The Treasury and Office of the Minister of Finance

Budget 2019 Information Release
August 2019

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[37]	to enable a Minister of the Crown or any department or organisation holding the information to carry out, without prejudice or disadvantage, negotiations (including commercial or industrial negotiations)	9(2)(i)
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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Fiscal Strategy for the 2019 Budget Policy Statement

Date:	6 November 2018	**Report No:**	T2018/2996
		File Number:	BM-2-1-2019

Action Sought

	Action Sought	**Deadline**
Minister of Finance (Hon Grant Robertson)	**Provide** feedback on budget allowance settings for inclusion in the final 2018 *Half Year Economic and Fiscal Update* forecasts and the 2019 *Budget Policy Statement*	Tuesday 13 November

Contact for Telephone Discussion (if required)

Name	**Position**	**Telephone**		**1st Contact**
Nathan Spence	Analyst, Macroeconomic and Fiscal Policy	[39]	N/A (mob)	✓
Neil Kidd	Team Leader, Macroeconomic and Fiscal Policy	[39]	N/A (mob)	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Fiscal Strategy for the 2019 Budget Policy Statement

Executive Summary

This report provides the Treasury's advice on fiscal strategy and budget allowances in light of the preliminary 2018 *Half Year Economic and Fiscal Update* (HYEFU) forecasts, emerging pressures and progress against the Budget Responsibility Rules (BRRs). Decisions taken on operating and capital allowances will be included in the final HYEFU forecasts and the *2019 Budget Policy Statement* (BPS).

The economic and fiscal outlook remains positive. The preliminary HYEFU forecasts show that the Government is on track to meet the BRRs with the operating balance before gains and losses (OBEGAL) surplus rising to around $8.9 billion (2.4% of GDP) by 2022/23 and net debt initially rising from 19.9% in 2017/18, before falling to 18.8% of GDP in 2021/22 and 17.2% in 2022/23. Real GDP growth is forecast to be around 3% on average over the next five years and the unemployment rate is forecast to be 4.5% in 2022/23. Based on the preliminary forecasts there is fiscal headroom against the Government's BRRs.

The Budget 2019 initiatives received in the October check-in indicate that the Budget 2019 operating allowance will be oversubscribed and the multi-year capital envelope will be under pressure. Budget allowances are normally heavily oversubscribed, though the submissions in the October check-in suggests the oversubscription for the Wellbeing Budget could be higher than in recent years.

There are options to manage the pressures on Budget allowances. A strong focus on prioritisation and savings in Budget 2019 would be needed to meet current Budget 2019 allowances. However, to the extent there will be high-value, wellbeing-enhancing investment opportunities, adjustments to the fiscal strategy could be considered. There is an option to increase Budget 2019 operating and/or capital allowances in line with the forecast fiscal headroom against the BRRs. A further option would be to consider modifying the net debt rule in the BRRs to enable even greater investment, although this would require careful design and communication to maintain a sustainable and resilient fiscal trajectory while ensuring additional investment is well spent.

While the case for higher levels of investment is evident in many areas, initiatives are not currently fully developed which gives rise to concerns around ensuring high-value from any additional expenditure. Therefore the Treasury recommends keeping Budget allowances at their current levels for the BPS but signalling that if, during the Budget process, the current allowances are not sufficient to deliver strategic priorities then the Government would consider lifting allowances. The Treasury does not recommend modifying the BRRs at this time as there is scope to adjust Budget allowances within the BRRs. However, as better information on potential investments becomes available this could be revisited.

Recommended Action

We recommend that you:

The economic and fiscal outlook

a **Note** that the preliminary 2018 Half Year Economic and Fiscal Update (HYEFU) forecasts show a positive economic and fiscal outlook

b **Note** that the preliminary 2018 HYEFU fiscal forecasts show forecast operating balance before gains and losses (OBEGAL) surpluses and forecast net debt reducing to 18.8% of GDP in 2021/22 in line with the Government's Budget Responsibility Rules (BRRs)

Fiscal headroom

c **Note** that preliminary forecasts indicate there is fiscal headroom to increase Budget allowances while maintaining consistency with the BRRs

