19 May 2011

Westpac Institutional Bank

NZ Budget 2011

Wielding the axe

- **The 2011 Budget focused heavily on cost-cutting measures, to establish the path for a return to surpluses and make some key programmes more affordable over the longer term.**
- **The deficit will reach a record $16.7bn this year (8.4% of GDP), due to a revenue shortfall and some significant up-front costs. However, various cost-cutting initiatives will kick in significantly by 2013, bringing the Budget back into surplus by June 2015.**
- **A tighter fiscal stance over the next few years suggests a more moderate GDP growth and interest rate profile than we had assumed.**

Comment

Finance ministers have a long tradition of under-promising ahead of the Budget and over-delivering on the day, and this year was no exception. This time, though, the stated intention was a sharp clampdown on government spending, and Budget 2011 delivered more on this front than many, including us, would have anticipated.

Given that the Budget was tighter than we had assumed, we'll be making some downward revisions to our GDP growth forecast for 2012. The degree of fiscal drag will take the pressure of the Reserve Bank during the Christchurch reconstruction phase, allowing a slower pace of OCR hikes over the next couple of years.

The Government has had to contend with two major cost pressures – one immediate and one over the longer term. The immediate concern is that an already substantial operating deficit, the result of a prolonged recession, has been blown out further by the costs of rebuilding Christchurch after two devastating earthquakes. These costs will be heavily front-loaded, making an increase in borrowing inevitable. But the Government also saw a role for covering this expense through savings elsewhere.

The second issue is the long-term sustainability of the fiscal accounts. With the baby boomers now starting to hit retirement age, superannuation and healthcare will be an increasing draw on the government's finances. The Government needed a credible plan to get back into surplus, in order to deal with the looming cost of population ageing.

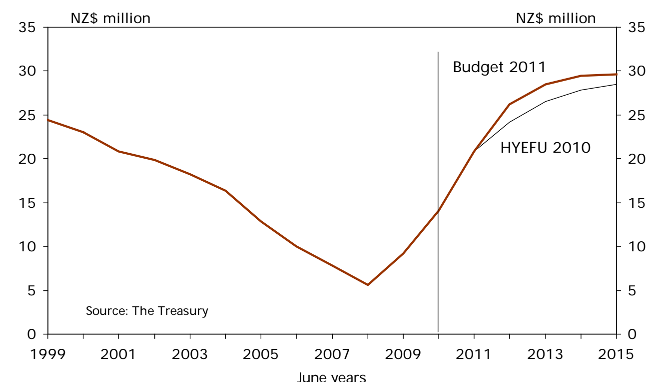
Spending control

The operating balance (excluding gains and losses) is expected to reach a record $16.7bn for the year to June 2011. Much of the increase in the deficit, relative to the December Half-Year Fiscal and Economic Update (HYEFU), is due to the costs of rebuilding Christchurch after a second major earthquake in February. The Government announced the creation of the Canterbury Earthquake Recovery Fund, which is to have a budget of $5.5bn.

But the Canterbury earthquakes simply exacerbated the need to bring operational spending under control. In the weeks before the Budget the Government had hinted that this would be a "zero Budget." In fact, Government expenditure is now forecast to drop by a total of $1.2bn over the next four years. New spending of $4bn will be more than offset by $5.2bn of cost savings elsewhere.

These changes are expected to generate the first meaningful operating surplus in 2014/15, a year earlier than in the HYEFU projections. This would see net government debt to GDP peak in the same year at 29.6% – not coincidentally, just below the 30% threshold that has been cited by some as a danger zone for our sovereign credit rating.

