19 May 2022

Budget Battles Inflation

- **Health and carbon dominate Budget**
- **Inflation a key underlying theme**
- **Recession risks real**
- **But return to surplus still anticipated**
- **Bond programme increased**

Key forecasts:

OBEGAL returns to surplus, of 0.6% of GDP, in 2024/25. The deficit peaks at 5.2% of GDP in the June year 2022. A deficit of 1.7% is expected for the June year 2023.

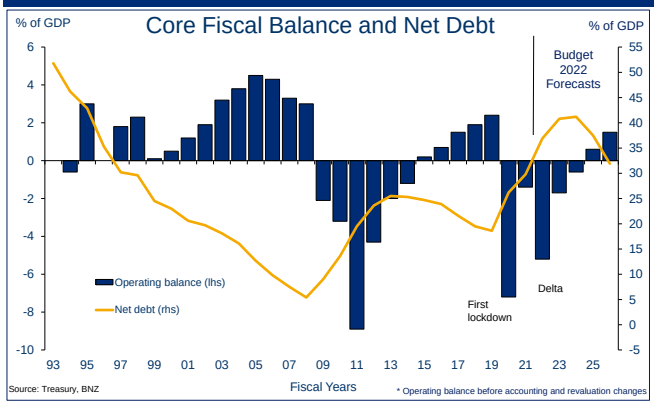
Net core crown debt, measured the new way, is expected to rise to a peak of 19.9% in June 2024. Its trough was 1.8% in 2019. The impact of Covid is clear. Under the "old" measure net core crown debt peaks at 41.2% well below the Government's new peak allowance of 50%.

GDP growth is forecast to be 4.2% in the June year 2023 following an estimated 1.7% for 2022. Growth of 0.7% is forecast for 2024 and 1.6% in 2025. On balance these numbers are not much different to our own. We are forecasting 3.8%, 0.7% and 2.5% respectively.

Treasury forecasts the unemployment rate to be 3.3% in June 2023, 4.4% June 2024, 4.8% in June 2025. Our respective forecasts are: 3.5%, 4.0% and 4.4%.

Treasury's CPI inflation track is well above our own at 5.2% for the June year 2023 and 3.6% in June 2024. It does not settle in the RBNZ target range until 2025. Our forecasts are 1.7%, 2.5% and 2.0%.

Surplus beckons



Main themes

The government promised that this Budget would be all about climate change and health. And so it was. We got all the details on the Government's climate change proposals earlier in the week so today was all about health. It will remain a moot point for many as to what the government will be able to deliver in the health sector but it has definitely delivered the money. In the five years to 2026 the increase in core crown expenditure on health is a whopping $12.9bn. This accounts for almost a third of the total increase in government expenditure whereas health represents only a fifth of total expenses.

Across the budget, though, expenses are blowing out simply because of rising costs with the Minister of Finance stating that 70% of the increase in total government

Budget 2022	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	29.7	29.4	30.1	28.9	30.6	31.2	31.3	31.5	31.8	32.2
Core Crown Expenses	27.7	27.3	28.0	34.2	31.5	35.4	31.6	31.1	30.4	29.8
OBEGAL	1.5	1.9	2.4	-7.2	-1.4	-5.2	-1.7	-0.6	0.6	1.5
Gross Sovereign Issued Debt (incl settlement c	31.6	29.8	27.2	32.1	29.4	31.8	32.4	35.0	37.1	36.1
Net Core Crown Debt	21.6	19.5	18.6	26.2	29.8	36.9	40.8	41.2	37.5	31.9
Domestic Bond Programme ($NZm)	8,000	7,000	8,000	25,000	45,000	20,000	25,000	25,000	25,000	15,000
(June years)										
Real GDP (annual average % change)	3.6	3.6	3.1	-1.1	5.3	1.7	4.2	0.7	1.6	2.5
Consumer Price Index (annual % change)	1.7	1.5	1.7	1.5	3.3	6.7	5.2	3.6	2.7	2.2
Unemployment rate (June qtr)	4.8	4.5	4.0	4.0	4.0	3.1	3.3	4.4	4.8	4.7
90-day Bank Bill Yield (March qtr. av.)	2.0	2.0	1.7	0.3	0.3	1.8	3.4	3.6	3.6	3.6
Trade Weighted Index (March qtr. av.)	76.5	73.8	72.7	69.7	74.7	75.0	75.0	75.0	75.0	75.0

expenditure was due to this. Naturally, this also makes inflation a key focal point for the Budget which includes, amongst other things: the extension of fuel tax relief and a similar extension in half price public transport; a temporary cost of living payment (aggregating to $1.05 billion) for those earning up to $70,000 and not already eligible for the winter energy payment; and the passing of legislation to expedite greater competition in the supermarket sector.

