NZ Half-Year Economic & Fiscal Update Preview

6 December 2023

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New team, new game plan

Summary

- The Treasury's first shot at incorporating the policies of the new Government into the outlook will be published 20 December in the Half-Year Economic and Fiscal Update. We say 'first shot' because given the short turnaround there's a good chance all the details of the new policy agenda are not fully captured. Given the new Government is understandably currently more certain about the details of spending it wants to add than it is about precisely what it wants to cut, the risk is that the HYEFU signals higher bond issuance and a little more fiscal stimulus from the June 2025 year onwards than actually ends up occurring. The big unknown at this stage is how much government spending will *eventually* get cut.

- While we suspect changes to fiscal settings will end up broadly neutral from an aggregate demand perspective, given the Half-Year Update at face value may well be more stimulatory, it will potentially add to the likelihood of another hike in February. May's Budget could end up being a better signal for the aggregate demand implications of fiscal settings, given the Treasury will have more time to crunch the numbers and the Government more time to get into the weeds. But the RBNZ won't hold off hiking for the sake of that, if they think it's needed.

- The "mini Budget" will certainly provide a taste of things to come, but we think this will be more "policy statement" than "Budget". Changes to revenue and expenses for the remainder of the current fiscal year (to June 2024) are expected to be relatively small compared to 2024/25 onwards (which will be laid out in great detail as part of Budget 2024).

- Looking through revisions, economic data since the Treasury's Pre-election Update forecast has landed pretty close to their expectation. Credit where it's due: they picked recent stronger migration and GDP better than most (including us) and their Q3 CPI inflation forecast was bang on. However, we'd still characterise their prior medium-term activity outlook as a little optimistic, and think that characterisation is likely to remain come the Half-Year Update (a downside fiscal risk).

- Turning to the fiscals, monthly financial statements to October show the starting point for revenue and expenses is also close to forecast, and while the residual cash deficit is wider than expected, the Treasury has noted the variance is expected to be largely timing, meaning a decent chunk of the miss will likely unwind in the forecast. Changes to policy settings will have sizable impacts on the outlook for revenue and expenses, but these should offset to a large extent. We expect the Government to maintain a laser focus on achieving an OBEGAL surplus in 2026/27, as sovereign credit ratings agencies are watching closely. They might end up making deeper spending cuts to deliver on that.

- NZDM's funding requirement is expected to lift slightly. We have pencilled in a $5bn increase in bond issuance to June 2027 (with no change to the remainder of the current fiscal year). But if the Government follows through with its signalled fiscal discipline (and the Government's fiscal strategy – which could be released as late as 31 March – has teeth), this could be the last upgrade for a while.

The detail

The Treasury will open the Government's books on 20 December with the publication of the Half-Year Economic and Fiscal Update (henceforth 'Half-Year Update').

The Half-Year Update will be the Treasury's first attempt at incorporating the change in policy direction following the election, including lower forecast expenses and lower revenues (all else equal). We say "first attempt" as some of the finer details of policy settings may not be available until Budget 2024 processes get underway. Indeed, it's been a very short turnaround from coalition negotiations concluding (24 November), Ministers being sworn in (27 November) and the likely finalisation date for the fiscal outlook (we think first week of December), meaning the Treasury may not have had enough back-and-forth time with the Government to incorporate every aspect of the policy agenda. The wheels of Government turn a little more slowly than some financial market participants may appreciate. The upshot: meaningful forecast revisions could occur between the Half-Year Update and the Budget Update (released May 2024), even if the broad policy mix is maintained.

The 'mini-Budget' will be released alongside the Half-Year Update, incorporating the Treasury's forecasts and signalling the direction the new Government intends to take. In terms of the macroeconomic picture, the mini-Budget probably won't provide a lot of additional information over and above the Half-Year Update. However, if the Budget Policy Statement and encompassing fiscal strategy is released on the day (which seems unlikely), this would be of interest as it would provide a feel for the risks around fiscal settings going forward.

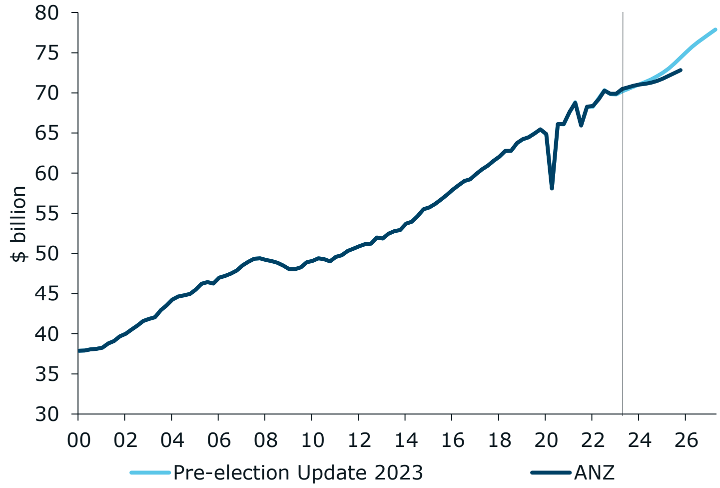
Lastly, before we dive into the details, it's worth highlighting that a change in Government introduces significant uncertainty around how the Treasury may weigh up the implications for the likes of revenues, expenses, and bond issuance. That's because the policy costings parties campaigned on were produced by external providers that are likely to make slightly (or significantly) different assumptions to the Treasury. Likewise, any early judgements and assumptions we make about this stuff could differ meaningfully too.

