ANZ Research

NZ Budget 2022

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Big Budget

Summary

- As expected, the Treasury has downgraded its medium term outlook for economic activity (real GDP) but added more oomph to inflation. As it turns out, the net result on nominal GDP and therefore forecast tax revenue is slightly positive.
- Both tax revenues and core Crown expenses are expected to be higher over the forecast. But risks to the economic outlook could easily see the former come in lower, and the latter come in higher than forecast.
- It's a big budget with a big focus on health and climate change:
  - Climate change announcements were largely made earlier in the week.
  - Key health reforms include a whopping $11.1bn opex spend over four years to get Health New Zealand off the ground and clear DHB deficits. Covering DHB deficits looks like it'll take up $2-3bn of this $11.1.
  - A $1bn cost of living support package was also announced. This will come out of the recently-increased (and now deceased) Covid Response and Recovery Fund. It'll certainly help address the symptoms of high inflation, but from a core inflation and monetary policy perspective, it's not a cure.
- The operating balance before gains and losses (OBEGAL) is expected to post its first post-pandemic surplus (of $2.6bn) in the 2025 fiscal year. It's forecast to reach 1.5% of GDP in 2026 – comfortably within the new "rule"
- Under the Government's updated fiscal rules, net debt is no longer a key constraint on fiscal settings (the OBEGAL is front and centre here). Nonetheless, ratings agencies and tax payers alike will want to maintain a sharp focus on government debt. The Government's new headline measure of net debt (which includes assets held in the NZ Super Fund) isn't ringing any alarm bells. However, the projected $100 billion increase in total borrowings in the 2024 fiscal year compared to the 2019 HYEFU forecast (pre-pandemic) shows just how much flex there's been in the Crown's balance sheet in the wake of Covid.
- Reflecting the updated fiscals, a higher starting point for interest rates, and the extra $5bn needed per year to buy back LSAP bonds from the RBNZ, New Zealand Debt Management has increased its bond issuance guidance. Issuance over the 2023-25 fiscal years will be $25bn, and 2026 will be $15 – as expected.
- There are some big numbers in this Budget, and some good initiatives too. But depending on how the economy evolves, there's also a risk that the cost to taxpayers is larger than simply servicing and paying down the Government debt that comes with that. With economic capacity already stretched, the RBNZ might need to "make room" for government spending by inflicting higher interest costs on businesses and households.

Inflation takes its toll

The Treasury's economic forecasts paint a picture of an economy that is facing increasingly strong growth headwinds, with the Treasury identifying inflation as "the principal economic challenge in New Zealand and abroad" in their Budget Economic and Fiscal Update (BEFU). An important note – the Treasury's economic forecasts were finalised on 24 March 2022, and so do not incorporate the latest CPI inflation or labour market data for Q1 (although both came in reasonably close to their expectations).

Overall, the economy has weathered the impact of Delta and Omicron better than the Treasury expected in the Half-Year Economic and Fiscal Update (HYEFU) in December, which leaves Q4 real GDP $1.8bn higher than forecast. But that's where the good news ends. Looking through the near-term bounce-back from the Delta lockdown and Omicron disruption, the Treasury's medium-term outlook for real GDP has been downgraded (figure 1). That's become something of a pattern both here and overseas as high inflation, central bank tightening, and the ongoing impacts of supply chain disruption and war all create strong headwinds to growth. And in New Zealand, you can add a rapidly slowing housing market and recessionary levels of business and consumer confidence to that list. In fact, the economy is expected to be more-or-less going sideways in 2023 according to Treasury's forecast, as higher interest rates and a normalisation in government consumption expenditure from pandemic-era levels both weigh on growth.

One contributor to slower growth is the downturn in the housing market. Treasury are forecasting house price falls to continue over 2022, with prices forecast to fall 5.0% in 2022 and another 1.5% in 2023 (figure 2). In HYEFU, "slight" house price falls were anticipated in 2023 – however with April prices already down almost 5% from their November 2021 peak (ANZ seasonal adjustment), it's going to be a much faster slowdown than the Treasury previously thought. Treasury expect house prices to only increase gradually over the rest of the forecast, with higher interest rates, negative real wage growth, and current strength in residential investment putting downwards pressure on prices. We see significant downside risk to the Treasury's forecast – particularly in 2022. We're predicting a 10% fall in house prices over 2022 (and there are downside risks even to that!). Either way, both consumer spending and residential investment are expected to soften as a result of falling house prices – it's just a question of how far prices fall, and how much that drags spending down.

