WESTPAC ECONOMIC BULLETIN

Review of the New Zealand Government Budget 2022.

19 May 2022

Westpac Economics Team

economics@westpac.co.nz

westpac.co.nz/economics

Staying the course will be easier said than done.

- The 2022 Budget showed that the Government's books remain in good shape, and comfortably within the new fiscal rules.
- However, it's still early days for this new framework, and there is a risk of slippage.
- Putting money towards delivering more public services will be challenging in an economy that is already looking stretched.
- The details of the Budget were generally well signalled, and have no real impact on our economic forecasts.
- But we differ from the Treasury's view of the economy in some important respects.

The shape of this year's Budget was pre-signalled to such an unusually high degree that it's difficult to find a fresh take on it. Rather than trying to summarise the whole thing, here are five themes that we found most interesting from an economic perspective.

The Government's accounts remain in good shape. While the operating balance isn't expected to return to surplus for another three years, it's on a credible path there and the debt requirement looks manageable. It's all well in line with the new fiscal rules that the Government set out a few weeks ago, which allowed for more flexibility around spending while still providing some discipline.

But it's early days for the new framework. While this year's Budget conforms with the new rules, it doesn't necessarily guarantee that future Budgets will be. For example, the multi-year approach to funding allocations in areas such as Health, Natural Resources and Justice means that a large part of the

Economic forecasts: The Treasury and Westpac

	Actual	Treasury (Budget 2022)					Westpac				
June year	2021	2022	2023	2024	2025	2026	2022	2023	2024	2025	2026
Real GDP growth	5.3	1.7	4.2	0.7	1.6	2.5	1.4	3.8	2.8	2.5	2.5
Annual CPI inflation*	3.3	6.7	5.2	3.6	2.7	2.2	6.7	2.9	2.7	2.4	2.0
Unemployment rate*	4.0	3.1	3.3	4.4	4.8	4.7	3.1	3.1	3.5	3.9	4.0
Nominal GDP growth	7.5	5.8	10.8	4.9	4.8	5.1	5.0	6.2	4.8	5.2	5.1
90-day interest rate**	0.3	1.8	3.4	3.6	3.6	3.6	2.7	3.6	3.5	2.5	2.1
TWI exchange rate**	74.7	75.0	75.0	75.0	75.0	75.0	71.3	74.4	73.7	72.0	71.0

*Quarter over same quarter last year ** Quarter average new spending allowance for next year's Budget has already been pre-allocated. That would imply that other departments' funding demands will be squeezed into a tighter cap than otherwise. We'll find out next year whether they hold to that.

Getting value out of new spending is challenging in an economy that's already stretched. There's a risk that even large increases in funding may not lead to the delivery of more public services, but might just add to the cost structure instead. The difficulty of finding more workers to deliver those services is a particular challenge when the unemployment rate is already at a record low. The resumption of skilled migrant inflows will help over the next few years, but the demands on the workforce will extend beyond skilled roles.

There are no major implications for our economic forecasts. The details of this Budget were signalled well in advance, at least in terms of the dollar amounts, and were already captured in our forecasts. The nature of the announced spending isn't obviously more or less stimulatory than we expected. There was a cost-of-living relief package that will help to shore up consumer spending through the middle of this year, but the effects will be quite short-lived.

There are some curious aspects to the economic forecasts that underpin this Budget. In particular, the Treasury is forecasting persistently high inflation in the next few years, but without a hot economy to power to power that inflation. Wages rise sharply even as unemployment climbs, and house prices largely hold their ground in the face of rising interest rates. We feel like half of these forecasts will be proven wrong, we just don't know which half.

Getting the view right on inflation is especially important for the fiscal accounts. Higher inflation tends to boost the tax take – for instance through bracket creep on personal income tax rates – which means that it has a strong bearing on how much will be in the kitty to find the Government's future spending ambitions. It's not simply a matter of whether the Treasury believes that the Reserve Bank will do its job, though that will make for some interesting conversations too.

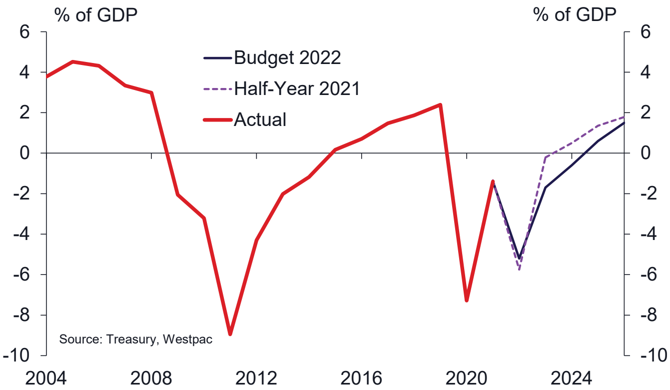
Financial projections.

As expected, the 2022 Budget showed that the Governments books, all things Covid considered, are in good shape. From an expected operating deficit (OBEGAL) of 5.2% of GDP in 2022, the Treasury expects the OBEGAL to return to a small surplus by 2025.

