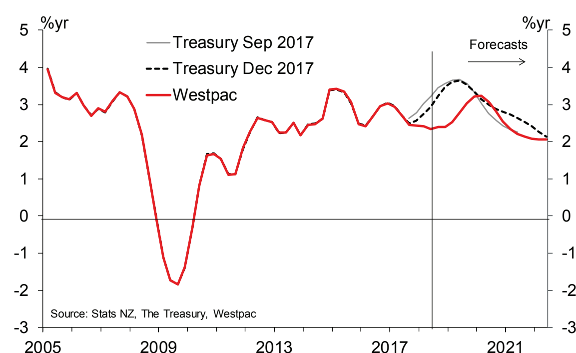
New Zealand Half Year Economic and Fiscal Update 2017

14 December 2017

Wishful thinking

- The HYEFU forecasts suggested that the Government's spending plans will be matched by a lift in tax revenue, meaning no real need to borrow more than previously planned.
- We were very surprised by that prognostication.
- This was all based on economic forecasts that we think are far too optimistic.
- We doubt the economy will live up to Treasury's bullish expectations. If it doesn't, the tax take may fall short of forecast, leaving the Government with difficult choices.

Real GDP growth forecasts



HYEFU 2017 economics forecasts

	2017(a)	2018	2019	2020	2021	2022
	Actual	F/cast	F/cast	F/cast	F/cast	F/cast
Economic (June years, %)						
Real GDP growth	2.7	2.9	3.6	3	2.6	2.1
Unemployment rate	4.8	4.7	4.4	4.2	4.0	4.1
CPI inflation	1.7	2	1.9	2.1	2.2	2.2
Current account balance	-2.9	-2.1	-2.3	-2.7	-3.3	-3.9
Fiscal						
(June years, % of GDP)						
Total Crown OBEGAL	1.5	0.9	0.9	1.6	2	2.5
Net core Crown debt	21.8	21.7	22.2	21.9	20.8	19.3
(June years, $ billion)						
Core Crown revenue	27.7	27.3	27.5	27.7	28.0	28.3
Core Crown expenses	28.0	28.5	28.6	28.2	28.0	27.6
Bond programme	8	7	7	7	7	7

The Half-Year Fiscal and Economic Update (HYEFU) showed surprisingly little change in the bottom-line projections compared to the May Budget, despite incorporating a range of new spending initiatives from the newly-formed Government. We were particularly surprised to see very little change in the expected borrowing requirement. The Government expects to fund its extra operating expenditure by lifting tax revenue, while a substantial lift in

capital spending is expected to be funded from other parts of the Government's balance sheet rather than borrowing.

In our view, the economic forecasts that underpin the fiscal projections are too optimistic. Treasury is forecasting GDP growth to accelerate to 3.6% in the year to June 2019, on the back of a sharp lift in productivity growth. In contrast, we expect a more modest lift in GDP growth over 2019 and 2020, largely based on higher fiscal spending.

Treasury is forecasting 2% per annum house price growth, whereas we think Government policies will be more effective at reducing house prices, and that a weak housing market will impact consumer spending. We anticipate a slowdown in business investment next year following the recent plunge in business confidence, whereas Treasury seems not to have taken this into account. And finally, although Treasury anticipates that Kiwibuild will crowd out private sector building activity to some extent, it is still building in a large net increase in residential investment. By contrast, we don't expect Kiwibuild to have any significant impact on the macroeconomy.

If GDP growth doesn't accelerate to the extent that the Treasury is projecting, the risk is that future revenue will fall short, requiring the Government to either rein in some of its spending plans, find additional sources of revenue, or abandon its commitment to reducing net debt so rapidly. This vulnerability isn't unique to the new Government: we made similar comments at the time of the May Budget. And since our point of disagreement relates to the outlook for economic growth several years ahead, it's likely that our concerns will remain for some time.