Core Crown net debt



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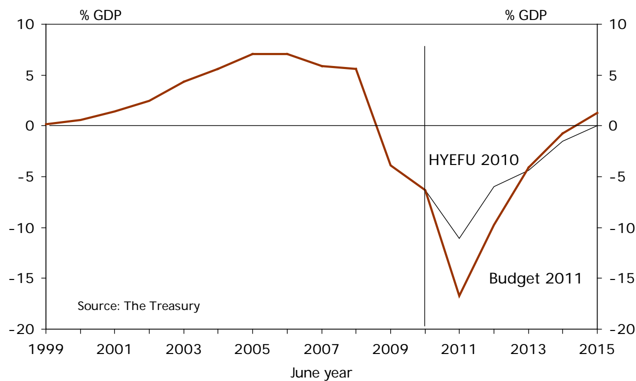
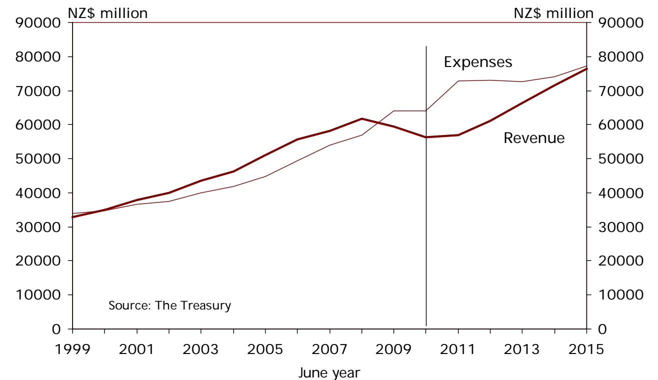
OBEGAL



Core Crown Revenue and Expenses



There are a few surprises for New Zealanders in terms of where the Government will be seeking those cost savings, although nothing that hadn't already been mooted:

State sector efficiency

The Government continued down the path of finding savings and reallocating resources in the public sector. There were two major initiatives in this Budget. First, state sector employers will now be required to meet contributions to KiwiSaver and other retirement savings schemes from their own budgets – effectively leaving them with the responsibility of where to find the cost savings. This is expected to save $650m over the next three years. A further $330m is expected to come from "efficiency savings" in core government agencies. Relative to the other initiatives, there is a lack of detail about how these savings will be achieved – and what effect it could have on the provision of services.

KiwiSaver

The changes to KiwiSaver (along with general public sector savings) contribute much of the heavy lifting in terms of finding expenditure savings in this year's Budget. By halving the value of member tax credit to a maximum of $521 per year (due to take effect in the year to June 2012) and removing the tax-except status of employer contributions to KiwiSaver (from April 2012) the Government estimates it will save $2.6bn over four years. In our view, these changes could see a reduction in the rate of enrolment, or a reduction in ongoing contributions to the scheme, particularly among high income earners. Meanwhile, the minimum contribution rate from employees and employers will rise from 2% to 3% in April 2013.

The Treasury estimates that these changes will increase the rate of national savings slightly, and we are inclined to agree. Bear in mind that only a small proportion of funds invested in KiwiSaver count as 'new' savings. The vast bulk are reshuffled from elsewhere, including 100% of the government contributions, which are borrowed. And it seems to us that higher-income earners are more likely to engage in reshuffling to take advantage of Government incentives than lower-income earners, for whom KiwiSaver might be more likely to actually induce new savings.

Working for Families

Families with at least one person in paid employment currently receive the maximum Working For Families (WFF) payments only if they earn less than $36,827. After this abatement threshold, WFF payments fall by 20 cents for each additional dollar earned. Today's Budget outlined a plan to reduce the abatement threshold gradually to $35,000, and increased the abatement rate to 25 cents in the dollar. There were also tweaks to payments for children 16 and over.

The Government has effectively accelerated the process it kicked off in last year's Budget with the removal of inflation indexation of the WFF abatement threshold. Over time, inflation will drag more households above the abatement threshold, thereby losing their eligibility for WFF support. Eventually, WFF will become relevant only for low-income earners. We were surprised by the choice to increasing the abatement rate. By increasing the effective marginal tax rate, this will dull work incentives and possibly reduce labour force participation.

Student loans

By promising to retain interest-free loans for students, the Government has effectively retained the most costly aspect of this policy. The changes to eligibility simply tinker around the edges. Nonetheless, Treasury estimates that by clamping down on student loans to over-55s and part-time students, suspending inflation adjustment of the repayment threshold (a move mirroring WFF changes) and introducing measures to claw back more money from borrowers now based overseas (reducing the repayment holiday from three years to one), it will save $277m in operational expenses and $170m in capital over four years.

Government assets and liabilities

The Government has confirmed that it intends to sell partial shares of four state-owned power companies and Air New Zealand – and as promised, it will campaign on this as an election issue. The proceeds from partial sales are estimated at $5-7bn, which will reduce debt and shrink the size of the balance sheet. The government has also extended its plans for infrastructure spending, with an extra $1.6bn to be spent on broadband, rail and schools.

