ANZ Research

2020 Half-Year Economic & Fiscal Update Preview

10 December 2020

Contact

Miles Workman for more details.

Glass Half-Full Economic and Fiscal Update

Summary

- Economic developments, chiefly housing-driven domestic demand, are likely to see the Treasury upgrade their near-term economic outlook.
- That's likely to see the fiscals upgraded – at least for the current fiscal year. Government financial statements to October show the fiscals have not deteriorated as much as the Treasury thought they would at the Pre-election Update.
- But caution around the medium-term outlook is still warranted. While the better starting point will probably dovetail into a slightly better medium-term economic outlook, we're not convinced it'll be large enough to change the overall narrative that headwinds are expected to persist while fiscal stimulus is poised to wane.
- Despite recent positive vaccine news, we think it's still too early to take the $14bn COVID-19 contingency out of the fiscal outlook. But the balance of risks favours this happening eventually – perhaps this will happen gradually or is a story for Budget 2021 or the 2021 Half-Year Update. The Minister of Finance has repeatedly said that if these funds are not needed, they will not be borrowed. That suggests fiscal prudence will win out and it won't get re-purposed later. But never say never.
- A better fiscal starting point and outlook should see bond issuance guidance downgraded. We expect a cumulative downgrade of $20bn to June 2024. Then, depending on vaccine developments, economic momentum and fiscal policy decisions, further downgrades to guidance appear likely at next year's Economic and Fiscal Updates, with the next possible contender being Budget 2021 in May.
- It's our expectation that the RBNZ will adjust the LSAP in line with bond issuance. While we see no need for the RBNZ to lower its $100bn LSAP guidance, fewer bonds on issue could see the purchase term extended at the February MPS. That'll require an extension of the current indemnity.
- Turning to policy, Labour's 2020 election manifesto suggests their majority win isn't a game changer for the overall fiscal stance – it's more of a 'steady as she goes' situation. And on face value that suggests fiscal policy decisions won't be a huge driver of changes to the bond programme – at least at this update.
- Since the onset of this crisis, the Government's Fiscal Strategy has been to "run operating deficits in the short term to fight COVID-19, cushion its impact and position New Zealand for recovery". Understandably, the Fiscal Strategy has been pretty light on details around eventual consolidation (how and when it intends to return to surplus and return debt to "prudent" levels). And with the usual accompanying Budget Policy Statement delayed, we'll just have to wait until next year (before March 31, but probably earlier) before we know how the Government plans to broadly manage the books through the recovery. Overall, we expect fiscal prudence and consolidation to get a lot more air time once the health part of this crisis is dealt with and the economic recovery is looking more assured. But at the same time, there's a lot of additional spending that could be justified.

Key points

The Treasury will open up the Government's books for the third and final time in 2020 on 16 December.

The near-term outlook is less dire than initially feared…

There's still significant uncertainty surrounding the economic and fiscal outlook, but it's fair to say things are looking better than the Treasury (and pretty much every other forecaster, including us) were expecting back in May's Budget and even September's Pre-election Update. The Half-Year Update should include an upgrade to the economic outlook, at least in the near term.

In part, the better-than-expected economic dataflow of late speaks to the efficacy of both fiscal and monetary policy. No one was expecting the housing market to get this hot earlier in the year. Combined with the wage subsidy, so far this has done an amazing job of filling the hole in the economy brought about by lockdowns, a closed border, and the weak global backdrop – albeit while causing other issues and exacerbating some longer-term risks.

We also shouldn't overlook the importance of New Zealand's successful management of the health aspect of this crisis. Unlike in most countries, many households and businesses have been able to mostly return to business as usual. Meanwhile, however, a small portion of the economy continues to really feel the pain. We will never know precisely how many jobs and businesses successful virus containment has saved, but we think it's been significant in terms of preventing the downturn from rapidly broadening across industries.

A better-than-expected starting point for the economy has also been reflected in the Government's monthly financial statements, with core Crown residual cash coming in $4.0bn ahead of the Pre-election forecast in the four months to October. And it's been pretty broad-based across fiscal indicators, with better revenue and expenses leading to smaller-than-expected deficits and lower-than-expected debt.

That said, 2021 is still shaping up to be a tough year for many, with growth likely to recoil a touch as housing momentum peters out and the lost summer of international tourism bites (peak international tourism typically happens in Q1). There are also significant COVID-induced headwinds in the Northern Hemisphere that could create a bit of a growth wobble between now and the implementation of large-scale inoculations. So there is good reason for the Treasury's forecasts to maintain a healthy degree of caution.

