ANZ Research

2019 Half-Year Update Review

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Contact

Miles Workman
Senior Economist
Telephone: +64 4 382 1951
Miles.Workman@anz.com

Sharon Zollner
Chief Economist
Telephone: +64 9 357 4094
Sharon.Zollner@anz.com

More spending, in time

Summary

- As previously signalled, the Government intends to increase infrastructure spending over the next few years.
- An extra $12 billion of infrastructure spending has been added to the fiscal outlook, and that will support growth over the medium term. However, given the delays typical with infrastructure spending, we doubt they'll be able to implement this as quickly as they hope. We await further announcements regarding the specific projects to be funded.
- As expected, the Government has formally declared 'mission accomplished' on its target of bringing net core Crown debt down to 20% of GDP within five years of taking office. The 15-25% debt window now applies, and according to the Treasury's latest nominal GDP forecasts there's still plenty of headroom to up the fiscal ante from here.
- Net debt is forecast to peak at just 21.5% of GDP in 2022 (previously 20.7% in 2021).
- Debt Management's bond issuance guidance has been lifted by $2 billion over the next four years to June 2023, which with $6 billion pencilled in for the additional (2024) forecast year brings total issuance over the next five years to $42 billion.
- The NZD saw a modest rally following the release, justifying the markets bias on the currency from the week prior. The 10-year NZ Government bond yield however fell around 3.5bps as the promise of additional spending did not eventuate in a materially larger government bond issuance programme – as had been anticipated by markets following the announcement of additional spending.
- Overall, the Treasury's Half-Year Update forecasts show the Government's books are expected to remain in good shape over the next five years. Underpinning this, the Treasury's economic outlook remains a little more optimistic than our own, but the flexible debt target means that shouldn't result in any tough decisions down the road – provided the target range isn't pushed to its limits.

HYEFU 2019 forecasts (Budget Update 2019 forecasts in brackets)					
Economic (June years)	2019/20	2020/21	2021/22	2022/23	2023/24
Real GDP (ann. ave. % chg.)	2.2 (3.0)	2.8 (2.8)	2.7 (2.4)	2.5 (2.4)	2.4 (N/A)
Nominal GDP (ann. ave. % chg.)	5.1 (5.8)	5.2 (5.4)	5.3 (4.9)	4.9 (4.7)	4.8 (N/A)
Current account deficit (% of GDP)	-3.2 (-3.4)	-3.4 (-3.4)	-3.6 (-3.3)	-3.7 (-3.3)	-3.8 (N/A)
Unemployment rate (June qtr, %)	4.3 (4.0)	4.2 (4.1)	4.2 (4.2)	4.3 (4.3)	4.3 (N/A)
CPI (ann. % chg.)	1.9 (2.0)	1.9 (2.1)	2.0 (2.0)	2.0 (2.0)	2.0 (N/A)
Fiscal (June years)	2019/20	2020/21	2021/22	2022/23	2023/24
OBEGAL - % of GDP	-0.3 (0.4)	0.0 (0.6)	0.5 (1.3)	1.1 (1.7)	1.5 (N/A)
Core Crown Residual Cash - % of GDP	-1.6 (-1.3)	-2.4 (-1.3)	-1.6 (-0.2)	-0.6 (0.3)	0.2 (N/A)
Net Core Crown Debt - % of GDP	19.6 (20.4)	21.0 (20.7)	21.5 (19.9)	20.9 (18.7)	19.6 (N/A)
Bond Programme (gross, NZ$bn)	10.0 (10.0)	10.0 (10.0)	8.0 (8.0)	8.0 (6.0)	6.0 (N/A)

Details and assessment

The Government has tweaked its fiscal strategy (aka Budget Responsibility Rules), declaring mission accomplished on rule number two: *The Government will reduce the level of Net Core Crown Debt to 20% of GDP within five years of taking office*. Going forward, the Government will make tax and spending decisions subject to maintaining net debt within a 15-25% of GDP window. There have been no other changes to the Government's overall fiscal strategy, which is outlined in the Budget Policy Statement.

Moving to the range target has allowed the Government to include an extra $12 billion in infrastructure spending over the next five years while still leaving a sizeable buffer for new spending announcements come Budget 2020 (should the Government feel that way inclined, as governments tend to do as elections approach). There were no new announcements on the tax and operating expenditure front. Based on the Treasury's current nominal GDP forecasts, the Government could comfortably lift spending (or reduce taxes) by another $12 billion (or more) over the next five years and still keep net debt under 25% of GDP, so there's definitely room for more.

