# Economic Note

**Budget 2019 Review**

30 May 2019

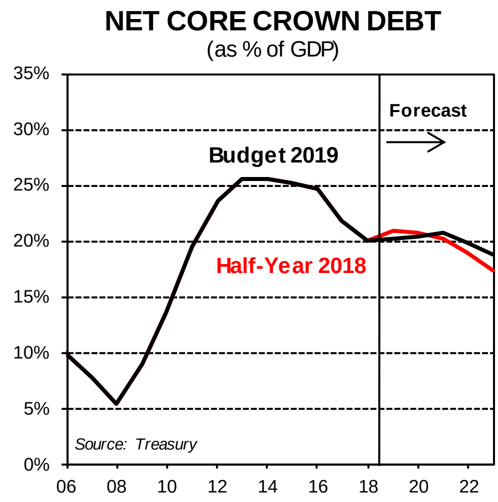
## Being well-budgeted

- The Wellbeing Budget showed a healthy set of Government books.
- Notably, the Government has announced additional spending, investment and borrowing compared to the Half-Year Update.
- However, we are a touch less optimistic than the Treasury on the growth and tax revenue outlook.
- On this basis, we suspect that there may be a small risk that the Government misses its net debt target, although time will tell.

### Summary

**This Budget ticks all the usual fiscal boxes.** The Treasury estimates show small surpluses, while net debt tracks down below 20% of GDP by the end of the forecast period. So far, so good.

**Also, the Government has incorporated additional spending compared to the Half-Year Update.** The Budget 2019 operating allowance has been increased by $1.4bn and the Budget 2020 allowance has been increased as well. And in many ways, the economy could do with the boost.




**However, we see downside risks to Treasury's economic and tax revenue forecasts.** Indeed, while our real GDP forecasts are within cooee of Treasury's, our nominal GDP forecasts are lower. Note that it's nominal GDP that matters for tax revenue.

**As such, we suspect that there may be a small risk that the Government misses its net debt target.** Indeed, the Government has committed to extra spending, investment and borrowing, assuming that it will have the tax revenue to do so. Of course, time will tell if they do.

This Government also introduced the new Wellbeing Budget. For our part, **we are supportive of the new framework and its potential for informing spending and investment decisions.** However, these changes will take time to bed down and time for the impacts of new spending and investment to be revealed. Success will also depend heavily on ensuring there is appropriate feedback from measured outcomes back into policy refinement, something NZ's short electoral cycle may hamper.

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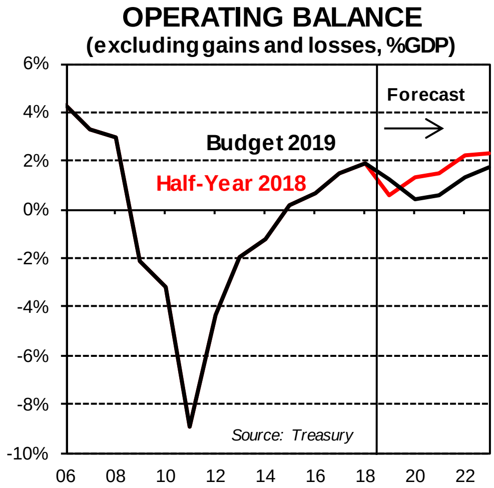
## Operating surpluses still healthy, but…




**Budget 2019 shows healthy operating balance estimates.** While the Operating Balance excluding gains and losses (OBEGAL) dips to 0.4% of GDP in 2019/20, it gradually increases to 1.7% of GDP by 2022/23.

**As we anticipated, though, the OBEGAL estimates are lower than as at the Half-Year Economic and Fiscal Update (HYEFU).** The 5-year cumulative OBEGAL is around $9bn less than the 5-year total included in the HYEFU. We largely agree with the direction and magnitude of the change in the OBEGAL over the forecast period.

However, **we expect tax revenue to be modestly weaker than Treasury's estimates**. Indeed, the Treasury's estimate of core Crown revenue over the five-year period has actually lifted compared to the HYEFU.

**Accordingly, we don't quite see the same room for additional spending that the Treasury's revenue forecasts do.** Indeed, the Government's lift in the Budget 2019 operating allowance to $3.8bn from $2.4bn contrasts to our expectation that the operating allowances would be largely unchanged. *See the growth section below for more discussion.*

## Higher net public debt than previously signalled = more bonds on issue

**As expected, Budget 2019 shows the Government meeting its debt target.** The Budget forecasts showed net core Crown debt falling from 20.7% of GDP in 2020/21 to 18.7% of GDP in 2022/23. Compared to the 2018 HYEFU, Budget 2019 shows net debt around 1% of GDP higher by the end of the forecast period.

**However, we suspect that the Government may be at risk of missing its 20% of GDP by 2021/22 net debt target.** We are marginally less bullish than the Treasury on the growth outlook and expect higher net public debt over the forecast period. This will likely translate into weaker crown revenue relative to the Treasury forecasts. There are also some (upside) risks around the outlook for government spending. Once the government spending floodgates have opened, it might prove difficult for the Government to maintain some modicum of expenditure restraint and meet its (admittedly higher) spending limits. The recent strike by teachers is a case in point.

