ANZ Research

Budget 2021 Review

20 May 2021

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A touch more stimulus

Summary

- Budget 2021 shows the Government looking to strike a balance between fiscal consolidation and addressing some significant issues.
- Key policy announcements include: main benefit increases, $1.5bn for the vaccine rollout, $4.7bn for health, $3.8bn for the housing acceleration fund, and an extra $3.9bn in the multi-year capital envelope.
- Additional spending in this and upcoming Budgets was non-trivial, but not a game changer for the macroeconomic outlook.
- The Government's broad fiscal strategy is unchanged from February's Budget Policy Statement. Fiscal flexibility remains important, given ongoing virus risks.
- The Treasury has upgraded its economic outlook, which has created a little extra wiggle room on the spending front while also contributing to a lower projected debt level than previously.
- But the overall deterioration in the Government's books remains significant. Net core Crown debt is expected to peak at 48% of GDP in 2023 (more than $100bn higher than projected before this crisis).
- Compared to December's Half-Year Update, Debt Management's gross bond issuance guidance has been downgraded by a cumulative $10 billion over the next few years. This is less than we were expecting.
- Markets will be disappointed by the lack of a reduction to next year's bond programme. And while the planned introduction of a new 2051 bond in the second half of calendar 2021 is welcome from the perspective that it extends the NZGB curve to 30 years, it will add to curve-steepening pressure.

Table 1: Key forecast changes (Budget 2021 vs Half-Year Update 2020)

Budget 2021 forecasts (Half-Year Update 2020 forecasts in brackets)					
Economic (June years)	2020/21	2021/22	2022/23	2023/24	2024/25
Real GDP (ann avg % chg)	2.9 (1.5)	3.2 (2.6)	4.4 (3.7)	3.3 (3.8)	2.9 (3.2)
Nominal GDP ($bn)	334.4 (323.9)	349.7 (338.8)	371.7 (359.7)	392.9 (382.7)	414.4 (404.8)
Unemployment rate (June qtr, %)	5.2 (6.6)	5.0 (6.8)	4.4 (5.7)	4.2 (4.7)	4.2 (4.0)
CPI (ann. % chg.)	2.4 (1.4)	1.7 (1.2)	1.8 (1.4)	2.0 (1.8)	2.1 (2.1)
Fiscal					
OBEGAL - % of GDP	-4.5 (-6.7)	-5.3 (-4.9)	-2.6 (-2.9)	-1.4 (-2.0)	-0.6 (-1.0)
Core Crown Residual Cash - % of GDP	-7.6 (-12.4)	-11.2 (-10.7)	-6.9 (-6.6)	-1.5 (-1.4)	0.8 (1.0)
Net Core Crown Debt - % of GDP	34.0 (39.7)	43.8 (49.1)	48.0 (52.6)	46.9 (50.7)	43.6 (46.9)
Bond Programme (gross, NZ$bn)	45.0 (45.0)	30.0 (30.0)	25.0 (30.0)	25.0 (30.0)	25.0 (25.0)

Details and assessment

Finding a balanced path towards a balanced budget

As expected, Budget 2021 aims to strike a delicate balance between the need to rebuild fiscal buffers and directing a little more spending to where it's urgently needed.

Key Budget announcements include:

- $1.5bn from the COVID-19 Response and Recovery Fund to support the vaccination programme;
- $4.7bn in health to support PHARMAC, transitioning to a new health system to replace DHBs, and establishing the Maori health authority;
- $3.8 billion for the Housing Acceleration Fund;
- Higher main benefit rates, between $32 and $55 extra a week per adult; and
- A $3.9 billion increase in the multi-year capital allowance for projects including upgrading school property and funding KiwiRail purchases.

In our view, the most significant of these announcements is the increase in main benefit rates. That's going to make a big different for low-income households. And these households are likely to spend the cash rather than save it. The money will therefore be quickly circulated through the economy, supporting demand. However, severe capacity constrains in some key sectors, construction in particular, are likely to blunt the impact of other policies. The construction sector is already rushed off its feet, so it's not clear how additional capital expenditure to increase construction can happen without crowding out private sector spending.

