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NEW ZEALAND GOVERNMENT BUDGET 2017 REVIEW

25 May 2017

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SUPER TROUPER

KEY POINTS

- **The 2017 Budget resembles an ABBA medley;** I have a dream (delivering for New Zealanders); the name of the game (growth); money, money, money (rising surpluses); gimme, gimme, gimme (health primarily); and lay all your love on me (infrastructure and family income package). An SOS for savings initiatives.
- **A good growth picture underpins rosy fiscal projections.** GDP growth averages over 3% (nominal 5.1%). That's a tad optimistic given capacity pressures. The operating surplus is projected to rise to 2.2% of GDP. Net debt falls to 19.3% of GDP. The bond tender programme is unchanged for 2017/18 at $7 billion and largely maintains that level thereafter.
- **The odds of a recession between now and 2021 are non-trivial given historical experience.** It's prudent to build-up a war-chest, which the strategy caters for via a more restrictive debt target (10-15% of GDP). Treasury is projecting an uplift in the business cycle in 2018/19, which we don't buy into, but we won't split hairs over that.
- **Surpluses provide options to reinvest and address priority needs and still offer tax reductions.** A $2 billion per year 'family incomes package' of adjustments to tax thresholds and increasing Working for Families is the flag-bearer. Investing in a growing economy gets $1 billion, and public services $7 billion, with $3.9 billion for health. These are large numbers but are spread over four years and are what's required just to keep the wheels turning.
- **The fiscal stance is more expansionary** to the tune of 1.1% of GDP (say 0.2-0.3ppts per year), though still restrictive in aggregate. **This is partially offset by underspend in 2016/17. But the positive fiscal impulse in 2018 and 2019 will be modestly relevant for the RBNZ.**
- **The Budget ticks all the right boxes, though the missing is savings.** It's not absent; you see semblances of it through the growth strategy, responsible fiscal management, resuming Super Fund contributions, and little microeconomic tweaks. We say 'missing link' because the economy is entering a juncture where funding a domestic savings shortfall to meet our investment needs via international capital is becoming more challenging. More domestic saving is required or investment needs to fall. **A more proactive stance towards saving is needed in the future or interest rates will need to move up further than would otherwise be the case to do the job.**

Budget 2017 forecasts (HYEFU 2016 forecasts in brackets)					
June years	2016/17	2017/18	2018/19	2019/20	2020/21
Real GDP (ann. ave. % chg.)	3.5 (3.6)	3.4 (3.5)	3.8 (2.9)	2.9 (2.4)	2.4 (2.3)
Nominal GDP (ann. ave. % chg.)	6.2 (5.2)	4.8 (5.6)	5.4 (5.0)	5.0 (4.1)	4.2 (3.9)
Current account deficit (% of GDP)	-2.8 (-3.0)	-3.0 (-3.8)	-3.3 (-4.1)	-3.7 (-4.4)	-3.9 (-4.4)
Unemployment rate (March qtr, %)	5.0 (4.8)	5.0 (4.6)	4.6 (4.2)	4.3 (4.3)	4.3 (4.3)
CPI (ann. % chg.)	1.8 (1.5)	1.6 (2.0)	2.1 (2.1)	2.2 (2.0)	2.1 (2.1)
June years	2015/16	2016/17	2017/18	2018/19	2019/20
OBEGAL - % of GDP	0.6 (0.2)	1.0 (1.2)	1.4 (1.8)	2.0 (2.2)	2.2 (2.7)
Core Crown Residual Cash - % of GDP	0.0 (-0.8)	-0.6 (-0.7)	-0.5 (0.5)	0.5 (1.0)	0.4 (0.8)
Net Core Crown Debt - % of GDP	23.2 (24.3)	22.8 (23.8)	22.1 (22.2)	20.6 (20.3)	19.3 (18.8)
Bond Programme (gross, NZ$bn)	8.0 (8.0)	7.0 (7.0)	7.0 (7.0)	7.0 (6.0)	6.0 (6.0)

2017 BUDGET REVIEW

I HAVE A DREAM

It's business as usual in terms of key priorities:

- **Keeping the economy growing**.
- **Delivering better public services**, including, we note getting the Productivity Commission to look at how productivity could be lifted across the government sector.
- **Social investment**.
- **Infrastructure**.

