

A Balancing Act

Budget 2018 Preview

Anne Boniface, Senior Economist +64 9 336 5669

- Finance Minister Grant Robertson delivers the new Government's first Budget next week.
- The policy direction has already been set by the HYEFU. Budget 2018 will maintain the focus on health, education and public service spending.
- Capital spending is expected to be broadly in line with HYEFU projections. However, the better than expected tax take and reallocated spending mean there is some extra money to play with.
- The Government remains wedded to its Budget Responsibility rules. We expect the Budget to project increasing operating surpluses, with core crown debt to GDP forecast to be less than 20% by 2021/22.

The rubber hits the road for the new Government next week with the release of their first Budget. The path was laid out last year with the release of the Half Year Fiscal Update (HYEFU) just before Christmas. Necessarily, this was something of a rushed affair, with the Treasury noting upfront that it was difficult to fully map out the economic and fiscal impacts of the new policies given the relatively short time since the 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. But even allowing for this, the HYEFU included an additional \$8.4bn of operational spending over the next four years compared to the previous Government's plan.

Fast-forward six months, and the analysis and processes behind the Budget will have gone through a much more rigorous process. So too will have the negotiation processes both between Ministers and their Departments, and also between the political parties in power: Labour, NZ First and the Greens. Stationed firmly at the pointy end of this process is Finance Minister Grant Robertson, who's balancing the Government's reputation for responsible fiscal management against a desire to allow the government to follow through with as many of its pre-election promises as possible.

A strong starting point helps this balancing act. The tax take is running \$1.1 billion ahead of forecast in the nine months to March, and the net debt position is 21.4% of GDP versus a forecast of 22.2%. In addition, the Government has managed to reprioritise \$700 million of spending over the next 4 years, and they expect tougher enforcement by the IRD to add another \$700m to revenue over the next four years.

The Government will see scope for more operating spending while maintaining projected surpluses. Beyond the near term, the Government's ability to spend will be dictated by the strength of the economy. At the time of the HYEFU, we argued that the Treasury's GDP growth forecasts looked overly optimistic. Then, growth was forecast to accelerate to 3.6% by 2019, underpinned by firm growth in business investment, ongoing growth in house prices and additional residential construction activity on the back of Kiwibuild initiatives. These are three key sectors where our take on the outlook differs. We expect a lull in business

investment and hiring, modest house price falls in response to new policies targeting the housing market, and subdued growth in total construction activity over the next year or two – despite Kiwibuild starting (since it will mainly crowd out private sector investment in a capacity constrained industry). While the Treasury may not have entirely come around to our way of thinking just yet, there may be some moderation of their forecasts, and the downside risks may get more of a mention.

The 2018 Budget will continue to focus on the Government’s core themes including sustainability, social inclusion, education and healthcare. While it won’t be the fully-fledged Wellbeing Budget that has been slated for 2019, there’s no doubt that there will be some more subtle changes in store as the Government and Treasury begin to head down this path and attempt to broaden the perspective away from just financial implications of policy initiatives.

Spending initiatives announced to date include \$100m to tackle homelessness, more than \$700m boost to overseas development funding, and \$190m extra funding for the Ministry of Foreign Affairs and Trade. There’s also a new R&D tax credit, as well as changes to apply GST to imported goods valued at less than \$400.

Despite revenue surprises, the Government still feels constrained, and will probably have to prioritise some of its spending plans. Cheaper GP visits in particular look likely to now be phased in and other policies could meet the same fate.

It remains to be seen what further announcements will be unveiled in the Budget. However, they could include more details around regional spending initiatives, the Green Investment Fund and the flagship Kiwibuild programme.

However, the Finance Minister has made it very clear that these policy initiatives will take place within the bounds of Labour’s Budget Responsibility Rules. The most tangible commitments under these rules are:

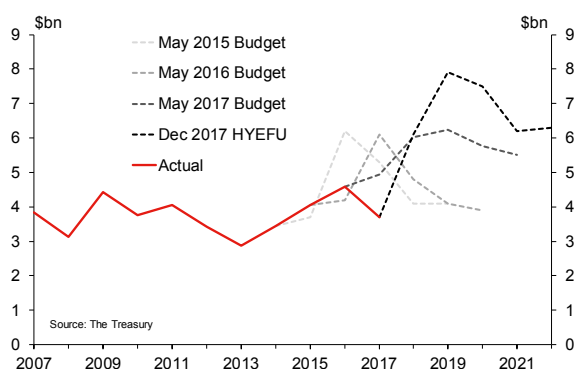
- There will be a sustainable operating surplus across the economic cycle,
- The level of core crown debt will fall to 20% of GDP by 2021/22. And,

- The Government will maintain its expenditure to within the recent historical range of spending to GDP ratio.

