ANZ Research

NZ Half-Year Economic & Fiscal Update 2022

14 December 2022

Contact

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Reprioritising

Summary

- As expected, the Treasury's updated economic forecasts include higher interest rates, weaker economic activity, and more inflation. All that, alongside historical data revisions, has netted out in an outlook for a smaller nominal economy than expected at Budget in May.
- Forecast government revenues are expected to be stronger in all years of the projection, but higher inflation and rising interest costs mean expenses are also higher.
- The Government has not changed the operating allowance for Budget 2023, with the Government focusing on reprioritisation. However, the multi-year capital envelope was increased.
- The operating balance before gains and losses (OBEGAL) is still expected to post its first post-pandemic surplus ($1.7bn vs $2.6bn at Budget) in the 2024/25 fiscal year, but downside economic risks could see this pushed out a year come Budget 2023.
- New Zealand Debt management have lifted their bond issuance guidance as follows:

Issuance guidance ($bn)

	Jun-23	Jun-24	Jun-25	Jun-26	Jun-27
Bonds					
2022 Budget Update	25	25	25	15	NA
2022 Half-Year Update	28	30	30	20	20
Treasury Bills					
2022 Budget Update	3	3	3	3	NA
2022 Half-Year Update	3	3	3	3	3

- The increase in bond issuance was close to our expectation, but was driven by a larger Kāinga Ora funding requirement than we pencilled in, but with smaller negative economic impacts.
- Importantly, the Treasury's forecasts pre-date the (hawkish) November MPS, meaning there's a touch of downside risk to these figures.

A weaker economy, with risks skewed south

The Treasury's updated economic forecasts are a reflection of the key themes we have seen since Budget 2022 six months ago. Upside risks to inflation have materialised (both here and overseas), while downside risks to the growth outlook have continued to build, not least due to the fact that central banks have significantly stepped up their hawkishness in response to those inflation surprises. The Reserve Bank of New Zealand is leading the charge in that regard, forecasting a 5.5% peak in the Official Cash Rate (OCR) in the November Monetary Policy Statement (MPS) and explicitly acknowledging they are aiming to induce a recession to take the heat out of surging domestic inflation pressures.

It's important to note that the Treasury's economic projections were finalised on 9 November, and therefore do not incorporate the RBNZ's further hawkish tilt in the November MPS. All else equal, that speaks to downside risks to the Treasury's economic outlook, and upside risks to interest rate assumptions. As an example, the Treasury are assuming that the 90-day interest rate will peak at 5.1% – a fair clip below what would be implied by an OCR peaking at 5.5% as forecast by the RBNZ. We are currently forecasting the 90-day interest rate to peak at 5.85% given our expectation for a 5.75% peak in the OCR.

Turning to the details, the Treasury expects the economy to enter recession in 2023, with the economy shrinking 0.8% in calendar year 2023 (figure 1), not far off the RBNZ's November MPS forecast for a 1.0% contraction. House prices are set to fall around 20% from their November 2021 peak (figure 2), versus our forecast for a 22% peak-to-trough decline (which incorporates our forecast for the OCR to peak at 5.75%). Unemployment is expected to rise to a peak of 5.5%, versus the current low level of 3.3% (we see it rising to 5.3%, and the RBNZ was even more pessimistic, picking 5.7% in 2025). Clearly, the Treasury's forecasts for GDP, house prices, and unemployment would be a touch more pessimistic if they had been able to incorporate the latest hawkish turn from the RBNZ.

