

# NZ Pre-election Economic & Fiscal Update

16 September 2020



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## Contact

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## Big picture unchanged: colossal shock, colossal deficits

### Summary

- As expected, the Treasury has dovetailed a stronger starting point for the economy into a weaker medium-term view.
- At a high level, changes to the fiscal outlook are immaterial. Substantial (but narrowing) deficits are forecast over the next four years and net core Crown debt as a share of the economy is expected to peak a little higher (but with the level pretty close to Budget forecasts).
- New Zealand Debt Management have downgraded their bond issuance guidance slightly, with a near-term downgrade more than offsetting expectations for higher issuance in the 2024 fiscal year.

### Key points

The Treasury's Pre-election Economic and Fiscal Update shows the Government's books are expected to be in pretty similar shape to the picture outlined in the May Budget, but the near term is a touch stronger and the final forecast year (2024) a touch weaker. This is underpinned by an economic outlook that isn't too dissimilar to our own. Importantly, given the degree of uncertainty around virus developments, the fiscal policy response, and the economic outlook more broadly, we'd classify these forecast changes as more cosmetic than meaningful. The absolute story remains unchanged: a colossal deterioration in the fiscal position is underway and economic headwinds will be with us for a long while yet.

### A better starting point for the economic outlook, but a downgrade to the medium term

As expected, the Treasury has dovetailed a stronger starting point for the economy into a slightly weaker medium-term outlook.

Q2 GDP will be published tomorrow at 10:45am. The Treasury's outlook has a 16% contraction pencilled in – a significant improvement from -23.5% at Budget, and not too far from our [expectation of -12%](#). But Q2 is old news. More importantly, the Treasury have updated a number of forecast assumptions, downgrading their expectation for potential GDP, reflecting a lower capital stock (owing to weak business investment), a smaller labour force (reflecting weaker net migration and displaced worker effects) and weaker productivity. A weaker outlook for the global economy has also weighed. These are all sensible adjustments in our view, and have seen the Treasury's central forecast land pretty close to ours on average (figure 1, over).

The Treasury have now incorporated more persistent impacts of this crisis on the labour market, with a higher unemployment rate over the medium term than expected at Budget time. The Treasury expect the unemployment rate to peak a little lower than we do (figure 2), but on the other hand expect it to remain higher for longer. Set against the degree of forecast uncertainty currently (and measurement issues that made the signal in Q2's very optimistic unemployment read of 4.0% virtually meaningless), this is neither here nor there. We know these data are far from perfect.

Figure 1. GDP

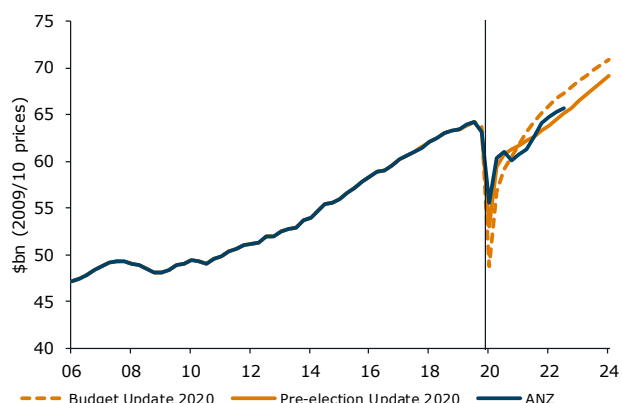


Figure 2. Unemployment rate



Source: The Treasury, Stats NZ ANZ Research

The Treasury's 90-day rate outlook implies they expect the OCR will be taken to broadly zero. This is at odds with [our view](#) that the RBNZ will cut the OCR by 50bp to -0.25% in April 2021. CPI inflation is expected to remain below the RBNZ's 2% target midpoint over the entire forecast horizon, but it gets close (1.9%) in the 2024 fiscal year.

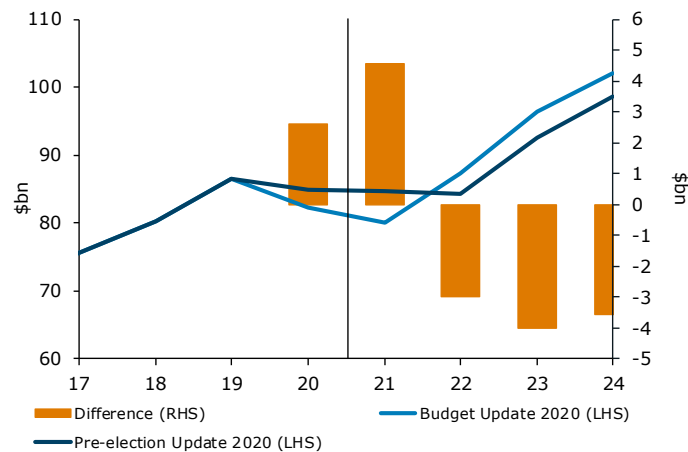
An outlook for weaker activity and subdued price pressures has seen the Treasury's outlook for nominal GDP downgraded by \$13 billion over the forecast horizon – and that implies a weaker tax take.

