New Zealand Half Year Economic and Fiscal Update 2018

13 December 2018

Money in the tin

- New Zealand's fiscal position remains healthy, with large surpluses forecast as far as the eye can see and debt expected to drop below 20% of GDP.
- This year's operating surplus is expected to be lower due to a catch-up on last year's unintended spending shortfall.
- The Government has scope to increase its spending while remaining within its fiscal responsibility rules, but has not done so today.
- But with the pressures of three governing political parties, we think that the Government will eventually accede to demands for more spending.
- The Treasury's economic growth forecasts previously looked too optimistic, but are now broadly in line with our view.

The Half-Year Economic and Fiscal Update (HYEFU) shows that the Government still has plenty of money in the tin, with forecasts of large surpluses as far as the eye can see and a falling debt to GDP ratio.

Yet the Government did not announce any plans to ramp up spending, even though it is comfortably within its self-imposed fiscal responsibility rules. We doubt that the Government's hands will stay off the piggy bank forever. The New Zealand public tends to ask for a slice of the action when it sees a large surplus. And the current Government faces the added pressure of having to satisfy the interests represented by three political parties. We suspect that the Government will announce an increase in spending plans closer to the time of the next election.

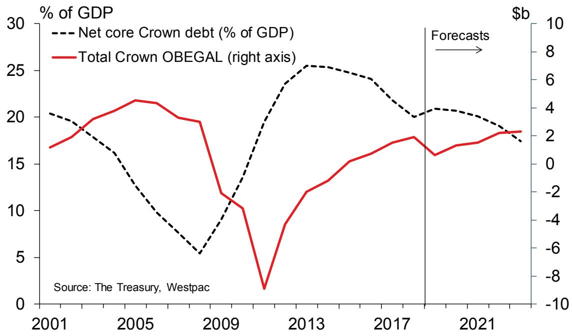
The Treasury has adopted a more realistic-looking set of economic forecasts, with moderate economic growth for the year ahead. Despite this, there was little overall change in forecasts of government revenue and spending.

The Government provided some more detail on how the Wellbeing Framework will be applied to future Budgets, and set out five whole-of-government priorities for next year's Budget. We regard the Wellbeing Framework as a positive development, but not a guarantee of good policymaking.

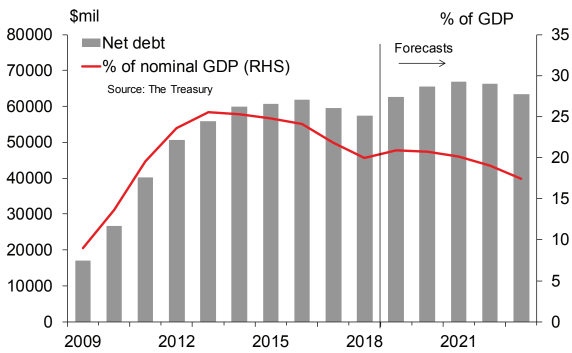
Rosy fiscal projections

At first glance, the Government's operating balance (OBEGAL) projections appear to have been revised lower. However, this reflects timing issues and some reclassification of spending. The surplus in the June 2018 fiscal year was $2.2bn higher than expected, largely due to a sizeable shortfall in spending towards the end of the year. The Treasury assumes that this shortfall will be made up in the current fiscal year (and the fiscal accounts for the four months to October show that this is indeed happening), with the result that the surplus for the June 2019 year is $2bn lower than previously forecast.

Operating balance (excl. gains and losses)



Net core Crown debt GDP



HYEFU 2018 economics forecasts

	2018	2019	2020	2021	2022	2023
	Actual	F/cast	F/cast	F/cast	F/cast	F/cast
OBEGAL, $m (June years)						
HYEFU	5,534	1,724	4,113	5,084	7,562	8,438
Change since Budget	2,393	-2,013	-1,307	-637	250	-
Net debt as % of GDP						
HYEFU	20.0	20.9	20.7	20.1	19.0	17.4
Change since Budget	-0.8	-0.2	0.1	-0.1	-0.1	-
GDP growth, ann avg % (June years)						
HYEFU	2.7	2.9	3.1	2.7	2.5	2.3
Change since Budget	-0.1	-0.4	-0.3	0.0	0.0	-
Government bond programme, $bn (June years)						
HYEFU	7	8	8	8	7	6
Change since Budget	0	0	0	0	0	-

The projected surpluses for the following two years are also lower, but this is the result of some transport spending being reclassified from capital to operational spending – a change that has no net impact on the Government's borrowing requirements. Surpluses are still projected to increase as a share of GDP over the coming years, based on current spending plans.

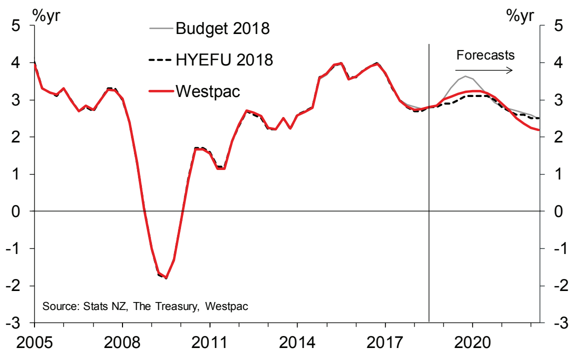
The Government expects to comfortably meet its goal of reducing net core Crown debt below 20% of GDP by 2022. The net debt to GDP ratio is expected to rise over the next couple of years, when planned capital spending outweighs the operating surplus, but then fall to 19% of GDP by 2022.