On top of that, emerging priorities are:

- **Resilience** – a lower net debt target (announced earlier) of 10-15% of GDP by 2025 and a small tax hike via a lift in EQC levies. While strong surpluses are projected (refer below), any cash is eaten up by investment needs, so residual cash is pretty well zippo on average over the projection period.
- **Family incomes;** sharing the spoils.

None of this is surprising. Most of this rhetoric has been a feature of the Budget for years. It's basic, sensible and ticks all the right boxes. However, the stronger focus on the latter two will reflect a) where the economy sits in the business cycle (ie well advanced); and b) political and economic reality.

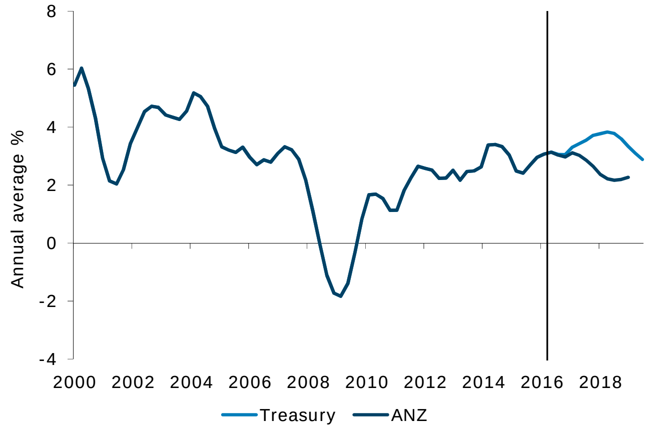
NAME OF THE GAME

Growth is the name of the game, and the Budget projections expect a fair bit of it.

The economy is projected to grow just over 3% per year in real terms over the forecast period. The usual drivers (migration – stronger for longer, construction, commodity prices etc) feature.

Treasury is expecting growth to accelerate back towards 4% in 2018/19 with the Family Income package a key driver. We suspect most of this will get crowded out; the economy simply doesn't have the capacity to see that sort of uplift.

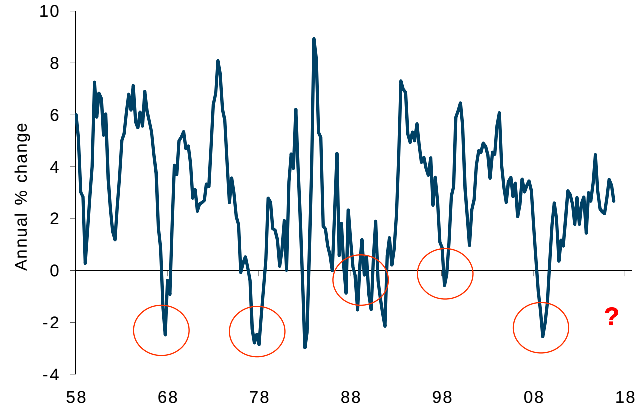
FIGURE 1. REAL GDP: TREASURY VS ANZ



Source: ANZ, Treasury

The odds of a recession between now and the projections' endpoint (2021) is non-trivial given historical business cycle dynamics. The year "8" has tended to be a graveyard for the business cycle, and 2018 is around the corner. In that situation it's prudent to build-up a war-chest to absorb such challenges, which the strategy caters for via a more restrictive net debt target (15% of GDP).

FIGURE 2. LONG-TERM GDP GROWTH CYCLES



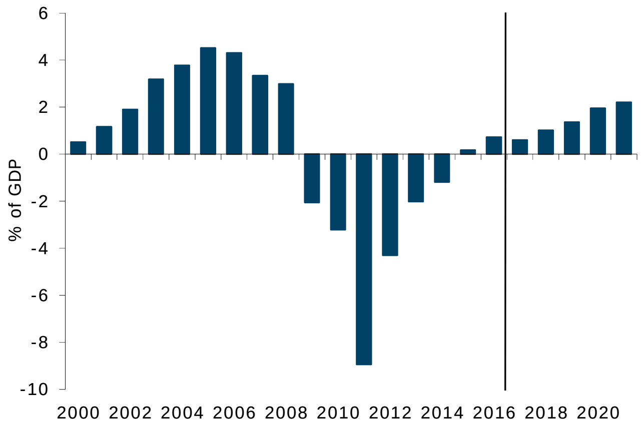
Source: ANZ, Statistics NZ

That said, we're also expecting solid growth (and anticipating that the historical pattern will be broken), so we don't have too many quibbles with the forecasts. They're a bit optimistic in our eyes but we won't split hairs over that. You just need to appreciate the risks around them.

