ANZ Research

NZ Budget 2023

18 May 2023

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Budget 2023 brings the bonds

Summary

- Budget 2023 is another big budget with a focus on the cyclone rebuild and the cost of living. But the additional fiscal stimulus represents more pressure on CPI inflation and therefore an upside risk to the OCR outlook.
- The Treasury's updated economic forecasts are rosy, and therefore represent a risk that NZDM will need to issue even more bonds than signalled today, and a risk that key fiscal indicators improve more slowly than presented today.
- A weaker starting point for government revenues has been partially baked into the outlook, with revenues weaker across the entire forecast horizon.
- Spending (both operational and capital) is higher. After accounting for reprioritisations and the usual reshuffling of Government spending between fiscal years (owing to delays etc), Budget 2023 injects a little more than $5bn of additional spending (opex and capex) into the economy in the very near term (year to June 2024) compared to the Half-Year Update. That's about 1.4% of GDP over the next year for the RBNZ to consider next week.
- As expected, the forecast return to surplus has been delayed by another year to 2026, and at just $0.6bn, it wouldn't take much (given the Treasury's rosy economic forecast) to push this out to 2027.
- To fund it all, New Zealand Debt Management have lifted their bond issuance guidance significantly:

Issuance guidance ($bn)

	Jun-23	Jun-24	Jun-25	Jun-26	Jun-27
Bonds					
2023 Budget Update	28	34	32	30	24
2022 Half-Year Update	28	30	30	20	20
Treasury Bills					
2023 Budget Update	4.5	9	9	9	9
2022 Half-Year Update	3	3	3	3	3

- The increase in bond issuance was double our central expectation, and there remain upside risks to this. NZDM have also tweaked their approach to tenders, aimed at giving them more flexibility to issue where demand is highest.
- The RBNZ won't have to wait long to bake today's information into its outlook – the May Monetary Policy Statement (MPS) is next Wednesday (see our Preview). We doubt the RBNZ will go so far as to specify precisely what fiscal settings imply for the OCR, but today's Budget certainly adds a touch more oomph to the demand pulse, working against the broad macroeconomic slowdown the RBNZ is trying to engineer to tame inflation.
- This document from the Treasury states "Our rule of thumb for the impact of fiscal policy on inflation and interest rates is that an additional fiscal stimulus equal to 1% of GDP would cause the OCR to rise by an additional 30 basis points".
- All up, it may be a 'no frills' Budget insofar as its focus is a little narrower than recent Budgets, but there are frills here in a macroeconomic context, with increased government spending adding to an already too-strong inflation impulse, and a little more Government dissaving adding widening pressure to an already too-wide current account deficit.

The ‘no frills’ Budget does what is needed for the cyclone recovery, but adds to the inflation impulse

As expected and greatly needed, the cyclone recovery was a key focus of Budget 2023. Announced in the lead-up to the Budget, the Government has put an additional $1bn aside for the immediate cyclone response. There has also been a very sizeable increase to the outlook for capital spending over the next few years, and an increase in operating spending to support the recovery.

The cost of living is also front and center in Budget 2023, including:

- Extending 20 hours free early childhood education to 2-year-olds
- Scrapping prescription co-payments
- Free public transport for kids under 13 and half price up to age 25.

There is also a sizeable increase in funding ($3.1bn capex and $465m opex) for 3000 additional public housing places. That’s needed, but with capacity stretched, it might take a while to deliver.

All up, Budget 2023 certainly focusses on what’s important (the cost of living and cyclone recovery), but the additional spending will add to aggregate demand and CPI inflation pressures, presenting upside risk to the OCR outlook.

Treasury’s economic outlook upgraded meaningfully, with recession no longer expected

Surprisingly, the Treasury’s updated economic outlook is stronger than that presented at the Half-Year Update. That reflects judgements that the cyclone recovery will boost activity, more stimulatory fiscal policy, and a stronger recovery in services exports from the return of international tourism. There is no longer a recession in the Treasury’s forecast, with the economy expanding 1.1% across the 2023 calendar year.

