Economic Update

2016 Half-Year Economic and Fiscal Update — 8 December 2016

New PM spoilt for choice

- **Overall, Treasury paints a healthy picture of the NZ Government's books.**
- **The Government has taken the impact of the Kaikoura earthquake in its stride.**
- **For now infrastructure spending takes priority, as the Government keeps its tax cut powder dry for election year.**

FISCAL PROJECTIONS					
Period Ending (June year)	**2017**	**2018**	**2019**	**2020**	**2021**
Core Revenue ($bn)	**80.5**	**84.2**	**88.4**	**92.6**	**97.1**
(BEFU 2016)	*78.5*	*82.1*	*87.0*	*91.4*	-
Core Expenses ($bn)	**78.3**	**80.1**	**82.4**	**85.2**	**87.8**
(BEFU 2016)	*77.4*	*79.7*	*82.0*	*84.8*	-
OBEGAL ($bn)	**0.5**	**3.3**	**5.4**	**6.8**	**8.5**
(BEFU 2016)	*0.7*	*2.5*	*5.0*	*6.7*	-
OBEGAL (% GDP)	**0.2**	**1.2**	**1.8**	**2.2**	**2.7**
(BEFU 2016)	*0.3*	*0.9*	*1.7*	*2.2*	-
Net core crown debt (%GDP)	**24.3**	**23.8**	**22.2**	**20.3**	**18.8**
(BEFU 2016)	*25.6*	*25.0*	*23.1*	*20.8*	-

Implications

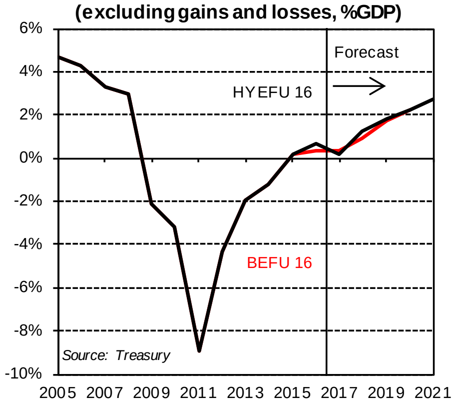
The underlying health of the Crown accounts is slightly better than that laid out in the Budget earlier this year. Revenues are firmer, but so are expenses. Operating surpluses lift in coming years to $3.3bn (1.2% of GDP) by 2018 and then further to $8.5bn (2.7 % of GDP) by 2021. In the short term, the estimated $1bn of additional earthquake costs (read Kaikoura) has reduced the extent of the expected 2016/17 surplus.

The better fiscal outlook adds to the Government's choices. A clear winner for the added revenue will be infrastructure spending, with the Government increases its capital allowances by $2.9bn over the forecast period. Debt repayment will be a further priority. Tax cuts will remain an option for next year, given ongoing bracket creep, but have been downplayed in the HYEFU release.

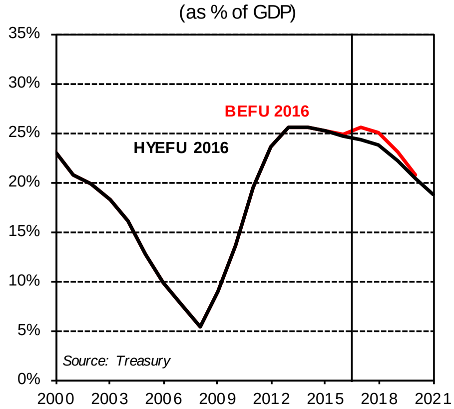
Meanwhile, the Treasury estimates the direct fiscal cost of the recent Kaikoura earthquakes to be $2-3bn. It expects a degree of the needed spending will come from reprioritising existing spending allocations and from insurance, leaving the estimated $1bn of added net spending. Earthquake costs have in the past proved over time to be larger than initial estimates. Still, at this point, the Crown's earthquake costs appear readily manageable.

At the margin, **we see the added capital spending as reducing the chances of a further OCR cut.** The construction sector will be quite stretched over several years as it meets the broader demands of a fast-growing population and earthquake recovery.

OPERATING BALANCE
(excluding gains and losses, %GDP)



NET CORE CROWN DEBT
(as % of GDP)

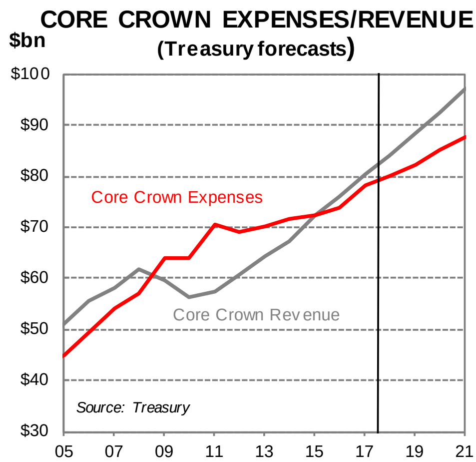


Operating Balance

The cumulative Operating Balance Before Gains and Losses (OBEGAL) is effectively unchanged from Budget 2016. In other words, the trend of steady Improvement remains. Treasury expects the OBEGAL to improve in each subsequent year, with a surplus of $0.5bn in 2016/17, increasing to $8.5bn by 2020/21.

Tax revenues are stronger compared to Budget 2016 on the back of improving economic growth. Compared to the Budget, **tax revenue has been revised up by $7.6bn across the four years** 2016/17 to 2019/20.