Figure 1. Real GDP forecast

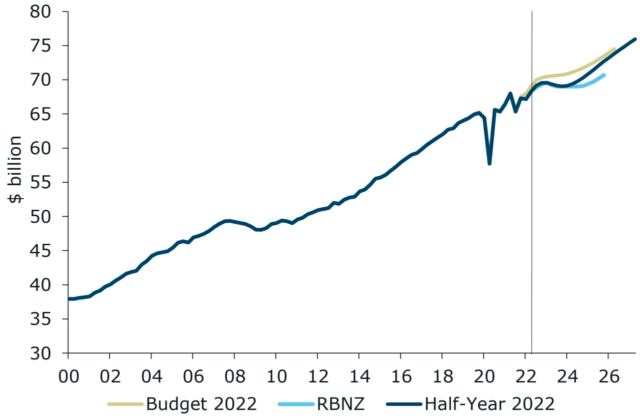
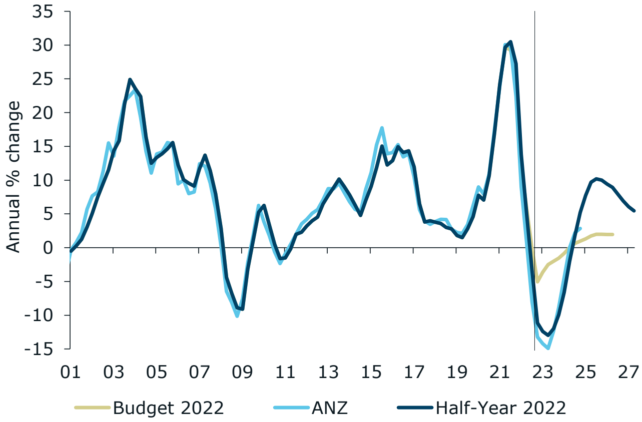


Figure 2. House price forecast



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

The Treasury expects inflation to continue to ease from the current level of 7.2% in Q3 (figure 3). That's more optimistic than the RBNZ, who are forecasting a re-acceleration to 7.5% in Q4 and Q1 (we see inflation peaking a little lower at 7.3% in Q1, but uncertainty remains very high). Should inflation pressures come in hotter than the Treasury expects, the impacts on the fiscal position would be a little ambiguous. Faster growth in prices may bolster tax revenue, but it could also be met with higher interest expenses (as the RBNZ responds to inflation), and weaker real activity (weighed down by the higher-than-otherwise rates environment). On balance it would be a stretch to call this a good news story for people on the street, but there would be some offsets from a fiscal position perspective.

Figure 3. Inflation forecast

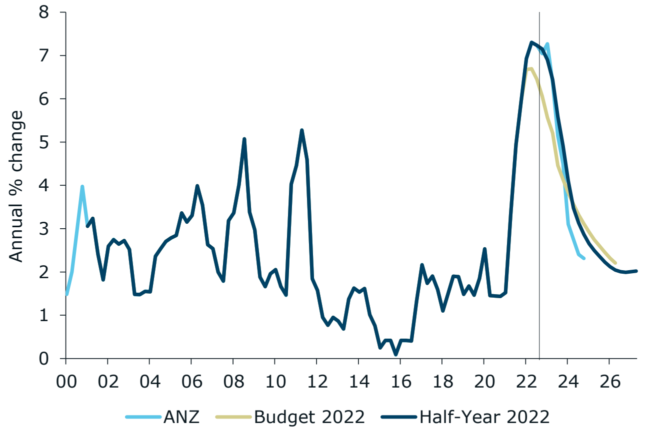
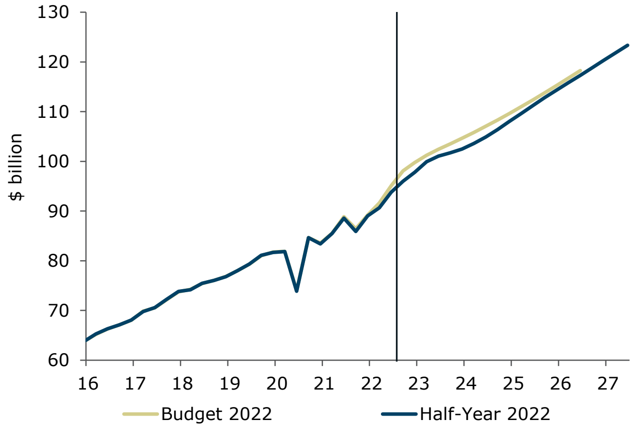


Figure 4. Nominal GDP forecast



Source: Stats NZ, The Treasury, ANZ Research

The bottom line is the medium-term outlook for the nominal economy is looking softer than the Treasury expected back in May, with weaker activity managing to offset the positive contribution from higher inflation (figure 4). At the same time, that same high inflation means the Government is having to fork out more money just to provide the same level of services. Rather than increasing the operating allowance to make up for this higher inflation outlook, the Government has found places to reprioritise, resulting in the Treasury continuing to predict a return to surplus in 2024/25.