Figure 1. Real GDP forecast

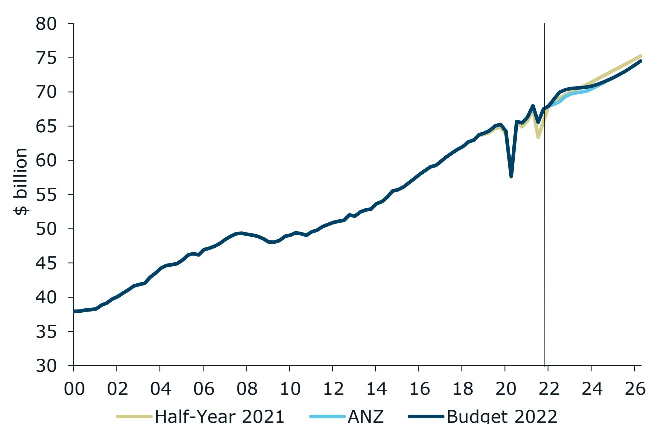


Figure 2. House price forecast

Source: Stats NZ, REINZ, CoreLogic, The Treasury, ANZ Research

Inflation has come in hotter once again than the Treasury (and we) were forecasting back in December. Treasury were forecasting a peak of 5.6% in the March quarter – but on the day that print was 6.9%. And while we've been tentatively forecasting that that was the peak, recent rises in oil prices, NZD weakness, and surging rents raise the risk that inflation may actually hold up at or around 7% in the June quarter.

But what's particularly concerning about the current inflation surge is the strength in non-tradables (ie domestic) inflation. And the Treasury's forecast for non-tradables is, frankly, alarming. They are forecasting that non-tradables inflation will remain above 6% over the next year or so (and above 3% until at least 2026), highlighting that the inflation problem is increasingly a domestic one. Inflation may well peak in H1 2022 – but the concerning persistence in non-tradable inflation (bolstered by the tight labour market) means that an aggressive monetary policy response is needed, even if it will likely cause higher unemployment.

Even with an aggressive increase in interest rates baked into the forecast, the Treasury are forecasting that inflation won't return to the 2% midpoint of the RBNZ's target by the end of their forecast horizon (figure 3). If our forecast for domestically generated inflation was as strong as the Treasury's, we would be seeing much more upside risk around our expectation of the OCR peaking at 3.5%.

Regardless, the Treasury see the RBNZ having to hit demand hard to bring price pressures down – and an unfortunate side effect is likely to be a rise in unemployment over coming years. Treasury expect the unemployment rate could rise to just under 5% by 2026. It's tough medicine to take for an economy that has endured two years of pandemic disruption and border closure. But as the Treasury note, not getting on top of inflation would have "severe economic implications". Treasury are forecasting the 90-day interest rate to rise to a peak of 3.6% over the next year as the RBNZ continues to up the ante in their fight against inflation.

Bringing it all together, when you balance out the Treasury's lower growth outlook for the real economy with a stronger (and more persistent) inflation forecast, you actually end up with a slightly higher outlook for nominal GDP relative to HYEFU (figure 4). And that's what matters for the fiscal outlook, given taxes are set against nominal outcomes (eg nominal salary and wages, and consumption spending etc).

