New Zealand Half Year Economic and Fiscal Update 2019.

11 December 2019

Review of NZ Half-Year Economic and Fiscal Update, December 2019.

- The Government has announced $12b of extra investment, dominated by transport projects.
- This reinforces our view that government activity will stimulate the economy over the coming years.
- However, we had already allowed for something like this, so there will be no material change to our economic forecasts.
- Capital expenditure is usually delayed, so the stimulatory impact will be less than the Treasury estimates.
- For the RBNZ, this extra fiscal stimulus could increase its OCR forecast by up to 20 basis points, reducing the chance of further OCR cuts.
- There was no new operational spending announced.
- The Treasury is forecasting smaller future fiscal surpluses due to the weaker starting point for the economy.
- This leaves the Government less room to spend up at the May Budget, although we still think some increase in operational spending will be forthcoming at that time.

HYEFU 2019 economics forecasts

	2019	2020	2021	2022	2023	2024
	Actual	F/cast	F/cast	F/cast	F/cast	F/cast
OBEGAL, $m (June years)						
HYEFU	7,347	-943	57	1,752	4,061	5,924
Change since Budget	3,882	-2,256	-2,074	-2,931	-2,085	-
Net debt as % of GDP						
HYEFU	19.0	19.6	21.0	21.5	20.9	19.6
Change since Budget	-1.1	-0.8	0.3	1.6	2.2	-
GDP growth, ann avg % (June years)						
HYEFU	2.4	2.2	2.8	2.7	2.5	2.4
Change since Budget	0.0	-0.8	0.0	0.3	0.1	-
Government bond programme, $bn (June years)						
HYEFU	-	10	10	8	8	6
Change since Budget	-	0.0	0.0	0.0	2.0	-

The Half-Year Economic and Fiscal Update (HYEFU) was dominated by the announcement of a major increase in the Government's capital spending plans over the coming years. For some time now we've been in no doubt that a lift in fiscal spending was on the cards; what strikes us most about today's announcement is that the Government has continued to take a prudent approach. The planned increase in spending is modest relative to the size of the economy, and is spread over several years, rather than trying to front-load it in a response to the current period of slower economic growth. The net debt to GDP ratio is expected to remain close to its current level, and well within the 15-25% range that the Government has adopted in its fiscal responsibility rules.

Given what we had already assumed, today's announcements won't have a substantial impact on our forecasts of GDP, inflation and interest rates. Capital spending typically gets delayed due to capacity constraints in the construction industry, so the actual economic stimulus arising from today's announcement will be well within what we had already baked into our forecasts.

We still see scope for the Government to announce more operational spending in next year's Budget as well, although the softer starting point for the economy means that there isn't much wiggle room left. The Treasury's economic growth forecasts are broadly in line with our own, and therefore we're not anticipating a revenue 'surprise' by the time that the Budget rolls around.

As for monetary policy, we suspect that the Reserve Bank will cautiously welcome today's announcement. The Treasury estimates that the increase in capital spending will boost the level of GDP by 0.25% to 0.4%, in a sustained fashion from 2021 onwards. If the RBNZ took these figures at face value, we estimate that it would lift the projected OCR track by around 20 basis points. That would take a further rate cut off the table, and could even have the RBNZ forecasting rate hikes as early as mid-2021. However, the RBNZ typically adds its own layer of judgement as to how much of the Government's spending plans are actually achievable. Even so, the confirmation of higher fiscal spending reduces the odds of another OCR cut at its next review in February.

Capital spending.

