Westpac Institutional Bank

On your marks, set...

NZ Half-Year Economic and Fiscal Update 2016

- Treasury's upgraded economic growth forecasts underpin a more positive outlook for the fiscal accounts. The Treasury is now forecasting larger surpluses than in Budget 2016.
- Early estimates put the additional cost to the Crown of the Kaikoura earthquakes at $1bn.
- There is a big lift in capital spending allowances over the coming years. In part this spending has been spurred by very strong population growth.

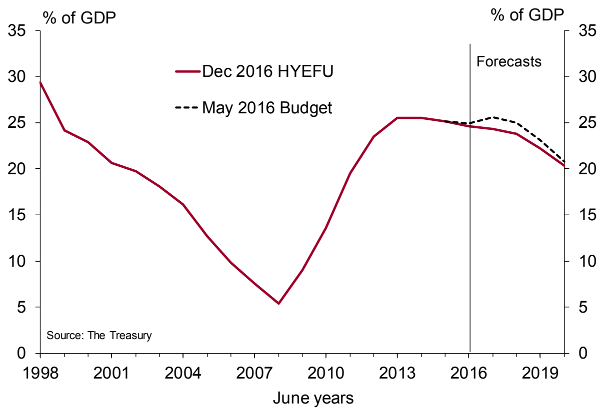
Key Treasury forecasts

	2016	2017	2018	2019	2020
Total Crown operating balance (OBEGAL), $m (June years)					
HYEFU	1,831	473	3,340	5,366	6,772
Change since Budget	1,163	-246	885	394	91
Net debt, % of GDP (June years)					
HYEFU	24.6	24.3	23.8	22.2	20.3
Change since Budget	-0.3	-1.3	-1.2	-0.9	-0.5
Government bond issuance programme, $bn (June years)					
HYEFU		8	7	7	6
Change since Budget		1	0	0	-1
GDP growth, ann avg % (March years)					
HYEFU	2.8	3.6	3.5	2.9	2.4
Change since Budget	0.2	0.7	0.3	0.1	-0.1

Today's Half Year Economic and Fiscal Update (HYEFU) showed a solid improvement in the Government's books but refrained from announcing any new policy initiatives. This shouldn't come as a surprise, given both the timing of the HYEFU and economic developments since the May Budget. The NZ economy has continued to perform strongly, even exceeding Treasury's already optimistic projections. And stronger dairy prices have led to an improved outlook for the terms of trade, and helped boost nominal GDP forecasts. Core Crown net debt projections are lower across the forecast horizon, while revenue forecasts are higher.

This robust set of fiscal accounts leave the Government with plenty of options as it heads into an election next year – prospects for which suddenly got a bit more interesting this week following Prime Minister John Key's resignation. Whether this translates into tax cuts or additional spending remains to be seen, but today's HYEFU suggests the Government's accounts are sufficiently robust to withstand some loosening of the purse strings.

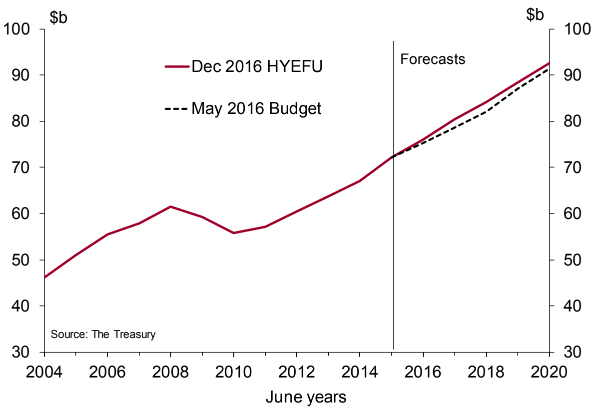
Core Crown net debt



Relative to the Budget, the Treasury has revised up its GDP growth forecasts but made very little change to its inflation outlook. Inflation is still expected to return to the 2% midpoint of the RBNZ's target band by mid-2018 (similar timing to our own forecasts). However, Treasury's nominal GDP growth forecasts have benefitted from an upgrade to the outlook for the terms of trade. Surging dairy prices (up more than 50% since mid-year) will provide a big boost to national incomes in the near term, and nominal GDP growth forecasts now are cumulatively $23.7bn higher than in the Budget over the four years to 2020.

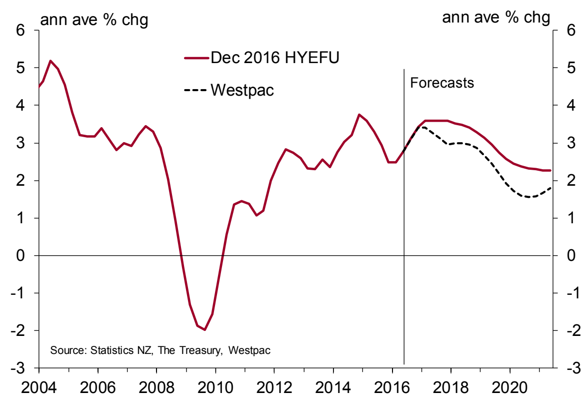
The stronger growth outlook is expected to benefit the Crown accounts via an increased tax take. Core Crown tax revenue is expected to reach $89.9bn by 2020/21 (from $66.6bn in 2015/16).

