ANZ Research

2020 Budget Economic & Fiscal Update Preview

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Contact

Miles Workman
Senior Economist
Telephone: +64 4 382 1951
Miles.Workman@anz.com

The end of the beginning

Bottom line

- All eyes will be on how the Government intends to manage the books through this crisis. While uncertainty is extreme, it's important the long-run objectives and the spirit of the new fiscal strategy be maintained as we navigate the volatility ahead.
- That said, the Government will need to build in some flexibility around targets, eg the timing of return to surplus.
- The Treasury's Budget Economic and Fiscal Update (BEFU) will show rapidly widening fiscal deficits in the near term that will send debt spiking higher.
- For our part, we expect net core Crown debt will lift to 40-50% of GDP, with the Total Crown OBEGAL recording a near-term deficit close to 10% of GDP. This could see bond issuance lift to around $145bn over the next few years, $100bn higher than December's Half-Year Update. But a more positive economic outlook than our own could temper the BEFU forecasts.
- There will be a Pre-election Economic and Fiscal Update later in the year (likely mid- to late-August). This will partially mitigate the short shelf life that all forecasts have in this environment.
- As usual, there will probably be a few more policy announcements in the lead-up to the Budget. Grant Robertson's Pre-Budget Speech to the Chamber of Commerce on Thursday seems a likely platform.

Key points

The Treasury's Budget Economic and Fiscal Update (BEFU) and the Government's accompanying Fiscal Strategy Report (FSR) will be released at 2pm on Thursday 14 May. The COVID response is all that matters, but at this early stage we don't expect the Government to have all the answers. Nor do we think the Treasury is in a position to develop a definitive view on how the economic and fiscal situation is going to play out. Financial markets will be most interested in Debt Management's bond issuance guidance, but this will be subject to change as the Treasury's economic outlook and Government policy evolves. Given it's an election year, a Pre-election Economic and Fiscal Update is just a few months away – the numbers could change significantly by then. The Treasury and Government are expected to communicate this uncertainty very clearly. Less prone to wild revisions will be the Government's fiscal strategy – at least the longer-run aspects of it.

The Government's new fiscal strategy will be front and centre

At this early stage in the crisis, the Government's fiscal strategy will be the centrepiece among the numerous documents released on Budget day. The broad approach of how the Government intends to manage the books through this crisis will be laid out, and while economic uncertainty is high and policy will need to be responsive, the long-run objectives and the spirit of the new fiscal strategy are likely to be broadly maintained as we navigate the uncertainty and volatility ahead.

The Government has had to abandon its previous fiscal strategy of maintaining net core Crown debt between 15-25% of GDP, and adopt a highly accommodative fiscal stance that will eventually need to be consolidated.

The Fiscal Strategy Report is the Minister's document, and unlike the Treasury's BEFU will have an element of political spin. However, the Public Finance Act clearly states what must be included. First, the Government must state its long-term (10 or more years) objectives for:

- total operating expenses,
- total operating revenues,
- the balance between total operating expenses and total operating revenues,
- the level of total debt; and
- the level of total net worth.

These 10+ year objectives may have been tweaked since December's Budget Policy Statement to allow for a higher debt-to-GDP ratio in the long run. Previous Treasury advice has been that net core Crown debt at 30% of GDP is prudent (sustainable). This is still a low level by international standards, but a buffer is considered necessary, given New Zealand is always just an earthquake or global crisis away from a significant fiscal deterioration.

Probably more interesting will be the Government's short-term intentions. Here the Government must spell out its intentions for the above variables over at least the next two years. The Government must also assess whether these intentions are consistent with the Principles of Responsible Fiscal Management and the Government's long-run objectives.

Importantly, with debt spiking higher, the Government's short-term intentions will not be consistent with The Principles. Therefore, the FSR must state the reasons for this, simple enough, but also outline how the Government plans to ensure that those short-term intentions will eventually become consistent with the Principles, and over what timeframe.

New Zealand doesn't have legislated fiscal targets like some other countries. Rather, we have the Public Finance Act that requires the Government to develop its own fiscal strategy, which the Treasury (and public) assess against the spirit of the Act. So far, while it does rely on the voting public being the watchdogs, this technically pretty toothless approach has actually proven highly effective at ensuring that governments maintain prudent fiscal settings. Indeed, thanks to more than a decade of prudent fiscal management the Government's war chest is now well stocked to lean against the impacts of COVID-19 and support the recovery. But by the same token, fiscal consolidation is now required to be signalled.

