NZ Half-Year Economic & Fiscal Update 2021

15 December 2021

Contact

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Wind change

Summary

- As expected, the Treasury has added some oomph to its economic outlook. And that's expected to translate into a much better fiscal outlook.
- Despite the Government adding more discretionary spending to the outlook, net debt as a share of GDP is expected to peak lower than previously.
- The better outlook combined with an intention to run down their liquidity buffer has allowed New Zealand Debt Management to significantly reduce signalled bond supply.
- The Government's broad Fiscal Strategy around debt and the operating balance (outlined in the Budget Policy Statement) is unchanged from Budget.
- Stepping back, there are now very good cyclical and structural arguments against loosening the fiscal purse strings any further. But there are also people in desperate need of support. It'll be a tough gig getting the balance right.

Far better starting point – but Omicron looms large

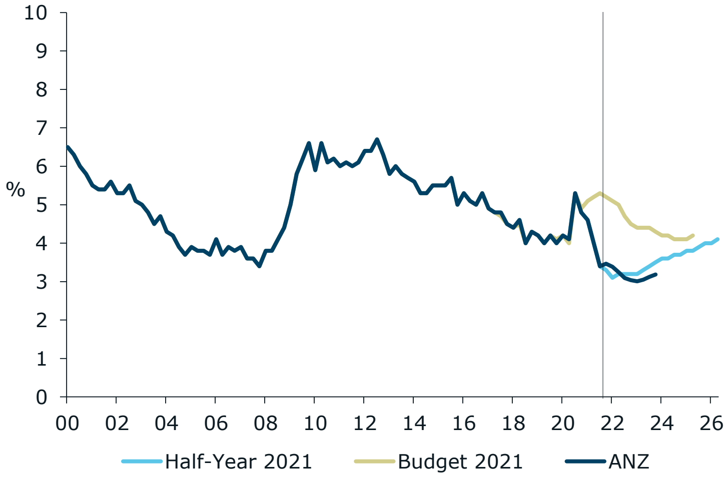
The economy is in a strange place right now – we've just come to the other side of yet another costly lockdown, which has hit some businesses hard, and cost the tax payer a fortune in much-needed fiscal support. But at the same time, the starting point (looking through GDP volatility) is far stronger and more inflationary than anyone predicted back in May, when Budget 2021 was published. For the Government's books, that translates into a decent lift in forecast tax revenue, which supports a longer-term reduction in the ratio of net debt to nominal GDP, despite the lift in discretionary spending. Unfortunately, we're far from leaving COVID behind, with the latest Omicron variant seeing even highly vaccinated countries re-imposing restrictions. So while the economic outlook is undoubtedly stronger than in mid-2021, COVID continues to cast a long shadow.

In terms of the near-term outlook, the Treasury, like us, expect that the New Zealand economy has weathered the latest lockdown better than in 2020. They are forecasting that GDP fell about 6% q/q in Q3, and will rapidly rebound over the next couple of quarters. Given that the forecasts were finalised on 10th November, they won't have seen some of the surprising strength in recent partial GDP indicators (which mean we're forecasting 'only' a 4.5% q/q decline). But the story is the same – the economy has a strong starting point, and should recover fully from the Delta lockdown.

Key drivers of growth identified over the next year include pent-up demand from lockdown, strong building activity, and the Traffic Light System (TLS) enabling more economic activity to take place than under the more restrictive Alert Levels. We'd add a robust labour market to that list.

A key development since Budget 2021 has been the unprecedented speed at which the labour market has tightened. The unemployment rate has fallen to a joint-record low of 3.4%, despite also record-high labour force participation. That's far better than anyone was expecting back in May – and is the feather in the cap of New Zealand's economic recovery from COVID (figure 1).