Core Crown revenue



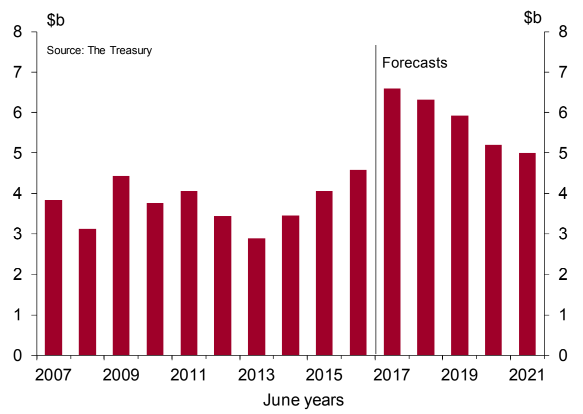
The Treasury continues to have a more optimistic growth outlook than our own forecasts. That said, the divergence of opinion is not as stark as it has been at times in the past. The biggest difference of opinion comes in the outer years of the forecast horizon where we expect slower population growth, the wind down of the Canterbury rebuild and high household debt levels to be a drag on GDP growth.

GDP growth

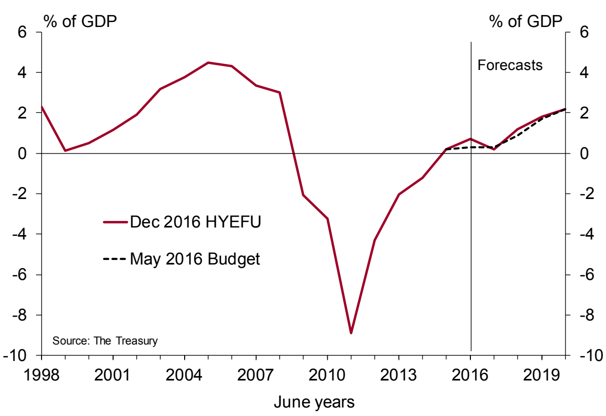


With projections of growing surpluses a feature of today's accounts (the operating balance before gains and losses is forecast to increase from $0.5bn in the current fiscal year to $8.5bn by 2020/21), the Government appears to have plenty of room for some kind of election year spend up (be it tax cuts or a family support package or a combination of both). However, population growth has dictated to some extent where additional capital spending will be required. The Government has substantially increased its allowance for capital spending in the coming years, from $900m to $3bn in 2017. Thereafter, the capital allowance has been increased to $2bn per year. This means capital spending (including contributions to the NZ Super Fund) is estimated to be $32.1 billion over the forecast period, a big step up from the capital spending of $18.4 billion over the previous five years. Auckland's City Rail Link is one high profile beneficiary of additional spending, but there is also likely to be more to be spent on the likes of schools and transport infrastructure.

Net capital spending



Operating balance (excluding gains and losses)



Earthquake costs

One development that hasn't been fully incorporated into the Treasury's economic projections (but has been factored into the fiscal side of the equation) is the recent Kaikoura earthquakes.

The earthquakes are having a significant impact on smaller regional centres in North Canterbury. In addition to the huge impact on people's lives, there has been damage to assets and disruption to activity, particularly in industries such as tourism, primary production and transportation. But while the impact on affected regions is pronounced, it is home to only a relatively small share of New Zealand's population. Overall conditions in the New Zealand economy are expected to remain resilient.

The Treasury's preliminary estimate is that the direct cost to the Crown from the earthquakes will be around $2 to $3 billion, the majority of which relates to repairs to roading infrastructure. Some of this spending will be funded by insurance or existing resources. As a result, HYEFU forecasts only assume a net increase in Crown operating costs of $1 billion in 2016/17. There will also be some expenses associated with repairs to privately held assets, including several large buildings in the Wellington CBD. But again, insurance will cover much of the resulting spending.

For our part, we estimate that the overall costs of reconstruction, including government spending, are likely to be equivalent to around 2% of annual nominal GDP. While that's certainly not insignificant, it is manageable from a nationwide perspective, especially given the extent of insurance cover (as a comparison, reconstruction spending following the 2010/11 Canterbury earthquakes costs is expected to be equivalent to 15% of annual GDP). The government did stress that there is still considerable uncertainty around the cost of the earthquakes, and it will reassess them as more information comes to light.

Post-quake reconstruction spending will reinforce the already strong outlook for construction spending over the coming years. However, with the construction sector already stretched, reconstruction activity is likely to crowd out some existing planned work. In addition, we are likely to see an intensification of cost inflation in the construction sector.

Market reaction

Markets were most interested in any changes to the Government's bond issuance programme, and on this front, developments were relatively minor. Issuance in the current year was revised up (from $7bn to 8bn) but this was more than offset by reduced issuance in later years. Pricing in bond markets hasn't changed in response to today's announcement indicating it was broadly in line with expectations.

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