ANZ Research

2019 Half-Year Economic & Fiscal Update Preview

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More capital from the capital

Bottom line

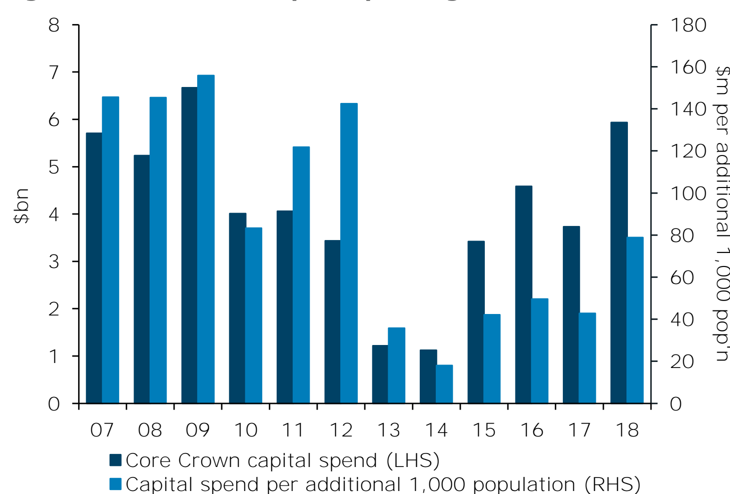
- The Minister of Finance has signalled that the Half-Year Economic and Fiscal update and accompanying Budget Policy Statement will include a "significant boost to infrastructure spending". We're on tenterhooks as we await details around the type, timing, and magnitude of spending.
- Recent comments by the Minister suggest that the Government is ready to declare 'mission accomplished' on their target of bringing net core Crown debt down to 20% of GDP within five years of taking office. Indeed, net debt came in below 20% of GDP in both the 2018 and 2019 fiscal years, but was at 20.2% in the first four months of the current (2020) fiscal year.
- Previously, spending decisions were made subject to the constraint of keeping net debt on a 20% of GDP trajectory into the 2022 fiscal year (five years from taking office). Now it looks like the Government is happy to apply the 15%-25% window target a little earlier. That's a wide range, but we think the Government won't want to push the debt ratio too far towards the upper end of the range to reduce the odds of a breach down the track.
- Given the typical delays in infrastructure spending, additional fiscal stimulus could come too late for the RBNZ, which is really hoping to see a boost to GDP growth in the year ahead (before inflation pressures and inflation expectations slip further). But the Bank will take some comfort from the medium-term implications for GDP.
- And should downside risks to the economy materialise and capacity open up, the more planning that gets done now (even if it's for the latter forecast years), the easier it will be to bring forward if the economy really needs a pick-me-up.
- Overall, we think the Government could comfortably bump up spending by $5-15 billion, but it might want to hold something back for Budget 2020 and the 2020 election.

Key points

The Treasury's Half-Year Economic Update (HYEFU) and accompanying Budget Policy Statement (BPS) will be realised at 1pm on Wednesday 11 December - and it's shaping up to be a doozy.

The Minister of Finance's recent statement that "Cabinet has agreed to a significant boost to infrastructure investment" has put us on tenterhooks. Like many others, we've been pointing out for some time that a lack of infrastructure spending this past decade, alongside strong migration-led population growth, has resulted in an infrastructure deficit that has become a significant headwind to economic growth and productivity.

Figure 1. Core Crown capital spending



Source: Stats NZ, Treasury, ANZ Research

But given the current state of the economy, and in particular with capacity pressures biting in the construction sector, it will be challenging to implement new initiatives as quickly as the Government might hope.

Take, for example, the recent announcement that schools will receive an extra $400 million for maintenance that needs to be spent over the next two years. Schools certainly will be able to put it to good use. But in some regions, where construction activity is already very high and builders and tradespeople hard to find, this could end up crowding out private sector investment and/or adding to already-elevated construction costs – particularly given the housing market is beginning to pick up again.

