16 May 2013

Save the lollies till next year

New Zealand Government Budget 2013

- **Another cautious budget delivered in better economic circumstances.**
- **The stronger economy has given the Government more wiggle room to increase spending or reduce revenue.**
- **The Government chose to reduce revenue by lowering ACC levies.**
- **We doubt the much-vaunted housing reforms will have much effect on house prices.**
- **No surprises in the memorandum of understanding regarding the Reserve Bank's macroprudential tools.**
- **Overall this budget will stimulate the economy slightly, and points in the direction of higher interest rates next year.**

The economy is improving and so are the Government's books. This improvement has generated a bit of loose change, allowing the government to either increase spending, reduce revenue, or generate larger surpluses. In the event, the Government chose to stick to its "small government" instincts and deliver lower ACC levies from 2014/15. This pretty much amounts to a tax cut. All the while the focus remains on a return to surplus in 2014/15, followed by reductions in Government debt.

Spoilt for choice

The 2013 Budget confirmed that Government revenues have been stronger than expected - this year's deficit is now forecast to come in at $6.3 billion, instead of the $7.3 billion deficit forecast six months ago. What's more, the strong economy means the books will be looking better than expected over the next few years.

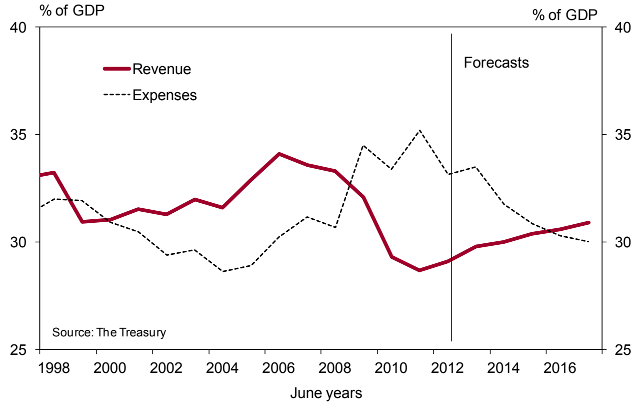
Revenue disappointments had forced the Government to make the last two budgets "zero budgets", with no net increase in spending. The economic improvement this year has allowed the Government to award itself an "operating allowance" of an extra $900m per annum.

The decisions the Government made on how to spend its extra revenue are summarised in the next section. The biggest item is a reduction in ACC levies, although we don't know the details yet. Reducing ACC levies amounts to a tax cut in disguise. Government will extract less revenue from the economy while still providing the same services.

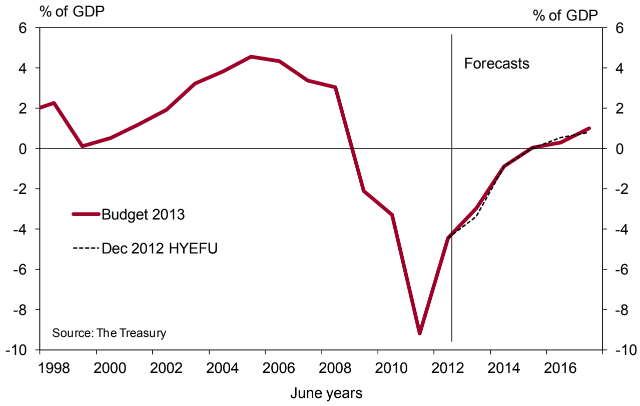
Still on track for surplus

Despite some minor shuffling of the spending deck, the Government remains on track to achieve a surplus in 2014/15. But the Government has deliberately sailed very close to the wind, forecasting a surplus of just $75 million that year. The Government could have allowed the projected surplus to widen. Its choice not to implies a certain degree of confidence that it will reach its surplus goal.

Core Crown revenue and expenses



Operating balance (excluding gains and losses)



Perusing the Treasury's economic forecasts leaves us feeling that this confidence is well placed. In our assessment, the Treasury's forecasts are conservative (see the economic forecasts comparison on page 4 for more details). If our more bullish forecasts are closer to the mark, the Government will experience another round of windfall revenues over the next year, leaving it in the happy position of being able to deliver more spending lollies or tax cuts in election year – while still delivering on that promised surplus.

