ANZ Research

NZ Half-Year Economic & Fiscal Update 2020

16 December 2020

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Books better, as expected

Summary

- As expected, the Treasury has revised up the economic outlook, reflecting recent resilience in the economy, but risks remain. The economic forecasts are similar to our own.
- A better economic outlook is supporting an improved fiscal outlook, but deterioration in the Government's books and uncertainty remains significant. Net core Crown debt is forecast to increase from 18.6% of GDP in 2019 to 52.6% in the 2022/23 fiscal year – that's a downgrade from just over 55% in the Pre-election Update.
- New Zealand Debt Management have downgraded their bond issuance guidance slightly, exactly as expected. Provided downside economic and virus risks do not materialise and Government policy doesn't change significantly, we think further downgrades are likely in the future.
- There's not a lot to report on the policy front, which isn't surprising given the Budget Policy Statement has been delayed. We'll get more clarity early next year, including on policies related to the problematic state of the housing market.

Key points

The Treasury's Half-Year Economic and Fiscal Update (HYEFU) was very consistent with our expectations, and shows a better starting point for both the economy and the fiscal position that is expected to persist into the medium term. The Treasury's outlook acknowledges the more resilient starting point for the economy, along with risks in both directions. We think the Treasury's central outlook is a reasonable middle ground – it's not dissimilar to our own. Implicitly, more momentum in the economy is assumed, with a similar GDP outlook predicated on an unchanged OCR outlook – we agree that further monetary stimulus is looking less necessary by the day, and will review our OCR forecast in the New Year.

A better medium-term outlook, higher tax-take and lower costs have reduced pressure on the Government's finances. Although deficits are expected and debt is expected to increase, this is by less than previously assumed. The bond programme has consequently been downgraded, in line with our expectations.

Policy changes will be a key theme for the New Year, but there isn't a lot to report today. The usual accompanying Budget Policy Statement has been delayed, and when that's released, policy tweaks could be a little more meaningful (the BPS is required to be published before 31 March 2021). Indeed, New Zealand is yet to have a discussion about what fiscal consolidation should look like (ie the post-crisis "prudent" debt target, and how this will be achieved). On housing, house price inflation is assumed to cool over the forecast horizon, but unaffordability is assumed to worsen, underscoring the need for big, bold, urgent measures. We expect policy announcements regarding the housing market in the New Year.

All up, the starting point and outlook is a little better, but the broader story is much the same: the economy is not out of the woods, economic scarring is unavoidable, but the initial fiscal and monetary policy response has been very effective at limiting the damage brought about by lockdowns. Unfortunately, that's not been without a cost. The former leaves in its wake a significant deterioration in the fiscal position (for future tax payers to deal with), while the latter has exposed decades of inadequate policy action to ensure housing supply is able to flex with demand.

Slightly better economic outlook, but risks remain

As expected, the Treasury has dovetailed a stronger starting point (in part supported by the wage subsidy) for the economy into a slightly better medium-term view, bringing their forecasts in line with our own. Like us, they see near-term upside risk, reflecting recent resilience in economic data. But they also remain cognisant of downside risks, particularly possible COVID-19 resurgence in 2021, though renewed lockdowns are now assumed to be less costly than previously assumed.

The near-term outlook is assumed to be less volatile than our own expectations, reflecting that the Treasury forecasts were finalised on 13 November, before the GDP partials were released. The Treasury had pencilled in a rebound of 10.5% q/q for Q3 GDP (released 10:45am tomorrow), followed by a 2.3% lift in Q4. By contrast, we expect to see a 14% q/q rebound, followed by a technical recession as we enter 2021. But ultimately, the near-term difference is just noise – and it's old news. The Treasury expects a return to a very similar level of GDP to us, with a slow recovery expected from 2021 onwards.

The significant effects of our lost summer of tourism are forecast to become evident in 2021, in line with our own expectations. The Treasury highlights the possible upside risk that continued momentum in the domestic economy may provide more of an offset to this headwind than built into their forecasts.