Realistically, however, most of the above are temporary measures that will provide some relief but won't stop higher prices eroding household spending power and, in turn, curtailing GDP growth.

Inflation, of course, also impacts the fiscal accounts with both expenditure and revenue climbing. But the impact on expenses has been greater than the impact on revenue. Accordingly, the fiscal position is "worse" than presented at the HYEFU. The main cost drivers are: higher wage growth, higher interest rates, an across the board pick up in input costs; and government benefit payments that are indexed to wages and inflation.

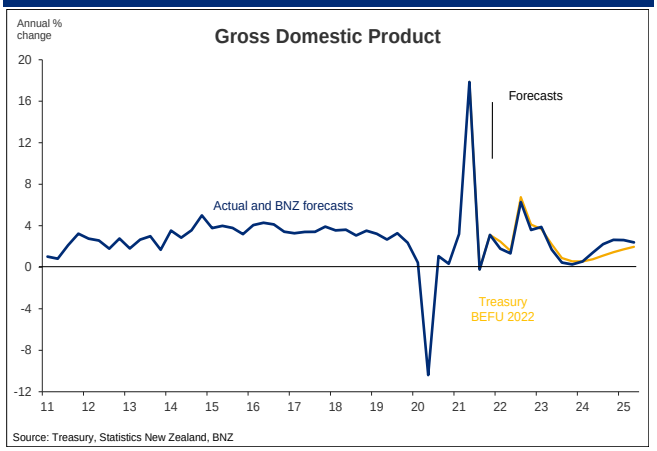
More generally, however, it shouldn't be overlooked that, yet again, the major fiscal theme is the ongoing strength in New Zealand's fiscal accounts relative to others and the relatively speedy return to fiscal surplus. By good luck or good management New Zealand remains fortuitous to be in this position.

The economic outlook

Broadly speaking, Treasury's economic forecasts look reasonably realistic. Indeed, if anything they are conservative, in the sense that growth is weak and inflation high.

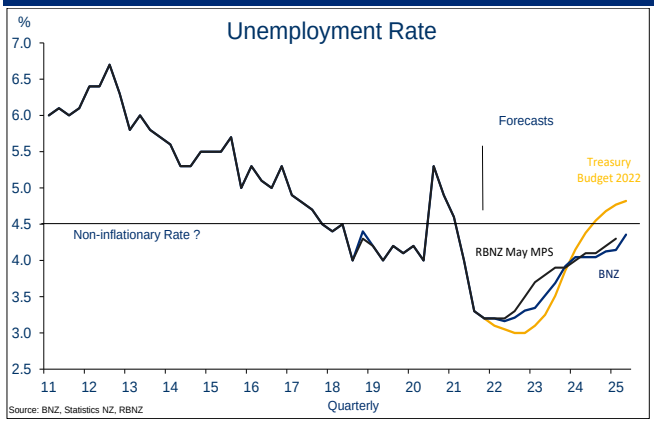
They forecast the same annual average growth as do we for the year ended June 2024. We get there with a recession. They carefully avoid such by printing a series of very low quarterly growth moves.

Growth slump acknowledged



Matching the weakness in growth are expectations that the labour market softens relatively quickly. We have noted previously that the only way we could see the unemployment rate rising to its NAIRU was for employment growth to be near zero for a sustained period of time. For all intents and purposes Treasury has done just that in predicting almost zero growth in employment in the June years 2024 (0.1%) and 2025 (0.5%). This sees the unemployment rate hit 4.4% in 2024.

Strong unemployment increase anticipated



Helping the Treasury's cause is the expectation that net migration rises to 20,000 over calendar 2023 on its way to 40,000. We think there is a very real risk that net migration fails to rise in this manner resulting in a lower unemployment rate for longer.

