

Budget 2009: Reining it in

Budget 2009 Preview (28 May 2.00pm NZT)

- **The Government's 2009 Budget will be released on Thursday, May 28.**
- **This will be one of the most important Budgets for the NZ economy in years. Faced with a dramatic decline in revenues and a huge expense burden, Budget 2009 will be more about good management than providing additional relief to households and businesses. Expect tax cuts and super contributions to be delayed, and future operating spending allowances to be reduced.**
- **An operating deficit (excluding gains and losses) of around \$1.5bn is expected for 2009, before blowing out to over \$8bn in 2010 as economic conditions deteriorate. On our estimates, operating deficits begin to narrow in 2011 as the benefits of expected policy changes begin to bite, but we do not foresee a return to surplus over the forecast period.**
- **Bond issuance is set to rise substantially from the current fiscal year, but overall will not be as large as predicted back in December. Our estimates suggest a bond programme of \$10bn will be required in 2010 (compared with a forecast of \$7.7bn at the December update), reaching a peak of \$12bn in 2011 (from \$15bn), before easing back to just under \$10bn in 2013 (from \$15.8bn).**
- **We expect fiscal policy to remain in expansionary territory over the next two years, but importantly the stimulus is now likely to be less than we and the RBNZ previously anticipated. Therefore, this Budget will likely leave the RBNZ with more work to do.**

On Thursday, 28 May, Finance Minister Bill English will release the National Government's first Budget since they were elected in November last year. For a new Government, the first Budget is always important as it provides the platform for delivering election promises and changes in policy direction for future years. But this year, more than ever, the Budget stakes are high. Mr English will need to convincingly demonstrate how the Government will rein in spending so as to avoid a credit rating downgrade and ensure future generations are not saddled with debt.

Figure 1: OBEGAL

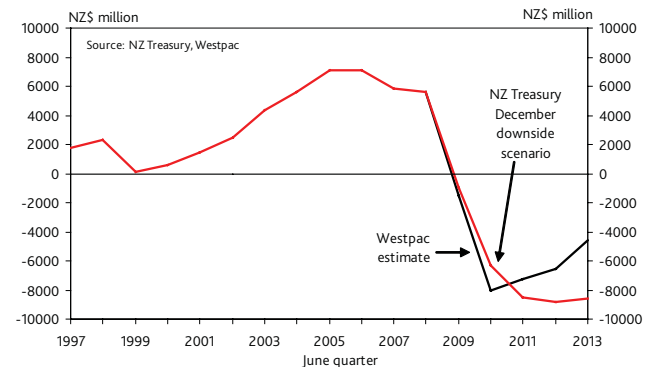
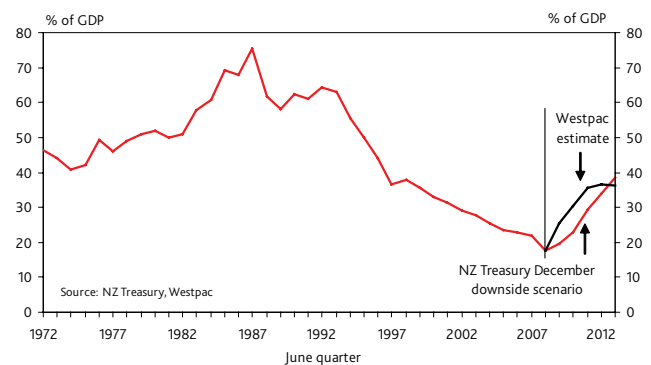


Figure 2: Gross sovereign-issued debt



Achieving this will be no mean feat. Government revenues are falling dramatically as the global downturn hits the domestic economy hard. Meanwhile, the legacy of the previous Government's big spending ways is that expense growth is well entrenched and rising. Moreover, it will take time and more than a little fiscal discipline to turn that spending tide around. Indeed, Mr English put the dilemma the Government faces into perspective in one of his recent speeches:

"Core Crown expenditure in the current year to June 30 is expected to be \$63.5 billion – up \$21.6 billion or 51% in the past five years. By contrast, the economy is estimated to have grown by just 23% in that time – and tax revenue by just 24%. Let me say that