Temporary supports extended

The Government has announced an extension to key cost of living supports, but has also signaled when these will end. The petrol excise duty cut and half-price public transport will end on 31 March 2023 (although Community Services Card holders, including tertiary students, will receive permanent half-price public transport from 1 April 2023). The petrol excise duty will be 25cents/litre until the end of February, before being phased out and completely removed by the end of March. Oil prices have fallen in recent months, and are now lower than when the cut to the petrol excise duty was announced.

The end of these policies will technically add to headline CPI inflation in the March quarter (just as they helped to chop the top off the peak in inflation in Q2 2022), but they were expensive, with the Government spending over $1bn on reducing fuel prices. Our forecast for inflation to nudge up to 7.3% y/y in Q1 2023 is consistent with today's announcement.

More forecast revenue, but a touch more spending too

Core Crown tax revenues are expected to be higher than in Budget 2022, across the entire forecast horizon, by an average of $2.3bn per year (figure 5). A stronger-than-expected economy over 2022 and the stronger outlook for inflation have both contributed to this revision.

The Treasury has increased the multi-year capital allowance (MYCA) to $12bn, versus the remaining balance of $2.9bn as of November 2022. Part of this increase reflects the inclusion of an extra fiscal year (2026/27) in the MYCA, but the increase is still significant. There is roughly $4bn of extra capital spend here that can be classed as an ‘upward surprise’ relative to our expectations.

Core Crown expenses are expected to be around $18.3bn higher over the 2023-26 fiscal years than at the Budget Update. This reflects the impact of stronger inflation and higher interest rates on the cost of providing government services (eg benefits like superannuation) as well as the cost of financing. However, discretionary operating spending has not been given a material bump.

Figure 5. Core Crown tax revenue

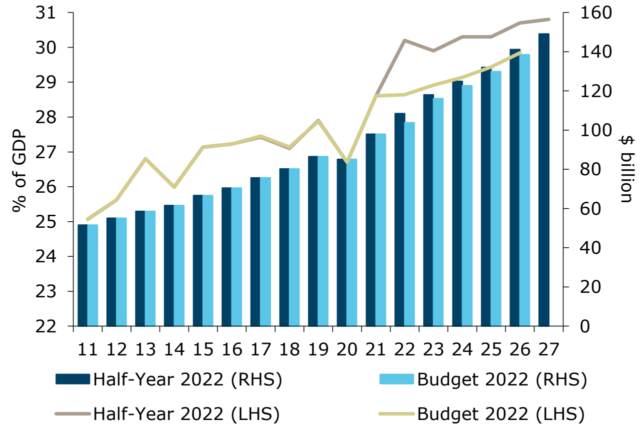
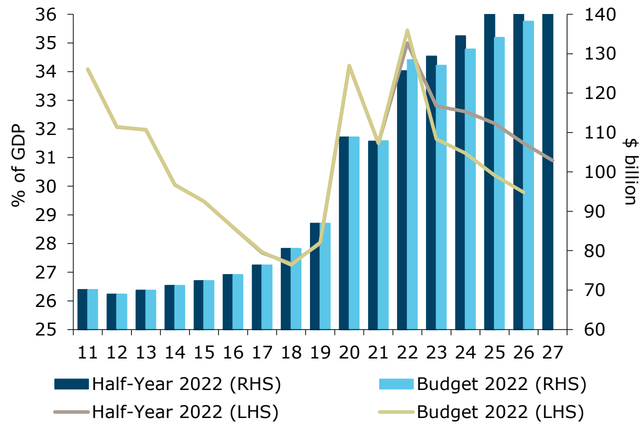


