RESEARCH

ECONOMY WATCH

14 December 2017

HYEFU Holds the Fort for the Budget Bun Fight

- **HYEFU hangs together remarkably well**
- **With a largely unaltered bond programme**
- **As Treasury net-increases nominal GDP forecast**
- **NZGB bond rates fall in relief, NZD steady**
- **But BPS flags pressures for Budget 2018**
- **Where spending promises more fully accounted**

The broad numbers in today's Half-Year Economic and Fiscal Update (HYEFU) were always likely to be there or thereabouts. And so they were. While the government's operating surplus track has been lowered, and the debt track increased, each is not significantly different to what the pre-election update projected (and the bond programme was largely unaltered). So we see little point in haggling over the key numbers all that much, at this stage.

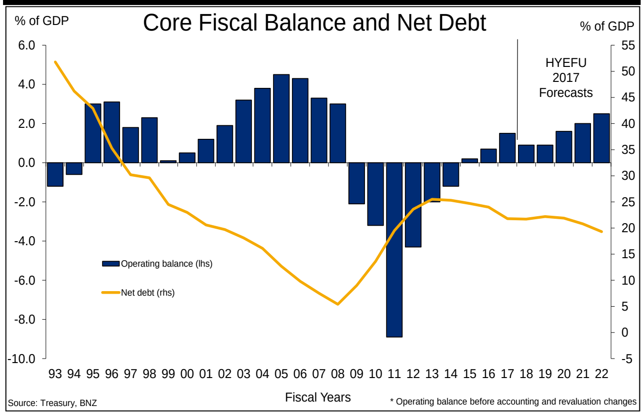
Any fuss about the HYEFU might particularly nonplus international observers, as they go about putting New Zealand's fiscal accounts in global perspective. They still look very good, relatively speaking.

Having said this, there are some issues worth teasing out, which we would categorise as big-picture and small-picture. The big picture is about the new government's approach to debt in the context of risks, including to the economic forecasts. Our small-picture interest is about what policies, exactly, are included in this HYEFU, what has been deferred to next year's Budget, and how all of this might be relevant to the shape of the economy over the nearer term.

Starting with the big picture, today's "opening of the books" has Treasury forecasting net Crown debt declining to 19.3% of nominal GDP by 2022. This conforms to the promises made by Finance Minister, Grant Robertson. Sure, this is about as far as it goes (down), whereas the previous government signalled an intention to get net debt down even further, to between 10 to 15% of GDP by 2025. But after accounting for the extra money the new government is going to put into the NZ Superannuation Fund the net difference would be even less significant.

In any case, the real accountability is about the quality and value of the spending the government intends to carry out – whether capital or current - rather than thinking a specific debt ratio is somehow ideal, or not. This invites a genuine debate about policy, not of accounting.

Under Control

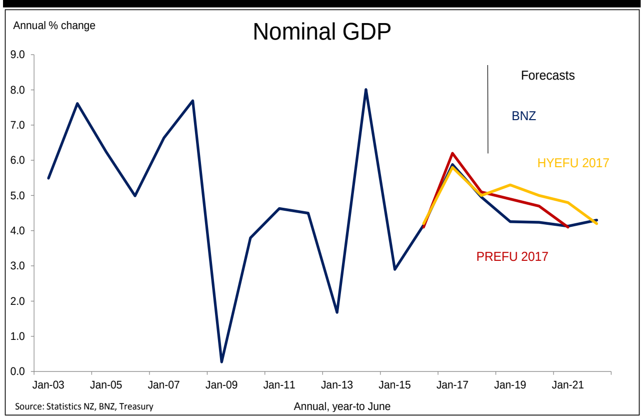


Having said this, there is the general issue of how well the government accounts will handle the next shock that will (inevitably) come along – whether human-made or not.

We mention this with Treasury's baseline economic forecasts again fluttering on the strong side of a fan chart. While it toned down its expectations for real GDP growth over the near term – based on the (recently dry) weather, soft housing and subdued consumer expenditure growth – this is more than made up for over the medium term.

This, along with more near-term CPI inflation, and a sustained pickup in wage inflation (aided by the minimum wage going up to $20.00 by 2021, compared to $17.60 under the PREFU) means Treasury's nominal GDP forecasts end up a bit higher at the end of the forecast horizon than the PREFU had. This sustains core tax revenue.

Still Pushing It



While Treasury's forecasts are achievable, we'd (still) say the risks are tilted to disappointment rather than pleasant surprise. Then again, this is principally with real GDP in mind. It might turn out that inflation – in prices and wages – could surprise on the high side, in which case we'd presume more response from the Reserve Bank (while noting that higher interest rates also tend to boost government revenue, by way of the tax on interest income earned).

Sure, the global economy is doing well, and could be a source of upside surprise – as Treasury Secretary Gabriel Makhlouf mentioned in his address to those attending the HYEFU lock-up. However it's difficult to translate this, one for one, into greater real growth in the NZ economy, given the resource pressures it is already experiencing. Again, the true upside might spill over into inflation.