Budget 2019 operating allowance

d **Note** that it will be very challenging to both address emerging spending pressures and direct significant funding to the Government's wellbeing priorities within the current Budget 2019 operating allowance

e **Agree** to keep operating allowances at their current levels for *the 2019 Budget Policy Statement* (BPS) but signal that if during the Budget process the current operating allowances are not sufficient to deliver strategic priorities then the Government would consider lifting allowances

Agree/disagree

f [38]

Budget 2022 allowances

g **Note** that the HYEFU forecasts will need to include a Budget 2022 operating and capital allowance assumption as the last year of the forecast period is now 2022/23 (2019/20 – 2022/23)

h **Agree** to set the Budget 2022 operating allowance of $2.400 billion per annum (the same level as for Budget 2021) which signals new nominal operating expenditure to be constant across the forecast period

Agree/disagree

Multi-year capital envelope

i **Note** that as part of the Budget 2019 Strategy Cabinet paper, Cabinet agreed to move from a single-year capital allowance to a rolling multi-year envelope and that the level would be agreed to at HYEFU [CAB-18-SUB-0428], and

j **Agree** to set the multi-year capital envelope at $13.100 billion ($9.025 billion after pre-commitments), as illustrated below:

($ billion, total)	**Budget 2019**	**Budget 2020**	**Budget 2021**	**Budget 2022**
Single-year capital allowance	3.700	3.400	3.000	3.000
Multi-year capital envelope for Budget 2019-22	13.100			
Multi-year capital envelope for Budget 2019-22 (after pre-commitments)	9.025			

Agree/disagree

Neil Kidd
Team Leader, Macroeconomic and Fiscal Policy

Hon Grant Robertson
Minister of Finance

Treasury Report: Fiscal Strategy for the 2019 Budget Policy Statement

Purpose of Report

1. This report contains the Treasury's advice on fiscal strategy and budget allowances on the basis of the preliminary 2018 *Half Year Economic and Fiscal Update* (HYEFU) forecasts and emerging pressures.

2. This report provides you with an opportunity to ensure you are comfortable with progress towards the Budget Responsibility Rules (BRRs), or if not, adjust policy settings before forecasts are finalised.

3. Specific decisions are sought on the operating allowances and multi-year capital envelope. Any decisions taken in this report will be included in the final HYEFU forecasts due to be published in mid-December and inform *2019 Budget Policy Statement* (BPS) drafting. Decisions on allowances need to be taken by Tuesday 13 November to feed into HYEFU forecasts.

Budget Policy Statement 2019

4. You are scheduled to release your BPS on 13 December (the same day as HYEFU is released). The BPS provides the opportunity to outline the priorities that will guide the Government's decisions for the Wellbeing Budget 2019, the policy areas that the Government will focus on in the coming year, and how this relates to the Government's fiscal strategy.

5. You have received advice on what the BPS could include to frame Budget 2019 as the first Wellbeing Budget in '*Wellbeing and Living Standards Deliverables through to June 2019*' (T2018/3041). Any decisions will be incorporated into an initial draft BPS that will be prepared for your consideration.

The economic and fiscal outlook

The economic and fiscal outlook remains positive

6. Preliminary HYEFU forecasts show ongoing solid economic growth. Real economic growth is slightly slower than forecast at the *2018 Budget Economic and Fiscal Update* (BEFU), but tax revenue is forecast to be slightly higher.

7. Annual average real GDP growth still forecast to be around 3% on average over the next five years. After accounting for revisions, cumulative nominal GDP (the key driver of the tax forecasts) is unchanged over the four years to 2022. Interest rates are forecast to stay low for longer, starting to rise from early 2020 to contain inflation.

8. Tax revenue is forecast to be a cumulative $2.5 billion higher over the four years to June 2022 than forecast in BEFU.[1] The higher starting point (tax revenue was $0.7 billion higher in the year to June 2018 than forecast at BEFU) is mostly offset by forecasts of slightly softer economic growth and delayed interest rate increases. Policy changes, chiefly increases to rates of fuel excise and road user charges, have added $2.0 billion to the tax forecasts, with most of this occurring in the June 2021 year.

9. The HYEFU economic and tax forecasts will be finalised and reported to you on Thursday, 22 November. The final forecasts will include new economic data (for example, the OCR decision on November 8, inflation and labour market data) and any changes to the fiscal strategy. Forecasts will be updated again for Budget 2019. Refer to Treasury Report T2018/2912 *HYEFU 2018 Preliminary Economic and Tax Forecasts* for further information on the preliminary economic and tax forecasts.

