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27 May 2016

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RATINGS

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Long-term Issuer Rating, Foreign Currency	Aaa/Stable
Long-term Issuer Rating, Domestic Currency	Aaa/Stable

Ceilings

Bonds, Foreign Currency	Aaa
Bonds, Local Currency	Aaa
Deposits, Foreign Currency	Aaa
Deposits, Local Currency	Aaa

Source: Moody's Investors Service

Contacts

Steven A. Hess 212-553-4741
Senior Vice President
steven.hess@moodys.com

Marie Diron 65-6398-8310
Senior Vice President/ Manager
marie.diron@moodys.com

Atsi Sheth 65-6398-3727
Associate Managing Director
atsi.sheth@moodys.com

Government of New Zealand

The 2016-17 Budget: Strong Economic and Fiscal Outlooks Are Credit Positive

On 26 May, the government of New Zealand (Aaa, stable) presented its budget for the 2016-17 fiscal year which begins on 1 July. The budget forecasts an economic outlook that is somewhat stronger compared to earlier projections. This stronger outlook translates into higher government revenues and, therefore, somewhat higher surpluses than earlier projected. While there are risks to the outlook, overall we view the upwardly revised projections as credit positive for the government.

The budget estimates a small fiscal surplus of 0.3% of GDP this fiscal year, with the surpluses rising gradually to 2.2% of GDP through 2019-20. After six years of operating deficits brought about by a mild recession followed by major earthquake costs in 2011, the budget returned to a small surplus in 2014-15.

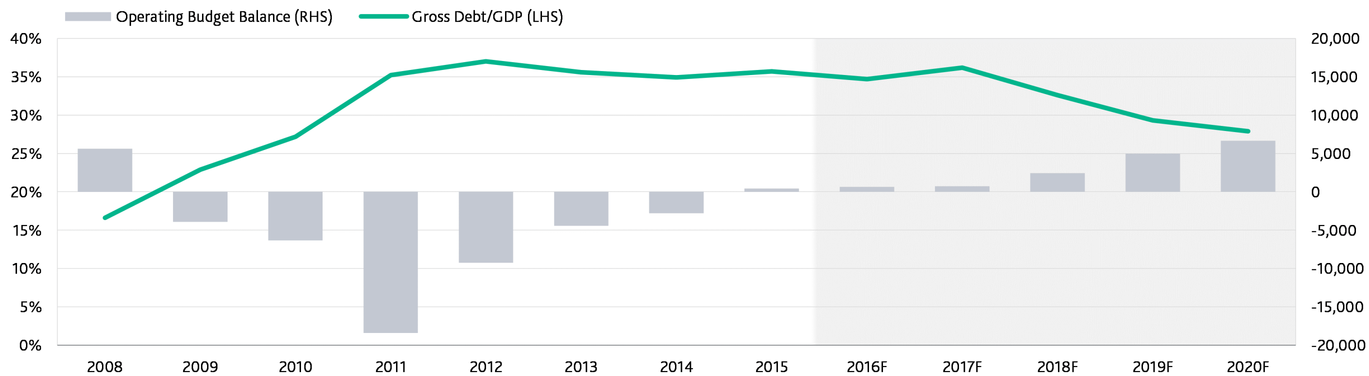
One main factor supporting the surplus trend over the next several years is a relatively strong economic outlook. Real GDP is projected to grow by an average of 2.8% annually over the five years to June 2020, with positive impetus coming from net migration, service exports (mainly tourism), and housing construction. Net migration has been at record levels recently and the tourism industry has seen very strong arrivals. While housing construction has been concentrated in Christchurch because of the earthquake reconstruction, the housing market in Auckland is very strong and, partly because of immigration, is expected to remain so.

Beside a 10% annual increase in tobacco excise tax from January 2017, there are no significant changes in the tax policy. As a result, government revenues are projected to rise broadly in line with nominal GDP and remain at around 30% of GDP.

Expenditure control is the main factor underpinning the increase in the budget surplus as a percentage of GDP, with lower interest rates a contributing factor. In the budget, expenditures are projected to fall from close to 30% of GDP in fiscal 2015 to 28.3% at the end of the period, with a nominal growth rate of 3.3% annually over the coming four years. Revenues will increase at a higher 5.0%.

After a slight rise in 2016-17, the government's debt ratios are projected to decline. Gross debt as a percentage of GDP will fall to 27.9% by 2019-20, from 36.2% in fiscal 2017 . One of the stated policy objectives of the government is for net debt to decline to "around" 20% of GDP by 2020. The budget projects that the ratio will reach 20.8% that year compared with 25.6% at the end of 2016-17. These debt trends are positive for the sovereign's credit profile.

Exhibit 1
Rising Operating Balances, Declining Debt On the Horizon
(% of GDP or NZ$ millions, June years)



Source: New Zealand Treasury

We view the budget projections as reasonable, but with some risks. Because much of the fiscal improvement is based on solid economic growth, the main risks come from failure of the economy to record such gains. One possible cause would be less growth in or a reversal of net migration, which would result from exchange rate movements and/or the relative performance of the Australian and East Asian economies vis-à-vis New Zealand. Such a development would also affect construction, which is one of the drivers of economic growth.

A second risk would be to tourism, which could materialize if, for example, the NZ$ strengthened, especially against the Australian dollar. We consider these risks could affect economic growth and government finance, but probably not enough to change the overall direction.

Other factors that could possibly affect growth negatively include housing prices, household debt and lower dairy prices for an extended period. The latter appears to be already occurring and is presumably built into the government's forecasts.

One further source of risk relates to possible constraints on restraining expenditure over a multi-year horizon. The rapid increase in population puts pressure on spending for social services and infrastructure. Moreover, with the government running a budget surplus and debt falling as a proportion of GDP, demands for additional spending may increase.

Moody's Related Research

- **Credit Analysis**: Government of New Zealand, 24 March 2016
- **Credit Opinion**: Government of New Zealand, 31 December 2015
- **Banking System Outlook Update**: Outlook Remains Stable But Pressure on Asset Quality Is Rising, 5 April 2016
- **Sector Outlook**: Policy Effectiveness Amid High Leverage and China's Rebalancing To Drive Outlooks, 27 April 2016

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