A step to the left

First impressions of a new Government

20 October 2017

- Labour and New Zealand First have formed a minority coalition government, with a confidence and supply agreement from the Greens.
- Policy details are thin on the ground, but the new Government is likely to be more interventionist in the economy, tougher on foreign investment, and more liberal on social spending than the last Government.
- Policy details so far suggest some downside risk to our GDP forecast for 2018 and upside risk to our GDP forecasts for 2019 and 2020, but this could change as new information comes to light.
- The impact that the new Government has on the economy, in both the short run and the long run, will depend on whether it addresses the distortions in New Zealand's tax system that favour property and have skewed the economy.
- Proposed changes to the RBNZ Act seem unlikely to have a large effect on the conduct of monetary policy.

NZ First, Labour to form coalition government

After nearly a month of negotiations, New Zealand finally knows the form of the next Government. This bulletin summarises the facts to date, and provides our assessment of the possible policy changes. Of course, details are thin on the ground at present, so our assessment will be updated as new details on the Government's legislative program come to light.

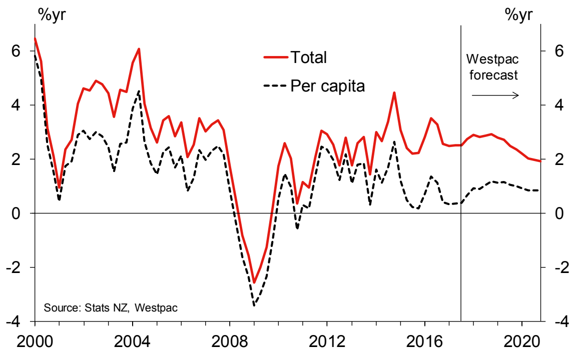
New Zealand First will form a coalition with Labour. This will be a minority government, with only 55 seats in a 120 seat Parliament. The Green Party has struck a confidence and supply arrangement with the coalition government, in return for certain policy concessions. This will be New Zealand's most diverse ruling grouping, with most legislation requiring the agreement of all three partners.

Under the deal, Jacinda Ardern will be Prime Minister, while Winston Peters has been offered the position of Deputy Prime Minister and is considering whether to accept. New Zealand First will have four ministerial positions within Cabinet and one undersecretary role, while the Greens will have three ministerial positions outside Cabinet and one undersecretary role.

During his press conference, Winston Peters said that many New Zealanders believe that today's capitalism has not delivered for them, "and they are not all wrong." While that is a rather sweeping statement, he was alluding to some genuine concerns. Over the past few years New Zealand has experienced a business upturn, with GDP growth of around 2½ to 3%. But this has mainly been driven by population growth – per capita GDP growth has been stuck around ½% per annum. In other words, households have not really been participating in the upturn.

But the real bugbear is a perception of rising inequality, particularly asset inequality – property owners have seen their wealth balloon as land prices rose, while non-property owners have been left behind and are struggling to buy their own home. In our view, the only way to fix these housing affordability concerns is to change the tax system. New Zealand's tax treatment of housing (particularly the lack of a broad capital gains tax) has skewed economic activity towards property and farming and away from other productive activities, has encouraged higher borrowing, and has skewed savings decisions towards property and away from financial assets. Property owners enjoy tax benefits, while those who do not own property have to pay rent out of their after tax income, as well as paying tax on their savings while they build towards a house deposit. To make matters worse, landlords enjoy tax-deductibility on mortgage interest while first homebuyers do not.

Figure 1: GDP growth and per capita GDP growth



How the tax treatment of property changes under the new Government is crucial to the outlook – not only for house prices themselves, but also for the economic cycle and the long-run health of the economy.

Before the election, Labour said that it would tax capital gains on property investors who resell within five years (currently two years), and remove property investors' ability to write off losses on rental properties against their personal income. If these measures do survive the coalition negotiations, they might reduce house prices by a little, but the effect would be small.

Labour also planned to convene a tax working group that might recommend some variation on a capital gains tax, land tax or deemed rate of return tax on property excluding the family home – this could produce the gamebreaker for house prices, but it is far from certain that the coalition government will go ahead with Labour's plan. The Greens are probably in support, but New Zealand First said before the election that ruling out a capital gains tax would be a bottom line in any coalition negotiation.