This represents a meaningful change in fiscal stance, as the Government had previously maintained a net debt trajectory towards 20% of GDP into the 2022 fiscal year (five years after the election). But despite the decent boost to infrastructure spending, the Government has chosen to keep the net debt profile contained (peaking at just 21.5% of GDP in 2022).

From a macroeconomic perspective, fiscal policy is poised to become a little more stimulatory than previously. But we're sceptical about baking too much of this into the year-ahead outlook. After all, infrastructure spending takes time to plan and implement, and with capacity constraints currently biting in the construction sector, today's announcements appear more of medium-term story than a meaningful near-term boost to growth. In terms of back-stopping the growth outlook the latter might have been more useful to the RBNZ, but they seem content that downside risks to the near-term outlook are dissipating. And they will be happy to see the medium-term growth outlook underpinned.

The Treasury's economic outlook has been downgraded, but remains a little more optimistic than our own. However, as long as the Government doesn't sail too close to the upper limit of the debt target, that's unlikely to matter. The debt target range, if not pushed to the limit, can accommodate a slightly weaker economy. And should the economy get hit with a material downside economic shock, that's justifiable grounds to deviate temporarily from the fiscal target and deliver the economy a pick-me-up.

Key spending announcements include:

- $6.8 billion for new transport projects, with a significant portion for roads and rail, and details are to be announced at a later date;
- $400 million for school maintenance (announced prior to the Half-Year Update) over the next 2 years;
- $300 million for regional investment opportunities;
- $300 million for District Health Board asset renewal;
- $200 million for public estate decarbonisation; and
- an extra $4 billion has been added to the multi-year capital envelope (to be allocated at a later date).

The Treasury has downgraded its economic outlook…

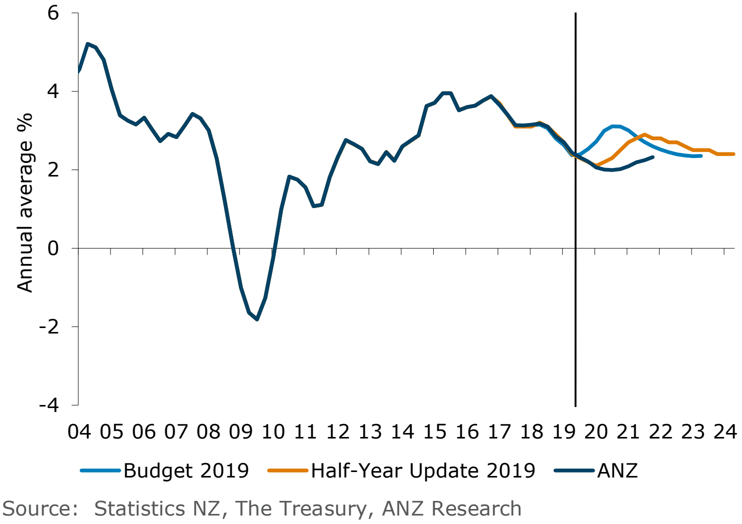
The Treasury's economic outlook still shows a pretty optimistic pick-up in growth to just under 3% by 2021, but, as expected, they have downgraded their near-term outlook meaningfully from the Budget Update.

The Treasury assumes that the easing in monetary policy over the past year and further fiscal support that has been announced will help drive a pick-up in growth and lead to a gradual rise in inflationary pressures.

The Treasury have revised their migration forecast upwards substantially, reflecting strength in recent outturns and a higher medium-term assumption. Strong population growth, low interest rates, and rising house price inflation is expected to support residential investment over the next couple of years, before growth moderates. The labour market is expected to remain tight, with the unemployment rate remaining around current levels, and solid incomes and stronger house price inflation support household consumption. Business investment is expected to pick up, as private businesses invest in response to a tight labour market and capacity constraints. Public investment and consumption spending is expected to rise in 2021 and 2022, supporting growth. The terms of trade are projected to remain around current levels.

Compared to our own economic outlook, Treasury's forecasts still appear a little optimistic, even with some extra fiscal stimulus. Their forecast 90-day interest falls around 20bp from current levels by June 2020 to 1%, possibly suggesting a further OCR cut. From there they expect the RBNZ to keep the OCR on hold before gradually hiking around 50bps over 2022-24.

Figure 1. Real GDP forecasts



Source: Statistics NZ, The Treasury, ANZ Research

…but nominal GDP is expected to hold up a bit better

But what really matters for tax revenue is nominal GDP. Here, the whole forecast profile has been given a boost relative to the Budget Update, reflecting the higher starting point (following the release of national accounts for year ended March 2019), and despite the downgrade to the real activity outlook. This supports the debt ratio from the get-go. A solid terms of trade outlook and CPI inflation at 2% over most of the forecast horizon helps keep nominal growth buoyed (which averages 5.0% over the forecast period).