The marginally higher net public debt profile translates into more bond issuance. **Today, the Debt Management Office (DMO) announced gross issuance will total $42bn over the next five years. This will be a cumulative $5bn higher over the 2019/23 period than previously forecast in the 2018 HYEFU.** The forecast 2019/20 New Zealand Government Bond (NZGB) programme is set at NZ$10 billion ($2bn higher than forecast at the 2018 HYEFU), with forecast bond programmes for 2020/21 and 2021/22 revised higher by $2bn and $1bn respectively. The forecast 2022/23 bond programme is unchanged at NZ$6 billion.

The DMO note the programme is consistent with the Government's commitment to maintain levels of NZGBs on issue at not less than 20% of GDP over time. **We expect that the shift to a more flexible net public debt limit from 2021/22 will impact on the issuance profile insofar as its impacts on the outlook for government debt. We will have to wait for subsequent budgets to confirm this.**

**The DMO confirmed that issuance for the remainder of 2018/19 is planned to be in line with the previously-announced Government Bond Tender Schedule**. Furthermore, subject to market conditions, a new 15 May 2031 nominal bond is expected to be launched, via syndication, before 31 December 2019. A flexible approach to Treasury-bill issuance will continue to be taken in the annual borrowing programme.

| Gross NZGB issuance $bn | 2018/19 | 2019/20 | 2020/21 | 2021/22 | 2022/23 | 5-year Total |
|---|---|---|---|---|---|---|
| Budget 2019 | 8.0 | 10.0 | 10.0 | 8.0 | 6.0 | 42 |
| Half-Year Update 2018 | 8.0 | 8.0 | 8.0 | 7.0 | 6.0 | 37 |
| Change in issuance | 0 | 2.0 | 2.0 | 1.0 | 0 | 5.0 |
| NZGB's on issue (% of GDP) | 23.5% | 23.3% | 22.2% | 23.4% | 21.6% | n/a |

## Economic Forecasts

**The economic backdrop has deteriorated somewhat since the Half-Year Economic and Fiscal** update, and the near-term economic forecasts have been revised lower to account for this. Beyond this, the economic forecasts are fairly similar to the Half-Year Update. We see the Treasury's nominal growth forecasts as being slightly more optimistic than ourselves from the June year 2021, particularly around the inflation outlook. **We remain less convinced that inflation will reach 2% as quickly as the Treasury outlook projects.**

**The Treasury's interest rates forecasts are also on the high side** as the forecasts were finalised before the Reserve Bank of New Zealand (RBNZ) cut the Official Cash Rate (OCR) in May. The Treasury commented that it does not believe the OCR cut would "substantially alter the Treasury's economic outlook". Given we expect the RBNZ to cut at least once more, we do expect there will be an impact, particularly on consumer spending, house prices and residential investment. Indeed, we have higher forecasts than Treasury on all these variables (while ASB is somewhat more conservative on non-residential investment due to low business confidence).

The 10-year Government bond yield forecasts are also somewhat higher than our own forecasts, suggesting that the Government may find borrowing costs are ultimately lower than projected.

**The revised Fiscal Impulse** confirms that Government spending over the year to June 2019 was likely simulative for economy, but not by as much as previously projected. Some of that stimulus has been shifted into the June 2020 year, but at best fiscal policy is now likely to be neutral for the economy (instead of a drag).

In an environment where the RBNZ is cutting the OCR because growth is slowing and inflation pressures are muted, one could speculate that the RBNZ may have hoped for a bit more of a boost from Fiscal settings than the Government is providing. This risk is that that, if the Government struggles to spend its money fast enough (which can be the case with infrastructure projects for example), spending is not as simulative as expected and fiscal settings end up being a contractionary force on the economy.

