Westpac

Institutional Bank

15 December 2015

Threading the needle

NZ Half-Year Economic and Fiscal Update 2015

- Treasury's weaker activity forecasts have put a dent in tax revenue.
- Consequently, the Treasury is now projecting lower surpluses than in the Budget update.
- Despite this, the Government has opted not to tinker with its spending plans, instead accepting higher levels of debt throughout the forecast horizon.

Key Treasury forecasts

	2015	2016	2017	2018	2019
Total Crown operating balance (OBEGAL), $m (June years)					
HYEFU	414	-401	356	957	3,485
Change since Budget	1,098	-577	-1,120	-1,038	-139
Net debt, % of GDP (June years)					
HYEFU	25.2	26.9	27.7	27.1	25.6
Change since Budget	-0.5	0.6	2.2	2.7	2.7
Government bond issuance programme, $bn (June years)					
HYEFU		8.0	9.0	9.0	9.0
Change since Budget		0.0	2.0	2.0	2.0
GDP growth, ann avg % (March years)					
HYEFU	3.2	2.1	2.4	3.6	3.0
Change since Budget	-0.1	-1.0	-0.4	0.8	0.6

Today's Half Year Fiscal and Economic Update (HYEFU) showed a bigger deterioration in the Government's books than we had expected. While there was little discernible change to the Government's spending plans, revenue projections have taken a hit. The Treasury is now forecasting lower tax revenues over the next four years on the back of weaker nominal GDP growth. Flowing on from this, the operating balance is expected to dip back into deficit territory this year after recording a wafer thin surplus in 2014/15 before gradually improving thereafter, more slowly than in the May Budget.

Nonetheless, as we detail below, our view remains that the Treasury's medium term economic growth forecasts look too optimistic and that there is considerable downside risk to their inflation projections. If we're right, this could see the Government's revenue projections further downgraded in the 2016 Budget.

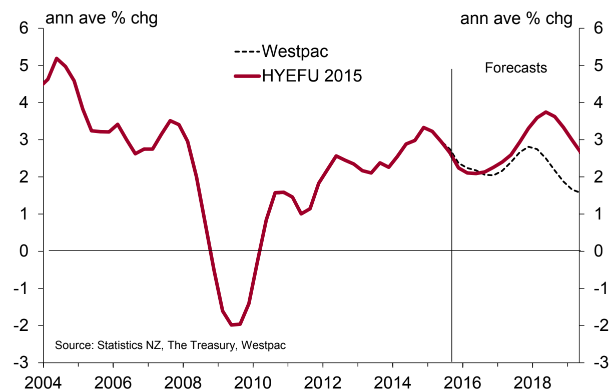
To date, the Government has been content to maintain its spending plans in the face of the worsening outlook for revenue. In effect they have chosen not to respond to the lowered revenue forecasts by reducing their spending, instead opting to accepted higher debt levels and smaller operating surpluses. But we think the direction of risk is clear. Further downgrades to the outlook for nominal GDP could mean the Government is forced to make tough decisions on the expense side of the ledger at some point down the track.

Economic Forecasts

Relative to the Budget, the Treasury has lowered its GDP growth forecast in the near term, while raising it for 2018 and beyond. In the near term, El Nino weather conditions are predicted to weigh on agricultural production, depressing growth in the first half of 2016. Further out, growth is forecast to improve on the back of a recovery in export prices, accommodative monetary policy and strong population growth. Dairy prices in particular are expected to improve from mid-2016, returning to around $3,500/tonne by the end of 2017 – a notably more optimistic view than our own assessment. Consequently, we think there is scope for

growth to disappoint relative to Treasury forecasts at this horizon, especially once you factor in the scaling down of reconstruction activity in Canterbury.

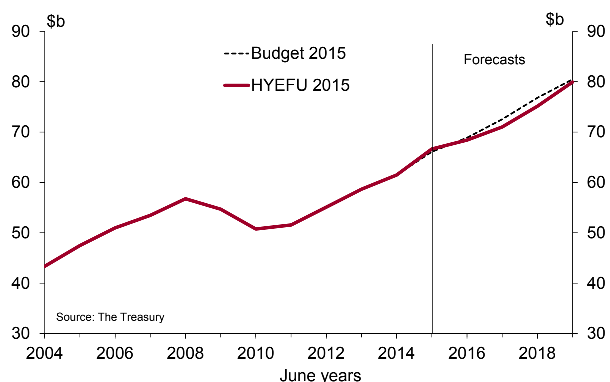
GDP growth



In contrast to the Treasury's revised GDP growth forecasts, there has been little change to their inflation outlook. The Treasury is projecting CPI inflation to rise to 1.4% by March next year (notably higher than the RBNZ's 1.2% forecast and our own 1.1% pick) with inflation expected to return to the 2% midpoint of the RBNZ's target band by the end of 2016. In contrast, even the RBNZ doesn't expect inflation to get back to this level until a full year later.

