New Zealand Government Budget 2019

30 May 2019

Contents as labelled

- The Budget boosted spending on mental health and indexed benefits to wage growth.
- We broadly support these spending choices. These are areas of actual need, rather than being expenditure that buys votes or coalition support.
- There was nothing on housing or anything that will boost flagging business confidence.
- We were surprised that the Government ramped up spending so much when the economy is slowing.
- The Treasury's revenue forecasts look a little too generous, meaning that future surpluses may not be as high as forecast.
- The Budget was mildly stimulatory for the economic outlook, as the extra spending will trickle through the economy.
- But New Zealand is still running a fiscal policy that is unsustainable over the long term.
- The contents of the first "Wellbeing Budget" were very much as labelled, with more measurement of wellbeing and progress against child poverty targets included.

The Government's first official Wellbeing Budget was delivered today. The Government ramped up spending significantly, with a major boost to mental health services. Lumped under the umbrella of "child poverty," there was also money to index benefits to wage rates, fund youth justice, health care in schools, and more money for low and middle decile schools to replace "voluntary" school fees.

We basically support the thrust of this spending, which is focussed on things the private sector can't provide. There was less vote-winning middle class welfare such as the year of free tertiary education, and fewer sops to coalition partners such as the Provincial Growth Fund. Instead, the spending targeted New Zealand's most deprived households and was aimed at areas of clear need.

Notable for its absence was any focus on housing. The best opportunity to address housing affordability was Capital Gains Tax, but that is now off the agenda. With Kiwibuild also looking like a failure, perhaps Government was keener to allow the housing discussion to fade into the background.

Also notably absent was anything that could be expected to alleviate low confidence in the business sector.

What surprised us was the amount that the Government increased its spending plans – for example, the spending allowance for next year was lifted from $2.4bn to $3.8bn. Given that the economy is slowing, we had expected the Government would be more cautious. Treasury has moderated its economic forecasts, which were previously too optimistic but now look more realistic to us. However, we still think Treasury is too bullish on its government revenue forecasts. The implication is that surpluses may not be as big as forecast.

The New Zealand Government's finances are in fantastic shape and markets barely batted an eyelid at the extra spending, but we still worry about the long term outlook. The aging population is inevitably going to cause healthcare and superannuation costs to balloon, meaning the Government's policy trajectory is unsustainable. Yet there appears to be no plan to deal with this.

Today was hyped as the first Wellbeing Budget. The distinction from previous Budgets was noticeable, but not radical. A shiny new Wellbeing Budget document reported on various aspects of New Zealanders' current wellbeing, making use of the data provided in the Treasury's Living Standards Framework. There was a Child Poverty Report, which is now a legal requirement. It showed that child poverty is trending down when measured in absolute terms, but is static to rising when poverty is defined as being relative to average incomes.

The wellbeing concept is only freshly minted, and the targets have not yet been tested. Only time will tell whether this approach actually leads to better Government policy.

Policy Initiatives

Policy announcements in today's inaugural Wellbeing Budget were split into 5 categories.

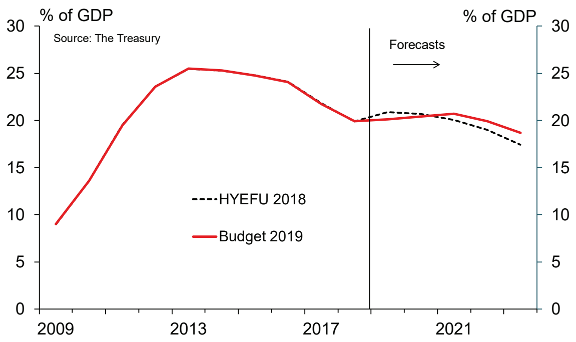
- Taking mental health seriously
- Improving child wellbeing
- Supporting Maori and Pasifika aspirations
- Digital economy
- Transforming to a low carbon economy

Of these, it was improving child wellbeing that garnered both the most attention and the saw the biggest increases in spending. There was more money for Oranga Tamariki (Ministry for Children), and funding for initiatives aimed at addressing family and domestic violence. This was no surprise. The Government has long signalled this is a key priority. Indeed, it has legislated a requirement to set and report on child poverty reduction goals.

