RESEARCH

Economy Watch

15 December 2021

Government funding requirements slashed

- **Bond programme aggressively reduced**
- **As past overfunding acknowledged**
- **And economy reveals starting point resilience**
- **Government spend up looms**
- **But so too do fiscal surpluses**

HYEFU highlights

Accounts return to surplus in the June year 2024. Following a 5.7% of GDP and 0.2% of GDP deficits in fiscal 2022 and 2023 respectively.

Surplus rises to 1.8% of GDP by June 2026.

Net core crown debt peaks at 40.1% of GDP in June 2023. Falls to 30.2% by June 2026.

GDP growth averages 2.5% over the next five years.

Annual CPI inflation peaks at 5.6% in Q1 2022. It falls progressively to 2.2% by June 2026.

Unemployment rate falls to 3.1% in Q1 2022 and then rises slowly to 4.1% by June 2026.

Cash rate climbs to 3.0% and stays there

Nothing is normal anymore. Who would have thought a government could announce one of the biggest spend ups of all time and accompany this with a massive reduction in its requisite funding programme. Yet this is exactly what today's Half Year Economic and Fiscal Update HYEFU delivered.

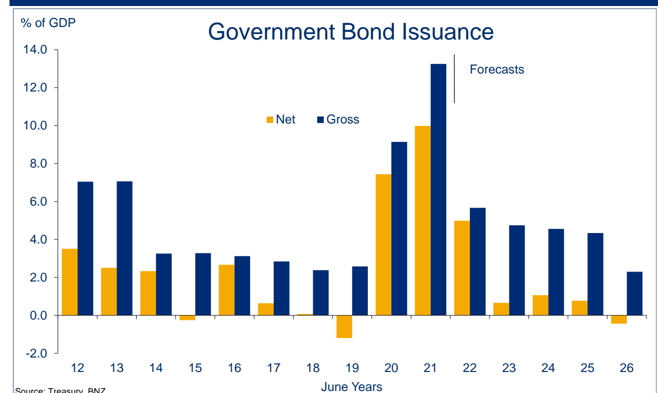
How can this be so? In short, it reflects a massive improvement in the fiscal starting point accompanied by upward revisions to expectations for future government revenue streams.

Bond programme slashed

For financial markets, the biggest news of the day is that the NZ Government bond programme has been slashed by $31 billion over a four year period. That's equivalent to a staggering 9.0% of GDP. That the Government can do this is largely a function of NZDM's decision to "repay" the excess cash balances built up in the system due to the effective overfunding of the fiscal needs of the country which, in turn, is a function of stronger than expected economic activity and inflation.

Bond issuance for the June year 2022 has been cut to $20 billion from $30 billion. As a consequence, the expected syndication of a new bond this fiscal year has been canned. In each of the following three years the programme is reduced by $7 billion to $18 billion per annum. $10 billion will be issued in the June year 2026. With significant bond maturities from fiscal 2023 onwards, forecast net issuance falls to just 0.5% of GDP per annum on average over the last four years of the forecast horizon.

Bond issuance shrinks



HYEFU 2021	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
	actual	actual	actual	actual	actual	f/cast	f/cast	f/cast	f/cast	f/cast
(June years, % of GDP)										
Core Crown Revenue	29.6	29.3	30.1	29.0	30.9	30.5	31	31.2	31.4	31.6
Core Crown Expenses	27.7	27.2	28.0	34.3	31.7	35.3	30.5	30.1	29.5	29.3
OBEGAL	1.5	1.9	2.4	-7.3	-1.3	-5.7	-0.2	0.5	1.4	1.8
Gross Sovereign Issued Debt (incl settlement c	33.6	32.2	29.3	39.1	38.6	44.5	46.4	45.7	40.1	35.5
Net Core Crown Debt	21.6	19.4	18.6	26.3	30.1	37.6	40.1	39.9	34.6	30.2
Domestic Bond Programme ($NZm)	8,000	7,000	8,000	25,000	45,000	20,000	18,000	18,000	18,000	10,000
(June years)										
Real GDP (annual average % change)	3.5	3.7	2.9	-1.4	5.1	0.8	4.9	2.2	2.3	2.3
Consumer Price Index (annual % change)	1.7	1.5	1.7	1.5	3.3	5.1	3.1	2.7	2.4	2.2
Unemployment rate (June qtr)	4.8	4.6	4.0	4.1	4.0	3.2	3.3	3.6	3.8	4.1
90-day Bank Bill Yield (March qtr. av.)	2.0	2.0	1.7	0.3	0.3	2.0	3.2	3.1	3.1	3.1
Trade Weighted Index (March qtr. av.)	76.5	73.8	72.7	69.7	74.7	77.2	78.3	78.7	78.9	78.9

The reduction in issuance could have been even greater had it not been for the fact that NZDM has decided to maintain a $15 billion buffer in a bid to take funding pressure off the government in the event of another shock. Pre-COVID that buffer was at least $2 billion, in practice it was around $5 billion.