Figure 1. Unemployment rate

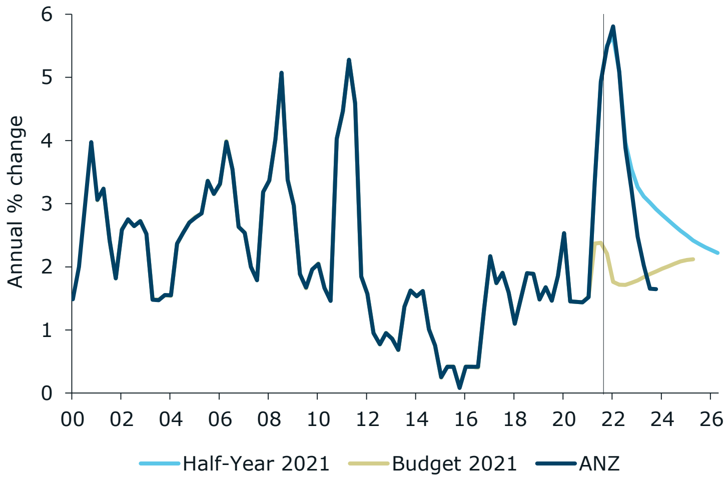


Source: The Treasury, Stats NZ, ANZ Research

Broadly consistent with our view, the Treasury are forecasting that unemployment will keep declining, reaching a low of 3.1% in Q1 next year, before rising towards Treasury's 4.25% NAIRU estimate in the later years of the projection. The tight labour market is feeding into Treasury forecasts that hourly earnings growth will accelerate to a peak of 4.6% by the end of 2023, before decelerating slightly to 4.2% by 2026.

Unfortunately, as the economy has roared ahead, inflation has also surged well above the RBNZ's target range of 1-3%. Treasury are now expecting inflation will rise to a peak of 5.6% y/y in Q1 2022, before easing to 2.2% by 2026. That's a much slower decline in inflation pressures than we are expecting. The Treasury's forecasts also imply a more-contractionary level of monetary policy than ours, with the 90-day interest rate picked to rise to a peak of 3.1% over the projection – broadly consistent with the RBNZ's November conditional OCR forecast endpoint of 2.61% in 2024. Given the scope for nasty surprises, we think the RBNZ will be doing well to get the OCR to even our lower endpoint assumption of 2%.

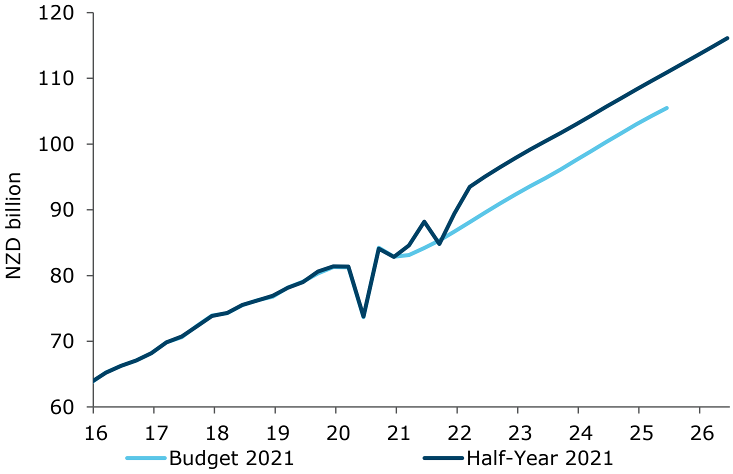
Figure 2. CPI inflation



Source: The Treasury, Stats NZ, ANZ Research

All up, Treasury's economic projections show a stronger outlook for economic activity, and this, combined with surging inflation, has seen the nominal GDP forecast boosted by a sizeable $78bn out to June 2025 (figure 2). That means despite increased spending on the current lockdown, the Government has more fiscal headroom than expected in Budget 2021 due to a significantly higher expected tax take.

Figure 3. Nominal GDP forecast



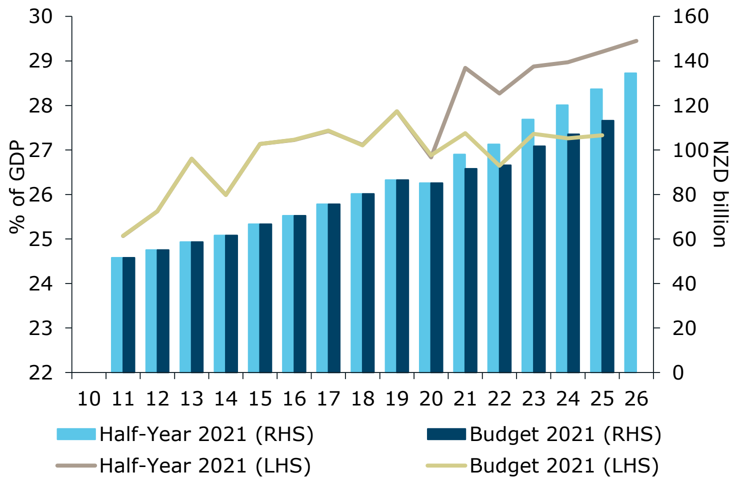
Source: The Treasury, Stats NZ

Fiscals improve, despite Delta

The Delta outbreak has been costly – with the Government topping up the COVID Response and Recovery Fund (CRRF) by $7bn and making an additional $3bn available. In total, $64.8bn of the total CRRF has been allocated, with $4.3bn currently unallocated. But that's a 2021 story (touch wood) – and stronger nominal GDP growth over the medium term means the fiscal outlook is looking considerably rosier.

