13 December 2018

Fiscal Forecasts Weather Toned-Down GDP

- **Rosy fiscal outlook pruned only slightly, near term**
- **As Treasury forecasts not-so-strong real GDP**
- **More believable but still vulnerable**
- **So Budget 2019 up against fiscal rules**
- **Bond programme kept minimal (into 2023)**
- **Treasury delays and caps forecast OCR upcycle**

Today's Half-year Economic and Fiscal Update (HYEFU) was, in broad respect, very similar to the May Budget, as we expected it would be. Yes, there was a little bit of surplus pruning regarding the nearer term. But this was the consequence of toned-down economic forecasts, which now look less vulnerable to disappointment. So the end result is arguably a more assured set of fiscal projections.

At heart, it's still a solid set of fiscal accounts and projections. And majorly so in a global context.

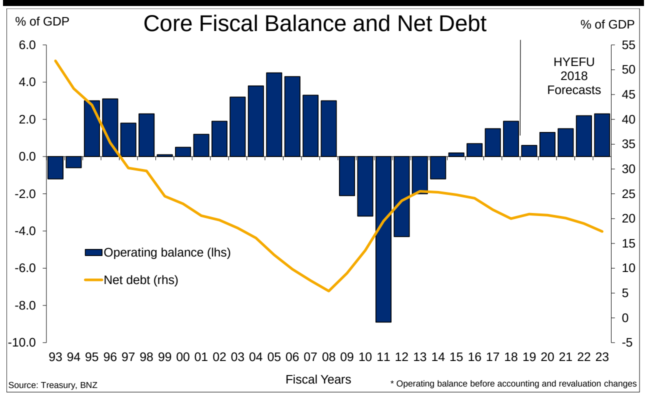
For the record, the 2018/19 core operating surplus expectation has been moderated to 0.6% of GDP, compared to the Budget's 1.2%. But the shortfall is gradually made up for over the course of the following few years. By 2021/22 the projected (OBEGAL) surplus is virtually identical – HYEFU from Budget – namely 2.2% from 2.1%.

Accordingly, the government's net debt ratio faces a bit of upward pressure near term. However, because of its better than expected starting point, the 20% of GDP "target" is just as comfortably achieved over the coming years. By June 2022, it gets down to 19.0%. And it plumbs 17.4% in 2023 – the new year that today's HYEFU has extended to.

But, yes, there is a near-term dent in getting there. This essentially reflects Treasury having toned down its GDP growth trajectory. We questioned the strength of it at Budget time, especially the near-4% annual growth in calendar 2019. Now, the Treasury's real GDP growth forecasts look more achievable to us, running closer to 3.0% for each of the next couple of years and slowing to 2.5% per annum after that.

Still, they remain a bit above what we have as a central view (conscious of the maturity of New Zealand's current economic cycle). And, looking forward, we think the risks are more for NZ economic growth facing headwinds than

Just A Near-Term Hiccup

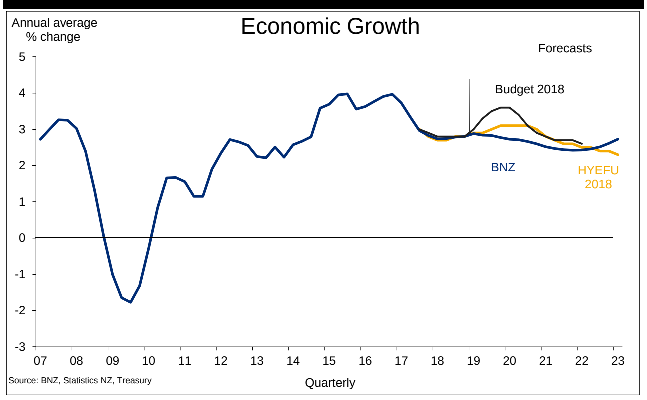


encountering new tailwinds. Some of this is global, some of it about domestic capacity constraint.

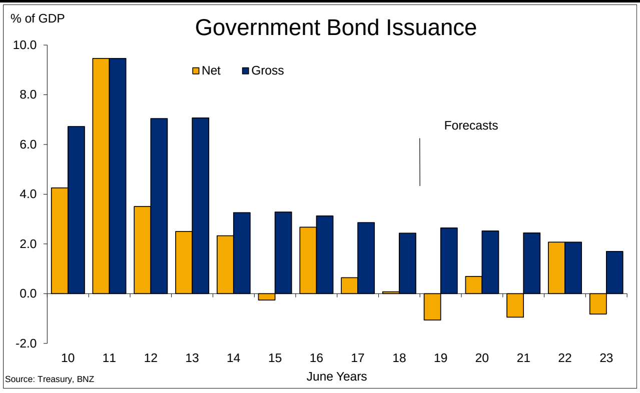
Luckily, for the tax revenue projections, Treasury had a good hedge in place in the Budget, in the form of (unusually) low CPI inflation forecasts. These were thus able to be revised up in the HYEFU, without any drama – to a remarkably steady 2.0% per annum. This, along with sustained strength in the terms of trade, has helped fill the gaps from the toned down real GDP forecasts.

Even so, Treasury has a view of an economy running into a slightly positive output gap (excess demand). From this, Treasury's view of the unemployment rate basing around 4% would give the impression of a NAIRU at least as much as this level. This supports a robust outlook for wage inflation.

