WESTPAC ECONOMIC BULLETIN

New Zealand Government Budget 2023.

18 May 2023

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No-No-Frills.

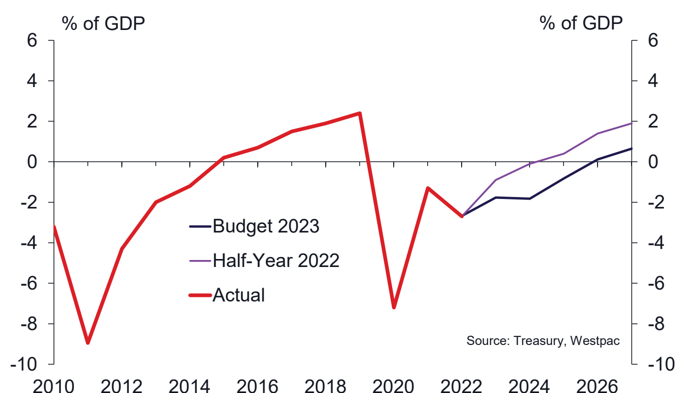
- As expected, Budget 2023 showed a deterioration in the Government's books.
- If anything, the deterioration was worse than we expected, as the Government has not been as frugal as we had anticipated.
- That said, the Government still meets its fiscal targets, but with even less headroom than before.
- For our part, we see more downside risks to the Treasury's forecasts. The upshot is that the surplus target is likely to be harder to hit than the Government anticipates.
- For the Reserve Bank, the Budget is more expansionary than signalled at the Half-Year Update.
- For financial markets, the bond programme is larger than we had anticipated, as the Government has larger deficits to fund over the forecast period.

Budget 2023.

As expected, Budget 2023 shows a deterioration in the Government's books. Indeed, as we predicted in our Budget preview, the operating balance (OBEGAL) returns to surplus one year later (in 2025/26) than was forecast in at the Half-Year Update last December.

However, the projected operating balances are weaker than we had anticipated. For example, we had estimated that the books would show a surplus of circa 1% and 2% of GDP in 2025/26 and 2026/27, respectively. Whereas the Treasury has forecast surpluses of just 0.1% and 0.7% for the respective years. Given the margin of error in these projections, there are clear risks that the Government does not get there in 2025/26 nor 2026/27.

Operating balance (OBEGAL) as a % of GDP



Economic forecasts: The Treasury and Westpac

	Actual	Treasury (Budget 2023)					Westpac				
June year	2022	2023	2024	2025	2026	2027	2023	2024	2025	2026	2027
Real GDP growth	1.1	3.2	1.0	2.1	3.1	2.9	3.2	1.1	0.9	2.5	3.0
Annual CPI inflation*	7.3	6.2	3.3	2.6	2.3	2.1	5.9	3.7	2.7	2.0	1.8
Unemployment rate*	3.3	3.7	5.0	5.3	4.9	4.8	3.5	4.5	5.0	4.8	4.3
Nominal GDP growth	5.8	8.5	5.3	5.3	5.5	5.1	5.3	4.6	3.9	4.9	5.1
90-day interest rate**	2.2	5.3	5.0	3.9	3.4	3.0	5.9	5.6	3.8	3.6	3.6
TWI exchange rate**	72.2	70.9	70.3	69.9	69.5	69.3	71.5	71.7	70.9	70.8	70.8

*Quarter over same quarter last year ** Quarter average

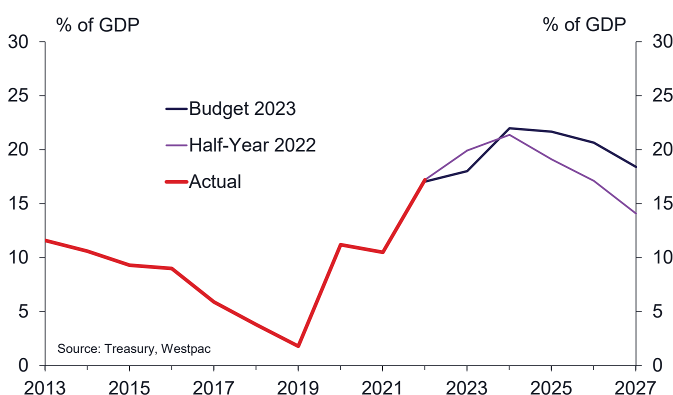
The key driver of the surprise is higher forecast expenditure. We had anticipated that operating expenditure would be kept within previously announced Budget allowances and any new spending would be funded via reprioritisation and savings. That was not the case. For example, Budget 2023 shows an $8.3bn increase in forecast Core Crown expenses over the 5-year period compared to the Half-Year Update.

