WESTPAC ECONOMIC BULLETIN

New Zealand Pre-Election Economic and Fiscal Update (PREFU) 2023.

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Westpac Economics Team
economics@westpac.co.nz
westpac.co.nz/economics

Kelly Eckhold, Chief Economist
+64 21 786 758
kelly.eckhold@westpac.co.nz

Challenges and choices.

- The PREFU showed the expected deterioration in the Government's books since Budget 2023, including a delayed return to surplus.
- We think the Treasury's forecasts for economic growth, and hence both the tax take and projected return to surplus, are on the optimistic side.
- There may also be upside risks to forecast expenditure from high inflation and population pressures.
- Hence fiscal challenges remain that will require tough choices for future governments.

Fiscal outlook – challenges and choices lay ahead.

On the surface, the Government's books contain no huge surprises. But scratching beneath the surface reveals medium-term and long-term challenges that future governments of all shades will need to grapple with.

As expected, the Pre-Election Economic and Fiscal Update (PREFU) showed some deterioration in the Government's books since Budget 2023 and a delayed return to surplus. The Treasury now forecasts that the operating balance (OBEGAL) will return to surplus one year later (i.e., in 2026/27) than previously.

Over the forecast period (2022/23 to 2026/27), the cumulative OBEGAL is around $12.7bn lower than forecast at the Budget – close to our estimate of a $15bn deterioration. The Treasury's revenue projections were downgraded by less than we

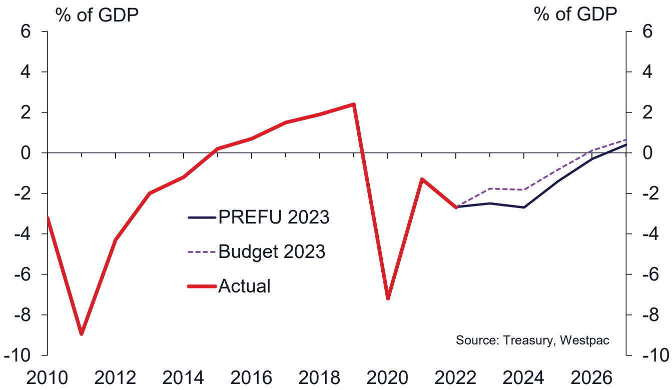
Economic forecasts: The Treasury and Westpac

	Actual	Treasury (Budget 2023)					Westpac				
June year	2022	2023	2024	2025	2026	2027	2023	2024	2025	2026	2027
Real GDP growth	1.2	3.1	1.3	2.0	3.3	3.2	3.1	0.5	0.5	2.6	3.6
Annual CPI inflation*	7.3	6.0	3.8	2.5	2.1	2.0	6.0	3.7	2.7	2.3	1.9
Unemployment rate*	3.3	3.6	4.8	5.4	4.8	4.6	3.6	5.0	5.1	4.5	4.1
Nominal GDP growth	5.9	8.3	5.9	5.1	5.8	5.5	7.4	1.9	3.7	5.2	6.0
90-day interest rate**	2.2	5.6	5.6	3.9	3.4	3.1	5.6	5.9	4.9	3.9	3.6
TWI exchange rate**	72.2	70.9	70.4	70.0	69.6	69.3	70.9	69.4	67.8	67.3	67.2

*Quarter over same quarter last year   ** Quarter average had expected, but spending was upgraded relative to our expectations and Budget 2023 estimates.

Looking ahead, we see upside risks to spending and downside risks to revenue that, in the absence of mitigating action, point to downside risks to the operating balance and upside risks to government borrowing compared to the picture depicted in the PREFU.

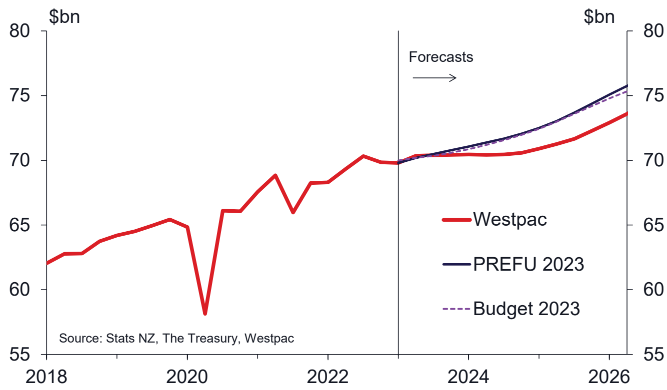
Operating balance (OBEGAL) as a % of GDP



The Treasury's economic forecasts appear optimistic.

