ANZ Research

2021 Half-Year Economic and Fiscal Update Preview

8 December 2021

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Contact

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Fiscal policy in a constrained economy

Summary

- The Treasury’s economic outlook is due for an upgrade, but with some fresh lockdown volatility to incorporate into the near term.
- A better outlook means more forecast tax revenue to pay for higher government spending. Net debt as a share of GDP should peak below that forecast at Budget.
- We think NZDM could shave their funding programme by around $15bn overall, but it could be more if they decide to run down liquid assets.
- The Government’s Budget Policy Statement may signal new fiscal indicators (operating and debt) that are not affected by unconventional monetary policy. These shouldn’t be a game changer for the overall fiscal strategy.
- Overall, the economy is looking overheated, with economic resource scarce and inflation everywhere. All else equal, this brings forward the appropriate time for Government debt consolidation. However, some households and businesses remain in desperate need of support.

The detail

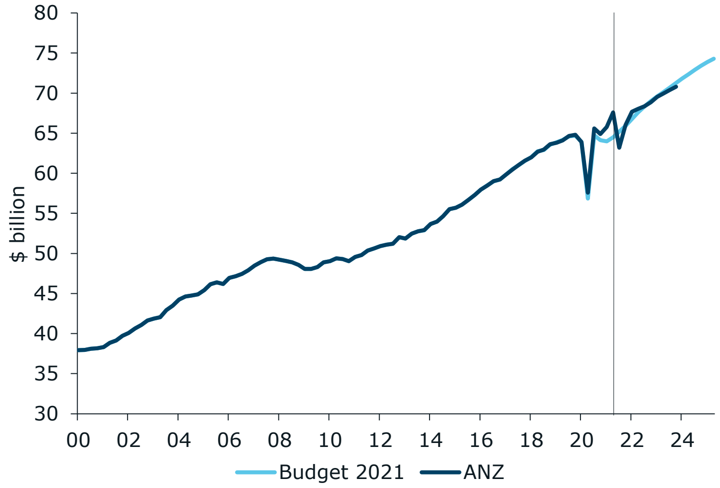
On 15 December, the Treasury will open up the Government’s books, showing the impacts of the Delta outbreak, a $7bn increase to the COVID Response and Recovery Fund (plus any other policy decisions), and a better-performing underlying economy (looking through lockdown volatility).

The Treasury’s Half-Year Economic and Fiscal Update (HYEFU)

The Treasury’s economic outlook has a lot of starting point surprises to incorporate:

- **Real GDP** growth was much stronger in Q2 than forecast at the Budget Update (BEFU), coming in at 2.8% q/q vs 0.8%. But Q3 growth will be much, much weaker than BEFU’s +1.1% forecast (keep an eye out for our Q3 GDP Preview later this week). However, looking through the volatility, our forecast suggests the overs and unders might roughly cancel out (figure 1). Like ours, the Treasury’s medium-term activity forecasts will be a function of the assumptions they make about the factors underpinning domestic and global supply and demand. And there’re a lot of assumptions to make: the evolutions of NZ housing, global growth and asset prices, how the tight labour market will interact with the broader economy, the path and efficacy of monetary and fiscal settings, the assumed path of net migration, the evolution of supply-chain bottlenecks and associated costs; the list goes on. Just how all these assumptions net out in their real GDP outlook really is anyone’s guess.