Table 1: Economic Outlook – March years

	Actual	Budget					Treasury's HYEFU forecasts				
	2010	2011	2012	2013	2014	2015	2011	2012	2013	2014	2015
Real GDP (ann ave % chg)	-0.7	1.0	1.8	4.0	3.0	2.7	2.2	3.4	2.9	2.7	2.7
Nominal GDP (ann ave % chg)	1.1	5.3	4.7	6.4	5.4	4.9	6.4	5.7	5.5	5.2	4.7
Unemployment rate (%)	6.0	6.8	5.7	4.8	4.8	4.6	6.1	5.2	4.9	4.6	4.5
CPI inflation (ann % chg)	2.0	4.5	3.1	2.4	2.5	2.6	4.5	2.9	2.6	2.2	2.0
TWI*	65.3	67.2	66.7	64.5	60.3	56.0	68.7	63.1	59.1	55.6	53.0
90-day bank bill rate (%)*	2.7	3.0	3.0	3.9	4.7	5.0	3.3	4.5	5.0	5.0	5.0

* Average for March quarter

Table 2: Fiscal Outlook – June years

	Actual	Budget					Treasury's HYEFU forecasts				
	2010	2011	2012	2013	2014	2015	2011	2012	2013	2014	2015
OBEGAL ($bn)	-6.3	-16.7	-9.7	-4.1	-0.7	1.3	-11.1	-6.0	-4.4	-1.5	0.0
(%GDP)	-3.3	-8.4	-4.7	-1.8	-0.3	0.5	-5.5	-2.8	-1.9	-0.6	0.0
Gross Debt (%GDP)	28.3	35.8	37.2	35.5	37.9	35.0	33.3	34	33.3	35.7	34
Net Crown Debt (%GDP)	14.1	20.8	26.2	28.5	29.5	29.6	20.8	24.2	26.5	27.8	28.5
Bond Programme ($bn)	12.5	20.0	13.5	12.0	10.0	8.0	13.5	13.5	13	9.5	10
Fiscal impulse (core crown, %GDP)	2.0	1.3	0.0	-2.1	-1.9	-0.9	1.5	-1.5	-1.1	-0.9	-0.7

Treasury's economic forecasts

As expected, the Treasury's forecasts are heavily shaped by the February earthquake, with GDP growth slowing to 1% in the year to March 2011 but accelerating to 4% by March 2013 as reconstruction ramps up. We think this is a realistic forecast, even in light of government cutbacks. The Treasury estimates that fiscal policy will be neither boosting nor constraining the economy in the year to June 2012, but will become a significant drag on GDP over 2013 and 2014 – up to 2% of GDP.

If anything, the Treasury's economic assumptions seem fairly conservative – for the boost from Canterbury reconstruction (with residential building not ramping up until calendar 2012, and ebbing by 2014), for export growth (peaking at 3% in March year 2012, despite rising terms of trade), and for inflation (bobbing around 2.5% after calendar 2011). Should growth and inflation prove stronger than the Treasury expect, stronger revenues could lead to an earlier return to surplus than signalled.

Bond programme

The Debt Management Office (DMO) had already announced an increase in the bond tender programme to $20bn for this year, partly reflecting the larger operating deficit this year and partly due to pre-funding of future deficits. A combination of pre-funding and cost savings in later years meant that the bond programme for the next few years was largely unchanged from the HYEFU. However, there was a substantial decrease in expected bond issuance for 2014/15, down from $10.5bn to $8.0bn. The DMO confirmed that it will introduce a new inflation-indexed bond in the next year, with a maturity of September 2025.

Market implications

While the intentions of the Budget had been well signalled, the pace of improvement in the government's finance was probably more aggressive than the market had been expecting. In particular, keeping net debt below the threshold of 30% of GDP will be seen by debt markets as a positive. Ten-year Government bond yields fell 6bps after the release of the Budget.

The credit rating agencies have been thankfully quick to give their judgements. In particular, Standard & Poor's – the only agency that has our sovereign rating on a negative outlook – expressed comfort with the Budget itself, though it reiterated that retaining our AA rating will require an improvement in external debt levels for the nation as a whole. The NZ dollar initially rose 40pts on the S&P comment, but has since given back about half of its gains.

The change to the expected fiscal stance has mixed implications for the RBNZ. We don't think it will be dissuaded from resuming rate hikes as the reconstruction begins in 2012. However, the looming fiscal drag on the economy in 2013 and beyond could slow the intended pace of hikes. We will be reviewing our OCR forecasts carefully, given that a key point of difference in our forecasts is for a longer and larger tightening cycle than the RBNZ is currently projecting.

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