RESEARCH
ECONOMY WATCH

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Fiscally Sound But Risks Building

- **NZ fiscal accounts still amazingly strong**
- **But it all gets much more difficult from here**
- **Government spending rising strongly**
- **And risks to GDP growth are downside**
- **Treasury and RBNZ differ on interest rate track**

Key data

The fiscal surplus for the year ended June 2018 is estimated to be 1.1% of GDP. It is forecast to rise steadily to 1.2% in fiscal 2019, 1.7% in 2020 and to 2.1% by fiscal 2022.

Net core crown debt is currently 20.8% of GDP. It is forecast to rise to 21.1% by June 2019 and then trend down to 19.1% by June 2022.

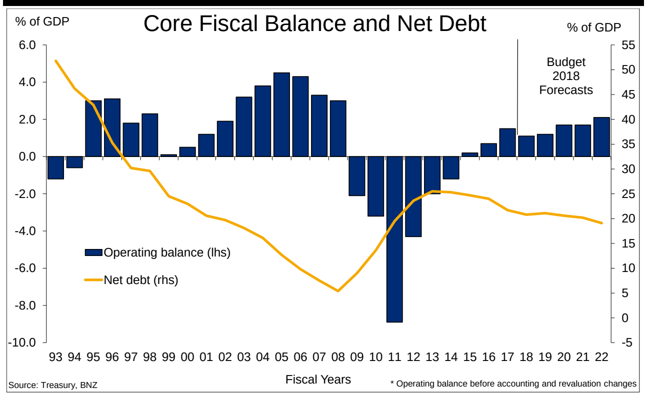
GDP growth is expected to average 3.0% per annum over the forecast period. It peaks at 3.4% in the year ended June 2020 before drifting down to 2.5% by 2022.

The Government intends to issue $8.0 billion of Government bonds in each of the next three fiscal years and then $7.0 billion in fiscal 2022.

The Big Picture

Year in year out New Zealand governments have been delivering fiscal forecasts that are the envy of much of the rest of the world. The 2018 Budget was no different with the newly-ensconced Labour-led Government being able to confirm increased capital and operating spending while still maintaining a rising trend in its surpluses, and a falling trend in its net debt balances.

Solid Balances



There were many who thought the Government would have to accede to a higher debt target or cut back on expenditure but they missed two important things:

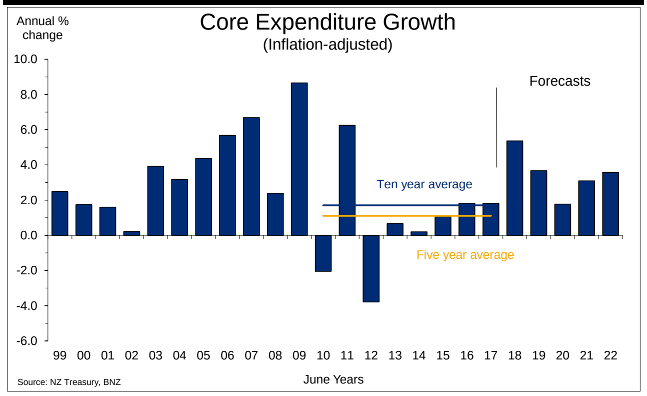
- The Minister of Finance was wedded to his surplus and debt targets and was always going to do everything humanly possible to achieve them. It would have been bad politics to fail at the first hurdle.

- Aiding and abetting him was the fact that the Government has been the beneficiary of stronger than expected tax flows, which provided a stronger revenue base to extrapolate out from. Without this, solving the equation would have been much harder.

