ANZ Research

Budget 2022 Preview

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Catch (Budget) 22

Summary

- The Catch-22 facing the Government right now is how to alleviate inflation pressures while delivering an expansionary budget.
- The Government has already set up Budget 2022 to be a big one, announcing at the Half-Year Update a $6bn operating allowance, a $4bn increase to the multi-year capital envelope, and a newly minted $3.7bn Climate Emergency Response Fund.
- The above figures might sound small compared to the total $74.1 billion COVID Response and Recovery Fund (which was increased by another $5bn in February 2022), but that $6bn operating allowance is a biggie. Unlike the one-off nature of capex spending (ignoring depreciation), operating is per year. That $6bn operating allowance represents $30bn over the next 5 years.
- With this much spending already announced, and the likes of the OECD recommending a rapid withdrawal of fiscal stimulus to reduce the burden on monetary policy of macroeconomic stabilisation, we do not expect further increases in spending. In terms of where the money is directed, health reform and climate change are expected to be the big ones.
- Those looking for Government initiatives to address sky-high inflation may be disappointed. Targeted support to help those doing it tough still looks to be very much needed, but additional macroeconomic stimulus is not. All else equal, the latter will be met with higher-than-otherwise inflation pressures and interest rates.
- We expect the Treasury's economic outlook to be downgraded on the activity side (largely reflecting the impacts of a higher OCR and stretched capacity), but stronger inflation will provide at least a partial offset to the outlook for nominal GDP (which is what really matters for the fiscals).
- The starting point for the fiscals is a touch stronger than the Half-Year forecast, but that likely reflects the fact that the Delta lockdown had less severe economic impacts than the Treasury were expecting. Therefore, the full starting point surprise is unlikely to be baked into the outlook.
- The Government's updated fiscal strategy (ie new fiscal rules) puts the OBEGAL front and centre. The Minster has already said that the Budget forecasts will show a one-year delay to reaching surplus compared to the Half-Year Update.
- Increased government spending (ie February's increase to the COVID Fund), the $5bn of planned LSAP bond buy-backs from the RBNZ each year, and higher interest rates are expected to lift the Government's funding requirement. We expect NZDM to increase bond issuance guidance to $25bn over the 2023-25 fiscal years (from $18bn), and lift 2026 to $15bn (from $10bn).

The detail

On May 19, the Treasury will open up the Government's books once again and produce a fresh set of economic and fiscal forecasts. The Minister of Finance will table the Government's spending plans for the years ahead in "The Budget", and the Government's Fiscal Strategy Report will incorporate the recently announced new fiscal rules.

The Treasury's updated economic outlook likely to include more inflation, but less activity…

What are the main economic developments since the Half-Year Update? Delta-lockdown impacts on real GDP were smaller than the Treasury's forecast, CPI inflation printed stronger, the OCR is on a sharper trajectory higher, and the labour market evolved close to expectation (ie it's tight, with capacity stretch very evident). There's also the Ukraine crisis, but the economic impacts of this in the Treasury's forecast will likely be dwarfed by the higher OCR (which is largely responding to domestic inflation).

Nominal GDP (which is what really matters for the fiscal outlook) came in about $1bn above forecast in Q3 (after stripping out data revisions), but weaker than expected in Q4. In other words, there was a smaller Delta-induced contraction, but a smaller rebound too. Looking through the lockdown noise (and data revisions), it appears to be a slightly weaker starting point for momentum in the nominal economy on balance, but the Treasury's judgements (and reconciliation with the tax data) could swing it the other way.