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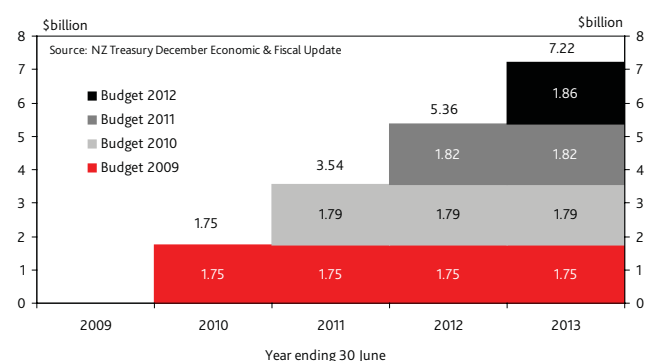
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another way: Crown spending has jumped by more than double the rate of both economic growth and tax revenue in the past five years.”

In fact, if previously budgeted increases in new spending were retained in this Budget, it is expected that core crown operating expenses would increase by \$20bn over 2008-2013 (or 33%), that operating deficits would reach \$10bn per year indefinitely and that Crown gross debt would hit 45% of GDP by 2013 (from 17.5% in 2008) and 70% by 2023. For a small economy that is already highly dependent on foreign funding, that is an untenable situation and means some tough decisions need to be made.

Both the Prime Minister and Mr English have already indicated what some of those tough decisions will be. For example, the tax cuts earmarked for 2010 and 2011 and the annual contributions to the Super Fund over the next few years will more than likely be postponed. The Government is also going through a rigorous process of assessing and reprioritising all spending decisions, and recent commentary suggests that some significant savings have and will continue to be made. But, as we see it, the most effective way the Government can begin to get on top of expenses is by reducing the spending allowances for future Budgets, currently set at \$1.75bn per year for the 2009 Budget, increasing by 2% per year in each of the next three Budgets. Cumulatively, that totals \$17.87bn in new spending over the next four years (see Figure 3). We expect the Government to halve those spending allowances, with the bulk of the remaining allowance being committed to health and education initiatives. That, in conjunction with the other savings related initiatives discussed above, should be enough to keep spending and thus future deficits in check. It would also send a clear message to the public and importantly the ratings agencies that this Government means business.

Figure 3: Forecast new operating initiatives - Dec 2008



Ugly economic backdrop

It should come as no surprise that the economic backdrop underpinning the fiscal outlook has deteriorated further since the December economic and fiscal update, and is downright ugly relative to the last full set of forecasts released in the Pre-Election update (PREFU) on October 6 last year. Indeed, the growth outlook is now even worse than the supposed downside scenario presented in December. In that scenario, trading

partner growth of 0.4% and 1.6% was forecast for the 2009 and 2010 calendar years. The most recent predictions from Consensus Economics put trading partner growth at a shocking -2.3% for 2009 and +2.0% for 2010.

On that basis, we expect the Budget to reveal a much deeper and more prolonged downturn in real GDP than anticipated in the downside scenario in December. With below trend growth forecast over the next three years, the Treasury will likely project above-trend growth of around 4.5% in both 2012 and 2013. The peak in the unemployment rate is also expected to be higher than in the December downside scenario, at closer to 8.0%, rather than 7.5%.

More substantial downward revisions will come via the Treasury’s nominal GDP growth forecasts. Falling commodity prices and weaker demand pressure will again see the Treasury lower their inflation and terms of trade forecasts relative to the downside scenario in December, resulting in much weaker growth in the nominal economy. Mr English has highlighted that they expect a decline in nominal GDP of around \$50bn over the three years to 2012, relative to what was anticipated in the PREFU.

That is a huge hit in anyone’s language and will knock a substantial chunk off tax revenues (over \$20bn by our estimates) over the same period. Above trend real GDP growth from 2012 will see the forecasts of the nominal economy rebound sharply which will help boost tax revenues in 2012 and 2013.

In terms of expenses, even assuming the government cuts the future operating spending allowance by half, the bulk of the gains will not be felt until later in the forecast period. That is because the previous Government’s spending decisions will take time to work through. Therefore, we continue to anticipate a blow-out in the operating balance in the near term. We expect the operating balance excluding gains and losses (the OBEGAL) to show a deficit of around \$1.5bn in the year ended June 2009, lifting to a peak of \$8.0bn in June 2010. Thereafter, the deficit should begin to narrow, to be around \$4.5bn by 2013.

