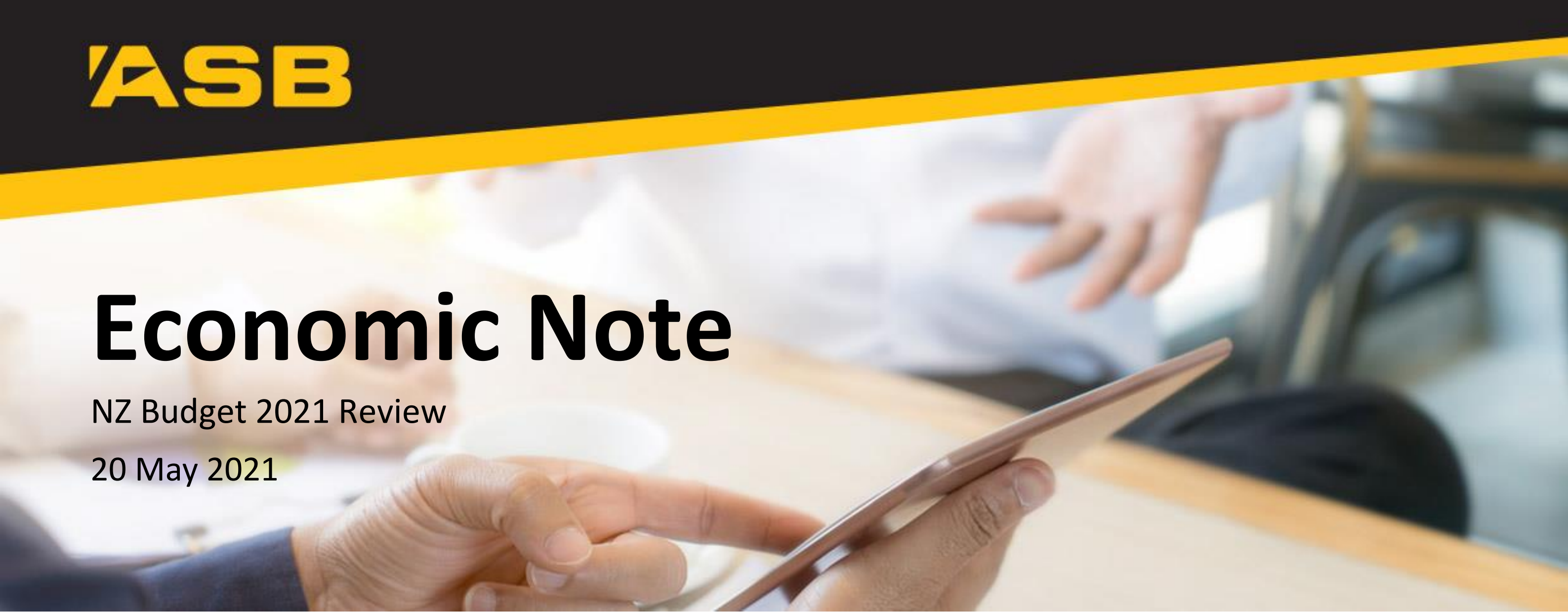

Economic Note

NZ Budget 2021 Review

20 May 2021

It's time to deliver

- Budget 2021 showed an improved NZ economic and fiscal outlook, with smaller operating deficits, a lower peak in crown debt and a modestly scaled-back NZ Government bond programme compared to previous COVID-era updates.
- The stronger fiscal position leaves the Government with more policy options. Rebuilding the economy and enhancing wellbeing have been given top priority. Operational and capital allowances for government spending have been increased, albeit modestly, with government spending expected to decline as a share of GDP over the projection period.
- The Government have committed to rebuilding the economy and enhancing societal and economic wellbeing. Massive investments are signalled. It will take time to assess whether this will pay dividends.

Summary

Budget 2021 makes all the right noises. The economic and fiscal outlook has been revised up and fiscal prudence of sorts maintained. Modest increases in operational and capital spending allowances have been earmarked, with government spending expected to decline as a share of GDP over the projection period.

The dividend from the Government's deft handling of the pandemic and the stronger-than-expected performance of the NZ economy – an extra $15-37b or so of nominal income per annum versus last year's Budget forecasts – leave the Government in a much stronger position. Fiscal deficits are generally lower, with net core crown debt to fall to 43.6% of GDP by 2024/25. **COVID-19 has taken its toll on the public finances, but NZ's fiscal metrics remain world class and the envy of many of our trading partners.**

The brighter fiscal picture has also provided the Government with more policy options. There is a strong focus on rebuilding (increased capital allowances as part of the $57.3bn of infrastructure spending until 2024/25) and other wellbeing priorities, with a once in a generation increase in income support payments. **Delivering on these objectives may pay huge economic and social dividends, but it will not be easy.** It will take time to assess whether the Government is on the right track.