Figure 6. Core Crown expenses



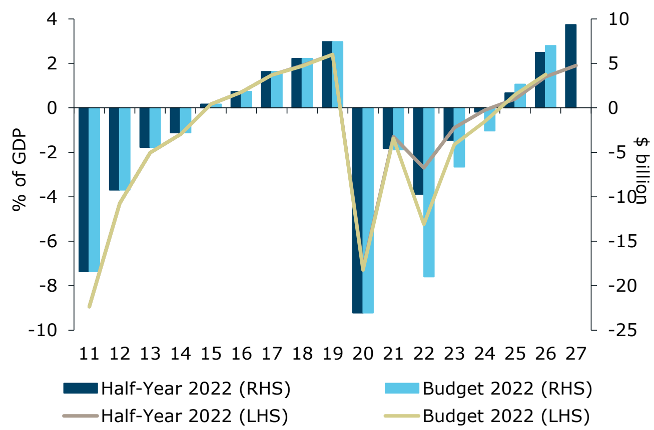
Source: The Treasury

Surplus still forecast for 2024/25

The Treasury is still forecasting a return to surplus in the 2024/25 fiscal year (figure 7). However, the OBEGAL surplus for that year has been revised down by $0.9bn to $1.7bn. Given economic risks, that surplus could easily be blown into the 2025/26 fiscal year come the Budget Update forecasts.

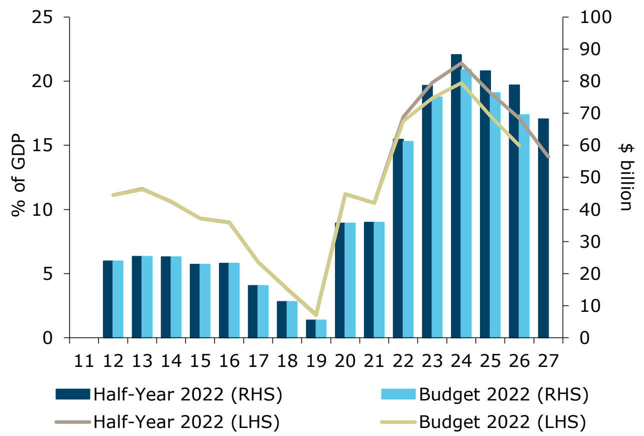
Net debt is expected to be a touch higher over the forecast, with valuation changes across newly included assets (including the NZ Super Fund) contributing to a worse starting point for net debt (figure 8). However, net debt is still expected to remain well below 30% of nominal GDP – the new 'ceiling' that has replaced the Government's explicit debt target.

Figure 7. Total Crown OBEGAL



Source: The Treasury

Figure 8. Net debt



Source: The Treasury

Bond guidance has been upgraded

NZDM has lifted bond issuance guidance from $25bn in the current fiscal year to $28bn. Thereafter, each year has been given a $5bn bump, with NZDM signalling a $30bn programme for 2023/24 and 2024/25, and $20bn programmes for 2025/26 and 2026/27 (the latter being the additional fiscal year). This was pretty close to our expectation, but we did under-estimate Kāinga Ora funding impacts, and over-estimate negative economic impacts.

Table 1. Issuance guidance ($bn)

	Jun-23	Jun-24	Jun-25	Jun-26	Jun-27
Bonds					
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Source: NZ Treasury

This increase reflects a significant bump to the funding requirement ($13.8bn) associated with Kāinga Ora's financing needs. Of note, there is around another $4bn of HNZ maturities occurring over the Treasury's forecast horizon where refinancing decisions have not yet been made. This represents an upside risk to NZDM's funding requirement (on top of any future spending decisions that are yet to be made).