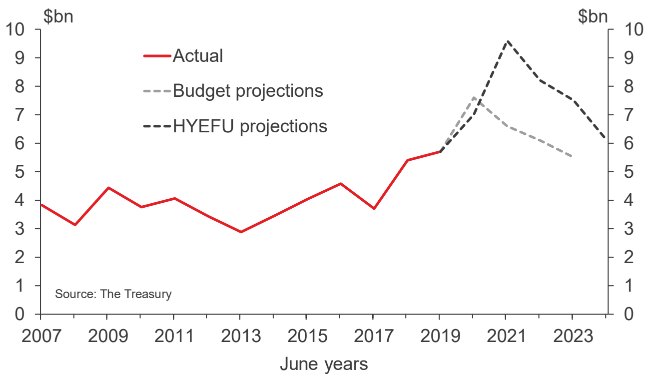
The HYEFU incorporates a total of $12bn of new investment, on top of the existing investment plans. While the Finance Minister had previously talked of a range of short- to medium-term infrastructure projects, the profile is more spread out than that implies. Of the $12bn that was signalled, $8.1bn occurs within the five-year horizon for Budget forecasts, with the remaining $3.9bn falling into later years. Around $1.4bn is expected to be spent in the June 2021 year, ramping up to just over $2bn in each of the next few years.

Of the $12bn total, $8bn has been allocated to specific projects, though there was no detail on these beyond the already-announced $400m of grants for school maintenance and upgrades. The lion's share ($6.8bn) will go to transport projects, particularly road and rail. Smaller amounts will go to District Health Boards, regional investment opportunities, and decarbonisation (e.g. removing coal-fired boilers from schools and hospitals). The remaining $4bn will be allocated in future Budgets.

Coming on top of the Government's existing plans, this creates a formidable profile for planned capital spending over the next few years, as the chart below shows. (We exclude contributions to the Super Fund to make the figures more comparable with previous years). Net capital spending reached $5.7bn in the June 2019 fiscal year; the HYEFU projects this to rise to $7bn in the current year and an eye-watering peak of $9.6bn in the following year.

As we've been noting for some time, the challenge here is not the willingness to spend, but the ability. Capital spending has risen from its lows in recent years, but it has fallen short of what was projected in each of the last five Budgets, sometimes by billions of dollars. (Note that the forecast for the current year has already been revised down by $500m since the May Budget.) While the Finance Minister said that the $8bn of spending allocated so far was for "shovel-ready" projects that were able to be brought forward, it remains to be seen whether the Government will be able to overcome the bottlenecks that have hampered its previous spending plans.

Government net capital spending

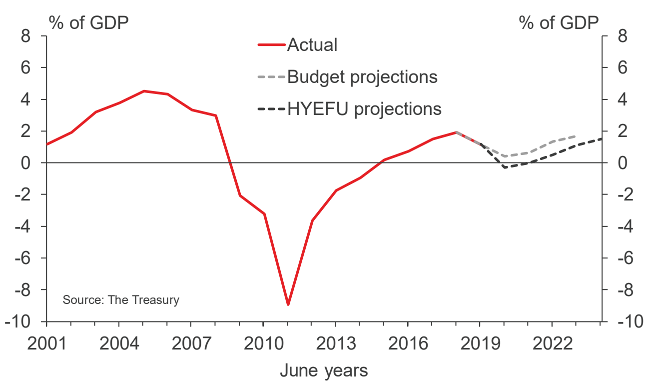


Fiscal projections.

The HYEFU fiscal projections acknowledge the softer than expected starting point for the economy. Tax revenue forecasts are lower compared to the May Budget, and social assistance payments are expected to be higher. The Treasury has significantly lowered its interest rate assumptions over the forecast period, which also worsens the operating balance in two ways: less income from resident withholding tax on interest, and an increase in the discounted present value of ACC's claim liabilities.

The operating balance is expected to briefly slip into a deficit of $943m in the year to June 2020, against a forecast surplus of $1.3bn in the Budget. A tiny surplus is forecast for June 2021, steadily increasing to $5.9bn in June 2024. Overall, the projected balances are around $2bn a year less than was forecast in the Budget.