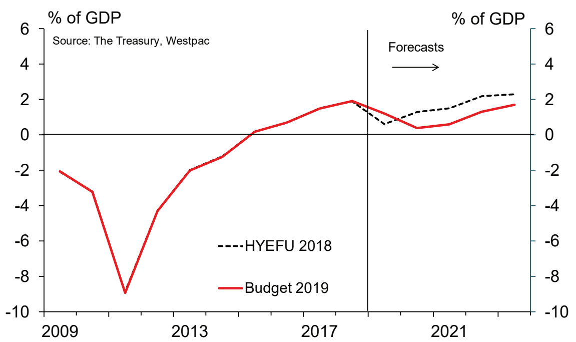
The other area which received a large chunk of new spending was mental health and addiction services. A broad array of policies were budgeted for including increased access to mental health services as well as a new mental health and wellbeing commission. This seems to us to be a sensible use of taxpayers money and aligns well with the Wellbeing priorities.

One initiative in today's Budget that caught our eye was the switch to indexing main benefits to wage inflation. Treasury estimates that this will increase payments on average by $11 a week more than the current practise of linking benefits to changes in CPI inflation. Over time, wage inflation tends to run ahead of CPI inflation due to improvements in productivity, and a consequence of the change is that we're likely to see a lift in the relative income of beneficiaries. However, unlike

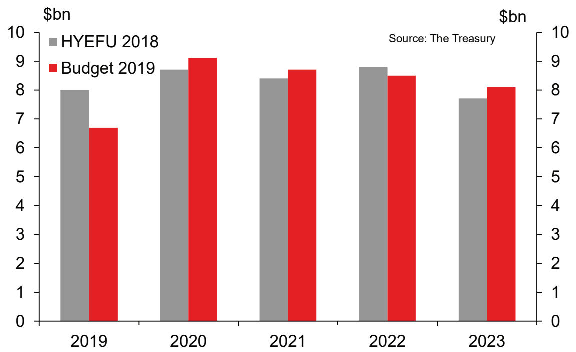
Net core Crown debt to GDP



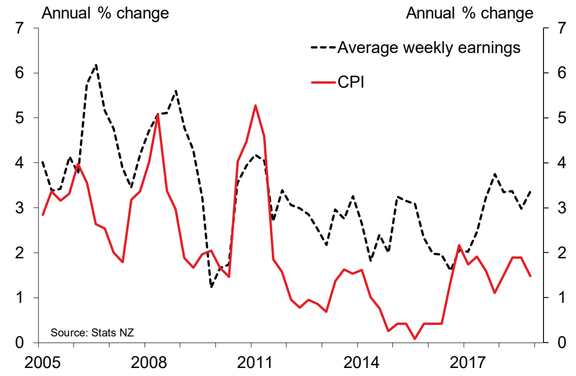
Operating balance (excl. gains and losses)



Net capital spending



Inflation and income growth



the earlier announced changes to abatement rates (which allows beneficiaries to earn more before their entitlements are affected, encouraging participation in the labour force), the change in indexation is unlikely to be a catalyst for increased participation. And in a tight labour market the Government will be faced with the double whammy of rising wage costs and a rising welfare bill.

More money for rail projects was a clear win for New Zealand First who have long championed the benefits of rail. In addition to more money for Kiwirail, there was also extra money poured into the Auckland City Rail Link and also earmarked for new interisland ferries. While we don't have any particular objection to rail and investment in public transport, this is certainly one area where the quality of investment is key. The Government already bails out Kiwirail to the tune of $200 million a year and the extra money for Auckland's CRL is simply covering a cost blow out. There is a reason old rail routes were mothballed, and the costs and benefits of rail should be impartially considered against other options.