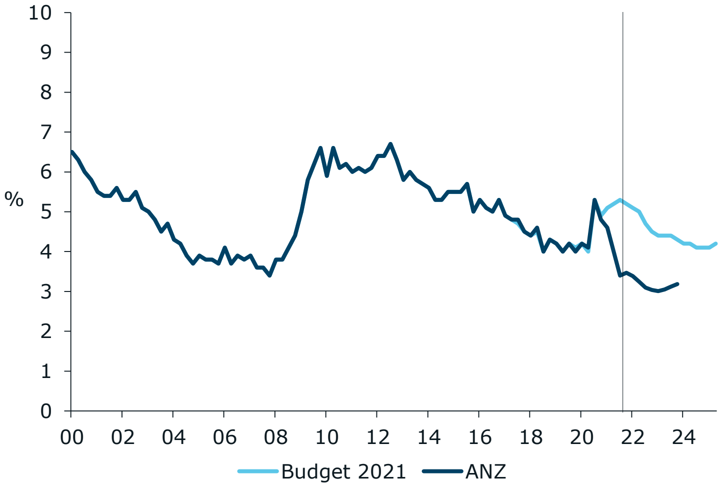
Figure 1. Real GDP forecast



Source: Stats NZ, ANZ Research, the Treasury

- But the very tight labour market should add confidence that the underlying demand pulse is strong. The unemployment rate hit 3.4% in Q3 vs BEFU's 5.3% forecast. Our expectation is that it will go as low as 3% (figure 2). Treasury may not go that far, but they'll certainly be revising their estimate down significantly.

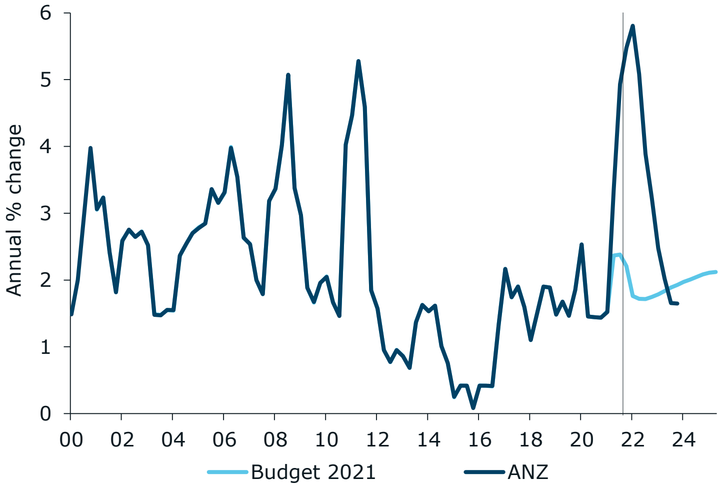
Figure 2. Unemployment rate



Source: Stats NZ, ANZ Research, the Treasury

- CPI inflation has been much stronger than the BEFU forecast – about twice as strong in fact, coming in at 4.9% y/y in Q3 vs BEFU's 2.4%. We think inflation will lift to around 6% before coming back to earth as tighter monetary policy weighs (figure 3). We should note that we had a similar forecast to the Treasury when the BEFU forecasts were released – things have moved very quickly over the past six months or so!

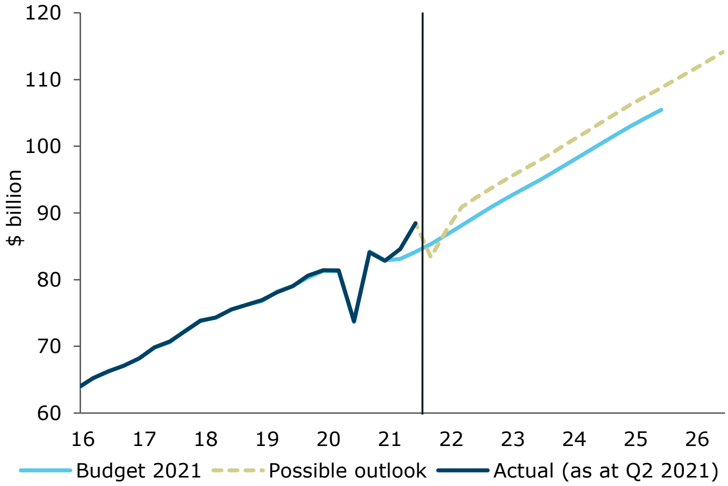
Figure 3. CPI inflation forecast



Source: Stats NZ, ANZ Research, the Treasury

- The nominal economy (which is what really matters for the fiscal outlook) came in at $88.5bn (sa) in Q2, more than $4bn higher than the BEFU forecast. Putting this together with the stronger labour market and price pressures, and provided the Treasury assume a similar rebound from lockdown to us, we'd expect to see a relatively solid upgrade to the outlook for the nominal economy. Out to June 2025 we estimate the Treasury will likely upgrade their forecast by a cumulative $40bn or so (figure 4).