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. Further disruptions to global trade and increased financial market volatility, reducing global and domestic growth. Slowing trading partner growth would reduce demand for our exports and lower the terms of trade. Less demand and increased uncertainty would reduce GDP growth and tax revenues, lowering fiscal surpluses and raising net debt.
2. A stronger domestic economy, driven by an increase in net migration that raises consumption and business activity. Rising business sentiment would increase investment and reduce unemployment. A larger workforce would boost aggregate consumption in the economy. More demand would increase inflationary pressure, which raises nominal GDP and tax revenues to generate larger fiscal surpluses and lower net debt.

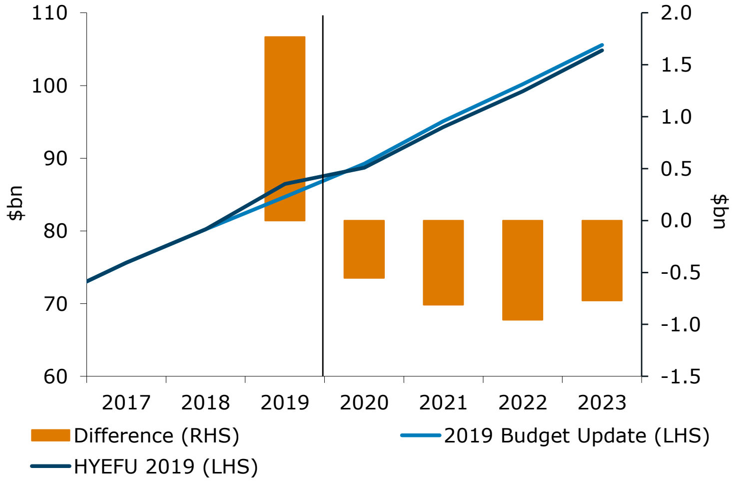
Overall, the Treasury baked more softness into their near-term central forecasts, but they still assume a bounce back in growth over 2021. On balance, the risks still appear to be skewed to the downside on growth and inflation:

- Further trade tensions could raise financial market volatility and weaken trading partner growth, with a downturn in Chinese growth of particular concern.
- The world economy could recover sooner than expected given a resolution to trade tensions or the easing in monetary conditions to date.
- The effect of low business confidence dampening domestic growth could persist.
- Weather conditions could negatively affect agricultural output and electricity generation.
- More binding than expected capacity constraints could see increased government capital spending result in higher inflationary pressures.
- Net migration could hold up more strongly than assumed.
- The proposal to increase bank capital requirements was yet to be confirmed when the forecasts were finalised.

Looking though the noise, solid nominal GDP growth keeps tax revenues growing

Despite the stronger nominal GDP profile, tax revenues are slightly weaker over the forecast horizon than was forecast at the Budget Update, but a stronger starting point provides a significant offset. Revenues are expected to lift from $86.5bn in the 2019 fiscal year to $110.5bn in the 2024 fiscal year.

Figure 2. Change in core Crown Tax Revenue

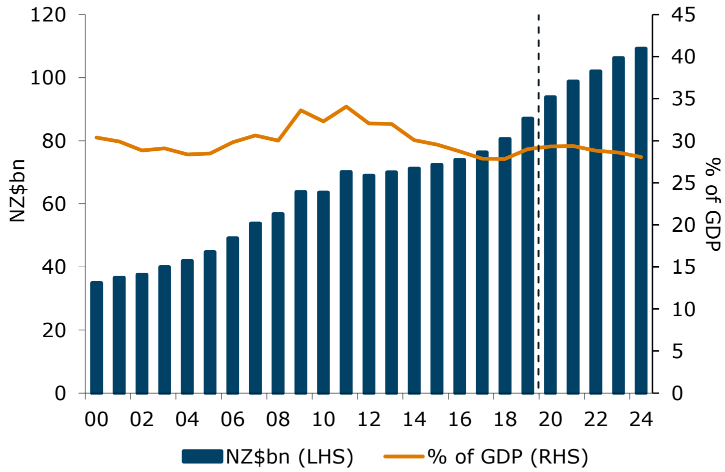


Source: The Treasury

Higher expenses, smaller surpluses, and higher debt

Core Crown expenses are slightly higher than forecast at the May Budget Update across the board. Overall, core Crown expenses are forecast to grow from $87.0bn in 2019 to $109.2bn by 2024. As a share of GDP, core Crown expenses are forecast to remain below 30%, peaking at 29.4% of GDP in 2021 before declining to 28.1% by 2024.