Fiscal projections

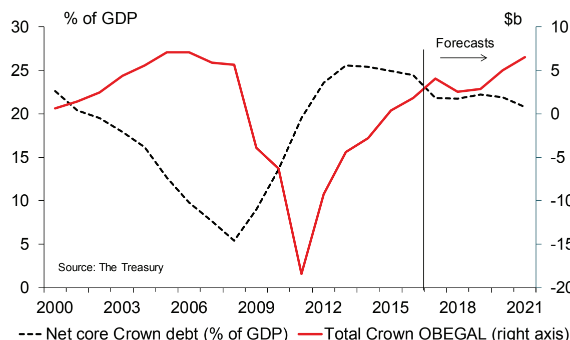
The Treasury noted that it was difficult to fully map out the economic and fiscal impacts of the new policies, given the relatively short time since the new Government was formed. Most of the detail provided was around the Government's '100-day plan' commitments, while other policies that were detailed in the coalition agreement were generally assumed to be funded out of the existing spending allowances.

The HYEFU includes an additional $8.4bn of operating spending over the next four years, compared to the Pre-Election Fiscal and Economic Update (PREFU) in August. This largely consists of a $5.5bn Families Package and an additional $2.5bn for tertiary education. This extra spending is expected to be matched by extra tax revenue stemming from the cancellation of adjustments to personal income tax thresholds, which the previous Government had scheduled for next year.

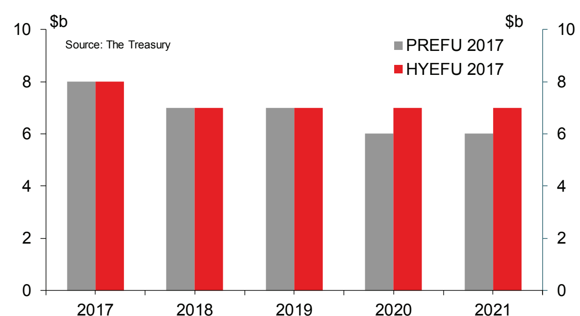
The operating balance forecasts are slightly lower for the next few years compared to PREFU. However, by the June 2021 year the surplus is expected to rise to $6.5bn, matching the PREFU forecasts, then to surge to $8.8bn in the June 2022 year. That late surge in the surplus plays an important role in the Government's fiscal responsibility commitments: it brings net core Crown debt down to 19.3% of GDP by June 2022, meeting its goal of reducing net debt to 20% of GDP within five years.

However, it's difficult to track where that sharp rise in the surplus comes from. The PREFU forecasts didn't extend

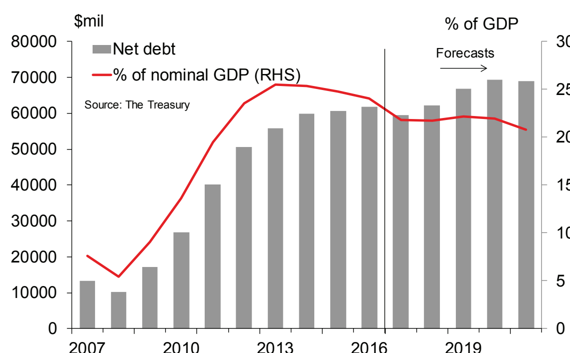
Operating balance (excl. gains and losses)



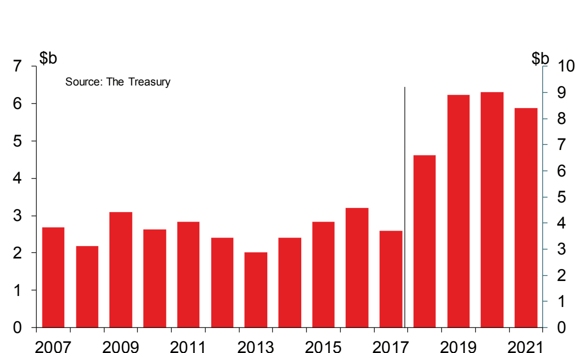
Bond issuance forecast, Budget 2017 vs HYEFU



Net core Crown debt GDP



Net capital spending



out as far as 2022, but Labour's pre-election fiscal plan assumed a $6.6bn surplus in that year. The difference in forecasts appears to come from a sharp slowdown in spending growth, but it's hard to identify where this slowdown is meant to occur.

