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More than a feeling

Bottom line

- The Government's books are in a healthy position, and the Treasury's Budget Economic and Fiscal Update forecasts should show this persisting. However, we expect a slightly softer economic outlook to drive a small deterioration in the fiscals compared to December's Half-Year Update.
- Despite the softer economy there should be enough wiggle room for the Government to still meet its 20% debt objective.

Key points

The starting point for the Government's books is in good shape...

The starting point for the Government's books is in good shape. Here's what we know from the Government Financial Statements for the nine months ended March 2019 compared to the Half-Year Update forecasts:

- The total Crown OBEGAL surplus of \$2.5bn is running ahead of the Half-Year Update forecast by \$329 million. Two thirds of the variance is owing to factors outside of the core Crown, with Crown entities posting a stronger-than-expected surplus on the back of lower expenses. Lower core Crown expenses also contributed.
- As at March, tax revenues were running \$542 million below forecast. Softer GST revenues account for around two thirds of the forecast variance, but some of this appears timing related, so should reverse in coming months. Lower corporate tax accounts for the remainder.
- Core Crown expenses of \$63.5bn show a \$583 million underspend, more than offsetting weaker tax revenues. As Minister Robertson and the Treasury have already outlined, around \$200 million of this is because of an underspend on the Fees Free programme with enrolments not meeting initial forecasts. Spending on social assistance benefits was also a little lower, reflecting ongoing tightness in the labour market.
- **Net core Crown debt (the most binding of the Government's fiscal target indicators)** was \$855 million lower than forecast at \$60.5bn (20.6% of GDP vs 20.9% expected).

All up, there's nothing in the starting position to suggest urgent and drastic change is required to steer the books towards where the Government wants them to be. But a weaker economic and fiscal outlook could have made for a few tough choices.

...but the economic outlook is probably due for a downgrade...

We wouldn't be surprised if the Treasury's economic outlook proves a little more upbeat than our own. That's at least been the recent experience. However, we know the starting point will be weaker, and suspect the near-term outlook will have been downgraded too.

The Half-Year Update included quarterly growth forecasts of 0.7% for both Q3 and Q4 2018. Actual data printed at 0.3% and 0.6% respectively. And now, near-term indicators suggest their earlier forecast for quarterly growth of 0.8%

q/q over 2019 is on the optimistic side. So far, indicators for Q1 GDP point to growth closer to 0.5% q/q – **we’d be surprised if the Treasury haven’t** at least downgraded this one. Thereafter, **we’re less certain. It’s likely the Treasury are** expecting growth to pick up from mid-2019 (we are too, albeit gradually), but the question is how strong it will be? **And that’s a tricky one.** Because the Treasury’s forecasts are finalised well before the Budget publication date (in order to accommodate the Budget decision-making process), **it’s possible that the economic outlook doesn’t include** the impact from the OCR cut that was delivered on May 8. Cosmetically it may be in the tables, but the additional stimulus may not be baked fully into the GDP and inflation outlooks.

What really matters for tax revenue is nominal GDP. And on that front, things are probably looking a little softer than at the Half-Year Update too. As outlined above, real GDP is due for a downgrade (at least in the near term). And on the prices side, the recent loss of economic momentum and waning capacity indicators suggest inflation pressures are a little softer. From a trade perspective, **despite prices for New Zealand’s** key exports holding up remarkably well in the face of slowing global growth (for dairy a lot of the explanation here lies with softening global supply), it would be hard to justify an upgrade to the terms of trade outlook.

...and that’s likely going to impact the fiscal outlook

Fiscal policy decisions (**which are guided by Government’s Budget Responsibility Rules**, and at a more detailed level the Wellbeing Budget priorities) together with the **Treasury’s economic outlook** (**which** informs the revenue and expenses forecasts) will determine where the fiscal forecasts land.

From the slightly higher starting point, delayed and reprioritised spending, alongside a slightly softer tax revenue outlook, will likely see the forecast OBEGAL surplus downgraded a touch. However, lifting surpluses across the forecast horizon are still expected.