Figure 3. Inflation forecast

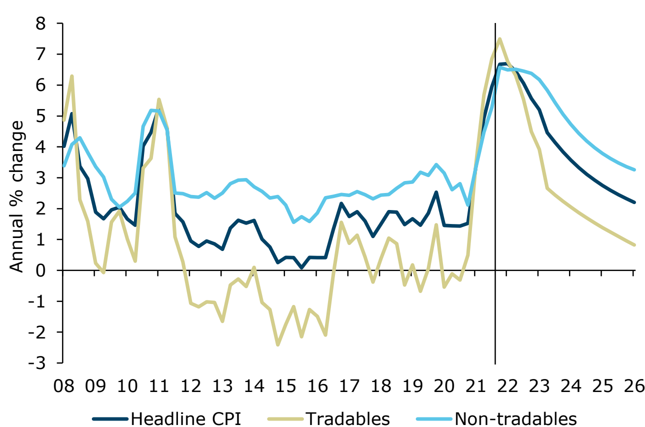
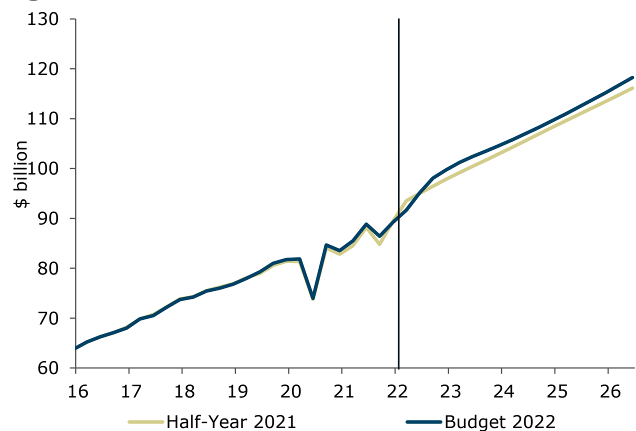


Figure 4. Nominal GDP forecast



Source: Stats NZ, The Treasury, ANZ Research

More forecast revenue, but even more spending

As expected, and as the recent monthly statements to March 2022 show, the starting point for the fiscal outlook is a touch stronger than expected at HYEFU. And the Treasury's updated forecast carries this through into the outlook

The best place to see this is in the outlook for tax revenue, where there's been a cumulative upgrade of around $11.5bn over the forecast horizon (from the year to June 2023 to 2026) (Figure 5).

Core Crown expenses are expected to be around $23.5bn higher over the 2023-26 fiscal years than at HYEFU. That's on top of the very significant increase announced at the HYEFU in December, which already incorporated Budget 2022's $5.9bn operating allowance and a $4bn boost to the multi-year capital envelope. The coming fiscal year (to June 2023) sees a $7bn increase in expenses compared to HYEFU - a big change for an economy already struggling with capacity constraints.

Figure 5. Core Crown tax revenue

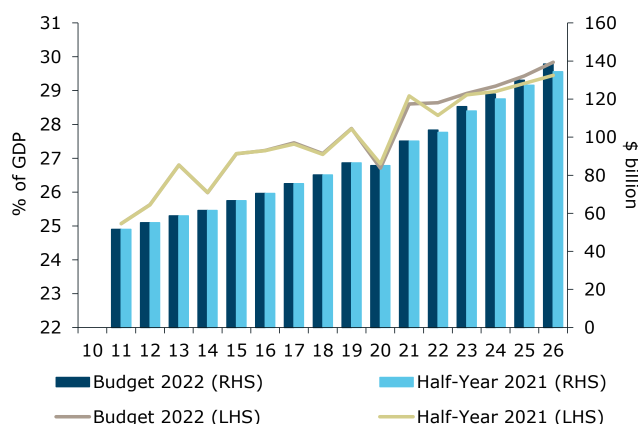
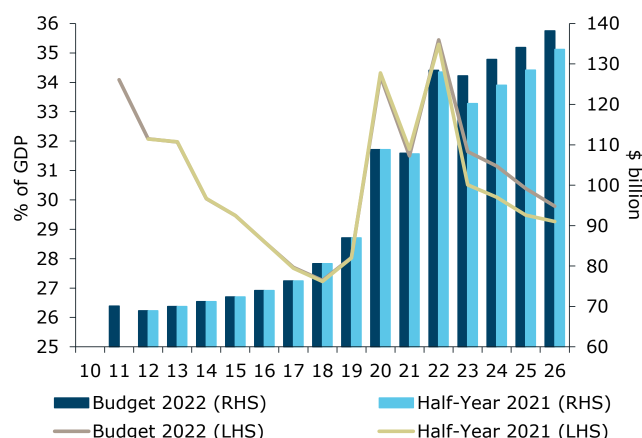


Figure 6. Core Crown expenses



Source: The Treasury

So where is the money being spent?