The Half-Year Update could include a small upgrade to the economic outlook…

Ironically, it wasn't long after the Pre-election Update was published that some elements of the Treasury's "optimistic" economic forecasts turned out to in fact be a little soft. At 0.9% q/q, Q2 GDP was stronger than the Treasury's 0.6% q/q forecast and our forecast of 0.4%. Stronger-than-expected net migration is likely to square that circle somewhat. At around 120k in September 2023, annual net inflows beat the Treasury's forecast for a peak of 100k by a decent margin (and everyone else's too!).

We've recently revised our migration and GDP forecasts a little higher, and wouldn't rule out the possibility of the Treasury doing the same. However, we still have a softer medium-term real GDP outlook than the Pre-election Update forecast, suggesting come the Half-Year Update, we're likely to continue to characterise the Treasury's medium-term forecast as still being a little optimistic (figure 1, over).

Figure 1. Real GDP forecast



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

Data since the Pre-election Update hasn't been one-way traffic. The Q3 unemployment rate of 3.9% was 0.1% pts higher than the Treasury's Pre-election update forecast, with employment growth weaker. But compared to the typical volatility in the survey, that's neither here nor there.

On the prices side, CPI inflation appears to be evolving in line with the Treasury's forecast: they were spot on for the Q3 release, and their 4.8% y/y forecast for Q4 2023 is in line with our expectation. Meanwhile, the terms of trade have come in a little stronger.

A function of both prices and real activity, nominal GDP is key when it comes to the fiscal outlook, as nominal, not real, GDP is taxed. Since the Budget, Q2 nominal GDP came in stronger than expected, with the two preceding quarters revised higher too. But the Treasury already knew what government revenues and expenses were looking like for that period, so a bigger starting-point for the economy than previously expected probably won't have much bearing on the fiscal outlook. Forecasts will matter though, and it's worth noting that the Treasury will have locked down their economic outlook well before the release of Q3 GDP (14 December). A decent forecast miss alongside potentially-significant revisions to these data could have implications for the Treasury's understanding of underlying economic momentum compared to that presented in the Half-Year Update, but we'll have to wait and see.

All up, looking through data revisions, the Treasury's economic forecasts have captured the recent vibe of the economic data well. That suggests that economic forecast changes between the Pre-election Update and the Half-Year Update should be relatively minor. But there are fiscal policy changes for the Treasury to factor into the economic outlook, including the impacts of tax cuts on private consumption, which will be at least partially offset by lower government spending. What the Treasury has to say about the economic impacts of fiscal policy following the change in Government will likely be the most interesting part of their economic outlook. Our latest outlook includes lower demand from government but more from the private sector, but this wasn't a game changer for our take on the overall outlook; nor do we expect it to be for the Treasury.

...but that's unlikely to drive much improvement in the fiscals (if any)

Overall, the starting point for the Government's books is close to the Pre-election Update forecast. In the four months to October, core Crown tax revenue was running $0.3bn above forecast (reflecting higher direct taxes and source deductions), while core Crown expenses were $0.4bn below forecast (with the Treasury noting this variance appears to be timing).

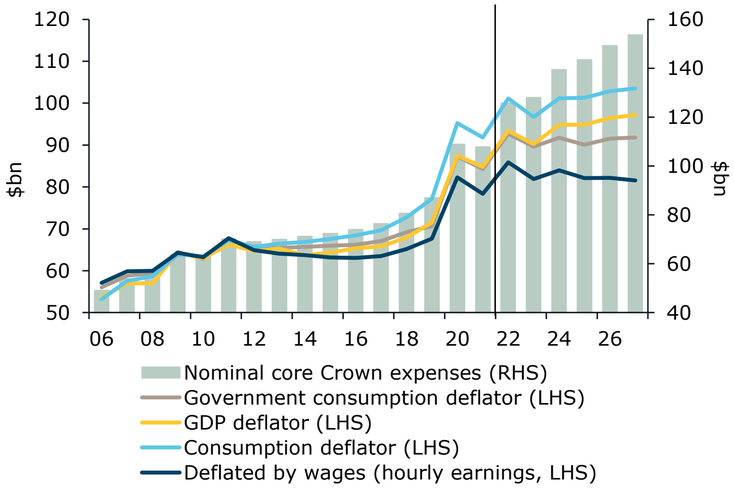
Meanwhile, the core Crown residual cash deficit of $10.4bn was around $1.8bn wider than forecast. But the Treasury also noted that "at this stage most of this variance is timing in nature and is expected to unwind in the future". That suggests the starting point miss probably won't be carried into the updated outlook.

