ANZ Research

Budget 2020 Review

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Big umbrella

Summary

- Today's $50bn Budget package and associated bond issuance guidance were bigger than expected. Policies worth $22 billion had been announced before today, around $10bn was new initiatives, leaving around $20bn or so unallocated.
- It's a big umbrella, but this crisis is a monsoon. We think there's more work to do and that tougher choices will need to be made. Getting out the cheque book is the easy part. Supply-side regulation, changes to tax settings, and reprioritising existing spending to ensure the taxpayer is getting maximum bang for its buck will be the real challenge.
- Key policy announcements include a targeted extension to the wage subsidy and increased spending on infrastructure and public housing. But there's plenty more decisions and announcements to come.
- The Government's new fiscal strategy is suitably flexible – it intends to return debt to prudent levels one day (which won't be over the Treasury's forecast horizon) and run substantial deficits in the near term to cushion the blow and support the recovery.
- Core Crown net debt is forecast to peak at 53.6% of GDP in 2023 and 2024 (previously 21.5% in 2022). Total Crown OBEGAL deficits widen to 10.1% of GDP by 2021, narrowing to a deficit of 1.3% by 2024. On that trajectory, surpluses will begin in 2025.
- Compared to December's Half-Year Update, Debt Management's gross bond issuance guidance has been lifted by $148 billion to $190 billion over the next few years. That's around $45 billion more than we were expecting.
- The Treasury's central economic outlook is a little more optimistic than our own. But they have carefully communicated the uncertainty around this. We don't see today's Budget announcements as presenting significant upside risk to our economic outlook. Fiscal stimulus will certainly help, and make a difference, but it cannot provide a full offset.
- Bonds and the NZD have reacted negatively to today's announcements, with the significant boost in the borrowing programme weighing on the bond market. It does add to the risk that we see the RBNZ expand its QE programme, but until or unless that's confirmed, the market will be understandably nervous.

Budget 2020 forecasts (Half-Year Update 2019 forecasts in brackets)

Economic (June years)	2019/20	2020/21	2021/22	2022/23	2023/24
Real GDP (ann. ave. % chg.)	2.8 (2.2)	-4.6 (2.8)	-1.0 (2.7)	8.6 (2.5)	4.6 (2.4)
Current account deficit (% of GDP)	-3.4 (-3.2)	-2.0 (-3.4)	-5.7 (-3.6)	-4.2 (-3.7)	-3.8 (-3.8)
Unemployment rate (June qtr, %)	4.0 (4.3)	8.3 (4.2)	7.6 (4.2)	5.7 (4.3)	5.2 (4.3)
CPI (ann. % chg.)	1.7 (1.9)	1.3 (1.9)	0.8 (2.0)	1.5 (2.0)	1.8 (2.0)
Fiscal					
OBEGAL - % of GDP	-9.6 (-0.3)	-10.1 (0.0)	-8.3 (0.5)	-4.7 (1.1)	-1.3 (1.5)
Core Crown Residual Cash - % of GDP	-10.9 (-1.6)	-14.7 (-2.4)	-10.7 (-1.6)	-7.6 (-0.6)	-3.6 (0.2)
Net Core Crown Debt - % of GDP	30.2 (19.6)	44.0 (21.0)	49.8 (21.5)	53.6 (20.9)	53.6 (19.6)
Bond Programme (gross, NZ$bn)	25 (10.0)	60 (10.0)	40 (8.0)	35 (8.0)	30 (6.0)

Details and assessment

Big and vague

Today's Budget was bigger than expected, reflecting the extreme situation we find ourselves in, the important role of fiscal policy, and the uncertain outlook.

All up, the Government has committed to a $50bn budget package, with $22 billion already allocated before today (on things like the initial wage subsidy).