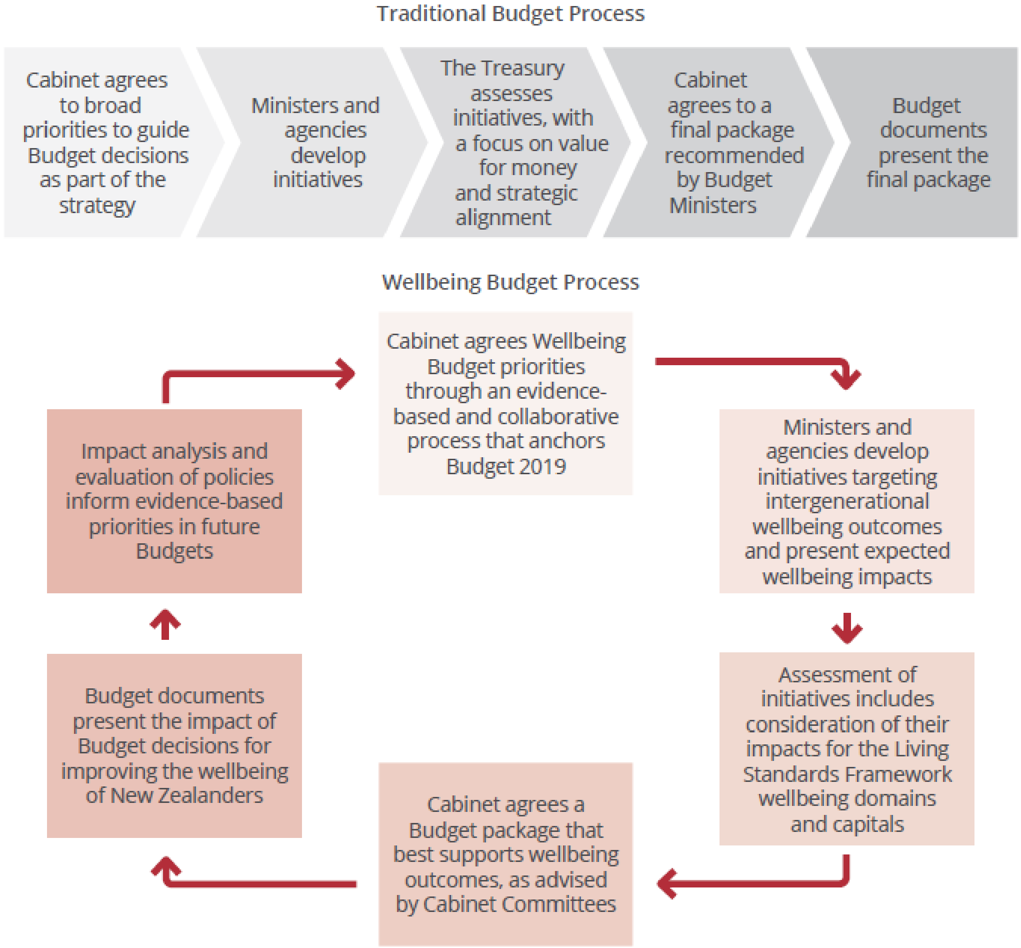
## The first *Wellbeing Budget*

Budget 2019 has been labelled by this Government as the first *Wellbeing Budget*. The Government states that it represents a significant change from how Budgets have previously been designed, developed and presented. Specifically, the Wellbeing Budget focuses on five priority areas:

- ***Taking mental health seriously***: Supporting mental wellbeing for all New Zealanders, with a special focus on under 24-year-olds. To this end, the Government announced $455m worth of funding for a new frontline service for mental health.
- ***Improving child wellbeing:*** Reducing child poverty and improving child wellbeing, including addressing family violence. On this front, the Government has announced specialist services as part of $320m package to address family and sexual violence.
- ***Supporting Māori and Pasifika aspirations***: Lifting Māori and Pacific incomes, skills and opportunities. With this in mind, Whanau Ora received a major funding boost.
- ***Building a productive nation***: Supporting a thriving nation in the digital age through innovation, social and economic opportunities. To this end, the Government has put aside $300m for a venture capital fund and nearly $200m for vocational education reforms.
- ***Transforming the economy***: Creating opportunities for productive businesses, regions, iwi and others to transition to a sustainable and low-emissions economy. The key policy for this priority area was a $1bn boost in funding for KiwiRail, while the Government has earmarked a $229m package to encourage sustainable land use.

The process for developing the Wellbeing Budget is also significantly different from the traditional budget process. The figure below gives a graphical representation of the new process.

## Figure 1: Comparison of the Wellbeing Budget process and the traditional budget process




*Source: Treasury*

## Market reaction

**Marked reaction was modest,** despite the budget signalling an increase in bond issuance and the higher profile for government spending. The NZD barely budged against the USD, while NZD wholesale interest rates were up fractionally, with larger moves higher for longer tenors. Government bond yields firmed, albeit fractionally, with larger increases for longer tenors. Yields on the 10-year NZ Government bond tenor initially climbed 4bps (to 1.76%) in the hours following the Budget announcement.

### Market reaction to Budget 2019 (released 2pm)

| Key Rates | 1:55 pm | 2:05pm | 2.40 pm |
|---|---|---|---|
| NZD/USD | 0.6514 | 0.6515 | 0.6515 |
| NZD/AUD | 0.9412 | 0.9414 | 0.9414 |
| NZD/EUR | 0.5847 | 0.5848 | 0.5851 |
| NZD/JPY | 71.33 | 71.36 | 71.37 |
| NZD/GBP | 0.5159 | 0.5160 | 0.5161 |
| NZ TWI | 72.11 | 72.11 | 72.12 |
| NZ 90 day Bank Bill | 1.67 | 1.67 | 1.67 |
| NZ 2 year swap rate | 1.48 | 1.48 | 1.48 |
| NZ 10 year swap rate | 1.95 | 1.96 | 1.97 |
| NZ 2 year bond yield | 1.28 | 1.29 | 1.29 |
| NZ 5 year bond yield | 1.41 | 1.42 | 1.42 |
| NZ 10-year Bond yield | 1.72 | 1.75 | 1.76 |

Source: Bloomberg

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