However, the new Government's policy agenda will certainly impact the outlook for both revenues and expenses. According to National's fiscal plan (note: the Treasury will form their own view on these policies), tax relief to the tune of $3-4bn per year from 2024/25 onwards will be offset by spending cuts (a little over $2bn pa), and new revenue initiatives. But with the controversial foreign buyers' tax (signalled by National to generate around $0.75bn pa) now off the table, we could see deeper spending cuts and/or shallower income relief than previously signalled.

Anchoring our expectations here is an assumption that the Government will want to preserve a forecast OBEGAL surplus for the 2026/27 fiscal year and will tweak policy settings accordingly. As we've noted previously, seven consecutive years in deficit following the pandemic (one year more than following the Global Financial Crisis) is not appropriate for the economic conditions. Sovereign credit ratings agencies are watching closely, and there is very little room for slippage.

That said, given the short amount of time between Ministers being sworn in and the Half-Year Update, we don't think there will be sufficient time to incorporate much in the way of policy changes over and above what was agreed in coalition negotiations. But come Budget 2024 (and beyond) we think there is scope for further spending cuts if the Government deems that appropriate (eg perhaps to maintain a projected surplus should revenues fall short of expectations). As we have noted previously, it really doesn't matter what price assumption you use, after adjusting for the rapidly rising cost of delivering public services, the Pre-election Update forecast showed around $15-20bn more real Government expenditure in the outlook per year, compared to pre-pandemic (2019) levels (figure 2).

Figure 2. Real core Crown expenses



Source: The Treasury, ANZ Research

The National Party campaigned on cutting spending by a little more than $8bn over four years. Of course, seeing scope for large savings in the aggregate numbers versus identifying at least $8bn worth of low-hanging fruit (read: cuts in goods and services that are acceptable to voters) in a line-by-line exercise are very different endeavours. But while it might not be a story for the Half-Year Update, we do see a chance that fiscal settings end up a little more contractionary over the medium term.

A small increase to NZDM's bond issuance guidance expected

Table 1 shows our expectation for bond issuance guidance. Compared to the Pre-election Update, we've pencilled in a $5bn increase in issuance guidance over the four years to June 2027. This reflects a lot of different things: higher bond yields, an assumption that a very small part of the starting point shortfall in residual cash is carried through, and small net impacts from changes to fiscal policy settings and the economic outlook. But there is plenty of scope for a surprise on the day!

Table 1. NZDM bond issuance guidance ($bn)

Year to June	Jun-24	Jun-25	Jun-26	Jun-27	Jun-28	Total (24-27)
2023 Pre-election Update	36	35	30	28	NA	129
Half-Year Update (ANZ expectation)	**36**	**36**	**32**	**30**	**20**	**134**

Source: The Treasury, ANZ Research

An additional fiscal year will be added to the forecast horizon too (2027/28). For that year we've pencilled in $20bn bond programme, assuming around $18bn for repurchases and maturities, and a touch of smoothing by NZDM between fiscal years (to get a nice round number). We have also allowed for a small cash deficit. There shouldn't be any pressure on issuance from the LSAP in 2027/28 given that active QT will end in the first quarter of that fiscal year (assuming QT continues at the current $5bn pa pace). As discovered in the Pre-election Update, maturing Kāinga Ora bonds are provisioned for in NZDM's issuance guidance, meaning the 2027/28 fiscal year will factor in the $0.9bn October 2027 Kāinga Ora maturity too.

For the current fiscal year, we think NZDM will be eager to avoid a further increase in bond issuance if possible. There are already two syndications in the pipeline before the end of June 2024 that we estimate will need to raise around $8.5bn between them, and the tender run rate is already elevated at $500m per week. If there is a lift to the current year funding requirement, NZDM may smooth that across the forecast horizon where they can by flexing short-term funding and/or cash and letting liquid assets fluctuate a little.

From these glut-like levels, the market certainly doesn't appear to have a lot of appetite for more bond supply and will be hoping that a change in Government provides some relief on that front. All else equal, higher bond supply means higher yields, meaning higher Government funding costs, and ultimately a larger burden on taxpayers into the future. And with global term premiums on the up lately, finance cost risks are certainly topical right now.

