FROM ROCK STAR TO ROCK SOLID

HYEFU UPSHOT: The New Zealand outlook is rock solid. Despite a low inflation and commodity-price induced hit to the projected tax take, an improving trend is evident to the fiscal outlook, which will keep the ratings agencies on message. The focus on expenditure restraint will deliver a fiscal stance similar to that flagged in Budget 2014, which will thus continue to detract mildly from demand pressure and will keep the OCR lower than would otherwise be the case.

KEY POINTS

- The Treasury’s economic and fiscal forecasts remain reasonably upbeat, underpinned a solid domestic demand outlook. GDP growth over the next five years is expected to average 2.8%, slightly higher than assumed in the PREFU.
- The Treasury projections don’t look too dissimilar to our own, consistent with the economy in a strong growth and low inflation sweet-spot.
- Low inflation and the dairy-induced falls to the goods terms of trade are expected to contribute to more modest than otherwise rise in nominal GDP growth and hence government revenue, although this is partly offset by a lower outlook for crown expenditures.
- A $572m OBGEL deficit is now projected for 2014/15, with a shading down of forecast surpluses in subsequent years. This is minor in the general scheme of things with the public finances on an improving trajectory.
- Bond issuance was unchanged relative to the Budget projections, with a total of $36bn of gross issuance through to 2018/19, with issuance from 2015/16 onwards steady at $7bn per annum.
- Net public debt is expected to peak in 2015/16 and fall thereafter. This is still world class in relation to OECD peers.
- The 2015 Budget Policy Statement looks to maintain the balance between being a responsible fiscal manager and improving the supply side capacity for the economy.
- A restrictive fiscal stance will help to support a lower than otherwise NZ dollar and keep pending increases in the OCR parked until well into 2015.
THE HYEFU IN A NUTSHELL

The Treasury’s economic and fiscal forecasts remain reasonably upbeat. GDP growth over the next five years is expected to average 2.8%, slightly higher than the PREFU forecast. The unemployment rate is expected to fall from 5.4% at present to 4.5% towards the end of the projection period. The current account deficit is expected to move into the low 6% to high 5% range. Treasury have revised up estimates of potential output growth, underpinned by strengthening net immigration, increased business investment and improved productivity.

The Treasury projections are also consistent with our view that growth is becoming more domestic-demand driven, with a strong outlook for household consumption and residential and business investment. This and the declining goods terms of trade are expected to see the current account deficit rise to over 6% of GDP by the March 2016 year before easing into the high 5% range.

Inflation is projected to be below the midpoint of the RBNZ’s 1-3% inflation target until the start of 2016. Short-term interest rates are expected to firm over the projection period, but to remain historically low, symptomatic of the benign global environment and an improving supply side for the New Zealand economy. Projected falls in the NZD are gradual, reflecting the solid economic outlook in relation to an uncertain global scene.

Low inflation and the dairy-induced falls to the goods terms of trade are expected to contribute to more modest rise in nominal GDP growth and hence government revenue, with core crown revenue expected to reach $83.5bn by 2017/18 (vs $84.2bn in Budget 2014).

Given the weaker revenue backdrop, the emphasis remains on expenditure restraint and getting more value for money. The 2015 Budget policy statement confirmed that spending allowances for Budget 2015 and 2016 were each reduced to $1bn, but that the allowance was phased in over three years to provide a $2.5bn allowance for Budget 2017. Core Crown Expenditure is projected to fall below 30% of GDP by 2015/16 and remain below 30% over the projection period.

The Finance Minister notes “this will allow us to consider modest tax cuts and/or additional debt repayment in Budget 2017, as economic and fiscal conditions allow”.

FIGURE 2. CORE CROWN REVENUE AND EXPENDITURE

Source: ANZ, Treasury

The OBEAGL is projected to be a $572m deficit in 2014/15 (-0.2% of GDP), a deterioration from the +0.1% surplus flagged at the Budget. The OBEAGL surplus by the June 2018 year is expected to be a shade over $3bn in 2017/18 (versus $5.6bn projected in Budget 2014) and $4bn in 2018/19. Projections for stronger nominal GDP growth in later years helps to ensure that the HYEFU projections are on a similar improving trend to the Budget.

FIGURE 3. UNDERLYING OPERATING BALANCE (OBEAGL)

Source: ANZ, Treasury
**HYEFU 2014/BPS 2015 REVIEW**

**Net core Crown debt is now projected to peak at 26.5% of GDP in 2015/16 (vs. 26.4% in 2014/15 in Budget 2014); and is expected to fall to 22.5% of GDP by 2018/19.** In the scheme of things it is a modest deterioration in relation to the circa $240bn of nominal GDP and relation to the circa $80 Crown balance sheet.