In thinking about negative shocks, though, the government's clear commitment to a 20% net debt target might end up being the metric that exerts the most discipline. While it is keen to dispel the impression that it will be a classic centre-left tax-and-spend government, elements of borrow-and-spend could well be put to the test over time.

Talking of ratios to GDP, it's worth noting, as a technical matter, that today's HYEFU has adopted the recent (upward) revisions to NZ annual nominal GDP for working out the various fiscal ratios (but the Treasury's macro-economic forecasts have not adopted these, as yet). This is why ratios of government revenue, expenses and debt have been pruned over the last few years – in the order of 0.5 percentage points. This starting point fillip then helps the fiscal forecasts achieve their "aims", such as getting net debt down to 20% of GDP and running Crown expenses around 30%.

The Treasury's macro-economic forecasts will formally adopt the revisions to historical GDP after the Q3 national accounts are published, 21 December.

Turning to the small-picture issues, we remain interested in what government policies have been accounted for, which have not, which of the previous government's policies and spending lines might eventually be pruned and, which policies are yet to be specifically accounted for.

The latter is especially relevant to next year's Budget. This will front up to the election spending promises (including those of coalition partners) that have not been accounted for to date. While today's HYEFU did well to squeeze in Labour's 100-day plan, given the tight timeframe involved post government formation, this is obviously not everything that has been promised.

As a reminder of Labour's 100-day plan, the following are most fiscally relevant:

- Free first-year post-secondary education and training
- Raising student allowance $50 per week starting 1 January
- Healthy Homes programme (legislation passed 30 November)
- Ban overseas buyers of NZ homes *
- Stop Housing NZ selling state houses
- Affordable Housing Authority/Kiwibuild
- Families package, Winter Fuel rebate, Best Start and increases to Paid Parental Leave*
- Resume contributions to NZSF by Xmas (approved by Cabinet)
- Child poverty reduction targets (to be embedded in the Public Finance Act)
- Raise minimum wage, starting 1 April 2018 to 16.50 (from $15.75)
- Improve Workplace Fairness *
- Establish Tax Working Group
- Zero carbon emissions over time

(*) denotes legislation required

The capital items that have been accounted for are confined to the Kiwibuild scheme (of 100,000 affordable homes over the coming 10 years) and earlier resumption of payments to the NZ Superannuation Fund that the last Budget committed to.

To be fair, Robertson announced today that, in the forecasts, allowances for coming Budgets have been boosted. For the 2018 Budget this has gone up to $2.6b (as a running annual) from the $1.7b that was signalled in the Budget earlier this year. The allowance for Budget 2019 has been lifted to $1.875b, from $1.7b while for 2020 has been kept at $1.875b, compared to the $1.8b line that Budget 2017 signalled. While these might sound like big numbers to the average person they are not to anyone with experience of fiscal matters, especially amid demographic pressure.

So the big question is whether funds for the remaining government policy that needs to be allocated, in specifics, can fit within these new allowance bands. As much as today's HYEFU held its shape remarkably well, the real test will be the next Budget.

Indeed, Grant Robertson alluded to this in today's Budget Policy Statement (BPS), stating "As part of Budget 2018, and beyond, the Government will realign existing spending to better reflect our priorities and to help address New Zealand's social and infrastructure deficits.

We also expect to manage a number of cost pressures across the public service in Budget 2018 arising primarily from the underfunding of core public services in recent years. We are still uncovering the scale of these pressures. Our commitment as a government includes extra resources for health, education, increasing police numbers and a significant funding increase for conservation."

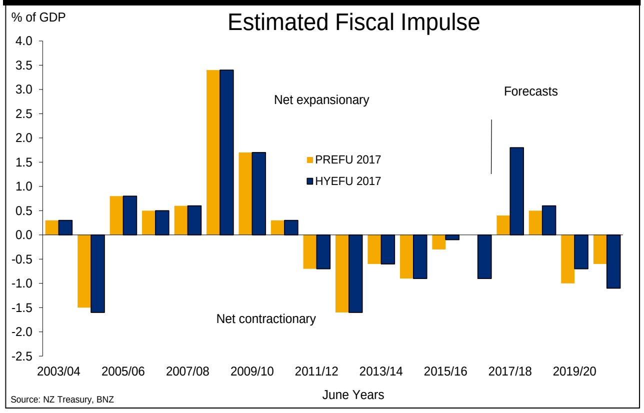
The BPS also mentioned, by the way, that "The Government is also mindful of ensuring fiscal policy does not place undue pressure on monetary policy. Running a larger surplus when the economy is strong would help to reduce upward pressure on the exchange rate and interest rates, thereby supporting exporters and households."

This is obviously relevant to RBNZ policy and a reminder of how the Budget earlier this year and the key policies of the new Labour-led government have been important in nudging the central bank toward a tightening bias.