This Budget at a Glance document outlines key allocations. By a long shot, "Setting up our health system for success" is the big one: $11.1bn in operating spend over four years. About $2-3bn of this appears to be simply clearing current DHB deficits, so Health New Zealand can start with a "clean slate". This balance sheet reshuffle is difficult to interpret from a fiscal stimulus perspective, but even after accounting for that component, these are some big numbers for some big reforms.

A $1bn cost of living support package was also announced. This comes out of the now-deceased Covid Response and Recovery Fund (more on the details on page 8). In theory, this isn't "extra" spending (as it's coming out of the CRRF). However, that fund was increased by $5bn in February this year, so it can be thought of as extra spending compared to HYEFU.

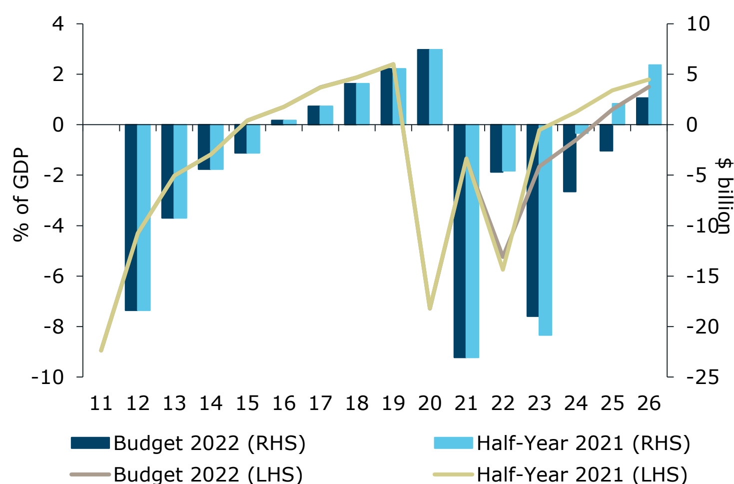
Climate change announcements were also sizable, with most of the big picture announced earlier in the week.

Key fiscal indicators forecast to improve

The Government's fiscal rule to keep surpluses within a band of zero to two percent puts the OBEGAL front and centre. And once again, changes since the Half-Year Update are very much as expected. A return to surplus has been pushed out by one year to 2025 (that was signalled by the Minister of Finance ahead of Budget). And 2026 sees the surplus coming in at 1.5% of GDP – well within the 0-2% target.

Capex spending is now a lot less constrained compared to the debt-targeting days before COVID-19. That is, there is no longer a debt "target", it's a "ceiling". Provided the Government is meeting its surplus rule, the new debt "ceiling" shouldn't prevent the Government from lifting capital spending should projects be deemed worth pursuing. That's not a story for today, but it does suggest that as this flexibility it utilised in the future (watch this space for Budget 2023), Government debt could end up higher than forecast here. Overall, the new net debt measure (which includes a wider range of assets and liabilities – including the very sizable NZSF) is forecast to peak at 19.9% of GDP in the 2024 fiscal year. Total borrowings, which ignores Crown-owned assets altogether, is set to grow from $110.2bn in 2019 (pre-pandemic) to $248bn by 2026. Relative to HYEFU, total borrowings are expected to be $27bn higher come 2026. As is the case in many countries, the Crown balance sheet has leaned into this shock with a bulldozer.

Figure 7. Total Crown OBEGAL



Source: The Treasury

Given the risk of a hard landing for the NZ economy appears to be intensifying, it's fair to say that risks to the Treasury's fiscal outlook are skewed to even higher spending and weaker revenue than presented above. That, of course, would be fiscal policy playing its automatic stabiliser role and not something to attribute to discretionary fiscal policy decisions. However, regardless of the economic outlook, we wouldn't be surprised to see the Government utilise the inherent flexibility in its fiscal strategy (ie fiscal rules) by lifting capex over coming Budgets and increasing operational spending once the return to surplus achieved. In that light, we have less confidence that the longer term (eg 2026) debt forecasts will come in as "low" as currently forecast – there's a lot of economic uncertainty and discretionary-policy-decision water yet to flow under the bridge.