However, higher expenses have accounted much of the revenue gains. In particular, $1bn of Kaikoura earthquake expenses reduce the OBEGAL in the first year. And much of the remaining higher revenues are eaten away by higher benefit expenses, ACC forecast changes, and higher financing costs (i.e. higher interest rates since the Budget).



Capital Expenditure & Debt

While the Government has kept its tax cut powder dry, it has put aside more funds for capital spending. The capital spending allowance has been increased by $2.9bn over the forecast period compared to the Budget Update; a further $2.5bn has been allowed for post-2020.

All up, **the net debt track picture still shows steady improvement**. Net debt reaches its target of 20% of GDP by 2020, albeit the precise figure is 20.3% at that stage.

Economic Update

Nominal GDP growth has been revised higher, compared to Budget 2016 assumptions. This strength reflects a higher starting point, a stronger near-term outlook for prices (including dairy) and stronger real economic growth.

The economic forecasts were finalised on November 10th, prior to the Kaikoura earthquake. However, **the Treasury judges the economic impact will be small at the national level**, which is in line with our own thinking.

Overall, the Treasury's economic forecasts are reasonably similar to our own. However, the Treasury expects growth to peak in June 2017 while we expect growth to peak in 2018. Nonetheless, **we both see growth picking up over the coming years.**

Bond Programme

The bond programme has seen an additional $1bn of issuance for the current financial year to help cover earthquake costs. The plan for the following 2 years – to issue $7bn per fiscal year – is unchanged. Further out though, the 2019/20 year has been pushed lower by $1bn, down to $6bn, leaving the total size of the programme over the prior issuance horizon unchanged. The forecast for the 2020/21 fiscal year has been set at $6bn.

Bond tender programme $bn					
Period Ending June	**2017**	**2018**	**2019**	**2020**	**2021**
HYEFU 2016	**8.0**	**7.0**	**7.0**	**6.0**	**6.0**
BEFU 2016	*7.0*	*7.0*	*7.0*	*7.0*	-

Market Reaction

The report's release pushed the NZD up further for the day, with NZD/USD taking out resistance at 0.72, having stood in the 0.7185 area prior to the release. The move was more pronounced in NZD/AUD, with previous resistance around the 0.96 level swiftly eliminated, pushing the pair to around 0.9620, a gain of 40 points. The interest rate reaction was marginal. Swap rates were steady beyond a 1bp to 2.11% by the 1-year rate. The 10-year government bond yield fell 1bp, with bond issuance changes fairly neutral.

Policy and Budget 2017

Budget 2017 priorities are basically identical to the last Budget Policy Statement. The only addition is that the 4th priority, rebuild Christchurch, has been extended to also include responding to the Kaikoura earthquakes. The operating allowance has been lifted slightly as population growth requires additional investment in health, education and other key public services.

No tax policy changes were announced (yet). However, further in the document the Treasury assumes that "tax policy changes enacted and announced by the Government will take place as planned and will affect tax revenue and receipts."

Lastly, the Government's $1.0b July 2016 commitment to finance housing-related infrastructure has been formally incorporated into the Government's spending plans. This spending will be focused on high growth areas where regional councils are facing significant financial constraints in providing the required infrastructure. At this stage, the funds will be allocated over 2017/18 and 2018/19.

Economic Forecasts

Economic Forecasts	2016	2017			2018			2019			2020		
June years (ann avg)	Actual	HYEFU	ASB	Budget*	HYEFU	ASB	Budget*	HYEFU	ASB	Budget*	HYEFU	ASB	Budget*
GDP (Production)	2.8	3.6	3.2	2.8	3.5	3.7	3.3	2.9	3.3	2.9	2.4		2.6
Private consumption	2.7	4.0	3.8	3.4	3.7	4.4	2.8	3.3	4.1	2.6	2.8		2.4
Govt consumption	1.7	2.6	2.0	1.9	1.5	1.6	1.7	1.0	1.6	1.0	1.1		1.1
Residential Invest	8.2	14.3	16.4	6.7	7.8	4.0	7.1	2.1	-0.8	6.6	-1.7		0.5
Non-market Invest	12.8	2.1	3.0	4.7	3.4	7.5	3.0	-4.9	5.3	-9.5	0.2		-0.8
Market investment	0.6	9.3		5.2	6.7		6.1	6.2		7.6	3.9		5.8
Exports	5.1	1.4	1.4	-0.3	1.9	1.6	4.3	3.0	2.5	3.1	2.7		2.3
Imports	1.2	5.7	4.8	2.4	5.0	5.1	4.7	4.0	4.8	4.4	2.8		3.0
Inflation (ann % chg)	0.4	1.5	1.2	1.3	2.0	1.8	2.0	2.1	2.0	1.9	2.0		2.1
Unemployment	5.0	4.8	5.0	5.7	4.6	4.7	5.2	4.2	4.6	4.7	4.3		4.5
90-day bank bills**	2.4	1.9	2.1	2.2	1.9	2.1	2.3	2.3	2.3	3.5	3.2		4.2
TWI**	73.6	76.5	73.4	71.0	74.9	74.6	70.1	75.0	73.7	70.4	74.5		69.8

*Budget 2016 economic foreacsts were published on a March year basis, HYEFU forecasts published on a June year basis **quarter average

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