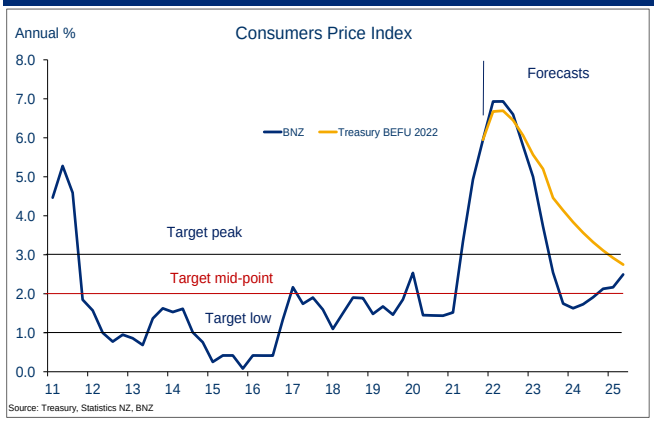
Whatever the case, Treasury sees the tightness in the labour market resulting in substantial wage growth. Treasury forecasts 6.0% growth in average ordinary time hourly earnings in the year ended June 2023 and a further 6.1% the year after. If they are right, we would be very concerned that this would result in businesses failures as such cost increases would be unbearable on such a sustained basis.

That said, Treasury's inflation forecasts are consistent with such wage growth. Treasury sees annual inflation sitting above 3.0% for around three years.

In terms of the monetary policy response, Treasury's forecasts imply the cash rate peaking at around 3.5%. They have an alternative scenario with the cash rate peaking at around 5.5% in the event that inflation is more aggressive. Their downside scenario for rates is around 3.0%.

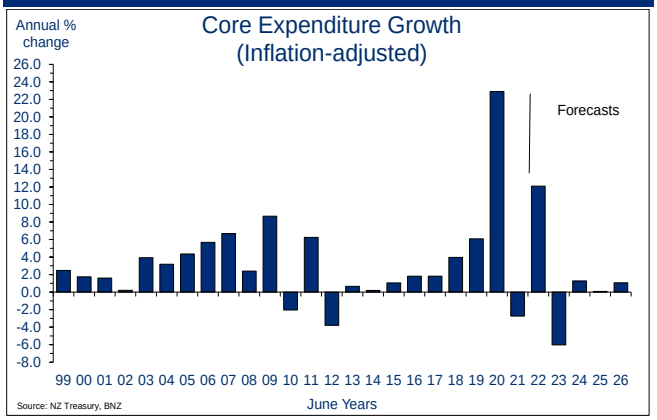
Perhaps the biggest risk to Treasury's view is its house price forecasts. Treasury sees house prices fall only 2.5%! We are looking at a 15%+ fall. If you were to put this decline into Treasury's models it would no doubt result in lower private consumption, GDP and CPI inflation. To be fair, Treasury's forecasts would have been put to bed before the latest miserable data was made available. But, equally, we have been forecasting significant house price declines for some time now.

Inflation higher for longer?



Overall, the fiscal prognosis that is presented makes sense alongside the economic estimates, particularly given that Treasury's growth forecasts are appropriately conservative. However, we are concerned that expenses could yet be problematic. The government's intent to get core crown expenses down to 29.8% of GDP (from its current peak of 35.4%) is meritable. However, achieving this target will require almost zero real expenditure growth in the latter years of the forecast period. This will be challenging.

Achievable or not?



Monetary policy implications

There will be little in today's Budget that will unnerve the central bank. In the near term, increased expenditure, especially in terms of household support, will add to inflationary pressure but as this is largely compensating for unexpectedly high inflation anyway, which would soften economic activity, the net impact will be negligible.

In short, whatever the RBNZ was thinking yesterday, it will be thinking the same today. So no need for us to alter our interest rate expectations. Nonetheless, it is interesting to see just how much potential upside risk that Treasury sees for rates, while it sees very little downside risk.

Bond programme increased

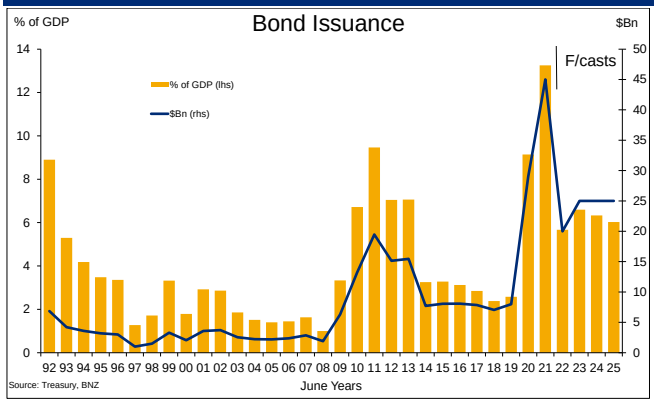
The bond programme has been increased by $7.0 billion a year in fiscal years 2023-25 inclusive. In fiscal 2026 it is increased by $5.0 billion. This was a bit higher than we had anticipated.