Given the likelihood of a small downgrade in tax revenues, we don’t see much upside in terms of higher discretionary spending. However, a downgrade to the labour market outlook could see forecast spending on social assistance payments rise, but this has actually been tracking below forecast to date.

As at the Half-Year Update, operating allowances for Budget 2019 to Budget 2022 were confirmed at \$2.4bn per Budget, with some pre-commitments leaving a little less than that in the kitty for 2019 and 2020. We expect operating allowances to remain unchanged, but if anything, the risk is skewed towards these being lowered slightly to keep the debt projection on course towards 20% of GDP. Capital spending, set by the multi-year capital envelope, is also expected to remain unchanged. No change to allowances implies all new spending decisions will either be made **against what’s yet to be** allocated, or from reprioritised spending. Minister Robertson has said the Government has found cost savings of \$1bn over the forecast period.

Overall, the Government appears quite adamant about achieving its fiscal targets, **with the Minister of Finance recently stating “fiscal sustainability is an inherent part of a wellbeing approach”**. Of these targets, reducing the level of net core Crown debt to 20% of GDP within five years of taking office is perhaps the most focused on and therefore binding.

But we think there’ll be enough wiggle room to accommodate that...

“Within five years of taking office” implies the net debt forecasts will land at or below 20% of GDP in the 2022 fiscal year. And indeed the Half-Year Update forecasts showed the Government overachieving on this front, with net debt reaching 19% of GDP in June 2022. This implies there was always a little wiggle room for a slightly softer economy and/or unplanned expenses (such as

the one-off cost of the Government's recent firearm buyback scheme). Provided discretionary spending remains contained, a slightly softer revenue forecast shouldn't derail the projected return of net debt to 20% by 2022.

All things considered, we're not expecting large changes to Debt Management's bond issuance guidance. At the Half-Year Update the face value of gross NZGB issuance was forecast at \$8bn from fiscal years 2019 to 2021, followed by \$7bn in 2022 and \$6bn in 2023. This didn't test the 20% of GDP lower limit and with nominal GDP expected to come in a little softer, it shouldn't test it now. However, there could be a little more funding pressure at the margin, so a small increase (of around \$1bn) somewhere in the forecast wouldn't surprise us.

With the large nominal bond maturity this year, and similarly sized maturities due over the next two years, we are probably due for a new bond syndication to be announced. A replacement 10-year benchmark nominal bond is a strong contender here, but a 15-year or 20-year also wouldn't surprise. Debt Management will want to set up lines where demand is highest, and that's the tricky part, as demand can vary significantly from investor to investor.

Treasury bills outstanding were at \$4.6bn as at 30 April 2019. This is a bit higher than earlier guidance, but that likely reflects greater short-term funding requirements associated with the maturity and repurchase of March 2019 nominal bonds, so should unwind.

...but there's limited upside for fiscal policy to support a sustained return of inflation to the RBNZ's target midpoint

In terms of the macroeconomic impacts of fiscal policy (ie pressure on GDP, inflation and interest rates), we expect only small changes from the Half-Year Update. Delayed spending will likely see the positive fiscal impulse previously forecast for the year to June 2019 revised lower, but with some of that strength pushed into the later years. At the end of the day, the ability for the Government to use fiscal policy to stimulate the economy will remain constrained so long as strict adherence to the debt target continues.

The Wellbeing impact

New spending decisions made out of the operating allowances, capital envelope, and reprioritised spending **will be guided by the Government's Budget Wellbeing priorities** of:

- Creating opportunities for productive businesses, regions, iwi and others to transition to a sustainable and low-emissions economy;
- Supporting a thriving nation in the digital age through innovation, social and economic opportunities;
- Reducing child poverty and improving child wellbeing, including addressing family violence;
- Supporting mental wellbeing for all New Zealanders, with a special focus on under 24-year-olds; and
- **Lifting Māori and Pacific incomes, skills and opportunities.**

Some decisions have already been announced, including [\\$320 million to fight domestic violence](#) and [\\$98 million for a whānau-centred pathway to break the cycle of Māori reoffending](#). And more are likely to be announced before Budget day.



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