Overall, we think the Treasury's central forecasts are well within the range of plausible outcomes. The initial lockdown (and now, renewed measures) is just one part of this shock. There are still the persistent impacts of a closed border ([which will be felt much more acutely in the months ahead when net visitor arrivals would normally be lifting rapidly](#)), and the very sharp and synchronised global slowdown that will impact export earnings, investment and confidence more broadly. Combine this with the fact that the economy is yet to be weaned off an unprecedented amount of temporary support measures (such as the wage subsidy and mortgage relief), and the downgrade to the Treasury's medium-term outlook appear quite justified. Given the seasonality of the New Zealand economy (high activity in the summer months though both international tourism and housing) the real test for New Zealand's economic resilience is fast approaching.

### Fiscal outlook much the same, but a few timing changes

The Treasury has been able to incorporate more detail into the fiscals since the May Budget, but the aggregate debt and deficit forecasts aren't all that different. While the expected cost associated with the COVID response has been downgraded (by \$4bn overall) the downgrade to the medium-term economic outlook is expected to keep the pressure on the Government's books. Overall, changes to the fiscal outlook are immaterial compared to the degree of forecast uncertainty that surrounds them.

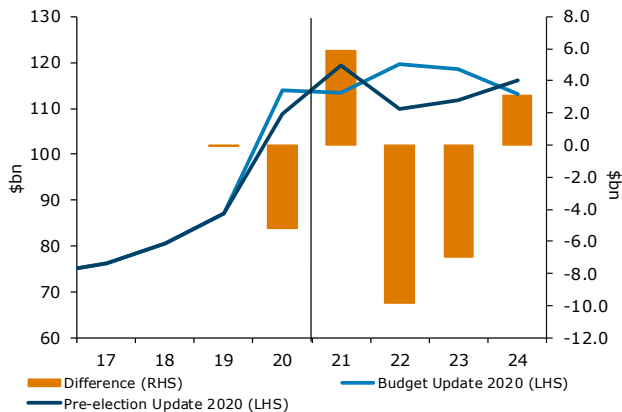
**Figure 3. Change in core Crown tax revenue**



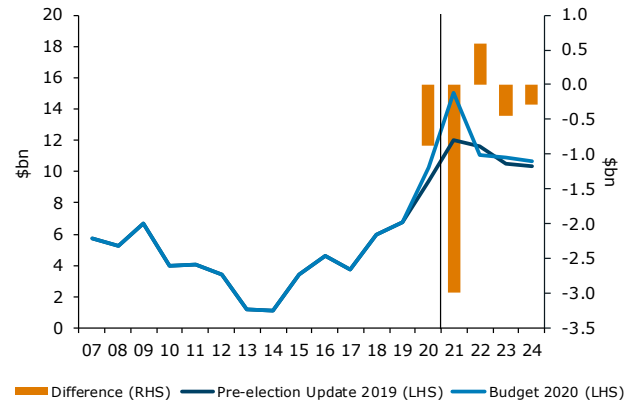
Source: The Treasury

The weaker medium-term economic outlook sees core Crown tax revenue lower by around \$6bn over the forecast horizon compared to Budget (figure 3). However, spending is also expected to be lower overall (figure 4), providing an offset. As expected, the \$14bn unallocated portion of the COVID Response and Recovery Fund (CRRF) is assumed to be fully allocated over the forecast horizon.

**Figure 4. Core Crown expenses**



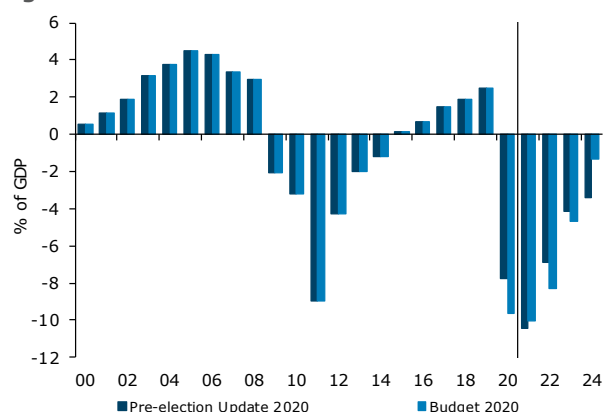
**Figure 5. Net core Crown capital cash flows**



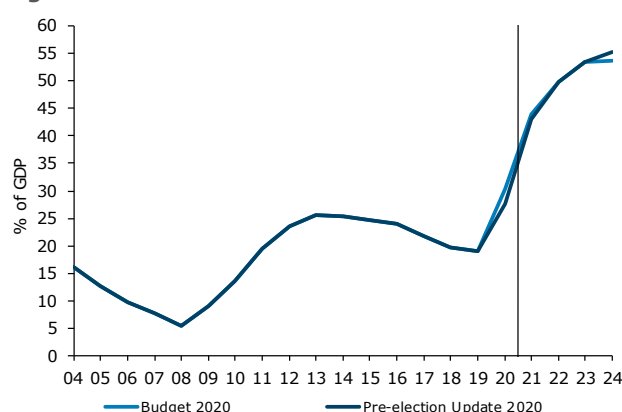
Source: The Treasury

Forecast OBEGAL deficits are expected to be a little narrower as a share of the economy in the near term, but wider by the 2024 fiscal year (figure 6). Net core Crown debt is forecast to peak at 55.3% of GDP in the 2024 fiscal year (figure 7), versus 53.6% in 2024 in the Budget. This forecast tweak is immaterial in our view given what's yet to come to pass over the next four years.

