ASB

Economic Note

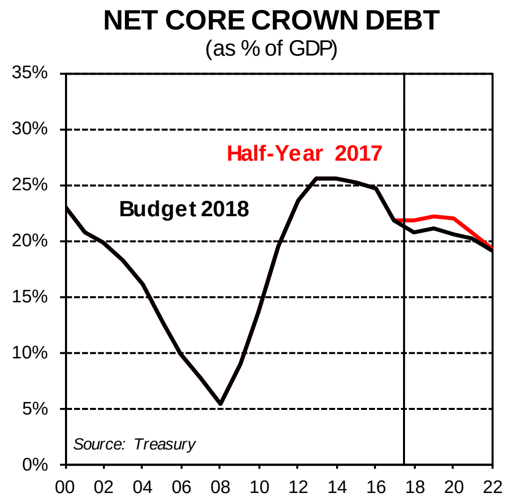
Budget 2018 Review

17 May 2018

Granting with prudence

- Budget 2018 shows a healthy set of Government books, with the Government on target to keep to its fiscal responsibility rules.
- However, we anticipate less tax revenue than Treasury and a marginally less rosy fiscal picture over the 5-year forecast period.
- All things considered though, this Budget is a solid effort and should boost the Government's fiscal credibility.

Summary



The new Labour-NZ First Government has effectively passed its first fiscal credibility test. The Budget and the healthy forecasts show that the Government is on target to achieve its fiscal targets. In particular, the Budget shows that net debt is on track to fall below 20% by 2021/22**.**

In part, the **Treasury's slightly generous economic and tax revenue forecasts (in our view) have helped the Government get there.** However, we do agree with the general trends that the Budget forecasts provide and thus acknowledge that this Budget is a prudent one.

In terms of policy, there aren't a lot of new initiatives to focus on. Indeed, the main spending increases come in baseline increases for health, education and housing: "rebuilding critical public services" as the Government puts it.

Meanwhile, **the wellbeing framework (that we thought would be an interesting sidebar to this Budget) has been effectively deferred to Budget 2019.** In fact, the Government has already named it *Budget 2019: the Wellbeing Budget*.

Interestingly, an announcement buried in the Fiscal Strategy Report may well go a long way to summarising the theme of this Budget. Specifically, **the Government is going to consult the public later this year on the creation of an Independent Fiscal Institution.** Such organisations already exist in the UK and Australia, for example. They are generally set up to report independently on the sustainability and accuracy of fiscal policies announced by either governments or opposition parties. And the creation of such an organisation here in New Zealand may well be the lasting legacy of Budget 2018

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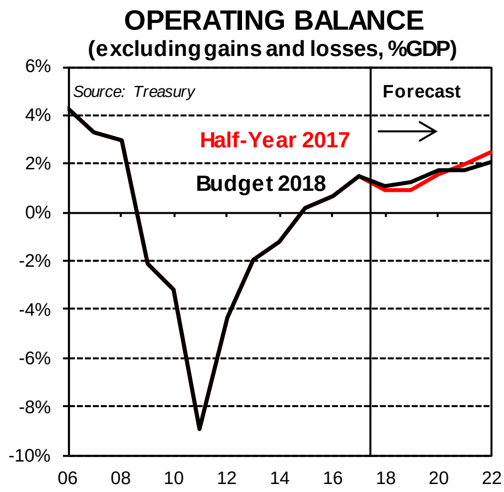
Operating Surpluses barely lower

The first Budget operating balance estimates under the new Government make for healthy reading. The Operating Balance Excluding Gains and Losses (OBEGAL) increases gradually from 1.1% of GDP in 2017/18 through to 2.1% of GDP in 2021/22.

To our surprise however, the OBEGAL estimates are only a touch lower than as at the Half-Year Update. For example, the 5-year total of Budget OBEGAL is just $400m less than the 5-year total included in the Half-Year Update.