Figure 4. Nominal GDP



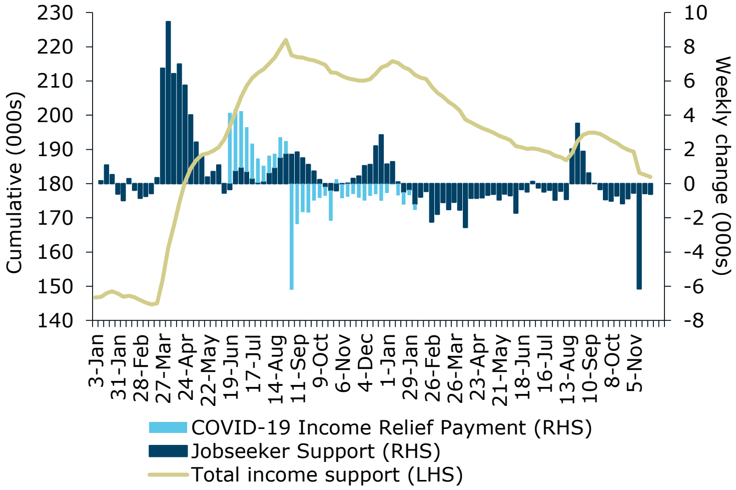
Source: Statistics NZ, The Treasury, ANZ Research

For tax revenue, we estimate the Treasury could easily add an additional $15bn over the forecast to June 2025 compared to BEFU. Indeed, the monthly statements of the Government for the four months to October 2021 show tax revenue was running about $2.5bn above forecast. Conversely, renewed wage subsidy and business support payments have pushed expenses almost $5bn above forecast for the current fiscal year. However, the near-term bump in expenses is a temporary phenomenon (it's lockdown-induced) while stronger revenues (to the extent that they reflect stronger economic momentum) should hopefully be more persistent.

As always, a better economic outlook provides an option for the Government to squeeze in a little more spending, while still showing an improvement in the trajectory for net core Crown debt as a share of GDP. We already know the Government has added another $7bn to the COVID Response and Recovery Fund (bringing it to a total of just under $70bn all up), but there could be more.

Without knowing what additional spending decisions the Government might make, it's hard to know where the key fiscal forecasts will land. But based on what we know, the likely upgrade to the tax take looks like it'll be larger than the lift in Government spending – particularly as higher discretionary spending will be at least partially offset by lower expected beneficiary payments. Indeed, reflecting the tight labour market, the number of people on government support is now lower than it was before COVID (figure 5).

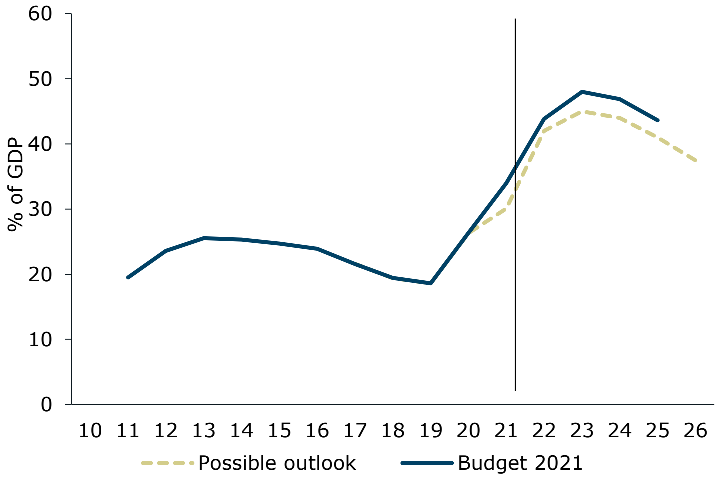
Figure 5. Jobseeker and COVID



Source: MSD, ANZ Research

All up, we expect a decent downgrade to the debt-to-GDP profile, with the new forecast peak likely to come in around 45% of GDP, give or take (figure 6). It's also possible that the Government introduces a new net debt indicator that excludes the impacts of unconventional monetary policy. If so, the new headline measure could peak even lower.

