16 May 2013

Westpac Institutional Bank

Still on track with the "promise" of a lolly in 2015

- **Budget confirmed that Government is on track to achieve surplus in 2014/15.**
- **Treasury suggests that the economy is on a sounder footing, giving the Government more wiggle room to increase spending or reduce revenue.**
- **Government chose to reduce revenue by requiring lower ACC levies than previously planned.**
- **Otherwise, budget changes amounted to tinkering.**
- **The Christchurch rebuild is core to this budget with cost estimates up along with the Government's contribution to the rebuild.**
- **The memorandum of understanding with the Reserve Bank Governor has been signed, confirming that the Reserve Bank can use its macroprudential tools.**
- **The bond programme has been reduced by $3 billion largely on the back of improving Government accounts.**

The economy is improving and so are the Government's books. This improvement has generated some loose change. However, this Government's instincts are to run a tight ship. No wild spend ups. Instead, this Government prefers "small government" – in other words lower taxes and fees. In the end, the Government did a little bit of everything. The Government announced some more spending this year plus a promise of lower ACC levies from 2015; all the while the focus remains on a return to surplus in 2014/15, followed by reductions in Government debt.

Operating Balance

The 2013 Budget shows the Government's books are heading in the right direction. Tax revenue is tracking ahead of forecast and expenditure below. All up, this year's deficit forecast has fallen from $7.3 billion to $6.3 billion.

This improvement has allowed the Government to add $100 million to this Budget's operating allowance. While this is peanuts, it does follow the previous two "zero budgets". That said, it has trimmed operating allowances from 2014 to $1 billion from $1.2 billion previously.

Despite this minor shuffling of the spending deck, the Government remains on track to achieve a surplus in 2014/15. The surplus remains small at $75 million. But in a way, Government has introduced spending initiatives so that it continues to sail close to the wind, implying a degree of confidence around this target. It could have simply let the surplus widen. Instead it actively chose not to.

The additional change generated by the improving economy and tax revenue has been channelled into a signalled reduction in ACC levies. In other words, tax cuts in disguise. The kicker however, is that we don't get to see the precise make-up of levy reductions. ACC levies could be reduced for the employer, employee or motor vehicle accounts. On that we must wait for details.

Economic Forecasts

Treasury expects the economy to grow modestly over the next four years. Growth is expected to reach 2.5% in 2013, stutter to 2.4% in 2014 before peaking at 3.0% in 2015.

In our view, this is conservative, particularly in 2014 and 2015. We forecast growth at 2.9% and 3.7% respectively over these years. The major difference appears to lie in private consumption. We expect the accelerating housing market and associated increase in confidence to spillover into higher spending by households. Treasury doesn't share this view and nor does the Reserve Bank.

We are happy to agree to disagree. In our view, households are getting their Dutch courage back at a rapid rate as house price rises accelerate to around 10% growth per annum. The borrow and spend mentality will follow. In our view, more household spending will result in higher inflation and lead to sooner interest rate rises than both the Treasury and the Reserve Bank are factoring in.

Spending and policy initiatives

The Christchurch rebuild remains front and centre of the Government's plans. The total cost to the Crown is estimated at $15.2 billion, up $2.1 billion on previous estimates. $900 million has been committed from the Future Investment Fund (proceeds from State asset sales) for Christchurch hospitals, the justice and emergency services precinct and tertiary education institutions. A further $300 million will go towards anchor projects in the city's CBD. The remainder relates to a mixture of land zoning decisions, school property expenditure and funding for the Canterbury Earthquake Recovery Authority.

The total costs of the rebuild have also been revised from $30 to $40 billion. The main impact of this increase is to lengthen the rebuild period. We also remain wary, particularly of commercial projects down the track. Rising costs may make it difficult for many business cases to stack up.

Levy reduction or tax cuts – you choose the handle, but effectively they are the same. The government has signalled reductions in the ACC levy rates of around $300 million in 2014/15 and $1,000 million from 2015/16 onwards.

The Government has moved the goal posts on New Zealand Superannuation Fund contributions, meaning a later start to contributions. Previously, it signalled that contributions would resume in tandem a return to surplus. Now, it wants net debt to hit 20% of GDP before starting contributions. This change implies a two-year delay in the start date for contributions.

The Government is pressing on with its asset sale plans, announcing that Meridian Energy is the next State-owned Enterprise up for sale. The sale is planned for the second half of 2013.

Housing was major area of tinkering by the Government. $100 million was set aside for improving the “health” of homes, particularly targeting low-income households. Other measures in addition to the housing accords with councils announced prior to the Budget include a trial on Housing New Zealand properties of a Warrant of Fitness programme.

Memorandum of understanding with Reserve Bank

The memorandum of understanding between Minister of Finance and Governor of the Reserve Bank of New Zealand regarding the use of macro-prudential tools was broadly as expecting, retaining all of the four tools previously canvassed by the Reserve Bank. The Reserve Bank will consult with the Minister and The Treasury before using the tools, which are strictly for the purpose of maintaining stability in the financial system. The memorandum said the Reserve Bank would publish information on its framework for deciding when to use macroprudential tools. The Financial Stability Report will be the key vehicle for explaining and assessing the use of these tools.

Market Implications

The bond programme has been reduced by $3 billion largely on the back of improving Government accounts. This reduction is comprised of $1 billion less Treasury bill outstandings in 2013/14 and $2 billion less gross bond issuance in 2014/15. This lower supply of may put upward pressure on rates.

Overall, this Budget is less contractionary than previously reported in the Half-Year Update, and may put upward pressure on interest rates. In the five years to 2017, the fiscal policy is expected subtract 0.7 less percentage points of GDP than at the Half-Year Update. The tax cuts (the reduction of ACC levies) are the major driver of this change.

The memorandum of understanding with the RBNZ was as expected – we continue to expect their deployment within a year.

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