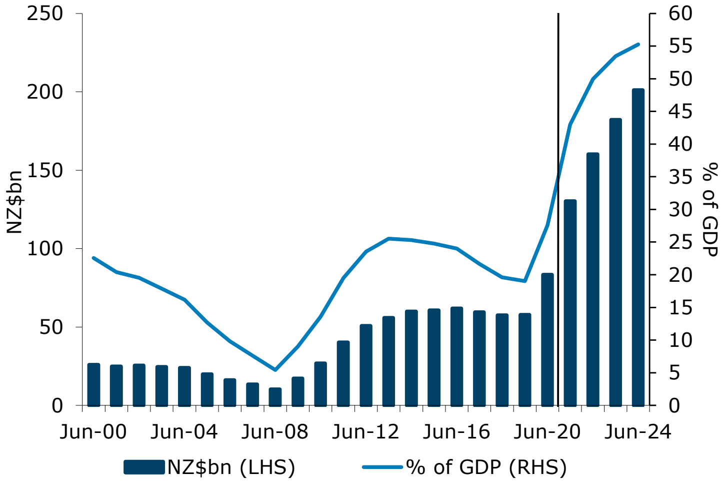
But importantly, the risk of the Government needing the $14bn it has set aside to respond to COVID-19 resurgence appears to be reducing. We're not out of the woods yet, so this is likely to stay in the fiscals for now. But provided another Alert Level 4 lockdown is avoided, the Minister of Finance could be making good on his word that if these funds are not needed, they will not be borrowed. At that point, the Treasury accountants will take this out of the fiscal outlook and that will translate to a smaller bond programme (all else equal). We think this change could happen as early as next year, but it could also happen gradually – starting from next week!

…with caution still warranted around the medium-term outlook

With so much uncertainty around virus and vaccine developments, the sustainability of recent housing momentum, seasonal impacts of the crisis, the economy's broader economic resilience, and the global outlook, we think the Treasury will maintain a healthy dose of caution in its medium-term economic outlook. So while the stronger starting point will probably be worth a little bit from a momentum perspective, we think the Treasury (just like the RBNZ, and us) are well aware that this doesn't change the fact that headwinds remain and the data (including the Q3 bounce in GDP) is volatile. In fact, it's worth highlighting that a strong rebound in GDP in Q3 increases the odds of weak (or even negative) growth in Q4 and early 2021. And that implies increased odds of a double-dip recession. However, this doesn't necessarily imply a significantly different medium-term outlook for the level of GDP – rather, it just reflects the possibility that the near-term data could be more volatile than expected.

For the fiscals, this picture still lends itself to a moderate upgrade. OBEGAL deficits are likely to be narrower on average over the forecast horizon, with net core Crown debt peaking a little lower – we estimate peak net debt will be closer to 50% of GDP in 2023/24, compared to 55.3% of GDP at the Pre-election Update.

Figure 1. Net core Crown debt (PREFU forecast)



Source: The Treasury, ANZ Research

Fiscal policy to transition from sugar-rush to low GI

Provided further lockdowns are avoided, the days of sugar-hit fiscal support (such as the wage subsidy) appear to be behind us. That means fiscal policy's influence on the macro-economy is going to be a little more 'slow burn' from here, focused chiefly on infrastructure and addressing key supply constrains via RMA reform. But construction is one industry where capacity constraints (including labour) appear to be biting, and that's likely to dampen the stimulatory impact over the coming years.

Despite capital expenditure by Government being an extremely important driver for activity over the longer run, its impact on activity in the near term does tend to get overstated. Delays are an unfortunate reality that closed borders are only going to exacerbate (given the industry's dependence on imported labour and the time it takes to train workers).

But what's really important here is that the Government be absolutely relentless when it comes to addressing New Zealand's infrastructure deficit. It's going to take a long time and the benefits are going to accrue only slowly. But a very lengthy pipeline of planned projects is needed, and is owed to younger generations who are already inheriting some big burdens.

Stepping back, we're actually 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. And that's why it's so important that the Government focus on addressing key supply constraints such as the RMA. Delaying the 2021 minimum wage rise – and instead boosting incomes at the lower end of the spectrum though tax and transfer settings – would also make for a speedier recovery by keeping more people in work than otherwise, but the Government's stance here appears unlikely to change. At least the Flexi-wage scheme will provide some offset.

Fewer bonds on issue…

When it comes to bond issuance guidance there are lots of moving parts to consider – and many of them involve guessing the assumptions the Treasury will make. But we think the direction is pretty clear, and that NZ Debt Management will likely signal fewer bonds on issue over the coming years than they did at the Pre-Election Update. And depending on virus and economic developments, further downgrades to issuance guidance appear likely beyond next week's Half-Year Update (see Table 1).