We did not see anything transformational in this Budget, but it has clearly signalled the direction of travel. Enhancing wellbeing is clearly the top priority and NZ has a lot to be grateful about. However, there is clearly more work for the Government to do in some key areas. To date there has been little progress in boosting economy wide productivity, addressing bottlenecks in transport and improving housing affordability. **Massive investment in these key areas has been announced, but a long journey lies ahead.** It will take time to assess whether the Government is on the right track. Somewhat ironically, capacity constraints and labour shortages in a growing number of sectors may slow the delivery of these programmes.

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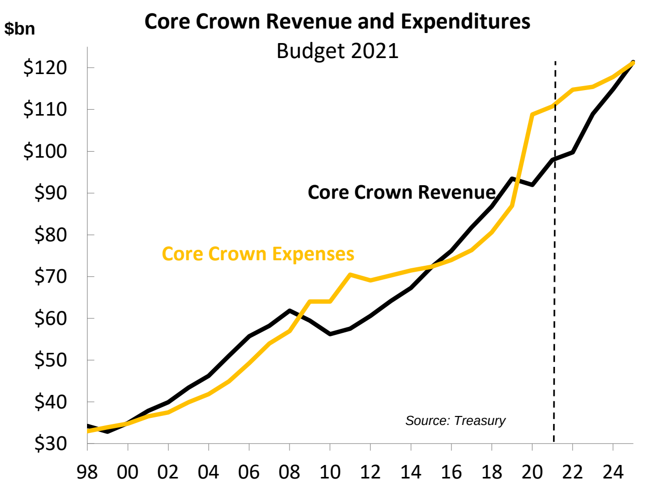
Stronger fiscal starting point but still a long way to go

Budget 2021 confirmed that the NZ public finances have weathered the COVID-19 storm much better than envisaged a year or so ago. The starting point for the economy is stronger, with the level of nominal GDP in the June 2021 year ($334bn) close to $37bn higher than forecast in Budget 2020. Higher nationwide incomes mean a higher tax take, reduced pressures on Crown expenditures and improved debt serviceability via lower deficits and debt to income ratios.

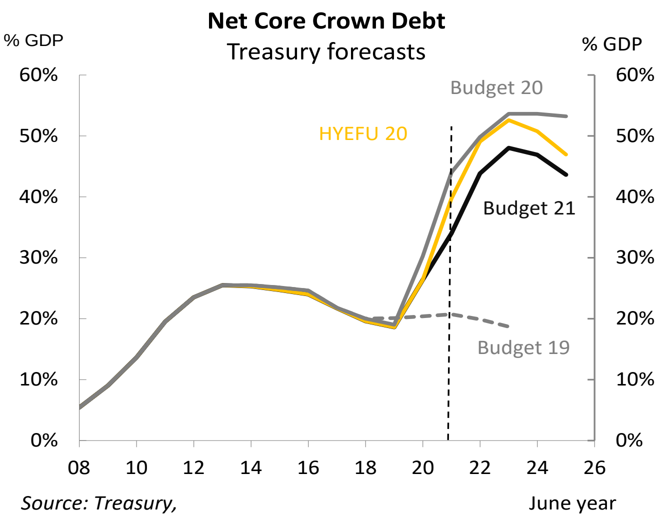
FISCAL PROJECTIONS - Budget 2021					
June years	**2021**	**2022**	**2023**	**2024**	**2025**
Core Revenue ($bn)	**97.9**	**99.8**	**108.9**	**114.9**	**121.3**
(HYEFU 2020)	*95.0*	*95.9*	*103.8*	*109.7*	*116.2*
Core Expenses ($bn)	**110.7**	**114.7**	**115.4**	**117.8**	**121.1**
(HYEFU 2020)	*114.2*	*109.1*	*112.0*	*115.3*	*118.7*
OBEGAL ($bn)	**-15.1**	**-18.4**	**-9.5**	**-5.7**	**-2.3**
(HYEFU 2020)	*-21.6*	*-16.4*	*-10.3*	*-7.5*	*-4.2*
OBEGAL (% GDP)	**-4.5**	**-5.3**	**-2.6**	**-1.4**	**-0.6**
(HYEFU 2020)	*-6.7*	*-4.9*	*-2.9*	*-2.0*	*-1.0*
Operating Bal ($bn)	***1.3***	***-15.6***	***-5.2***	***-0.9***	***3.0***
(HYEFU 2020)	*-25.6*	*-15.0*	*-6.4*	*-3.2*	*0.7*
Net core crown debt (%GDP)	**34.0**	**43.8**	**48.0**	**46.9**	**43.6**
(HYEFU 2020)	*39.7*	*49.1*	*52.6*	*50.7*	*46.9*