The Government has certainly not got its books under control via expenditure constraint. Using our inflation forecasts (which are higher than the Government's) the

Budget 2018	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
	actual	actual	actual	actual	actual	f/cast	f/cast	f/cast	f/cast	f/cast
(June years, % of GDP)										
Core Crown Revenue	29.2	28.4	29.5	29.5	29.8	29.5	29.9	30.1	30.2	30.4
Core Crown Expenses	32.0	30.1	29.5	28.7	27.8	28.1	28.5	28.2	28.3	28.0
OBEGAL	-2.0	-1.2	0.2	0.7	1.5	1.1	1.2	1.7	1.7	2.1
Gross Sovereign Issued Debt (excl settlement	38.5	37.4	38.0	36.2	33.8	32.8	29.3	28.6	27.0	27.3
Net Core Crown Debt	25.5	25.3	24.7	24.0	21.7	20.8	21.1	20.6	20.2	19.1
Domestic Bond Programme ($NZm)	14,000	8,000	8,000	8,000	8,000	7,000	8,000	8,000	8,000	7,000
(June years)										
Real GDP (annual average % change)	2.2	2.7	3.9	3.8	3.3	2.8	3.3	3.4	2.7	2.5
Consumer Price Index (annual % change)	0.7	1.6	0.4	0.4	1.7	1.4	1.5	1.8	1.9	2.0
Unemployment rate (June qtr)	5.9	5.2	5.5	5.0	4.8	4.5	4.2	4.1	4.1	4.2
90-day Bank Bill Yield (March qtr. av.)	2.6	3.4	3.5	2.4	2.0	2.0	2.6	3.4	3.9	4.0
Trade Weighted Index (March qtr. av.)	76.3	81.5	76.2	73.6	76.5	74.9	75.8	75.5	75.4	75.0

Spending Up

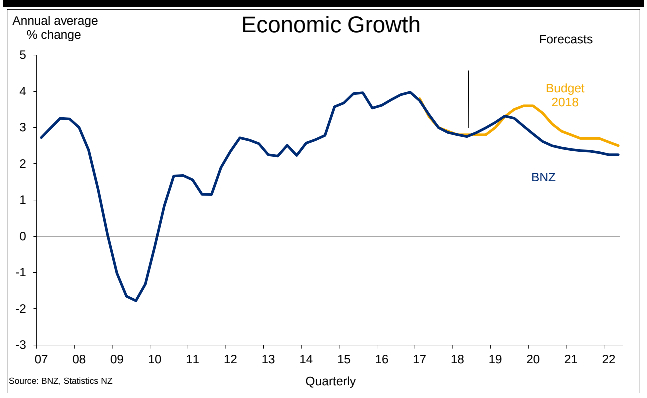


average real growth in government expenditure over the five years ended June 2022 will be 3.1%. This compares with a 1.1% average over the last five years and 1.7% over the last ten.

We are also concerned that there must surely be upward pressure on the expense track given the promises Labour has made to the electorate and there is more downside risk to Treasury's growth forecasts than there is up. Were these risks to play out the surplus and debt targets could come under pressure. That said, one could argue that in an economy short of infrastructure that a higher debt target might be excusable. After all there is nothing magical about 20% as a target for net core crown debt.

As for those growth forecasts, we do have a more pessimistic view of the likely outturns for the economy than does Treasury. For the four years ended June 2022 Treasury sees the New Zealand economy growing an average of 3.0% per annum, peaking at 3.4% in 2020 and falling away to 2.5% by 2022. In comparison we are forecasting 2.6% per annum over the same period. We don't see the same increase in private consumption as does Treasury as we don't see the flow through from the Government's fiscal package lasting as long; and we have a lower investment profile, as activity is constrained by a combination of physical capacity constraints and

Optimistic?



uncertainty over, or dislike of, Government policy changes.

If we are right then the Government will have less revenue to play with and a lower surplus track, as a consequence, but we wouldn't want to overstate our concerns in this regard. Moreover, it is quite plausible that the revenue Treasury loses from a shortfall in real activity is offset by higher-than-expected inflation thus delivering a similar level of nominal GDP albeit of different composition.

Implications for the RBNZ

The majority of what was released in today's Budget will already have been incorporated into the Reserve Bank's forecasts. The overall fiscal impulse is greater than that announced at the time of the HYEFU but this is largely because of policy measures that have been announced since then and already utilized by the Bank in its latest Monetary Policy Statement.

What remains of interest to us is the fact that Treasury is still at odds with the Reserve Bank as to when the cash rate needs to rise in order for inflation to meet target. Treasury states that interest rates are forecast to rise from the end of 2018. We can only interpret that as meaning as at the November Monetary Policy Statement. Moreover, Treasury sees the 90 day bank bill rate averaging 2.6% by the June quarter 2019 and 3.4% by June 2020. This is way more aggressive than the RBNZ stated course of action. To top things off, Treasury claims that the neutral 90 day interest rate is 4.25%. Incidentally, it also sees the NAIRU as being 4.25% and forecasts the unemployment rate falling to a low of 4.1%.