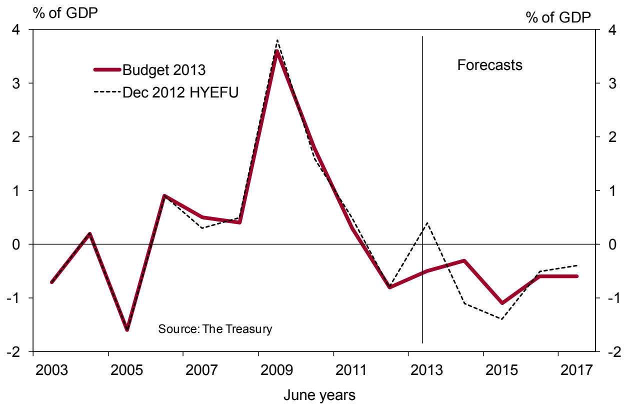
The Government's investment plans

The capital side of the Government's books are probably more interesting at present than the operating balance. Having raised $1.7 billion from the partial sale of Mighty River Power, the Government has made the first announcement of what it will do with the proceeds – the first instalment of the so-called Future Investment Fund. Unfortunately, much of the money is required for the rebuild of Canterbury and the ongoing rescue of KiwiRail, rather than being available for the type of productivity-enhancing investment in national infrastructure that we might have hoped for.

For every action

The decision to lower ACC levies rather than build up a larger surplus amounts to a slight stimulus to the economy. Or to be more accurate, Government will be constraining the economy to a lesser extent. We had anticipated the Government's austere ways would snip chunks off economic growth in 2014 and 2015. But as the chart below shows, the trimming effect is now less drastic in those two years. We can now expect slightly stronger economic growth during the years of the Canterbury rebuild – meaning the Reserve Bank will have to work harder to keep inflation in check. Today's budget points in the direction of higher interest rates over coming years.

Effect of fiscal policy on GDP



The magnitudes involved at this stage are tiny and of little practical consequence. But the chain of reasoning is a cautionary tale. Should the Government loosen the purse strings more ardently next year, the Reserve Bank could be forced to respond by aggressively lifting interest rates.

Will the budget affect house prices?

The budget included a range of initiatives related to housing. Many were laudable. Funding NGOs to provide subsidised housing seems cost-effective and reduces the administrative burden on Housing New Zealand. A Warrant of Fitness for rental properties overcomes a glaring market failure due to informational asymmetry, and should be applied more widely than to just Housing New Zealand houses. But none of the initiatives will have much effect on house prices over the next few years.

The most important announcement relating to housing was the Government's plans to reach accord with councils to create special zones in which consents for new housing can be issued in a streamlined fashion. If agreement cannot be reached, the central government will issue consents itself.

We haven't seen the details yet, but our impression is that streamlining consents will slightly reduce the total cost of building new houses within the special zones. That may eventually have an effect on the price of houses in general – but the effect will probably be small and it will take decades to be felt. The most likely short-term effect may be an increase in the value of land within the slated special zones.

New Zealand's chronically high land prices are a function of the tax system. The housing market is currently being stimulated by low interest rates. Until either the tax system or interest rates change, we expect house prices will just keep on rising (with the notable exception of Canterbury where rebuild dynamics matter).

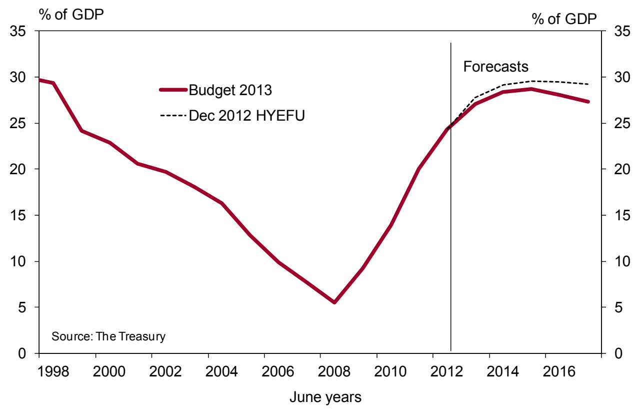
Memorandum of understanding with Reserve Bank

A memorandum of understanding (MOU) between the Minister of Finance and Governor of the Reserve Bank of New Zealand regarding the use of macro-prudential tools was released along with the budget. The MOU was broadly as expected, retaining all of the four tools previously canvassed by the Reserve Bank. The Reserve Bank must 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.

Bond programme

The improving Government accounts have allowed the Debt Management Office to scale back its borrowing programme 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. The three main ratings agencies all made positive noises about the budget, and affirmed New Zealand's credit rating.

Core Crown net debt



Policy announcements in a nutshell

This year's policy announcements fall into some broad categories, emanating from the overriding Budget themes of fiscal austerity and a preference for smaller government.

We agree that continued austerity is the right strategy to offset the impetus of the Canterbury rebuild. But we are not so convinced by the details of all policies. This Government wants to be seen as "doing something" without getting too involved. The end result is a little too much tinkering and not enough vision for our liking.

