ANZ Research

Budget 2023 Preview

10 May 2023

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No frills and no free lunch

Summary

- Despite the 'no frills' label being attached to Budget 2023 ahead of its release, we expect it to add a little more stimulus to an already capacity-constrained economy – that's still 'frilly' as far as inflation and the RBNZ is concerned. While fiscal policy is the right tool to respond to cyclone Gabrielle, the decision not to fund the rebuild by increasing taxes or introducing a levy means the response will require reprioritisation of spending. And to the extent that that doesn't cover the cyclone's tab, it'll likely mean higher-than-otherwise interest rates as the RBNZ responds to any inflationary implications of the larger deficits, resulting in reduced private sector activity. There is no such thing as a free lunch.

- On balance, the economy has underperformed the Treasury's December Half-Year outlook, and some of this weaker momentum is expected to be factored into the Budget Update forecasts. While cyclone-related spending and possibly a higher net migration assumption could provide meaningful offsets, the Treasury's Half-Year forecasts for real activity over the medium term were quite optimistic – a high hurdle for an upgrade.

- A weaker starting point for tax and a possible downgrade to the economic outlook suggest the fiscal outlook will be weaker. Cyclone spending net of any reprioritisations will also weigh on the Government's books. We think it's likely that the first post-pandemic OBEGAL surplus will be delayed by another year to 2025/26.

- Increased spending (net of reprioritisations) and a weaker tax take will also put additional pressure on NZDM funding requirements. Kāinga Ora maturities after 2023 and any increase in Kāinga Ora spending may also add to the funding requirement, but that may be a story for later on.

Table 1. Bond issuance (Half-Year vs ANZ expectations for Budget 23)

	Jun-23	Jun-24	Jun-25	Jun-26	Jun-27	Total (24-27)
2022 Half-Year Update	28	30	30	20	20	100
Budget 2023 (ANZ central expectation)	**28**	**32**	**32**	**24**	**22**	**110**
Budget 2023 (ANZ high)	28	35	35	25	25	120
Budget 2023 (ANZ low)	28	30	30	22	20	102

- All up, while responding to the cyclone is absolutely the right thing to do, running wider-for-longer fiscal deficits and adding further macroeconomic stimulus to an already out-of-balance economy is potentially problematic. New Zealand's record-wide current account deficit, a near record-low unemployment rate, and CPI inflation near a multi-decade high are all good reasons to consolidate the fiscal position faster than otherwise, but it's not clear that Budget 2023 will deliver that. Time will tell, but to ensure value for money for taxpayers, and from an economic sustainability perspective, Budget 2023 needs a very clear and credible strategy towards eventual fiscal consolidation. Sovereign credit rating agencies and NZ Inc's external creditors more generally appear to be watching closely.

The detail

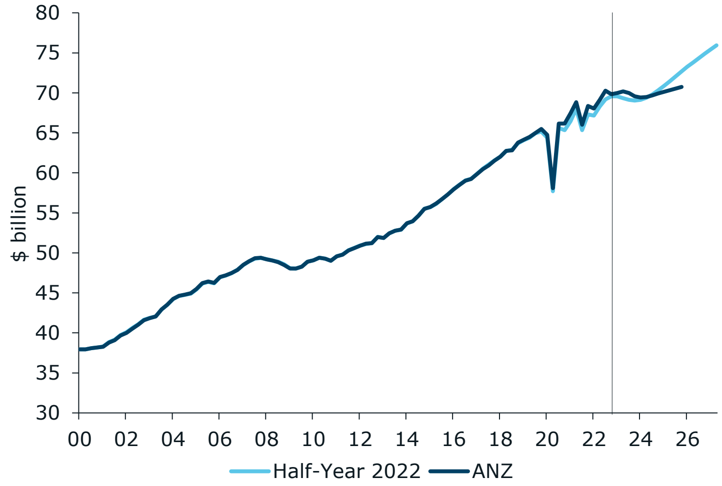
On 18 May, the Treasury will open the Government's books once again and produce a fresh set of economic and fiscal forecasts. The Minister of Finance will table the Government's spending plans for the years ahead, including the details of the cyclone response. The Government's Fiscal Strategy Report will outline how all of this dovetails with the government's fiscal rules.

A lot to account for in the Treasury's updated economic and fiscal outlook…

Economic and fiscal developments since December's Half-Year Update have been quite meaningful for the fiscal outlook.

- Q4 GDP came in at -0.6% q/q vs the Treasury's Half-Year update forecast of +0.6%. As we noted at the time, some of the softness in the Q4 growth is noise, and some of it is capacity constraints biting when the economy typically runs hottest. But nonetheless, the data also suggests there is less economic momentum. A glass-half-full view of it would point out that upwards historical revisions and stronger growth in Q3 mean the real economy wasn't actually any smaller in level terms in Q4 than the Treasury's forecast. However, in terms of the tax base (where history is known) historical GDP revisions don't mean a lot – they don't result in any more tax retrospectively coming in; they just suggest the economy was slightly more or less tax rich than previously thought. What does matter for the outlook is the state of economic momentum, and that is looking a bit softer than the Treasury's Half-Year forecast.