**FIGURE 4. NET CORE CROWN DEBT**

![Net Core Crown Debt Graph]

Source: ANZ, Treasury

**The fiscal stance remains contractionary to the tune of 2.5% of GDP over the period from 2014/15 to 2017/18**, in a similar ballpark to the 2.3% of GDP in Budget 2014, with the core Crown fiscal impulse equivalent to 3% of GDP through to (and including) 2018/19. **Tight fiscal policy, all else equal, will keep pressure off OCR settings and the NZD.**

**FIGURE 5. CORE CROWN FISCAL IMPULSE**

![Core Crown Fiscal Impulse Graph]

Source: ANZ, Treasury

**BOND PROGRAMME UNCHANGED**

The domestic bond programme was unchanged compared with the Budget 2014 projections by virtue of a solid residual cash position. There will be a cumulative $36bn of bonds scheduled to be issued from 2014/15 till 2018/19.

**FIGURE 6. BOND TENDER PROGRAMME**

![Bond Tender Programme Graph]

Source: ANZ, Treasury

**BUDGET POLICY STATEMENT (BPS) 2015**

Treasury also released the 2015 *Budget Policy Statement* which reiterated the government’s key fiscal and economic priorities. These maintained a similar set of themes to the previous few years, with the focus on responsibly managing the Government’s finances, returning to an OBEGAL surplus in 2014/15 (this objective remains in place despite a small deficit being projected), maintaining surpluses, reducing net debt to 20% of GDP by 2020 including repaying net debt in dollar terms from 2017/18, building a more productive and competitive economy (improving skills, infrastructure, addressing housing affordability via the provision of more supply in Auckland and Christchurch) delivering better public services and rebuilding Christchurch (the cost of the rebuild to the Crown is now estimated at $16bn). **These are all sensible policies and will maintain the balance between being a responsible fiscal manager and improving the supply-side capacity for the economy.**

**COMMENT AND ASSESSMENT**

The Treasury projections don’t look too dissimilar to our own, consistent with the economy in a strong growth and low inflation sweet-spot. The HYEFU conveys a relatively upbeat assessment of the economic near-term outlook with a solid outlook for economic growth, and a strengthening labour market backdrop. Some...
slippage was to be expected given the run of low inflation outturns and the halving of dairy prices since February. However, the New Zealand economy remains sound under the bonnet reflecting a number of supply-side supports.

Treasury’s assessment of the risk profile (downward for the terms of trade and upward for net immigration) is likely to skew this mix of growth further, with the Treasury having a modest easing trajectory for the NZD. There remains considerable uncertainty over the speed limit of the economy and how pronounced the run of current low inflation will persist. So far, so good, however.

We are not overly concerned with the modest deterioration in the fiscal accounts. The fiscal balances are the difference between two large and variable numbers, with the lower surplus track minor in relation to the $90bn in government revenue and expenditure. Our public debt levels are low in relation to GDP and in comparison to OECD peers. The key thing is that the public finances are moving in the right direction. At the margin, lower Government saving will impact nationwide saving, which underscores the importance of the private sector doing part of the heavy lifting and for households to continue to live within their means.

A stable trend in bond issuance is projected, further emphasizing that the fiscal accounts are on the right track. The unchanged profile for bond issuance was slightly surprising in light of the marginally weaker fiscal profile, but it reflects the underlying cash position holding up well in relation to the wider fiscal accounts.

The HYEFU projections confirmed that via expenditure restraint the fiscal stance is likely to remain tight, although the increase in operational expenditure allowances for Budget 2017 (and potential tax cuts) will detract from this at the margin. A restrictive fiscal position remains a headwind to the economic outlook, and all else equal is helping to support a lower than otherwise NZ dollar and Official Cash Rate. A low inflation backdrop is likely to keep the OCR on hold through till the remainder of next year, with fiscal policy playing a role.

### SUMMARY OF HYEFU PROJECTIONS

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<td>Unemployment rate (March qtr, %)</td>
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<td>CPI (ann. % chg.)</td>
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| **June Years** | **2013/14** | **2014/15** | **2015/16** | **2016/17** | **2017/18** | **2017/19** |
| OBEgal - % of GDP | -1.3 (-1.1) | -0.2 (0.1) | 0.2 (0.5) | 1.0 (0.9) | 1.1 (1.3) | 1.4 (1.3) |
| Operating Balance - % of GDP | -1.2 (-1.2) | 0.8 (1.2) | 1.4 (1.6) | 2.1 (2.0) | 2.2 (2.5) | 2.6 (2.5) |
| Core Crown Residual Cash - % of GDP | -1.8 (-1.9) | -1.7 (-2) | -1.4 (-1.2) | 0.0 (-0.2) | 0.2 (0.1) | 0.6 (0.1) |
| Net Core Crown Debt - % of GDP | 25.6 (25.9) | 26.5 (26.8) | 26.5 (25.9) | 25.2 (24.3) | 24 (23.8) | 22.5 (23.8) |
| Bond Programme (Gross) | 8.0 (8.0) | 8.0 (8.0) | 7.0 (7.0) | 7.0 (7.0) | 7.0 (7.0) | 7.0 (7.0) |

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