In contrast to households, there was little in today's Budget for businesses. The pervasive pessimism in recent business confidence surveys is unlikely to be unwound by the announcement of a new venture capital fund or funding to boost research aimed at supporting R&D expenditure. Equally, there was little sign that the Government is concerned by firms' growing concerns about rising costs (including from rising minimum wages and increased regulation) and their inability to pass these on to consumers.

The financials

The financial bottom lines of this year's Budget were much in line with what we expected: smaller projected surpluses and more debt issuance over the coming years, while still squeaking within the Government's self-imposed fiscal responsibility rules. However, the details of how they got there were something of a surprise, with a substantial increase in planned spending against largely unchanged revenue forecasts.

The Budget allocated an extra $15bn of core Crown spending over the next five years, with the most rapid increase coming up front. The allowance for new spending in this year's Budget was increased to $3.8bn per year, compared to $2.4bn per year previously. Next year's Budget has been given a $3bn per year allowance for new initiatives, falling back to $2.4bn per year in subsequent Budgets.

While the Government's desire to ramp up spending comes as no surprise, we thought they might be more constrained in their ability to do so, given the softer than expected starting point for the economy. However, the Treasury's GDP forecasts were little changed from the HYEFU, with the recent shortfall in growth expected to be quickly caught up next year.

Similarly, we were surprised that there was almost no change to the revenue forecasts. In fact, the Treasury has increased its tax revenue forecast for the current fiscal year by over $700m, despite a shortfall of over $500m in the first nine months of the year. Some of that shortfall is likely to be a matter of timing, but not all – for instance, corporate tax revenue has consistently fallen short of forecasts over this year. This is a significant change: in past years the Government has benefited from the tax take surprising to the upside even if the economy itself hasn't. But that no longer seems to be the case.

The increase in planned spending means that the projected surpluses over the coming years have been eroded, by a cumulative $9.2bn. That also means an increase in the net debt profile, which rises to a peak of 20.7% of GDP in June 2021 before dropping to 19.9% of GDP in June 2022. Both the surplus and net debt profiles are in line with the Government's self-imposed fiscal responsibility rules, albeit only just in the latter case.

In contrast to the planned ramp-up in operating spending, capital spending over the next five years has actually been reduced slightly, from $41.6bn to $41.1bn. That measure is slightly misleading though, as ongoing delays in the capital spending programme mean that more and more of it is being pushed out beyond the five-year horizon of the Budget projections. Capital spending in the current fiscal year is running $1.3bn below the previous forecast, and that shortfall is not expected to be fully made up by 2023.

The Finance Minister recently announced that beyond 2022 the Government's net debt target would switch to a range of 15-25% of GDP, implying more headroom to borrow and spend if the economy slowed or if opportunities for investment arose. However, the long-term fiscal projections showed net debt settling at just under 19% of GDP in the later years. That's higher than the previous long-term projections, which settled at around 16% of GDP. But it's still in the lower half of the range, which doesn't suggest that the Government is in a hurry to make use of that additional flexibility.

Budget 2019 economic forecasts

	2018(a)	2019	2020	2021	2022	2023
	Actual	F/cast	F/cast	F/cast	F/cast	F/cast
Economic (June years, %)						
Real GDP growth	3.2	2.4	3.0	2.8	2.4	2.4
Unemployment rate	4.4	4.1	4.0	4.1	4.2	4.3
CPI inflation	1.5	1.8	2.0	2.1	2.0	2.0
Current account balance	-3.4	-3.4	-3.4	-3.4	-3.3	-3.3
Fiscal						
(June years, % of GDP)						
Total Crown OBEGAL	1.9	1.2	0.4	0.6	1.3	1.7
Net core Crown debt	19.9	20.1	20.4	20.7	19.9	18.7
(June years, $ billion)						
Core Crown revenue	86.8	91.6	96.4	102.9	108.1	113.8
Core Crown expenses	80.6	87.3	93.3	98.9	101.7	105.7
Bond programme	-	8	10	10	8	6

Economic Forecasts: The Treasury and Westpac

Looking into the details of the Treasury's projections, their near-term forecasts for economic growth look similar to our own. However, their longer-term forecasts still assume strong nominal GDP growth of close to 5% per annum over the next few years, along with related gains in Crown revenues (i.e. the tax take). We think that's too strong.