With the economy facing ongoing capacity constraints, any boost to demand will likely culminate in further inflation pressures. However, the Treasury’s forecasts do not include a significantly stronger monetary policy response from the Reserve Bank despite the extra fiscal stimulus. The RBNZ’s guidance has been that they need to see the economy slow meaningfully to tame inflation, so this does strike us as a little odd.

In the Treasury’s forecasts, the OCR is assumed to peak at 5.25% (it’s already there and another hike is expected next week), remaining contractionary for longer compared to the Half-Year Update’s forecast peak of around 4.9%. Gradual cuts from 2024 are expected. The Treasury’s forecasts don’t see inflation return to the 2.0% target midpoint over their forecast horizon, but it gets close at 2.1% by come June 2027.

Turning to the details, the Treasury expects the economy to grow 1.1% across 2023. That’s a marked contrast to the Half-Year Update, in which the economy was seen as shrinking 0.8% in calendar year 2023, and substantially stronger than the RBNZ’s February MPS forecast for a 0.9% contraction. That reflects strong government consumption and investment, as well as higher private investment in response to the cyclone. House prices are forecast to fall around 21.3% from their November 2021 peak (figure 2), despite a higher net migration assumption, and versus our updated forecast for a 18% peak-to-trough decline, which is already looking a little pessimistic. Unemployment is expected to rise to a peak of 5.3%, versus the current level of 3.4% (we see it rising to 5.4%, and the RBNZ expect it to reach 5.7% in 2025).

The Treasury has built in a larger net migration assumption, 66,000 in the year to September 2023, which no doubt contributes to stronger activity. However, like the RBNZ, the Treasury's assumptions state that migration is net positive for demand, suggesting additional pressure on interest rates on net.