More bonds on issue…

As expected, the amount of bonds that New Zealand Debt Management (NZDM) expect to issue over the coming years got a decent nudge higher (table 1). Guidance has been lifted by $7bn in the 2023-25 fiscal years, and by $5bn in 2026. The cumulative bump is $26bn over the four years to June 2026, but $20bn of that is simply extra funding so the Treasury can buy back LSAP bonds from the RBNZ. The additional $6bn largely reflects higher government spending and higher interest rates.

Table 1. Issuance guidance

	Jun-22	Jun-23	Jun-24	Jun-25	Jun-26
Bonds					
2021 Half-Year Update	20	18	18	18	10
2022 Budget Update	20	25	25	25	15
Treasury Bills					
2021 Half-Year Update	4	3	3	3	3
2022 Budget Update	4	3	3	3	3

Guidance on Treasury bill issuance is unchanged from HYEFU. NZDM continue to expect T-Bills on issue to vary over any fiscal year between $3bn and $10bn (as the funding requirement warrants).

NZDM also signalled their intention to undertake two syndications by the end of the year. One of these will be the already-announced and brand-spanking sovereign Green Bond (expected late 2022). The other will be a tap syndication of the 2035 linker (inflation indexed bond), which will be undertaken alongside a repurchase of the 2025 linker. Gross issuance into linkers is expected to be between $1.5bn and $3bn in the year to June 2023, and bond line size caps have been lifted from $6bn to $10bn.

NZDM released an insight note about supporting the NZ linker market, explaining the rationale around their linker strategy.

As expected, NZDM appears to have made no meaningful tweaks to its liquidity buffer strategy and expects to hold a similar amount of financial assets over the forecast as it did at HYEFU. That is, the bond programme incorporates around the same $15bn buffer before.

…means a higher run rate

Bond markets were expecting a lift in issuance over coming years, and they got it, with issuance coming in exactly as we flagged in our Preview. At a high level then, we think the market will easily take forecast issuance in its stride. But the make-up of issuance matters, and with two syndications signalled, if we assume they collectively raise $4 to $5bn (more on that later), that implies $20 or $21bn of bonds will be issued via tender, which in turn, implies a lift in the pace of weekly issuance from $425 to $450m. A big step-up was always on the cards given the temporary lull in issuance since December, following NZDM's announcement that it would run down cash and liquid assets, that's a slightly higher run rate than we were expecting. Spreading issuance over more syndications (and including a nominal bond in the mix) would have taken pressure off the weekly run rate of issuance, but confining syndications to a Green bond (which while likely to be in good demand, are as yet untested) and a linker (generally less popular and liquid) will keep the pressure on the bond market week in, week out.

NZDM's initiative aimed at lifting the profile and liquidity of the linker market (by engaging in switches/buybacks, increasing individual tranche sizes) is a welcome development, but the proof will be in the pudding, so to speak. It's

also worth noting NZDM said the bonds it buys from the RBNZ (as a part of the unwind of the LSAP) will be retired. This is as expected, but it confirms that what NZDM buys from the RBNZ will have no mechanical bearing on the make-up of what they issue on the other side.

What about inflation and the macroeconomic context?

Budget 2022 is very much focused on significant health reform and climate change. These are both very important issues that require significant resources to address them. However, very stretched economic capacity (just talk to any business trying to find workers right now) and sky-high inflation means we, and the RBNZ, need to consider the broader macroeconomic implications of fiscal settings. And non-tradable inflation at 6% y/y shows inflation isn't just a global problem that NZ is importing, it's a domestic issue too.

It might be needed, but depending on where we are in the economic cycle, the costs of a big budget may well be larger (and more front loaded) than the implied burden on tax payers associated with servicing and eventually paying down any additional Government debt. In particular, if fiscal settings are adding to demand for already-constrained resources, inflation pressures are going to be higher than otherwise and the RBNZ will need to offset that with a higher-than-otherwise OCR. In other words, the RBNZ might need to "make room" for Government spending by inflicting higher interest costs on businesses and households.

