ANZ Research

2019 Budget Review

30 May 2019

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Take it to the limit

Key points

- All up, the Treasury's Budget Update forecasts show the Government's books are expected to remain in good shape over the next four years.
- Government spending has been bumped up on both the operational and capital side. This means smaller surpluses and higher debt, but all within (at) the limits of the Government's fiscal targets.
- Debt Management's bond issuance guidance has been lifted – more than we expected, and largely reflecting increased spending. Issuance for both the 2019/20 and 2020/21 fiscal years has been lifted by $2bn to $10bn, while issuance for the 2021/22 fiscal year has been bumped up by $1bn to $8bn. The 2022/23 guidance of $6bn is unchanged from the Half-Year Update.
- A new bond syndication has been announced, to occur before 31 December 2019: a May 2031 replacement nominal 10-year benchmark. Treasury bills on issue are also expected to be a little higher than forecast in December, reflecting larger short-term funding requirements.
- The NZD was little changed post-Budget, but the 10-year NZ Government bond yield lifted around 2.5bps as a result of the higher issuance plan. That said, the increase in the bond programme will be welcomed by the market, especially in the face of large maturities over coming years.
- As expected, the Government's updated fiscal strategy (to target net debt within a 15-25% of GDP range once the 20% of GDP point target is achieved in 2021/22) had little impact on the fiscals.
- Underpinning all this, the Treasury's economic outlook remains a little more optimistic than our own. A downside surprise in the coming years could make for some tougher decisions in future Budgets.

BEFU 2019 forecasts (HYEFU 2018 forecasts in brackets)					
Economic (June years)	2018/19	2019/20	2020/21	2021/22	2022/23
Real GDP (ann. ave. % chg.)	2.4 (2.9)	3.0 (3.1)	2.8 (2.7)	2.4 (2.5)	2.4 (2.3)
Nominal GDP (ann. ave. % chg.)	3.8 (4.3)	5.8 (5.6)	5.4 (5.1)	4.9 (4.7)	4.7 (4.5)
Current account deficit (% of GDP)	-3.4 (-3.5)	-3.4 (-3.6)	-3.4 (-3.6)	-3.3 (-3.6)	-3.3 (-3.7)
Unemployment rate (June qtr, %)	4.1 (4.1)	4.0 (3.9)	4.1 (4.0)	4.2 (4.1)	4.3 (4.1)
CPI (ann. % chg.)	1.8 (2.0)	2.0 (2.0)	2.1 (2.0)	2.0 (2.0)	2.0 (2.0)
Fiscal (June years)	2018/19	2019/20	2020/21	2021/22	2022/23
OBEGAL - % of GDP	1.2 (0.6)	0.4 (1.3)	0.6 (1.5)	1.3 (2.2)	1.7 (2.3)
Core Crown Residual Cash - % of GDP	-0.9 (-1.7)	-1.3 (-0.8)	-1.3 (-0.3)	-0.2 (0.3)	0.3 (0.8)
Net Core Crown Debt - % of GDP	20.1 (20.9)	20.4 (20.7)	20.7 (20.1)	19.9 (19.0)	18.7 (17.4)
Bond Programme (gross, NZ$bn)	8.0 (8.0)	10.0 (8.0)	10.0 (8.0)	8.0 (7.0)	6.0 (6.0)

Details and assessment

Spending is set to be a little higher than we anticipated…

Budget 2019 included a little more spending than we anticipated, with a bump on both the operating and capital side. However, based on December's Half-Year Update forecasts, which showed net core Crown debt falling to 19% of GDP in 2021/22 (1%pt of GDP below target), we always knew there was a bit of wiggle room come Budget day. Despite higher spending, the Government is still expected to meet its Budget Responsibility Rules.

… enabled by optimistic economic forecasts.

Treasury's economic outlook is a little more optimistic than our own, and any surprises to the downside of their expectations could make for a few difficult decisions in the coming years (provided the Government sticks to its 20% of GDP debt target).

From a macroeconomic perspective this Budget suggests fiscal policy is likely to be a little more stimulatory that previously thought. But overall, keeping net debt on its trajectory to 20% of GDP by 2022 prevents fiscal settings from persistently adding to demand pressures.

