Economic Weekly

17 May 2021

Keeping the taps on trickle in Budget 21

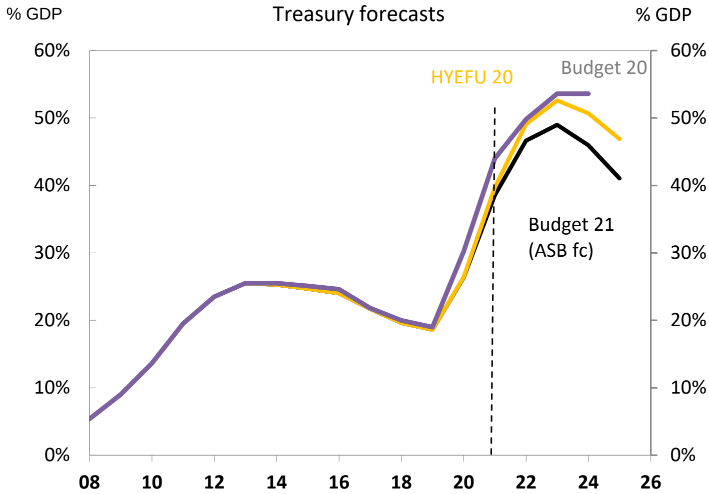
The NZ 2021 Budget (Thursday 20th May, 2pm) takes centre stage this week. NZ has dealt with the COVID-19 pandemic relatively well and our economic performance has held up remarkably as a result. Compared to the chaos and dire economic forecasts which formed the backdrop for the 2020 Budget, the 2021 Budget should be comparatively straight forward. Nonetheless, debt is up, owing to a lift in spending over the past year, while revenue has trended sideways. As a result, the NZ Government has little wiggle room with spending decisions and will need to take a more considered targeted approach to this Budget, compared to last year's 'kitchen sink' approach.

The global pandemic is not over yet, so there remains the expense of keeping borders closed and vaccinating the entire country free of charge this year. Furthermore, the NZ economy is still in a fragile place and the Government needs to avoid weaning off fiscal support too soon. To be working in harmony with monetary policy settings, fiscal settings also need to be stimulating the economy over 2021, rather than restraining it. Finally, infrastructure is creaking at the seams as the population growth of recent years has placed pressure on everything including health, education and transport.

A detailed look at our forecasts for this week's Budget is in a full note by Senior Economist Mark Smith (see here). Compared to previous fiscal updates, the stronger economic backdrop means that annual deficits are expected to be smaller over the forecast horizon, and public debt is expected to rise less rapidly - and then fall away faster. We forecast net core Crown debt will peak under 50% of GDP by 2023/23 and then drop back to 41% by 2025. The Australians have a similar target in last week's Budget, with Australian net debt forecast to peak at 40.9% in 2024. This places NZ and Australia in a relatively strong position compared to some of our international counter parts who have been hit harder by COVID-19, such as the UK and the US which are both forecast to see net debt rising to over 100% of GDP by 2025 (according to the IMF's April World Economic Forecasts).

Net Core Crown Debt

Treasury forecasts



Source: Treasury, ASB June year

Financial markets will be more closely focused on the projected bond issuance programme, and we expect the NZ Government bond programme will be trimmed by up to $40bn over the next 4 years. We expect issuance of around $20-25 billion per year over the next three years. jane.turner@asb.co.nz

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7244	0.7276	0.7162	0.5995	FLAT	0.7135	0.7305
NZD/AUD	0.9310	0.9271	0.9252	0.9276	FLAT/DOWN	0.9160	0.9460
NZD/JPY	79.17	79.20	77.91	64.27	FLAT/UP	75.60	80.00
NZD/EUR	0.5964	0.5985	0.5985	0.5547	FLAT	0.5880	0.6130
NZD/GBP	0.5139	0.5184	0.5203	0.4906	FLAT	0.5050	0.5380
TWI	75.4	75.2	74.9	67.95	FLAT	N/A	N/A

*^ Weekly support and resistance levels * Current as at 9.30am today; week ago as at Monday 5pm*

NZD Recap and Outlook

It was a topsy-turvy week in global financial markets last week, and this was mirrored in the performance of the NZD/USD.

Having started the week around 0.7300, the NZD/USD cratered to 0.7150 mid-week as risk aversion and the USD spiked. The currency recovered most of its losses on Friday, such that it opens the week around 0.7250. NZD/AUD enjoyed a pop up to the 0.9300 resistance level after iron ore prices finally pulled back from their strong run.