But as for using Treasury's fiscal impulse indicator to gauge this, that would seem to be a step too far. Sure, this net-stimulus measure has been boosted a lot for the near term, but principally for fiscal 2017/18, and on the back of judging more contractionary effect for 2016/17. For 2018/19 and beyond there is no clear signal of added impetus coming from government policy settings.

The other detail we were interested in today's HYEFU was the bond programme. While we thought it would probably nudge up, it didn't (yes, it was revised up to $7b, from $6b, but only for 2021…the rest was unchanged at $7b per year, including in the added year of forecast, 2022). The Debt Management Office also reiterated its recent announcement re near-term management of specific debt issues. The DMO also highlighted that the new government has carried over the approach signalled in Budget 2017, of maintaining gross debt of at least 20% of GDP. This is to aid ongoing liquidity in the NZGB market.

Netting Out



But judging by the market's reaction, it was also bracing for a little more in the bond programme than proved to be the case. There was a direct rally in bond rates in the order of 6 basis points, made all the more strong by the fact there was sell-off pressure coming through Australia during the day. The currency, however, hardly reacted, albeit after having recovered a bit of ground over the last week or so, for other (various) reasons.

What will the rating agencies make of today's HYEFU? We suspect they will be, like us, deferring any judgement on the fiscal accounts until we see next year's Budget. That's when everything will be rinsed through and we'll have a better handle of how Treasury's economic forecasts are looking as well.

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HYEFU 2017	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
	actual	actual	actual	actual	actual	actual	f/cast	f/cast	f/cast	f/cast	f/cast
(June years, % of GDP)											
Core Crown Revenue	28.1	29.2	28.3	29.5	29.6	30.0	29.6	29.7	29.9	30.1	30.4
Core Crown Expenses	32.0	32.0	30.1	29.5	28.7	28.0	28.5	28.6	28.2	28.0	27.6
OBEGAL	-4.3	-2.0	-1.2	0.2	0.7	1.5	0.9	0.9	1.6	2.0	2.5
Gross Sovereign Issued Debt (excl settlement	39.1	38.5	37.4	38.0	36.2	34.0	31.9	30.0	28.5	26.0	27.1
Net Core Crown Debt	23.6	25.5	25.3	24.7	24.0	21.8	21.7	22.2	21.9	20.8	19.3
Domestic Bond Programme ($NZm)	15,000	14,000	8,000	8,000	8,000	8000	7000	7000	7000	7000	7000
(June years)											
Real GDP (annual average % change)	2.6	2.2	2.5	3.3	2.7	2.7	2.9	3.6	3.0	2.6	2.1
Consumer Price Index (annual % change)	1.0	0.7	1.6	0.4	0.4	1.7	2.0	1.9	2.1	2.2	2.2
Unemployment rate (June qtr)	6.3	5.9	5.2	5.5	5.0	4.8	4.6	4.4	4.2	4.0	4.1
90-day Bank Bill Yield (March qtr. av.)	2.6	2.6	3.4	3.5	2.4	2.0	2.0	2.4	3.6	4.1	4.2
Trade Weighted Index (March qtr. av.)	72.4	76.3	81.5	76.2	73.6	76.5	73.8	73.8	73.8	73.8	73.8

HYEFU 2017 - PREFU 2017	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
	actual	actual	actual	actual	actual	actual	f/cast	f/cast	f/cast	f/cast
(June years, % of GDP)										
Core Crown Revenue	0.0	0.0	-0.1	-0.2	-0.5	-0.4	-0.3	0.1	0.1	0.2
Core Crown Expenses	0.0	0.0	0.0	-0.3	-0.5	-0.6	-0.2	0.4	0.5	0.3
OBEGAL	0.0	0.0	0.0	0.0	0.0	0.1	-0.1	-0.3	-0.3	0.0
Gross Sovereign Issued Debt (excl settlement	0.0	0.0	-0.1	-0.3	-0.7	-0.6	0.2	-0.4	-0.5	-0.2
Net Core Crown Debt	0.0	0.0	-0.1	-0.2	-0.5	-0.7	-0.3	0.7	1.9	2.0
Domestic Bond Programme ($NZm)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1000.0
(June years)										
Real GDP (annual average % change)	0.0	0.0	0.0	0.0	0.0	-0.1	-0.3	-0.1	0.2	0.3
Consumer Price Index (annual % change)	0.0	0.0	0.0	0.0	0.0	0.0	0.7	0.0	0.0	0.1
Unemployment rate (June qtr)	0.0	-0.1	0.0	0.0	0.0	-0.1	-0.1	0.0	-0.1	-0.3
90-day Bank Bill Yield (March qtr. av.)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.2	0.3	0.3
Trade Weighted Index (March qtr. av.)	0.0	0.0	0.0	0.0	0.0	0.0	-4.3	-4.7	-4.9	-4.2

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