Only some of the extra $30bn has been allocated, including:

- $4bn business support package, including a targeted $3.2bn wage subsidy extension;
- $3bn infrastructure investment and 8,000 public house build programme;
- $1.4bn for trades and free training and apprenticeships;
- $1bn environmental jobs package; and
- $3.3bn new funding to strengthen core services including health and education

The Government initially provisioned $52 billion for its COVID response, but has more than maxed that out with COVID-19 related funding decisions now totalling just over $62bn. And there's nothing to stop an increase further down the track if conditions require.

The Government has done away with its long-run objective to maintain net debt between 15-25% of GDP, and has replaced it with "the Government will stabilise and then reduce net core Crown debt to prudent levels over the long term (subject to any significant shocks) and beyond", noting that prudent debt levels are those that are within sustainable limits and provide a buffer for future shocks.

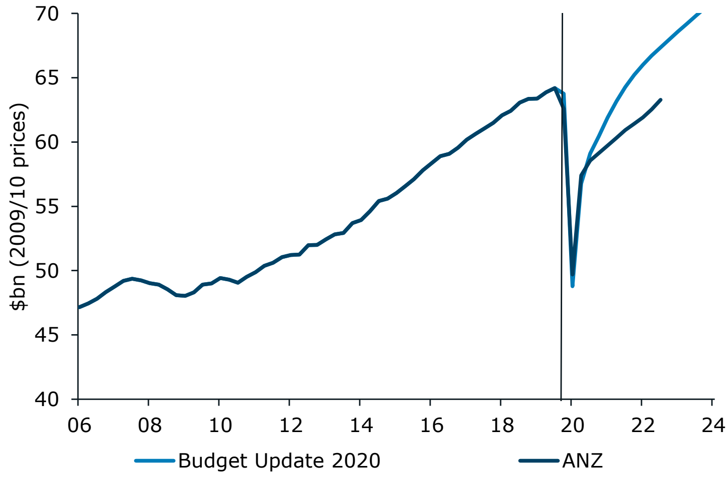
We think a flexible approach is sensible at this stage, and that the strategy will probably become more specific than that once we're on the other side of the crisis. Fiscal consolidation (ie. higher taxes, and/or lower spending) is a story for another day.

For now, the Government's near term focus is to run large fiscal deficits to cushion the blow of the crisis and support the recovery. Appropriately flexible, the long-term objective for the operating balance is to return to surplus and maintain an operating balance subject to the debt objective. Again, no explicit timeframes provided.

A significant downgrade to the Treasury's economic outlook – but does it go far enough?

Compared to our own outlook, the Treasury's central economic forecasts are a little more optimistic (figure 1). However, it's not worth getting too caught up in the differences. Uncertainty is extreme around both, with game-changing risks on both the upside (eg. vaccine) and downside (eg. second wave of inflection).

Figure 1. Real GDP forecasts

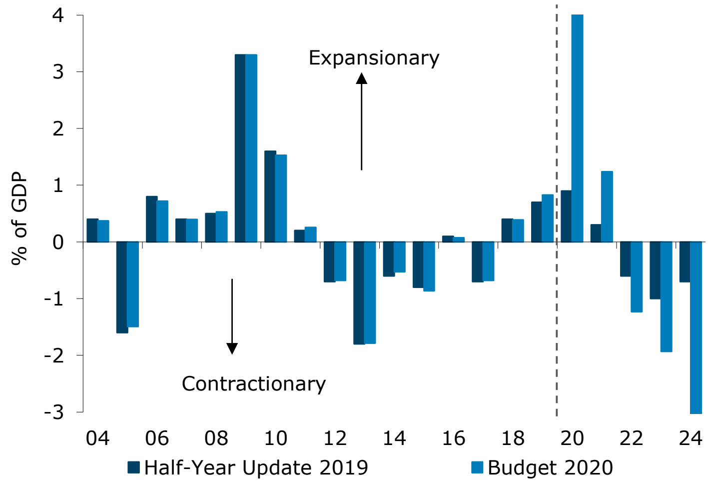


Source: Statistics NZ, The Treasury, ANZ Research

The real question is: do we think today's Budget announcements present an upside risk to our economic outlook? Broadly speaking, the answer is no.