Key spending announcements

Key spending announcements (which have been passed through the lens of the Treasury's Living Standards Framework) include:

- $2.9 billion to invest in healthcare for District Health Boards over five years.
- $1.7 billion to invest in hospital infrastructure over the next two years.
- $1.2 billion to invest in schools over 10 years.
- $1 billion to invest in KiwiRail and $406 million for the Auckland City Rail Link.
- $535 million to index main benefits to wage growth (rather than CPI) and reduce sanctions.
- $455 million for a mental health frontline service and $124 million for further support.
- $320 million to address family violence.
- $300 million for a venture capital fund for start-ups firms.
- $229 million for a sustainable land-use package, focusing on waterways.
- $200 million for vocational education reforms.
- $197 million to strengthen the Housing First Programme.
- $154 million for a new transition service for young people leaving state care.
- $106 million to help the transition to a low-carbon future.
- $98 million for a whānau-centred pathway to break the cycle of Māori reoffending.

The macroeconomic context

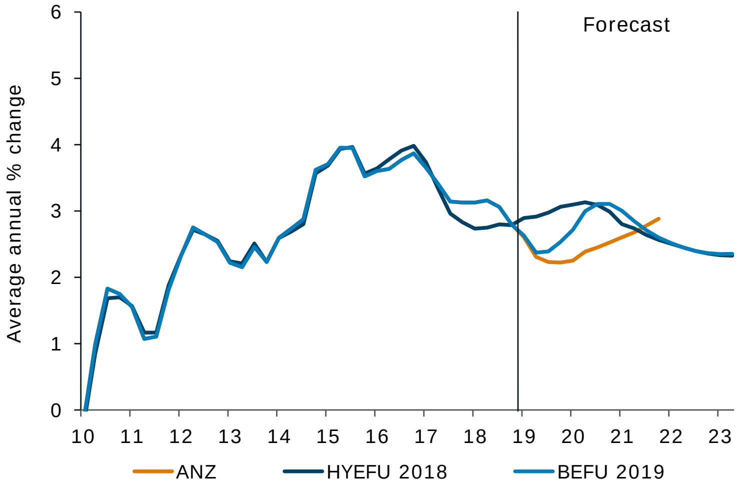
A softer near-term outlook, but solid medium-term.

The Treasury's economic outlook has been downgraded in the near term, but shows a heroic pickup in growth to just over 3% by 2020. Treasury still assumes moderate growth in residential investment (aided by KiwiBuild), solid (private and public) consumption growth, and acceleration in business investment from here. The terms of trade are lower over the next few years, and the unemployment rate is slightly higher.

We see scope for disappointment.

Compared to our own economic outlook, Treasury's forecasts still appear a little optimistic, even with some extra fiscal stimulus. Indeed, with Treasury expecting real growth of 0.6% q/q for Q1, it may not be long before outturns begin to disappoint. Our expectation is that Q1 growth will come in at 0.5% q/q, and we note there are some small downside risks to this.

Figure 1. Real GDP forecasts



Source: The Treasury

The nominal GDP outlook looks a little out of date.

But what really matters for tax is nominal GDP. Here, the outlook is similar to the Half-Year forecasts, with a slight downgrade over the next year. On the prices side, CPI inflation is little changed and hits 2% over the next few years. However, they also haven't incorporated OCR cuts and expect the RBNZ to starting hiking interest rates from mid-2020.

As part of the forecast process, the Treasury makes a judgement on how much of the upside and downside economic risks out there get baked into their central outlook versus how much goes into their risks and scenarios. There were two scenarios focused on:

1. Weak trading partner growth, driven by trade tensions or a China slowdown. This would mean lower nominal GDP growth due to slower exports, business investment, and consumption growth. Surpluses would be smaller each year, and net debt higher.

2. More wage pressure, given greater capacity pressures in the labour market. Greater household income is assumed to flow through to higher consumption and nominal GDP growth, improving the Governments operating balance and lowering net debt.

We see the downside risks to growth dominating.