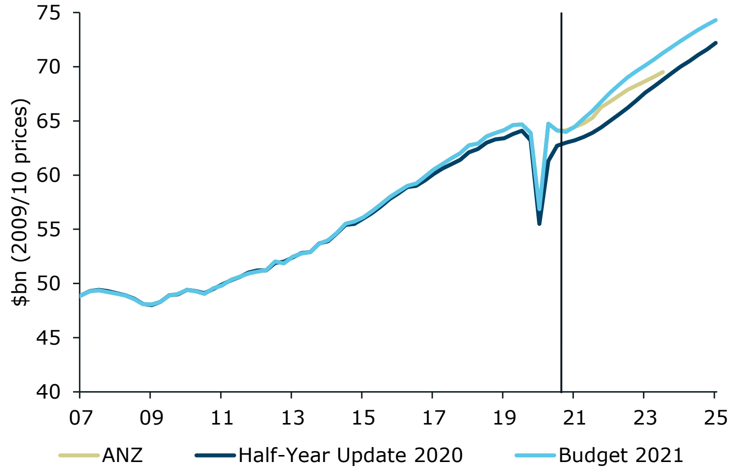
The above initiatives are funded from a mix of allocations from pre-signalled spending and higher capital and operating allowances, which in part has been made possible by a better economic outlook.

A solid upgrade to the economic outlook…

As expected, the Treasury has upgraded its central economic forecasts to reflect the better-than-expected data flow, and evidence that underlying economic momentum is a little stronger (figure 1). Similar to our outlook, GDP growth is forecast to move broadly sideways over 2021, albeit from a much stronger starting point than was expected in the Half-Year update in December. However, the Treasury are expecting real GDP to accelerate a bit faster from 2022.

While it's very uncertain what the economy will look like that far out, there's probably downside risk to their forecast. As the Treasury notes, while vaccination progress may see the border open up next year (Treasury assume 1 Jan 2022), global travel may take a lot longer to normalise, if it ever does. And with many parts of the economy already bumping into capacity constraints (with labour availability hampered by closed borders, and global supply disruptions looking like they'll persist at least to the end of the year), one has to question just how much faster the economy can grow, and to what extent rising demand may just translate into higher prices.

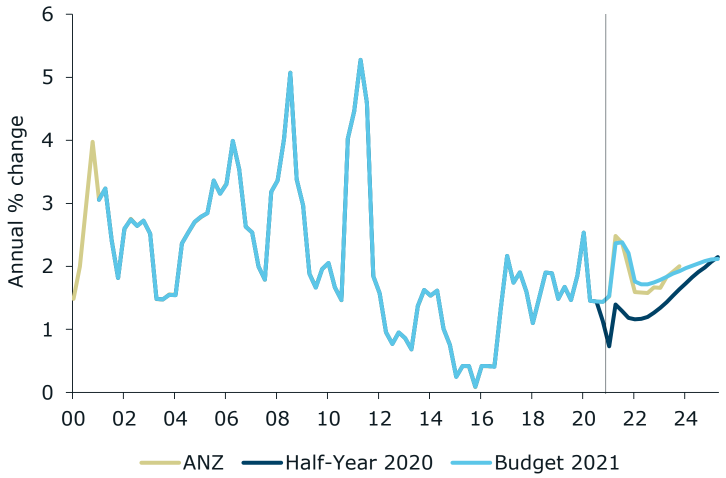
Figure 1. Real GDP forecasts



Source: Statistics NZ, The Treasury, ANZ Research

And it does look like the Treasury's economic projections may be underestimating the degree of capacity constraint in the economy. They have upgraded the outlook for CPI inflation to something very close to our own forecast (figure 2). However, we already see considerable upside inflation risks developing, with our ANZ Business Outlook survey showing that pricing intentions and cost expectations are through the roof. It's increasingly looking like an economy that's struggling to grow against capacity constraints, rather than an economy that will feature a lot of twiddling thumbs and idle machinery over 2021.

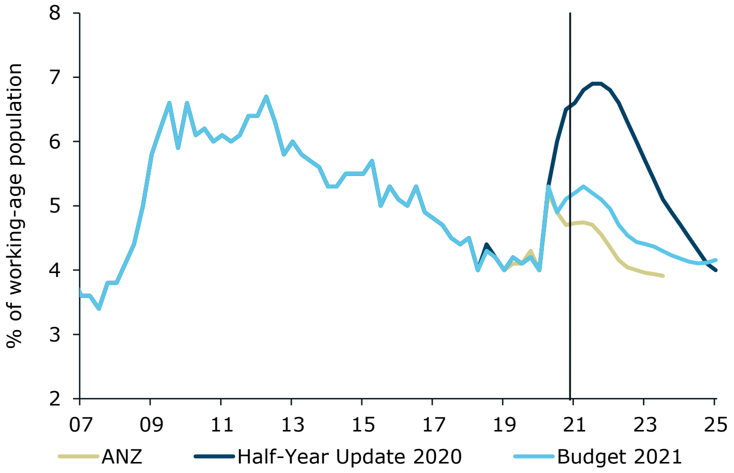
Figure 2. CPI forecast (BEFU, HYEFU, ANZ)