MONEY, MONEY, MONEY

The projections show solid surpluses in each of the forecast years. The OBEGAL is projected to rise to 2.2% of GDP ($7.2 billion) by 2021, with net debt down to 19.3% of GDP by 2021. Projected surpluses tend to get whittled away, so treat those forecasts with a grain of salt. But the message is still one of strength and surpluses providing options to reinvest. Government spending as a share of GDP is projected to decline to 27.5% from 29.2% in 2015/16.

FIGURE 3. TREASURY OBEGAL FORECASTS

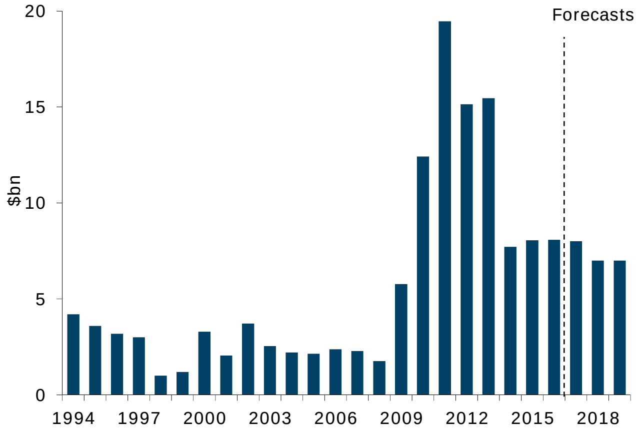


Source: Treasury

2017 BUDGET REVIEW

A stronger economy offset by more spending initiatives left the bond tender programme largely unchanged. The programme for 2017/18 is set at $7 billion (unchanged), $7 billion in both 2018/19 and 2019/20, and $6 billion in 2020/21. Aggregate issuance (including the current financial year) is $35 billion compared with prior estimates of $34 billion. A new 2029 nominal bond will be launched via syndication before the end of the year. Inflation-indexed bonds are expected to be around $1 billion of the $7 billion 2017/18 programme. The DMO also plan to begin repurchasing $5 billion of the March 2019 nominal bond in 2017/18, subject to market conditions and portfolio requirements.

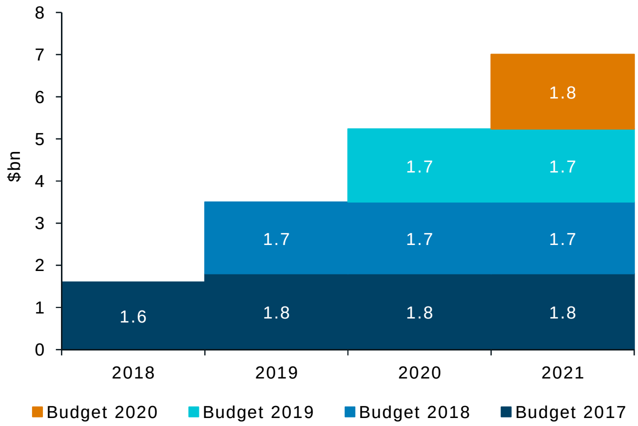
FIGURE 4. BOND TENDER PROGRAMME



Source: Treasury, DMO

The provision for future initiatives in subsequent Budgets was raised from $1.5 to $1.7 billion. Higher nominal GDP (and thus higher tax revenue) provides the flexibility, and with net migration expected to stay stronger for longer, that money will be needed to keep the wheels turning.

FIGURE 5. NEW OPERATING ALLOWANCES



Source: Treasury

The capital allowance in the 2017 Budget was upped to $4 billion (previously $3 billion), and was set at $2 billion in Budget 2018 and $2.5 billion in 2019 and 2020 (previously $2 billion).

The 2017 Budget is projecting a 5 year investment total of $30.6 billion over 5 years for the core Crown. This compares to $32.1 billion flagged in last year's Budget. The Government has a broad capital investment program (net purchase of physical assets, net investments by Crown entities and advances etc) that needs to be acknowledged.