Table 1: Comparison of Key Economic and Tax Indicators between BEFU and Preliminary HYEFU Forecasts

June years		2018 Actual	2019 Forecast	2020 Forecast	2021 Forecast	2022 Forecast	2023 Forecast[6]	4-year total
Economic growth[1]	**HYEFU18**	**2.7**	**3.0**	**3.2**	**2.7**	**2.3**	**2.1**	
	BEFU	2.8	3.3	3.4	2.7	2.5	n/a	
Economic growth per capita[1]	**HYEFU18**	**0.7**	**1.2**	**1.6**	**1.4**	**1.1**	**1.0**	
	BEFU	0.7	1.3	1.7	1.3	1.3	n/a	
Unemployment rate[2]	**HYEFU18**	**4.5**	**4.4**	**4.2**	**4.2**	**4.3**	**4.5**	
	BEFU	4.5	4.2	4.1	4.1	4.2	n/a	
CPI inflation[3]	**HYEFU18**	**1.5**	**2.0**	**2.1**	**2.1**	**2.1**	**2.0**	
	BEFU	1.4	1.5	1.8	1.9	2.0	n/a	
Current account balance[4]	**HYEFU18**	**-3.4**	**-3.6**	**-3.4**	**-3.3**	**-3.4**	**-3.5**	
	BEFU	-2.6	-3.1	-3.0	-3.0	-3.1	n/a	
Nominal GDP growth[5]	**HYEFU18**	**5.5**	**4.2**	**5.7**	**5.1**	**4.5**	**4.2**	
	BEFU	6.1	4.7	5.0	4.6	4.5	n/a	
Nominal GDP ($billions)	**HYEFU18**	**289.3**	**301.5**	**318.7**	**335.0**	**350.1**	**364.7**	
	BEFU	291.0	304.6	320.0	334.7	349.8	n/a	
	change	-1.7	-3.1	-1.2	+0.3	+0.3	n/a	-3.8
Tax revenue ($billions)	**HYEFU18**	**80.2**	**84.1**	**89.0**	**94.8**	**100.4**	**105.2**	
	BEFU	79.5	83.9	89.0	93.9	99.0	n/a	
	change	0.7	0.2	0.0	0.9	1.4	n/a	2.5

1. Production GDP, annual average % change 2. June quarter 3. Annual % change 4. Annual as % of GDP
5. Expenditure measure 6. BEFU forecasts were out to June 2022 only.

Preliminary fiscal forecasts show an improved net debt track

10. Preliminary HYEFU forecasts show net debt is slightly lower than forecast at BEFU, reaching 18.8% of GDP in 2021/22 and 17.2% in 2022/23. The net debt track is supported by a stronger starting position, higher tax receipts and higher top down adjustments to capital spending. These factors are partially offset by initially weaker operating balances, relating to higher benefit expenses and transport operating expenditure, and the impact of expense transfers from previous years.

[1] The reported cumulative forecast tax revenue amount in the *HYEFU 2018 Preliminary Economic and Tax Forecasts* was $1.9 billion. The difference is driven by updated forecasts of transport-related taxes, i.e. additional revenue from increases to fuel excise and road user charges rates, and updated forecasts of GST paid by the Crown.

11. The outlook for the operating balance before gains and losses (OBEGAL) and residual cash is weaker in the near-term and then stronger in the medium-term compared to the BEFU forecasts, while the outlook for net worth and net debt is improved throughout the forecast period. OBEGAL surpluses are lower than forecast at BEFU until 2021/22, after which they exceed the BEFU forecast, rising to $8.9 billion (2.4% of GDP) in 2022/23.

12. The HYEFU fiscal forecasts will be finalised on Monday 26 November and a report will be provided soon after. Refer to Aide Memoire T2018/3154 *HYEFU 2018 Preliminary Fiscal Forecasts* for further information on the preliminary fiscal forecasts.