There has been surprisingly little change in the Treasury's PREFU forecasts – finalised in early August – compared to those in Budget 2023. And so as was the case with the Budget, we think the Treasury's forecasts for economic growth, and hence both the tax take and projected return to surplus, are on the optimistic side.

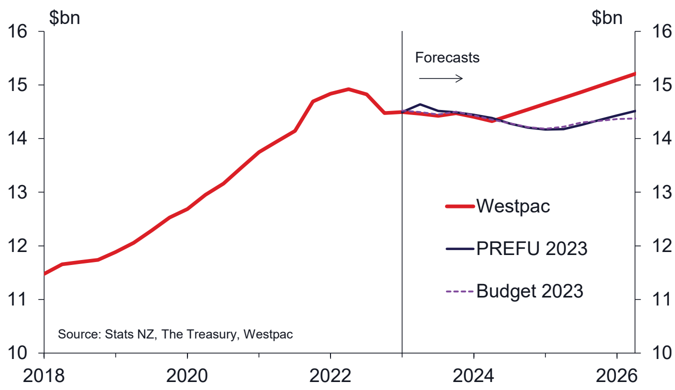
Real quarterly GDP



Looking first at overall economic activity, the Treasury's forecasts for economic growth are stronger than our own. However, the Treasury is also assuming that interest rates will fall faster than we expect, and that inflation will remain contained. On both of those fronts, we're much more circumspect than the Treasury. As we've seen in other countries, inflation in New Zealand has been 'sticky', with core inflation lingering at high levels well after the start of the interest rate hiking cycle. Against that backdrop, central banks face having to keep interest rates higher for longer. The related pressure on borrowing costs signals downside risk for both private spending and economic growth compared to the Treasury's forecasts (but upside risk to the government's financing costs). The Treasury's forecasts take an optimistic view on the rebalancing path the economy is to take and suggests rebalancing can occur without further policy action from the RBNZ.

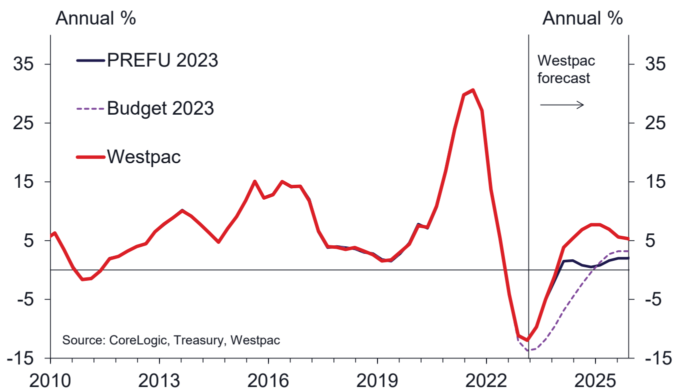
Digging into the details of the Treasury's forecasts there are also some key assumptions that warrant closer scrutiny. Most important is the Treasury's assumption for government consumption spending – i.e., the provision of public services. The Treasury continues to assume that the aggregate amount of services provided by the government will essentially remain unchanged over the coming years. However, with the population rising at a rapid pace, the Treasury acknowledges that would mean that the Government ends up spending less on public services on a per-capita basis. That's despite the growing demand for all manner of public services including health care, education, and aged care services. In addition, the Treasury has made a large upwards revision to its forecast for net migration, meaning that the pressure on spending levels – including infrastructure – is likely to be even more pronounced than previously assumed.

Public consumption spending



Another notable assumption in the Treasury's forecasts is that slowing economic growth will result in imports remaining flat for the next two years. That in turn flows through to an improvement in New Zealand's trade balance. That seems like quite an abrupt change, especially given the rapid rise in the population. While we're also forecasting an easing in import demand as growth cools, we still think that import levels will continue to rise over the coming year – even with a weaker economic growth profile. And that also means a more gradual improvement in the current account in our forecasts.

House price growth



Lastly, the Treasury's forecasts assume only muted outlook for house prices. The Treasury is assuming that house prices only grow by around 1% to 2% per annum over the next couple of years. That's despite the projected easing in interest rates and a pickup in population growth. In contrast, with the housing market having already found a base in recent months, we expect that house prices are on course to rise by close to 8% next year.

Fiscal challenges lie ahead.

In our minds, what happened before the PREFU hinted at what lies ahead on the fiscal front. Recall that, on 28 August, the Government announced circa $3.4bn in operating expenditure cuts and savings. This belt-tightening, and $0.7bn of additional revenue from increased fuel taxes announced since the Budget, was important in ensuring that the PREFU shows OBEGAL a return to surplus at the end of the forecast period.