Over the medium term, the Treasury have revised up their outlook for economic activity and the picture is very similar to our own (figure 1). The outlook is assumed to be supported by continued expansionary monetary policy over the forecast horizon, the elevated terms of trade, and flow-on effects from a strong housing market. An eventual full re-opening of the border in early 2022 (the same as our assumption) is expected to support growth in later years, including through the return of international visitors and an increase in net immigration.

However, uncertainty, the closed border, weak growth in our trading partners, supply disruptions and sugar-hit fiscal stimulus rolling off (namely the wage subsidy) will all weigh. Over the forecast horizon, the recovery is assumed to be slow, reflecting a degree of scarring from the economic downturn – weighing on investment decisions, labour market participation and productivity in years to come.

Figure 1. GDP

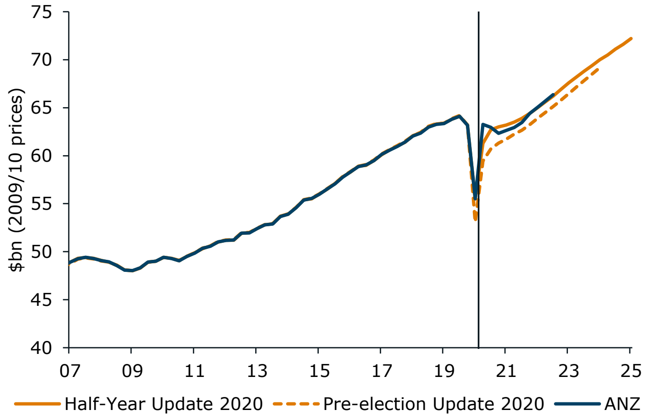
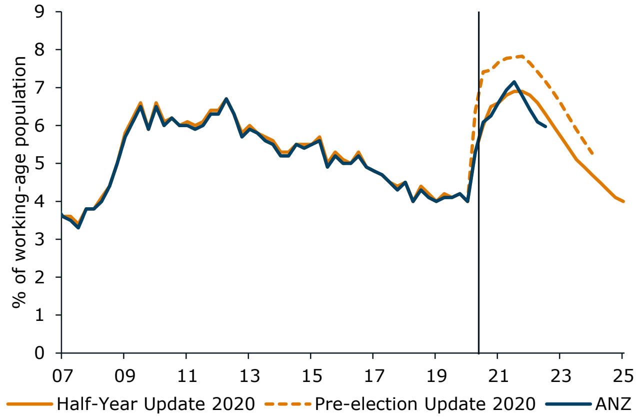


Figure 2. Unemployment rate



Source: The Treasury, Stats NZ ANZ Research

The Treasury expects the unemployment rate to rise to a similar level to us (peak of 6.8%), before gradually declining over the medium term (figure 2). CPI inflation is expected to moderate further as we head into 2021 (to reach a trough of 0.7% y/y in Q1), before increasing gradually to reach 2% in 2025 – still a very subdued outlook, similar to that contained in the Pre-election Economic & Fiscal Update.

Importantly, though, the Treasury's forecasts are premised on less monetary stimulus than our own. The 90-day rate is assumed to be broadly flat over the forecast horizon. This implies that a stronger degree of underlying momentum in the economy is assumed in their forecasts. That's consistent with our view that on balance the risks around our medium-term forecasts are now skewed to the upside, and further monetary stimulus may accordingly no longer be necessary, given recent resilience in the economy.

An outlook for stronger activity, higher terms of trade and a marginally higher price level have seen nominal GDP upgraded by $48 billion over the forecast horizon to June 2024 – and that implies a higher tax take.

