14 May 2013

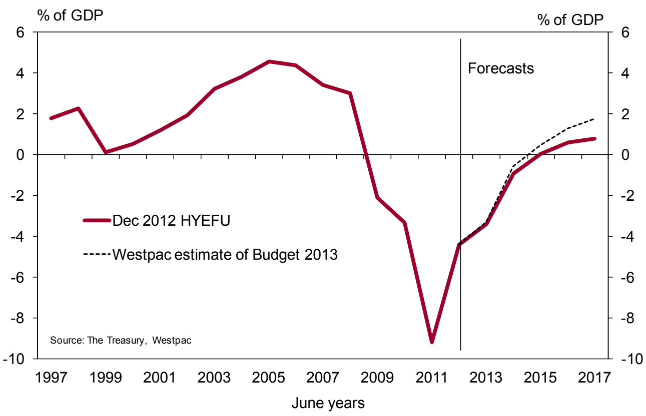
Westpac Institutional Bank

Bread and butter, no jam

Budget 2013 Preview (16 May 2:00pm)

- **Budget 2013 will be released this Thursday. A stronger starting point for the economy and improved tax take will mean a smaller than expected operating deficit of around $6.9bn this year.**
- **The Government looks to be on track to return to surplus by 2014/15, but with little wiggle room at this juncture. Consequently, the increase in new operational spending this year will be small and focused on key sectors such as health.**
- **Announcements around capital spending and asset sales are more likely to be headline-grabbers.**
- **We don't expect a substantive change in the bond issuance programme.**

Operating balance (excluding gains and losses)



The lead-up to the 2013 Budget has been unusually quiet. That in itself is not a bad thing – especially if you compare it to the previous two Budgets, where most of the pre-announcements were around cost control and squeezing more revenue from the existing tax regime. This time, though, the fiscal accounts have been tracking on the stronger side of forecasts, and the National Government's long-stated goal of returning to surplus by 2015 looks to be on track under current policies.

Even so, that doesn't leave a lot of wiggle room in either direction, hence the paucity of new initiatives announced before this week. New operational spending is likely to be in line with what was already allowed for in last year's Budget, and much of that increase will be claimed by health and education. Indeed, the main points of interest will probably fall outside the day-to-day affairs of the operating balance – look for further details on earthquake recovery costs, asset sales and investment in capital.

Operating balance (excluding gains and losses)

The accelerating economy is giving the Government some breathing room. Tax revenue was running about 1% ahead of forecasts in the nine months to March, due to both higher than expected incomes and stronger collection and enforcement by the IRD. We expect this to translate to a $6.9bn deficit for the current fiscal year to June, compared to the $7.3bn deficit projected in the Half-Year Economic and Fiscal Update (HYEFU) last December.

The Government has long maintained a goal of returning to an operating surplus by the 2014/15 fiscal year – and has clearly been prepared to do what it takes to meet that goal. By last year's HYEFU, that commitment left them just squeaking in with a projected surplus of $66m in 2014/15. With the accounts now on a stronger path, we expect this week's Budget to project a more substantial surplus of over $1bn.

Still, that amounts to just 0.5% of GDP, well within the margin of error for forecasts that far ahead.

Economic assumptions

Compared to the HYEFU, we expect the Treasury to raise its forecasts for real GDP growth, with recent momentum stronger than expected and the positive effects of the Canterbury rebuild more clearly kicking in. However, that should be at least partly offset by a softer inflation track – and it's nominal rather than real (inflation-adjusted) activity that matters for the tax revenue projections, so we expect a modest rather than a major improvement on balance.

Lower inflation will also help to reduce the rate of growth in spending, as there are many items that are formally or informally indexed to inflation. Low inflation (as well as global influences) also suggests that the Treasury may lower its interest rate forecasts, which would be a small positive for the operating balance via lower financing costs.

Spending details

The National Government's original plan was to allow for $800m per annum of new spending initiatives in each subsequent Budget. Those increases had to be canned in each of the past two years (the 'zero Budgets') as the fiscal accounts fell short of forecasts. This time, though, the planned spending increases can be achieved. Still, an $800m increase isn't a lot, representing just a 1.2% increase on 2011/12 spending levels.

Health and education are likely to claim the lion's share of this, as they have in previous years (even during the 'zero Budgets'). Of the few initiatives that have been pre-announced, the largest is an additional $158m over the next four years for tourism. There will undoubtedly be a wide range of announcements on the day (and the predilection for funding new initiatives through

Budget Economic and Fiscal Update - May 2013

	Actual	Treasury's HYEFU forecasts					Westpac estimates of main changes				
June years	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2013**	**2014**	**2015**	**2016**	**2017**
OBEGAL $bn	-9.2	-7.3	-2.0	0.1	1.4	2.0	-6.9	-1.2	1.2	3.2	4.6
Net debt (% of GDP)	24.3	27.8	29.2	29.5	29.5	29.3	27.7	28.6	28.5	27.5	26.2
Bond programme ($bn)	13.5	14.0	10.0	10.0	8.0	7.0	14.0	10.0	10.0	8.0	7.0
March years											
Real GDP (ann avg % chg)	1.6	2.3	2.9	2.5	2.4	2.4	↑ Real activity now on a stronger footing...				
CPI (ann % chg)	1.6	1.5	1.9	2.2	2.2	2.2	↓ ...but the high NZD is subduing inflation...				
90-day interest rates	2.7	2.7	3.1	4.1	4.6	4.8	↓ ...implying a slower rise in interest rates.				

savings elsewhere will probably continue), but the overriding theme will remain one of restraint.

Other major features

Indeed, it's likely that the biggest points of interest in Thursday's release will fall outside the scope of the operating balance. First up are asset sales: after completing the partial sale of Mighty River Power, the Government is expected to announce details on the timing of the next listing(s). And on the other side of the ledger, we await details on how the proceeds will be spent on social assets such as hospitals, schools and roads through the Future Investment Fund.

We're also looking for an elaboration of the Treasury's estimates of the costs of the Canterbury earthquakes, which were recently upgraded from $30bn to $40bn, with the Government's liability increasing by $2bn. Some of the increase will reflect better information, and some will reflect rising construction costs. But Prime Minister John Key has referred to greater private sector involvement in the recovery, which suggests that the cost estimates are increasingly venturing into the realm of improvement rather than just replacement. We're taking a conservative view on how many of these planned improvements will come to fruition, given the constraints that the construction sector will be facing for many years to come.

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