We put the major policy announcements into the following categories:

1. The **Canterbury rebuild** spending is a no brainer. There's an element of let's get on with it. Not too many arguments from us here.
2. The **tinkering in the housing sector** may help at the margin. In general, we are supportive of measures to increase the supply of land and to reduce building costs. However, while the tax system favours housing and interest rates remain low, house prices will continue on their upward trajectory.
3. The Government talks a good game around building a more competitive economy. To us, most of the **growth enhancing** measures look more like tinkering. We doubt their effectiveness.
4. The economy has improved and the Government has some **spare change.** It proposes to spend it on reducing ACC levies, which amounts to a tax cut.
5. **Health and Education** (along with New Zealand Superannuation) gobble up a large chunk of spending as a matter of course. Health in particular looms large, with an ageing population likely to lead to large increases in spending in future years under current policy settings. For now, this Government continues to feed the beast without addressing the long-term challenges. We are always hopeful of seeing progress towards a long-term fix next year.

Policy	Cost/Savings over 4 years to June 2017	Comment
SPENDING MEASURES	**$m**	
Health	$1,598	This increase is to meet cost pressures and population growth. The largest increases include $100m for disability support services, $70m for aged care and dementia services, and $48m for more elective operations.
Education	$901	A grab bag of initiatives on the second major area of discretionary operational spending. The main areas are $215 million for schooling, including nearly $80 million for operations grants; $173 million for early childhood education; and $92 million for Greater Christchurch Education Recovery and Renewal and 21st Century schools.
Housing and other initiatives	$524	Housing initiatives include $100m over three years for the Healthy Homes programme, targeted at low-income families – this programme is expected to insulate around 46,000 additional homes. $27m is earmarked for increased spending on income-related rent subsidies so as to extend them to community housing providers. $47m has been made available to extend reviewable tenancies from 2015/16. This programme assists Housing New Zealand tenants to move to alternative housing once their situations allow for this. Also, there was an additional $130m for tertiary education.
Internationally-focused growth package	$423	Close to $200m for tourism ($158m) and export education ($40m) marketing plus $200m new funding for science and innovation.
Emissions Trading Scheme Review	$417	This measure comes from last year's review of the Emissions Trading Scheme. Most of the costs relate to the exemption of agriculture from the scheme.
Social Development	$368	The bulk ($189m) of this is designated for the next phase of welfare reform, including new funding to help people into work.
Canterbury Earthquake Recovery	$211	More funding for this large bucket.
New Contingencies	$667	This is the Government's slush fund for spending as needs arise.
TOTAL NEW SPENDING	**$5,109**	
OTHER MAJOR INITIATIVES		
ACC levies	$3,000	The Government has signalled reduction in ACC levies from 2014/15. 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. Final decisions on levies for 2014/15 will be made this year, following public consultation.
SAVINGS		
TOTAL SAVINGS	**$1,509**	A mixture of cost savings, reprioritisation and carry forward of underspends as well as some small revenue gathering initiatives. Individually not a big deal, but they do add up.
CAPITAL SPENDING		
Christchurch hospitals	$426	Earmarked for the redevelopment of Christchurch and Burwood Hospitals.
KiwiRail Turnaround plan	$94	Additional capital for the fourth year of KiwiRail's turnaround plan.
Irrigation infrastructure	$80	This initiative announced earlier in the year is for regional irrigation projects with funding coming from the Future Investment Fund. A new Crown company will be established on 1 July to act as a bridging investor for irrigation projects to help kick-start these projects.
School Network Upgrade	$50	Additional funding for broadband in schools (the School Network Upgrade Project).
Contingencies and other initiatives	$850	Contingencies for key projects, including new, modern schools; Christchurch's justice and emergency services precinct; and Canterbury tertiary education institutes.
TOTAL NEW CAPITAL SPENDING	**$1,500**	

Economic Forecasts: The Treasury and Westpac

The Treasury expects the economy to grow modestly over the next four years. Growth is forecast to be 2.5% in March this year, to slow to 2.4% by March 2014, and peak at 3.0% in March 2015.

Compared to December's *HYEFU*, this profile has growth peaking later and higher, reflecting the combined effects of a higher than expected exchange rate and the recent drought – which in turn will cause the Reserve Bank to keep interest rates low for longer.

In other respects the Treasury's forecasts have not changed too much. In particular, while it has lifted its forecast for the total amount of quake-related construction from $30bn to $40bn, this is mainly expected to impact beyond 2017.