Table 2: Comparison of Key Fiscal Indicators between BEFU and Preliminary HYEFU Forecasts

$ billion, June years		**2018 Actual**	**2019 Forecast**	**2020 Forecast**	**2021 Forecast**	**2022 Forecast**	**2023 Forecast**
OBEGAL	**HYEFU18**	**5.5**	**1.8**	**4.3**	**5.3**	**8.0**	**8.9**
	BEFU	3.1	3.7	5.4	5.7	7.3	n/a
	change	2.4	-1.9	-1.1	-0.4	0.7	n/a
Residual Cash	**HYEFU18**	**1.3**	**-5.6**	**-2.5**	**-1.1**	**1.2**	**3.1**
	BEFU	-1.3	-3.9	-1.7	-1.9	0.7	n/a
	change	2.6	-1.7	-0.8	0.8	0.5	n/a
Net Worth attributable to the Crown	**HYEFU18**	**129.6**	**133.7**	**141.4**	**150.5**	**162.7**	**176.3**
	BEFU	117.6	124.5	133.3	142.9	154.7	n/a
	change	12.0	9.2	8.1	7.6	8.0	n/a
Net Debt	**HYEFU18**	**57.5**	**63.1**	**65.8**	**66.9**	**65.9**	**62.8**
	BEFU	60.4	64.2	65.9	67.6	67.0	n/a
	change	2.9	1.1	0.1	0.7	1.1	n/a
Net Debt (% of GDP, June years)	**HYEFU18**	**19.9**	**20.9**	**20.6**	**20.0**	**18.8**	**17.2**
	BEFU	20.8	21.1	20.6	20.2	19.1	n/a
	change	0.9	0.2	0.0	0.2	0.3	n/a

There are risks to the outlook

Economic risks

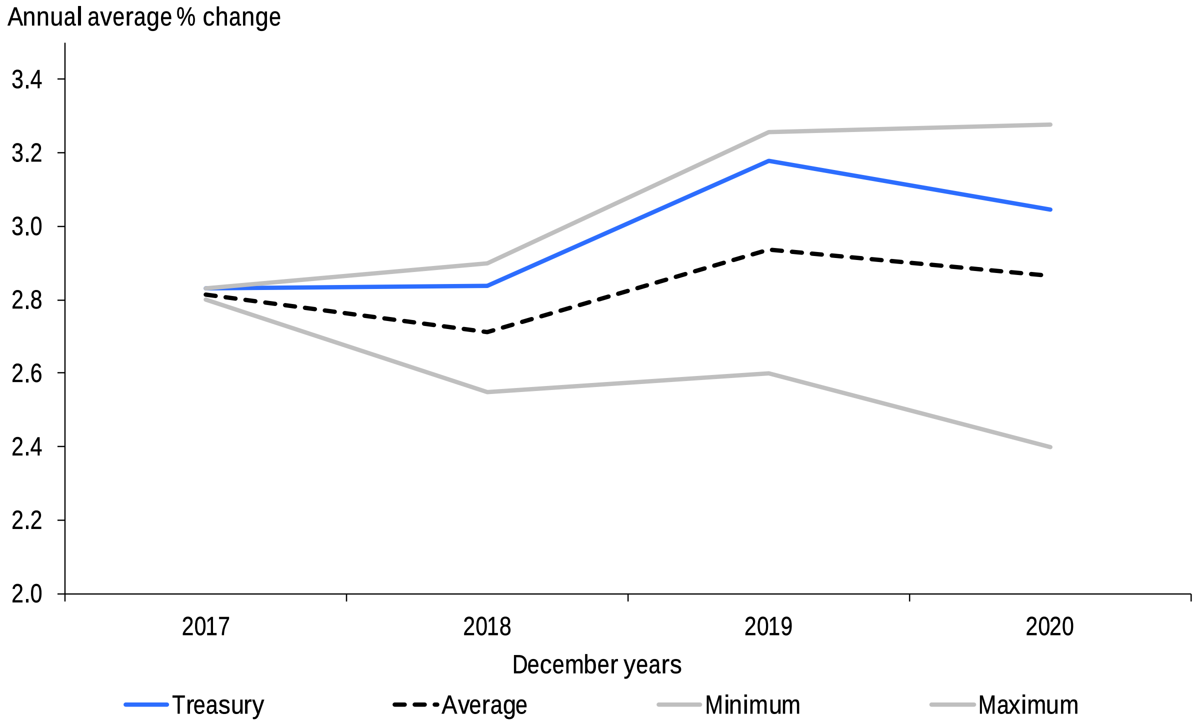
13. There are upside and downside risks, particularly with respect to nominal GDP and tax revenue. Risks to real GDP growth are currently more to the downside compared with BEFU. Key risks to the economic outlook include:

- Higher-than-forecast nominal wages leading to lower business activity and higher inflation (impact on nominal GDP and tax revenue could be minimal or positive).
- More binding capacity constraints in sectors such as construction might spur further inflation, raise nominal residential investment costs and delay project delivery (impact on nominal GDP and tax revenue could be minimal or positive).
- Increasing global trade tensions resulting in weaker global demand for New Zealand exports (negative impact on both real and nominal GDP and tax revenue).
- Declining business and consumer confidence weighing more strongly on investment and consumption (negative impact on both real and nominal GDP and tax revenue).

- Further depreciation in the New Zealand dollar, feeding into higher domestic inflation and widening the current account deficit (impact on nominal GDP and tax revenue could be minimal or positive).

14. The Treasury's forecasts of real GDP growth fall within the range of market views but are slightly stronger than the average.

Figure 1: Treasury vs other institutions forecasts of GDP growth



Note: the forecasts for a number of institutions will not incorporate the stronger-than-expected June quarter GDP data. The six institutions compared across are ANZ, ASB Bank, Bank of New Zealand, the Reserve Bank, Westpac, and New Zealand Institute of Economic Research.

Tax revenue risks

15. If some of the downside risks to our economic forecasts materialise, this would have a flow-on effect to the tax forecasts. Key risks to the tax forecasts include:

- The higher-than-forecast tax revenue for the year ending June 2018 may not persist. We have made a judgement that the higher starting level for tax revenue persists through the forecast period.

- Our judgements may be too optimistic. Inland Revenue forecast $1.6 billion lower tax revenue than the Treasury despite using the same macroeconomic forecasts as a base. The differences occur mainly in the forecasts of corporate tax, in which the two agencies use slightly different macroeconomic parameters as growth drivers for their respective forecasts (this difference has been present in previous forecasts).

Fiscal risks

16. Key risks to the fiscal forecasts include:

- Population growth resulting in higher levels of government expenditure. Population growth results in higher forecast tax revenue in the forecasts but higher levels of government expenditure from population growth are not included in the fiscal forecasts. Budget allowances are included in forecasts to represent new government expenditure but they are not automatically adjusted for population growth.

- [38]

Progress against the Budget Responsibility Rules (BRRs)

17. The preliminary fiscal forecasts show consistency with the BRRs and that there is fiscal headroom against the Government's BRRs:

- Net debt is forecast to reach 18.8% by 2021/22.
- OBEGAL surpluses are forecast to reach $8.0 billion (2.3% of GDP) by 2021/22.
- Core Crown expenditure is forecast to fall from 29.3% of GDP in 2018/19 to 28.1% of GDP in 2021/22 and 2022/23.

Current Budget allowances

18. For the BPS, you will need to consider whether fiscal settings should be adjusted. This requires a judgement taking account of the fiscal outlook and risks, macroeconomic conditions, expected fiscal pressures and investment opportunities, and the wider fiscal and economic strategy. The following sections discuss existing budget allowance settings, emerging fiscal pressures and opportunities, and our advice on how these could be managed and communicated in the BPS.

19. The BEFU forecasts did not include a Budget 2022 operating and capital allowance figure as at the time this was outside of the forecast period (2018/19 – 2021/22). The HYEFU forecasts will need to include a Budget 2022 operating and capital allowance as the last year of the forecast period is now 2022/23 (2019/20 – 2022/23). This is discussed further in the *Budget 2022 allowances for* HEYFU section.

Budget operating allowance

20. As part of the Budget 2019 Strategy Cabinet paper, Cabinet agreed to keep the operating allowances as signalled in Budget 2018 [CAB-18-SUB-0428]. Table 3 shows the operating allowances before and after pre-commitments.