Figure 3. Core Crown expenses

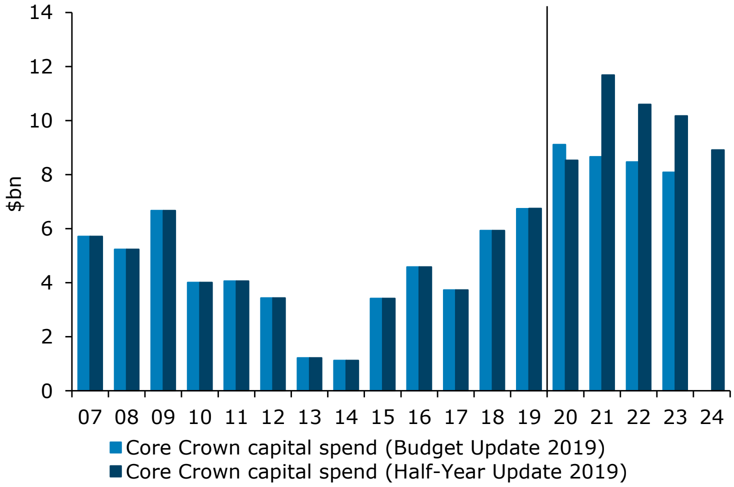


Source: The Treasury

We're not surprised by the fiscal loosening. We noted at the 2019 Budget Update that the Government's spending plans had pushed the limits of the 20% debt target and left no buffer for a slightly weaker economic and tax outlook – that was before one-off accounting changes (ie income tax recognition and the KiwiRail impairment write-down) flattered the Government's books in the year June 2019.

A little extra capital spending is a good thing. Years of capital underspend has left New Zealand with an infrastructure deficit 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 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 in order to effectively lean against the wind of a slowing economy. The jury is out on that one, but what is certainly true is that if one waits for spare capacity to open up, one is guaranteed to miss the boat in terms of timing, given the lags inherent in infrastructure spending. However, even if there's some near-term jostling, over the medium term new roads, rail, and other infrastructure that supports private sector development should boost the economy's productive capacity.

Figure 4. Core Crown capital cash flows

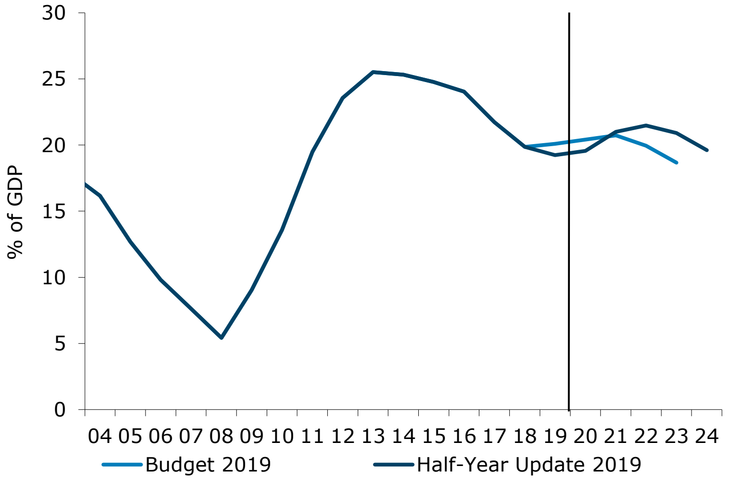


Source: The Treasury

The debt and bond issuance profile

As a share of GDP, net core Crown debt is forecast to pick up a little less than we expected. A stronger nominal GDP forecast helps that. Overall, net debt is expected to peak at 21.5% of GDP in 2022, before easing to 19.6% by 2024. In terms of the Government's 15%-25% target window, this implies there is still plenty of headroom to up the fiscal ante if they so desire.