Source: Statistics NZ, The Treasury, ANZ Research

Treasury has also upgraded its labour market outlook, but again it's probably underestimating the degree of stretch in New Zealand's labour market – understandable given its economic forecasts were finalised before the surprisingly good 4.7% unemployment rate outturn in Q1 (figure 3). Treasury presents upside and downside scenarios for the unemployment rate. We think that the labour market is more likely to follow the upside (better) scenario. Unemployment is already low, and employment growth has been impressive, given the difficulty finding labour reported by firms. A tight labour market will only make it more difficult for firms to grow without resorting to more capital-intensive production processes (and that can take time, especially given the global disruptions to global shipping routes, semi-conductor production and supply chains more generally).

Figure 3. Unemployment rate forecast



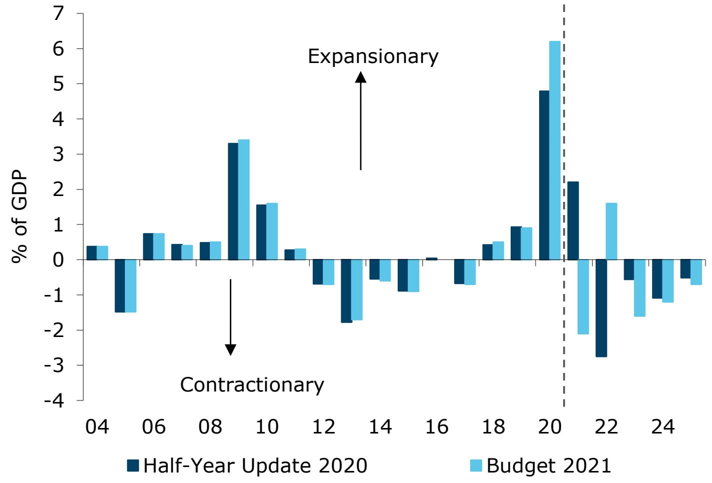
Source: Statistics NZ, The Treasury, ANZ Research

While the economy may be trying to grow quickly, capacity constraints mean that it may not grow as fast as Treasury expect (in real terms. This may see some of the demand impulse feeding through into price pressures, rather than activity. But from a fiscal point of view, that's not all bad news. Higher prices also boost nominal GDP, and that's what gets taxed at the end of the day. And lower unemployment means reduced operational spending on things like unemployment support (all else equal). So overall, the Government's books may benefit, especially since the economy looks like it won't need additional fiscal support to keep the recovery moving.

Turning things around, what about the impact of fiscal policy on the economic outlook? That's also complicated. According to the Treasury's fiscal impulse estimate, the days of fiscal settings *directly* contributing to headline *growth* are more or less in the rear view mirror (Figure 4). However, there has been a re-phasing of spending, and that's reduced the 2021 impulse and pushed up the 2022 impulse. Overall, the impulse remains contractionary on average over the forecast horizon. That was inevitable given the size of recent stimulus – a positive impulse would be impossible to sustain without government debt exploding. And importantly, it's becoming clear that the strength of the economic recovery means that additional macro stimulus is no longer needed.

Indeed, with capacity pressures becoming more and more of a limit in pockets of the economy, the Government needs to be thinking more about fixing the supply side of the equation than about adding to demand. Too much focus on the latter is likely to do little more than crowd out private sector activity and drive up prices. And finally, to the Government's credit, a big part of the reason why further macro stimulus is no longer needed is the efficacy of the Government's COVID response. The simple fiscal impulse measure doesn't capture second-round impacts such as the efficacy of the wage subsidy in keeping people connected to the labour market.