Figure 1. Real GDP outlook



Source: Stats NZ, The Treasury, ANZ Research

- But it's nominal GDP that really matters for tax, and despite the level of real GDP coming in slightly above the Treasury's Half-Year forecast in Q4, the level of nominal GDP did not. In fact, it was around $0.8bn smaller than the Treasury's forecast despite upwards revisions to historical GDP for prior quarters. Rebasing the Half-Year nominal GDP forecasts and banking the Q4 growth surprise suggests tax revenues could come in between $4-9bn lower over the four years to June 2027 (ie roughly $1-2bn lower per fiscal year). But that's before factoring in other potential changes to the outlook.

- Government financial statements for the nine months to March certainly suggest the economy is running colder than the Half-Year forecasts, with tax revenue $2.3bn below forecast on softer corporate tax, GST and other individuals' tax. At face value, this suggests the tax outlook could be even weaker than our nominal GDP-based estimate above.

- But there's a lot more for the Treasury to incorporate than just recent data outturns. Cyclone Gabrielle will have both economic and fiscal implications for the outlook. This note (from the Treasury) provides a high-level overview of the Treasury's estimated damage (which they clock at $9 to $14.5bn), hinting that the Budget forecasts will contain a "significant amount of cyclone-recovery investment". Of course, far from all of the damage will end up on the fiscal books. Much of the damage was to private property: some insured, some not. But the damage to infrastructure (roads and bridges particularly) is fiscal policy's problem with the rebuild to inevitably be spread over years).
- A key question for the economic outlook is; will the net migration surge continue or fizzle out? No one can answer that with certainty, but whatever the Treasury's assumption, it could have a meaningful impact on their economic and tax forecasts. As we've noted previously, the recent net migration run rate, if maintained, could be enough to keep the NZ economy out of recession. If the Treasury significantly upgrade their last published (HEYFU) assumption of a net inflow of 36,500 by the end of their forecast, economic activity should get an upgrade too (all else equal).
- However, the Treasury finalised their Half-Year Update forecasts before the hawkish November Monetary Policy Statement delivered a 75bp hike and signalled a higher terminal rate. Higher interest rates since then have been reflected in the Government's interest costs, and assuming the Treasury make no changes to their neutral OCR assumption, tighter monetary policy than previously assumed is likely to weigh on the activity outlook too.
- All up, there's definitely a weaker starting point for the Treasury to factor in on both the economic and fiscal side, but their medium-term outlook is likely to remain on the optimistic side of ours. However, optimism has its limits. We think the hurdle is high for the Treasury to actually upgrade the activity outlook. Given the RBNZ believes a recession or something close to it is necessary to bring inflation down, any perceived upside to demand, whether via higher government spending, net migration or some other driver, could see the RBNZ deliver a higher OCR than otherwise, spoiling the party.

The Government's primary fiscal rule is to keep surpluses within a band of 0-2% of GDP. Given the factors discussed above, we think the forecast for a return to surplus is likely to be delayed by another year to 2025/26. The Half-Year forecast was for the OBEGAL to record its first post-pandemic surplus ($1.7bn) in 2024/25. But even at the time we thought risks to the Treasury's economic outlook could easily push this into 2025/26. A forecast surplus for 2026/27 is expected, but that will assume relatively constrained new spending in subsequent Budgets, and will possibly be underpinned by a relatively optimistic economic outlook. The following paragraph is copied from our Preview of Budget 2022 (ie this time last year) and still seems relevant:

> *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.*

If our expectation proves correct, and the OBEGAL deficit is indeed pushed out another year, that would mark six years in deficit since the onset of COVID-19. That's the same amount of time in deficit as was triggered by the Global Financial Crisis and Canterbury earthquakes. But current macroeconomic conditions are very different to the 2008-2014 period:

- Between the year to June 2009 and 2014 the unemployment rate averaged around 6% (ie there was slack in the labour market to accommodate fiscal expansion). Post pandemic it's averaged just under 4%, hitting a record low in recent quarters (there is currently no slack).
- Between the year to June 2009 and 2014 CPI inflation averaged 2.3% y/y (and that includes the impact of the increase in GST from 12.5% to 15%). Post pandemic it's averaged 4.3% y/y, recently hitting a multi-decade high of 7.3% in June 2022. That means that the RBNZ is more likely to respond to any perceived inflationary risks (including via fiscal settings), given the risk that inflation expectations could become unanchored. In other words, potentially higher-than-otherwise mortgage and business lending rates (as well as higher interest costs for the Government/tax payer) could be the indirect result of further fiscal expansion.
- Between the year to June 2009 and 2014 the current account deficit averaged a smidge over 3.5% of GDP. The post-pandemic average is a little over 4.5% of GDP. That's not too bad until you consider the fact that it widened to a record high of 8.9% in Q4 2022 – that's a worry from an external sustainability perspective. Sovereign credit ratings agencies watch these metrics for very good reasons. If NZ becomes too unbalanced, it could look riskier to foreign creditors, pushing risk premiums higher and adding upwards pressure to the cost of credit in NZ (for both the private and public sectors).