But that's not to say stimulatory fiscal policy isn't going to play a significant role in the years ahead – it most certainly is! But it's also no panacea. The Treasury's fiscal impulse estimate shows just how stimulatory fiscal policy is set to become (figure 2). However, it's up against a very weak global backdrop, extremely low business confidence, high unemployment and weaker household incomes.

Figure 2. Fiscal impulse



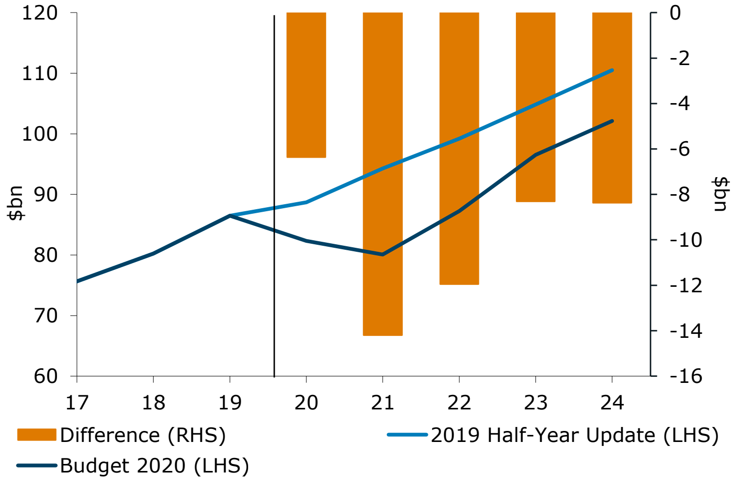
Source: The Treasury

To demonstrate uncertainty around the outlook, the Treasury has leaned heavily on economic scenarios. It's worth noting that their central forecast does not capture today's full fiscal package. Rather, it assumes $35 billion of discretionary fiscal support, so given the size of the Budget package was a little larger than that, they will likely be seeing small upside risks to their forecasts.

A significantly weaker economy means a much smaller tax take…

The Treasury's central forecasts show the Government is expected to receive around $50bn less tax revenue over the five years to June 2024 compared to the Half-Year Update last December. While this is forecast off a highly uncertain economic outlook, there's no missing the key signal here: revenue from all major tax types will be significantly weaker going forward.

Figure 3. Change in core Crown Tax Revenue

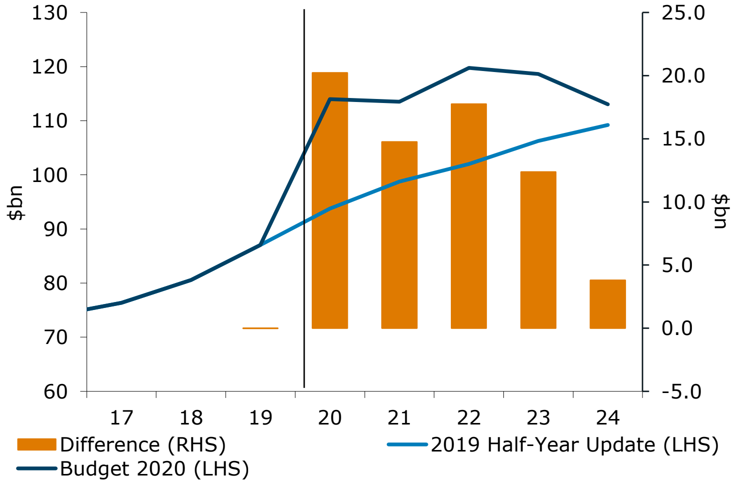


Source: The Treasury

...and with spending poised to lift markedly...

Discretionary spending decisions alongside automatic stabilisers (ie welfare payments) will see core Crown expenses lift markedly. Compared to the Half-Year Update, core Crown expenses are forecast to be around $70 billion higher between the 2020-2024 fiscal years (figure 4).