Stronger nominal GDP growth has resulted in a total $54.9bn bump in expected tax revenue out to June 2025, compared with Budget 2021. That gives the Government considerably more flexibility to increase spending while keeping the fiscal indicators moving in the right direction.

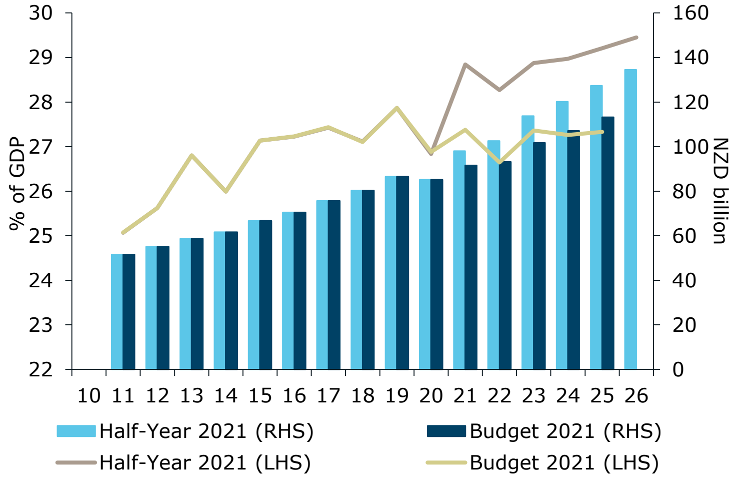
Figure 4. Core Crown tax revenue



Source: The Treasury

Core Crown expenses are up by an additional $29.4bn to June 2025, compared with what was planned in Budget 2021. Increased spending partly reflects the near-term impact of the Delta variant (wage subsidy and resurgence support payments), as well as increases in New Zealand superannuation due to rising wages, and allowances for new spending in Budget 2022.

Figure 5. Core Crown expenses



Source: The Treasury

The operating allowance for Budget 2022 has been set at a rather sizeable $6.0bn to fund significant reforms planned over the next few years (including reform of the health system and DHBs). The operating allowance for each subsequent Budget will be lower, at $4.0bn for Budget 2023, and $3.0bn each for the 2024 and 2025 Budgets. But, an increase to the operating allowance is permanent (ie without an explicit policy change, that extra $6bn in Budget 2022 makes it into the base line in every subsequent Budget). So the next few budgets worth of allowances add up to a significant rise in spending overall. The multi-year capital allowance has increased $4.0bn for the next four years, with the total unallocated allowance sitting at $9.8bn over the next four budgets.

Despite significantly increased spending, the stronger position for tax revenue means the outlooks for the OBEGAL deficit and net core Crown debt have both improved on Budget 2021 (which itself was a significant improvement on the previous forecast). The operating deficit is expected to increase to 5.7% of GDP in the 2022 fiscal year – reflecting the impact of fiscal support through lockdown. But beyond that, the OBEGAL is in surplus from 2024 onwards. Previously, the Government was expected to be in deficit over the entire projection period. Net core Crown debt is expected to peak at 40.1% of GDP in fiscal year 2023, before slowing significantly to 30.2% in the 2026 fiscal year. That's a marked improvement on Budget 2021, where debt was forecast to peak at 48% of GDP, and only fall to 43.6% in 2025. Of course, with the emergence of Omicron, the outlook for the economy is far from certain, and if tighter restrictions are once again required, that could see the economic outlook deteriorate.