Here are the key things we're expecting to see in the FSR:

- The Government will run significant deficits in the near term to limit the economic fallout of COVID-19 and facilitate the eventual recovery.
- This will encompass discretionary spending announced to date (such as the wage subsidy), any additional spending announcements to support households and businesses, increased operating and capital allowances to provision for future decisions, enhancing automatic stabilisers (ie increased benefit payments), and an overview of its increased contingent liabilities (such as the Government's just-announced SME lending scheme).
- It will also include recent changes to tax settings, such as the loss carry-back tax scheme. We suspect the Government may be reluctant to make significant further adjustments to tax settings in order to maintain their revenue base – tax reductions are politically very difficult to reverse. Smaller tweaks (to lower-end income thresholds, say) may be the extent of it.

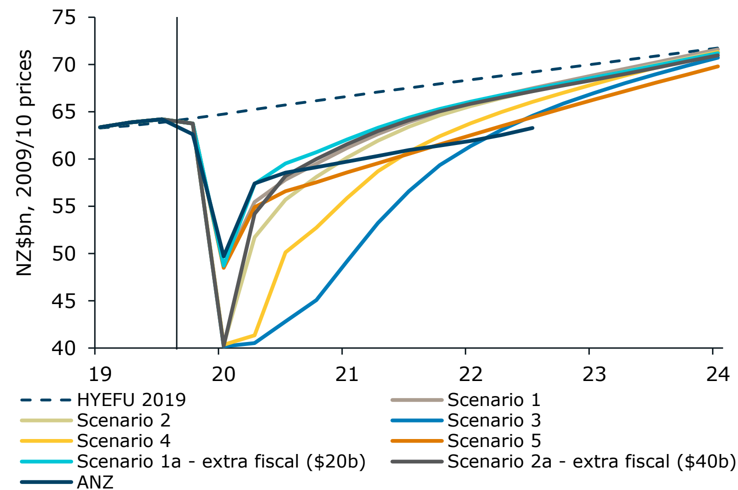
- The first target the Government will have to set its sights on will be a return to surplus. However, given the early stage in the crisis there will need to be plenty of flexibility built in here. For example, the Government might choose to target a return to surplus within five years, but potentially earlier as economic conditions permit, or later as they require. We'd expect this target to be firmed up as the situation becomes clearer. Future-proofing the strategy against the possibly of having to tighten lockdown measures down the track makes a lot of sense. But there also needs to be enough constraint ingrained to prevent a pro-cyclical fiscal stance if the recovery surprises on the upside.
- The debt target naturally follows – we expect the first port of call will be to stabilise the debt-to-GDP ratio below a level informed by the Treasury's advice, which will include a small margin. For our part, we think net core Crown debt will peak somewhere between 40-50% of GDP over the next few years. As at February 2020, it was sitting at 19.2%. The March figures are out Friday and are expected to show the beginning of the deterioration.
- Once the debt ratio has stabilised, the Government will aim to put it back on a trajectory towards its (possibly adjusted) prudent long-run level – around 30% of GDP sounds about right. A growing economy will help achieve this the painless way, but sustained surpluses will also be required to see it happen over a reasonable time horizon. It's a question for another day to some extent, but the fact remains, fiscal consolidation will require increased revenues (higher/new taxes) and/or a pullback in expenditure.
- Consideration of the interaction between fiscal and monetary policy could get a little more attention now that the RBNZ is active in the secondary market, soaking up a lot of the bonds that NZDM are issuing. Fiscal-monetary coordination is nothing new, but the landscape is shifting. The idea that the RBNZ could directly finance the Government has recently been raised. Temptingly efficient, certainly, but we don't think this is something that would happen quickly, as it could call into question central bank operational independence and the New Zealand Government's credit worthiness. Any changes on this front will need to be signalled well in advance, investigated in a transparent way (to limit the erosion of NZ's strong institutional settings), and with a clear governance framework developed.
- We don't see any reason why the Government would change its main fiscal target metrics: total Crown OBEGAL and net core Crown debt. They are quite complementary.

The FSR will also discuss policy themes, along with the hard numbers that will be the focus for markets. We discuss policy options later, but themes that are likely to feature in the FSR are a green recovery, rebuilding a new economy, productivity, wealth and income equality, and hopefully, intergenerational equality, given the long-standing debt burden the COVID response will leave behind.