Figure 4. Fiscal impulse



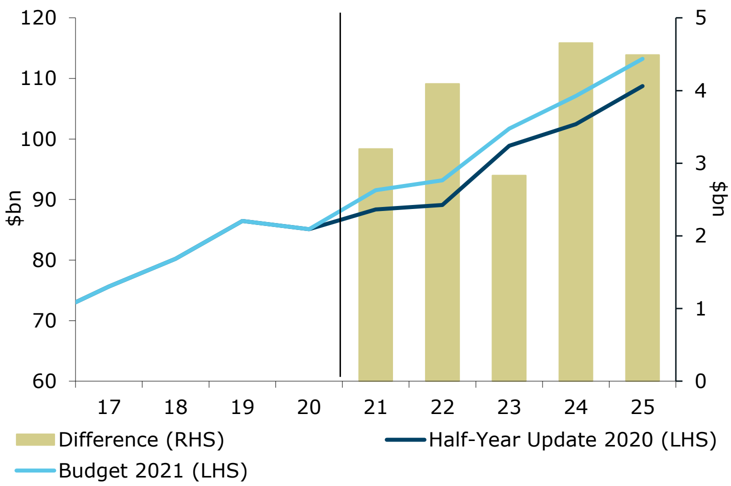
Source: The Treasury

Putting it all together, the Treasury's forecast for nominal GDP is expected to be $87bn larger on a cumulative basis to June 2025 compared to the Half-Year Update. But as we noted in our Preview, this partly reflects revisions to the historical level of GDP, in addition to stronger underlying economic momentum.

...means higher expected tax receipts...

Reflecting the larger nominal economy, forecast tax revenue is also expected to come in stronger over the entire forecast horizon (Figure 5).

Figure 5. Change in core Crown Tax Revenue

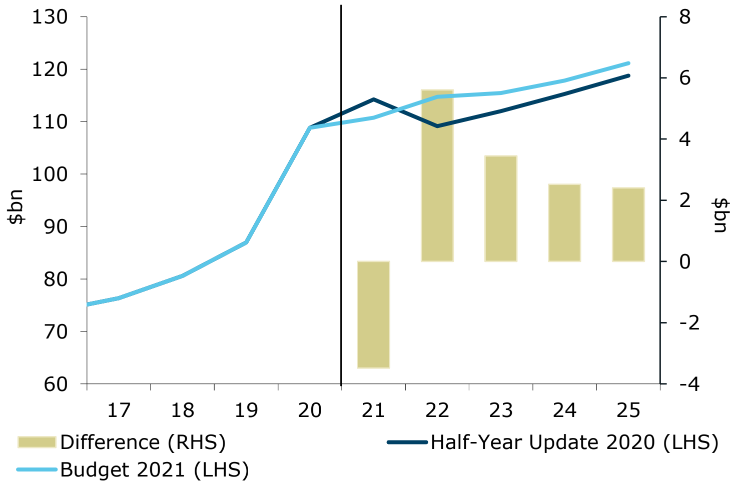


Source: The Treasury

...and room to consolidate a little faster, while squeezing in a little more spending

Overall, core Crown expenses are expected to be around $10bn higher over the forecast horizon to 2025. But there is some re-phasing going on here, with some spending that was previously pencilled in for the current fiscal year being pushed into 2022. On the operational side, the Budget 2021 operating allowance has been increased from $2.625bn to $3.8bn. Thereafter, allowances have been lifted from $2.625bn to $2.7bn for the next three budgets.

Figure 6. Core Crown expenses



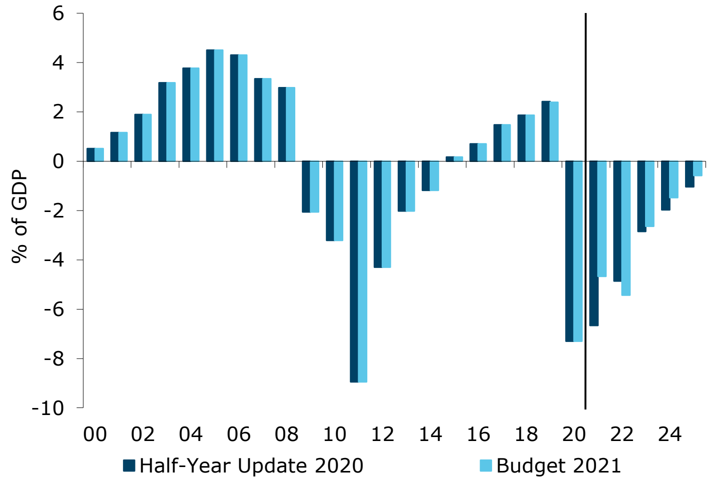
Source: The Treasury

On the capital spending side, the Government has signalled a capital allowance of $12bn to be allocated from this Budget to Budget 2024. That's around a $4bn increase from the Budget Policy Statement in February. However, without the Government doing more to address numerous supply constraints (labour, land, red tape, productivity, and materials), we are dubious that throwing more money around will actually deliver additional projects at either their estimated cost or completion date. But a long and healthy pipeline of projects will be a welcome signal to the construction sector, and hopefully provide some certainty and confidence to get investing in capacity.