Figure 6. Total Crown OBEGAL

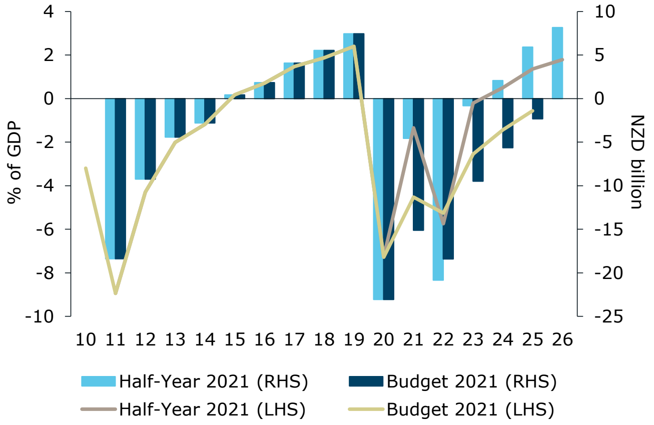
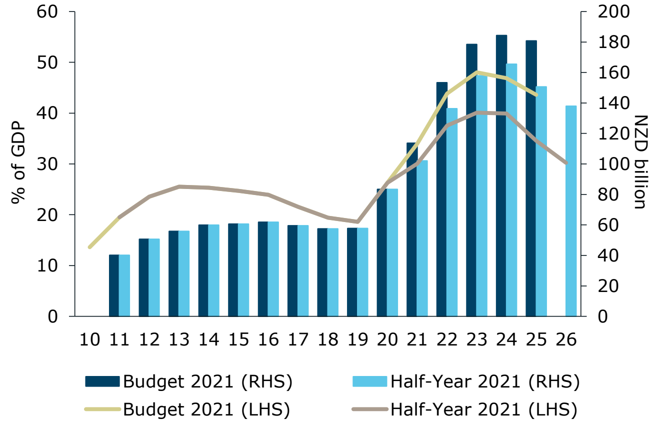


Figure 7. Net core Crown debt



Source: The Treasury

Plenty for the bond market to digest

It's a big day for markets. Bond issuance guidance was downgraded meaningfully, the second syndication that was pencilled in for the second half of the fiscal year has been canned, and NZDM provided guidance on its liquidity buffer strategy and its intentions regarding linker issuance.

New Zealand Debt Management (NZDM) has downgraded its bond issuance guidance by a stonking $31 billion over the 4-years to June 2025, including a $10bn downgrade to the current fiscal year which leaves around $4.8bn to go over the next 6 months (Table 1). Even accounting for the fact that this partially reflects an unwinding of liquid assets held by the Treasury (which we flagged as a key risk), this was a larger downgrade than expected. The big influence on this updated guidance: running down liquid assets and a much better economic and fiscal outlook.

Table 1. Issuance guidance

	Jun-22	Jun-23	Jun-24	Jun-25	Jun-26
Bonds					
2021 Half-Year Update	20	18	18	18	10
2021 Budget Update	30	25	25	25	NA
Treasury Bills					
2021 Half-Year Update	4	3	3	3	3
2021 Budget Update	5	4	4	4	NA

The market was asking for guidance on NZDM's liquidity buffer strategy, and NZDM delivered in spades! Not only will we see the pace of tender issuance drop sharply in the second half of the current fiscal year, but with the second syndication cancelled, near term bond supply will be significantly curtailed. With $14.7bn of issuance already complete and a $500m tender scheduled for tomorrow, that leaves just $4.8bn of bonds to be issued through to June 30th. That is consistent with weekly tenders of between $200m and $250m, depending on when tenders resume in 2022, which is well down on the $500m pace seen so far this year. NZDM will announce the January bond tender schedule at 8am tomorrow.

Treasury analysis suggests that $15bn is an appropriate liquid buffer to hold to safeguard against an adverse event. That's much higher than the $37.5bn or so sitting in the Crown Settlement Account (CSA) at the RBNZ as at October. However, NZDM always intended on running that down. Forecast cash and marketable securities held by the Treasury to June 2025 has seen a downgrade closer to $10bn by the end of the forecast period.

The Treasury note that the cash buffer would "comprise of cash and liquid, high-quality financial assets and is complemented by the Crown's overdraft facility at the RBNZ".

As the CSA is run down, Settlement Cash (SCL) will rise, putting more cash in the system. In simple terms, government spending will be financed from previously issued bonds, as opposed to via to-be-issued bonds, so there won't be any withdrawal of liquidity from the system, and in fact there will be an injection of liquidity. At the margin, that should put downward pressure on short term interest rates and bond yields.