The Treasury's economic forecasts will be highly uncertain

We expect the Treasury's central forecasts will be a little more optimistic than our own. If the Treasury's earlier scenarios are anything to go by (a big if; a lot has happened since then), we expect the key difference to be in their medium-term growth profile, with a stronger recovery in the latter years. This all comes down to the potential GDP assumption. Unlike the Treasury scenarios we envisage a long-lasting hit, as reduced business investment weighs on the capital stock, lower migration dampens growth in the working-age population, and high unemployment reduces the labour force participation rate. In other words, we think this shock will result in a persistently lower productive capacity compared to the trajectory the economy was on pre-COVID. The Treasury may well change its assumptions.

Figure 1. Real GDP – the Treasury's economic scenarios and ANZ forecast



Source: The Treasury, ANZ Research

It's also likely the Treasury will forecast an unemployment rate below 10% (ANZ's forecast peak: 11%). Indeed, the Minister has said the Government is hoping to keep it below that level, and the Treasury's earlier scenarios suggested the level of fiscal stimulus would have a large impact on the unemployment rate in their forecasts.

For communicating uncertainty, scenarios are where it's at. We think the Treasury are likely to put extra emphasis on their usual "Risks and Scenarios" chapter to discuss the outlook under different paths for COVID-19. Two possible scenarios would be the development of a vaccine by year end (upside scenario), and the possibility of a second or even third wave that sends the economy back into Level 4 lockdown. Throw a similar outcome for NZ's key trading partners into that latter scenario, and the economy would enter a whole new level of dire.

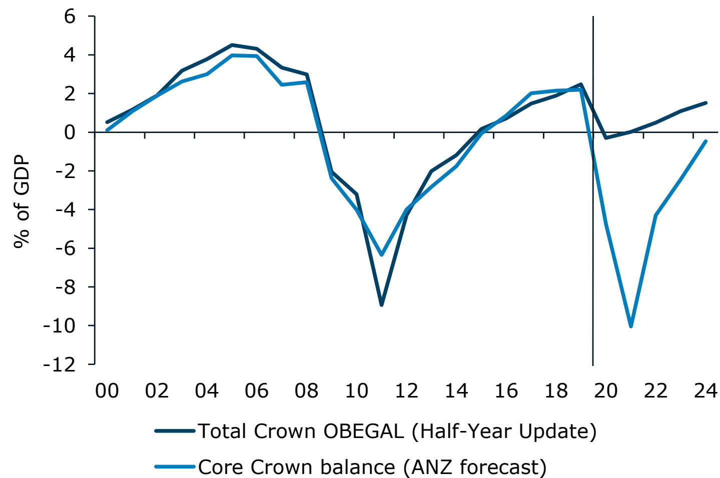
The fiscal forecasts will garner much attention but are also extremely uncertain

The weak economy will weigh on tax revenues – heavily – and expenses are skyrocketing. Deficits and debt will be the key theme of the fiscal outlook, but uncertainty around the economic outlook and the path of the policy response could mean the forecasts have a pretty short shelf life. The Budget should include a marked increase in both capital and operating allowances over the near term. And it's possible that much of this won't yet be allocated, with the Government yet to make decisions on what particular infrastructure projects to fund and where to lift operational spending in a way that best supports the recovery once COVID risks are contained.

The fiscal forecasts were probably locked down in late April, and given the speed at which the Government is having to move, it's possible that some policies such as the new SME direct lending scheme haven't been incorporated in the fiscal outlook. This is understandable, and if this were to occur we'd expect to see the details outlined in a separate box in the BEFU or as a separate media release.

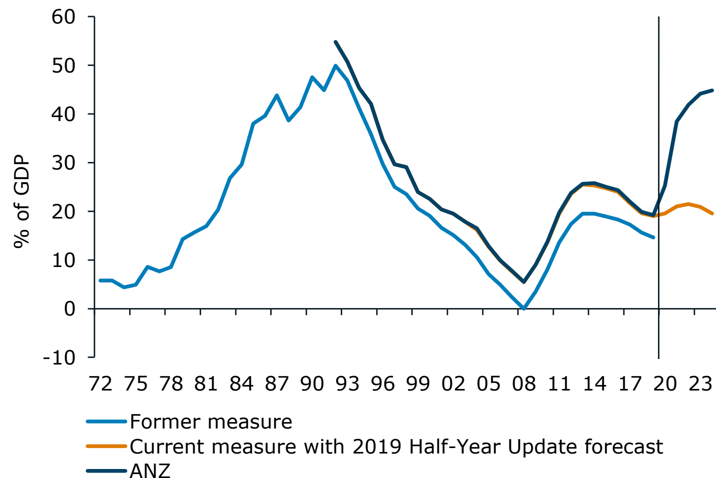
We expect the Government will need to run an operating deficit close to 10% of GDP in the 2021 fiscal year, with smaller deficits then forecast thereafter (figure 2). Such a track will send net core Crown debt spiking higher (figure 3). A more optimistic economic forecast would reduce the GDP ratios for a given level of spending, as well as implying lower spending directly on the likes of unemployment benefits, but it's just a matter of the degree of deterioration.