Figure 5. Core Crown net debt

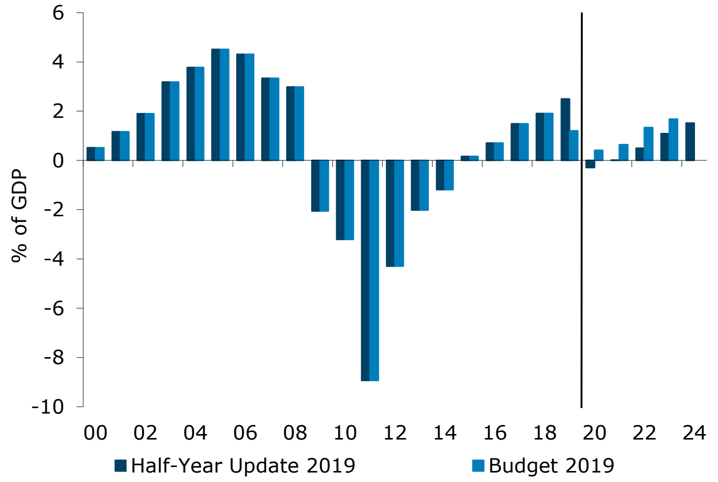


Source: The Treasury

Total borrowings are forecast to grow from $110.2bn in 2019 to $145.3bn in 2024. Total borrowings aren't part of the Government's suite of fiscal strategy indicators, but it is very important from a tax-payer's (and rating agency's) perspective, as it captures the spending decisions made outside of the core Crown accounts (such as by Housing New Zealand).

As expected, the OBEGAL surplus is a little softer over the forecast horizon. But after a brief stint in deficit in 2020 (by $900 million) it's back in growing surplus mode, lifting to $5.9 billion by 2024.

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 a similar profile. In forecast terms at least, the adjusted OBEGAL suggests the Government is delivering on its ambition to deliver sustainable surpluses across the economic cycle.

On the funding side, Debt Management's bond issuance guidance has been lifted slightly – an additional $2bn compared to the May Budget Update. Issuance guidance is unchanged out to 2022, with 2023 lifted by $2 billion. The additional forecast year is set to see $6 billion in issuance.

New issuance guidance is much lower than what we were expecting. This reflects a number of factors, including slightly higher Treasury bills issuance, a stronger starting point for cash in the door, lower financial assets in the forecast years, and a lower interest rate assumption, which for a given face value of bond issuance implies more cash in the door.

That said, we still see upside to issuance further out – either though higher spending or a weaker economy than the Treasury expect, or some combination of the two.

Table 1. Bond issuance guidance

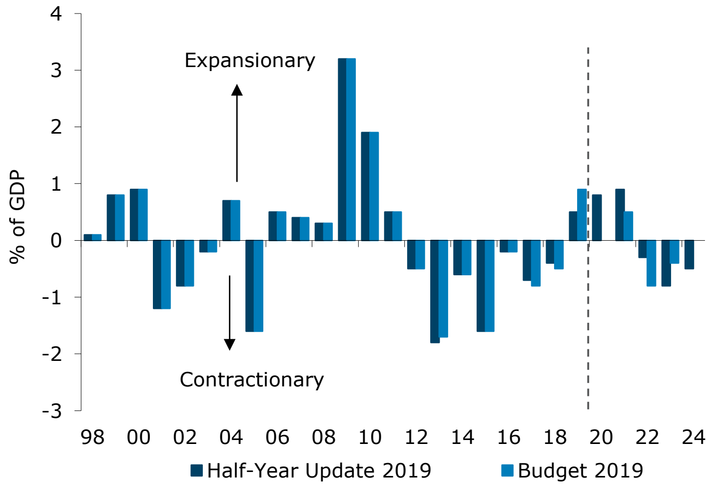
	Jun-20	Jun-21	Jun-22	Jun-23	Jun-24
Budget Update 2019	10	10	8	6	N/A
Half-Year Update 2019	10	10	8	8	6

The NZD saw a modest rally following the release, justifying the markets bias on the currency from the week prior. The 10-year NZ Government bond yield however fell around 3.5bps as the promise of additional spending did not eventuate in a materially larger government bond issuance programme – as had been anticipated by markets following the announcement of additional spending.

A little more fiscal stimulus, but it's probably overstated

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 – particularly if they take the fiscal impulse on face value, which is significantly stronger in 2020 and 2021. But looking through the noise, and the fact that the fiscal impulse generally overstates the near-term boost to activity (noting that the 2019 impulse has been downgraded), we don't think this is a game changer for the year ahead – it's more of a medium-term story. The fiscal impulse now averages zero over the forecast horizon, compared to -0.2 at the Budget Update.

Figure 7. Fiscal impulse



Source: The Treasury

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). And while today's additional infrastructure spending of $12 billion is at the higher end of our estimated range of $5-$15 billion, the near-term boost to growth is unlikely to be significant. Infrastructure spending takes time, but we're interested to see what the details bring when subsequent announcements are made.

Infrastructure spending is hard. But that's not to say it isn't worth doing. Years of under-investment in key infrastructure has resulted in a national infrastructure deficit, meaning there's plenty to get on with. But because infrastructure spending takes time, 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 later than the RBNZ might prefer, the economy has been crying out for better infrastructure for a long time.

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

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