That said, be aware it is likely that, next February, the RBNZ will announce it will reduce its LSAP bond holdings. It will sell the bonds back to the NZDM which, in turn, will probably issue paper to fund the purchase.

Other key NZDM announcements were:

- T bills on issue as at June 2022 will be $4 billion and will then be reduced to $3 billion
- T bills will be used more actively to manage short term cash needs so actual issuance could vary between $3 billion and $10 billion.
- Issuance of inflation indexed bonds is now expected to be between $400 million and $1 billion in 2021/22. The bonds will be issued using a single price auction mechanism.
- There are plans to commence a repurchase programme of the 15 April 2023 nominal bond before June 2022.

Not surprisingly, longer dated paper rallied in the face of this supply shock. The ten year bond rallied around ten basis points with the five year down six.

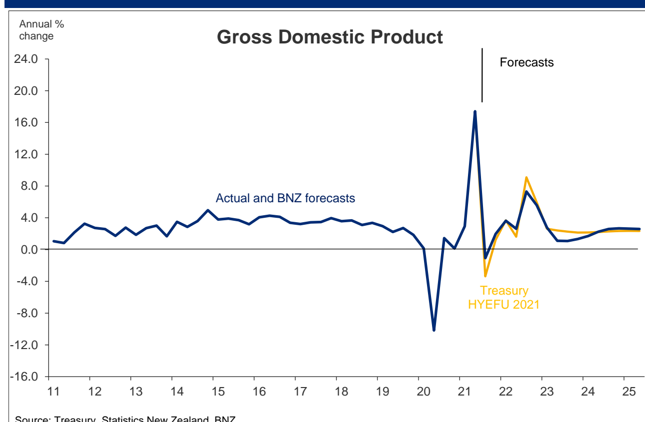
Treasury economic forecasts believable

Of course, there are massive risks around the forecast track for the real economy, prices, fiscal outturns and future debt programme but, for the time being, an "improved" general outlook is also putting a cap on future debt requirements.

Nominal GDP is stronger in the HYEFU than the Budget but we are quick to note this is because of inflation not activity. Activity levels are actually lower than previously forecast.

We are broadly comfortable with Treasury's growth and price expectations. We have some timing differences but our end points are close.

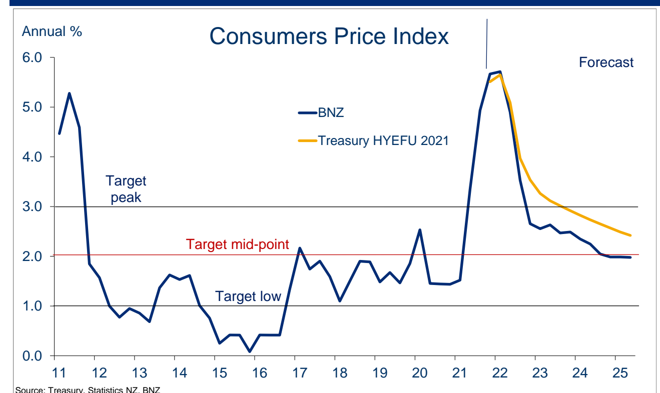
Growth forecasts believable



Our CPI inflation forecasts are lower than Treasury's but we have been stressing the upside risks to our view.

Interestingly, Treasury assumes inflationary pressures remain elevated right out to June 2026. At no point in the forecast horizon does the unemployment rate get back to Treasury's 4.25% NAIRU. This sits alongside annual CPI inflation which doesn't fall to the midpoint of the RBNZ's target band within the forecast horizon either.