Figure 1. Real GDP forecast

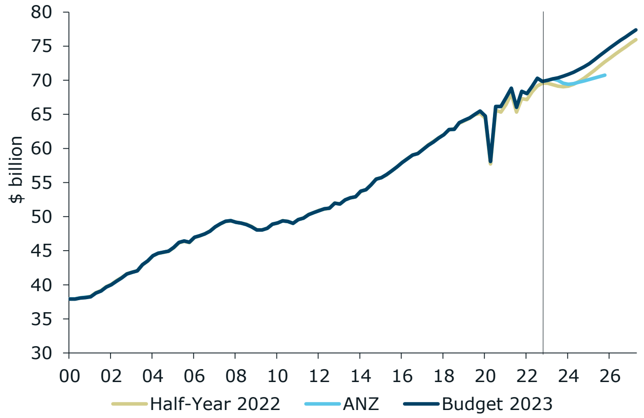


Figure 2. House price forecast

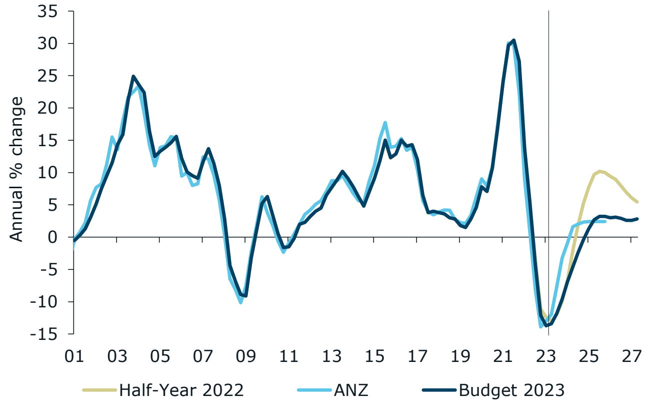


Figure 3. CPI inflation forecast

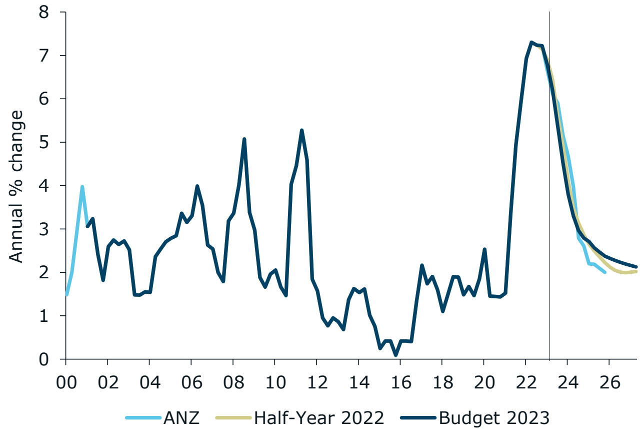
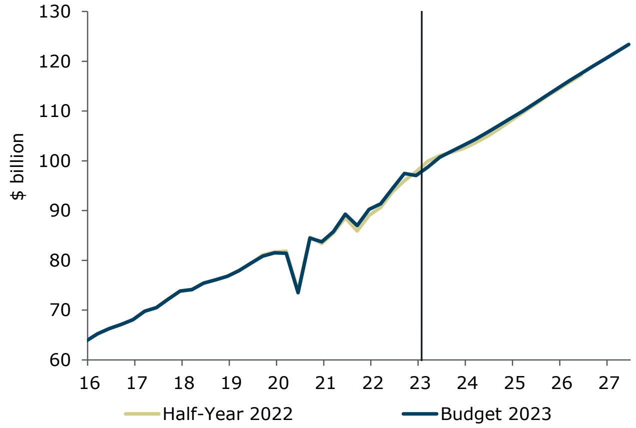


Figure 4. Nominal GDP forecast



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

The Treasury's forecast for the nominal economy is slightly stronger than expected in December, resulting in a cumulative $4.9 billion increase in nominal GDP across the forecast period.

All up, the Treasury's forecasts look optimistic to us, particularly insofar as if things do start to evolve as presented, that would in all likelihood elicit a more aggressive response from the RBNZ.

Less forecast revenue and more spending

Core Crown tax revenues over the forecast horizon are expected to be $8.9bn lower than forecast at the Half-Year Update. That reflects the weaker-than-expected starting point for the current fiscal year, partially offset by a stronger economy as outlined above.

The Treasury has increased the multi-year capital allowance (MYCA) by $8.5bn to $20.5bn. Some of this expenditure falls outside the forecast period, but the phasing has changed, with spending being heavily front loaded. That includes an extra $9.1bn of unallocated spending, $6 billion of which falls under the National Resilience Plan.

Core Crown expenses are expected to be around $8.3bn higher over the 2023-27 fiscal years than at Half-Year Update. The Government has increased the operating allowance for new spending initiatives by $500m each year to $3.5bn from 2024/25, which contributes $3.0bn to the increase in expenses. The remaining $5.3bn reflects the impact of the increased cost of delivering government services, particularly from public sector wage growth, the indexing of income support measures to inflation, and higher interest rates raising the cost of financing. Increases in core Crown finance costs account for $2.2bn of that increase, and with our expectation of upside risk to interest rates, that's going to put further pressure on the Government's operating balance in future years.

All up, reprioritised spending to the tune of $4bn over four years (ie around $1bn pa) has partially offset the impact on NZDM's funding requirement, Government debt, and inflation pressures. But new spending net of reprioritisations still looks sizeable, with roughly an extra $5bn of spending (additional capital and operating) added to the year to June 2024 alone. That's around 1.4% of GDP that the RBNZ wasn't previously expecting based on the Half-Year Update, and could have implications for the interest rate outlook. See the macroeconomic context section for further discussion.