The main reason for the increase is the impending sale of RBNZ bonds which accounts for $5.0 billion per annum. Additionally, there was some adjustment to reflect the weaker fiscal position, the $0.5 billion increase in the Budget operating allowance in 2022/23 and a raised investment programme.

Interestingly, NZDM took the opportunity in this Budget to expand its IIB issuance. Gross issuance into IIBs is expected to be between $1.5billion and $3.0 billion in 2022/23. Indeed, NZDM has said that one of the two syndicated bonds that will be issued this calendar year will be a tap of the existing 2035 IIB (alongside the repurchase of the 2025 IIB). The other issuance will be the green bond previously announced.

Around the time of the Budget announcement New Zealand bonds edged higher in yield. We doubt that this was anything specific to the Budget. It certainly wasn't because of any concern expressed by ratings agencies as S&P was quick to affirm its comfort with the government's accounts.

Bond issuance relatively lofty



stephen_toplis@bnz.co.nz

Economic Forecasts	BNZ						Treasury (Budget 2022)					
(Annual average % change, June years)	**2021 Actual**	**2022 Fcast**	**2023 Fcast**	**2024 Fcast**	**2025 Fcast**	**2026 Fcast**	2021 Actual	2022 Fcast	2023 Fcast	2024 Fcast	2025 Fcast	2026 Fcast
Private consumption	7.4	-1.4	3.5	1.1	2.0	2.7	7.8	-1.6	3.3	1.3	2.1	2.7
Public consumption	8.3	10.0	2.6	0.7	0.7	1.1	8.3	12.6	1.4	-4.8	-1.7	1.5
Residential investment	16.5	0.5	5.0	-4.9	0.2	2.0	16.6	0.9	12.1	-6.0	-3.1	-0.5
Business investment	3.6	5.9	5.1	-0.1	2.7	3.9	3.8	6.6	9.9	-0.9	0.1	2.2
Exports	-11.0	1.5	15.3	5.1	3.7	3.3	-11.1	2.7	8.4	6.6	4.8	4.1
Imports	-4.7	15.4	10.3	3.3	1.2	4.4	-4.2	15.4	5.4	-0.2	1.2	2.9
GDP (expenditure measure)	**6.1**	**0.1**	**3.6**	**0.7**	**2.5**	**2.0**	**6.1**	**0.4**	**4.2**	**0.8**	**1.6**	**2.5**
GDP (production measure)	**5.2**	**1.5**	**3.8**	**0.7**	**2.5**	**2.0**	**5.3**	**1.7**	**4.2**	**0.7**	**1.6**	**2.5**
Employment	0.7	3.1	0.7	0.6	1.7	1.2	0.7	3.4	1.0	0.1	0.5	1.4
Unemployment	4.0	3.2	3.5	4.0	4.4	4.9	4.0	3.1	3.3	4.4	4.8	4.7
CPI inflation	3.3	6.9	3.7	1.7	2.5	2.0	3.3	6.7	5.2	3.6	2.7	2.2
Current account balance - % of GDP	-3.3	-7.3	-7.0	-5.0	-3.9	-4.5	-3.3	-6.7	-6.4	-4.9	-4.0	-3.6
TWI (June qtr avg)	74.8	71.9	73.2	72.7	73.4	72.5	74.7	75.0	75.0	75.0	75.0	75.0
90-day bank bill rate (June qtr avg)	0.3	2.1	3.2	2.7	1.9	1.9	0.3	1.8	3.4	3.6	3.6	3.6

Contact Details

BNZ Research

Stephen Toplis
Head of Research
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Jason Wong
Senior Markets Strategist
+64 4 924 7652

Nick Smyth
Senior Interest Rates Strategist
+64 4 924 7653

Main Offices

Wellington
Level 4, Spark Central
42-52 Willis Street
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Toll Free: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Toll Free: 0800 283 269

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Toll Free: 0800 854 854

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