But while near-term implementation might be a challenge, particularly for anything housing-related, having some large infrastructure projects in the pipeline (such as new and improved roads) is a great idea. Should downside economic risks materialise, fiscal policy will be in a better position to provide a timely offset if planning is already well underway.

The key question is how significant is 'significant'? The signal from the Minister is that they're about to declare 'mission accomplished' on their target of reducing the level of net core Crown debt to 20% of GDP within five years of taking office. It is true that net debt came in below 20% of GDP in both the 2018 and 2019 fiscal years, but it was at 20.2% in the first four months of the current (2020) fiscal year, and based on BEFU forecasts and the washing out of positive one-off factors, this was poised to rise in the near term before any additional spending is factored in.

In fact, if the Treasury's economic outlook were downgraded sufficiently, it is possible debt would be forecast to come in above 20% in 2022 anyway. So to some extent, the signalled fiscal 'loosening' could partly be a result of not having to tighten fiscal policy just to show the forecasts achieving the 20% point target.

How much the Government will lift spending is a bit of an open question. 'Mission accomplished' on the 20% target implies that the Government will roll into its previous guidance that it will maintain net debt between 15%-25% of GDP, which in our view still fits snugly into the 'prudent' fiscal strategy basket. Indeed, the Treasury has previously said that net debt at 30% of GDP is a prudent debt ratio.

Based on BEFU forecasts (and assuming no second round economic impacts), debt at 25% of GDP across the forecast horizon suggests the Government could lift spending by a little more than $20 billion over the next five years. But an increase of this size seems highly unlikely. Long lag times for infrastructure spending and typical delays mean it will be difficult for the Government to ramp

up capital spending in the current fiscal year (to June 2020), so we wouldn't expect to see a significant bump at least until 2021. Further, we think it's unlikely that the Government will push the limits of the 15%-25% debt window for fear of a breach.

Perhaps a more realistic guess (note: forecasting political decisions is a mug's game) is that net debt will be allowed to lift to around 23% of GDP by 2022, and maintained around that level thereafter. This implies a possible increase in spending in the $10-15 billion range. That said, the Government may want to hold something sweet back for the Budget 2020 and next year's election, meaning an increase closer to $5 billion is arguably just as likely. It really comes down to your interpretation of 'significant'.

Nonetheless, a lift in spending by $5 billion or more will certainly give nominal GDP growth a decent bump (eg a $1 billion lift in Government spending over the year to June 2019 would have added 0.35%pts to annual nominal GDP growth). However, as a rule of thumb, for every 1% the nominal economy has grown over the past 30 years, the real economy has grown about 0.6%. Based on this, an extra $10 billion in spending over the next five years could bump up real GDP growth by around 0.3-0.5%pts, but the profile of the extra spending is what really matters for growth and we won't know that until HYEFU day.

Even before the Government loosens the purse strings, developments since the BEFU should accommodate a little extra spending. However, as always, much will depend on the Treasury's economic outlook.

- Net core Crown debt is in a stronger-than-forecast starting position, with the Government's financial statements for the four months to October showing net debt $1.8 billion below forecast (reflecting the stronger opening position from the year ended June 2019 audited financial statements, which was $2.6 billion lower than forecast). However, much of this is timing-related.
- Upward revisions to nominal GDP as part of the year ended March 2019 national accounts release will lower the ratio for a given (but historical) debt level. Should the Treasury's economic forecasts assume a higher nominal GDP base, this should provide a little wiggle room (all else equal). That said, we think their near-term real GDP outlook is due for a downgrade (more on that later).

Unfortunately, assessments of how key fiscal indicators have been evolving relative to the BEFU forecasts are complicated by changes to how some tax revenue is recognised. In particular, the move to Inland Revenue's new Simplified Tax and Revenue Technology (aka START) has made income tax comparisons a little more uncertain. There's also the one-off positive impact on the books from the $2.6 billion KiwiRail impairment reversal in the year ended June 2019. So not only does it look like the HYEFU and BPS will start fresh with the fiscal strategy, it will also provide a clean slate on the noisy accounting treatment front.