In short, current macroeconomic conditions are not conducive to running fiscal deficits the way the post-GFC era was. The economy is now out of balance from both capacity and external balance perspectives, and any further fiscal stimulus may mean more work for the RBNZ to do to get the economy back onto a sustainable path. Those weather events were particularly badly timed (and as we write there's another one going on).

Turning to Government debt, the forecast for net debt is expected to peak a little higher than previously, but the better-than-expected starting point may contain this significantly. At $72.8bn, net debt was $4.8bn lower than the Half-Year forecast in March 2023. Importantly, this better starting position is owing mostly to valuation changes opposed to a better core fiscal position, so should be at least partially looked through from a fiscal management perspective. Regardless, there is plenty of wiggle room before potentially breaching the 30% of GDP 'ceiling' specified in the Government's fiscal rules. The Half-Year forecast was for net debt to peak at 21.4% of GDP in the year to June 2024. To put some perspective around the recent increase in debt, this measure was sitting at 1.8% of GDP in 2019, suggesting a 'breach' of the ceiling could be only one significant economic shock away.

NZDM is expected to upgrade its bond guidance (again)

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

- A weaker outlook for tax revenue, plus the additional cyclone-related spending net of any reprioritisations, means Government debt needs to lift, and that debt will need to be funded.

- NZDM's guidance at the Half-Year Update included additional funding for Kāinga Ora spending, plus rolling over the maturing Kāinga Ora 2023 bonds. However, the Government had not at that time made a decision on how Kāinga Ora bonds maturing after 2023 would be managed (eg possibly rolled into NZDM's borrowing programme). If these Kāinga Ora maturities are included (which presumably will happen at some point), this would add a further $7.6bn to NZDM's funding requirement, potentially with a legacy all the way out to 2040. But only $3bn of this matures within the Treasury's current forecast horizon to June 2027. Any increase in Kāinga Ora spending from here is also expected to be funded by NZDM – this seems unlikely for Budget 2023, but we can't rule it out.
- Interest rates have surprised the Treasury's Half-Year Update forecasts to the upside, meaning less cash in the door for a given face value of bonds that go out. We think a lot of this 'surprise' pertains more to the recent pace of hikes than the Treasury's longer-run interest rate projections, meaning the impact on NZDM's funding requirement could be relatively front loaded.
- As outlined quite some time ago, NZDM's funding programme already incorporates the maintenance of a 'cash buffer'. Broadly, we don't expect any change to this strategy, but this buffer does provide NZDM with a bit of freedom to smooth funding across fiscal years.
- Funding to buy the planned $5bn of LSAP bonds from the RBNZ each year is expected to remain unchanged. The hurdle for deviating from this 'set and forget' policy appears high.

Table 2. NZDM bond issuance guidance ($bn)

	Jun-23	Jun-24	Jun-25	Jun-26	Jun-27	Total (24-27)
2022 Half-Year Update	28	30	30	20	20	100
Budget 2023 (ANZ central expectation)	**28**	**32**	**32**	**24**	**22**	**110**
Budget 2023 (ANZ high)	28	35	35	25	25	120
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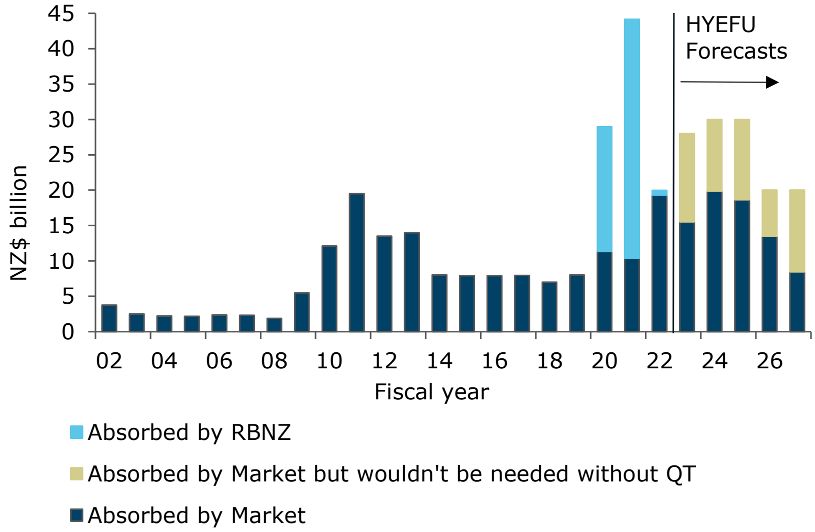
Our central estimate in the table above lands on an extra $10bn of bond issuance over the four years to June 2027. But if the Treasury's economic outlook is materially weaker, and/or the degree of new spending (net of reprioritisations) is larger, something closer to the high scenario could be on the cards. Conversely, if the Treasury's forecasts are on the rosy side and reprioritisations cover most of the cyclone tab, then the low scenario cannot be ruled out. Guessing the bond programme is as much art as science!