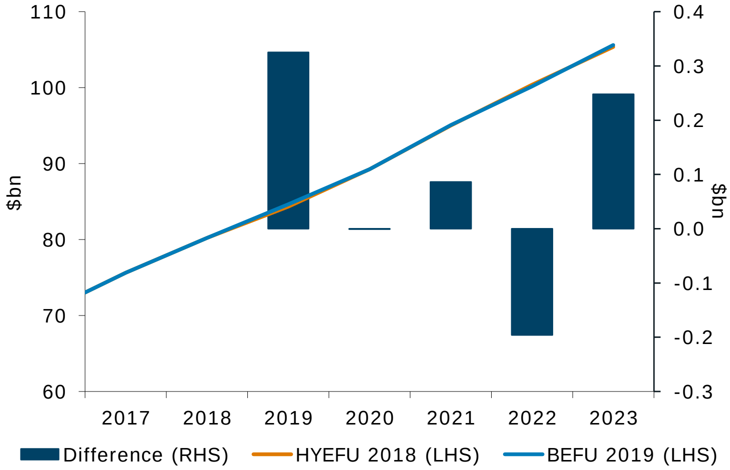
Overall, we think the Treasury could have baked in a little more softness into their central forecasts. Other downside risks to growth and inflation far outnumbered the upside risks:

- Weak sentiment could have a more pronounced effect on business investment.
- Capacity constraints could be more binding, slowing growth and pushing up inflation.
- Oil prices may be lower than assumed given the ability of US production to respond.
- Productivity could be weaker than anticipated.
- The risks to house price growth are tilted to the downside.
- Agricultural output and power generation is vulnerable to weather conditions.
- The proposal to increase bank capital requirements is yet to be confirmed.

The tax revenue forecast is broadly unchanged.

All up, a similar nominal GDP profile has resulted in a broadly similar tax revenue forecast over the next few years (figure 2). Tax revenues are expected to lift from $84.7bn in the 2018/19 fiscal year to $105.6bn in the 2022/23 fiscal year.

Figure 2. Change in core Crown Tax Revenue



Source: The Treasury

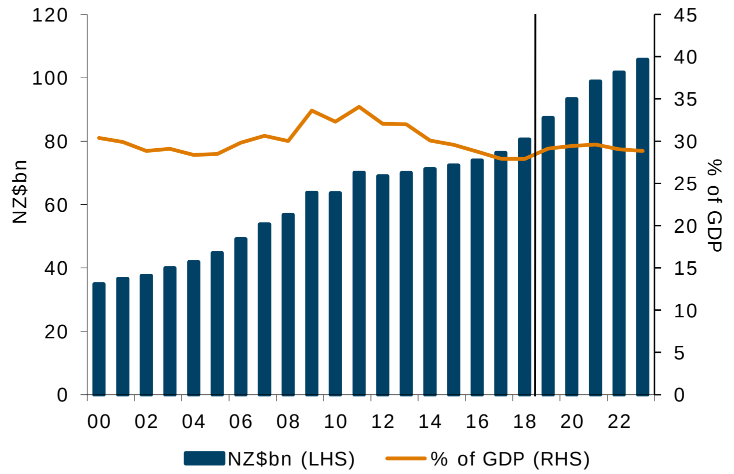
Expenses are higher throughout the forecast…

With the exception of the current (2018/19) fiscal year, core Crown expenses are higher than forecast in December's Update. Increased operational and capital spending accounts for much of the lift, but delayed spending being pushed out into the forecast years has also contributed. The operating allowance for Budget 2019 has been lifted by $1.4bn to $3.8bn and increased by $600 million to $3.0bn for Budget 2020 (with the no change to the $2.4bn for subsequent Budgets). The multi-year capital envelope has been bumped up from $13.1bn over Budgets 2019-2022 to $14.8bn.

…but remain below 30% of GDP.

Overall, core Crown expenses are forecast to grow from $87.3bn in 2018/19 to $105.7bn by 2022/23. As a share of GDP, core Crown expenses are forecast to remain below 30%, peaking at 29.6% of GDP in 2020/21 before declining to 28.8% by 2022/23.

