Spending up is hard to do

Budget responsibility rules are not the main constraint

- The new Government's first Budget will be subject to a set of self-imposed fiscal responsibility rules, effectively ensuring that it won't be a radical departure from recent Budgets.
- Questions have been raised as to whether the Government will be able to meet its target of reducing net debt to 20% of GDP.
- We think that the Government will hit this target, though perhaps not for the desired reasons.
- Limited capacity in the construction sector means that capital spending is already falling short of what was planned.
- Delayed spending also means delayed borrowing. Net debt has come in well below projections, only some of which can be put down to a stronger tax take.
- Until the government finds a way around its capacity constraints, the net debt ratio is likely to continue tracking below forecasts.

Author:

Michael Gordon

Senior Economist

Phone: +64 9 336 5670

Email: michael.gordon@westpac.co.nz

The new Labour-led Government will present its first Budget on 17 May. We'll be releasing our full preview of what to expect from the Budget itself shortly. But we felt it would be useful to separately address an issue around the constraints that the Government faces in preparing the Budget.

During last year's election campaign the Labour Party committed itself to a set of Budget Responsibility Rules, which were later affirmed in the coalition agreement. These rules include:

- Running sustainable operating surpluses across the economic cycle;
- Maintain operating spending as a share of GDP within the range of recent years; and
- Reducing net core Crown debt to 20% of GDP within five years of taking office.

The rules are similar to the principles that guided recent Budgets under the previous Government. The aim appears to have been to ward off any fears that a shift to a centre-left government would lead to a big spend-up and a worsening of the country's credit quality.

But these rules have been criticised from other angles. Some have questioned whether the net debt target is achievable given the demands on government spending – particularly around the nation's infrastructure, which is creaking under the weight of rapid population growth and past under-investment. Indeed, some argue that the government shouldn't be trying to reduce net debt, but should borrow more while interest rates are historically low. New Zealand's government debt-to-GDP ratio is already low by developed country standards, and investors and credit rating agencies would not balk at a modest increase in debt.

Regardless of the merits of this view, an infrastructure spend-up is much easier said than done.

Firstly, we note it's not strictly true that the government is reducing debt. The projections in the Half-Year Fiscal and Economic Update (HYEFU), released last December, show net core Crown debt rising to $69bn by June 2020, a $10bn increase over three years (see the first chart). But since net debt would grow at a slightly slower pace than nominal GDP, the debt-to-GDP ratio falls in the projections.

Why is the government borrowing at all, if it's running a surplus? The answer is that the 'surplus' refers only to the operating balance, which covers recurring items – ongoing expenses such as providing healthcare, education and social welfare, against ongoing sources of revenue such as tax. But this is far from the full story of the fiscal accounts.

The other major aspect is capital spending, which includes investment in long-lived assets such as buildings and infrastructure. While the capital budget is only a fraction of the size of the operating budget, it's large enough to be significant – the HYEFU included $34bn of capital spending over five years (excluding contributions to the Super Fund). That's well in excess of the projected operating surpluses over that time, so part of it will have to be funded through borrowing.

Projected spending is one thing, reality is another. From around 2015 the government began to recognise the need for a lift in capital spending, to support the rapid growth in the population. But we've yet to see actual spending rise beyond the levels seen over the last decade (see the second chart). At one point, net capital spending was projected to rise to $6bn in the June 2017 year; it actually slowed in that year to $3.7bn.

The Treasury has cited delays and capacity constraints in the construction sector as reasons for the shortfall. In this case, the spending shortfall is added back into the following years' projections. This backlog of delayed spending, plus the additions to spending plans in the last few Budgets, mean that the projections for capital spending over the next few years have ballooned out rapidly.

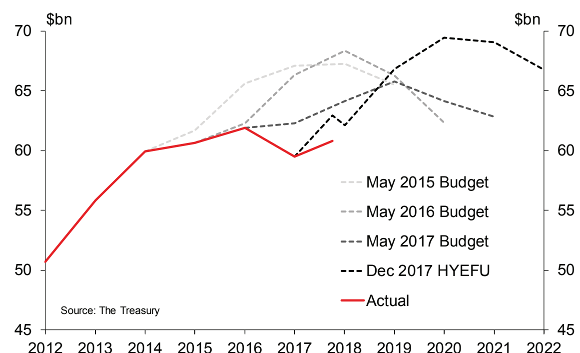
The HYEFU suggested that capital spending would reach $8bn in the June 2019 year – roughly a doubling from the pace of recent years, when capacity constraints were already holding it back. We find this implausible. It's likely that some portion of this spending will continue to be delayed.

The side effect of delayed spending is delayed borrowing. Net core Crown debt has fallen well below what was forecast in recent Budgets. Some of that can be put down to a stronger than expected tax take. But it's also the case that the government hasn't had to borrow for projects that have yet to begin.

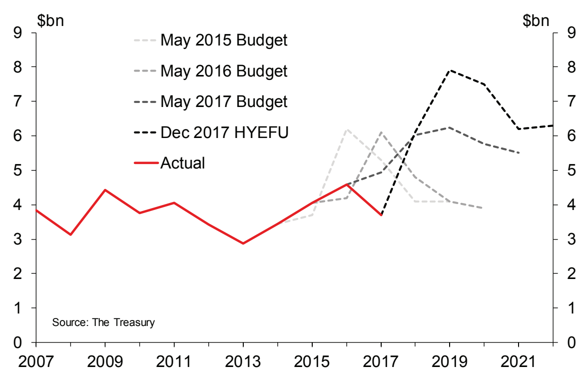
The new Government will need to find a way around the construction sector's capacity constraints just to achieve what was already in the HYEFU plans, let alone adding more to the pile. Unfortunately, the signs are that little has improved on this front. We'll have to wait for next week's Budget for an update on how capital spending is tracking, but the fiscal accounts for March show that net debt is already running $2.2bn (equal to 0.8% of GDP) below what was projected in December. Only half of that can be put down to a stronger tax take.

There's no doubt that the government could find ways to spend more money if it had to. But the critics of the Budget Responsibility Rules aren't calling for spending for spending's sake. They argue for more spending in areas that will produce a long-lasting return to the nation, such as investing in classrooms, hospitals and transport infrastructure. But these are the very same areas where the government is already struggling to spend as quickly as it would like. And while we think that the Government could meet its net debt target quite comfortably, it may not be for the reasons they intended.

Net core Crown debt



Government net capital spending



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 license 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 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.