Figure 6. Net core Crown debt



Source: The Treasury, ANZ Research

Overall, a lower debt ratio is good news from a debt sustainability perspective, but it's important to note that this is not driven by discretionary policy decisions. Rather, it's the better economic and tax outlook driving the improvement, while the Government's increased spending plans are providing a partial offset. That's been the sequence of events in the COVID response to date: The Treasury upgrades the economic and tax outlook, and the Government lifts spending, but the debt ratio still peaks lower than before. That's not fiscal consolidation via discretionary fiscal policy decisions, it's consolidation by positive economic surprises. Nice while it lasts.

The Government's Budget Policy Statement

The Government will publish its Budget Policy Statement (BPS) alongside the Treasury's Half-Year Update. This document will outline the Government's policy goals (such as climate change, child poverty and housing affordability), and also include the Government's overall fiscal strategy, including its short-term intentions and long-term objectives around key fiscal indicators such as debt and the operating balance.

At Budget, the Treasury noted it was reviewing the appropriateness of the Government's fiscal indicators to ensure they are fit for purpose given the impacts of unconventional monetary policy. It's possible that this work has led (or will eventually lead) to the Government adopting new (or tweaked) fiscal indicators. Stripping out the impacts of unconventional monetary policy won't be a game changer from a broad fiscal strategy perspective, but this would likely flatter key indicators a bit.

Perhaps more important than how government debt is measured, is how fiscal decisions are made in the context of the overall economic cycle. As we outlined in our recent Quarterly Economic Outlook, the degree of capacity stretch in the economy has surprised us, the RBNZ and the Treasury on the upside over the past year or so. Economic resource is now very stretched and that's culminating in very strong inflation pressures. If the Government throws even more spending into the mix now, it may achieve little else than higher inflation and interest rates than otherwise.

However, pro-cyclical fiscal policy through a macroeconomic lens is one thing; helping households and businesses in desperate need of support is another.

And that's where things get tricky. While it's a fine balance, we can't shy away from the fact that capacity constraints are biting much earlier than expected, and that means a laser focus on the value of existing and new government spending initiatives in that context is required. Hopefully, this is something that gets further consideration in Budget 2022.

While the data are aligned in their message that increased fiscal spending would be a step towards pro-cyclical fiscal settings, we should remind ourselves just how quickly things can turn. Policy makers need to stand ready to respond to whatever comes next. It could be stagflation (in which case policy makers really need to take their foot off the inflation accelerator), or it could be a net demand shock (as global and domestic supply capacity recovers and demand wanes alongside the housing market). Of course things may also evolve exactly as we expect them to, but so far the post-COVID track record for forecast accuracy (by anyone) hasn't been too flash.

NZDM's (the Treasury's) bond programme

Our expectations as described above point to a downgrade to the Government's funding requirements, and therefore NZDM's bond issuance guidance. However, to get to this point we've had to guess where the Treasury's economic and tax forecasts might land, guess the likely change in government spending, and now we must guess NZDM's likely strategy:

- On its own, we think the better fiscal outlook could comfortably shave a cumulative $10-15bn off the Treasury's overall funding requirement to June 2025. But given COVID-related spending has been very strong in recent months, with core Crown residual cash tracking very close to the BEFU forecast in the four months to October, NZDM might not want to take much out of the current fiscal year.
- Then there's NZDM's sizable liquidity buffer to consider. As at October, the Crown settlement account was sitting at around $37.5bn. It was $3bn at the end of 2019. Part of this accumulation of liquid assets was intentional: in a pandemic you just don't know when the Government might need to deliver a multi-billion wage subsidy with no warning. But part of this reflects rigid bond issuance in the face of positive economic and fiscal surprises. At Budget, NZDM said they will provide further guidance on their strategy for the liquidity buffer at "subsequent EFUs". That's not a commitment to provide guidance next week, but it would be very disappointing if they don't, given the implications for the Settlement Cash Level and therefore cash markets. Given the starting point, we think NZDM could comfortably shave another $10bn or so off their funding programme, partially unwinding previous overfunding. If so, NZDM may prefer to line this up with bond maturities, with the first opportunity being the April 2023 NZGB. Coordination with the RBNZ is another option: the RBNZ owns Government bonds, while NZDM owns cash – seems a simple enough trade. However, the RBNZ noted at the November MPS that "more details on how bond holdings will be reduced will be provided early next year", so it would seem this option is probably off the table for now.
- A higher interest rate outlook since BEFU will add to the funding requirement. This, combined with a flexible approach to T-bill issuance, could make up the rounding difference, preventing a more material downgrade to the bond programme than we've pencilled in (table 1).