Generally, we are less bullish than the Treasury in this regard. **We expect smaller operating surpluses**, on the back of less tax revenue than the Treasury expects. In other words, we have a more conservative view on economic growth (see our growth section for more discussion).



The flip side of the unexpectedly higher revenue forecasts is room for extra spending. On top of additional revenue, additional room for spending has been found via reprioritisation and initiatives as expected. In turn, Budget 2018 operating allowances have been increased to $2.8bn, from $2.6bn previously. Subsequent Budgets also get a lift of around $500m.

Slower pace for KiwiBuild

It was interesting to note that the Budget included a box (Page 14) that provided an update on the economic impact of KiwiBuild. Treasury notes there is no change in its overall assumptions of additional nominal residential investment generated by KiwiBuild, but **it has revised (i.e. lengthened) the timeframe over which this occurs.** The Treasury now assumes that around $2.5 billion of additional nominal residential investment (as opposed to the $5bn projected in the Half Year Update), will now occur in the forecast period which ends in June 2022.

Given intense capacity pressure in the construction sector, **this forecast change is a prudent move to better reflect the realities**, although we still view the Treasury's residential investment forecasts as being overly optimistic.

Key policy initiatives

The five key themes in Budget 2018 built on similar themes from the 100-Day Plan. The themes are:

- Rebuilding critical public services;
- Taking action on child poverty, housing and homelessness;
- Promoting economic development and supporting the regions;
- Enhancing and protecting our natural resources;
- Enriching New Zealand's culture and identity.

The *Rebuilding critical public services* theme accounts for the largest share (57%) by far of operating spending in Budget 2018. This was well-signalled by the Government as this theme includes the health, education and justice sectors as well as some welfare spending.

Breaking this theme down further, **Health grabs the lion's share of the spending**, with $3.2bn in operating spending over the four years. As the Government puts it: "Budget 2018 puts our district health boards (DHBs) back on track to deliver the quality care New Zealanders expect and deserve, when they need it". Education also accounts for a large share, with a total $1.6bn operating spending allocated over the five years. Early childhood education (ECE) is the key beneficiary, with increases in school operations grant and ECE support.

Infrastructure spending is also a focus of this Budget. The Budget forecasts include core Crown capital spending totalling $41.8 billion. Indeed, through to 2021/22 capital allowances have increased $300m in each Budget.

Specifically allowances have been set at $3.7 billion for Budget 2019, $3.4 billion in Budget 2020, and $3.0 billion from Budget 2021 onwards.

Major capital programmes include the School Growth Package, KiwiBuild, the City Rail Link and Housing. The Infrastructure Fund, Kaikōura rebuild and Crown Infrastructure Partners will also proceed as planned. Like the operating allowance much of the increase in capital spending is devoted to health and education, with the Government also committing around $2bn to Kiwibuild. Meanwhile, contributions to the NZ Super Fund have resumed in the current financial year.

Other notable expenditures are:

- **The justice sector is set to receive $1bn in operating expenditure and $216m in capital.** Included in this is increasing the number of police officers and added funding for managing offenders.
- **Research and Development has been allocated $1.1bn in operating expenditure**, as has enhancing New Zealand's international presence (foreign aid; diplomatic and trade representation).

Net Debt on track, bonds replace T-bills

The net debt track also shows a steady decline over the forecast period. The Budget shows net core Crown debt falling from 20.8% of GDP in 2017/18 to 19.1% of GDP in 2021/22. Net debt as a % of GDP averages 0.8 percentage points lower than as forecast in the Half-Year Update. Notably, net debt reaches 19.1% of GDP by 2012/22 as signalled by the Government.

As per the comments above, **we are less bullish than the Treasury** in this regard. We expect higher net debt over the forecast period. That said, we still expect net debt to decline over the forecast period and anticipate that the Government is still likely to get net debt below 20% of GDP by 2021/22.

As expected, the Debt Management Office (DMO) has made a small increase in the Government bond programme. **Gross issuance is expected to total $38bn over the next five years.** Compared to the Half-Year Update, the bond programme has increased by $3bn, with an additional $1.0bn in each of the 2018/19, 2019/20 and 2020/21 years.