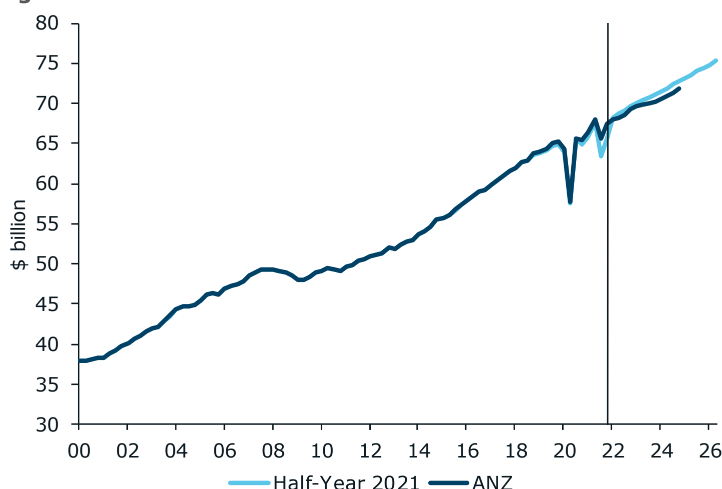
Turning to the outlook, the Treasury (like us) are likely to acknowledge the changing composition of the economy:

- Front-loaded OCR hikes will weigh on the outlook for domestic demand (eg private consumption and investment);
- Higher and more persistent inflation bolsters the nominal economy, but hurts households and businesses;
- The house price outlook will likely be downgraded;
- Borders are reopening, which requires assumptions around what that means for net migration and international tourism and education exports;
- The degree of capacity stretch in the economy looks greater still (as evidenced by roaring domestic (aka non-tradable) inflation.

In terms of real activity, this mix is largely pointing one way: down. However, when it comes to the outlook for nominal GDP, there will likely be some offset from higher inflation. That's not a good news story for people on the street, but tax revenues and key fiscal ratios (eg debt to GDP) don't discriminate here.

Based on our estimates (it's a guess really), risks are skewed towards a slight downgrade to the Treasury's nominal GDP forecast overall. But key assumptions – such as the efficacy of higher rates in slowing demand and taming inflation – could mean we're well off the mark.

Figure 1. Nominal GDP outlook



Source: Stats NZ, The Treasury, ANZ Research

…as the fiscal outlook incorporates more spending and the better starting point

In the nine months to March, core Crown tax revenue was running $2.7bn ahead of the Treasury's forecast. Tax receipts (cash concept) were not significantly outperforming the Half-Year forecast, but that's likely just timing. Meanwhile, expenses were running close to forecast – but they probably would have been running below had it not been for the Omicron outbreak.

It's difficult to know how the Treasury will reconcile the stronger tax revenue starting point with their updated outlook. It's possible they tee up the bulk of the positive revenue surprise to smaller-than-expected Delta-lockdown impacts. All else equal, that would leave less scope for an upgrade to the outlook for tax revenues (ie a smaller hole in GDP and tax in 2021 doesn't imply a significantly stronger medium-term outlook).

When announcing the Government's updated fiscal rules, the Minister of Finance said Budget 2022 will not include any increase to the multi-year capital envelope. That means the $4bn increase (to $9.8bn over 4 years) announced at the Half-Year Update in December is it (for now). Given the pressure on inflation, we'd be very surprised if the Government decided to increase the operating allowance for Budget 2022 (from a lofty $6bn). Again, that was already increased in December last year. There is also the newly minted $3.7bn Climate Emergency Response Fund. It's possible this gets a bump, but perhaps that's a story for after the fund has been running for a while. All up, as far as we can tell, the only increase to spending since the Half-Year Update will come from February's $5bn increase to the COVID Response and Recovery Fund.

Putting it all together, we're expecting a small improvement in the fiscals for the remainder of the 2022 fiscal year (starting point), but a small downgrade thereafter.

The Government's updated fiscal rule to keep surpluses within a band of 0-2% of GDP puts the OBEGAL forecast front and centre. As already foretold by the Minister of Finance, the forecast return to surplus will be delayed by one year in the Budget forecast. That's now expected to happen in the year to June 2025. The $2.1bn surplus previously forecast for 2024 will likely come in at a deficit of around $2-4bn (reflecting higher COIVD spending, and possibly a weaker economy). By 2026, we expect the forecast will show a surplus in excess of the 0-2% of GDP rule (but lower than the 8.2% forecast at the Half-Year Update). That suggests there is plenty of flexibility for the Government to increase spending in the future while still meeting its rule – but these decisions tend to get made closer to the time.