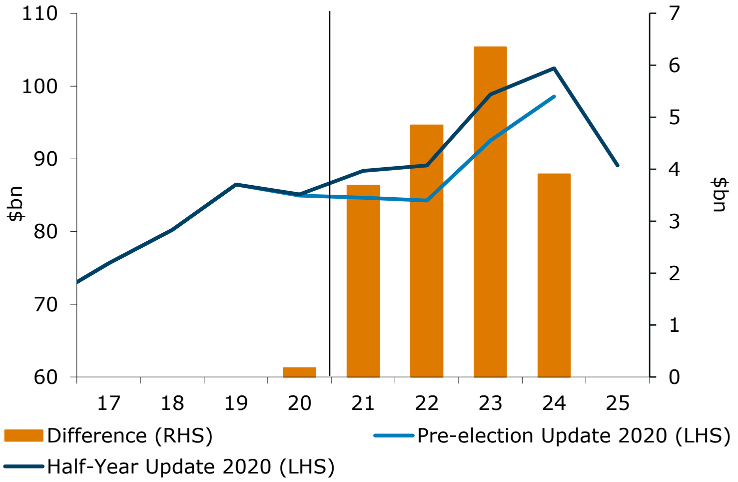
Overall, we think the Treasury's central economic forecasts are a reasonable middle ground, given upside risks building around our own forecasts, but also the many risks that are set to persist for a while yet.

Fiscal outlook better…

We already knew the starting point for the fiscal outlook was a little better than the Pre-election forecasts, and that's been carried through into the outlook much as we expected. Importantly, at this early stage, changes to the fiscal outlook are still immaterial compared to the degree of forecast uncertainty that surrounds them.

Tax revenue is forecast to come in stronger across the forecast horizon – $16.8bn higher on a cumulative basis to June 2024, with upgrades to all key tax types (eg source deductions, GST and corporate tax).

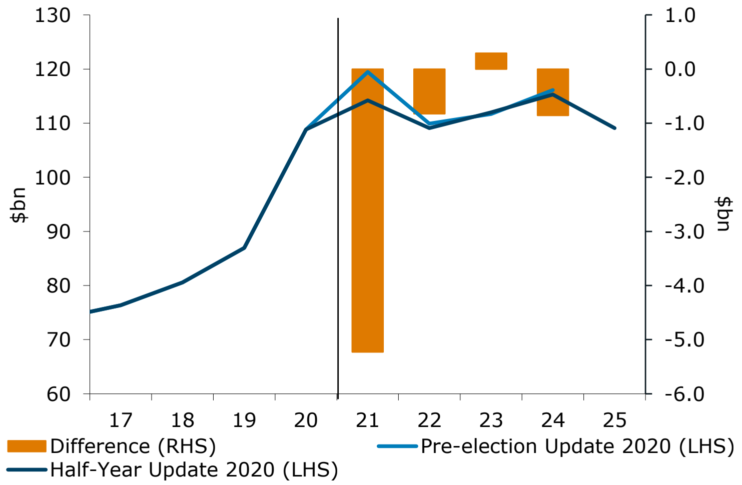
Figure 3. Core Crown tax revenue



Source: The Treasury

Expenses are expected to come in a little lower than at the Pre-election Update, chiefly on the back of lower automatic stabilisers (eg unemployment benefits). Discretionary policy decisions do not appear to have had much impact on the overall fiscal position. Of the $14.1bn unallocated COVID contingency at the Pre-election Update, $3.8bn has now been allocated (for vaccines and managed isolation costs and the like). The remaining unallocated $10.3bn is still baked into the fiscal outlook, and the Minister of Finance is sticking to his guns that if these funds are not needed they will not be spent and the fiscal position will be better for it.

Figure 4. Core Crown expenses



Source: The Treasury

There are a few overs and unders around core crown residual cash compared to the Pre-election Update, but the cumulative cash position is now expected to be a little stronger than previously. The additional forecast year (to June 2025) is expected to post a cash surplus of $3.9bn.

Forecast OBEGAL deficits are expected to be smaller across the forecast horizon, narrowing from -7.3% in 2020 to -1.0% by 2025. Net core Crown debt is forecast to peak at 52.6% of GDP in the 2023 fiscal year (figure 6), and dip to 46.9% in 2025. This is pretty close to our expectation that forecast debt was likely to peak closer to 50% than the 55.3% published at the Pre-election Update. Importantly, the Government is seeking advice from the Treasury on what fiscal indicators should be embedded in the Fiscal Strategy (ahead of Budget 2021) given the Government's current key fiscal indicators (core Crown net debt OBEGAL) are being adversely affected by unconventional monetary policy, chiefly the LSAP and FLP. From a fiscal strategy perspective, it's good to have indicators that are influenced mainly by the things under the Government's control, but also something that captures the whole-of-government position (ie the true potential liability on the tax payer).