Figure 3. Core Crown expenses



Source: The Treasury

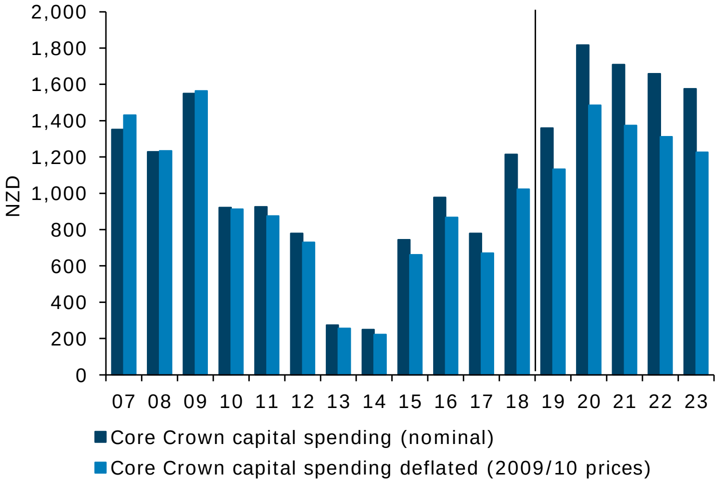
NZ needs better infrastructure.

We think a little extra capital spending is a good thing. Years of capital underspend has left New Zealand with an infrastructure deficit. And we think that's restricting the economy's ability to grow. That said, while there's definitely a strong case to loosen the Government's purse strings and address

Worthwhile infrastructure pays for itself via stronger GDP in the long run.

New Zealand's infrastructure deficit faster, this needs to be done in a way that doesn't crowd out and compete with private sector investment. Capacity constraints are particularly acute in the residential construction sector, so Government spending on new houses is likely to crowd out private investment. However, funding new roads, rail and other infrastructure that supports private sector development could go a long way towards boosting the economy's productive capacity and even lean against the wind of a slowing economy. And on that front, this Budget makes some headway – more than we anticipated but not at game-changing levels.

Figure 4. Capital spending per capita

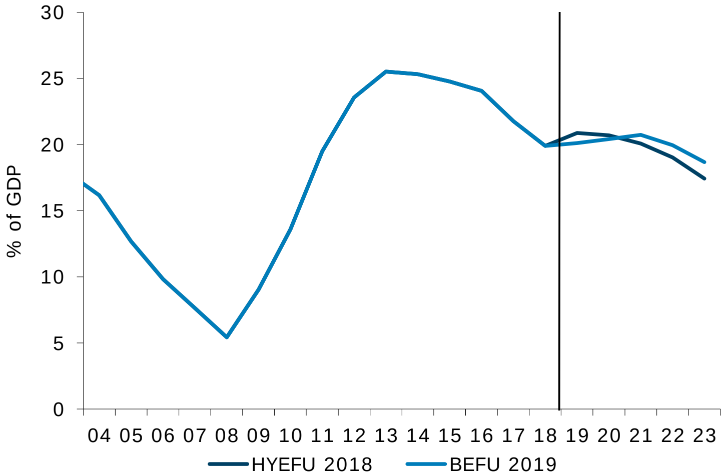


Source: The Treasury

The fiscal strategy targets are still met

As expected there was enough wiggle room in the Government's books to accommodate a little extra spending (or softer economic outlook) while still meeting the fiscal strategy targets. Of these, reducing the level of net core Crown debt to 20% of GDP within five years of taking office is probably the most binding. And this has now been pushed to its limit. Treasury forecasts show net core Crown debt lifting from 20.1% of GDP in the current fiscal year to a peak of 20.7% in 2020/21. In 2021/22 net debt comes in at just below target at 19.9% of GDP, and then falls to 18.7% in 2022/23. In level terms, net core Crown debt doesn't decline until the last forecast year, which is when the first core Crown residual cash surplus is achieved.

Figure 5. Core Crown net debt



Source: The Treasury

The tweak to a range had little impact.