Figure 5. Core Crown tax revenue

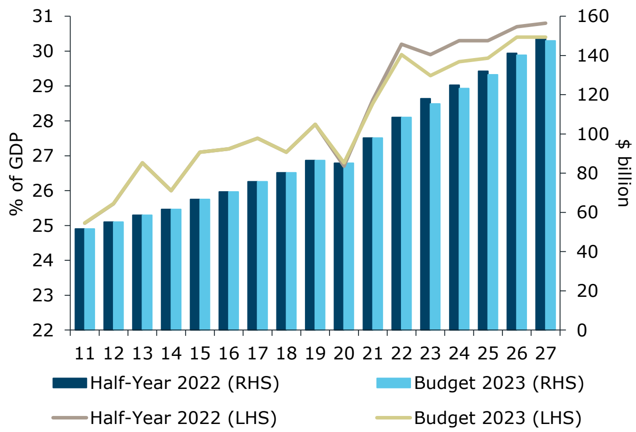
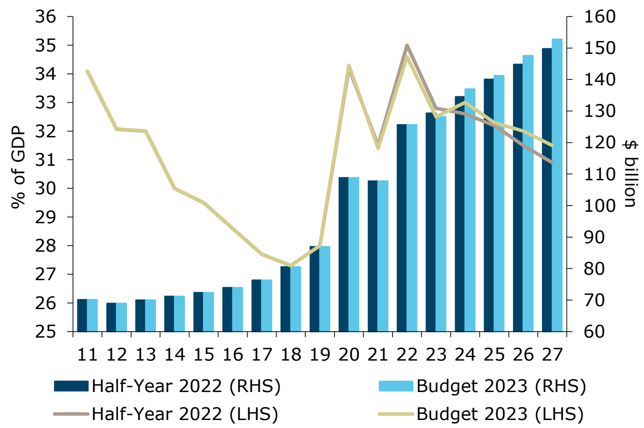


Figure 6. Core Crown expenses



Source: The Treasury

Forecast surplus pushed out another year to 2025/26

The Treasury is forecasting the return to surplus will be delayed until the 2025/26 fiscal year (figure 7), but it's wafer thin at just $0.6bn. Given downside risks to the Treasury's economic forecasts from higher interest rates, and the flow on to weaker revenue, we wouldn't be surprised if the return to surplus is in practice delayed another year to 2026/27.

The OBEGAL deficit has been revised wider by $7.1bn in 2023/24 reflecting the weaker tax revenue starting point and higher expenditure. When incorporating the increased capital expenditure in response to the cyclone, the core Crown residual cash deficit has been revised wider by over $9.2bn in 2023/24 to $26.8bn. That means a larger shortfall in funding, which has added to NZDM's funding requirement.

Net debt is expected to rise to a higher level than forecast at the Half-Year Update, although valuation changes (largely driven by the NZ Super Fund's performance) contribute to a better starting point (figure 8). Net debt is forecast to reach $95.3bn by 2025/26, compared with $5.4bn in 2019. By the end of the forecast period in 2026/27, net debt is over $20bn higher than was forecast at the Half-Year Update.

Figure 7. Total Crown OBEGAL

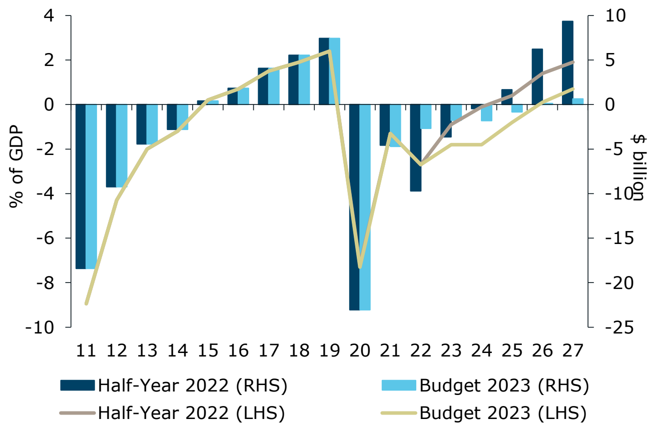
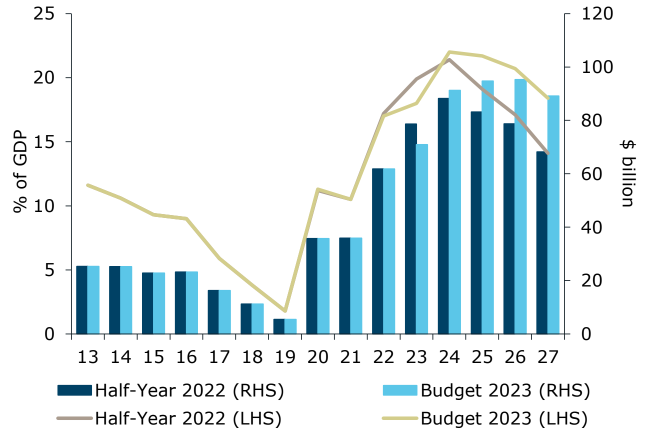


