DEAR PRUDENCE

- The key message in next week’s Budget will be that the Government can achieve its fiscal targets despite tough trade-offs regarding spending priorities.
- The Treasury’s forecasts are expected to remain upbeat, and to show that the Government can squeeze out a little more spending over the next five years and still meet its debt objective.

KEY POINTS

- **In the Government’s first Budget we expect to see strict adherence to the Budget Responsibility Rules**, including a projected return of net core Crown debt to 20% of GDP within five years. Consistent with this, the Government has announced that it has reprioritised around $700m in spending over four years (including a halt to irrigation subsidies). While in the grand scheme of things this isn’t a large number, it confirms the Government remains committed to achieving its debt target. But given tough trade-offs about spending priorities it seems unlikely they will be aiming to overachieve on that front, and we expect some strong messaging around spending pressures and the need to push these targets to their limit.

- **Revenues should get a small bump** from the new “Amazon tax” (GST on online purchases under $400), the removal of negative gearing on investment property, and the targeting of foreign and multinational companies on the tax front. In addition, the starting point for the Government’s books is stronger than forecast in the 2017 Half Year Update. For the nine months ended March, core Crown tax revenue was running $1.1bn ahead of forecast, with expenses slightly below forecast. Accordingly, the core Crown residual cash deficit was $1.4bn narrower than forecast at $1.6bn and core Crown net debt was running at 21.4% of GDP compared to a forecast of 22.2%. The positive surprise in tax revenues is expected to persist into the last quarter of the fiscal year.

- Together, the higher stating point and small bump in revenue provide the Government with a few options. But we expect there will be little room for additional sweeteners of any significant size.

- If capital allowances are unchanged then any new spending will be operational, which could be reflected in higher operating allowances or incorporated directly into baselines. At the time of writing, the nurses’ pay settlement is a possible candidate.

- **We suspect the Treasury will maintain an upbeat economic outlook that will flatter the fiscal books.** We expect an outlook broadly similar to that in the Half Year Update, which had real GDP growth at 2.9% and 3.6% in the years to June 2018 and 2019 respectively. Nominal GDP growth averaged close to 5% per year over the five year forecast horizon. While it’s
likely that Treasury’s near-term activity forecasts will be downgraded modestly (reflecting a softer finish to 2017), the medium-term forecasts should remain upbeat. Slower near-term momentum is unlikely to dampen nominal GDP growth significantly, given we should see a stronger outlook for the terms of trade (our own ANZ Commodity price index has continued to push higher over 2018). All up, we expect a set of economic forecasts that are a bit more optimistic than our own view, which provide the basis for projected growth in tax revenues over the next five years.

- **From a stronger starting point, we expect to see slightly smaller improvements in the OBEGAL surpluses and a slower decline in net core Crown debt than in the Half Year Update.** Given our expectations for forecast higher operational spending alongside higher revenues, we expect core Crown residual cash flows to follow a broadly similar profile to that in the Half Year Update. That should correspond to no change in the NZDMO’s bond issuance guidance. However, given we believe the risks lie towards softer economic outcomes (relative to Treasury) we see future upside risk to the issuance profile. Markets will be on the lookout for any details or plans to fund infrastructure spending off the Crown’s balance sheet through the use of special purpose vehicles outside of the DMO.

- **Stepping back, New Zealand’s fiscal accounts are in a strong position relative to many international peers** and that provides options should economic risks materialise. However, as things stand, we think there is room for a bit more capital spending. There is a clear infrastructure deficit, and done well, infrastructure investment pays for itself through stronger future productivity and GDP growth (beyond the initial impetus to growth). More importantly, future-proofing the basics – keeping the population housed, healthy, schooled, cyber-connected and efficiently moving – provides the platform upon which high-performing economies are built. But it is a balancing act. The Government needs to ensure their spending doesn’t compete with and crowd out private activity. This is why the focus should be on a long, relatively smooth forward-looking pipeline of prioritised infrastructure spending, with the option to ramp up if economic activity were to soften.

- **Given the pressures we’re seeing on infrastructure and the likely balance of risks around Treasury’s economic outlook, we suspect the debate on loosening fiscal targets is not over.** But for Budget 2018, the Government will be eager to show it can deliver on its Budget Responsibility Rules in a pragmatic and prudent fashion.

### ANZ expectations of BEFU 2018 (HYEFU 2017 forecasts in brackets)

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<tr>
<td>Real GDP (ann. ave. % chg.)</td>
<td>2.8 (2.9)</td>
<td>3.5 (3.6)</td>
<td>2.1 (3.0)</td>
<td>2.7 (2.6)</td>
<td>2.2 (2.1)</td>
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<tr>
<td>Nominal GDP (ann. ave. % chg.)</td>
<td>5.1 (5.0)</td>
<td>5.2 (5.3)</td>
<td>5.1 (5.0)</td>
<td>4.9 (4.8)</td>
<td>4.1 (4.2)</td>
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<tr>
<td>Current account deficit (% of GDP)</td>
<td>-2.4 (-2.1)</td>
<td>-2.3 (-2.3)</td>
<td>-2.6 (-2.7)</td>
<td>-3.2 (-3.3)</td>
<td>-3.6 (-3.9)</td>
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<tr>
<td>Unemployment rate (March qtr, %)</td>
<td>4.5 (4.6)</td>
<td>4.4 (4.4)</td>
<td>4.1 (4.2)</td>
<td>4.0 (4.0)</td>
<td>4.1 (4.1)</td>
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<tr>
<td>CPI (ann. % chg.)</td>
<td>1.8 (2.0)</td>
<td>1.9 (1.9)</td>
<td>2.1 (2.1)</td>
<td>2.2 (2.2)</td>
<td>2.1 (2.2)</td>
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<tr>
<td>OBEGAL - % of GDP</td>
<td>1.1 (0.9)</td>
<td>1.0 (0.9)</td>
<td>1.6 (1.6)</td>
<td>1.9 (2.0)</td>
<td>2.4 (2.5)</td>
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<tr>
<td>Core Crown Residual Cash - % of GDP</td>
<td>-0.6 (-0.9)</td>
<td>-1.4 (-1.5)</td>
<td>-0.7 (-0.8)</td>
<td>0.0 (0.1)</td>
<td>0.7 (0.7)</td>
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<tr>
<td>Net Core Crown Debt - % of GDP</td>
<td>21.2 (21.7)</td>
<td>21.9 (22.2)</td>
<td>21.8 (21.9)</td>
<td>21.1 (20.8)</td>
<td>20.0 (19.3)</td>
</tr>
<tr>
<td>Bond Programme (gross, NZ$bn)</td>
<td>7.0 (7.0)</td>
<td>7.0 (7.0)</td>
<td>7.0 (7.0)</td>
<td>7.0 (7.0)</td>
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