As expected, the recent tweak to the Government's fiscal strategy to target net core Crown debt within a 15-25% of GDP range has had little impact (if any) on the fiscal numbers at this stage. Indeed, it's a little early to be making spending decisions out that far.

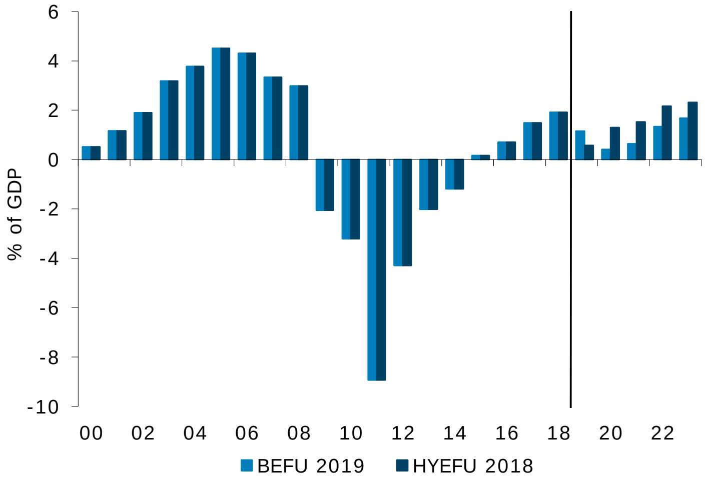
Total borrowings are higher.

Total borrowings, which isn't part of the Government's suite of fiscal strategy targets, but still very important from a tax payer's perspective, is forecast to grow from $112.1bn in 2018/19 to $131.3bn in 2021/22, before declining to $130.6bn in 2022/23.

The operating balance starting point is solid, and the forecasts show consistent surpluses.

As expected, the starting point for the total Crown operating balance before gains and losses (OBEGAL) is solid at a surplus of $3.5bn in the 2018/19 fiscal year. The OBEGAL surplus narrows to $1.3bn in the coming fiscal year (on higher and delayed spending), but then gradually widen towards $6.1bn by 2022/23.

Figure 6. Total Crown OBEGAL



Source: The Treasury

After adjusting for the cyclical position of the economy, the underlying OBEGAL is a touch lower than the headline measure, but with surpluses maintained overall. At face value the adjusted OBEGAL suggests the Government is delivering on its ambition to deliver sustainable surpluses across the economic cycle.

The Budget pushes the limits with no room for downside surprises.

All up, higher spending means debt is a little higher than forecast at the Half-Year Update and surpluses a little lower, but all within the Government's fiscal strategy targets, which have now been pushed to the limits.

Funding party

The bond programme is $5bn larger.

On the funding side, increased Government spending has contributed to a significant lift in Debt Management's bond issuance guidance over the next few years – an additional $5bn compared to the November Half-Year Update. Issuance for both the 2019/20 and 2020/21 fiscal years has been lifted by $2bn to $10bn and issuance for the 2021/22 fiscal year has been bumped up by $1bn to $8bn. The 2022/23 guidance of $6bn is unchanged from the Half-Year Update. We had previously noted upside risks to the issuance profile but this surprised us on the upside. Increased issuance and a similar nominal GDP outlook means the Government's commitment to maintain NZGBs on issue above 20% of GDP shouldn't become binding any time soon.

A new bond will be syndicated this year.

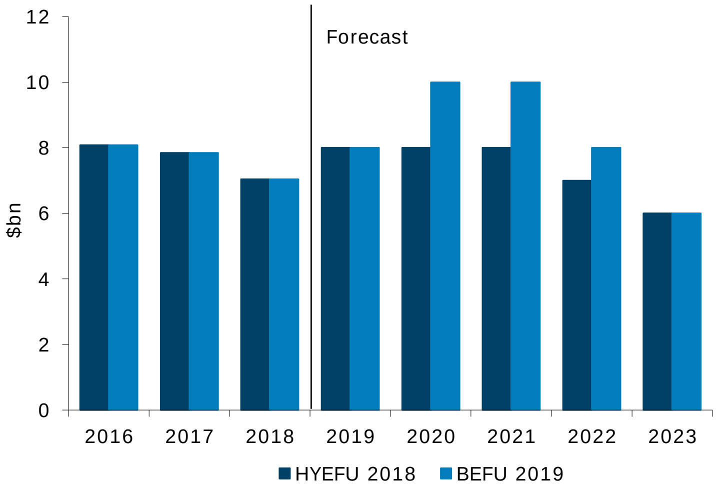
A new bond syndication has been announced to occur before 31 December 2019 (a May 2031 replacement nominal 10-year benchmark). This is in line with our expectations and matches closely with the recent 2031 ACGB bond in Australia.