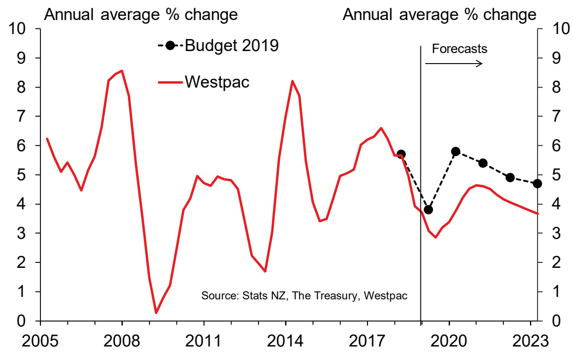
We think that the Government will actually be confronted with more modest increases in both real activity and revenue than they are expecting. That means related pressure on the projected surpluses.

A key area where we disagree with the Treasury is residential investment. The Treasury is expecting to see home building continuing to push higher over the coming years. In contrast, we think that the peak in the construction cycle will come much sooner, in 2020. That's because after strong increases in recent years, home building activity is now more commensurate with population growth. In addition, migration and population growth have already started to slow.

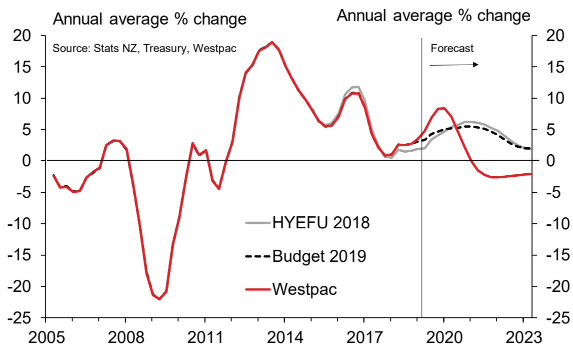
We also expect that house price inflation will cool by more than the Treasury expects in the early 2020s as interest rates start to nudge upwards. As a result, we expect softer growth in household spending.

Finally, the Treasury is assuming a strong pick up in domestic price growth over the coming years (i.e. the GDP deflator), and that supports related growth in the forecast tax take. However, we're more circumspect about the chances of a near term acceleration in price growth. Inflation has been rising only gradually for a number of years, and we expect that will remain the case for some time. If we did see a rapid pick up in domestic prices, that would actually be a negative for New Zealand households' spending power.

Nominal GDP growth (annual average)



Residential Investment



Economic Forecasts: The Treasury and Westpac

	Actual	Treasury					Westpac				
June year	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2019**	**2020**	**2021**	**2022**	**2023**
Real GDP growth	3.2	2.4	3.0	2.8	2.4	2.4	2.3	2.8	2.9	2.0	1.6
Annual CPI inflation*	1.5	1.8	2.0	2.1	2.0	2.0	1.7	1.8	2.0	2.2	2.1
Unemployment rate*	4.4	4.1	4.0	4.1	4.2	4.3	4.3	4.0	3.8	3.6	3.7
Nominal GDP growth	5.7	3.8	5.8	5.4	4.9	4.7	3.1	3.8	4.6	4.1	3.7
90-day interest rate**	1.9	1.8	1.9	2.3	2.5	2.6	1.7	1.7	1.7	1.9	2.1
TWI exchange rate**	73.8	73.7	73.7	73.8	74.0	74.1	71.6	72.3	71.8	71.8	71.7

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

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.