In terms of the economic outlook, the Treasury's November Monthly Economic Indicators report noted that 'weaker-than-forecast investment and services exports are likely to see overall New Zealand GDP growth fall below Budget forecasts'.

In addition, the Treasury has revised its terminal neutral 90-day rate down 75bps to 3% since the BEFU (implying a neutral OCR of around 2.75%). This seems like a sensible tweak to us given the Treasury's BEFU 90-day rate forecasts implied they expected the OCR would be on hold over 2020, and gradually lifted by around 50 basis points from 2021 onwards. In fact, the RBNZ has since cut the OCR 75 basis points. So in terms of the impact of the economic outlook, the degree of monetary stimulus assumed in the forecasts should be broadly unchanged. However, the assumption change does imply that the Treasury is unlikely to be forecasting OCR hikes as they were in May (at least not as

aggressively), and that could mean lower RWT tax revenue forecasts. Win some, lose some. With the additional fiscal stimulus baked into the outlook, it will be interesting to see whether they think further OCR cuts are required.

One thing's for sure; with real Q2 GDP growth coming in at 0.5% q/q (below the BEFU forecast of 0.7%), and forward indicators suggesting their BEFU Q3 and Q4 GDP forecasts of 0.8% q/q are also on the optimistic side (we've pencilled in growth of 0.4% q/q for Q3 and 0.5% for Q4), their near-term growth forecasts are certainly due for another downgrade.

But nominal GDP is what really matters for tax revenues and spending options. On that front, nominal growth has remained solid (up 1.9% q/q in Q2). And, with the terms of trade continuing to improve as softening global growth weighs on import prices and supply-side developments keep export prices buoyed, supports remain in the pipeline. It would also be uncharacteristic for the Treasury to forecast CPI inflation below the 2% target for too long, which will also keep nominal growth forecasts buoyed.

Overall, a still-solid nominal GDP outlook suggests tax revenues are unlikely to be downgraded materially. And that implies that any uplift in Debt Management's bond issuance guidance will largely be a function of how much extra the Government plans to spend, which, as discussed, could be anywhere between $5-15 billion over the next four years (or less if they hold back for next year).

Table 1. Possible bond issuance guidance

	Jun-20	Jun-21	Jun-22	Jun-23	Jun-24
BEFU 19	10	10	8	6	N/A
HYEFU 19 (high estimate)	11	12	12	12	10
HYEFU 19 (low estimate)	10	11	10	8	7

We think Debt Management will wait until Budget 2020 before announcing a new bond syndication – at which time a 2041 nominal and 2045 linker seem likely contenders. There's plenty of scope to build up outstandings of the new 2031 NZGB between now and then.

All up, the HYEFU and BPS are shaping up to be a doozy for the economy and for markets. Here are a few key things we'll be on the lookout for:

- The size, timing, and type (road, rail, hospitals etc) of new infrastructure spending.
- How close to 25% of GDP the Government is willing to let net debt lift.
- How the Treasury's estimated fiscal impulse has changed relative to BEFU. Given typical delays on the spending front, this indicator has been overstating the stimulatory impact of fiscal settings in the near term. But looking through that, the fiscal impulse will provide a good steer on how fiscal settings have changed from a macro perspective.

The decision to loosen the purse strings comes as no surprise and is something we thought would happen eventually (particularly in the lead-up to the 2020 election). Years of under-investment in key infrastructure means there's plenty to get on with. But while some may argue that the Government hasn't gone far enough, current economic conditions (ie capacity constraints) suggest it's going to be a challenge implementing additional capex in a hurry. Infrastructure spending takes time, so if downside risks to the outlook materialise, the fiscal response will need to go a further.[1] And while the fiscal bump may come a little too late for the RBNZ's liking, this is what the economy has been crying out for for a long time.

[1] See our Insights note Let's get fiscal for further details.

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