Given the degree of guessing involved, we've provided two possible scenarios: one where NZDM make very few changes to their liquidity buffer, and the other where they reduce this by $10bn. For both scenarios, we also consider NZDM's preference for stability in their issuance guidance. For the second scenario that's led us to shave $5bn from the remaining six months of the current fiscal year. In this scenario, we have also lowered our expectation for 2026 by $5bn to $15bn. We've continued to round to the nearest $5bn, but note the hurdle to NZDM switching their rounding to the nearest $2bn now feels pretty low.

Table 1. Bond issuance guidance

	Jun-22	Jun-23	Jun-24	Jun-25	Jun-26
2021 Budget Update	30	25	25	25	NA
2021 Half-Year Update (ANZ expectations with minimal change to liquidity buffer)	30	20	20	20	20
2021 Half-Year Update (ANZ expectations with reduced liquidity buffer)	25	20	20	20	15

At Budget, NZDM announced plans to introduce two new bonds this fiscal year, via syndication. The first was the 2051s, launched in September. No further details have been provided to date regarding the second, other than it will be a new bond (rather than the tap of an existing maturity). NZDM may provide details of the second bond at HYEFU (it could also be at a later tender schedule). We should add that the recently announced Green bond will be separate again, with NZDM flagging that as likely in fiscal 2022/23.

In any case, what matters is the chosen maturity. Our money is on a May 2047 bond, but May 2030 and May 2035 are also possibilities (all recent new bonds have had May maturities). We think a 2047 makes sense as it would align with Australia's second-longest bond, while also filling a gap in the NZGB curve. But we recognise that NZDM may not want to issue another ultra-long bond so soon after the 2051 (which was launched in September). A May 2030 would fill the first gap in the nominal curve, so is a contender, but we are mindful that the 2028/29 and 2030/31 fiscal years are already lumpy, with $14bn and $16.3bn maturing respectively. That being the case, NZDM may want to skip a maturity in the 2029/30 fiscal year so as to spread $30bn+ of refunding over three fiscal years. The next gap is in 2034, but with no Australian bonds maturing that fiscal year, it'd be an outlier. So that leaves a May 2035 as the next logical option (which would align closely with the Australian June 2035 bond).

In late August, NZDM stated that it would "be seeking views from market participants to inform issuance plans" for linkers, adding that its plans "will be communicated in future updates" and that "IIBs remain an important part of the bond portfolio". We are now more than three months on (during which time, ironically, interest in linkers has been piqued by the sharp rise in inflation) and we suspect NZDM have received and digested a good amount of feedback. We therefore expect to be informed about where they wish to take linker issuance at HYEFU, noting that this will likely involve a tweak to the way they are issued, rather than a cessation of issuance, given NZDM's strong commitment to the linker programme.

Summary

Overall, with so much change on the economic front since the May Budget, the scope for surprise at HYEFU (in terms of how that translates into the fiscals) is high. We're fairly confident that the vibe will be better, with high inflation helping flatter the debt ratio. But relying on growth and inflation to consolidate the Government debt position probably isn't going to see fiscal buffers rebuilt fast enough for the next inevitable downturn. Further, the degree of capacity stretch in the economy means existing and additional spending initiatives should be put under the microscope to make sure they deliver value to tax payers (opposed to just more inflation). It's a tough gig, but that's the reality of a rapidly changed economic backdrop.

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