Labour planned to start an investment fund charged with building 100,000 affordable houses (and the associated infrastructure) over ten years – this would probably suit both the Greens and NZ First, so it is likely to become policy. In our assessment, this would have only a small effect on average house prices, although it would skew the mix of new construction towards smaller / cheaper dwellings. The investment fund would probably cause us to lift our construction forecasts, and therefore our GDP forecasts. But the effect would probably be small in the short run, because in these times of a capacity constrained construction industry some private sector activity will be squeezed out. Where the investment fund could really help is by maintaining construction activity levels during downturns, thereby maintaining housing supply and preserving skills in the construction industry.

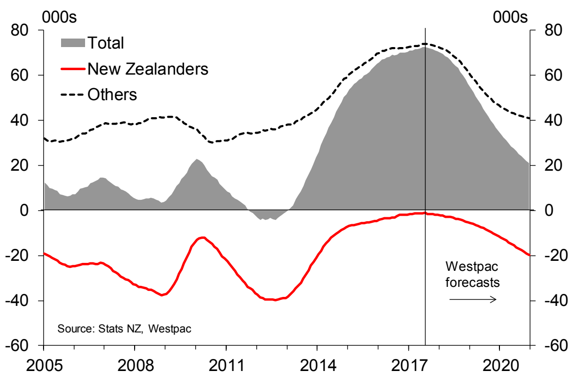
The one housing-related policy that has been announced by the Prime Minister elect is a ban on foreign buyers of residential property and tighter restrictions on the sale of rural land. This could have a downward impact on house prices, but in our view it would be fairly small. For example, in Vancouver foreign buyers were heavily taxed to the point of exiting the market completely. House prices briefly fell, but local buyers soon stepped into the breach and prices rose again. That said, a ban on foreign residential buyers would not be particularly harmful.

Closing New Zealand off to foreign direct investment in the farm sector or business sector would be a more worrying development. The OECD has identified that New Zealand's poor productivity performance is partly due to our isolation, and so improving connectivity to larger overseas economies would be of benefit. While lifting exports is part of that, the OECD singled out our restrictive foreign investment regime as a particular impediment to productivity growth. Restricting FDI further could isolate New Zealand further. We await further policy detail on this front with interest.

The new coalition Government is likely to be more interventionist in the economy than any Government New Zealand has seen in decades. New Zealand First favours hands on economic policies and regional development, and both Labour and New Zealand First's rhetoric often sounds more mistrustful of markets than the previous Government.

Both Labour and NZ First campaigned on reductions in net immigration. Labour estimated that its policies would reduce net immigration by 20,000 to 30,000 people per year, by restricting work and student visa numbers. However, net immigration has already turned. We are already forecasting a substantial reduction in net immigration over the coming few years, from over 70,000 now to around 20,000 by the end of 2020, with departures rising as well as a reduction in new arrivals. If immigration regulations were tightened, we would reduce our net immigration forecast even further. In turn, this would reduce our GDP forecast.

Figure 2: Net immigration forecast



There has been some concern in business circles about the availability of skilled labour if immigration is tightened up. We are less concerned, as the number of people involved in these shortages of highly skilled people are small and could be easily accommodated in the new targets. Recent migration policy has encouraged high numbers of low-skilled workers into the country, and it is here that business will feel the impact, with a possibility of low-skill wage rates rising. That would be no bad thing for certain sectors of New Zealand society.

Fiscal policy

The new coalition will tend to spend more than the previous Government, only partly funded by extra tax. Labour's costed fiscal plans include more spending than under the previous Government, weighted towards on education and health. This would be partly funded by cancelling the income tax cuts that were legislated to take effect on April 1 and by introducing new taxes. The balance would be funded by an additional $7bn of net core Crown debt over the next four years. In contrast, NZ First has not made any Budget responsibility commitments. Its more expensive policy proposals, such as removing GST from basic food, don't appear to have made the cut. But the coalition agreement with Labour will no doubt include some additional spending concessions, such as in regional development.

The change of government will also mean a change in the mix of capital spending. Labour has backed proposals for investment in public transport corridors in Auckland and a regional rail network between Auckland, Waikato and the Bay of Plenty. On the other hand, Labour wants to review the $1.8bn East-West Link in Auckland, and the $10.5bn of Roads of National Significance (RONS) that National proposed during the election campaign are now unlikely to happen.