The interaction between fiscal and monetary policy is something the Government is required to consider as a key element of the principles of responsible fiscal management. This doesn't prevent the Government from running pro-cyclical fiscal policy, but it should make them aware of the potential costs of doing so. The Fiscal Strategy Report contains very little mention of the impacts of fiscal settings on inflation and therefore monetary policy. Interestingly, the Treasury's BEFU document does include a box on the impacts of inflation on the fiscal forecasts, but we (and the RBNZ) are interested in the relationship the other way: what's the impact of fiscal settings on inflation (and therefore interest rates).

Fair to say that not all government spending (or potential tax cuts) are the same when it comes to inflation, and quantifying a basis point impact of fiscal settings is so fraught with uncertainty that even the New Zealand Treasury appear averse to doing it. For example, how much stimulus is there in a transferring DHB deficits on to the Crown's balance sheet? Is it just a balance sheet exercise, or will that enable more spending on health in the future – that's a question we can't answer with today's figures.

The fiscal impulse is one (but crude) way to assess whether the fiscal stance is adding more or less support to the economy compared to the year prior. However, it does not measure the economic impact of that support. Second round impacts of fiscal policy – particularly the success of the wage subsidy at keeping people connected to their jobs – appear to be a big part of the reason New Zealand's economic rebound has been so vigorous. That means it's also a key part of the reason why capacity pressures in the labour market are so acute right now. That's certainly not a bad news story, but it is what it is. Given the fiscal impulse is a change concept, and is based off very expansionary fiscal settings in recent years, it's actually quite a high bar for the impulse not to be shrinking on balance over the forecast horizon. And that's exactly what the Treasury's latest estimate show: A large positive impulse for the starting point (year to June 2022), but a small negative impulse thereafter. What that means is Government is contributing less to aggregate demand in 2023 than it did in 2022, but that doesn't mean fiscal settings are not still adding to inflation. And overall, the increase in

Government spending relative to HYEFU is still a lot in the context of a capacity-constrained economy. It certainly suggests the RBNZ needs to look well beyond the fiscal impulse when assessing the potential inflationary impacts of fiscal settings.

The Government has announced some new measures that will at least help address some of the symptoms of inflation, with a $1bn package. This includes:

- A cost of living payment of $350 in three monthly instalments starting August 1 for those earning less than 70k and who don't already receive the Winter Energy Payment. ($814m in total)
- A two month extension to the fuel duty reduction ($235m)
- Reducing the cost of public transport – a two month extension to the 50% reduction in public transport, and a permanent reduction for Community Services cardholders (can't argue with the latter half of that – it's targeted) ($130m).

These policies will certainly help take some of the edge off the impacts of high inflation, but while they'll help address the symptoms of high inflation, they're not likely to be part of the cure. In fact, somewhat counter-intuitively, these policies (alongside generally-high public spending) may make the RBNZ's job of containing medium term inflation a little harder.

That's because, all else equal, a tax break for households, or increase in transfer payments is still economic stimulus. It might help households through tough times, but it adds to the demand pulse, which adds to inflation. That's why such policies need to be very targeted towards those who really need it, while at the same time broader fiscal expansion is contained.

Broadly speaking, policy directed at bolstering the supply-side of the economy has a much greater chance of addressing high inflation. The reopening our borders to migrant workers is a great step towards alleviating capacity pressures in the labour market and therefore domestic inflation pressures. Migration is complicated though: it adds to supply and demand, which once again is why policy settings need appropriately targeted. Capex is another tricky one. We really need more and better infrastructure to bolster our productive capacity, and if the Government doesn't signal a lengthy pipeline, we'll likely loose capacity to deliver that. But at the same time, the industry is already full steam ahead, so adding more money to the mix may bid up prices.

Stepping back from the complex near term and medium term interactions between fiscal policy and inflation (and therefore monetary policy), it's important to remember that the RBNZ has all the firepower in the world to bonk inflation on the head. And we are 100% convinced they will. Any contribution to inflation pressures from fiscal settings can always be offset with a higher-than-otherwise OCR

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