Importantly, something close to the low scenario with downside risks to the Treasury's economic outlook would mean actual bond issuance is likely to end up higher than signalled on the day. In all scenarios, we assume NZDM continue to value a relatively smooth funding profile. And in all scenarios, this 'smoothing factor' pushes up issuance in 2025/26 at the benefit of containing issuance in 2023/24 and 2024/25. We also expect NZDM to continue rounding to the nearest 2 (or possibly 5) billion.

The 2022/23 funding task is pretty much on track to be completed and we don't expect it to be increased with just one month to go. Indeed, NZDM are on track to issue $27.63bn of the $28bn planned, which is close enough.

The question then becomes, how does NZDM manage the expected step-up to issuing $32bn of bonds a year, which is not only $4bn more than this year, but also a big uplift net of QE (as figure 2 shows)? The obvious answer is to issue more bonds via syndications, which have proven to be an effective way to get volume done (in comparison to conducting mega tenders every week of the year). Indeed, on an annualised basis, $32bn of bonds works out at $615m a week (or a touch above $650m if NZDM pause tenders as usual over the summer holidays).

Figure 2. NZGB issuance absorption since 2000



Source: NZDM, RBNZ, ANZ Research

Recent tender issuance has been running at $400m/week, and we think that's about the most the market can handle. Working backward from the $32bn funding task, and assuming the usual summer pause (which takes out 4 tenders), there are 48 remaining weeks to cover the volume. Take out another 3 (or 4) weeks for syndications (tenders are always cancelled on the weeks that syndicated issuance is conducted) and we're down to 44 (or 43) weeks.

At $400m a week, tenders will this raise around $18bn, with the remaining $14bn or so needing to come from syndications. We think that speaks to 4 rather than 3 syndications. The maths of getting $14bn done over 3 deals is just too big (an average of $4.7bn per deal). We think NZDM would be safer to aim for 4 deals averaging $3.5bn apiece (so that could be a mix of $3bn and $4bn deals), especially if longer-duration bonds are in the mix (which we think is likely, given the headache caused by having large maturities every year, as we do for the next five years (table 3).

Table 3. ANZ estimate of the funding task owing to refinancing maturities and coupon payments over the next 5 fiscal years ($bn)

Fiscal year	Rollovers	Coupons	Total
2022/23	16.2	4.6	20.8
2023/24	14.0	4.5	18.5
2024/25	15.1	5.1	20.2
2025/26	11.7	5.8	17.5
2026/27	15.4	6.0	21.4

Source: ANZ Research estimates, NZDM

To summarise, our expectation is that we see tenders continue at a $400m/week pace, with 4 syndications picking up the remaining $14bn or so of slack. Of course, we won't get this degree of granularity at the Budget, with the July tender schedule not due out till 28 June, and syndication volumes typically not released till deals launch, but that's our expectation.

As noted, we'd be surprised if the current year's funding task is increased; but if it is, the only way to meaningfully lift issuance this late in the year would be via a syndication in June. While not impossible, it would be a big surprise for the market for an announcement like this to come out of the blue since it hasn't been flagged anywhere.

In terms of what maturities upcoming syndications would target, with 3 or 4 likely, NZDM is likely to only provide details on the next one at the Budget, with details on later ones to come nearer the time. Demand for linkers has been patchy of late, and NZDM haven't issued any since November. As such, a new nominal bond seems most likely next, and with all of the 1-year gaps between now and 2034 closed, and the biggest gap being the 10yr gap between the 2041s and 2051s, a 2047 bond to match the second-longest ACGB maturity makes sense.

In sum

All up, in this economic climate even a 'no frills' budget could look pretty frilly from an inflation-fighting perspective. Monetary policy and external sustainability need friends here and now, as economic conditions simply aren't conducive to higher government spending or tax cuts. Budget 2023 will deliver a path to eventual fiscal consolidation, but it's not guaranteed that it won't generate a little more inflation in the meantime (necessitating a higher OCR).

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