Figure 8. Net debt



Source: The Treasury

Bond guidance has been upsized, big time, and we still see upside risks

Market participants went into today's Budget expecting a sizeable increase in bond programmes over coming fiscal years. They got that and some, with NZDM planning to issue an additional $20bn of bonds over the next four years ($10bn more than we expected).

As expected, the current fiscal year (which has only one month left to run) has been held unchanged at $28bn. Issuance for 2023/24 has been increased from $30bn to $34bn, and 2024/25 has been increased from $30bn to $32bn. As expected, 2025/26 has seen the biggest uplift in issuance guidance, but this is much larger than we anticipated (up from $20bn at the Half-Year Update to $30bn). Guidance for 2026/27 has been bumped from $20bn to $24bn. All up, the increase in issuance guidance is twice our central expectation, but in line with the upside scenario we presented in our Preview. As we discuss later, that's a lot of bonds for the market to digest.

$7bn of the increase in the bond programme relates to an increase in Kāinga Ora expenditure (which is now funded by NZDM). However, the $7.6bn of existing Kāinga Ora bonds maturing from 2025 are not accounted for in NZDM's current guidance, suggesting further upside risk to NZDM's issuance guidance down the track. Downside risks to the Treasury's economic (and therefore fiscal) outlook, and upside risks to the Treasury's near-term interest rate outlook (the RBNZ will need to respond to the extra demand from Government) suggest additional upside risk to today's issuance guidance.

Short-term borrowings (Treasury bills and Euro-Commercial Paper), have also been given a bump, from $3bn at the end of each fiscal year to $9bn. NZDM note that intra-year short-term borrowings are expected to vary from $6bn to $15bn. Broadly, there has been no change to NZDM's liquidity buffer strategy from the Half-Year Update.

Table 1. Issuance guidance ($bn)

	Jun-23	Jun-24	Jun-25	Jun-26	Jun-27
Bonds					
2023 Budget Update	28	34	32	30	24
2022 Half-Year Update	28	30	30	20	20
Short-term borrowings (T-bills and ECP)					
2023 Budget Update	4.5	9	9	9	9
2022 Half-Year Update	3	3	3	3	3

Source: NZ Treasury

NZDM has signalled an intention to tap the 2033 NZGB via syndication by the end of the calendar year. No additional information was provided about potential further syndications.

Figuring out exactly what $34bn of issuance means for the volume of syndications NZDM wants to do over the next fiscal year isn't simple, as it depends on how much issuance NZDM can do via the weekly tenders. The new, flexible approach to nominal bond issuance (see below) calls for weekly issuance to be varied, with NZDM giving an example of ranges varying from $350m to $650m. These are not concrete, and issuance could be outside those ranges. However, if NZDM count on getting, say, $550m of bonds away a week, they could make up the balance by issuing around $9bn of bonds over, say, 3 syndications (with the maths being $24.75bn via 45 tenders (52 weeks less 4 weeks for the Christmas/New Year holiday, less a further 3 weeks for syndications). Linker issuance can help close the gap, but investors have shown limited appetite for these this year, and we suspect that will be more or less what the mix looks like.

So, the big picture here is that more bonds are coming, and markets don't like it. Bond investors went into today on the back foot, but this is a lot more bonds than we or anyone else expected, and as such, we are likely to see continued bond underperformance to swap, and a steeper-than-otherwise bond curve.