On the revenue side of the Budget, forecasts were largely in line with our expectations. A slower economy has flowed through to a lower tax take, with Treasury's forecasts showing an $8.9bn reduction in forecast tax revenue versus the Half-Year Update. Notably, Treasury no longer expects a technical recession this year, although the Budget still shows a significant slowing in economic growth.

All up, the fiscal forecasts are more expansionary than we had anticipated. As a result, the Budget will add to inflation pressures in the short term. For example, Treasury estimates that the fiscal impulse is expansionary to the equivalent of 1.7% of GDP over 2023/24, compared to 0.7% contractionary as forecast in the Half-Year Update. We do note that the fiscal impulse then flips to contractionary from 2024/25 onwards.

As expected, the Treasury has expanded the bond programme to fund larger operating deficits. In total, the programme has increased from the Half-Year Update by $20 billion to $148 billion over the five-year forecast period to 2027.

Net core Crown debt as a % of GDP



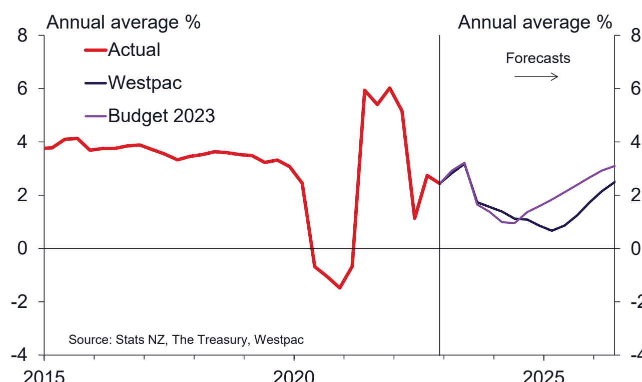
This increase was larger than we had anticipated. We had pencilled in a lift of $12bn ahead of the Budget, consisting of a $10bn increase to fund larger deficits resulting from lower tax revenue and $2bn extra capital spending (on the cyclone-related infrastructure rebuild). The extra $8bn can then be traced to the additional spending as discussed above.

Comparison of the Treasury Economic forecasts.

The Treasury's growth forecasts look optimistic to us, and the underlying details raise some red flags about the projected return to surplus.

Looking first at overall economic activity, the Treasury's GDP growth forecasts for the coming year are actually close to our own. However, beyond 2024 the Treasury is forecasting stronger economic growth, and we think that assumption will be challenged by prevailing economic conditions. Most notably, the Treasury expect that the OCR won't rise from its current level of 5.25%. In contrast, the RBNZ's last published forecast showed the cash rate rising to 5.50%, and the central bank confirmed that remains their plan back at the time of their April policy review. As we discuss in our latest *Economic Overview*,[1] our view is that the OCR will need to rise to a peak of 6.00%, which implies more pressure on households' finances and downside risks for both spending and economic growth in Treasury's forecasts.