**Figure 6. Total Crown OBEGAL**



**Figure 7. Net core Crown debt**



Source: The Treasury

Total borrowings are forecast to grow from \$110.2 billion in 2019 to \$286.6 billion in 2024 (a decent downgrade versus \$317.3 billion in 2024 at Budget). 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 few tweaks to the bond programme

New Zealand Debt Management (NZDM) have downgraded their bond issuance guidance by \$10 billion over the 4-year forecast horizon, with near-term guidance downgraded (2021 fiscal year down \$10bn to \$50bn, and 2022 down \$5bn to \$35bn) and a small upgrade to the 2024 fiscal year (up \$5bn to \$35bn).

This new profile reflects a number of factors, including lower-than-expected COVID-related costs incurred to date and more success in earlier syndications than previously expected, a small downgrade to funding requirements over the next four years as a whole, lower expected interest rates over the forecast horizon, and at the margin, a shift towards longer-dated issuance (requiring less debt to be rolled over during the forecast period). The Treasury still expects to hold a suitably large financial buffer over the forecast horizon, which at first blush appears largely unchanged from the Budget. T-bill issuance guidance is unchanged from Budget.

**Table 1. Bond issuance guidance**

	Jun-20 (actual)	Jun-21	Jun-22	Jun-23	Jun-24	Forecast total
Budget Update	25	60	40	35	30	165
Pre-election Update	29	50	35	35	35	155

The \$10bn reduction in this year's bond tender programme was well received by the market and the prospect of less issuance in coming quarters is likely to drive the curve lower and flatter in coming days. We assume there will be 37 more tenders over the remainder of the fiscal year beyond this month, and the \$10bn reduction in supply equates to around \$270m less issuance per week. However, NZDM have also flagged an intention to offer a May 2028 bond before the end of the year. If that was, say, a \$5bn issue and that week's tender is cancelled as per normal protocol, that would reduce the weekly required run rate of issuance by just over \$400m, paving the way for tenders

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of closer to \$600m than \$1bn like we have been seeing. We think that's worth more than the 1-2bps we have seen so far, especially at the long end. NZDM's projections now also show an intention to issue just \$12.5bn of 2024s before they mature, down from \$15.4bn at the Budget. The 2023s line is expected to reach \$15.7bn before maturity, which means next month is likely to be the last month of issuance for it, as we have flagged in earlier research. In a nutshell then, this is good news for the bond market.

### **A long road ahead**

All up, the Treasury's PREFU contained few surprises – which is how these things should be. Now, the focus turns squarely on the upcoming election. But other than providing a near-term distraction, we don't think the election result will lead to a material change in fiscal settings at a macro level (regardless of what the Government looks like on the other side). The incoming Government will be constrained by some notion of an upper limit for the debt ratio, and of course will face difficulties implementing the already lengthy list of initiatives currently in the pipeline (particularly on the infrastructure side).

[Previous communications from the Treasury](#) suggest the appropriate "upper limit" for net core Crown debt is around 50-60% of GDP when responding to a significant crisis (and around 30% of GDP during good times). The Treasury's latest forecasts show net core Crown debt comfortably within this range (lifting to 55.3% of GDP by 2024). That's a level that many advanced economies would be over the moon about, but there are some very good reasons why New Zealand governments should maintain relatively low government debt on average (such as relatively high private sector debt and our vulnerability to national disasters).

While not so much a story for the here and now (there is a crisis to deal with first), fiscal consolidation will be needed to return debt to prudent levels at some point. Growing the economy out of the debt position will naturally become part of the consolidation strategy, and the more the Government does today to boost the productive capacity of the economy tomorrow, the easier that will be (eg by addressing the infrastructure deficit). But this won't be sufficient to see debt returned to prudent levels over a reasonable time horizon (ie before the next big economic shock comes along). Higher taxes or fewer government services than otherwise are also likely to be required at some point. And the debate over who should cover this cost is only poised to intensify over the years ahead.

But now is not the time for austerity. If there are good (targeted, temporary, and timely) policy options available, this crisis justifies their pursuit. Changes to regulatory settings ([such as RMA and labour market regulation reform](#)) could also go a long way, providing a powerful boost to activity while limiting the fiscal burden on future tax payers. There's certainly scope in the PREFU forecasts and on the regulatory front for fiscal policy to go further in supporting the recovery. But for fiscal stimulus to really be effective, virus risks must first be contained.



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