Economic Note

Half-Year Economic & Fiscal Update Review

14 December 2017

Pass mark

- The Government's books remain healthy.
- With healthy surpluses and declining net debt forecast over the 5 years.
- However, we are wary about whether Treasury's economic forecasts can be attained.
- As a result, we expect smaller operating surpluses and higher net debt over the forecast period.

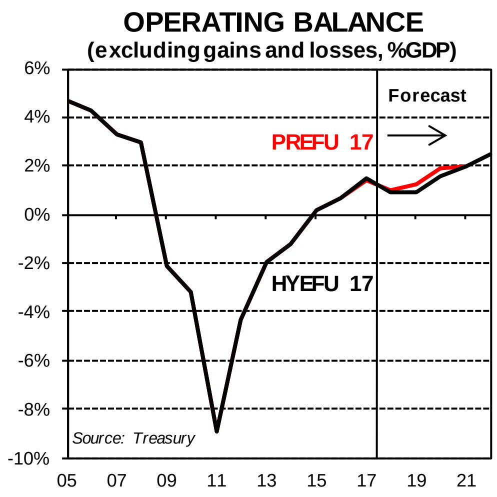
FISCAL PROJECTIONS					
Period Ending (June year)	**2018**	**2019**	**2020**	**2021**	**2022**
Core Revenue ($bn)	**84.7**	**89.5**	**94.6**	**100.0**	**105.0**
(PREFU 2017)	*84.6*	*87.8*	*92.4*	*96.7*	-
Core Expenses ($bn)	**81.7**	**86.3**	**89.2**	**92.7**	**95.3**
(PREFU 2017)	*81.0*	*83.7*	*86.1*	*89.5*	-
OBEGAL ($bn)	**2.5**	**2.8**	**5.0**	**6.5**	**8.8**
(PREFU 2017)	*2.9*	*3.5*	*5.7*	*6.4*	-
OBEGAL (% GDP)	**0.9**	**0.9**	**1.6**	**2.0**	**2.5**
(PREFU 2017)	*1.0*	*1.2*	*1.9*	*2.0*	-
Net core crown debt (%GDP	**21.7**	**22.2**	**21.9**	**20.8**	**19.3**
(PREFU 2017)	*22.0*	*21.5*	*20.0*	*18.8*	-

Implications

The new Labour-NZ First Government has effectively passed its first fiscal test. The HYEFU and the healthy forecast operating balances shows that the Government has remained committed to the Budget Responsibility Rules.

Our main quibble is that we see downside risks to Treasury's economic forecasts. As a result, **we anticipate smaller operating balances and higher debt levels than shown in these HYEFU forecasts.**

There are also a number of Labour/NZ First/Green policies that have yet to be fully developed and costed. There is also the risk that operating and capital spending allowances come under added



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pressure when Budget 2018 is prepared.

Operating Surpluses

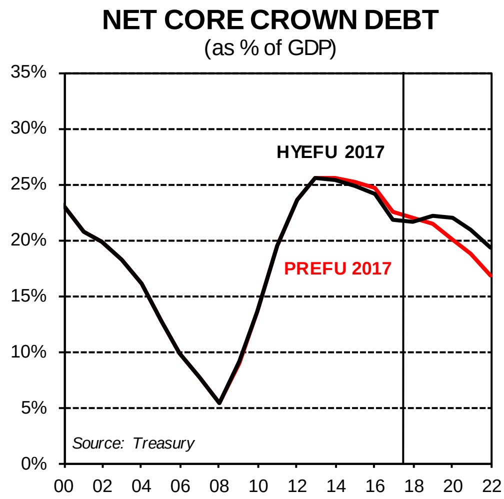
The first operating balance estimates under the new Government make for healthy reading. The OBEGAL increases steadily from 0.9% of GDP in 2017/18 and 2018/19 to 2.5% of GDP in 2021/22.

Moreover, and to our surprise, the OBEGAL estimates are largely unchanged from the PREFU. For example, the HYEFU 2020/21 OBEGAL is $100m higher than forecast at the PREFU.

Generally, we are less bullish than the Treasury in this regard. **We expect smaller operating surpluses**, particularly in the latter half of the forecast period (see our growth section for more discussion).

Net Debt & Bond Programme

The net debt track is higher, although the downward trend remains intact. The HYEFU shows net core Crown debt falling from 21.8% of GDP in 2016/17 to 19.3% of GDP in 2021/22. Compared to the PREFU, net debt as a % of GDP is around two percentage points higher in 2020/21 (20.8% vs. 18.8%). As per the comments above, **we are less bullish than the Treasury** in this regard. We expect higher net debt, particularly in the latter half of the forecast period.



Given the broadly unchanged profile for government debt relative to the Pre-election Economic and Fiscal Update (PREFU), the Debt Management Office (DMO) has announced a largely unchanged Government bond programme. **Gross issuance is expected to total $35bn over the next five years, at $7bn per annum.** Over the 2018/21 period, this was only $1bn higher than outlined in the PREFU, with the difference due to higher issuance relative to the PREFU over 2020/21.