The HYEFU also includes a substantial increase in planned capital spending, totalling $41.7bn over the next five years. This includes the restart of contributions to the Super Fund, which doesn't add to net debt as it involves accumulating financial assets. The Kiwibuild homebuilding programme has been allocated $2bn initially, as already announced, but also a further $3.4bn in later years.

Despite the large increase in capital spending in particular, expected bond issuance has been increased by only $1bn over the next four years compared to the PREFU. This implies that the Government will cover most of this additional spending from elsewhere on the Crown balance sheet, such as running down other financial assets.

Policy initiatives

Families Package

The Government will introduce a $60 per week payment for all families with children under one, extending out to three years for those on low or middle incomes. This group has a high propensity to consume, so this will tend to boost household spending. The accommodation supplement will be increased, and a new winter fuel payment will be introduced for beneficiaries and superannuitants. These changes amount to a 2-3% lift in the jobseeker benefit, and a 2% increase in superannuation payments – which will no doubt fuel debate about whether National Superannuation is affordable in the long run.

Working for Families (WFF) payments for families with children will lift substantially, and the income at which WFF payments start to abate will be lifted from $36,350 to $42,700. However, the abatement rate will increase from 22.5% to 25%, which amounts to an increase in the effective tax rate for middle-income families with children. Based on past research into the effects of WFF, these changes can be expected to reduce income inequality at the cost of reducing labour force participation among middle-income families (Treasury estimates that the total reduction in work hours will be 0.2% over the forecast period).

However, all of these increases in government transfers are still substantially smaller than the decision to cancel the previously-legislated tax cuts, so the net effect of government policy on household spending in 2018 will be negative – one more reason to expect economic growth to slow next year rather than accelerate as Treasury is forecasting.

Tertiary education

From next year, the Government will provide one free year of tertiary study, for those who have not studied previously. Over time, this will be scaled up to three free years of study. The policy will largely benefit those who were going to enter tertiary study anyway. The Government will also increase student allowances by $50 per week – as with young families, students have a high propensity to consume, so this will tend to boost private consumption.

Kiwibuild

The HYEFU allocates $5.4bn over five years to the Kiwibuild programme. The aim is that this funding will be recycled over time, as affordable homes are built and then sold on to the market.

The Kiwibuild programme is described as providing 100,000 affordable homes over the next ten years. However, the extent to which this results in a net increase in homebuilding, as opposed to crowding out the private sector, is a major point of contention. The Treasury did not give a forecast of the increase in the number of dwellings built. However, it estimates that residential building will be $5bn higher over the next five years than it would have been without Kiwibuild. Assuming an average build cost of $400,000, that would imply an extra 12,500 homes built over the next five years – well short of what the Kiwibuild programme suggests. It's clear that the Treasury is expecting a significant amount of crowding-out.

Provincial Growth Fund

The Government is establishing a $1bn per year Provincial Growth Fund as part of its coalition agreement with NZ First. This includes previously unallocated spending and some reprioritisation of existing plans. Spending will focus on capital investment, including infrastructure. This investment will aim to support jobs creation as well as other aims, such as environmental sustainability. Part of this program includes an examination of the North Island ports.

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Economic Forecasts: The Treasury and Westpac

The Treasury's economic growth forecasts have been updated for recent economic developments and the new Government's spending plans. The net impact of these changes has been a small downwards revision to growth over 2018, and an upwards revision to growth through 2021/22. To our eye, the Treasury's forecasts seem heroic, and we expect that growth will surprise to the downside.