Importantly, there was no mention of the RBNZ in this guidance. The RBNZ noted at the November MPS that "more details on how bond holdings will be reduced will be provided early next year". Based on the information released today, and the fact that the RBNZ can only run down its LSAP portfolio by allowing bonds to mature or by selling them to the Treasury, this suggest the RBNZ will deal with their bond holdings closer to when these bonds mature, potentially partially reinvesting the proceeds subject to economic conditions and desired SCL. NZDM have essentially elected to use the extra cash on hand to reduce upcoming bond programmes, rather than to help facilitate a run down in the RBNZ's LSAP portfolio.

With regard to linker issuance, NZDM said they will take a more flexible approach to issuance, noting they remain an important funding instrument. Details of upcoming IIB tenders will no longer feature on monthly tender schedules. Rather NZDM will conduct a survey of participants to gauge demand, and proceed more on an ad-hoc basis. A single-price auction mechanism (basically a Dutch auction process, as was used when the Linker 2016s were issued in the late 1990s) will be utilised, meaning that all bidders will be allotted bonds at the clearing price. New IIB issuance won't occur until March (at the earliest), so the market has plenty of time to digest the changes.

Today's announced reduction in bond supply does make the potential inclusion of NZGBs in the FTSE-Russell World Government Bond Index (WGBI) more of a line call, and a lot will depend on how NZD/USD fares between now and the sampling date in February. The criteria for inclusion are for a minimum market size (excluding bonds maturing within 1 year) of at least USD 50bn, EUR 40bn and JPY 5trn. Our analysis shows that the NZGBs already comfortably meet the EUR and JPY criteria, but are just shy of the USD criteria (at USD 49.4bn). But if we add in tomorrow's $500m tender and assume we see at least $500m of issuance in January and at around $1bn of issuance by the end of February, at the current exchange rate, that'd take NZGB outstandings to around USD 50.7bn. However, if NZD/USD falls below 0.6650, it'd be a line call.

Macroeconomic context and the Fiscal Strategy

There are now very strong cyclical (and structural) arguments in favour of the Government concentrating on rebuilding fiscal buffers for the next inevitable crisis (subject to COVID-19 developments).

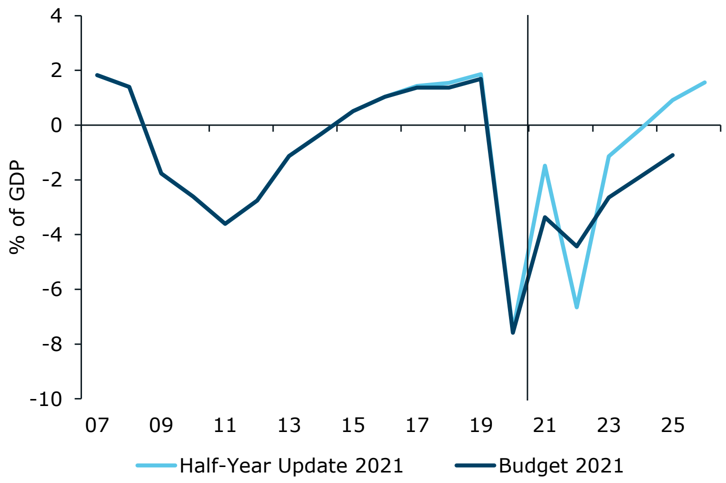
On the cyclical side, we, the RBNZ, and the Treasury are forecasting a positive output gap, meaning spare capacity in the economy is scarce and that's resulting in strong inflation pressures. For many, inflation is outpacing wage growth, meaning if you're not working longer hours you're going backwards. Further, high rates of inflation tend to hurt poorer people more, meaning some of the benefit of high fiscal outgoings is being offset. We're certainly not saying the Government should stop helping those in need, but we are highlighting that the economic landscape has changed drastically over the past year or so, and that biting capacity constraints could mean a regrettably high proportion of current and additional spending plans goes up in inflation smoke rather than real progress against goals.

Another factor to consider is that all else equal, a capacity-constrained economy (as unanimously forecast) brings forward the appropriate time for fiscal consolidation. If the Government is not rebuilding fiscal buffers during the peak of the cycle, they will have less ammunition at the bottom.

One way to assess the appropriateness of fiscal settings with regards to the economic cycle is to look at the cyclically adjusted budget balance, stripping out cyclical revenues and expenses. A good rule of thumb for any Government is to run a structurally balanced budget (or even small structural surpluses) on average. That way, fiscal policy should have the ammo it needs to respond to downturns, but it can also safeguard against the real benefits of Government spending being eroded by inflation during the upturn.