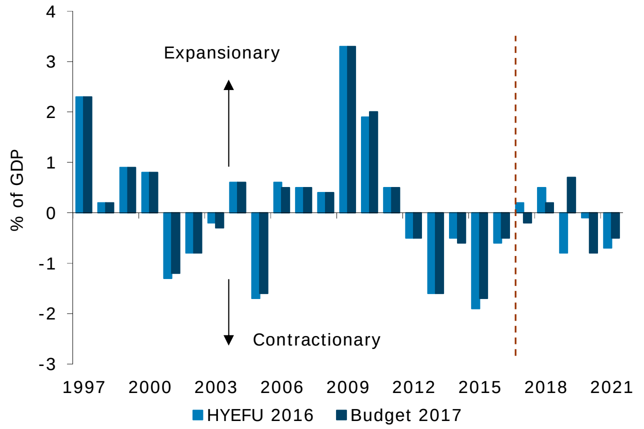
So while much has been made of the increases in capital spend, some is being offset elsewhere as money from Peter is taken to pay Paul.

Nonetheless, this investment is still sizeable relative to what the Government has typically undertaken. New capital spend and existing commitments by the Government and key agencies amount to more than $32 billion over the coming four years; that's a lift of 40% versus the last four years. So prospects for the construction sector remain very good.

KNOWING ME, KNOWING YOU

The fiscal stance is more expansionary to the tune of 1.1% of GDP (0.2-0.3ppts per year) over the forecast period.

FIGURE 6. CORE CROWN FISCAL IMPULSE



Source: Treasury

It's still restrictive in aggregate over the forecast horizon by -0.7% of GDP, with an expansionary stance in 2018 and 2019 but a contractionary position in 2020 and 2021. The latter partly reflects the perennial projected slowdown in spending, a popular feature of Budget forecasts largely because it's so far out you never really get held to it.

The change in stance is somewhat offset by underspend in 2016/17, but the fiscal impulse in 2018 and 2019 – and the nature of it (more

2017 BUDGET REVIEW

stimulus directly into the household sector) – will be modestly relevant for the RBNZ. The economy has an investment boom; sedate consumption is required to offset the inflationary pressure. The impulse from the Working for Families package (see below) will need to be closely perused.

LAY ALL YOUR LOVE ON ME

A $2 billion per year families package is the flag-bearer within the Budget. This includes:

- **Tax threshold changes** ($14k threshold lifted to $22k, and $48k to $52k).
- **Discontinuation of the 'independent earner' credit.**
- **Increasing the family tax credit.** The first child under 16 increases by $9 per week and for each child under 16 between $18 and $27 per week. Abatement rates were lifted as well.
- **Raising the maximum payment under the accommodation supplement** for a two-person household by between $25 and $75 per week, and larger families by $40-$80 per week.
- **Lifting accommodation benefit payments by up to $20 per week for students.**

The target group is low-to-middle income earners with young families and higher housing costs.

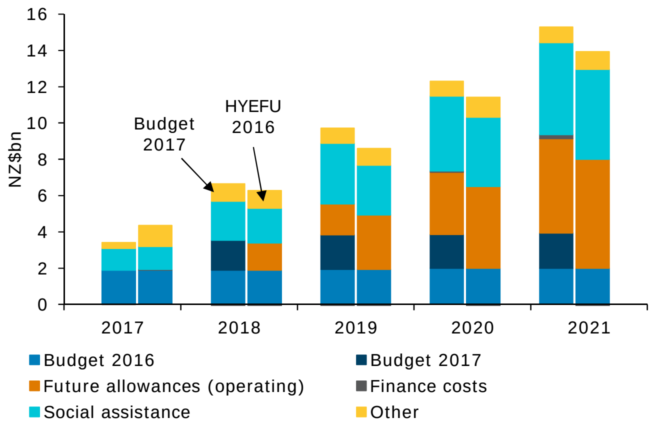
GIMME, GIMME, GIMME

In terms of the broader Budget package, there was the usual mixture of growth, infrastructure, health and social initiatives. These included:

- $1 billion investing in a growing economy.
  - Innovate New Zealand ($373 million)
  - Trade ($134 million to forge new trade opportunities).
  - Tourism ($61 million tourism infrastructure fund and $86m for DoC).
  - Natural resources ($81 million for predator control).
  - Film ($22 million over four years).
- Public services ($7 billion).
  - Health ($3.9 billion, with the recent pay settlement chewing up $1.5 billion of this)
  - Education ($1.1 billion)
  - Vulnerable children ($434 million)
  - Justice ($1.2 billion)
  - Social Development ($194 million)
  - Social housing ($185 million)
- Social Investment: $321 million, targeted at the most vulnerable.
- Infrastructure investment of $4 billion. This includes Kaikoura, rail around New Zealand, the Auckland city rail loop, new schools, defence, justice and health.