A new approach to NZGB tenders to better match supply with demand

All up, the increase in bond issuance guidance is large, but NZDM are clearly working hard to issue where demand is strongest (ie doing their darndest to ensure the government's financing cost is contained as much as possible).

On that score, they have announced a tweak to how NZGB tenders will be conducted going forward, giving NZDM a little more flexibility to respond to changing demand. From 1 July 2023 specific nominal bond lines and volumes offered will be announced closer to the tender date, allowing for market feedback and recent market dynamics to be considered. NZDM will continue to publish the tender schedule at the same time as previously (8am on the day prior to the last tender of the month), but this will only confirm the aggregate volume to be issued on each tender date as well as a range for each curve segment (eg 25s to 30s, 31s to 34s, and 37s to 51s).

On the second-to-last business day of each week, NZDM will collate market feedback in relation to demand for specific NZGB lines, and on the last business day of the week they will confirm, at 11:30am, the volumes and lines to be offered.

From 1 July, all NZGB, IIB and T-bill tenders will now close at 2:30pm (half an hour later than previously) to avoid clashes with the macroeconomic data calendar.

Macroeconomic context and implications

As we noted in our Preview, the current macroeconomic context is not conducive to further fiscal expansion, particularly in the near term. Yet, after looking through reprioritised and rephased spending (spending being moved between fiscal years), there's still more than $5bn of additional operating and capital spending in this Budget in the year to June 2024 that wasn't in the Treasury's Half-Year Forecast. That's around 1.4% of GDP.

A near record-low unemployment rate shows there is currently little spare economic resource to accommodate additional demand. By spending more, the Government is earmarking more resource, and the extent to which that can be accommodated without putting additional pressure on inflation will depend on how quickly spare resource opens up versus how quickly the extra demand for labour and other resources ramps up in practice. That's far from clear. But applying the learnings from the Review and Assessment of the Formulation and Implementation of Monetary Policy, the RBNZ will be keen not to undercook the stimulatory impacts of fiscal settings. That raises the risk of a hawkish tone at next week's MPS, and the potential for the OCR track to hint that monetary settings will need to be more restrictive than previously.

In a further complication, net migration has risen dramatically too. The RBNZ estimates that net migration is net inflationary – another reason they may sound more hawkish next week. But while it boosts demand (eg for housing), it also boosts labour supply. And there's no question that imported labour is going to need to be part of the cyclone rebuild effort – hopefully reducing the 'crowding out' of other economic activity.

Responding to the cyclone is absolutely the right thing to do. And the alternative to crowding out the private sector with higher than otherwise interest rates would be higher taxes and/or an even larger reduction in other government spending plans. There's no free lunch here. But given the starting point is a macroeconomy that is significantly out of balance (record-wide current account deficit and acute capacity constraints) higher taxes or a sharper axe on other government spending plans would have gone a long way to helping the RBNZ get the economy back to a more sustainable footing.

Of course, there are limits to how much government spending can be reprioritised. At the end of the day, the Government needs to deliver key services, even if the cost of those services is increasing rapidly with inflation. But the irony here is that fiscal (and monetary) policy was, with the benefit of hindsight, too stimulatory in the wake of COVID-19 – and that's a large part of the reason why high inflation has been so persistent. It's also a little ironic that high inflation also bolsters the tax base, given it's the nominal economy that's taxed (particularly when thresholds for income tax brackets aren't adjusted).

As already mentioned, the current account deficit is another very good reason for the Government to consolidate the fiscal position sooner rather than later. At 8.9% of GDP, the current account deficit reflects an economy living well beyond its means, potentially to a point where it is threatening the cost of accessing credit from abroad (as NZ becomes perceived as a riskier prospect to its creditors).