Real GDP growth forecasts



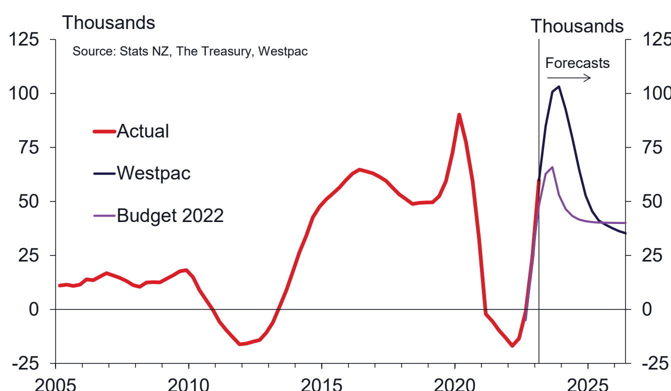
On top of that, we think that population pressures will pose a big challenge to the Government spending plans. The Treasury is forecasting that real Government spending will basically track sideways over the next few years. That's despite a

1 Available here: https://www.westpac.co.nz/assets/Business/tools-rates-fees/documents/economic-updates/2023/Other/Economic-Overview_QEO_report_16May23.pdf

projected rise in net migration. In other words, the Treasury expects that the Government will be providing *fewer* public services on a per-capita basis.

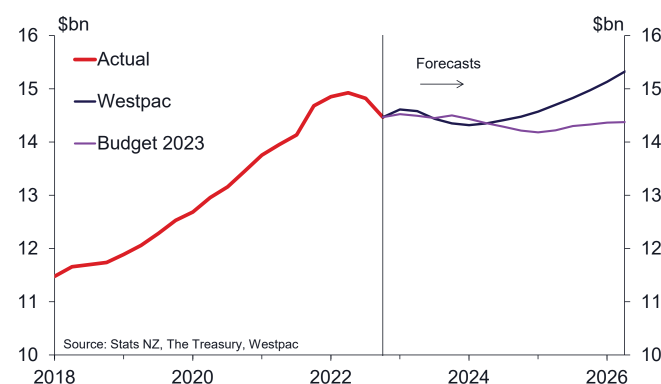
The risks on this front are especially stark as the Treasury's migration forecasts already look dated. The Treasury forecasts assume quarterly net migration peaked at the end of last year at 24,000. However, the March quarter figures out last week came in at 32,000. And with visa applications still strong, net migration doesn't look like it's going to slow down any time soon.

Net migration (quarterly)



In addition, and to use the Treasury's own words from the Half-Year Update, the Government's expenditure forecasts are not "automatically adjusted for inflation." This is not usually such a problem in times of low and stable inflation, but in the current inflationary environment it renders the expenditure forecasts as unrealistically low. With this in mind, we show a more realistic path for public consumption spending in the chart below.

Public consumption spending



Putting this all together, we see downside risk to the Treasury's growth and revenue forecasts. At the same time their expenditure forecasts are most likely too low. Accordingly, the probability that the Government does not meet its surplus target is high. As a result, future Governments will face tough choices and will need to either:

- Reprioritise existing services to fund new Budget decisions i.e. cut spending; and/or
- Introduce policy decisions to change revenue settings i.e. increase taxes.

Implications for RBNZ.

While the Reserve Bank typically takes the Treasury's fiscal projections as given, they have long been highlighting the risk of a larger boost to spending. That risk has now materialised, supporting our view that the RBNZ will now likely be looking to move the OCR higher towards 6 percent. That said, quantifying the impact for monetary policy is no simple task; we'll consider this in more detail in our upcoming *Monetary Policy Statement* preview.

Key initiatives – the 'Cost of Living Support'.

As anticipated, the Government focused its key announcements on cost-of-living support. The $2.6bn included:

- Extending 20 hours ECE to 2-year-olds, $1.2bn;
- Scrapping prescription co-payments, $0.6bn;
- Free public transport for kids, $0.3bn; and,
- Cheaper energy bills, $0.3bn.

However, the package was larger than we had anticipated. This package was around $1bn higher than the equivalent package at Budget 2022. The initiatives were also mostly permanent, whereas last year's were mostly temporary (e.g., time-limited direct transfers and the temporary fuel excise duties).

The other area of focus was the well-signalled spending and investment on the cyclone recovery. An additional $1bn was allocated for cyclone recovery on top of the circa $0.9bn that has already been allocated.

There was also a focus on building resilience. The Government has established a National Resilience Plan worth $6bn which is on top of the existing infrastructure pipeline. This programme will initially focus on building back from the recent weather events and will also fund strategic investments to address the long-term infrastructure deficit.

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