Figure 2. Government operating balance



Source: The Treasury, ANZ Research

Figure 3. Net core Crown debt



Source: The Treasury, ANZ Research

The name's Bond, Government Bond

New Zealand Debt Management's (NZDM) bond issuance profile is locked down after the fiscal forecasts, but there will nonetheless be a lot of uncertainty around the Government's future funding requirements. NZDM are therefore likely to include some buffer (which will show as a build-up of the Treasury's financial assets in the fiscal forecast), and signal how they might fill any gaps if bond issuance falls short of constantly changing funding needs in the near term.

NZDM has temporarily increased its overdraft facility with the RBNZ for the three months to 30 June 2020 from $5 billion to $10 billion, which will help meet any shortfall in issuance between now and then. This overdraft could be extended again if necessary. NZDM are also likely to signal flexibility around T-bill issuance. All up, we expect bond issuance guidance of around $45 billion in the 2021 fiscal year – that's $35bn higher than the Half-Year Update guidance. Cumulatively to June 2024, we expect to see gross issuance increase by just over $100bn compared to December's Half-Year Update.

Table 1. Potential bond issuance guidance

	Jun-20	Jun-21	Jun-22	Jun-23	Jun-24	Total
BEFU 20*	25	45	30	25	20	145
HYEFU 19	10	10	8	8	6	42

* The uncertainty band around these figures is wide. They are based on our economic outlook and assumptions around how this will flow through to the fiscal position. The Treasury's economic forecasts will differ to ours, and they will have a lot more detail on the policy response to incorporate.

Specifics of the fiscal policy response

So far, the Government has provisioned $52bn to cushion the immediate blow and support the recovery. As outlined in our Weekly of a few weeks ago, we see the fiscal policy response evolving in three interrelated stages:

1. **Damage control** to help households and firms survive while their income is grossly impaired by lockdown measures. The aim here is to ensure the best possible starting point for the recovery. This phase covers most of the policy announcements to date, including wage subsidies and SME loans. However, these policies are very costly, will leave behind a substantial debt burden on both current and future taxpayers. They can also only do so much. Extensive economic damage in unavoidable.

2. **Facilitating the recovery**. Once COVID-19 risks are under control and the lockdowns are eased, the economy will need a push-start to get momentum building. There are many ways to skin a cat here, including increased spending, tax cuts, and changes to regulatory settings that affect the supply-side of the economy (such as the RMA and minimum wages). The aim is to get the economy back on track towards full employment as fast as possible. But again, such policies can be extremely costly. We discuss specific policy options in more detail below.

3. **Unwinding the stimulus and rebuilding fiscal buffers.** This could be two or more years away, and will be a long-running process. This can occur when the economy has picked up enough momentum that fiscal stimulus can be withdrawn without sending it off course. Unwinding discretionary stimulus is pretty straightforward if the stage two responses are largely temporary in nature. However, simply reducing fiscal stimulus won't be sufficient to reduce the level of Government debt over a reasonable time horizon. To rebuild fiscal buffers for the next rainy day, current outgoings (such as NZ Super) could be put under additional scrutiny with a view to cost savings, and future spending allowances could be constrained. A lift in some tax rates and/or the implementation of new tax types may also be on the menu. Again, this is discussed in more detail below.

In reality, there will probably be quite a bit of overlap between these stages, reflecting differing impacts across sectors, over varying timeframes. A second wave of infection would introduce a very costly rinse-and-repeat of what we've already been through, or alternatively, the early development of a vaccine could fast-track us through the process.

The table below provides an overview of some of the announced and commonly discussed possible policy options. The upcoming Budget is likely to feature a range of stage 1 and 2 policies. Figuring out how to pay for it all (stage 3) will come later. Policy decisions will be made through the Wellbeing lens of the Living Standards Framework, but this won't reduce the focus on the economic recovery – it's all related.