It also looks like the Government is well on track towards finding a home for the remaining unallocated portion of the COVID-19 Response and Recovery Fund (CRRF). This $50bn fund was announced a year ago, and as at the February Budget Policy Statement $10.2bn was yet to be allocated. Fast forward to today, and just $5.1bn remains unallocated. This remains baked into the Treasury's fiscal outlook, but timing and phasing assumptions have had to be made. Stepping back, we do question where the funding would come from should a COVID resurgence require another Level 4 lockdown and significant wage subsidy payments. That scenario now presents a risk towards higher debt levels than captured in the Budget forecasts.

Together, the stronger economy and revenue outlook is more than enough to accommodate the additional spending and also drive a faster fiscal consolidation than expected at December's Half-Year Update. The forecast Total Crown OBEGAL deficit is expected to be a slightly smaller as a share of the economy come 2025 compared to the Half-Year Update, but there are unders and overs along the way as extra and re-phased spending impacts. In the event that the nominal economy outperforms the Treasury's expectation and the Government exercises fiscal constraint going forward, a surplus party remains possible for the 2025 fiscal year.

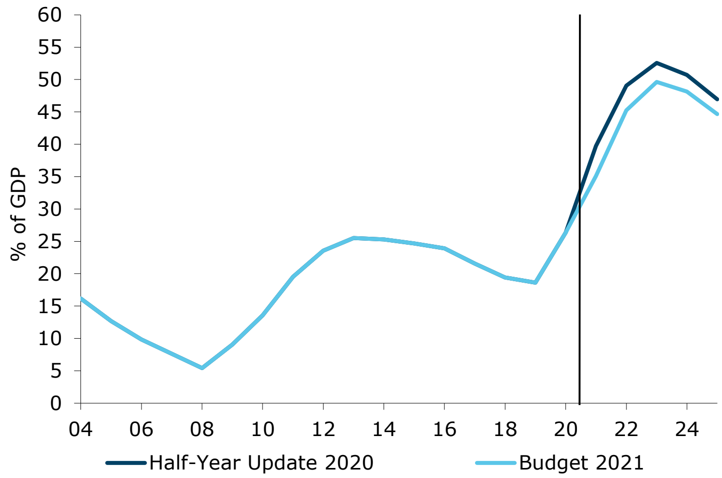
Figure 7. Total Crown OBEGAL



Source: The Treasury

As a share of the economy, net core Crown debt is forecast to peak at 48.0% in 2023 (figure 8). That's a decent downgrade to the Half-Year Update forecast of 52.6% and pretty close to where we expected to see it.

Figure 8. Core Crown net debt



Source: The Treasury

Total borrowings are forecast to grow from $110.2 billion in 2019 (pre-crisis) to $255.1 billion in 2025. That's about $6.5bn lower than the forecast peak in the Half-Year Update, but still more than a $100 billion increase by 2024 compared to the 2019 Half-Year Update (ie before the COVID crisis significantly shifted the fiscal forecasts). While total borrowings aren't part of the Government's core suite of fiscal strategy indicators, this is an important metric from both the taxpayers' and rating agency's perspective. That's because it captures the spending decisions made outside of the core Crown accounts (such as the relatively expensive funding by Housing New Zealand) for which we are all potentially on the hook.

While low interest rates mean the ongoing interest expense will be contained over the forecast horizon, high debt levels represent a very significant interest rate risk for the taxpayer, and one that will be there for many years to come.

The funding strategy

As expected, the better economic and fiscal outlook has allowed New Zealand Debt Management (NZDM) to downgrade their bond issuance guidance (Table 2). But relative to our expectation for a cumulative trim of $20bn to 2025, the $10bn downgrade is surprisingly small.