Most of last week's volatility centred around the crazy-strong read on US inflation. The surge in headline inflation to 4.3% in April briefly piqued fears that an earlier arrival of global inflation will have central banks reducing stimulus next year, a negative for stocks and risk appetite. But more soothing words from Fed officials (patience!) and some softer US data on Friday allowed some reversal of these fears on Friday.

We'll likely see more of these episodes in future. Inflation pressures are clearly rising globally, but investors/central banks/economists still don't know how long-lived the inflation spike will prove to be. This uncertainty will remain a source of volatility. Our sense is that the risk is growing that the current burst of inflation proves to be more long-lived than central banks expect. In part this underpins our view for an August 2022 start to RBNZ rate hikes.

For this week, the great inflation debate will likely remain front and centre for markets. There's more Fed speak this week, most notably from vice chair Clarida tonight, which will be more closely-watched than usual. We doubt there'll be much NZD reaction to Thursday's NZ Budget; the likely themes of better-looking fiscal accounts and a reduced bond programme are already well understood and priced in. Other data highlights worth keeping an eye on include Aussie employment on Thursday (fall in unemployment rate to 5.4% from 5.6% expected) and flash PMIs (UK/Europe/US) for May towards the end of the week.

All up, we suspect more choppy range trading inside the 0.7150-0.7300 range is likely for the NZD/USD this week. The support/resistance levels at either end of this trading range are looking well established with the currency having been contained in it for over a month. For NZD/AUD, speed wobbles have often kicked in around 0.9330, so a retreat back below 0.9300 looks like the bigger risk, but the Aussie employment figures will be the key driver.
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ASB foreign exchange forecasts (end of quarter)	Dec-20	Mar-21 <<actual	Jun-21 forecast >>	Sep-21	Dec-21	Mar-22	Mar-23
NZD/USD	0.72	0.70	0.73	0.74	0.74	0.74	0.73
NZD/AUD	0.94	0.92	0.91	0.89	0.91	0.94	0.95
NZD/JPY	75	77	80	83	84	85	88
NZD/EUR	0.59	0.60	0.59	0.59	0.58	0.57	0.54
NZD/GBP	0.53	0.51	0.51	0.51	0.51	0.50	0.48
NZD/CNY	4.7	4.6	4.7	4.7	4.7	4.7	4.5
NZD TWI	75.1	73.9	75.2	75.4	75.5	75.5	74.6

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	0.25	0.25	0.25	0.25	UNCH	UP
90-day bank bill	0.36	0.38	0.34	0.27	UNCH	UP
2-year swap	0.55	0.53	0.45	0.12	UNCH	UP
5-year swap	1.24	1.19	1.06	0.21	UNCH	UP
10-year swap	2.01	1.93	1.83	0.61	UNCH	UP
10-year govt bond yield	1.91	1.75	1.63	0.64	UNCH	UP
Curve Slope (2s10s swaps)	1.46	1.40	1.38	0.49	UNCH	DOWN

** Current as at 9.30am today; week ago as at Monday 5pm. Key UNCH = Broadly unchanged*

Market Recap

Local yields pushed higher with a curve steepening bias, outpacing gains in Australian and US yields. The trigger was stronger than expected US CPI data (headline 4.2% yoy, core 3.0% yoy) that pushed global longer-term yields higher on reflation-type trades. NZ 10-year swap yields climbed by close to 15bps last week, moving above 2% for the first time in roughly 2 months (up roughly 100bp since the start of the year). Yields on the 2-year swap (0.57%) briefly touched 2-month highs (up 25bps for the year) as did the slope of the yield curve (2s10s from swaps, +147bps). There was little market reaction to NZ data. BKBM (3m 0.36%) set lower last week, helping to trim gains in short-term yields.

Global longer-term yields pushed higher on the US inflation data but subsequently retraced on weaker than expected US economic data and wobbles in global equity markets. US 10-year Treasury yields (1.63%) were up just 3bps over the week, having peaked mid-week at 1.70%. Earlier in the week, messages by central banks in downplaying the risks of economic overheating were largely ignored and US Treasury auction demand was weak.

Near-term interest rate outlook

Market expectations have a full OCR hike priced in by mid/late 2022, close to our core view (+25bps August 22). We expect short-term yields to test the upper part of recent ranges as the market contemplates the eventual paring back of policy stimulus. It’s not just in NZ where this dynamic is likely to be in play: our CBA colleagues have flagged the risk that the RBA may have to lift the cash rate before 2024 given the resilience of the Australian economy. Australian labour market data this week could well tighten.

Thursday’s NZ Budget (see our preview here) is expected to show a much lower set of fiscal deficits and trimmed down profile for public debt issuance that should support NZ bonds (yields lower). However, near-term yields could nudge higher if Budget confirms a more positive NZ economic outlook. Intended RBNZ government bond purchases this week have been maintained at $350m, matching the NZ bond issuance profile by NZDM.