Gross NZGB issuance $bn	2017/18	2018/19	2019/20	2020/21	2021/22	Total to 2020/21
HYEFU 2017	7.0	7.0	7.0	7.0	7.0	28
PREFU 2017	7.0	7.0	7.0	6.0	-	27
Change in issuance	0	0	0	1.0	-	1.0
NZGB's on issue (% of GDP)	25.2%	23.7%	22.5%	20.2%	21.4%	-

The Government also signalled its commitment to maintaining a sustainable NZGB market with the intention to maintain levels of NZGBs on issue at not less than 20% of GDP over time. The HYEFU projections show total NZGB issuance troughing at around $67bn in 2020/21 (20.2% of GDP) and then rising subsequently. As has already been announced, the 20 April 2029 nominal bond is planned to be launched, by syndication, between 1 January 2018 and 30 June 2018 (subject to market conditions).

Economic Forecasts

Our main quibble with the HYEFU is that we see downside risks to Treasury's economic forecasts. Accordingly, **we anticipate smaller operating balances and higher debt levels than shown in these HYEFU forecasts.**

Part of our more bearish view is due to timing. We've more time to digest recent economic developments than the Treasury has. That said, the Treasury is more bullish on migration than we are. In addition, we expect the NZ dollar to appreciate over coming years and, along with weaker migration, this accounts for the majority of our weaker growth view.

Nominal GDP growth: The forecasts are similar to the PREFU in 2018, and then slightly higher compared to the PREFU from 2019. **Slightly higher nominal GDP forecast compared to the PREFU appears to be due to the Treasury's stronger CPI forecast**. The Treasury's stronger nominal GDP growth forecasts relative to ASB's likely reflect both stronger GDP and CPI growth.

Real GDP: Treasury has lowered its 2018 growth forecast relative to the PREFU, but still sees growth lifting to 3.6% 2019 (3.7% previously). These growth forecasts are significantly stronger than ASB's, although we recently revised our growth forecasts lower and prior to this revision did have a similar outlook to the Treasury's. Treasury's growth in GDP per capita peaks in the year ending June 2019 at 1.7% and eases to 1.1% in June 2022. In contrast, ASB expects a more modest profile of steady per-capital growth of around 1% per annum. The Treasury's forecasts for consumer spending are stronger than ASB's: the Treasury has a stronger population growth forecast than ASB, with net migration slower to moderate. Meanwhile, Treasury remains more optimistic on residential investment from 2019.

Trade-Weighted Index: The Treasury has a very low assumption of 73.8, which is significantly below its previous assumption of 78. The TWI was lingering just below these levels when the forecasts were finalised, but recently lifted above 74 and we expect the TWI will to continue to rise rather than stay low. The different TWI assumption is a key point of difference between ASB and Treasury's economic forecasts, as it likely accounts for much of the Treasury's stronger CPI inflation forecast.

CPI: CPI inflation is forecast to return to 2% by June 2018, with CPI inflation higher across the entire forecast period compared to the PREFU. The weaker TWI is likely to be a contributing factor to stronger inflation in the coming year. Consistent with viewing strong inflation pressures in the economy, the Treasury expects a faster lift in the 90-day bank bill forecast from 2020, implying a more aggressive tightening cycle than ASB expects.

Economic Forecasts	2017	2018			2019			2020			2021		
June years (ann avg)	Actual	HYEFU	ASB	PREFU	HYEFU	ASB	PREFU	HYEFU	ASB	PREFU	HYEFU	ASB	PREFU
GDP (nominal)	5.9	5.0	5.2	5.1	5.3	4.1	4.9	5.0	4.1	4.7	4.8	4.2	4.1
GDP (Production)	2.7	2.9	2.7	3.2	3.6	3.0	3.7	3.0	2.8	2.8	2.6	2.6	2.3
Private consumption	4.7	3.0	2.8	3.8	3.5	3.0	3.7	3.1	2.6	2.5	2.6	2.2	2.0
Govt consumption	3.4	2.8	4.1	1.8	1.9	4.1	1.4	1.0	4.1	1.4	1.0	4.1	1.1
Residential Invest	6.3	-1.5	2.8	-0.1	3.0	0.8	4.5	6.2	-2.3	3.0	8.0	-2.8	3.9
Non-residential Invest	3.8	6.7	3.6	7.6	5.5	4.1	5.3	6.0	3.8	6.2	5.1	4.0	5.2
Exports	0.0	3.4	3.3	4.0	2.7	3.0	2.5	2.8	2.5	2.3	2.1	2.5	2.2
Imports	6.0	2.7	3.0	4.1	3.3	3.9	3.8	5.0	3.0	4.4	4.3	2.5	3.6
Inflation (ann % chg)	1.7	2.0	1.6	1.3	1.9	1.6	1.9	2.1	1.7	2.1	2.2	2.0	2.1
Unemployment	4.8	4.6	4.5	4.7	4.4	4.5	4.4	4.2	4.7	4.3	4.0	4.8	4.3
90-day bank bills*	2.0	2.0	2.0	2.0	2.4	2.4	2.6	3.6	2.9	3.3	4.1	3.4	3.8
TWI*	76.5	73.8	74.9	78.1	73.8	76.4	78.5	73.8	77.1	78.7	73.8	74.6	78.0

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