And as figure 9 shows, government dissaving has been a key factor behind the widening deficit (at least up until March 2022 – which is the most recent data point for this particular cut of the data). Fortunately, the reasons for the Government's dissaving are well understood: the Government used its balance sheet to fill the massive hole left by lockdowns and the loss of international tourism and education exports. Unfortunately, however, the economy was overstimulated along the way, and that sucked in more goods imports (as well as pushing up inflation), contributing to the record widening in the goods deficit (as seen in recent monthly merchandise trade data).

Figure 9. Current account deficit contribution by sector (March years)

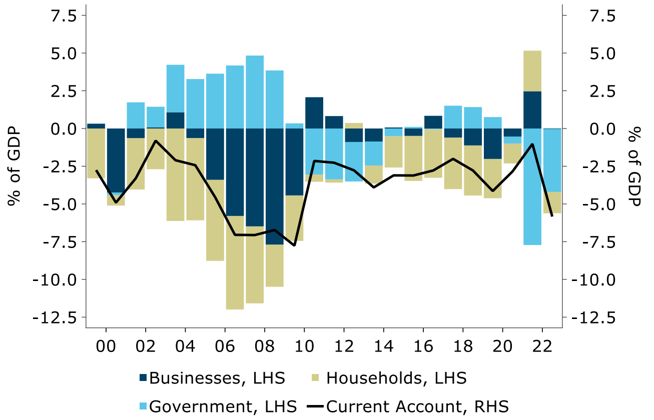
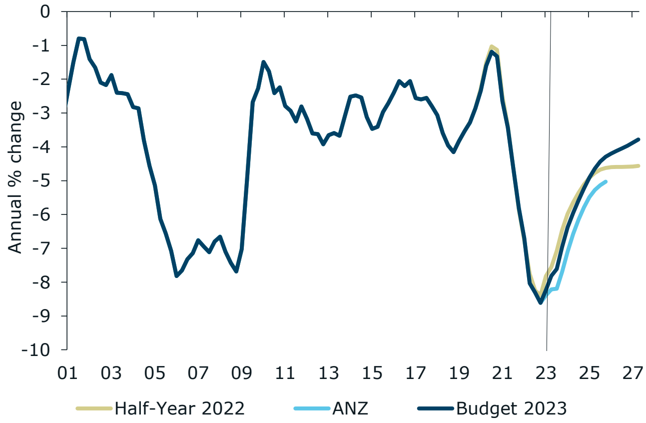


Figure 10. Current account forecast



Source: Stats NZ, Macrobond, The Treasury, ANZ Research

The current account deficit is expected to narrow now that the tourism recovery is underway, and the domestic demand pulse is softening on the back of contractionary monetary conditions. But the extra dissaving by Government implied by today's Budget suggests the narrowing might occur more slowly than otherwise and/or that the private sector will need to carry more of the burden of adjustment. Perhaps most importantly, even though the outlook is for a narrowing current account deficit, NZ is on thin ice from an external balance perspective, and is potentially only one significant terms of trade shock away from a much sharper adjustment in economic conditions than policy makers are hoping to engineer.

In the absence of increasing taxes or aggressively culling other initiatives, the Government faces a trade-off between supporting those in need and the amount of time it will take for the economy to transition to a more sustainable footing. It will happen because it must, but it's likely to take longer and occur via other channels (eg higher-than-otherwise interest rates) than had the overall fiscal position been less expansionary.

All up, Budgets (and the media coverage of them) do tend to be relatively micro-focused, highlighting which segments and initiatives get funding in the years ahead. That's important stuff, but it shouldn't overshadow the macroeconomic backdrop. Get macroeconomic policy settings wrong for too long and the Government's ability to deliver at the micro level could diminish. There might be fewer frills in this budget from a micro perspective, but through a macroeconomic lens we still see frills.

The next big question is how many frills does the RBNZ see? We've recently changed our OCR call to reflect the fact that inflation is looking like it'll be harder to tame than the RBNZ expects, and additional fiscal expansion is part of the reason (alongside several other economic factors). We now expect the OCR to peak at 5.75% (previous 5.5%); today's Budget adds a touch of upside risk to this.

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