Westpac
Institutional Bank

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# Budget 2016 First Impressions
## Fiscal mirage

- There were few surprises in the Budget.
- The Treasury is forecasting very strong economic growth, large surpluses, falling net debt and low bond issuance.
- We are sceptical. From 2018 the economy may be weaker than the Treasury is forecasting due to the wind-down of the Canterbury rebuild and a cooling of the current borrow-and-spend dynamic.
- Furthermore, this Budget made no allowance for tax cuts. In reality, tax cuts are a possibility.
- The policy announcements in today's Budget were generally modest, and looked sensible to us

**Budget 2016 economics forecasts**

| | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|
| | Actual | Forecast | Forecast | Forecast | Forecast | Forecast |
| **Economic (June years, %)** | | | | | | |
| Real GDP growth | 3.6 | 2.4 | 2.8 | 3.3 | 2.9 | 2.6 |
| Unemployment rate | 5.8 | 5.5 | 5.7 | 5.2 | 4.7 | 4.5 |
| CPI inflation | 0.3 | 0.2 | 1.3 | 2.0 | 1.9 | 2.1 |
| Current account balance | -3.5 | -3.3 | -4.6 | -4.3 | -4.1 | -4.1 |
| **Fiscal** | | | | | | |
| **(June years, % of GDP)** | | | | | | |
| Total Crown OBEGAL | 0.2 | 0.3 | 0.3 | 0.9 | 1.7 | 2.2 |
| Net core Crown debt | 25.1 | 24.9 | 25.6 | 25.0 | 23.1 | 20.8 |
| **(June years, $ billion)** | | | | | | |
| Core Crown revenue | 72.2 | 75.3 | 78.5 | 82.1 | 87.0 | 91.4 |
| Core Crown expenses | 72.4 | 74.4 | 77.4 | 79.7 | 82.0 | 84.8 |
| Bond programme | | 9 | 7 | 7 | 7 | 7 |

There were few surprises in the 2016 Budget, with its intentions having been well signalled by the Minister of Finance in recent weeks. The Budget struck a balance between restrained spending, greater investment in some sensible areas, growing surpluses and debt reduction. There was nothing in the spending plans themselves that we would find contentious. But it's clear that in terms of the improvement in the fiscal projections, it's the underlying economic forecasts that have done most of the heavy lifting. We're uneasy about the Treasury's forecasts of accelerating GDP growth into 2018, a time when we expect that the Canterbury rebuild will be winding down.

The stronger economic picture means that the Treasury now expects a modest operating surplus of $668m for the current fiscal year, in contrast to last December's Half-Year Fiscal and Economic update (HYEFU) which projected a dip back into deficit. The surplus is expected to remain small next year but to improve strongly in later years, reaching $6.7bn by June 2020. The strong economic growth forecasts have lifted the Crown revenue projections, while lower than expected inflation and interest rates have reduced projected social welfare and finance costs.

As signalled by the Minister, the 2016 Budget reduced its operational and capital spending allowances over the next five years as a whole, but brought forward the timing of some of this spending. In particular, the projected capital spend of $6.1bn in the June 2017 year will be the largest in many years, aimed at meeting the needs of a burgeoning population. (Notably, capacity is becoming a constraint in this area; one of the reasons for the large increase in spending that year is that some previous spending has had to be delayed.)

The larger surpluses projected over the next few years have been directed towards debt reduction. Net core Crown debt is expected to peak at 25.6% of GDP next year, then fall to 20.8% of GDP by 2020. Planned debt issuance has been reduced by $8 billion over the next four years. The faster reduction in net debt means that the Government is now aiming to restart contributions to the Super Fund in 2021, two years earlier than previously.

In the near term, this is a more stimulatory Budget than last year's one, largely due to the boost to capital spending which was already announced early this year. However, the net reduction in the spending allowances implies a drag on growth towards the end of this decade. That makes the Budget more pro-cyclical than we would see as ideal, given our economic forecasts – the fiscal impulse to growth is expected to become substantially negative by 2019, at a time when we expect the economy to be already slowing.

## Policy Initiatives

Today's Budget didn't contain any real showstoppers on the policy front. Instead, it was mostly a back-to-basics approach. The bulk of new spending is directed towards the likes of health, education, core government services, and science and innovation. The Innovate New Zealand package (worth $761 million) includes spending to support science and innovation, targeting tertiary education and apprenticeship programmes, with support for regional economic development. The Government's 'social investment' approach to welfare spending of recent years continues, aimed at intervening early in the lives of the most vulnerable New Zealanders, continues. In line with this, a range of support initiatives were announced aimed largely at children and young people.

In general, this seems a broadly sensible approach, dictated as much by necessity, as by any real political imperative. It comes on the back of recent very strong population growth and the backdrop of an aging population.

On the capital spending side of the accounting ledger, the Budget included an additional $2.1bn for education infrastructure (including 9 new schools), the regional roading programme (with projects in Gisborne, Marlborough and Taranaki) and an upgrade to the New Zealand Cycle Trail. IRD also gets a chunky $857 million for an upgrade of its administration systems.

On housing, there were relatively few new initiatives on either the demand or supply side. There were additional funds for social and emergency housing for those most in need as well as another $100m to free up surplus crown land in Auckland. We'll have to wait and see what the Government's National Policy Statement on Urban Development directing councils to allow more housing development will mean in practice. We'll withhold judgement until we've seen more details.

In other announcements, as widely expected, the one-for-two subsidy in the Emissions Trading Scheme (introduced during the GFC) is to be phased out – saving the Government $356m over the next four years. Meanwhile contributions to the Superfund are expected to be resumed a little earlier than previously signalled, with payments now expected to recommence in 2021. Tobacco excise duties will continue to rise, increasing 10% a year for the next four years.

## Economic forecasts

Compared to the HYEFU last December, nominal GDP has been substantially stronger than expected, which has flowed through into higher than expected tax revenue to date. Stronger activity has more than offset the weakness in dairy export prices and the sharp drop in world oil prices early this year. The Treasury's forecasts have effectively banked this stronger than expected starting point, so that the level of nominal GDP remains higher than in the HYEFU forecasts over the coming years.

The essence of the economic outlook is otherwise similar to the HYEFU. Real GDP growth is expected to average 2.8% over the next five years, peaking at 3.3% growth in 2017. Inflation is expected to remain low in the near term, but to return to the 2% target midpoint by the end of 2017 as the impact of the oil price plunge drops out. Dairy export prices have fallen by more than expected, but are forecast to gradually recover over the next couple of years. The OCR is assumed to be 2% or thereabouts in the near term, with gradual rate hikes through 2019 and 2020.

Our concern – and this is not a new one – is that we are not convinced that the Treasury's strong growth forecasts in the later years will eventuate. The level of quake-related building activity in Canterbury has already peaked, and by 2017 we expect it to have reached a phase of several years of decline. Falling quake-related construction, along with lower net inward migration, will see GDP growth slow to as little as 1.4% in 2019 on our forecasts. By comparison, the Treasury still expects growth to be rattling along at 2.7% by that time.

If growth turns out more in line with our forecasts, then something will have to give – either surpluses will be smaller and net debt will be higher, or some difficult decisions will need to be made about spending plans. And the desire to deliver income tax cuts would certainly have to be tempered.

## Bond Programme

The stronger fiscal position, and a renewed focus on debt reduction, has led the Government to slash its gross bond issuance programme by $8bn over the four years to 2020. Previously, the gross bond issuance programme was forecast to be $9bn a year for 2016/17 to 2019/20, but this has been cut to $7bn a year.

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