Operating balance, adjusted for one-offs

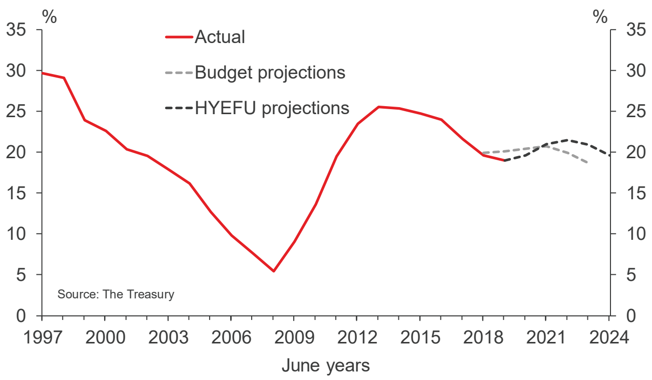


These figures suggest that there is only limited scope to ramp up operational spending in next year's Budget. We still think that the Government will increase its operational spending allowance, but perhaps by less than the $1.5bn per annum that we were previously allowing for. We should note that the next Budget has already been given an allowance of $3bn a year of new operational spending, so there is still lots of room to announce new Government programmes.

The increase in planned capital spending will be matched by extra borrowing. Over the coming five years there is $8bn of additional capital spending planned. That will be funded by an additional $8bn of Government bond issuance over the same period. The bond programme for the June 2023 year was increased by $2bn compared to the May Budget, and $6bn of issuance was forecast for the June 2024 year. While the Government hadn't previously announced its bond programme for the 2024 year, it's possible that under its previous forecasts it would not have needed to issue any bonds in that year, as large operating surpluses would have covered the capital spending programme by that point. Curiously, while the Finance Minister had previously described this as a once-in-a-generation opportunity to borrow at very low interest rates, there is no increase in the projected bond issuance until 2023, when interest rates are forecast to be higher than they are today.

Net core Crown debt is expected to rise from 19% of GDP currently to a peak of 21.5% of GDP in the June 2022 year, then falling to 19.6% by June 2024 as larger operating surpluses reduce the need for additional borrowing. That's a fairly narrow range overall, and comfortably within the 15-25% range that the Government has specified in its fiscal responsibility rules.

Net core Crown debt as a % of GDP

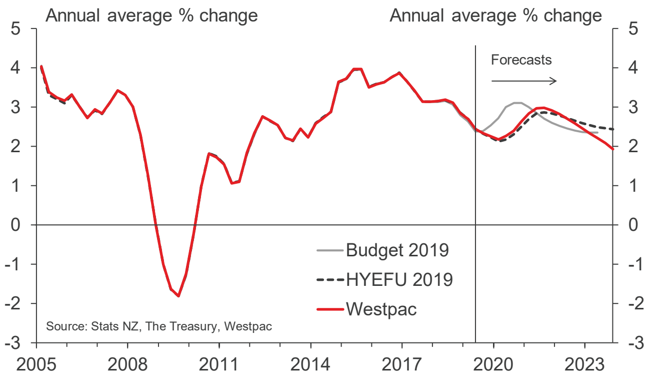


The Treasury's economic forecasts.

The economic forecasts that underpin the Government's projections for revenue growth and spending look reasonable to us.

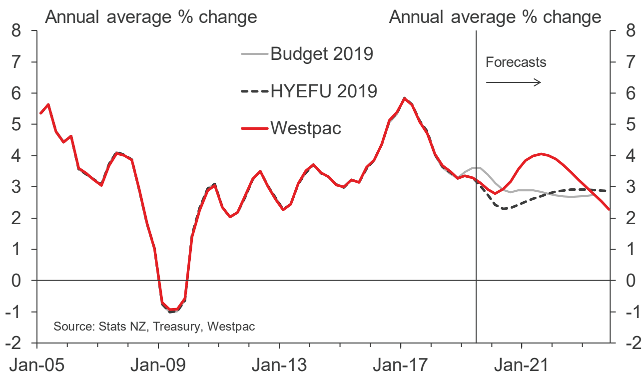
Back in May, we noted that the Treasury's forecasts looked too optimistic. The economy did indeed slow in recent months, and the Treasury has pulled down its forecasts accordingly. The Treasury's forecast for real GDP growth over the next few years now looks very similar to our own. Both we and the Treasury expect GDP growth is close to its low point and will soon start lifting, reaccelerating to around 3% in 2021. The Treasury has also revised its inflation forecasts, and like us now expects only limited price increases over the coming years.