Protracted elevated inflation

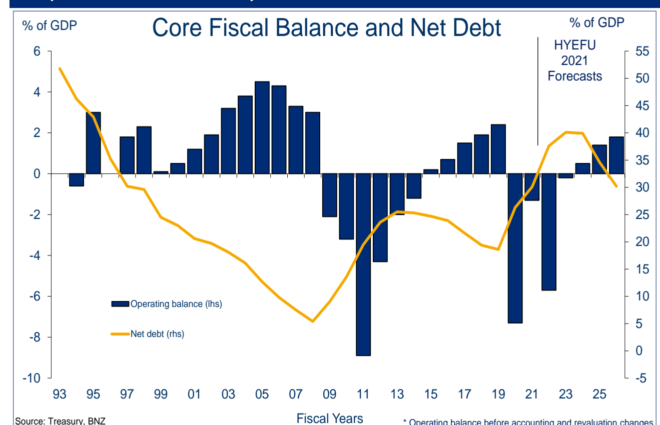


On this basis it should come as no surprise that Treasury has a cash rate which appears (based on Treasury's 90 day bank bill rate forecasts) to climb to 3.0% and simply stays there. We are not so convinced of this as a central view but can see how this could occur. There is certainly nothing in today's announcements to disavow the RBNZ of its view that rates need to head progressively higher.

Surpluses return

The big news on the fiscal front is that the government is now forecasting a return to surplus in the year ended June 2024. This is three years faster than previously anticipated. It also means net core crown debt peaks at "just" 40.1% of GDP in June 2023 (previously the peak was 48%). By June 2026 the debt is forecast to be just 30.2% of GDP. This keeps New Zealand's net debt position amongst the least threatening in the world.

Surpluses on their way



Remarkably, these fiscal numbers include a significant increase in forecast government expenditure. In particular, spending allocations have been bumped sharply higher:

- The operating allowance for Budget 2022 has been lifted to $6.0 billion from $2.7 billion.
- This is largely to fund the transformation of the health system and will likely include writing off existing DHB debt.
- The allowance for 2023 is raised to $4.0 billion from $2.7 billion
- In the following years it is raised to $3.0 billion from $2.7 billion.

Additionally, proceeds from the Emissions Trading System (ETS) will be put into a Climate Emergency Response Fund (CERF). This will release $4.5 billion to spend on climate related issues.

To cap things off, the capital expenditure allowance has been increased by $4.0 billion to $9.8 billion (spread over the next four years).

It's also worth noting that the Government still has $4.3 billion remaining in its already funded COVID recovery fund that it can call upon if needs be.

Too good to be true?

For now, this all appears to be a best of all worlds scenario:

- Spending up
- Investment up
- Deficits turning to surplus
- Debt down
- A war chest available for emergencies
- And (at least in Treasury's view) relatively stable asset prices (read: housing).

What could possibly go wrong?!

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Economic Forecasts	**BNZ**					**Treasury (HYEFU 2021)**				
(Annual average % change, June years)	**2021 Actual**	**2022 Fcast**	**2023 Fcast**	**2024 Fcast**	**2025 Fcast**	2021 Actual	2022 Fcast	2023 Fcast	2024 Fcast	2025 Fcast
Private consumption	7.1	1.0	4.3	1.8	2.3	7.5	1.2	3.4	1.1	2.0
Public consumption	6.8	6.5	1.2	1.5	2.0	6.8	4.8	1.8	0.6	0.8
Residential investment	17.7	4.2	1.1	-9.7	0.8	17.8	8.9	3.4	-2.1	-0.5
Business investment	4.4	0.2	6.4	2.6	3.0	4.5	2.9	9.8	4.0	2.6
Exports	-11.4	4.2	13.3	4.4	3.1	-11.4	2.1	7.1	6.3	5.0
Imports	-4.8	13.6	9.0	2.6	2.0	-4.2	12.2	4.9	3.0	2.7
GDP (expenditure measure)	**5.9**	**0.2**	**4.3**	**1.6**	**2.6**	**5.9**	**0.3**	**4.3**	**2.0**	**2.2**
GDP (production measure)	**5.1**	**1.8**	**4.2**	**1.6**	**2.6**	**5.1**	**0.8**	**4.9**	**2.2**	**2.2**
Employment	0.7	3.6	0.7	0.9	1.9	0.7	3.7	0.9	0.9	1.1
Unemployment	4.0	3.3	3.7	4.0	4.0	4.0	3.2	3.3	3.6	3.8
CPI inflation	3.3	4.9	2.6	2.2	2.0	3.3	5.1	3.1	2.7	2.4
Current account balance										
- % of GDP	-3.3	-5.9	-5.2	-4.4	-3.7	-3.3	-5.8	-5.4	-4.8	-4.4
TWI (June qtr avg)	74.8	73.3	75.3	72.1	71.3	74.7	77.2	78.3	78.7	78.9
90-day bank bill rate (June qtr avg)	0.3	1.8	2.7	2.2	1.9	0.3	2.0	3.2	3.1	3.1

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