Treasury also bases its inflation (and, hence, interest rate) forecasts on:

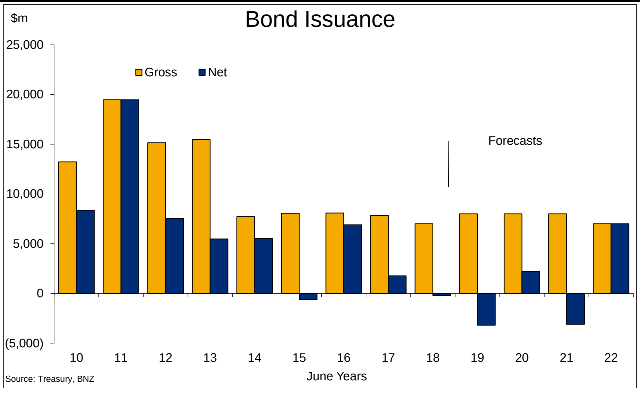
- The WTI price of oil being stable at $60 a barrel;
- The TWI being stable at 75; and
- Net migration dropping to 25,000pa by June 2022.

The balance of risk is that the actual outturns for the above prove more inflationary than Treasury assumes.

The Debt Programme

The debt management office has chosen to wind back its T-bill programme to the tune of $2.0bn and substitute this with an enhanced bond tender programme. The amount of bonds to be issues will increase by $1.0bn per annum (to $8.0 billion) for the years ended June 2019, 2020 and 2021. This results in a net addition to the funding programme of $1.0 bn. The bond tender programme returns to $7.0bn the year after.

A Stable Bond Programme



The 2018/19 programme will include $1.0bn of inflation linked bonds.

Note that there are further changes to net issuance as "the NZDMO plans to commence a repurchase programme of the 15 April 2020 nominal bond in 2018/19".

Another way that the Government will avoid increasing its core crown debt is by pushing debt into its Crown Entities. Rating agencies look at the consolidated accounts so will take this extra debt into consideration but the paper-shuffling will allow the Finance Minister to stick to his core crown debt targets. We might add that we don't see anything in this process that the rating agencies will be particularly perturbed by. Indeed, Moodys has already delivered a fairly glowing response to it.

For the record, total crown entity debt is forecast to rise to 2.2% of GDP by 2022 from 0.5% currently largely reflecting Housing New Zealand and New Zealand Transport Agency needs.

Housing New Zealand will seek to raise $2.9 billion over the four year forecast period from "third parties". The process will be kicked off with the issue of $1.0bn of bonds in the year ended June 2019.

Market Response

There is no need for the market to get excited by anything in today's Budget but the risks are that debt issuance will need to rise again and that overall government policy will put further upward pressure on inflation. This fits well with our view that the cash rate will eventually move earlier than the RBNZ anticipates and that, in the interim, the yield curve will steepen.

Other Issues

In no particular order of importance, we though it worth making folk aware of the following issues:

- The Government has reiterated that it will establish "an independent body that will be responsible for determining whether the Government is meeting its Budget Responsibility Rules to strengthen fiscal transparency and accountability". We would have thought that this was unnecessary but it's on its way so keep an eye out for its composition.

- The Government has confirmed that it will deliver R&D tax credits equivalent to 12.5% of R&D for those spending more than $100,000pa. This is expected to cost $1.0bn over four years. There is a big risk that this could get out of hand.

- Rental property losses will be ring-fenced. This, potentially, could have a negative impact on the supply of rental properties.

- The Government reaffirmed its commitment to passing a Zero Carbon Act and amending New Zealand's emissions trading scheme both of which will have implications for New Zealand businesses.

- The capital injection for Kiwibuild has effectively been delayed by a year and it is now assumed that "around $2.5 billion of additional nominal residential investment will occur in the forecast period, compared with around $5.0 billion" previously.