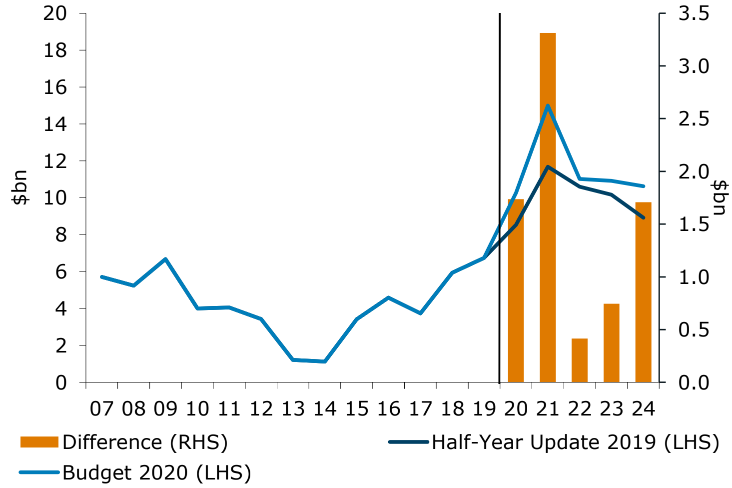
Figure 4. Core Crown expenses



Source: The Treasury

Government investment is also getting a boost (figure 5), some of it in addition to the Half-Year Update, and some of it being brought forward from the out-years. But even with labour market slack opening up and the recent loosening of the RMA, it will be challenging to get this implemented as quickly as hoped. Planning also takes time.

Figure 5. Net core Crown capital cash flows

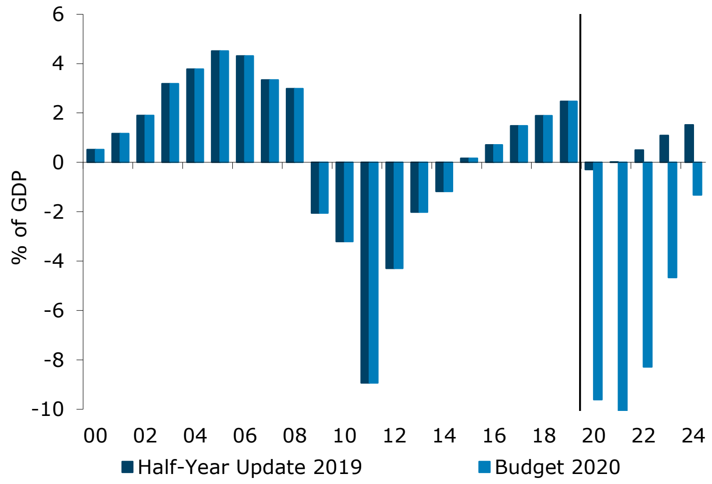


Source: The Treasury

…means large deficits and a sharp rise in debt

Total Crown operating deficits (before gains and losses) (ie. OBEGAL) are expected over the entire forecast horizon to June 2024. As expected, the books hit peak OBEGAL deficit in the 2021 fiscal year (at 10.1% of GDP) and are expected to narrow to 1.3% of GDP by 2024. Should the outlook unfold in line the Treasury's central forecasts and the Government maintain this trajectory, we could be having a surplus party in 2025. But given the economic risks, that feels a little optimistic.