The Treasury estimate that the Government will run cyclically adjusted deficits until 2024 (Figure 8) and that these will flip into surplus from 2025. That's a significant improvement from the Budget forecasts.

Figure 8. Cyclically adjusted balance



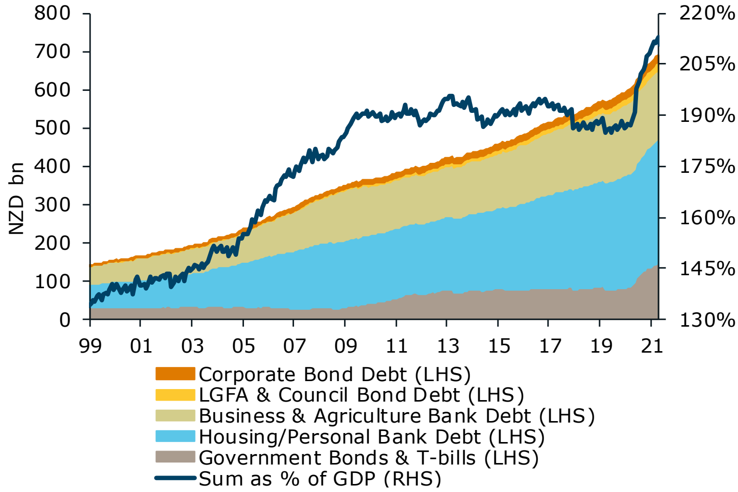
Source: The Treasury

However, "cyclically-adjusted deficits" are likely more severe than the above figure shows. That's because the output gap doesn't do a great job of accounting for the composition of the economy. An economy that's booming on the domestic front (as New Zealand currently is) will likely have more potent cyclical tax revenues than otherwise. Indeed, with the Treasury's forecast current account deficit expected to widen to around 6% of GDP, an estimate that accounts for the composition of the economic cycle would feature a worse outlook for structural deficits.

All up, the Government can point to the improved debt-to-GDP trajectory and say things are looking much better, but this is a far cry from consolidation via discretionary fiscal policy decisions. So far during the pandemic, the Government has lifted spending at every opportunity (ie every time the Treasury has forecast higher tax returns and a larger nominal economy). And while that was once appropriate (given expected economic conditions at the time), there has been a significant wind change over the past year or so, and Treasury's economic forecasts show that. Now, more government spending risks higher-than-otherwise inflation and interest rates. It's a tough gig, however. It's easy for the Government to get the cheque book out, but much harder to review existing spending promises and keep fiscal expansion contained. Further, some spending is really needed, so any macro-level review of fiscal settings still needs to start at the micro level.

On top of the cyclical position, there are other good reasons to put fiscal settings under the microscope. Households and the Government have taken on a lot of debt recently (figure 9). That debt will carry a lasting legacy, and leave us all exposed to higher interest rate risk. Add the costs of an aging population and climate change (which, alongside the housing crisis, are goliath challenges from an intergenerational inequality perspective), and it's easy to conclude that in the absence of some fiscal constraint today, taxes as a share of GDP can only go one way in the future: up!

Figure 9. New Zealand debt by sector



Source: Bloomberg, NZDM, ANZ Research

Regarding the Government's broad strategy around debt, the Government's short-term intentions and long-term objectives outlined in the Budget Policy Statement are unchanged from that published in February. The Government intends to "allow the level of net core Crown debt to rise in the short term to fight COVID-19, cushion its impact and position New Zealand for recovery." In the long term, the objective is "to stabilise net core Crown debt as a percentage of GDP by the mid-2020s and then reduce it as conditions permit (subject to any significant shocks)". The better-performing economy will certainly allow this to happen sooner than previously thought. Looking forward, increased economic certainty (touch wood) over the coming year or so should allow the Government to get a little more specific with its longer-run debt objective, possibly adding a range target of around 25-30% of GDP on average over the medium term.

The focus for Budget 2022 was hinted at, including:

1. Continuing to keep NZ safe from COVID-19;
2. Accelerating the recovery and rebuild from the impacts of COVID-19;
3. Laying the foundations for the future, including addressing key issues such as climate change, housing affordability, and child poverty.

The $6bn operating allowance signalled for Budget 2022 is large by historical standards. This, alongside the $4bn increase to the multi-year capital envelope, and $3.7bn (multi-year) newly-established Climate Emergency Response Fund, creates plenty of scope for some big spending announcements next year.

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