Table 2. Bond issuance guidance

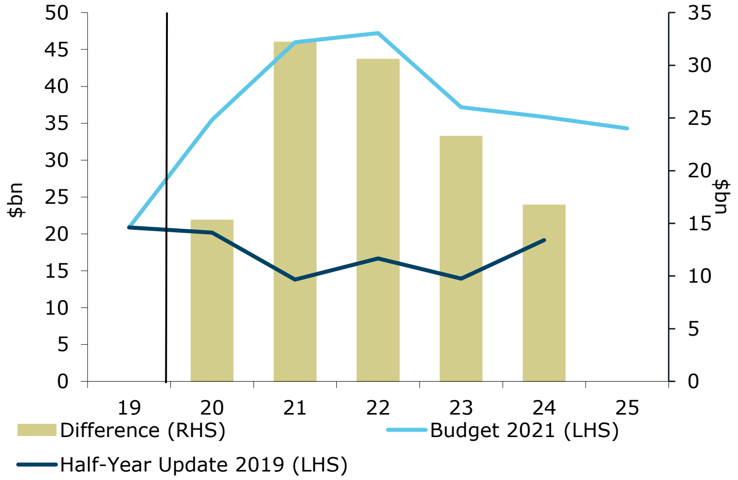
	Jun-21	Jun-22	Jun-23	Jun-24	Jun-25	Total (22-25)
Budget Update 2021	45	30	25	25	25	105
Half-Year Update 2020	45	30	30	30	25	115

It's not just the better economy influencing changes to the bond programme:

- Discretionary spending decisions are adding to funding requirements, partially offsetting the impacts of higher forecast revenues.
- Higher interest rates mean less cash in the door for a given face value of bonds that go out.
- NZDM have also trimmed T-bill guidance in the interest of stability in the bond programme.
- Regarding the substantial buffer of liquid assets accumulated by the Treasury over the past year or so (to manage funding and liquidity risks), NZDM appear comfortable holding a high balance "relative to history". And they have signalled they will provide guidance on enduring balances at future Economic and Fiscal Updates.

Perhaps the best way to visualise the amount of liquid assets the NZDM are expecting to hold is to look at forecast financial assets held by the Treasury (although this is not a perfect measure). Compared to the 2019 Half-Year Update (ie pre-COVID) and Budget 2021 this suggests NZDM have accumulated a very healthy buffer indeed (figure 9). It's our expectation that NZDM will look to partially run this down once COVID risks are well and truly in the rear view mirror, but when that will occur (and how) remains highly uncertain.

Figure 9. Financial assets held by the Treasury



Source: The Treasury

NZDM have also signalled their intention to introduce two new NZGBs via syndication. The first is expected to be a nominal 2051 (launched by the end of the year). Details for the second will be announced at a later stage.

How did the market take it?

Market participants were expecting a bigger downward revision to the size of next year's bond programme than we actually saw – we were expecting a cumulative downgrade of $20bn over the next four fiscal years, but we only saw a $10bn downgrade, with next year's programme unchanged at $30bn. We would thus regard this news as disappointing for the bond market, and expect bonds to continue underperforming (on a spread to swaps and ACGBs) and the curve to continue to steepen, continuing trends in place over the past few weeks. By our calculations, it actually implies a lift in the pace of tender issuance to around $480m per week, give or take depending on how many linkers NZDM chooses to issue and one's assumptions about the size of syndications.

We did get confirmation that the planned syndication of the new 2032 bond would proceed as planned next month. This was expected and won't perturb markets, but the announcement that two new bonds (rather than the one we were expecting) will be introduced in 2021/22 might do, at the margin. One of these new bonds will be a 2051 bond. We welcome that from the perspective that it will extend the NZGB curve to 30 years, but it will likely add to curve-steepening pressure.

At a security-specific level, today's projections also saw a change to the amount of 24s and 25s outstanding at maturity, with the forecast maturity lines for the 24s reduced from $13.5bn to $12.6bn and the forecast maturity line of the 25s increased from $13.7bn to $15.2bn, with the latter possibly reflecting a partial buy-back of linker ix25s prior to maturity. The forecast maturity of the 23s was left at $15.9bn, but that just matches what is on issue (net in market). None of this is likely to perturb markets much.

These new projections do not have mechanical implications for how many bonds the RBNZ can buy via the LSAP programme. Indeed, the projected total amount of bonds on issue by the end of the 2021/22 fiscal year has been held steady at $158bn. Assuming around $29bn of that is nominal bonds and $1bn is linkers, that mechanically implies that the maximum of bonds the RBNZ can buy with its indemnity cap is $89bn. Astute observers already know this, and as such, we don't believe the unchanged theoretical maximum amount of bonds that the RBNZ can buy will affect the market.