The mini-Budget: probably not what it sounds like

The mini-Budget probably *isn't* going to be what it sounds like: an overhaul of revenue settings and expenses for the second half of the current fiscal year (to June 2024). While there will be a few small tweaks here and there to fiscal settings over the next few months, the big change to fiscal settings (according to National's fiscal plan) will occur from the next fiscal year onwards.

And for good reason: the bureaucracy is not geared up to go through typical Budget processes this time of year – that's a goliath task, and there simply hasn't been enough time between coalition agreements concluding and the cut-off date for the Treasury to finalise their forecasts. Budget 2024 (due this coming May), will be the new Government's first Budget in a traditional sense.

So if the mini-Budget isn't a "traditional Budget", what is it? In a nutshell, we think it'll be more policy statement than Budget, outlining the broad direction that the new Government intends to take things:

- It'll outline the path for fiscal policy over the next few years, including signalled tax and spending cuts. The bulk of these kick off from the year to June 2025 (ie what will be covered in Budget 2024).
- It'll outline the lengthy list of regulatory reform, as signalled in the coalition Government's 100-day plan. This is the stuff that's likely to take effect before the current fiscal year is out, but which will have less impact on the overall fiscal position.

The mini-Budget will be a good one-stop shop for how the new Government intends to run things. But from a macroeconomic outlook perspective (provided the Treasury are able to incorporate enough of the new policy mix into the forecast), the Half-Year Update should give us what we (and the RBNZ) are looking for: are fiscal settings expected to be more or less stimulatory over the next few years than previously?

The November MPS suggested the RBNZ has very little appetite for upside surprises from any source. If the new Government's policies look more stimulatory than anticipated, OCR hikes could be more likely. However, we would note that the RBNZ didn't seem to blink following the 1.4% of GDP increase to Government spending announced in Budget 2023, and by our reckoning it's very unlikely that the looming rejig to fiscal settings (spending and tax cuts) will be more stimulatory than that. In addition, given the Treasury may not have been able to include all of the details of the new Government's policy agenda in such a short timeframe, it may also be worth waiting for the May Budget Update before assessing the likely fiscal stance over the next few years.

The fiscal strategy will be key for assessing risks to the fiscal outlook and bond issuance (but this may not be released until next year)

The Government is required to deliver a Budget Policy Statement (BPS) no later than 31 March. This is typically released alongside the Half-Year Update, but the limited time with feet under desks means it'll probably come later. Within the BPS, the Government must outline its fiscal strategy, specifying its short-term intentions and long-term objectives with respect to a number of key fiscal metrics and in accordance with the principles of responsible fiscal management. Unlike the Half-Year Update (which is a Treasury document), the BPS is owned by the Government.

As we noted in this post-election Insight note, the fiscal strategy will be key for assessing risks around fiscal settings over time. The previous Government's post-pandemic fiscal strategy was materially looser than it was before the pandemic, with little regard for the interaction between fiscal and monetary policy. That meant risks to Government debt were a little lopsided: if revenues beat the Treasury's forecast, there was plenty of wiggle room for the Government to increase spending in response, rather than reduce bond issuance. But if the fiscals deteriorated, issuance guidance would need to be lifted.

To avoid a repeat of such pro-cyclical fiscal policy settings, we hope to see something similar to the 2017 Fiscal Strategy Report that said "The Government intends to use any positive cyclical revenue surprises to strengthen the resilience of the balance sheet". If we get that, positive revenue surprises will go to paying down Government debt faster, taking pressure off bond issuance, and, compared to the counter-factual (ie spending it), inflation too.

As we've noted previously, running seven consecutive deficits following the pandemic (one year more in deficit than following the GFC) is questionable from the perspective of both inflation and external sustainability (NZ's current account deficit has blown out on the back of Government dis-saving). The initial COVID fiscal response was appropriate, but this wasn't unwound as economic conditions changed. Quite the contrary, in fact: additional fiscal stimulus was injected into the economy despite a record-low unemployment rate, no capacity to accommodate extra demand, and CPI inflation running at a multi-decade high.

As a result, fiscal policy has added to inflation pressures, and ultimately meant the OCR and broader borrowing costs have had to go higher than otherwise, crowding out private sector activity. And of course the fiscal war chest is now depleted.

In sum

All up, the Half-Year Update and accompanying documents will mark a reset in fiscal settings, and possibly introduce the broad fiscal rules this Government intends to play by. How it nets out in the Treasury's forecast is a little bit of a guessing game, but we think it'll be marginally positive for bond issuance. However, we wouldn't be surprised if the Half-Year Update ends up marking the last increase in bond issuance for a while. Indeed, if the Government is serious about contributing to getting inflation down, the focus needs to be on increasing aggregate supply (such as cutting red tape) and reducing demand (perhaps by cutting Government spending by more than the promised income relief package). Perhaps the latter will be one for Budget 2024.

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