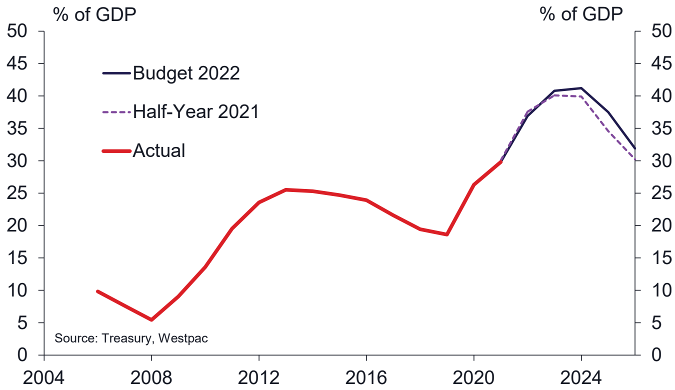
Similarly, the Budget showed that the Government's net debt track is sustainable. Under the Government's new debt measure, the Treasury expects net debt to peak at 19.9% of GDP in 2024, before reducing as a percentage of GDP in later years. These forecasts were broadly in line with what we expected ahead of today's release.

The Budget also ticks the boxes of the Government's fiscal rules. The key measure – running an operating surplus of between 0% and 2% of GDP in normal times – is met by 2025 or essentially as the books recover from the Covid hit. The other key metric – the net debt ceiling of 30% of GDP – is met over the full forecast period.

Operating balance (OBEGAL) as a % of GDP



Net core Crown debt as a % of GDP (old measure)



However, it's early days for this framework. While this Budget is consistent with the new rules, it doesn't necessarily guarantee that future Budgets will be. With this in mind, we note that the multi-year funding approach to areas such as Health, Natural Resources and Justice means that some of future Budget operating allowances have already been allocated. For example, Budget 2022 includes $5.9 billion of new operating spending in 2023, but these decisions, including pre-allocations, mean that $7.9 billion has already been allocated for 2024 and $8.3 billion for 2025 and 2026. Accordingly, only $2.5 billion, $2.6 billion and $3 billion remain unallocated for Budgets 2023 through 2025.

So while the multi-year funding approach may be well-intentioned in terms of providing more certainty for some departments, it may reduce certainty for others. Similarly, these longer-term spending decisions may to a degree tie the hands of future governments. One thing that is certain is that the new approach will change the fiscal management dynamics around these and future spending decisions. In short, the Treasury and the Minister of Finance will have their work cut out at least in the next few years while these changes are bedded in.

As expected, the Government bond tender programme was expanded to facilitate the buyback of a portion of the Reserve Bank's bond holdings. In total, the programme has increased from the Half-Year Update by $26 billion, to $110 billion over the five-year forecast period to 2026.

The majority ($20 billion) of this additional issuance will be to cover the first four years of the buybacks from the RBNZ. The remaining $6 billion to cover other funding needs (larger deficits/smaller surpluses) is only marginally smaller than the $8 billion that we had anticipated. Note that the remaining $5 billion of buybacks from the RBNZ (scheduled for 2027) falls outside the Budget forecast period. Bonds repurchased from the RBNZ will be retired and replaced.

Economic forecasts.

While the Treasury's growth forecast for the coming year is similar to our own, we have some questions about the assumptions underlying their longer-term forecasts. Compared to the Treasury's forecasts, we see downside risks for inflation, house prices and population growth. Accordingly, we see related downside risk for tax revenues over the coming years.

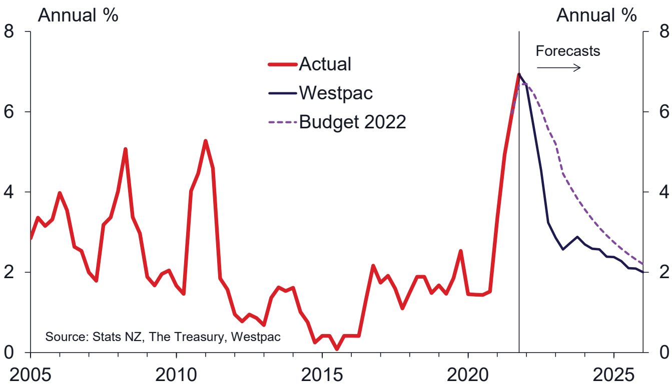
The main surprise for us was the Treasury's forecast for consumer prices, which shows inflation lingering above the RBNZ's 1% to 3% target band until 2025. Notably, that's not due to oil prices, which the Treasury assumes will ease back over the coming years. In other words, the Treasury assumes that ex-fuel inflation will continue to sizzle away for years to come.

There's no denying that inflation pressures are strong, and we also expect an extended period of high inflation. However, the extent and persistence of inflation pressures that the Treasury is forecasting seem overdone to us, especially given the related downturn in the labour market and economic activity that they're forecasting.