Tax changes	Comment
Income tax rates and/or thresholds	Reducing income taxes would increase disposable incomes and stimulate demand. But this tax type is a powerful revenue earner. Tax cuts are politically difficult to reverse, and income taxes may well need to be lifted from current levels in the future to pay for the COVID response. If we see reductions, expect them to be targeted at the lower-income end.
Corporate taxes	Likewise, a lower tax burden on businesses would leave them with more cash to cover overheads, invest and hire. But again, it's a strong revenue earner for the Government. Any gap between top personal income tax and corporate tax can also distort behaviour, so policy needs to be designed carefully. Business tax settings have already been tweaked with the provisional tax threshold increased, the reinstatement of building depreciation, writing off interest on the late payment of tax, and the tax loss carry-back scheme. Further small changes are likely.
GST	A temporary reduction in GST has been floated. This would incentivise people to bring forward spending (tax avoidance) and could give the economy a real jump start. However, increasing it again later would be politically difficult, particularly if the recovery is gradual and the economy fragile for some time, as that would affect lower income earners the most. GST is an efficient and broad tax.
Resident withholding tax on interest and dividends	Lower RWT would go some way towards mitigating the impact of low interest rates on those relying on interest income. However, this tax type is small in the scheme of things, so changes to tax settings wouldn't be a game changer. It's been floated in the past that lower RWT could incentive domestic savings and help narrow NZ's savings-investment gap, but that's a longer-run issue.
New tax types	New taxes are likely to be floated over years ahead as governments look towards fiscal consolidation while ensuring that the tax system is effective, fair, and efficient. Taxes on capital gains, inheritance, and wealth are all possibilities, but these are unlikely to get any airtime at the upcoming Budget.

Government spending	Comment
The wage subsidy	So far the Government has paid out more than $10 billion to businesses to support 1.7 million individuals (about 60% of the workforce). When the current policy runs out in mid-June we suspect the unemployment rate will spike higher. The scheme is very likely to be extended in a more targeted form, but this will be a balancing act. For some businesses it'll just be delaying the inevitable, at a huge cost to taxpayers.
Short-time work	Implemented in Germany after the GFC, workers have their hours significantly reduced, but their income is topped up by the Government. The Government can also incentivise upskilling/training through the programme. The idea is that otherwise-unemployed workers maintain their connection to the workforce through the downturn while businesses can align labour input with demand for its goods and services. It's an alternative to the wage subsidy, so is an unlikely option while that's in place.
Transfers and benefits	Unemployment benefits have been lifted and the winter energy payment doubled this year. Other payments to households, such as Working for Families Tax Credits, may also be looked at.
Public sector wages and employment	The Government has already introduced public sector pay restraints (largely capping incomes at the higher end), which will help maintain the number of workers within a certain budget. However, more public sector workers will be needed for a time as the demand for social services increases markedly. Severe economic downturns can drive a significant deterioration in poverty, crime, and health (including mental health) outcomes.
Helicopter money	This is a pretty old concept in which the central bank increases the money supply by giving everyone a lump sum payment. It's not pure helicopter money by its original definition, but the idea has been floated that the Government could do this via increased government debt. It wouldn't be efficiently targeted, but it could give consumption spending a big shot in the arm and support the economy – at least the part that doesn't go directly into imports or savings. The concept gets most people on the street pretty excited. It has some merits – it's temporary, stimulatory, and might help pull consumer and business confidence out of the doldrums, at least temporarily. However, it needs to be well-timed. As long as there's a risk of being thrown back into Level 4 lockdown, those who can, frankly, would be wise to save it for that possible rainy day. The Treasury will surely encourage the Government to consider the opportunity cost of this policy, ie those who are just scraping by and will spend it on necessities could be given a little more if the policy wasn't so broad based. But a more targeted policy is much more difficult to design and implement. This policy was recently adopted in the US.
Universal basic income	The introduction of a universal basic income (UBI) has been raised by some as an option to stimulate the economy. We're not convinced it would be better than something temporary, such as a well-timed one-off payment to households. A UBI has some merit, particularly in terms of not distorting work incentives, but it would be very costly, probably require higher tax rates or lower spending elsewhere, and do little (if anything) to improve poverty outcomes compared to the current targeted approach to welfare.
Superannuation	Intergenerational equality is set to become a hot topic – one that could divide the political spectrum, with New Zealand Superannuation payments accounting for a hefty chunk of government spending. New Zealand runs a pay-as-you-go system, where payments are funded from the current tax take.