Table 3: Budget operating allowances agreed to in the Budget 2019 Strategy Cabinet paper ($ billion, per annum)

	Budget 2019	Budget 2020	Budget 2021
Operating allowance (before pre-commitments)	2.400	2.400	2.400
Operating allowance (after pre-commitments)	1.678	2.257	2.400

Multi-year capital envelope

21. As part of the Budget 2019 Strategy Cabinet paper, Cabinet also agreed to move from a single-year capital allowance to a rolling multi-year envelope. The new approach is:

- For the envelope to roll forward each year (rather than be for a fixed period).
- For the size of the envelope to reflect capital investment over four Budgets.
- To count the full cost of capital expenditure decisions against the four-year envelope.
- To consider the impact of the profile of expenditure on net debt as part of the decision-making process.

22. The new multi-year capital envelope increases the amount of new capital funding the Government can commit to in Budget 2019. Cabinet agreed that the level of the envelope would be set and announced in the BPS.

23. Table 4 shows how the size of the new four-year envelope relates to the previously forecast single-year allowances, and the multi-year capital envelope after pre-commitments (assuming the cost of the P-8As are charged against the envelope, which you will receive advice on during the week of 5 November).

24. We recommend setting the multi-year capital envelope at $13.100 billion ($9.025 billion after pre-commitments) in the BPS and revisiting this level during the Budget process when better information on capital pressures and investment opportunities is available. This level is based on the existing single-year capital allowances and assumes a Budget 2022 level of $3.000 billion (the same level as Budget 2021).

25. In addition to reviewing the level during Budget, the size of the envelope can be reviewed when the next year of the envelope is rolled out, which will be at HYEFU 2019 when the Budget 2023 year is rolled into the forecast period.

Table 4: Illustration of how the new multi-year capital envelope relates to the previously forecast single-year allowances ($ billion, total)

($ billion, total)	Budget 2019	Budget 2020	Budget 2021	Budget 2022
Single-year capital allowance	3.700	3.400	3.000	3.000 (TBC)
Multi-year capital envelope for Budget 2019-22	13.100 (TBC)			
Multi-year capital envelope for Budget 2019-22 (after pre-commitments)	9.025 (TBC)			

The outlook for Budget 2019

Operating allowances are heavily oversubscribed

26. The Budget 2019 operating allowance is currently $1.678 billion per annum after pre-commitments ($2.400 billion before pre-commitments). [33]

[33]

The October check-in numbers should be treated as indicative only as final initiatives are not due until 14 December. In addition, the Government will be considering the recommendations of the Tax Working Group, which may recommend a package that is fiscally negative in the forecast period.

27. Historically the operating allowance has been heavily oversubscribed. For example, the level of oversubscription in Budget 2017 was 172% and in Budget 2018 was 218%. [33]

28. It will be very challenging to both address emerging spending pressures and direct significant funding to the Government's wellbeing priorities within the current Budget 2019 operating allowance.

29. Prioritisation, savings and revenue initiatives may help, but it is likely that significant options for Budget 2019 will be limited as a number of reprioritisation, savings and revenue generating initiatives were progressed for Budget 2018.[2]

30. Not funding low-value initiatives that seek new funding in Budget 2019 will help limit any increase in allowance. The October check-in stage can help with identifying early initiatives that should not progress further.

There is significant pressure against the multi-year capital envelope

31. The multi-year capital envelope is currently $9.025 billion after pre-commitments (assuming a multi-year capital envelope of $13.100 billion and the P-8As are counted against the envelope). [33]
[33]

32. The multi-year capital envelope is intended to fund capital initiatives for the next four Budgets (Budget 2019 – Budget 2022). This equates to an average $2.256 billion capital for each of the next four Budgets. We expect the capital envelope to come under more pressure relative to the operating allowance and for it to be challenging to remain within the envelope while at the same time directing funding towards the Government's wellbeing priorities.

[33]

34. We are also aware of capital cost pressure initiatives likely to come through Budget 2019 from Corrections, Foreign Affairs, Police, Defence, and Housing and Urban Development. The next section provides an overview of capital requirements between Budgets 2020-2030. The ability to deliver the capital projects given current capacity constraints is explored in the *Capacity constraints might limit the delivery of capital commitments* section.

[2] Agencies are required to identify 1% of possible prioritisation in their baselines for Budget 2019.

The outlook beyond Budget 2019

35. There will be significant future cost pressures beyond Budget 2019 as the demand for public services and the cost of them increase (for example, due to population growth). These pressures will require management to maintain a sustainable fiscal position.