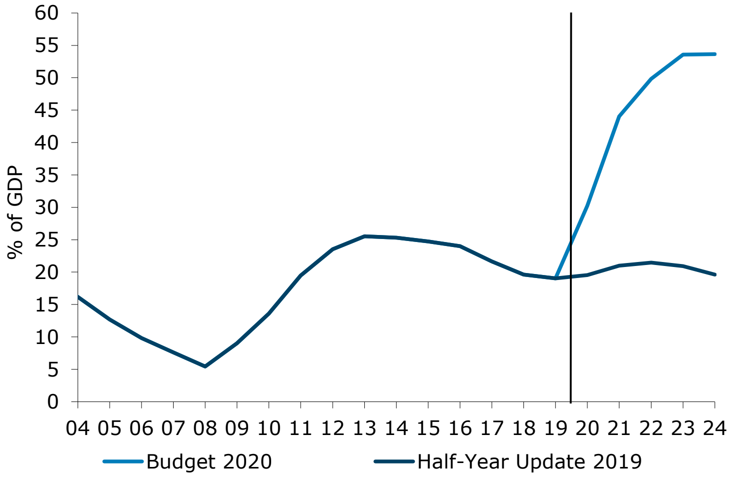
Figure 6. Total Crown OBEGAL



Source: The Treasury

Where there's deficits, there's debt (or fewer assets, but in this case, debt). As a share of GDP, net core Crown debt is forecast to spike higher from 19.0% of GDP in the 2019 fiscal year to a peak of 53.6% in 2023 (and be stable in 2024, figure 7). This is a touch higher than we anticipated.

Figure 7. Core Crown net debt



Source: The Treasury

Total borrowings are forecast to grow from $110.2 billion in 2019 to $317.3 billion in 2024. At the Half-Year Update this was forecast at $145.3bn in 2024. Total borrowings aren't part of the Government's suite of fiscal strategy indicators, but it's a very important metric from both the taxpayers' and rating agency's perspective. That's because it captures the spending decisions made outside of the core Crown accounts (such as by Housing New Zealand) for which we are all potentially on the hook.

The funding strategy

To fund it all, New Zealand Debt Management (NZDM) have lifted their bond issuance guidance – significantly! Total issuance of $190 billion over 2020-2024 is $45 billion higher than we expected. There is no change to the current fiscal year's guidance of $25 billion. Debt Management have also lifted the $12 billion tranche in existing nominal bond lines to $18bn.

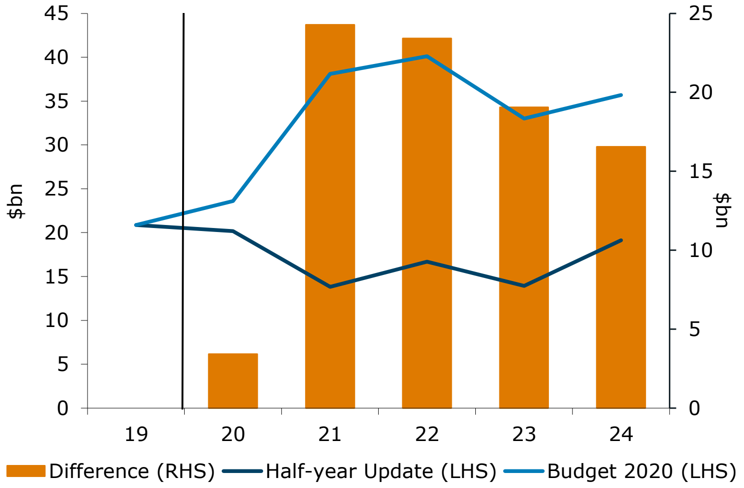
The marked lift to bond issuance adds to the risk we see that expansion in the RBNZ's LSAP programme may be required.

Table 1. Bond issuance guidance

	Jun-20	Jun-21	Jun-22	Jun-23	Jun-24
Budget Update 2020	25	60	40	35	30
Half-Year Update 2019	10	10	8	8	6

Uncertainty around the Government's funding requirements mean that NZDM have a bit of a buffer built into their guidance. Financial assets held by the Treasury are forecast to be significantly higher than at the Half-Year Update over the forecast horizon, but some of that will be provisioned for rolling over shorter-dated bonds (figure 8).

Figure 8. Financial assets held by the Treasury



Source: The Treasury

Given funding requirements are highly uncertain at present, NZDM have signalled they will maintain a flexible approach to T-bill issuance (outstandings are assumed to remain at $10bn over the forecast period) and can fall back on their RBNZ overdraft and Euro Commercial Paper programme. In other words, there is plenty of wiggle room.