The risks to issuance are on the upside.

Downside economic risks suggest upside risks to the issuance profile remain. But with net debt pretty much at the target limit, this would likely require a loosening of the Government's 20% point target for 2021/22.

Guidance for Treasury bills has also been nudged a little higher, reflecting increased short term funding requirements.

Figure 7. Bond tender program



Source: The Treasury

Bond yields rose slightly in response to the higher issuance plan.

The NZD was little changed post-Budget, but the 10-year NZ Government bond yield lifted around 2.5bps as a result of the higher issuance plan. That said, the increase in the bond programme will be welcomed by the market especially in the face of large maturities over coming years.

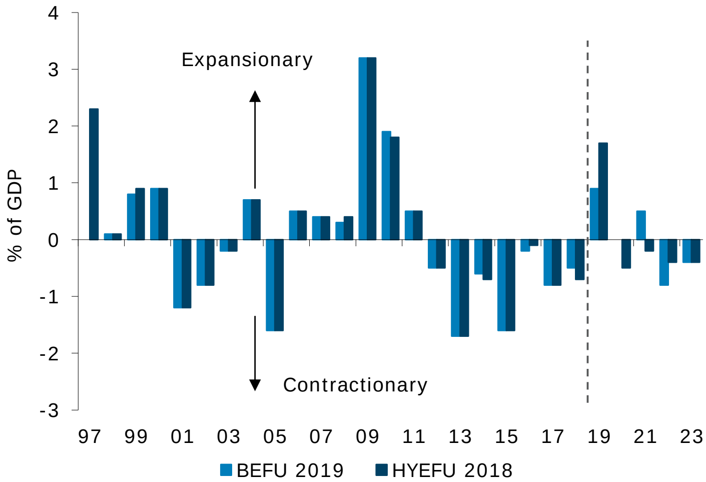
A little more fiscal stimulus, but not a game changer

The fiscal stimulus will be a little larger than previously expected, but not a game-changer.

In terms of the macroeconomic impacts of fiscal policy (ie pressure on GDP, inflation and interest rates), increased spending is expected to be a little more stimulatory than previously thought. At the margin, this should give the RBNZ a little more confidence in their growth outlook. But we still don't think this is a game changer. At the end of the day, strict adherence to the Government's debt target means fiscal policy settings have limited scope to stimulate the economy on a persistent basis. If the RBNZ was worried about upside inflation risks, that would be a good thing. However, core inflation remains muted so the RBNZ probably wouldn't mind a little extra fiscal stimulus around about now.

Delayed spending has seen the 2018/19 fiscal impulse downgraded (from 1.7% of GDP to 0.9%) but new and delayed spending sees this upgraded in the near term, but as noted, the expansionary impulse is not persistent.

Figure 8. Fiscal impulse



Source: The Treasury

The debate about how much the Government should borrow and spend will continue ad infinitum.

All up, this Budget has pushed government spending to the limits of its debt target, and while our own economic outlook is a little softer than the Treasury's, the Government's books would remain in good shape on our growth numbers. However, net debt's return to 20% of GDP would likely be delayed.

Given the array of economic risks out there, and the pressures we're seeing on New Zealand's infrastructure, we still see a very real possibility of fiscal targets being loosened in time. Indeed, this debate is likely to ramp up as we approach the next election. But for now, the Government remains content to push the limits of its targets while sticking to the 'fiscal prudence' script. Budgets can never please everyone. But this one does a reasonable job of trading off addressing some long-neglected areas (eg mental health) while building fiscal resilience for the inevitable rainy day.

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