Real GDP growth



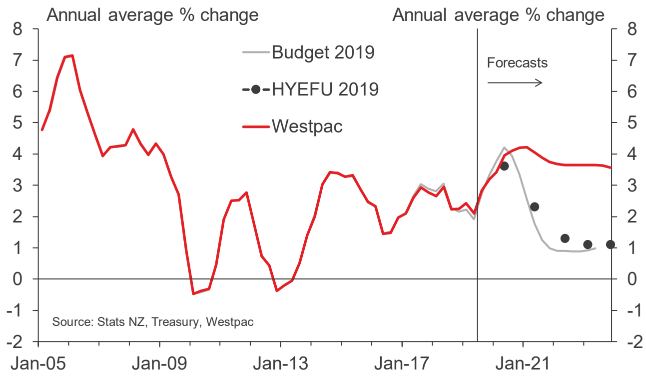
While the Government's overall forecasts for the economy look sensible, there are some interesting features just below the surface. It's notable that much of the downwards revision to the Treasury's forecast for economic growth is concentrated in their forecast for household spending, which they now expect to grow at rates of a little below 3% per annum. That's surprising as the Treasury has revised up its forecasts for both house prices and population growth. Since the Treasury finalised its forecasts in early November, we've actually seen signs that household spending is accelerating, and we expect that it will outpace the Treasury's forecasts by a wide margin over the next few years.

Household consumption spending



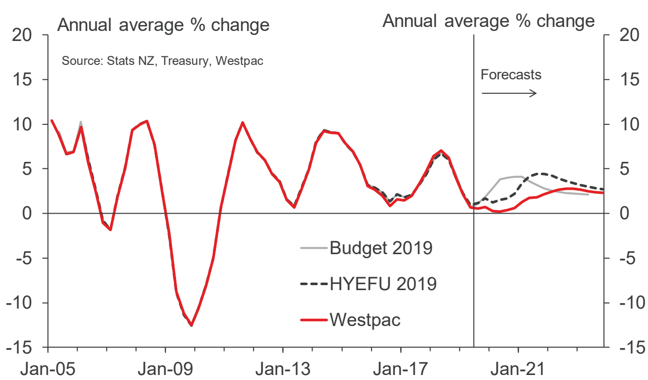
It's also notable that the HYEFU forecast assumes government consumption spending (that is, the provision of public services like health and education), will not ramp up significantly beyond 2020. There's a clear risk that this gets revised higher at the time of next year's Budget, especially given the rapidly approaching election.

Public consumption



While the Treasury is pessimistic on household spending and government consumption, we think it's too optimistic on the outlook for government investment. While the Government is planning on major spending increases in areas like infrastructure, we've frequently highlighted that such work often takes longer to ramp up than governments hope (as we've seen in recent years). Consequently, we expect that the government component of investment will accelerate more slowly than the Treasury is forecasting.

Non-residential investment



On the financial front, the Treasury has assumed that interest rates will remain low over the coming years, even with a pickup in GDP growth. Given the lingering softness in inflation, we would tend to agree.

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Economic Forecasts: The Treasury and Westpac

	Actual	Treasury					Westpac				
June years	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2020**	**2021**	**2022**	**2023**	**2024**
Real GDP growth	2.4	2.2	2.8	2.7	2.5	2.4	2.3	3.0	2.7	2.2	1.7
Annual CPI inflation*	1.7	1.9	1.9	2.0	2.0	2.0	1.8	1.8	2.0	1.9	2.0
Unemployment rate*	3.9	4.3	4.2	4.2	4.3	4.3	4.4	4.1	3.8	3.6	3.7
Nominal GDP growth	3.7	5.1	5.2	5.3	4.9	4.8	5.2	4.7	4.7	4.2	3.6
90-day interest rate**	1.7	1.0	1.0	1.2	1.3	1.5	0.9	0.9	0.9	1.2	1.6
TWI exchange rate**	72.7	70.8	70.8	71.6	72.1	72.6	69.2	70.0	71.4	72.0	72.2

*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

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.

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