Table 1. The many things influencing NZDM's bond issuance guidance

Influence on bond programme	Implication for HYEFU	Additional implication after HYEFU
Better economic and fiscal starting point	-$5bn for 2020/21. With around $30bn of issuance already completed this fiscal year, the hurdle to downgrade 20/21 more than this is pretty high as NZDM pursue stability in issuance.	No implication provided HYEFU guidance fully accounts for this.
Small upgrade to economic and fiscal outlook	Better-than-expected momentum in the fiscals could see 2021/22 guidance downgraded $5bn. Overall, an additional cumulative $5-15bn could be removed over the out years – it's difficult to gauge if this would be spread evenly.	No implications beyond HYEFU (assuming HYEFU forecasts are right). HYEFU will provide an updated benchmark to assess the risk of further changes to the outlook.
Successful virus containment means the $14bn COVID contingency is not needed.	We think the Treasury accountants will keep this in the fiscal outlook for now, but it was pretty front-loaded at PREFU ($7bn in 2020/21) so could be re-phased. We can't rule out a partial downgrade either.	Assuming no change at HYEFU, a cumulative impact of -$14bn from 2021/21.
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.	Small possibility this partially comes into play, but more likely to give NZDM confidence to "round down" than make material changes to their guidance at this stage.	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).	No immediate impact obvious. Broad fiscal policy settings are expected to be little changed. The increase to PAYE from 1 April 2021 is expected to bump up revenue by around $0.5bn p.a. That's margin-of-error magnitude, but another reason to "round down".	A big unknown with magnitude uncertain. Risks are skewed towards the Government spending more. But 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.	No implications for 2020/21 issuance as NZDM pursue stability. But could have a positive wave impact on the profile in the out years.	Similar story for future updates; not a game changer.
Treasury forecast assumptions, such as funding costs (interest rate) over the medium term, and the maturity profile.	Could be worth up to $1-2bn in a single fiscal year from 2021/22.	Same risk as at HYEFU.
Changes to Treasury bill issuance	T-bills could be wound down slightly ($1-2bn pa) in the interest of keeping the bond programme stable.	Same risk as at HYEFU.

In a nutshell, there are three key influences on bond issuance guidance:

- economic and fiscal developments (including automatic stabilisers);
- discretionary fiscal policy decisions; and
- Treasury/NZDM decisions and assumptions.

Overall, we expect to see a modest downgrade to bond issuance guidance next week, of perhaps $5bn in each fiscal year to 2023/24. But as Table 1 suggests, risks are skewed towards further downgrades in the future. We've assumed issuance guidance of $25bn for the additional forecast year (2024/25), given the skew of risks and benefits of signalling a wind down.

Table 2. Bond issuance guidance

	Jun-21	Jun-22	Jun-23	Jun-24	Jun-25
Pre-election Update	50	35	35	35	N/A
Half-Year Update (ANZ expectations)	45	30	30	30	25

NZDM are also likely to signal an intention to bring a new bond to market, via syndication, in the second half of the fiscal year. As we have noted in other research, we expect a new 2051 nominal bond to be launched around the time that the May 2021 bond matures. Such a maturity would match that of the longest ACGB, and extend the NZGB curve to 30 years, taking it beyond the longest non-government bond on issue in the New Zealand market (the Auckland Council 2050 bond).

Treasury-bill issuance guidance was set at $10bn pa at the Pre-election Update. We think the directional bias here is also slightly skewed to a lower profile, but that too could be a story for another day.

...means fewer for the RBNZ to buy

Fewer Government bonds on issue mean there will be less in market for the RBNZ to buy. We expect the co-movement between bond issuance and the LSAP to be pretty mechanical from here. But lower issuance is likely to bring into question the feasibility of the RBNZ purchasing up to $100bn under their current indemnity, which expires at the end of August 2022 and covers up to 60% of bonds on issue. Rather than reducing the signalled amount (and thereby risk a tightening in financial conditions) we expect the RBNZ is more likely to seek an extension to the indemnity to December 2022, or perhaps longer. In our view, this would most likely occur at the February MPS, and could be used as a dovish signal, with stimulus through the LSAP to be provided for longer, rather than being pared back with bond issuance.

A long road ahead

All up, we expect to see another Economic and Fiscal Update that's still riddled with significant uncertainty around the outlook, and that implies the key messaging will be broadly unchanged. Central forecasts are helpful when it comes to gauging the evolution of the economy relative to previous expectations, but it's worth bearing in mind the Big Picture: fiscal policy has done a great job of insulating the economy from this crisis, but that's resulted in a significant deterioration in the books – a deterioration that before too long warrants a serious discussion about fiscal consolidation and who should wear the long-term costs. Next year's Budget Policy Statement should have more to say about that.

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