[33]

[33]

[33]

Initiatives from Government reviews with fiscal implications

45. In addition to future operating cost pressures and capital pressures, there will likely be initiatives coming out of current Government reviews that will have fiscal implications which will need to be managed.

Capacity constraints might limit the delivery of capital commitments

46. There are signals that market capacity may be constrained which could limit the ability to deliver infrastructure and construction projects. The pace of Crown investment has likely also been constrained by agency constraints relating to the planning and procurement of capital works.

47. Current analysis suggests the output gap (a summary measure of the extent of pressure on resources in the economy) is positive, implying the economy is running slightly above its potential. Business surveys show firms have experienced increased difficulty in finding skilled and unskilled labour in the construction sector, indicating a tight labour market.

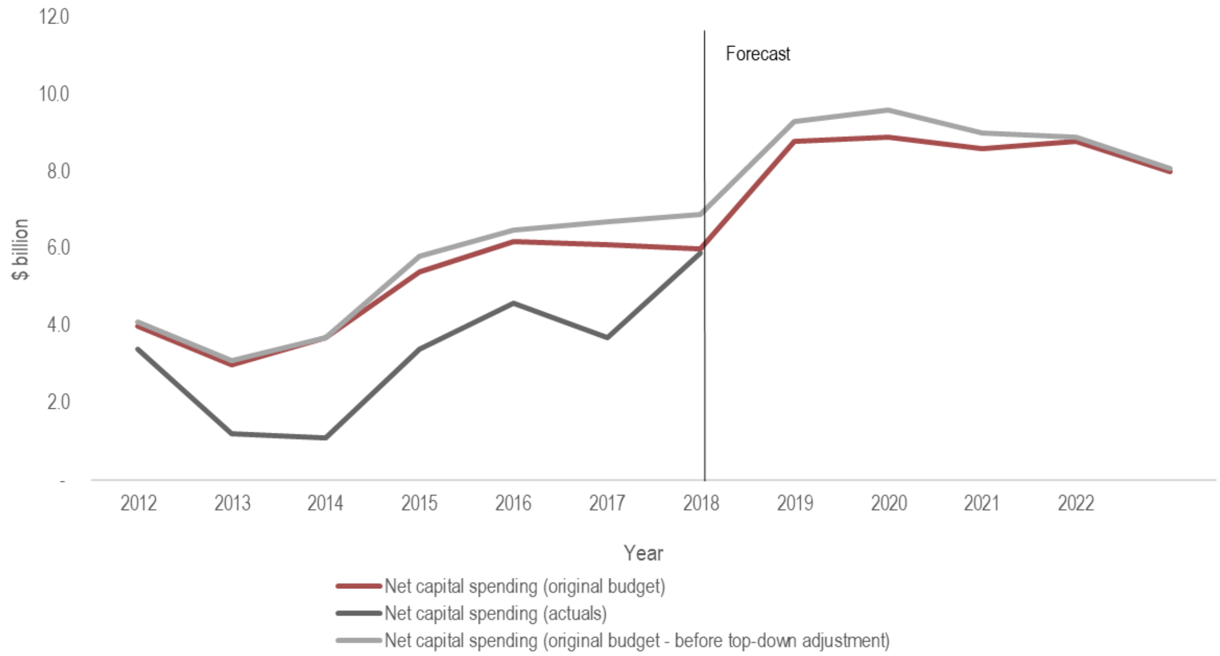
48. The Crown accounts in recent years provide additional insights into capacity pressures. Figure 3 shows that increased funding for capital expenditure has been budgeted since 2012, but actual spending by core Crown entities has come in under that which the agencies forecasted.

Implications for policy

49. Given current agency and capacity constraints we think there is limited room to significantly increase capital investment in the near term, without crowding out other activity.

50. The new multi-year capital envelope and the new independent infrastructure commission may help improve capacity over time by helping create a pipeline of upcoming work (giving firms time to prepare). For example, the new multi-year capital envelope allows the Government to commit to multiple large capital investments that will be implemented in future years.

Figure 3: Net core Crown capital spending budgeted and actuals



51. To the extent there will be high-value, wellbeing-enhancing investment opportunities, adjustments to the fiscal strategy could be considered. There is an option to increase Budget 2019 operating and/or capital allowances in line with the fiscal headroom against the BRRs.