Our bias is for longer-term NZ yields to ease and the yield curve to flatten, unwinding some of the sizeable run-up in yields of late. Forward rates based on the back end of the curve (e.g. 5-year forward-starting 5-year swap rate of 2.87%) look too high given our neutral OCR view (circa 1.25%-1.50%). NZ longer-term yields will take direction from global cues, and with little pricing side data to focus on this week (NZ producer prices and UK CPI are major exceptions), moves in oil, iron ore and other commodity prices could be influential drivers. Data – Chinese monthly retail sales, industrial production and fixed asset investment, global PMIs – could also impact yields at the margin. Central banks are expected to continue to hose down notions of policy support being withdrawn until the post-COVID-19 recovery is entrenched, and we expect the tone of the FOMC and RBA Minutes this week to be dovish.

Medium-term outlook

We expect the RBNZ to continue to trim its LSAP programme and to halt purchases from 2022, prior to raising the OCR from August 2022. Before then we could see longer-term yields nudge higher. The OCR is expected to reach 1.25% in March 2024, close to neutral levels. Our bias is for yields to edge up over the next few years, but to remain at historically-low levels, with the yield curve to flatten. mark.smith4@asb.co.nz

Domestic events

Data	Date	Time (NZT)	Market	ASB
Budget 2021	20/05	2:00pm		
Retail Sales volumes, Q1, % qoq	24/05	10:45am	-	-1.0

FISCAL PROJECTIONS - ASB Budget 2021 Estimates					
June years	**2021**	**2022**	**2023**	**2024**	**2025**
Total Crown OBEGAL (% GDP)					
ASB Budget 2021 Estimate	**-4.5**	**-3.8**	**-2.5**	**-2.3**	**-2.0**
Half Year Update 2020	*-5.7*	*-5.2*	*-3.8*	*-3.5*	*-3.2*
Net core Crown debt (%GDP)					
ASB Budget 2021 Estimate	**38.5**	**46.5**	**48.7**	**45.6**	**40.6**
Half Year Update 2020	*39.7*	*49.1*	*52.6*	*50.7*	*46.9*
Bond Tender Programme ($bn)					
ASB Budget 2021 Estimate	**45.0**	**20-25**	**20-25**	**20-25**	**15-20**
Half Year Update 2020	*45.0*	*30.0*	*30.0*	*30.0*	*25.0*

Budget 2021 is expected to show a turnaround in fiscal fortunes from the gloom that characterised much of 2020. **We expect Budget 2021 to show smaller fiscal deficits, a lower peak in Crown debt and a trimmed bond issuance programme.** However, this is from a considerably weaker fiscal starting point than pre-pandemic levels, with public debt having mushroomed since the onset of COVID-19. This was necessary given the need for fiscal policy to support the economy. **From the kitchen sink approach of Budget 2020, we expect a change in tone in Budget 2021, with more targeted and fiscally prudent fiscal messages instilled. Striking the right balance between supporting the economy, achieving the Government's key priorities and putting the public finances on a sounder trajectory so as to meet longer-term challenges will prove tricky**. Moves by the Government to set up an Implementation Unit to get more bang for its policy buck and to reconnect with our key trading partners are steps in the right direction. It remains to be seen, however, whether positive intent will translate into better economic and societal outcomes for NZ.

We expect the second consecutive quarterly fall in retail volumes that followed the ripper Q3 2020 outturn. Quarterly ECT spending was down around 2% in Q1 for total, retail and core values and consumer prices rose 0.8% in Q1, although Q1 also saw a sizeable lift in motor vehicle registrations. We also expect to see a running down of retail stocks over Q1 given well-publicised frictions with global supply chains resulting in stock shortages for key retail goods. This will further detract from Q1 GDP. Stock shortages, rising retail prices and slowing population growth are likely to constrain retail activity over 2021. However, strong household balance sheets, the build-up in household saving post-COVID-19, tightening labour market conditions and near-record levels of dwelling construction should fuel a post-Q1 rebound in retail volumes and keep the retail sector ticking over for the remainder of 2021.