In a pre-Budget speech, Grant Robertson announced the Government’s capital spending plans over the next 5 years will total \$42 billion. That is around \$10bn more than the National-led Government was forecasting, but there was no increase over the HYEUFU projections. That was surprising given the Government’s rumblings about the state of infrastructure in the health and education sector in particular.

But perhaps the biggest challenge will be lifting investment to the level forecast. The Government is forecasting a near-doubling of capital spending within two years. We seriously doubt they will be able to get that much investment done, given how capacity constrained the construction sector is. Less investment would also mean less debt. Consequently, we have concluded that the Government will easily meet its debt target, but it might be for the wrong reasons.¹

Government net capital spending



Revenue surprises are likely to be largely spent on new initiatives (rather than adding to operating surpluses) and the capital spending plans won’t be changing accordingly. Given this, we expect the Government’s bond issuance programme to be broadly unchanged from current intentions.

Anne Boniface
Senior Economist

	Actual	Treasury HYEUFU forecasts					Likely direction of changes
June years	2017	2018	2019	2020	2021	2022	
OBEGAL \$bn	4.1	2.5	2.8	5.0	6.5	8.8	Tax take stronger than expected, matched by more spending.
Net debt (% of GDP)	21.8	21.7	22.2	21.9	20.8	19.3	On track to meet 20% of GDP target within five years.
Bond programme (\$bn)	8.0	7.0	7.0	7.0	7.0	7.0	No change expected, capex spending unchanged from HYEUFU.
Real GDP (ann avg % change)	2.7	2.9	3.6	3.0	2.6	2.1	Forecasts likely to be trimmed due to delays in construction.
CPI (ann % change)	1.7	2.0	1.9	2.1	2.2	2.2	A softer than expected starting point for prices.
10-year Government bond yield	2.9	3.0	3.4	3.9	4.2	4.3	Global long-term rates are heading higher.

¹ We recently released a Bulletin explaining this point further. *Spending up is hard to do – Budget responsibility rules are not the main constraint*, available on our website <https://www.westpac.co.nz/assets/Business/Economic-Updates/2018/Bulletins-2018/Fiscal-responsibility-May-2018.pdf>

Contact the Westpac economics team

Dominick Stephens, Chief Economist +64 9 336 5671

Michael Gordon, Senior Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Anne Boniface, Senior Economist +64 9 336 5669

Paul Clark, Industry Economist +64 9 336 5656

Any questions email: economics@westpac.co.nz

Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Disclaimer

Things you should know

Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141 ("Westpac").

Disclaimer

This material contains general commentary, and market colour. The material does not constitute investment advice. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Country disclosures

Australia: Westpac holds an Australian Financial Services Licence (No. 233714). This material is provided to you solely for your own use and in your capacity as a wholesale client of Westpac.

New Zealand: In New Zealand, Westpac Institutional Bank refers to the brand under which products and services are provided by either Westpac or Westpac New Zealand Limited ("WNZL"). Any product

or service made available by WNZL does not represent an offer from Westpac or any of its subsidiaries (other than WNZL). Neither Westpac nor its other subsidiaries guarantee or otherwise support the performance of WNZL in respect of any such product. The current disclosure statements for the New Zealand branch of Westpac and WNZL can be obtained at the internet address www.westpac.co.nz. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: This material has been prepared and issued for distribution in Singapore to institutional investors, accredited investors and expert investors (as defined in the applicable Singapore laws and regulations) only. Recipients in Singapore of this material should contact Westpac Singapore Branch in respect of any matters arising from, or in connection with, this material. Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking licence and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activities. This material is intended only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance. Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking Regulatory Commission (CBRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

UK: The contents of this communication, which have been prepared by and are the sole responsibility of Westpac Banking Corporation London and Westpac Europe Limited. Westpac (a) has its principal place of business in the United Kingdom at Camomile Court, 23 Camomile Street, London EC3A 7LL, and is registered at Cardiff in the UK (as Branch No. BR00106), and (b) authorised and regulated by the Australian Prudential Regulation Authority in Australia. Westpac is authorised in the United Kingdom by the Prudential Regulation Authority. Westpac is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by

Disclaimer continued

the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation(EU) 596/2014).

Investment Recommendations Disclosure

The material may contain investment recommendations, including information recommending an investment strategy. Reasonable steps have been taken to ensure that the material is presented in a clear, accurate and objective manner. Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

- (i) Chinese Wall/Cell arrangements;
- (ii) physical separation of various Business/Support Units;
- (iii) and well defined wall/cell crossing procedures;
- (iv) a "need to know" policy;
- (v) documented and well defined procedures for dealing with conflicts of interest;
- (vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission ("CFTC") as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC ("WCM"), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 ("the Exchange Act") and member of the Financial Industry Regulatory Authority ("FINRA"). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not be subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.