Other key influences on the bond programme include higher interest rates (less cash in the door for a given face value of bonds that go out), and further out in the forecast, a bit more spending than previously. In the near term, a favourable starting position means NZDM hasn't needed to lift funding for the current fiscal year by as much as we anticipated.

Guidance around T-bill issuance is unchanged from Budget.

All up, we continue to see risks to NZDM's guidance as skewed to the upside, particularly beyond the current fiscal year, where there will be a little less scope to allow liquid assets to flux, and where downside risks to the Treasury's economic forecasts are more likely to materialise.

NZDM have signalled an intention to issue a 2030 nominal NZGB via syndication by the end of the current fiscal year (June 2023).

…meaning a higher run rate

Bond markets went into today expecting a decent lift in issuance, and they got it, with the overall lift in issuance very close to what we had in our Preview. While issuance for the remainder of this fiscal year came in $2bn less than what we had pencilled in (at $28bn instead of $30bn), that's balanced by issuance in 2026 and 2027 being $2bn more than what we had pencilled in. So overall, it was pretty close, hence the muted market reaction. We had been expecting two syndications over the remainder of the year, but having opted for $2bn less this year, one makes more sense and that's what NZDM have signalled.

As expected, the next bond will be a 2030 bond. This will be issued before 30 June, and while a specific maturity date hasn't been set, a May 2030 would align with the corresponding ACGB. Attention now turns to tomorrow's 8am announcement (that might get lost amid the Fed decision!) around when tenders will resume in January, and at what pace.

Assuming full allotment of tomorrow's tender, that'll take fiscal YTD issuance to $14.3bn. To complete a $28bn bond programme allowing for one week without a tender for the 2030 syndication, which we'll pencil in for $3bn, that leaves 24 tenders to fund $10.7bn of bonds if NZDM resume tenders on 12 January (or 23 tenders if they resume on January 19th). Given the maths, we suspect NZDM will opt to issue bonds at a $450m per week pace, and start sooner than later, on 12 January. Gross linker issuance has been signalled as being between $2.5bn and $3bn, but this doesn't signal anything given that linker issuance to date ($2.65bn) is already in this range.

Macroeconomic context and implications

As we noted in our Preview, macroeconomic conditions have become unbalanced, with economic capacity (particularly labour) extremely stretched, inflation way too high, and the annual current account widening to a point that may raise a few eyebrows among sovereign credit-rating agencies (the annual current account deficit broke a new record of 7.9% of GDP in Q3).

From a macroeconomic policy perspective, these are not ripe conditions for further fiscal expansion via higher spending or tax cuts. And that has clearly been factored into the Government's Budget Policy Statement, with no increase in the operating allowance and a continued focus on returning to surplus.

As noted above, the Government has also announced the phasing out of temporary cost-of-living measures, including the petrol excise cut, by the end of Q1 2023. These measures have provided some relief to households, especially when oil prices rocketed above USD100/bbl in mid-2022 (while the NZD depreciated against what seemed like an unstoppable USD). This high inflation environment is a serious challenge, and there is a very real need for support for many households. But there is no such thing as a free lunch, and policies designed to support households, like subsidised petrol prices, are a form of stimulus that offsets what monetary policy is currently trying to achieve. The decision to remove these temporary supports and not to further increase the operating allowance will reduce the risk that monetary and fiscal policy will be operating at cross purposes.

That being said, there is still some additional spending in the Treasury's latest outlook, particularly the expansion of the MYCA. We don't see this as a game changer for our OCR outlook (which sees the OCR peaking at 5.75% by May 2023), but the RBNZ will need to factor it in to their next forecasts, and all else equal, they may conclude it's worth a few basis points on the OCR over the medium term.

All up, it's clear that the Government is trying to balance the need to deliver core services with the need to avoid adding to demand in an economy that is still critically capacity constrained. Rather than simply increasing the operating allowance to make up for the impact of higher inflation on the cost of delivering services, they will absorb those costs through the existing operating allowance and reprioritisations. That's the right thing to do from a macro-balance perspective.

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