Source: Treasury

Looking through the COVID-19 induced volatility, Budget forecasts have annual growth averaging 2.5% - 3% per annum through till mid-2025. The Government highlighted still-continued uncertainties over the outlook, but believes the economy is on the right track. Linked to this has been NZ's success in containing the COVID-19 outbreak and the flexibility and resilience being displayed, as well as brighter signs in many of our major trading partners. However, Treasury are of the view that the Government's policy actions will significantly dampen house price inflation (to low single digit rates over the projection period), dampening the domestic recovery.



The massive dollop of policy support has played a key role, with around 90% of the $50bn COVID-19 Response and Recovery Fund (CRRF) spent (about 13% of NZ annual GDP), helping to keep much of the economy afloat. The Government has allocated close to 20% of GDP of funding to offset the COVID-19 hit.



This has come at a fiscal cost with NZ fiscal metrics not looking as bright as they did pre-COVID-19. COVID-19 continues to cast a shadow and some of the impacts of the outbreak could have persistent impacts, contributing to slower population growth and lower tourism incomes. Population growth over the five-year Budget projection period is expected to average 0.9% per annum, well below the 2% annual average of the preceding 5-year period.

What's more, increasing capacity constraints are limiting growth, with Budget forecasts showing the unemployment rate settling to just above 4% towards the end of the projection period. GDP growth forecasts have annual GDP growth slowing to under 2% at the end of the projection period. Still, NZ can count itself fortunate to be in the position it is now.

The fiscal projections from Budget 2021 have been revised up from Budget 2020 and the December 2020 Half Year Economic and Fiscal Update projections (see table). OBEGAL deficits are forecast to ease over the forecast horizon. A similar degree of upward revision is evident for the other fiscal balances. Forecasts for Crown Revenues and Crown Expenditures are higher than in the HYEFU 2020 and Budget 2020 forecasts, with the gap between the two closing by 2024/25.

Smaller deficits over the forecast horizon, combined with higher nominal GDP, have produced an improved set of debt metrics. Net Core Crown debt is now forecast to peak at 48.0% of GDP by 2023/23 and modestly decline thereafter, ending 2024/25 at 43.6% of GDP. Beyond the five-year forecast period, net debt continues to fall as a % of GDP, hitting 35.9% of GDP by 2029/30. This is compared with 53.2% (2024/25) and 47.5% (2029/30) in Budget 2020.

The return to outright surpluses still looks some way off. The longer-term Budget projections do not show OBEGAL surpluses until 2026/27 (2027/28 in Budget 2020). It will take much, much longer to get net public debt below pre-COVID-19 levels.

Smaller debt and bond programme

As a result of the improved fiscal outlook, the Government's debt requirements and bond issuance programme has been reduced. The NZ Government bond programme has been scaled back by $5bn per annum for 2022/23 and 2023/24. The annual profile (see table below) shows gross issuance holding at $45bn for 20/21, $30bn in 21/22, and $25bn from 2023/25.

The NZ Debt Management (NZDM) are also pursuing other options for funding and have signalled their intent to syndicate two new bonds in 2021/22. A 2051 nominal bond is set to be launched by the end of 2021, with a second bond to be announced in subsequent updates. Recall that NZDM had only signalled one syndication in the HYEFU and the syndication route looks to be an increasingly favoured option (a total of $19bn was issued via syndication in 2020/21). What's more, the Government's cash position is looking flush and another source of funding with the Crown Settlement Account ($40bn in April) bursting at the seams. Unfortunately, capacity constraints in an increasing number of sectors are limiting the ability to convert funding into action.

We envisage that the modestly scaled-back pace of issuance will likely trigger a further scaling back of the RBNZ's Large Scale Asset Purchase programme, which looks increasingly unlikely to hit its $100bn cap by mid-2022.