The numbers sound large but in most cases they are packages spread over four years.

FIGURE 7. INCREASE IN CORE CROWN EXPENSES



Source: Treasury

SOS

The missing link in this Budget are initiatives to stimulate saving; this is an issue that is set to become pertinent given the shortage of domestic saving to fund investment, and shifting perceptions towards reliance on international funding (drawing on global saving).

Savings policy is not absent. The Government is pulling a lot of levers via:

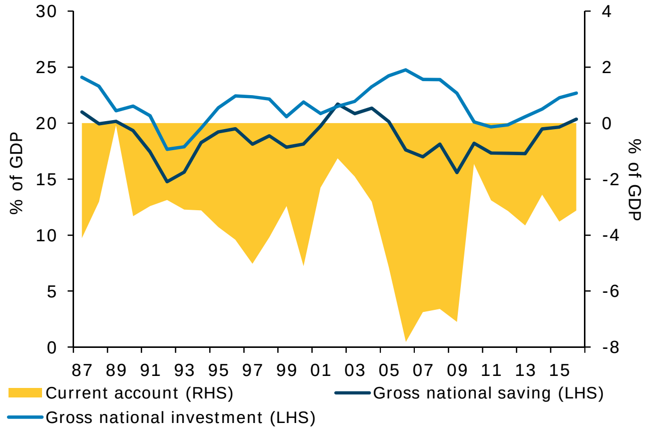
- the growth strategy;
- responsible fiscal management;
- resuming Super Fund contributions in 2021;
- KiwiSaver, now ingrained in the national psyche;
- little microeconomic tweaks; and
- boosting low-to-middle income family incomes.

New Zealand has a considerable pipeline of investment needs. This largely reflects catch-up, along with depreciation of the existing stock, the needs of an expanding (and shifting) economy, and the necessities of catering for a rapidly growing population. Items on the list range from critical housing requirements to transport, infrastructure, schools, hospitals and hotels (tourism).

2017 BUDGET REVIEW

Given a domestic saving shortfall, New Zealand's typical modus operandi has been to fund its investment needs through offshore borrowing, accessing the global savings pool (ie running a large current account deficit), with the banking sector acting as intermediary.

FIGURE 8: NATIONAL SAVING AND INVESTMENT



Source: ANZ, Statistics NZ

While that is still possible to a degree, New Zealand is facing far more challenges given prudential restrictions on foreign bank funding, credit rating agency attention, and financial stability considerations. Accumulating offshore debt is getting more attention, and it's not of the positive variety. **We can probably run a current account deficit up to 4.5% of GDP so global capital is still accessible, but anything beyond that will see net external debt lifting as a share of GDP.**

The onus is falling more on the saving side of the ledger to pull its weight to fund domestic investment needs. While a decent income growth backdrop will assist, there will still be trade-offs. In order for the investment wheels of the economy to continue to turn at the rate necessary, domestic saving will need to lift. Ultimately more saving equals less consumption, with the latter the sacrificial pawn to allow stronger investment.

We believe a more proactive stance towards saving is going to be required in the future. The savings laggard is the household sector. **It's just a question of time before more active encouragement is required and the playing field between housing and other investments will need to be drawn into the mix.** If saving fails to improve, then in the absence of more international debt being piled on, investment will need to fall. Or the relative price of credit (interest rates) will need to shift to such a level to get the right outcomes between saving and investment. It's that simple.

Expect this theme to grow in relevance over coming years as continued pressure mounts to not just maintain but lift investment. Everyone knows lifting investment is a necessity and we can't keep borrowing as we have done in the past to do it. There is as yet insufficient thought going into the realities of how this is going to be financed, given current saving performance.

ASSESSMENT

With the hard yards on fiscal replenishment done, and solid growth projected, the Government is in the enviable position of having options.

They've chosen to deliver on that via a balanced approach:

- Surpluses as far as the eye can see, though normal caveats apply.
- A strong focus on building resilience and rainy day coffers.
- A massive investment program; we're behind the 8-ball but at least we're fronting up and not borrowing to do it.
- The fiscal impulse is modest, but not overly worrying from a monetary policy perspective.
- The inevitable election-year lollies.
- The usual injections into key areas (health and education) to keep the wheels turning.

We're struggling to think of another country around the globe that can deliver that mix.

More proactive policy is going to be needed to lift national saving to fund national investment requirements (the Government sector is self-financing; the broader economy is not), but that's tomorrow's story, not today's.

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