	The problem is that the aging population means those collecting Super now are a much higher share of the total population, with fewer younger taxpayers per retiree footing a bill that is growing by the day. Attempts have been made in the past to address the fairness and affordability of superannuation (such as establishing the NZ Super Fund) but anything more than that (such as lifting the eligibility age or means testing) has been quashed. Nonetheless, it could be worth a revisit.
Fees free	The fees-free study policy was initially estimated to cost taxpayers $2.5bn over the first five years. The Government's current policy is to extend this to second-year students after the election. Most of the benefits of a tertiary education accrue to the individual, and in terms of society-wide benefits, a lifting unemployment rate will in any case incentivise study, weakening that argument. A more targeted approach (from a socio-economic and skills shortage perspective) could lead to better outcomes overall, but could prove politically challenging.
Retraining	A national retraining programme to support the transition to the new (post-COVID) economy could be on the cards. But transforming tourism workers into aged-care or forestry workers (for example) is no easy feat. It will take time.
Other operational spending such as health, education and social security and welfare, core government services, and environmental	Many areas of Government will be in need of more or better-allocated funding. Spending on health and social assistance could get a further bump come Budget day – not only to combat COVID-19, but also to deal with the fallout of lockdown in terms of mental health, poverty, and domestic violence. Money spent on early childhood education would get our seal of approval – it's at this point where the achievement gap begins, and that can have lasting consequences for lifetime education, potential earnings and productivity. The ship has well and truly sailed by the time one is making tertiary education choices.
Infrastructure spending	Roads, rail, hospitals, schools, three waters, electricity transmission, internet, climate change mitigation – we need it all. However, the cost benefit analysis should be the priority over job creation. It's encouraging to see the Government looking for shovel-ready projects to get on with. This is an important form of spending that, if the cost-benefit stacks up, can lift the economy's productive capacity, supporting higher-than-otherwise incomes.
KiwiBuild and social housing	The freeing-up of Air BnB housing is easing housing shortages for now, but a structural housing affordability issue remains. The residential construction sector could be in for the biggest slowdown it has faced in a generation. It's a golden opportunity to increase the quality and quantity of public and private housing at a reasonable cost and speed, and set up the infrastructure for faster private housing delivery in the next upswing. At the margin it might increase downward pressure on house prices over coming years, but housing affordability is a societal priority that should outweigh fear of any downward pressure on household spending as a result of a balance sheet hit for current homeowners.

Other	**Comment**
Minimum wages	Keeping people – particularly young people – connected to the labour market is of such paramount importance that we think it would be worth reviewing recent minimum wage rises to support employment now and into the recovery. The sectors hit particularly hard by COVID, retail and hospitality, are also those most impacted by minimum wage rises. The impact on minimum wage earners' disposable income could be addressed through the tax system or possibly by transfer payments. Getting the economy back to full employment is probably the single most important thing the Government can do to support wellbeing and maintain living standards generally.
Resource Management Act	Red tape is a hand-brake on development, but at the same time it's important to guard against negative externalities such as environmental degradation. The Government has announced it will fast-track eligible development and infrastructure projects under the Resource Management Act. This will help infrastructure get up and running faster than otherwise, and support the recovery. It's a good move, and could go further, but like all policy changes there are trade-offs.
Government lending directly to SMEs	Like the wage subsidy, Debt Management will need to raise the funds – and probably pretty quickly. The IRD will administer these loans. Like student loans, they will be an asset on the Government's books. But they're a riskier asset, and the contingent liability will be large. The interest write-off will be a small cost to the Crown (taxpayer), but it will be very interesting to see how much the Treasury provisions for debt write-offs. We suspect it will need to be large. The viability of some businesses has changed markedly, and in some cases pumping taxpayer cash in will prove to just be a very costly way to kick the can down the road. For others, it will be the difference between failing and not. Calibrating the policy to yield a net benefit will be the challenge.
Business Finance Guarantee Scheme	This isn't a direct expense to the Government (taxpayer), but a portion of the loans that get written off as businesses fail will be. So far, take-up of the scheme has been small, but the Government is making changes to make it more accessible and more appealing for firms. But this inevitably comes with more exposure for the taxpayer.
Local government	Central Government support for local councils may be investigated in order to see them through this period of reduced activity and income (ie tourism, rates) without having to exacerbate the economic downturn by seeing them shed headcount or compromise investment plans.

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This document has been prepared by ANZ Bank New Zealand Limited, Level 26, 23-29 Albert Street, Auckland 1010, New Zealand,
Ph 64-9-357 4094, e-mail nzeconomics@anz.com, http://www.anz.co.nz