Gross NZGB issuance $bn	2020/21	2021/22	2022/23	2023/24	2024/25	5-year Total
Budget 2021	45	30	25	25	25	150
Half-Year Update 2020	45	30	30	30	25	160
Change in issuance	0	0	-5	-5	0	10
NZGB's on issue ($bn)	128.1	158.1	167.2	179.6	189.4	n/a

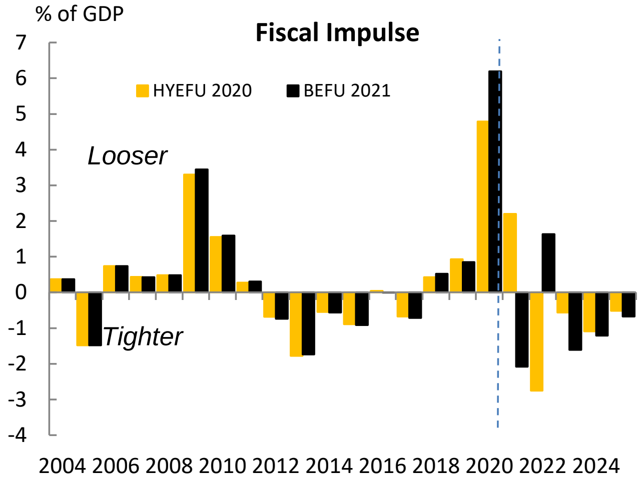
Now is the time for balance, not austerity

The improved fiscal outlook has provided the Government with more policy options, including cutting taxes, increasing spending or reducing debt more quickly. Wisely, the Government has not chosen to go down the austerity route and aim to return the books to surplus as quickly as possible, which could have hampered the economic recovery.

Budget 2021 has a focus on rebuilding and alleviating poverty. Welfare benefits, health, infrastructure and housing are key beneficiaries. A sizeable package of infrastructure spending is underway ($57.3bn till 2024/25). Part of this includes the $3.8bn housing package announced by the Government in March. **Once in a generation increases in income support for the less well-off are coming,** with weekly benefit rates to be lifted between $32 and $55 per week in two stages (July 2021 and April 2022), costing roughly $3.3bn over the next four years. There is also more support to encourage beneficiaries to enter the workforce.

Moreover, in recognition of the pressures on the public sector, Budget 2021 signals increases for both operational and capital spending:

- The operational allowances have been expanded to $3.8n from $2.625bn per year across the next four Budgets in the February Budget Policy Statement.
- Capital allowances have been also revised up to $12bn from $7.8bn over the next four years.



Source: Treasury, ASB

These increases were modest in light of the circa $111bn in core Crown spending. Core crown expenditures are forecast to decline as a share of GDP over the projection period (from 33.1% in 20/21 to 29.2% in 2024/25). However, the intent to place the public finances onto a sounder footing is understandable in light of the COVID-19 hit and the longer-term challenges posed by climate change and population ageing. There could be another large negative shock waiting in the wings so it would be prudent to build up fiscal buffers over time.

Taking the Treasury projections at face value, the Treasury fiscal impulse shows a more contractionary stance for 2020/21 than signalled in recent Treasury updates.

Looking further ahead

The Budget reiterated three core key goals for the Government this term, including keeping NZ safe from COVID-19; accelerating NZ's economic recovery; and addressing foundational changes of housing affordability, climate change and child wellbeing. The package of measures and policy focus of the Government remained aligned with those goals. **Linked to this were the five key wellbeing objectives identified in the 2021 Budget Policy Statement.** These included the transition to a low emissions and sustainable economy, boosting innovation and diffusing the gains of new technology, lifting Maori and Pacific incomes, skills and opportunities, reducing child poverty/improving wellbeing, and supporting physical and mental wellbeing. A quick stocktake suggests that in March, wellbeing in NZ was pretty good (8 out of 10 for all NZ). However, lower than average levels of wellbeing were for the unemployed sick and sole parents compared to the nationwide average. More investment to enhance the four wellbeing capitals – Human, Nature, Social and Financial/Physical - is underway as the Government seeks to boost societal and economic welfare.

Our View

The Government has done well in minimising the healthcare and economic toll of COVID-19, and our response here has been close to (or at) global best practice. The public finances are looking in considerably better than many feared a year ago and are heading in the right direction. **This has provided more fiscal leeway, with the focus on rebuilding the economy and on supporting the less well off, whilst also reducing debt and restoring fiscal buffers to cope with the next adverse event.**

There is a modicum of fiscal restraint on display, with only modest increases is operational and capital allowances and with spending expected to decline as a share of GDP. **Maintaining this restraint will not be easy given public demands for more funding and the widespread escalation of costs that have recently emerged.**

We did not see anything transformational in this Budget, but it has clearly signalled the direction of travel. Enhancing wellbeing is clearly the top priority and NZ has a lot to be grateful about. However, there is clearly more

work for the Government to do in some key areas. To date there has been little progress in boosting economy wide productivity, addressing bottlenecks in transport and improving housing affordability. **Massive investment in these key areas has been announced, but a long journey lies ahead.** It will take time to assess whether the Government is on the right track. Somewhat ironically, capacity constraints and labour shortages in a growing number of sectors may slow the delivery of these programmes.

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