Cash deficits see debt burden increase

The operating deficits will flow through to sizeable cash deficits, particularly as the Government remains committed to its capital spending programme and the \$5.8bn capital allowance set at the time of the December update. Delaying the contributions to the Super Fund will help provide some offset but, overall, the cash deficits will be more substantial than the operating deficits. That said, a tighter rein on future spending will result in smaller cash deficits in the out-years relative to those forecast in December.

On our estimates, tighter spending controls combined with the various saving initiatives should be enough to ensure that gross debt remains well below the 45% of GDP estimate under a ‘business as usual’ scenario. Even so, our forecasts suggest gross debt will still reach around \$76bn or 36% of GDP by 2013.

Budget Economic and Fiscal Update – May 2009

	Actual	Westpac Budget Estimates					Treasury's December update (downside scenario)				
	2008	2009	2010	2011	2012	2013	2009	2010	2011	2012	2013
Real GDP - ann ave % chg	3.2	-1.0	-3.5	2.0	5.0	4.5	-0.2	-0.3	2.3	4.5	4.2
CPI - ann % chg	3.4	3.0	1.1	1.1	1.6	2.5	3.1	3.1	1.0	1.2	1.5
Unemployment - %	3.7	5.0	8.0	7.2	6.8	6.0	5.0	7.2	7.1	5.9	4.8
OBEGAL \$bn	5.6	-1.5	-8.1	-7.5	-6.6	-4.5	-1.0	-6.3	-8.5	-8.8	-8.6
GSID - % GDP	17.5	25.6	30.3	35.8	36.6	36.3	19.5	22.7	29.4	34.0	38.6
Bond programme \$bn	1.8	5.5	10.0	11.4	12.0	9.6	4.5	7.7	11.2	15.0	15.9

Bond programme

The NZ Debt Management Office (NZDMO) has already announced a \$1.0bn increase in the bond programme for the current fiscal year and the introduction of a new longer term bond, as a result of the funding shortfall caused by the sharp decline in tax revenue relative to forecast. As such, we do not anticipate any further changes to this year's programme in the Budget.

However, our prediction of a larger cash deficit in 2010 and 2011, relative to the December update, will see bigger bond programmes in those years of around \$10bn (from \$7.7bn) and \$11.4bn (from \$11.2bn), respectively. Thereafter, we expect annual bond issuance to be lower than forecast in December, as a result of a narrowing in the cash deficits.

The sale of financial assets will also assist the Government in meeting the cash shortfall over the next four years. The Pre-Election and the December updates projected a substantial rundown in financial assets held by the NZ Debt Management Office (NZDMO) over the next five years (financial assets held by the NZDMO were forecast to fall from \$17bn in 2008 to \$5.8bn in 2013). We expect that will continue to be the case in the Budget.

Risks

With so many variables impacting on the government accounts, the risks to our forecasts are many. However, we see the key risks as being around the policy-related decisions, in particular the assumptions we have made around the reduction in the future operating spend allowance and the deferment of the super contributions. If, for example, the spending allowance is not reduced by as much as expected and the super contributions are merely reduced rather than postponed, then the impact would be much deeper operating deficits, a higher debt to GDP ratio, and a higher funding requirement than we have forecast.

Market implications

The immediate focus for markets will be on how 'responsible' the Budget really is, as well as the size of the borrowing requirement going forward. Importantly, the key question market participants will be asking is, will the Government have demonstrated a strong enough commitment to reining in expenses and containing the rise in government debt so as to avoid a credit rating downgrade?¹ We believe a Budget delivered on our expectations above, would greatly reduce the

risk of a downgrade. However, if the market deems the Budget to be lacking in that commitment, thus raising the probability of a downgrade, then government bond yields and swap rates will move higher.

Our focus will be more on the details provided around the delays to the tax cuts, and any suggestion of when/if they will be re-introduced, the timing and scope of the capital spending programme, and any changes to projections of the fiscal stimulus. While we expect the Government to continue to provide significant support to the economy over the next couple years, their commitment to fiscal discipline will likely see a smaller stimulus than estimated back in December (around 5% of GDP over 2009 and 2010). That is particularly important for the RBNZ. Reduced stimulus from the Government means the OCR will have to remain lower for longer.

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¹ New Zealand has held a AA+ foreign-currency credit rating by Standard & Poor's since 1996. Our current rating of AA+ (negative outlook) has been in place since January 12.