In coming years, it's possible that additional fiscal policy measures will be necessary to meet the operating surplus target. Since we see downside risks to Treasury's economic growth forecasts we also see downside risks to forecasted government revenue and upside risks to government expenditure. The combination of these risks indicates to us that under current policy settings and prevailing trends, reaching an operating surplus by 2026/27 may be challenging.

Treasury, too, sees challenges ahead. In the PREFU the Treasury writes: "Based on past analysis, the remaining Budget operating allowances should be broadly sufficient to meet remaining critical cost pressures not already funded, however, significant trade-offs will be required. There could also be additional demand (e.g., population changes) that could add extra pressure to future Budget allowances."

As a result, and regardless of who is in power after the 14 October election, the Government will face tough fiscal choices. Unless the Government is prepared to run higher operating deficits and higher levels of debt – risking reaction from both the ratings agencies and a monetary policy response from the RBNZ – any new Budget spending decisions will likely require cuts to spending elsewhere or new sources of revenue.

Bigger deficits mean a larger borrowing programme.

As expected, the deterioration in the underlying fiscal position has had implications for the government's borrowing programme. New Zealand Debt Management (NZDM) have advised that the NZGB programme for the 2023/24 fiscal year has been revised up to $36bn – an increase of $2bn from the programme announced back in May in Budget 2023. This is a relatively modest adjustment considering that the cumulative OBEGAL deficit in 2022/23 and 2023/24 is $6.9bn larger than projected in the Budget. Helping to explain the difference, the government's residual operating cash deficit is just $3.3bn larger than forecast in the Budget, while the government's closing cash balance in 2023/24 is about $1.9bn lower than forecast in the Budget.

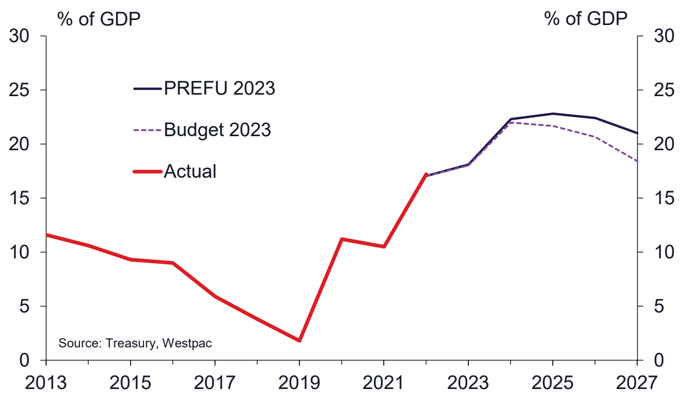
Fiscal outlook

	June Year (aapc)				
	2022/23	2023/24	2024/25	2025/26	2026/27
OBEGAL $bn					
Budget 2023	-7.0	-7.6	-3.6	0.6	3.2
PREFU 2023	-10.0	-11.4	-6.2	-1.5	2.1
Bond Programme $bn					
Budget 2023	28	34	32	30	24
PREFU 2023*	28	36	35	30	28

Looking across the whole forecast period, Treasury now projects total NZGB issuance of $129bn in the four years to 2026/27, up $9bn from Budget 2023 (still less than the $12.7bn cumulative deterioration in the OBEGAL balance over the period). Allowing for maturities and repurchases of bonds from the RBNZ (associated with the wind-down of the LSAP programme), net NZGB issuance is expected to increase by just over $49bn over the four year-period, lifting outstanding issuance to about $202bn by the end of 2026/27.

In the media release accompanying the announcement, NZDM noted that subject to market conditions, it expects to launch two new nominal NZGB lines, via syndication, before the end of the fiscal year. The maturities of these bond lines will be 15 May 2035 and 15 May 2054. As in the Budget forecast, gross issuance into inflation-indexed bonds (IIB) is expected to be less than $1bn in 2023/24. The composition of short-term borrowings will include a minimum of US$1bn of ECP and $2bn of T-Bills.

Net core Crown debt as a % of GDP



Contact the Westpac economics team

Kelly Eckhold, Chief Economist
+64 9 348 9382

Satish Ranchhod, Senior Economist
+64 9 336 5668

Darren Gibbs, Senior Economist
+64 9 367 3368

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Shania Bonenkamp, Graduate
shania.bonenkamp@westpac.co.nz

Any questions email:
economics@westpac.co.nz