Gross NZGB issuance $bn	2017/18	2018/19	2019/20	2020/21	2021/22	5-year Total
Budget 2018	7	8	8	8	7	38
Half-Year Update 2017	7	7	7	7	7	35
Change in issuance	0	1	1	1	0	1
NZGB's on issue (% of GDP)	25.00%	23.30%	22.90%	20.90%	22.00%	

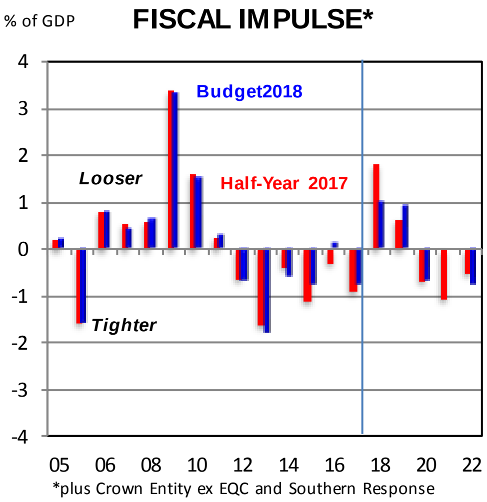
The $3bn increase in bond issuance offsets a $2bn expected reduction in outstanding T-bills over the forecast period, a reduction driven by a change in the DMO's funding strategy. The net lift in borrowing over the forecast period is $1bn, in line with our expectations for increased borrowing.

Economic Forecasts

The Budget economic projections depict a solid outlook for the NZ economy, with annual average growth (June years) in a 2.5% to 3.4% range over the projection period, somewhat higher than the 2.9% annual growth assumed for potential output. The Budget lists the usual supports, including the strengthening global economy and rising export prices, the terms of trade remaining close to record levels, strong population growth, accommodative monetary policy, rising household wealth and steady growth in household incomes. As such, pressures are expected to intensify on existing labour and goods market capacity, although the pick-up in consumer price and wage inflation is expected to be modest.

The Treasury notes that forecasts of nominal GDP in the Budget were cumulatively $46 billion higher over the five years to June 2022 than forecast in the Half Year Update, $40bn of which reflects historical revisions (and hence has limited implications for the fiscal outlook).

Modestly strengthening wage growth and the terms of trade around record highs are expected to contribute to strong rates of nominal GDP growth over the projection period (range of 4.5% to 5% per annum until June 2022).



The fiscal impulse suggests that fiscal policy will be supporting growth both this fiscal year and next, before policy moves to a more neutral phase. Increased government operating and capital spending (which includes the new Families Package), is expected to contribute to a pick-up in the pace of growth over 2018/19. Thereafter, growth in total government spending is forecast to slow and tax revenue to strengthen, which helps to restrain the build-up of demand pressures in the economy.

The Treasury's growth forecasts are stronger than ours in the near term, but lower than ours for later years. Our forecasts have a stronger outlook for private consumption (and higher wage inflation outlook), but we are less upbeat than Treasury on the outlook for residential and wider investment. We view activity in the residential sector to be at (or past) its peak given capacity constraints and cost pressures as opposed to the strong growth assumed in the Treasury projections.

With this in mind, it is not surprising that our nominal GDP (from the June 2020 year onwards), tax and thus OBEGAL forecasts are lower than Treasury's. The Treasury also appears to have banked more of this year's extra tax revenue over the forecast period than we have assumed. As mentioned above, **we are a touch wary of the Treasury's more bullish forecasts, although we mostly agree with the general trends.**

Market reaction

The NZD strengthened slightly following the release, potentially a relief rally in response to the Budget confirming a prudent set of fiscal numbers. The slight lift in debt issuance initially nudged 10-year bond yields up 2-3 basis points, adding to momentum from earlier overseas moves. The overall market reaction was very muted, indicating financial markets are quite comfortable with the fiscal numbers.

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