Figure 5. Total Crown OBEGAL

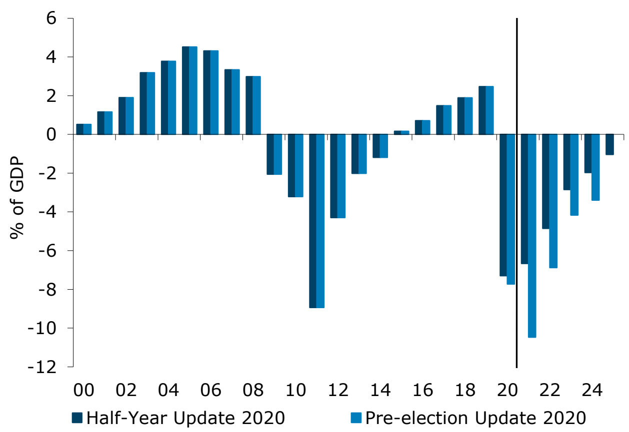
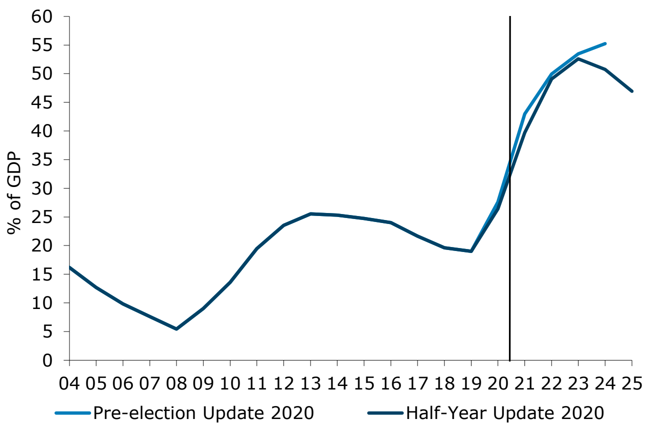


Figure 6. Net core Crown debt



Source: The Treasury

Total borrowings are forecast to grow from $110.2 billion in 2019 to a peak of $261.6 billion in 2024. That's a slightly lower peak compared to the Pre-election Update, but still a gargantuan deterioration nonetheless. 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 agencies' perspectives. That’s because it captures decisions made outside of the core Crown accounts for which the taxpayer is still potentially on the hook. The Government can improve its net core Crown debt outlook by funding outside of the core accounts (such as via Housing New Zealand), but interest costs are generally higher than the counterfactual (ie funding through NZ Debt Management).

A smaller bond programme, with further downgrades likely once virus risks have abated

As expected, New Zealand Debt Management (NZDM) has downgraded its bond issuance guidance by $20 billion over the 4-year forecast horizon to June 2024 (Table 1), with the profile to June 2025 in line with our estimates.

Table 1. Bond issuance guidance

	Jun-20 (actual)	Jun-21	Jun-22	Jun-23	Jun-24	Jun-25
Half-Year Update	29	45	30	30	30	25
Pre-election Update	29	50	35	35	35	NA

The Treasury has also signalled that it intends on bringing two new bonds to market, via syndication. The first will be a new May 2026 bond, to come in February, and the second will be a longer bond, to come before 30 June 2021. The Treasury has not specified a maturity, but we expect the longer bond to be a 2051, to match the maturity of the longest ACGB and to extend the NZGB curve to 30 years. A syndication in February is a little sooner than we expected, but it is a 5-year bond and should be well received, and the more bonds that are syndicated, the lower the run rate of tender issuance.

Treasury bill issuance has also been revised lower, from $10bn per year at the Pre-election Update to $8bn in the current fiscal year, and $6bn thereafter. This is a slightly larger downgrade than anticipated, but isn’t a surprise given where the fiscals landed and the skew of risks around funding requirements (table 2).

