19.7bn, and the balance of the Telstra Sale Special Account to the Funds by 30 June 2009.

In 2009-10 however, these funds will be used to finance the 'nation-building investments' announced in the Budget: \$10.7bn will be drawn from the Building Australia Fund (BAF), \$3.0bn from the Education Investment Fund (EIF), and \$3.2bn from the Health and Hospitals Fund. The funding from the BAF includes part of the Government's equity contribution for the National Broadband Network.

Prior to closing the Telstra Sale Special Account, \$1.5bn will be used for infrastructure projects, including the clean energy and key transport projects. The Government will also invest \$2.5bn set aside for the EIF in its Clean Energy Initiative, meaning the Clean Energy Special Account will have a balance of \$3.1bn.

Meanwhile, the **Future Fund** was valued at \$58.1 billion as at 31 March 2009, consisting of \$30.2 billion of (non-Telstra) assets, \$21.0 billion in cash and cash-like assets and \$6.8 billion in Telstra shares. The fund declined in value by 9.6% over the first nine months of 2008-09.

Australian Government Net Financial Worth



The Government also estimates the value of the Higher Education Loan Program at \$11 billion, while the AOFM has purchased around \$5 billion of RMBS since September 2008.

Market Reaction to Budget

With the surplus and key measures largely as expected, currency markets were little moved by the Budget. The AUD was at 0.7656 prior to the Budget numbers hitting the screens, and traded in a narrow 0.7650 – 0.7670 range in the first half hour.

On interest rate markets however, 3-yr and 10-yr bond futures rallied around 7 points in the first half hour, perhaps relieved that the deficit was not higher than expected and the issuance levels were as leaked earlier in the week. Equities were little moved with the SPI 200 futures remaining around 3900 after the release.

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