It's important to note that forecasting a surplus is very different from actually achieving one. The big test of the Government's new rule will be whether surpluses are actually delivered (rather than always being forecast, but pushed out as spending gets a bump in future Budgets). That might not prevent a gradual reduction in debt to GDP in "normal times" (the nominal economy does tend to grow), but it could mean the fiscal war chest isn't resupplied very well before the next inevitable crisis comes along. If fiscal buffers are not rebuilt fast enough, every economic shock could result in a structurally higher debt ratio.

Net debt no longer has "target" status when it comes to the Government's fiscal strategy – it's now a "ceiling" that is very unlikely to constrain fiscal settings, provided the OBEGAL rule is being met. This tweak to the fiscal strategy provides plenty of flexibility on capital spending going forward (something that would have been useful in the 2010s, when the population was growing rapidly, but capex was not).

All up, the new fiscal strategy leaves plenty of scope for the Government to increase spending in the future, over and above what will make it into the Treasury's forecast at Budget.

Net debt may no longer be a "target", but it'll continue to be watched very closely by ratings agencies and the public alike. Budget 2022 will offer a reset as we calibrate to the new headline debt measure (which includes more assets and liabilities, and is around 20% of GDP lower than the old measure).

We have mixed feelings about including the NZ Super Fund in net debt. Yes, it brings NZ's headline measure more in line with international peers such as Australia, but it disregards the fact that this is a special asset. Over the long run (beyond the forecast horizon), this asset is very much needed to be held against a very large liability: the fiscal cost of an aging population. On the one hand, including this asset means future governments will no longer be incentivised to halt contributions to the fund in order to make debt look better. But on the other hand, the improved cosmetics of this new indicator could end up loosening the Government's (and the public's) tolerance to take on more debt. Depending on the details, that could mean NZ may find itself in a worse position to deal with an aging population further down the track.

The Treasury's Long term Fiscal Statement discusses these issues in a lot more detail. It's not a story for Budget 2022, but something we should all have in the back of our mind as we evaluate the fiscal position.

NZDM to upgrade its bond guidance

As always, there's a lot to consider when it comes to guessing NZDM's bond issuance guidance:

- They'll need extra funding to buy the planned $5bn of LSAP bonds from the RBNZ each year.
- The Government increased the COVID fund by $5bn to $74.1bn. That's more debt that'll need funding (all else equal). We're not expecting any other spending increases over and above those announced at the Half-Year Update.
- Interest rates have lifted since the Half-Year Update. That means less cash in the door for a given face value of bonds that go out. We estimate this is probably worth around $1bn in any given fiscal year.
- Changes to the Treasury's economic and fiscal outlook have the potential to drive very significant changes to the Government's funding requirement. But we're expecting relatively neutral tweaks here, and are looking through a lot of the positive starting point surprise.
- As outlined at the Half-Year Update, NZDM's funding programme already incorporates a running down of its liquid assets over the coming years. We don't expect any change to this strategy or the pace of run-down.

Weighing it all up, we see a decent bump to bond guidance from 2023. As table 1 shows, our back-of-the-envelope estimate lands on $25bn from 2023 to 24, followed by 15bn in 2026. The 2022 fiscal year is basically done and dusted, so expect no change to guidance there. NZDM switched to rounding to the nearest $2bn at the Half-Year Update (from the nearest $5bn), meaning our expectation for $25bn years could easily come in at $24 or $26bn. And of course, NZDM can deal with any overs and unders via its flexible approach to T-bill issuance, adding an additional layer of uncertainty to our expectation.

Table 1. NZDM bond issuance guidance ($bn)

	Jun-22	Jun-23	Jun-24	Jun-25	Jun-26	Total (23-26)
2021 Half-Year Update	20	18	18	18	10	64
Budget 2022 (ANZ expectation)	20	25	25	25	15	90

Risks are skewed towards *actual* issuance coming in higher than NZDM's guidance, as the Government uses the increased flexibility in its fiscal rules to increase spending further down the track. But with such decisions not yet taken, they won't make it into the Treasury's forecast just yet, and therefore into NZDM's issuance guidance.