If the coalition sticks roughly to Labour's proposed fiscal policy, the changes would be fairly immaterial for ratings agencies and would not lead to significantly higher government bond rates.

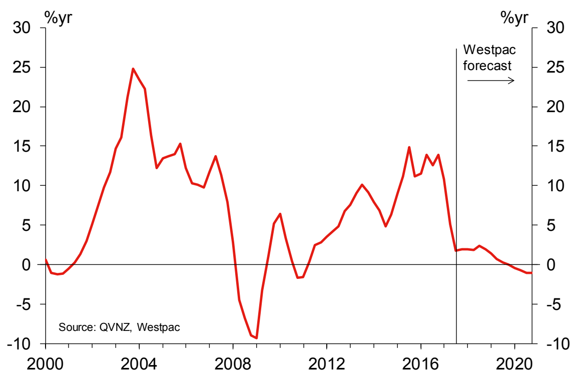
The near-term GDP and OCR outlook

Another comment Winston Peters made during his press conference was that he expects an economic slowdown to ensue. Certainly, there has been a run of weak economic data in recent months. We have been revising our GDP forecasts lower, and we have been forecasting a gradual slowdown in GDP growth for some time.

How the outlook changes from here depends on the details of Government policy, but what we know so far suggests downside risk to our GDP forecast for 2018 in recognition of the cancelled tax cuts, a possible hiatus in business investment while businesses acquaint themselves with the new government, and possibly weaker house prices than otherwise. However, with extra fiscal spending coming on stream over time and the Kiwibuild program ramping up, there may be upside risk to our GDP forecasts for 2019 and 2020.

Possible changes to the tax treatment of housing could have the biggest influence on our near-term GDP forecast. The irony for any Government is that taking action that materially reduces house prices, while probably good for society in the long run, would have a large impact on the short-term GDP outlook. Some consumer spending is essentially financed by rising house prices, and ending that cycle would cause the economy to take a near-term hit, even as it moves onto a more sustainable long-run footing. So if the tax treatment of housing was materially changed, we would move to reduce our near-term house price, GDP and OCR forecasts.

Figure 3: Westpac house price forecast



We calculate that Labour's plan to apply more fiscal stimulus to the economy will push the RBNZ's OCR forecast up by around 20 basis points relative to the counterfactual. However, other aspects of the coalition's policy manifesto will have other impacts on monetary policy. In particular, the trajectory of the housing market will be crucial, with a weaker housing market leading to a lower OCR forecast. We will provide a fuller assessment of the monetary policy outlook once more policy detail comes to light.

Monetary Policy

There are two issues at stake for monetary policy: the target(s) and the decision-making framework.

On the first issue, Labour favours a dual mandate for the Reserve Bank, with a focus on full employment as well as price stability. NZ First campaigned for what they termed a "Singaporean" model, requiring the RBNZ to target a favourable level of the exchange rate rather than the inflation rate. However, in yesterday's press conference Peters said that Labour had not agreed to this model. There has been no mention of raising or widening the existing inflation target range.

The effect of a dual employment/inflation mandate for the Reserve Bank would depend on how explicitly it's specified. In the absence of numerical targets for unemployment or the exchange rate, it's unlikely to make a significant difference to how monetary policy is run as a whole (it might be a factor in individual decisions). In countries such as the US and Australia, where the central bank has an employment mandate, it is typically specified in very loose terms.

In terms of the decision-making framework, Labour wants to move from a single decision maker to a committee, with a mix of four internal and three external members, and to publish the minutes of policy meetings. The majority of overseas central banks operate a similar framework, and with internal members holding a majority on the committee, it's unlikely to lead to substantially different monetary policy decisions – the RBNZ already operates an internal committee for monetary policy decisions.

Climate change policy

Both Labour and the Greens have committed to making New Zealand net carbon neutral by 2050, and a leaked document detailing concessions gained by the Greens has confirmed this as an aspiration of the new Government. This is much tougher emissions reduction target than the previous Government's plan. Labour planned to achieve the target via the Emissions Trading Scheme, while the Greens preferred a carbon tax and New Zealand First wanted neither, so it is uncertain how climate change policy will proceed. Importantly, both parties plan to bring agriculture within their climate change policies. This will tend to alter land use away from dairy and towards forestry. It will also reduce the burden of meeting New Zealand's climate change commitments that would otherwise be borne by non-agricultural industries.

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