AXA GLOBAL INVESTORS

research notes

Budget 2009 – An exercise in principle setting…

18 May 2009

The 2009 Budget is going to be one of the most challenging in a number of years. The numbers are going to look truly awful. The deterioration in the economy will feed through to lower operating balances and a rising borrowing requirement.

Of more interest to us than just the hard numbers will be the underlying messages the new Government will send around expenditure, revenue and, most importantly, public debt.

Balancing Act

A first Budget from a new government is always fascinating. It will set the fiscal tone for the whole term. This first Budget for this Government has been made all the more challenging by the economic environment in which it is being delivered.

First and foremost the 2009 Budget is a balancing act. It needs to balance the need to support aggregate demand during the recession, maintain the revenue base to ensure a pathway back to fiscal sustainability and manage debt levels.

This has been made somewhat easier given that our public finances start from a relatively healthy position, but the challenges are still immense.

Expenditure

Expenditure (including government investment) needs to be future focused, investment oriented and productivity enhancing. At the same time the Government needs to maintain a socially acceptable level of support for those in need. In our view, these are the primary criteria against which expenditure should be judged.

The new Government has already announced new spending as part of its fiscal stimulus package. In general, these initiatives fit these criteria.

One interesting aspect of this Budget will be the new Government's opportunity to cancel commitments made by the previous Government. These commitments were made in far healthier economic and fiscal times. The Minister of Finance has already flagged a number of areas where initiatives may be cancelled, most notably around tertiary education.

The Government has come in for some criticism that, at a time when it should be supporting jobs, it is driving through with public sector reform that has seen around 1000 jobs lost. The two are not inconsistent. The quality of expenditure is paramount, rather than spending for the sake of spending.

Revenue

Tax rates have reduced recently. The Company tax rate was lowered to 30% in 2008, and we have seen two tranches of personal income tax reductions, one under the previous Labour-led Government and one under the new National-led Government. It has been well flagged that the next two tranches of tax cuts scheduled for 2010 and 2011 will be postponed in the Budget.

As a general principle, we believe that over and above meeting the expenditure and investment goals outlined above, Government should return unspent tax revenue to the people who earned it in the first place. In short, lower tax is better than higher tax.

However, having already played some part in supporting aggregate demand, we believe it is right for the

Government to postpone the next tax cuts. From here we believe the Government needs to protect the tax base to support a return to fiscal surplus. We expect tax cuts to return to the agenda as the fiscal situation allows.

The Operating Balance

The combination of revenue and operational expenditure results in the operating balance – or the difference between too very large numbers. Our post-budget analysis will be focussing on the OBEGAL (Operating Balance Excluding Gains and Losses) in order to gain a true picture of the public finances.

The deteriorating OBEGAL position has been predicted in recent fiscal forecasts – most recently in the Treasury's Briefing to the Incoming Government. But given the deterioration in the global and New Zealand economy since then, operating balances could be expected to be larger, assuming no policy changes.

In particular, we will be looking for what will be an important part of returning the public finances to sustainability – moving OBEGAL back to a surplus position. The Australian Government managed this well in their recent Budget with fiscal surpluses forecast to re-emerge from 2015/16, albeit from a better starting point than New Zealand.

Debt

After many years of public debt falling as a percentage of GDP, it is again on the rise. Two words come to mind with regard to debt: "prudence" and "trajectory".

Prudence is less of a concern than it might have been in this Budget given the relatively good starting point following 15-years of fiscal consolidation. We have got room to move.

We believe trajectory, or the forward forecast track, is the more important issue for this Budget. It is important that the Government articulates, and even better demonstrates, a commitment to get the operating balance back to surplus and the debt track declining again as a proportion of GDP. Furthermore, it is important that the economic assumptions underlying the forecast track are credible. This will be a key focus for the sovereign rating agencies.

Obviously cancelling the next two rounds of tax cuts will help contain debt levels, but we believe this in itself won't be enough. We have suggested in the past that it may be necessary to suspend contributions to the New Zealand Superannuation fund. We don't have a problem with the Government doing this. Note, however that this is a debt management recommendation rather than an investment recommendation. It is a good time to be investing given equity market valuations.

Conclusions and Implications

- This will be a challenging time to be presenting a Budget, let alone a first Budget.
- Expenditure must be judged, as it always should be, by the extent to which it is future focused, investment oriented and productivity enhancing.
- Tax cuts have already played a part in supporting the growth. The focus now must be on maintaining the revenue base to support a return to fiscal sustainability.
- Debt levels will rise over the next few years, but the trajectory must start to point down at the end of the forecast period.

We do not expect the Budget to have any significant impact on our outlook for the New Zealand economy. Our view remains that the NZ economy will remain in recession over calendar 2009, although we expect the rate of decline to diminish as the year progresses. We see a return to very modest growth in 2010.

However we do expect the Budget to confirm a rising public sector borrowing requirement over the next few years. Rising supply, especially in an environment of heightened risk aversion has already influenced our decision to move underweight domestic bonds in our multi-sector portfolios.

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