Summary

The New Zealand fiscal situation still looks very sound. But the Government is being blessed with good fortune as tax revenues continue to push ahead of expectations. While we see no reason for significant criticism of what is being delivered we, equally, warn that things will get much harder for Government from here on in.

- Their electorate will continue to demand more and more spending and will be difficult to please;

- Government sector wage demands will keep climbing;

- Housing market issues will not be easily solvable; and

- The risks to lower than expected growth and revenue are mounting.

The current government is now well into its honeymoon period, the true test of its ability to manage the nation's books is now only just beginning.

Economic Forecasts	BNZ						Treasury (Budget 2018)					
(Annual average % change, June years)	**2017 Fcast**	**2018 Fcast**	**2019 Fcast**	**2020 Fcast**	**2021 Fcast**	**2022 Fcast**	2017 Fcast	2018 Fcast	2019 Fcast	2020 Fcast	2021 Fcast	2022 Fcast
Private consumption	5.2	3.9	3.6	1.9	1.3	1.8	5.2	4.0	3.2	2.5	2.3	2.3
Public consumption	3.2	4.8	2.6	2.1	1.5	1.2	3.2	4.4	1.7	1.7	1.8	1.7
Total consumption	**4.7**	**4.1**	**3.4**	**1.9**	**1.3**	**1.6**	**4.7**	**4.1**	**2.9**	**2.3**	**2.2**	**2.2**
Residential investment	5.0	2.5	5.9	6.5	6.0	3.9	4.9	2.3	1.4	5.0	5.5	3.9
Total investment	**4.2**	**5.0**	**3.9**	**3.7**	**3.9**	**3.4**	**4.1**	**3.9**	**4.3**	**6.3**	**4.4**	**3.3**
Stock change	0.3	-0.2	0.1	0.0	0.0	0.0	0.3	-0.3	0.2	0.0	0.0	0.0
Gross National Expenditure	**4.7**	**3.5**	**3.4**	**2.4**	**2.0**	**2.1**	**4.7**	**3.5**	**3.6**	**3.3**	**2.7**	**2.5**
Exports	0.0	3.5	2.7	4.3	4.5	4.5	0.1	4.2	2.0	3.8	2.8	2.5
Imports	6.0	6.5	3.7	3.3	3.1	3.7	6.0	6.4	3.2	3.8	2.9	2.5
GDP (expenditure measure)	**3.2**	**3.0**	**3.0**	**2.6**	**2.4**	**2.2**	**3.1**	**3.2**	**3.1**	**3.2**	**2.7**	**2.5**
GDP (production measure)	**3.4**	**2.8**	**3.3**	**2.6**	**2.4**	**2.2**	**3.3**	**2.8**	**3.3**	**3.4**	**2.7**	**2.5**
Output gap (% deviation, June qtr)	1.2	0.9	1.4	1.3	1.3	1.2	0.2	-0.1	0.7	0.8	0.7	0.4
Employment	5.2	3.7	2.1	1.7	1.2	1.4	5.2	3.8	2.1	1.9	1.5	1.3
Unemployment	4.8	4.4	4.3	4.4	4.3	4.1	4.8	4.5	4.2	4.1	4.1	4.2
Nominal wages	1.6	3.5	3.0	2.6	2.3	2.3	1.6	3.2	2.7	3.1	3.3	3.4
CPI inflation	1.7	1.8	2.4	1.9	2.1	2.1	1.7	1.4	1.5	1.8	1.9	2.0
Current account balance												
- $billion	-7.1	-9.1	-9.6	-8.8	-7.9	-7.1	-7.4	-7.6	-9.4	-9.5	-10.1	-11.0
- % of GDP	-2.6	-3.1	-3.2	-2.8	-2.4	-2.1	-2.7	-2.6	-3.1	-3.0	-3.0	-3.1
TWI (June qtr avg)	76.5	73.8	71.9	70.8	70.2	72.7	76.5	74.9	75.8	75.5	75.4	75.0
90-day bank bill rate (June qtr avg)	2.0	2.0	2.3	3.2	2.8	3.3	2.0	2.0	2.6	3.4	3.9	4.0
10-year bond rate (June qtr avg)	2.9	2.9	3.4	3.9	4.0	4.1	2.9	2.8	3.4	3.9	4.2	4.3

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