Table 2. The many things that influence NZDM's bond issuance guidance

Influence on bond programme	Implication for HYEFU	Additional implication after HYEFU
Better economic and fiscal starting point	Hard to put an exact number on this given all the other moving parts, but the $5bn downgrade to the current fiscal year looks to be heavily influenced by this.	No implication provided HYEFU guidance fully accounts for this.
Upgrade to economic and fiscal outlook	Again, hard to say how much this is worth, but fair to say it contributed significantly to the $5bn downgrade in the out years.	No implications beyond HYEFU (assuming HYEFU forecasts are right). HYEFU provides an updated benchmark to assess the risk of further changes to the outlook.
Successful virus containment means the remaining COVID contingency is not needed.	As expected the original $14.1bn was kept in the forecasts, but $3.8bn of this has now been allocated and the rest re-phased slightly, leaving an assumed $10.3 in the fiscals that may not be needed.	A cumulative impact of -$10.3bn.
NZDM decide the large buffer of liquid assets they are holding (just in case they need to facilitate significant and fast-moving policy decisions, such as another wage subsidy) is no longer needed.	NZDM say forecast cash balances are similar to those forecast previously, suggesting no impact on the bond programme – yet.	Further cumulative impact of around -$15-20bn. This reflects the fact that NZDM may decide to permanently hold larger cash buffers than pre-crisis (ie we may never see a full retracement). But provided downside virus and economic risks do not materialise, we think they'll run down their buffer from current levels to some degree.
Discretionary fiscal policy decisions (ie changes to tax and spending settings).	Implications indistinguishable from everything else.	Risks appear skewed towards the Government spending more. But depending on the Fiscal Strategy, this could equally be facilitated by positive surprises in the fiscals (if the data evolves that way) – ie increased Government spending may not need additional funding.
Delays in government spending (particularly capex) causing a re-phasing of issuance guidance.	Implications indistinguishable from everything else.	Could have a positive wave impact on the profile in the out years; not a game changer.
Treasury forecast assumptions, such as funding costs (interest rate) over the medium term, and the maturity profile.	Implications indistinguishable from everything else.	Could impact guidance by 1-2bn in a fiscal year; an ongoing risk.
Changes to Treasury bill issuance	T-bills have been wound down a little more than we thought in the interest of keeping the bond programme stable.	Ongoing risk that T-bill issuance is used to maintain stable bond issuance.

Market implications

Market implications of the HYEFU will be felt most by the bond market. While many (including us) expected the bond programme to be reduced, confirmation will nonetheless be well received, and it validates the recent outperformance of bonds against swaps. NZDM will announce the January bond tender schedule at 8am tomorrow, and that is likely to show either a four (or possibly five) week gap between tenders. Although the RBNZ has also put the LSAP in hibernation over that period, against a backdrop of reduced issuance, that further underscores the prospect of bond outperformance.

We expect FX markets to focus more on fiscal positives than on reduced bond issuance. Given the degree of offshore participation in the NZGB market, the prospect of fewer bonds does technically imply less demand for NZD. However, to the extent that better fiscals reflect a stronger economy and more fiscal flexibility, that takes pressure off monetary policy, and we therefore regard it as a positive for the NZD, which we expect to appreciate to 0.74 over the course of 2021.

Mechanically, fewer bonds on issue also means that there are now fewer bonds for the RBNZ to buy. Our calculations indicate that the RBNZ's indemnity cap will reach "just" $93bn by June 2022. That's clearly smaller than the RBNZ's $100bn LSAP programme. In our view, that is likely to lead the RBNZ to extend the LSAP (and the indemnity) to December 2022 (or later) at the February MPS. Based on new projections, we estimate the cap would be around $100bn by the end of 2022.

All else equal, that does imply a slower pace of purchases, but with issuance slowing too, that's no reason for the market to have a "taper tantrum". We estimate that the sustainable pace of purchases would fall to around $620m per week if the LSAP was extended by 6 months. But with two syndications due before June, if they collectively total $6bn, that leaves just $9.2bn to be funded over 22 weeks, implying tender issuance of just $420m per week. We would also argue that extending the LSAP by 6 months (or more) sends a dovish signal by essentially extending forward guidance.