NZDM are also likely to announce their intention to syndicate at least one new bond over 2022/23 (in addition to the planned syndication of the new Sovereign Green Bond already announced for the first half of the fiscal year). That's based on our expectation of $25bn of issuance and our assessment that the market only has appetite for a maximum of $350m to $400m bonds per week at tender.

Across 52 possible tender dates, assuming a 3-4 week pause over Christmas/New Year, and 2-3 syndications, that leaves NZDM with scope to hold, say, 46 tenders. If the pace of issuance is $400m per week, tenders would raise $18.4bn of bonds, leaving $6.6bn to be issued via syndication. That could be easily done via two syndications (ie the Green bond plus one more). However, given the untested nature of Green bonds, NZDM may opt to be safe and announce an intention to hold three syndications (the Green bond plus two more).

Investors tend to prefer syndications as an issuance mechanism, and doing more volume via syndications would take pressure off tenders (eg if $9bn were syndicated, weekly tender volumes would only need to rise to around $350m/week).

In terms of the likely bonds to be offered, with a 30yr bond already in place, the obvious thing to do would be to fill gaps on the nominal curve. In that regard, a 2030 nominal bond is a contender (there is a linker maturing that year, but it actually falls in the 2030/31 fiscal year and there are no maturities in the 2029/30 fiscal year). Heading into 2023, that would become the benchmark 7-year bond, which would appeal to domestic buyers and balance sheets. We don't think a 2034 (the next gap) would have much appeal, but a 2047 bond would fill the long gap between the 2041s and 2051s and match the second-longest ACGB maturity.

Fiscal policy in the macroeconomic context

Given its size, those expecting Budget 2022 to deliver a silver bullet to tame inflation are likely to be disappointed.

The reality is, gauging the additional inflation pulse from fiscal settings is never straightforward. For example, spending that simply reshuffles deficits from one balance sheet to another (say DHB deficits to the core Crown balance sheet) may not be stimulatory (provided the reshuffle doesn't facilitate further expansion by the first entity).

In other words, the details matter. As a rule of thumb, any spending announcements that look like they will divert already-utilised capital and labour towards the public sector will very likely add to inflation. For example, we might desperately need 1800 more police officers, but that's up to 1800 workers that won't be available to fill other roles, in an exceptionally tight labour market. Now, that's not to say the Government shouldn't do this; it just illustrates how government spending can crowd out private sector activity, adding to resource scarcity (in this case labour), which will bid up costs and prices, all else equal.

The Treasury's fiscal impulse is one (very crude) way of capturing the impact of fiscal settings on aggregate demand. And it's typical for this indicator to be revised upwards in the near term at each forecast round as spending is delayed (pushed into the next fiscal year) and as the government chooses to increase spending at each Budget. This "wave" effect will likely be no different at Budget 22. However, one of the bigger critiques of the fiscal impulse is that does not account for second-round impacts, which appear to have been very strong over the past couple of years – in particular the success of the wage subsidy in keeping people connected to their jobs. That has been a welcome surprise to everyone over the past couple of years.

It's worth noting that economic forecast accuracy (by us, the RBNZ, or the Treasury) hasn't been great these past couple of years. The impacts of the pandemic and the policy response have surprised on a number of fronts, and the outlook remains very uncertain. It's entirely possible that risks of a hard landing materialise by year end, with capacity opening up and a little extra stimulus looking more like a good thing.

All up, Budget 2022 is shaping up to be a big one. It'll likely be stimulatory, but the details will matter. Without yet knowing the details, we're agnostic as to whether all this spending is 'good' or 'bad', cognisant of both the near-term cyclical picture (inflation), but also the longer-term structural issues facing New Zealand. Targeted support is still very much needed by those struggling the most, but additional macroeconomic stimulus is not. The latter could end up pushing inflation and interest rate higher than otherwise, causing even more pain for households and businesses. There's no such thing as a free lunch.

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