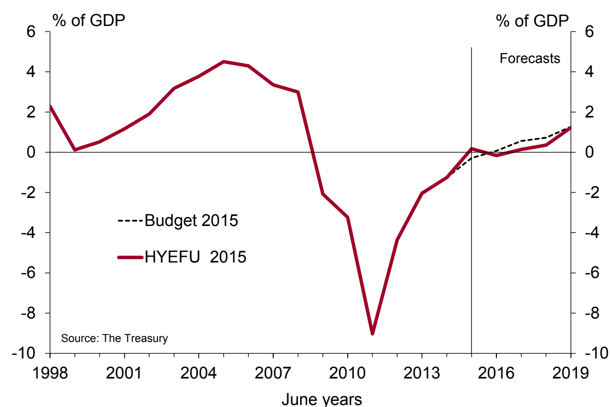
The combined impact of the change to real growth, inflation and term of trade forecasts are that the Treasury is now expecting $17bn less nominal GDP over the five years out to 2019, with consequently lower revenue forecasts. We think the risk is that the Treasury is still too optimistic on the outlook for inflation and growth, implying their nominal GDP (and therefore revenue) projections could come under further pressure between now and next year's Budget.

Core Crown revenue

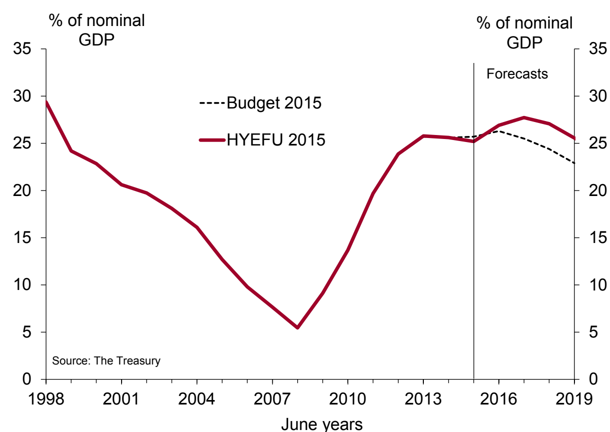


The weaker revenue projections mean net core Crown debt is now expected to peak higher and later than in the May Budget. Net core Crown debt is now expected to rise from 25.2% of GDP today to 27.7% in 2017 (previously it was seen peaking at under 27% of GDP).

Operating balance (excluding gains and losses)



Core Crown net debt



Indeed the profile for the increase in the operational spending allowance (which is labelled a spending allowance but could also be 'spent' in the form of reduced revenue i.e. tax cuts) was left unchanged. The allowances for operational spending increases are still an additional $1bn for next year's Budget and $2.5bn in the 2017 Budget. And unsurprisingly there were no new policy initiatives announced. That said, the allowance for new capital spending in next year's Budget has been increased by $1bn (although some of this may be covered by re-prioritising other investments).

Monetary policy's mate?

This $1bn increase in the capital spending allowance comes after RBNZ Governor Wheeler's comment last week that additional infrastructure spending in Auckland would be helpful, by reducing the economy's spare capacity and increasing inflation pressures. We wouldn't regard today's announcement as a response to the RBNZ, since the HYEFU was signed off before the Monetary Policy Statement, and the menu of projects mentioned by the Finance Minister – schools, transport, software upgrades – don't seem particularly Auckland-centric.

Nevertheless, could a boost to government spending be helpful to the RBNZ in meeting its inflation target? We would make two points here. First, our general view is that if there are projects worth doing, they should be done. But we regard infrastructure spending as a particularly clunky way of managing the economic cycle, given the narrow focus and long timelines for many projects.

Second, a one-off spending increase of $1bn in the June 2017 year, against the backdrop of the RBNZ's forecasts, would probably be of only marginal use. The RBNZ is forecasting 2.9% growth in the year to March 2017, which doesn't strongly suggest an economy in need of stimulus at that time. What's more, the spending increase is small relative to the size of the economy, amounting to just 0.4% of annual GDP (or less).

Market implications

The reduced revenue projections mean that the bond issuance programme has been increased by a total of $4bn over the next three years. On the face of it, increased bond supply should mean upward pressure on longer-term interest rates. However, the market seems to have taken some comfort from how the Debt Management Office plans to sell those bonds, with less reliance on regular tenders and more on large-scale syndicated sales, which have proven to be relatively successful to date. Interest rates on Government bonds were unchanged after today's announcement.

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