All about jobs, but more is needed

The Government expects today's announcements mean employment can return to pre-COVID levels within two years. That feels very optimistic. This economic crisis is like nothing we've seen before – it's literally shaping up to be a proverbial one in one hundred year event. The magnitude of this shock really requires a kitchen sink approach – and it's clear that the Government (and Reserve Bank) have more work to do.

There is a real trade-off between fast policy and good policy; and also between maximising short-term employment and maximising longer-term wellbeing, which requires productivity growth. We learned in the 1970s and 1980s that focusing on jobs as an end in themselves does not lead to great outcomes. We do not want to start a new industry digging holes and filling them in. That said, limiting the rise in the unemployment rate is a powerful way to limit the nasty social outcomes (such as poverty, mental health, general health, domestic violence and other crimes) that typically accompany severe economic downturns.

In such dire circumstances we should be asking if there is more on the policy front that the Government could be doing to guide the economy back to full employment. There is, but there's no such thing as a free lunch. It might be unpalatable in some regards, but a flexible approach to labour market regulation could yield net benefits great enough to at least warrant the discussion. Minimum wage rises have been a substantial cost to firms, and at the current juncture will likely be a significant drag on household incomes, as the loss owing to higher-than-otherwise unemployment will be greater than the gain to those earning at the minimum level. The Ministry of Business Innovation and Employment estimate that the recent minimum wage rise came at the cost of around 6500 jobs. That number is likely much higher now that the economy is in the midst of a severe crisis – and particularly in sectors such as retail, tourism and hospitality that are heavily exposed to the minimum wage and severely impacted by the crisis. The wage subsidy has, and will continue to mitigate the unemployment impacts in the short run, but this is a costly approach.

The Government has other levers it can pull (taxes and transfer payments) to maintain or increase incomes at the lower end of the spectrum, while simultaneously reducing the minimum wage burden on firms. This would keep more people connected to the labour market. Importantly, it's younger workers (those who in time will be picking up most of the tax tab for all this) who are most likely to be adversely affected by restrictive labour market regulation as they are the ones who will struggle to find meaningful employment. The training and apprentice package will certainly help, but it's not a game changer.

Labour market reform doesn't have to stop there. Incentives to hire during the recovery phase could be lifted by temporarily compensating businesses for taking on unemployed workers while they learn the ropes (a different approach to wage subsidies). Employment law could be tweaked to mitigate the risk businesses take on when hiring new staff in this highly uncertain environment. These are just ideas, not policy prescriptions, but if the aim is to protect jobs and boost employment then anything that could help should be put on the table. Such changes only need to be in place until the labour market is back on its feet again. We think that the economic situation is so dire that such tweaks should be considered in addition to the existing policy prescription, and not cast as a substitute for it.

How did the market take it?

Bonds and the NZD have reacted very negatively to today's announcements. Looking forward, the main issue will be digesting the additional bond issuance flagged today, with the $60bn of issuance over the next fiscal year well above ours and others' estimates. Issuance in the outer fiscal years is also significantly larger, and will take the amount of bonds (nominals and linkers) on issue to around $141bn by the end of fiscal 2020/21, and total outstandings peaking at around $225bn in fiscal 2023/24 (depending on the assumed composition of issuance). With tranche line ceilings increasing to $18bn (from $12bn) the pressure will be felt across the curve. We will also see the return of linker issuance, comprising $1-2bn of the $60bn total issuance, as well as two syndications.

The Budget also noted that Kāinga Ora will be borrowing an additional $5bn over coming years, which will put further supply pressure on the bond market. Bottom line: this is a lot of bonds for the market to absorb, and many will now be looking across the road to Number 2 The Terrace over coming weeks, wondering whether the RBNZ will expand its QE programme even further to accommodate the additional bond supply. It adds to the risk that that more QE may be required in time, but there are upside risks too, and we will wait to see how developments and unfold before forming a firm view on that. The fiscal boost could be argued as a positive for the NZD in that it's larger than expected, but the fact that it's debt funded does diminish its appeal somewhat, leaving us a bit circumspect.

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