At the moment, the RBNZ is buying bonds at a much slower pace than it could if it were aiming to reach $100bn by June 2022 (which would exceed the indemnity cap). The question then becomes; at what sort of pace will they continue buying? We have long said that we expect the RBNZ to continue to both gradually scale back the pace of LSAP purchases, and to tilt them towards shorter-maturity bonds. Nominal (ie ex linker) issuance over the remainder of this fiscal year is likely to continue at the current $300m/week pace. While the RBNZ is also purchasing bonds at that pace, it is targeting bonds of a lesser duration, leaving the market with no net dollar supply to absorb, but with some duration to absorb. With markets functioning well we don't expect that overall balance to change much over coming weeks.

As we progress into and through fiscal 2021/22, there are reasonable grounds to expect the RBNZ to scale back the pace of LSAP purchases to the point where the market is perhaps left absorbing roughly $10bn of bonds a year, plus syndications and linkers. This is the pace of issuance flagged for 2020/21 pre-COVID, and we think the market can absorb that sort of supply. Against a $30bn programme, assuming $1bn of that is linkers and say $6bn is issued via syndication(s), that implies a lift in nominal issuance to around $450m per week. If the RBNZ are comfortable allowing the market to absorb a net $10bn of bonds, then the LSAP could be wound back to around $250m per week by the second half of this year. That is only slightly less than the current pace, leaving us with the overall sense that the RBNZ won't change things by much over coming months.

Broad fiscal strategy unchanged…

The Government's fiscal strategy (short-term intentions and long-term objectives for managing the books) flexed considerably to facilitate the COVID response, with more than $100bn in additional debt (net core Crown debt) added to the outlook between the 2019 Half-Year Update (pre-COVID) and current forecasts. And while today's Budget documents showed no change to the Fiscal Strategy from February's Budget Policy Statement, we think that once COVID risks have abated a little further, the Government will look to add a little more detail – particularly regarding its long-term debt objectives. Currently on that front, the Government aims to "stabilise net core Crown debt as a percentage of GDP by the mid-2020s and then reduce it as conditions permit (subject to any significant shocks)". Pre-COVID, the Government's Fiscal Strategy was to maintain net core Crown debt between 15-25% of GDP. We think there is scope for any future target range to be higher than this, but COVID risks will need to have abated before the Government starts signalling firmer targets.

…but plenty more work to do

The economy is now standing on its feet again, and that means additional macro fiscal stimulus is no longer required. Now, the focus naturally turns towards the pace of consolidation. On the one hand, the COVID crisis has contributed to some very undesirable social outcomes that will require ongoing government funding to address, such as emergency housing (not to mention there are still pockets of the economy that will continue to struggle for as long as or our borders remain largely closed). But on the other hand, there is a real need to rebuild fiscal buffers so that there's enough ammunition to respond to the next inevitable crisis, whatever the cause, especially with the limits of monetary policy laid bare by COVID-19. This balancing act is expected to feature in many Budgets to come.

Meanwhile, the economic and political landscape is being impacted by this crisis, and that could impact the direction for policy over the longer run. Indeed, while the macro-policy response appears to have protected many jobs, it has also contributed to a widening wealth and generational inequality divide – one that New Zealand is yet to really have a detailed conversation about, particularly regarding who should be picking up the tab. At the moment, the Government's consolidation plan appears to be to grow their way out (and likely a higher than previously targeted debt ratio). But a slower-than-expected recovery or another economic shock could require more fiscal stimulus, given monetary policy is largely tapped out. And that's where the slow-burn 'grow your way out' strategy can run into problems.

Overall, Budget 2021 contained a little more spending than we had assumed, with the lift in operational spending expected to add a touch more stimulus over the coming year or two (largely via increased benefit payments). And while this will help maintain underlying economic momentum, this isn't a game-changer into the medium term (but it'll make a big difference for some of our most vulnerable!). On the capex side, hopefully the lengthy pipeline of spending encourages a little more investment in NZ's productive capacity. But spending and hoping isn't a great strategy, and the Government could be doing more to help address supply constraints. The Treasury's economic forecasts do acknowledge the stronger economic outlook, but we think they may be underestimating the degree of capacity constraint in the economy, which could see more inflation and less activity than they're assume (but the mix isn't crucial for the all-important nominal GDP outlook, which determines the tax take).

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