Finally, it is worth noting that it is the MPC, not RBNZ staff, who choose the size of the LSAP programme, so we will not hear anything from them till February. The MPC has, however, delegated the authority to set the size and composition of weekly LSAP purchases to RBNZ staff, and in theory they could slow the pace of purchases to match the run rate of issuance in January and February. But with a syndication due in February, the odds of that are slim, and we would expect the January LSAP schedule to largely match that seen in recent weeks (ie. $800m of NZGBs and $20m of LGFA bonds).

The long and winding road

All up, changes to the Treasury's outlook were broadly in line with our expectations. But it's still early days when it comes to both the economic recovery and what might still be required from fiscal policy, particularly if community transmission was to rear its ugly head over the summer holiday period.

But eventually, once virus risks are contained and the economic recovery is looking more assured, there's a balance that will need to be struck between rebuilding fiscal buffers (ahead of the next inevitable crisis) and the desperate need to address some of New Zealand's long-running, but intensifying issues such as the housing crisis, inadequate infrastructure and increasing inequality. The problem is, the initial COVID response has resulted in such a significant deterioration in the Government's books that squeezing out just a little more spending could be problematic from a fiscal sustainability perspective. That's why it's so important that the Government look beyond the cheque book towards supply and regulatory reform to help address these issues. The Treasury's Briefing to the incoming Minister of Finance warns that:

> *Even with lower interest rates, the fiscal position will become unsustainable in the medium term if the costs of public services continue to increase at historical rates and/or revenue is not increased as a share of the economy. These pressures are driven by an ageing population and cost increases in health and education; they existed before COVID-19, but a smaller economy and higher debt have brought the challenges forward. Though measures to enhance productivity remain important, even under optimistic scenarios higher economic growth alone will be insufficient to secure long-term fiscal sustainability. Strong management of revenue and expenses is required.*

Ultimately, we think the Government will need to firm up some of its long-term objectives within its Fiscal Strategy. These were understandably vague in May's Fiscal Strategy Report (released alongside Budget 2020), including the long-run objective for government debt:

> *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. Prudent levels of net core Crown debt are those that are within sustainable limits and provide a buffer for future shocks.*

Further guidance on what the Government deems "prudent" and "sustainable", but also the timeframe they are aiming to achieve this, will provide transparency to tax payers, reassurance to ratings agencies, and a benchmark for ongoing assessment of fiscal headroom as the economic and tax forecasts inevitably ebb and flow.

Previous communications from the Treasury (which pre-date the COVID crisis) suggest the appropriate "upper limit" for net core Crown debt is around 50-60% of GDP when responding to a significant crisis, and that around 30% of GDP is a reasonable prudent ratio during good times. That's a level that many advanced economies could only dream about. But there are some very good reasons why New Zealand governments should maintain relatively low government debt on average, including relatively high private sector debt, a significant net external liability position, and our vulnerability to national disasters. Nonetheless, in the post-COVID world, to the extent that funding costs are expected to remain low for longer, it is possible that the Treasury tweak their views here, perhaps considering 35% of GDP to be the "new prudent". Time will tell. However, based on current forecasts, that will still be difficult to achieve in a reasonable time horizon without raising taxes or putting existing outgoings under the microscope.

Stepping back, this is all pointing to an economy that's pretty close to being weaned off sugar-hit fiscal stimulus (such as the wage subsidy) and being put on a diet that's much lower GI (chiefly infrastructure spending). In fact, we're now pretty close to the point where fiscal policy will turn from being a direct support to growth to becoming a drag. That's not to say fiscal policy will no longer continue to support the *level* of activity – it will – but a persistent positive contribution to *growth* via tax and spending settings is just not feasible without persistently widening deficits and exploding debt. This isn't a critique of fiscal policy; this is just the reality of the Government's budget constraint. Next year's Budget Policy Statement (which is required by 31 March 2021, but we're guessing will likely be in February) could be very interesting indeed. This may even include a hint on how the key fiscal indicators within the Fiscal Strategy might be tweaked.

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