Major International Events for the week ahead

Data	Date	Time (NZT)	ASB
China Retail Sales, April, %yoy	17/05	2:00 pm	25
Australia May Board Meeting Minutes	18/05	1:30 pm	-
UK Unemployment, March, %	18/05	6:00 pm	-
Australia Labour Market, Unemployment, %	19/05	1:30 pm	5.4
UK CPI, April, %yoy	19/05	6:00 pm	-
Australia Retail Trade, April, %mom	21/05	1:30 pm	0.8
UK Retail Sales, April, %mom	21/05	6:00 pm	-
Eurozone PMI, May, index	21/05	8:00 pm	-

** Forecasts and commentary originally published by CBA Global Markets Research Friday 14 May at 12:09 pm*

China's household consumption continued to recover sequentially. However, we predict annual growth in **retail sales** may drop to 25% because of fading low base effects. We expect industrial production growth to ease to 11%yoy because of diminishing low base effects and moderating domestic growth impulse. However, external demand remains supportive. Fixed asset investment growth might ease to 20%yoy in April.

The **Reserve Bank of Australia's (RBA) May Board meeting minutes** are unlikely to contain any new information give the Statement on Monetary Policy was released shortly after this meeting. The RBA has revised up their GDP forecasts and revised their unemployment rate forecasts significantly lower. But wages growth and inflation are expected to remain relatively subdued over the next few years. Given the strength in the economy and the scale of both monetary and fiscal stimulus in place, we see wages growth and inflation lifting more quickly than the RBA expects.

The leading indicators of **Australia's labour market** are very strong and point to continued solid job gains ahead. We forecast a 40k lift in employment in April. Alongside an unchanged participation rate this would see the unemployment rate drop to 5.4% from 5.6% in March. We expect the unemployment rate to reach 5% by year end.

Our internal data is pointing to another solid lift in **Australian retail trade**. Retail trade continues to run at a high level and well above where we were pre-COVID-19. Services spending is also recovering. We expect consumer spending to continue to lift this year with a large pool of savings, a strong recover in the labour market, a booming housing market and an extension of tax cuts for low- and middle-income earners all supportive.

The **UK unemployment rate** fell to 4.9% in the three months to February. The Bank of England projects the unemployment rate to rise a little to 5.2% over Q2 as more people start to search for jobs.

UK headline CPI inflation accelerated at an annual pace of 0.7% in March from 0.4% the previous month. The Bank of England expects inflation to surge close to the 2% target in April as the influence of some Covid-related factors unwinds and because of higher household energy bills.

The recovery in consumer confidence and the solid pick-up in the BRC **UK retail sales** monitor point to strong retail sales growth in April.

The composite **PMI** will show if **Eurozone** expansion in economic activity is moderating or accelerating.

Key Forecasts

ASB NZ economic forecasts	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Mar-23
	<< actual	forecast >>					
GDP real - Q%	-1.0	-0.2	1.2	1.0	-0.6	-1.0	0.5
GDP real - A%	-0.9	0.1	14.0	1.1	1.5	0.7	4.5
GDP real - AA%	-3.0	-3.0	3.0	3.3	3.9	4.0	2.5
NZ House Prices (QV Index) - A%	15.4	17.4	18.5	13.6	8.4	4.1	5.1
CPI - Q%	0.5	0.8	0.6	0.8	0.6	0.5	0.5
CPI - A%	1.4	1.5	2.6	2.8	2.9	2.5	2.2
HLFS employment growth - Q%	0.6	0.5	0.3	0.4	0.4	0.3	0.5
HLFS employment growth - A%	0.8	0.3	0.8	1.8	1.5	1.3	2.2
Unemployment rate - %sa	4.9	4.7	4.6	4.7	4.7	4.7	4.0

Q% = percentage change on previous quarter

A% = percentage change since same quarter the previous year

AA% = percentage change for year ending quarter since the previous year

ASB interest rate forecasts	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>				
NZ OCR	0.25	0.25	0.25	0.25	0.25	0.25	0.75
NZ 90-day bank bill	0.27	0.35	0.35	0.35	0.35	0.35	0.90
NZ 2-year swap rate	0.28	0.47	0.50	0.55	0.65	0.75	1.15
NZ 5-year swap rate	0.54	1.12	1.10	1.20	1.30	1.40	1.80
NZ 10-year swap rate	0.98	1.96	1.90	2.00	2.10	2.15	2.35
NZ 10-year Bond	0.99	1.78	1.70	1.85	1.95	2.00	2.20

ASB foreign exchange forecasts	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.72	0.70	0.73	0.74	0.74	0.74	0.73
NZD/AUD	0.94	0.92	0.91	0.89	0.91	0.94	0.95
NZD/JPY	75	77	80	83	84	85	88
NZD/EUR	0.59	0.60	0.59	0.59	0.58	0.57	0.54
NZD/GBP	0.53	0.51	0.51	0.51	0.51	0.50	0.48
NZD/CNY	4.7	4.6	4.7	4.7	4.7	4.7	4.5
NZD TWI	75.1	73.9	75.2	75.4	75.5	75.5	74.6

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