The Treasury is forecasting that growth will accelerate to 3.6%. Underpinning this is a relatively firm outlook for household spending. This is an area where we see downside risk. Population growth has already started to slow, and we expect it will slow more sharply than the Treasury is factoring in. In addition, the Treasury is assuming that house prices will rise at a rate of around 2% per annum. In contrast, we expect that house prices will actually fall by around 1% per annum over the next few years in response to Government policies, such as the extension of the 'bright line' test on capital gains. This will be a significant drag on spending.

The HYEFU projections for investment also appear optimistic. The Treasury has assumed that business investment continues to expand at a brisk pace, as well as a relatively firm outlook for residential investment. In contrast, we expect that residential investment will grow only slowly. In addition, business investment may slow next year, following the recent plunge in business confidence.

Taking all of this on board, we expect that growth will be lower than the Treasury is assuming. Consequently, we also anticipate less pressure on inflation. This would result in lower nominal GDP growth.

The Treasury acknowledged many of the same downside risks that we have in a downside scenario that accompanied its central forecasts. In that scenario, softer investment and consumption spending result in weaker overall GDP growth and inflation (more in line with our own forecasts). If the Government's spending plans remain unchanged in the face of such conditions, the Government would face a surplus that is around $3.2b lower than it is counting on. The level of core Crown debt would also be $10.4b higher than assumed in the Treasury's central projections by 2022.

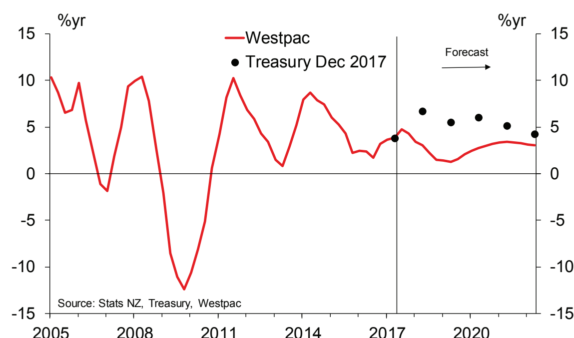
One additional point to note is that Stats NZ recently published its annual revisions to the national accounts, which increased the level of nominal GDP by 1.8% in the year to March 2017. The Treasury's did not have time to incorporate the revised GDP figures in its fiscal projections (which would have resulted in a higher forecast tax take). However, figures expressed as a share of GDP were calculated using the revised figures; for instance, the revisions reduced the net debt to GDP ratio by 0.4%.

Economic Forecasts: The Treasury and Westpac

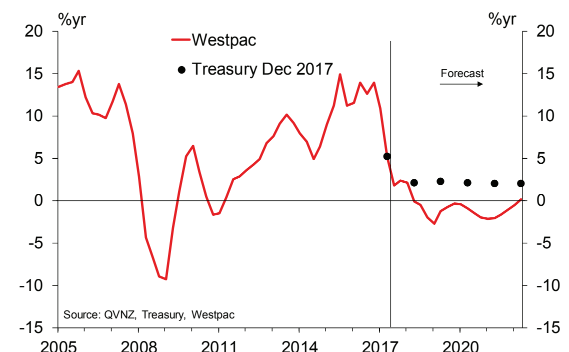
	Actual	Treasury					Westpac				
June years	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2018**	**2019**	**2020**	**2021**	**2022**
Real GDP growth	2.7	2.9	3.6	3.0	2.6	2.1	2.3	2.8	3.1	2.2	2.1
Annual CPI inflation*	1.7	2.0	1.9	2.1	2.2	2.2	1.5	1.8	1.9	1.7	1.8
Unemployment rate*	4.8	4.6	4.4	4.2	4.0	4.1	4.6	4.8	4.5	4.4	4.5
Nominal GDP growth	5.8	5.0	5.3	5.0	4.8	4.2	3.5	4.0	5.3	4.1	4.1
90-day interest rate**	2.0	2.0	2.4	3.6	4.1	4.2	1.9	1.9	2.5	3.0	3.2
TWI exchange rate**	76.5	73.8	73.8	73.8	73.8	73.8	70.9	69.8	69.9	70.1	70.9

*Quarter over same quarter last year, **Quarter average

Business Investment



House Prices



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