Westpac

Institutional Bank

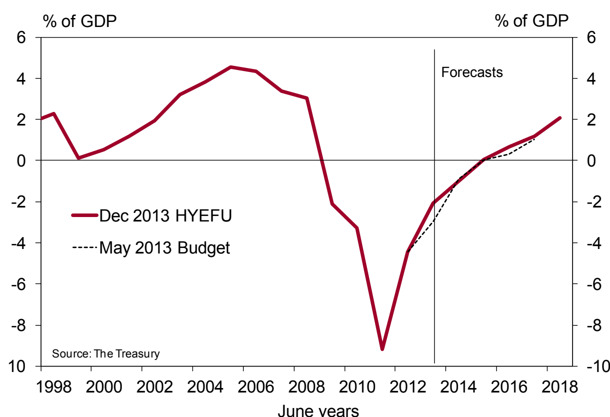
17 December 2013

Ship shape

Half-Year Fiscal and Economic Update 2013

- Today's Half Year Fiscal and Economic Update contained relatively few surprises.
- The Government remains firmly on track to meet its key targets regarding return to surplus and debt reduction according to Treasury's projections.
- The improved fiscal position has reduced the Government's need to borrow. The domestic bond programme has been reduced by $4bn and the Government also signalled its intention to repurchase up to $3bn of bonds in the second half of 2013/14.
- But despite the strengthening domestic economy, the government continues to take a cautious approach to spending. It remains to be seen whether this will persist in an election year.

Operating balance (excluding gains and losses)



Today's HYEFU confirmed the idea that the strengthening New Zealand economy has improved the Government's fiscal position and reduced its need to borrow. The improvement was much greater than the tiny increase in the forecast budget surplus for 2014/15 would suggest. But rather than making plans to spend this additional revenue, the Government has remained cautious, opting to rebuild buffers and reduce borrowing. All this comes as no surprise, but it remains to be seen whether such a conservative policy will be quite as strictly adhered in the lead up to next year's election.

Detail

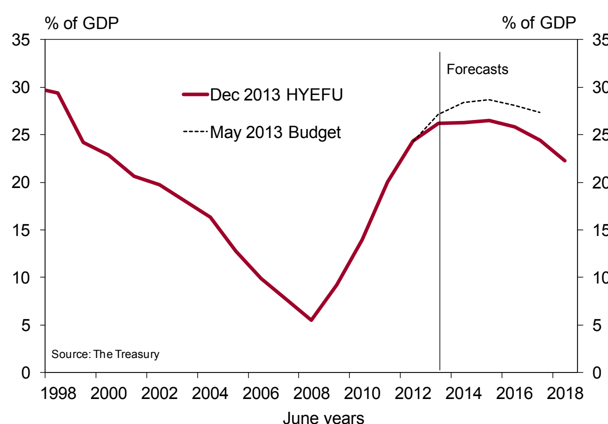
The 2013 HYEFU confirmed that the Government remains firmly on track to achieve its dual targets of a return to surplus and a 30% cap on net debt. With the economy gaining momentum and the tax take running ahead of forecast in the first 4 months of this fiscal year, neither line in the sand was seriously under threat. And unlike in previous updates no creative tinkering on either revenue or spending was required.

Treasury's growth forecasts have been revised higher. GDP growth is now expected to peak at 3.6% in March 2015 (previously 3%). Such an outlook accords very closely with our own view of the world. Our forecasts have GDP growth peaking at 3.7%, roughly along the same timeline.

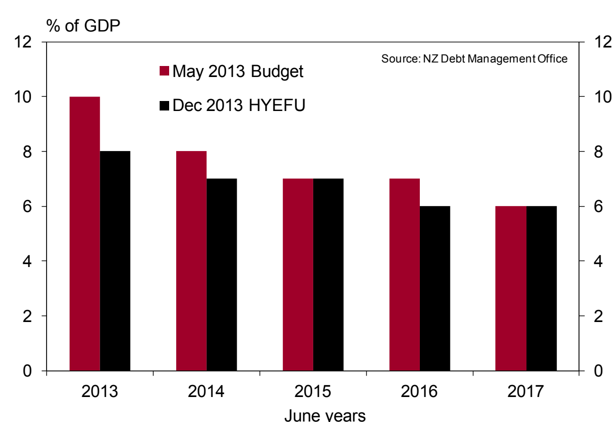
Unlike the Reserve Bank last week, while the Treasury acknowledged the strong terms of trade, it chose not to dwell on it, instead opting to feature the strong pickup in migration. There has been a significant upgrade to its migration forecast since the May Budget. Treasury now expects annual net migration to peak at around 26,000 in June 2014. But even this significant upgrade is more conservative than our own forecast. We expect net migration to hit 33,000 in December 2014. The Treasury expects strong migration to boost consumer spending – we think the boost could be even bigger than the Treasury expects.

The Treasury has also upgraded its inflation forecasts. Despite Governor Wheeler's increased focus on the 2% mid-point of

Core Crown net debt



Bond issuance



the target band, the Treasury is still forecasting inflation to remain consistently above 2% from Q1 2015 until the end of the forecast horizon in 2018. This may suggest that the Bank still has some work to do convincing its colleagues across the road that it is serious about 2%.

Stronger growth and higher inflation forecasts haven't translated to a bigger surplus in 2014/15 – the current forecast of the 2014/15 surplus is $86m, compared to the $75m forecast in the May Budget. The forecast improvement in the Government's cash position has been partly offset by forecast reductions in interest income from ACC and the Super Fund (basically a technical change), and forecast reductions in dividend income from state owned enterprises that have been partially sold faster than the May Budget had allowed for. Consequently, the rather modest improvement in surplus in 2014/15 belies the extent of improvement in the economy and the underlying fiscal position.

There has been substantial improvement in the forecast operating surplus beyond 2014/15. By 2017/18 the surplus is expected to reach $5.6bn.

With the improved outlook for economic activity and higher tax take, net core Crown debt is now expected to peak lower than in the May Budget at 26.5% of GDP. And the debt position is expected to improve more quickly, falling as a share of GDP to 22.3% by 2017/18.

Market implications

Perhaps the biggest surprise for markets in today's release was the extent of the decline in the Government bond programme. The asset sales and the improved tax take have reduced the Government's borrowing requirements by $4bn out to June 2017. The reduction in supply will be particularly acute over the first half of next year, with $2bn less issuance planned between now and June, no new tenders until February, and a $3bn partial buyback of the April 2015 bond.

Although some scaling back of the bond programme was seen as likely, there was also some speculation that the government would maintain a certain level of issuance in order to support liquidity in the domestic market. The sharper than expected reduction in supply has seen Government bond yields fall by 7-10 basis points; the spread versus the swap curve has widened by even more than this, with swap rates a few basis points higher in line with offshore movements.

Aside from the size of the reduction in the bond issuance programme, there was little new news in today's HYEFU and nothing to change our outlook for the macro economy or monetary policy. The government's determined march back to surplus territory means fiscal policy continues to be a headwind for growth. The Treasury's fiscal impulse measure is broadly neutral in the near term but shows that fiscal policy is expected to withdraw 0.7% of GDP from aggregate demand on average beyond this – marginally tighter again than in the May Budget, reflecting a larger than expected tax take but no increase in spending plans. However, the improvement in the economy has left the government well-placed should it choose to bring some treats out of the bag in election year.

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