More Achievable



At A Minimum



All of this, in turn, entails a tightening phase on the OCR. However, nowhere near as early and obvious as the Budget had. Treasury has today delayed the start of the OCR tightening cycle it (still) sees to H2 2020. And with a lower peak – consistent with an OCR circa 3%, a number of years down the track.

With respect to scenarios/risk, Treasury Secretary, Gabriel Makhlouf, and Finance Minister Grant Robertson, related, on balance, a sense of caution at todays' HYEFU lock-up. This was mainly with reference to the global outlook, but also with mention of some internal risks to growth.

In keeping with this, Robertson announced today that he was holding the spending allowances for coming years unchanged, compared to the Budget's trajectory. So still $2.4b available to allocate on operating expenditure in each year to 2022. And a capital expenditure allowance of $3.7b for the year to June 2019, $3.4b for 2020, and $3.0b for each of 2021 and 2022.

Accounting for all of this, and the earlier mentioned revision to the Treasury's macro-economic forecasts, the bottom line, if you like, is that there has been no change to the bond programme (or Treasury bill issuance, for that matter). However, it is worth pointing out that the new forecast year, of 2022/23, has set government bond issuance of $6b. This represents a step-down for the amount of $7b still scheduled for 2021/22, itself a step-down from what's been maintained with respect to 2020/21 (and the two years prior to that).

The NZ Debt Management Office went on to say that "inflation-indexed bond issuance is expected to be around $1.0 billion of the $8 billion 2018/19 programme" and that "there are plans to commence a repurchase programme of the 15 April 2020 nominal bond before 30 June 2019."

As for the wellbeing theme of today's HYEFU, focussed on by Grant Robertson, this is a prelude to budgets for the foreseeable future being Wellbeing Budgets. This will promote a range of social objectives, alongside the economic and fiscal targets. While these might be presented in separate documents, they are clearly intertwined.

In this regard, note that the changes are not just notional but are set to manifest in amendments to the likes of the Public Finance Act and the State Services Act. This is in order that decisions by various government departments take account of the collective achievement of the wellbeing objectives. It's all about prioritising spending, which is an added layer to bear in mind for next year's Budget.

As for market reaction to the economic and financial news in today's HYEFU it was, as you'd expect, imperceptible. We also wouldn't expect the rating agencies to feel the need to react. But this shouldn't engender a sense of complacency. Next year's Budget still has its work cut out, we think, to maintain such a rosy set of fiscal forecasts, as we saw in today's HYEFU.

Please see next page for tables.

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HYEFU 2018	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
	actual	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	29.6	29.9	30.2	30.4	30.4	30.7	30.9	31
Core Crown Expenses	32.0	30.1	29.6	28.7	27.9	28.0	29.5	28.7	28.8	28.4	28.3
OBEGAL	-2.0	-1.2	0.2	0.7	1.5	1.9	0.6	1.3	1.5	2.2	2.3
Gross Sovereign Issued Debt (excl settlement	38.5	37.4	38.1	36.3	33.9	33.2	29.7	28.8	27.2	27.4	25.4
Net Core Crown Debt	25.5	25.3	24.8	24.1	21.8	20.0	20.9	20.7	20.1	19	17.4
Domestic Bond Programme ($NZm)	14,000	8,000	8,000	8,000	8,000	7,000	8,000	8,000	8,000	7,000	6000
(June years)											
Real GDP (annual average % change)	2.2	2.7	3.9	3.8	3.3	2.7	2.9	3.1	2.7	2.5	2.3
Consumer Price Index (annual % change)	0.7	1.6	0.4	0.4	1.7	1.5	2.0	2.0	2.0	2.0	2
Unemployment rate (June qtr)	5.9	5.2	5.4	5.0	4.7	4.4	4.1	3.9	4.0	4.1	4.1
90-day Bank Bill Yield (March qtr. av.)	2.6	3.4	3.5	2.4	2.0	2.0	2.0	2.3	2.9	3.1	3.2
Trade Weighted Index (March qtr. av.)	76.3	81.5	76.2	73.6	76.5	73.8	73.5	73.9	74.8	75.1	75.2

HYEFU 2018 - Budget 2018	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
	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	0.0	0.1	0.1	0.7	0.5	0.3	0.5	0.5
Core Crown Expenses	0.0	0.0	0.1	0.0	0.1	-0.1	1.0	0.5	0.5	0.4
OBEGAL	0.0	0.0	0.0	0.0	0.0	0.8	-0.6	-0.4	-0.2	0.1
Gross Sovereign Issued Debt (excl settlement	0.0	0.0	0.1	0.1	0.1	0.4	0.4	0.2	0.2	0.1
Net Core Crown Debt	0.0	0.0	0.1	0.1	0.1	-0.8	-0.2	0.1	-0.1	-0.1
Domestic Bond Programme ($NZm)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(June years)										
Real GDP (annual average % change)	0.0	0.0	0.0	0.0	0.0	-0.1	-0.4	-0.3	0.0	0.0
Consumer Price Index (annual % change)	0.0	0.0	0.0	0.0	0.0	0.1	0.5	0.2	0.1	0.0
Unemployment rate (June qtr)	0.0	0.0	-0.1	0.0	-0.1	-0.1	-0.1	-0.2	-0.1	-0.1
90-day Bank Bill Yield (March qtr. av.)	0.0	0.0	0.0	0.0	0.0	0.0	-0.6	-1.1	-1.0	-0.9
Trade Weighted Index (March qtr. av.)	0.0	0.0	0.0	0.0	0.0	-1.1	-2.3	-1.6	-0.6	0.1

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