While we broadly agree with the Treasury's growth outlook for this year, beyond that we regard its economic forecasts are very much on the conservative side - our own growth forecasts for March 2014 and 2015 are 2.9% and 3.7% respectively.

This disagreement is not because of differences in view on the Canterbury rebuild – in fact the Treasury's forecasts for construction growth are rather more bullish than our own. Rather, the major difference appears to lie in private consumption.

We expect the accelerating housing market and associated increase in confidence to spill over into higher spending by households. The Treasury doesn't share this view.

The Treasury's forecasts for the housing market itself are slightly more cautious than ours – the Treasury expects 7% house price inflation in March 2014, compared to our 10%.

But more importantly, the Treasury's forecasts explicitly assume that saving rates will remain flat over the next few years, even as the housing market continues to warm up. We believe this assumption – that the proceeds from a credit-fuelled housing market upturn will all be squirrelled away rather than spent, against all historical precedent – will be sorely tested over the next few years.

That difference in view feeds through to the rest of the economic forecasts. Our stronger forecasts for the consumer spending imply faster economic growth, lower unemployment, and tighter monetary conditions – an earlier and steeper hiking cycle from the Reserve Bank, and greater pressure on the exchange rate as New Zealand outperforms its peers.

While the Treasury's forecasts haven't changed much since December, its assessment of the balance of fiscal risks has shifted somewhat. Back then the downside risks from global developments still dominated, particularly the European debt crisis. Now that these risks have receded somewhat the balance of risks has become more symmetrical in the Treasury's view.

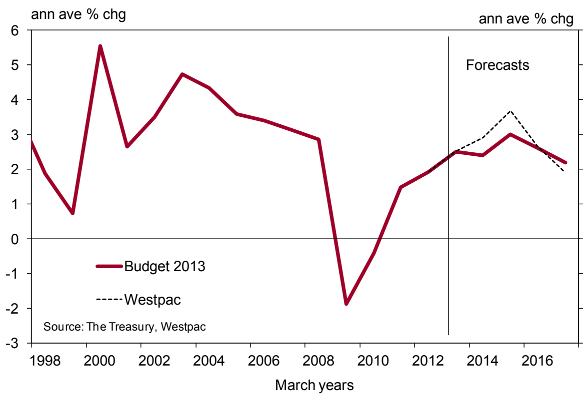
Interestingly, our own economic growth forecasts are remarkably close to the Treasury's 'upside scenario', in which the Treasury assumes both stronger house price inflation and a more 'normal' return to debt-funded consumption growth as house prices continue to rise (the scenario also assumes and a bigger boost to inflation from the Canterbury rebuild).

Economic forecasts: The Treasury and Westpac

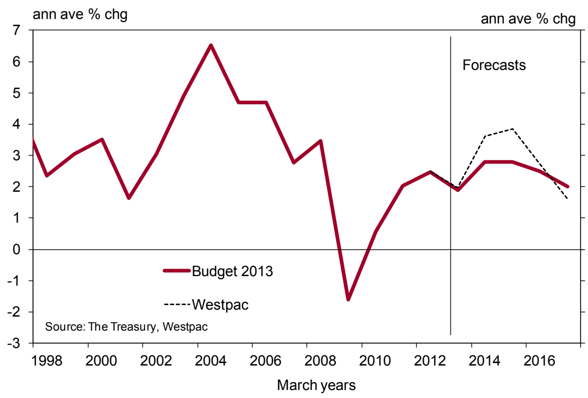
	Actual	Treasury					Westpac				
March years	2012	2013	2014	2015	2016	2017	2013	2014	2015	2016	2017
Real GDP growth*	**1.9**	**2.5**	**2.4**	**3.0**	**2.6**	**2.2**	**2.5**	**2.9**	**3.7**	**2.7**	**1.9**
Annual CPI inflation	**1.6**	**0.9**	**1.9**	**2.0**	**2.0**	**2.2**	**0.9**	**1.4**	**2.5**	**2.6**	**2.2**
Unemployment rate**	**6.7**	**6.9**	**6.0**	**5.9**	**5.5**	**5.2**	**6.2**	**5.7**	**4.8**	**4.7**	**5.0**
Nominal GDP growth*	3.8	2.7	6.4	4.6	4.3	3.9	2.1	5.2	5.4	5.1	5.1
90-day interest rate***	2.7	2.7	2.7	3.6	4.3	4.8	2.7	3.0	4.0	5.0	5.6
TWI exchange rate***	72.5	75.9	77.0	76.1	73.5	69.2	75.9	80.4	76.5	73.8	72.6

* Annual average % change, ** March quarter, seasonally adjusted, *** March quarter

GDP growth



Private consumption growth



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