That suggests some scope to increase planned borrowing and spending while remaining within the Government's self-imposed fiscal responsibility rules. It's also worth noting that while these rules use 2022 as the target date, they were only intended to apply to the Government's first term, and will be reviewed after the next election in 2020.

Economic forecasts more realistic

The economic forecasts than underpin the HYEFU look realistic to us. Back in May, the Treasury's forecasts saw real GDP growth accelerating to a peak of 3.6% per annum – an assumption that we described as 'heroic'. Now, however, the Treasury is expecting economic growth of around 3% per annum through to the end of 2020. Further ahead, the Treasury expects that growth will cool as net migration slows, export growth softens and interest rates start to rise. Those conditions are expected to see growth easing back to around 2.5% per annum in the early 2020s. We broadly agree with that outlook, though we expect a more pronounced slowdown in the later years.

Real GDP growth (annual average)

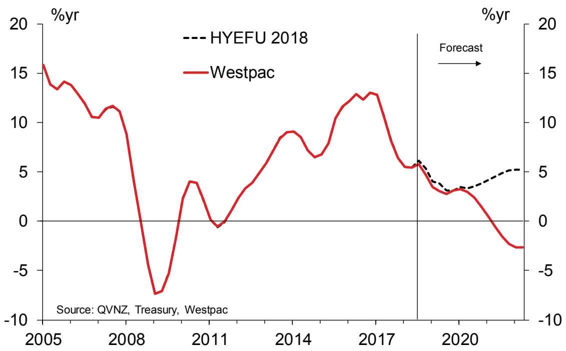


The downward revisions to the growth forecasts were concentrated in household consumption. That's notable as big increases in government spending are already being rolled out, including the Families Package. This suggests that government spending is not providing the boost to demand that had been expected at the time of last year's Budget.

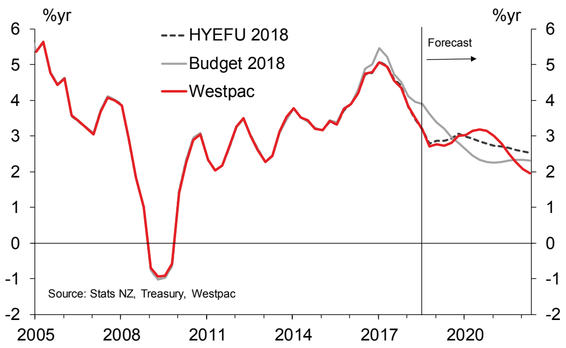
Interestingly, the Treasury is expecting subdued growth in household spending despite an optimistic view on house prices, with gains of 4.5% to 5% per annum over the coming years. These forecasts have the – perhaps unintentional –

effect of concluding that the Government will fail to attain its goal of limiting house price increases to household income growth. If house prices really did continue to rise at 5% per annum, housing affordability would steadily worsen.

House Prices



Consumption



The Treasury is still optimistic about a further pickup in residential building, supported by the Kiwibuild programme. We also expect some lift in homebuilding over the coming year, but we're more circumspect about a further acceleration as we head into the next decade. Building levels are already close to the pace needed to keep up with population growth, net migration is slowing, and policies to dampen house price growth could also put a brake on new developments. As for Kiwibuild, we expect that will mainly replace private sector activity rather than generate more building activity.

Despite lower forecasts of real activity, the Treasury is also forecasting more inflation over the next few years. While the Treasury previously expected inflation to remain below the RBNZ's 2% target midpoint for several more years, it now expects 2% inflation consistently over the forecast period. The result is little net change to its forecasts of nominal GDP, which is what matters more for its revenue and spending projections.

The 'Wellbeing Budget'

The 2019 Budget Policy Statement (BPS) was also released today. This document publicly sets the stage for next year's Budget. The five priorities identified for 2019 are:

- Creating opportunities for productive businesses, regions, iwi and others to transition to a sustainable and low-emissions economy.
- Supporting a thriving nation in the digital age through innovation, social and economic opportunities.
- Lifting Māori and Pacific incomes, skills and opportunities.
- Reducing child poverty and improving child wellbeing, including addressing family violence.
- Supporting mental wellbeing for all New Zealanders, with a special focus on under 24-year-olds.

Interestingly, this list omitted any explicit mention of addressing housing affordability and related issues. Although these obviously play an important underlying role in identified priorities such as child poverty, it is perhaps an early sign that the Government is looking to shift the conversation around Kiwibuild progress off the front pages.

As has been long signalled by the Government, next year's Budget will showcase a new 'Wellbeing' approach to policymaking. The basic ideas are to measure and report on a wide range of things beyond dollars and cents, such as health outcomes, and to report on how capital stocks are evolving, not just flows. For example, if economic growth (a flow) has been generated at the expense of the environment (a stock), a Wellbeing budget will report both sides of the story.

In order to assist the Treasury has developed a Living Standards Framework (LSF) and recently released an associated Dashboard of indicators that cover the many and varied aspects of wellbeing.

We're supportive of the development of the Living Standards Framework and think ultimately it will lead to an improvement in policy making. The key focus of policy should always be on improving the things that matter for New Zealanders and putting numbers on at least some of these things should mean they will enjoy more attention than they do now.

What's more, thinking about how the capital stock is changing is an eminently sensible approach. While this has always been done to some extent, and the LSF will never be able to entirely capture and quantify everything that impacts the wellbeing of all New Zealanders, adding more structure to the way non-financial outcomes of policies are measured will be helpful when comparing the trade-offs between policies. That said, the Government will still face difficult choices and political tradeoffs, and there is no guarantee that a Wellbeing Budget will lead to better decisions.

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