52. While the case for higher levels of investment is evident in many areas, initiatives are not currently fully developed which gives rise to concerns around ensuring high-value from any additional expenditure. Therefore the Treasury recommends keeping Budget allowances at their current levels for the BPS but signalling that if, during the Budget process, the current allowances are not sufficient to deliver strategic priorities then the Government would consider lifting allowances. This conclusion would be affected by the treatment of the recent pay equity Cabinet agreement and how it is counted against allowances. We will be providing further advice on this issue. The main advantage to this approach is that waiting until closer to final Budget decisions will provide better information as to what the appropriate size of any increase could be and any increase can be more easily directed to high-value initiatives.

53. A further option to manage fiscal pressures and provide for greater high-value investments would be to consider modifying the debt rule in the BRRs. This would

require careful design and communication to maintain a sustainable and resilient fiscal trajectory while ensuring higher investment is well spent. The Treasury does not recommend changing the BRRs at this time because there is currently fiscal headroom to increase allowances without needing to modify the BRRs.

54. [33]

55. We can provide fiscal scenarios showing different allowance settings if requested.

Budget 2022 allowances for HYEFU

56. As explained earlier, a Budget 2022 capital and operating allowance level will need to be agreed to for the HYEFU forecasts and announced in the BPS. The Budget 2022 capital allowance will form part of the multi-year envelope.

57. In recent years the approach to rolling out a forecast year has been to use the previous year's allowance level, as it is challenging to identify what an appropriate allowance will be in four year's time with the information available. The preliminary HYEFU forecasts assumed a Budget 2022 capital allowance of $3.000 billion and operating allowance of $2.400 billion (the same level as the Budget 2021 allowance).

58. As we currently do not have sufficient information to identify an alternative Budget 2022 capital and operating allowance level, we recommend assuming the Budget 2021 levels.

59. It should be noted that the Budget 2022 allowance levels we are recommending ($3.000 billion capital allowance and $2.400 billion operating allowance) differ from the Budget 2022 allowance levels in Fiscal Strategy Report 2018 (FSR) projections. The FSR contained an assumed 2022 capital allowance of $9.500 billion and operating allowance of $2.200 billion. The FSR allowance assumptions were made to keep the net debt track consistent with your intentions for the path of net debt beyond 2022. The impact of the different allowance levels on net debt in 2022/23 will be small as the cash flow profile of the $9.500 billion allowance is phased over 5 years in the FSR.

60. We will provide you with a Treasury Report once the final fiscal forecasts are released on 26 November 2018 that will set out different post-2022/23 operating and capital allowance assumptions for the Fiscal Strategy Model projections and their impact on the fiscal aggregates (such as net debt). Unlike the FSR, it is optional to publish the projections alongside the BPS.

Macroeconomic considerations in setting allowances

61. The PFA requires you to consider the interaction between fiscal and monetary policy. Building up strong fiscal buffers is important so that the fiscal position can support wellbeing by strengthening resilience to the next shock. At the same time, with subdued inflation and historically low interest rates, a somewhat more expansionary fiscal stance than at Budget 2018 would be unlikely to create macroeconomic imbalances.

62. Maintaining strong fiscal buffers are important to enable fiscal policy to play a stabilising role in any future downturn. While monetary policy plays the main role in supporting economic stability, fiscal buffers may be particularly important in a future downturn as conventional headroom to ease monetary policy is limited with the OCR at an historic low of 1.75 percent. During previous downturns, the Reserve Bank has cut the OCR by up to 5.75 percentage points.

63. Further fiscal expansion could place pressure on interest rates and exchange rates and displace private sector activity at the margin. This could bring forward OCR increases (currently projected to take place from early 2020) and put upward pressure on the exchange rate, weighing on the competitiveness of the export sector.

64. Even so, we consider there is currently reduced risk of fiscal expansion creating these sorts of imbalances. Risks from higher interest rates are less concerning in an environment of historically low interest rates and subdued inflation pressures. Market pricing indicates an OCR cut is more likely than a hike in the near-term. There may be some financial stability benefits in supporting aggregate demand so that interest rates return to normal levels, as very low interest rates can fuel asset price inflation.