Importantly, this also raises questions about how the Treasury expects the Reserve Bank to respond to the current inflation upswing. In the face of the strong and persistent domestic inflation pressures that the Treasury is forecasting, we would expect the central bank to be hiking rates much more aggressively than is assumed in the Budget.

This raises related risks for the Government's forecasts on two key fronts. First, if inflation is not as strong as the Treasury expects, nominal revenue growth could be lower than the Government is anticipating. Conversely, if inflation really is as strong as the Treasury is expecting, we could see even larger interest rate increases and a deeper slowdown in activity.

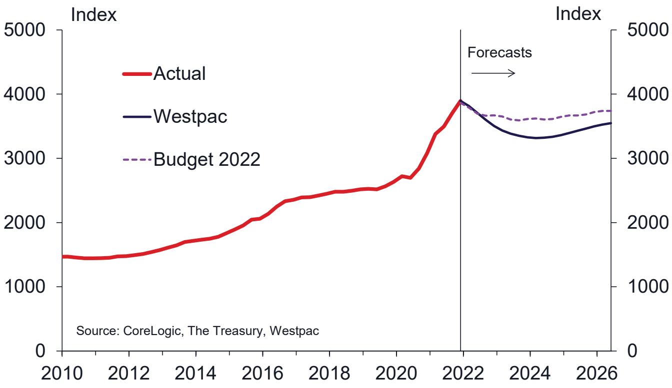
Inflation



The other big area where we disagree with the Treasury is around house prices. Roughly speaking, we expect house prices to fall by more than double the Treasury thinks they will. Indeed, actual falls to date this year are already close to the Treasury's forecast fall for the year as a whole (even allowing for difference in house price measures).[1] Plus with further mortgage rate rises to come for many borrowers and the generally weak market sentiment, we can't see how prices will not fall further.

This is important as the housing market is a key influence on the strength of economic conditions more generally, and a downturn along the lines we expect would signal downside risk to the Treasury's forecasts for economic activity.

House prices



Another notable feature of the Treasury's forecasts is their assumption for net migration. The Budget notes that annual migration is expected to increase to 40,800 people in mid-2026. That would be a bit lower than we saw in the years prior to the pandemic, when net migration averaged 50,000 to 60,000 people per annum. However, the Government is now rolling out its reset of migration policy. While the Government doesn't have a particular immigration target in mind, we do expect that the policy reset will mean lower net migration of around 30,000 people per annum.

The level of immigration has important implications for many parts of the economy. Indeed, if our lower migration forecast proves right, that would signal both slower growth in the economy's demand base and more persistent labour shortages than the Treasury has factored in.

Michael Gordon, Acting Chief Economist
+64 9 336 5670

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Satish Ranchhod, Senior Economist
+64 9 336 5668

Paul Clark, Industry Economist
+64 9 336 5656

1 Treasury is forecasting a 5% fall in prices over 2022 using the widely cited CoreLogic measure. However, the timelier REINZ house price index (which is closely aligned with the measure used by the Treasury) has already fallen 4% since the start of this year.

Key Budget initiatives

Policy initiative	Value over 4 years to June 2026	Capital	Comment
Health	$13.2bn	$1.4bn	$11.1bn to cover cost pressures, $202m for specialist mental health and addition services as well expanding and tailoring support for young people, $1.3bn on investment in health infrastructure, and $191m to increase the availability of medicines.
Cost of Living Support	$1.18bn		$814m for temporary cost of living payment for those earning up to $70,000/yr. Extension of half price public transport fares, as well as continued reductions in fuel excise duty and road user charges, total cost of $235m.
Climate Change Emergency Response			Climate Emergency Response Fund (CERF) established with $4.5bn from Emissions Trading Scheme (ETS) revenue.
Climate Change: Energy and industry	$764m	$1m	To be funded from CERF. Includes initiatives to decarbonise process heat production, support businesses to shift to cleaner energy sources, as well as market measures to support the transition to a highly renewable electricity system
Climate Change: Agriculture and Forestry	$728m	$292m	To be funded from CERF. Includes initiatives to accelerate the development of high impact technologies and establish a new Centre for Climate Action on Agricultural Emissions; boost forestry carbon sequestration and increase woody biomass, as well as support farmers/growers and whenua Māori to transition to a low emissions future.
Climate Change: Transport	$1.3bn	$2.3m	To be funded from CERF. Includes $569m 'Scrap and replace' scheme for Clean Car programme; $350m for improving access to low-impact transport; $61m to support bus driver workforce; $40m for decarbonising public transport buses; $23m to develop strategies for active modes and public transport; and $20m leasing scheme for low-emission vehicles.
Education	$2.9bn	$855m	Includes $450m to cover cost pressures, $292m for equity index implementation to replace current decile system; $262m for expanding pay parity for teachers; and $200m for reinvestment in the school property portfolio.

Contact the Westpac economics team

Michael Gordon, Acting Chief Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

Disclaimer