ANZ Research

NZ Insight: Increasing the contingency fund

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Contact

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More Government spending coming or just playing it safe?

Summary

- The Government has passed legislation that will allow it to spend more if needed. This is not a guarantee that it will spend more.
- We estimate that if this additional amount is spent and added to the Treasury's Half-Year Update forecast, the worst case scenario for projected net core Crown debt to GDP would be an increase in the peak of around 5%pts to 55%.
- NZ Debt Management's strong cash position and uncertainty around the cost of this lockdown, discretionary fiscal policy decisions, and the economic outlook mean it's too early to say what the implications are for bond issuance guidance. But recent developments make a downgrade come December's Half-Year Update less likely than before.
- Adding fiscal stimulus to an already resource-constrained economy would likely add pressure to inflation and interest rates. On the plus side, it would increase the likelihood the RBNZ will be able to normalise monetary policy before the next crisis – and help rebalance stimulus away from housing. But with household debt very high, a scenario where the RBNZ has to scramble to rein in runaway inflation would be very risky.
- Although we expect a strong bounce-back in the overall economy, lockdowns are very damaging for some households and businesses. Fiscal policy is much better placed than monetary policy to provide targeted support. But for the sake of future generations, it needs to be surgical.

Getting prepared

The Government has passed an imprest supply bill, providing authority to incur expenses and capital expenditure in the current fiscal year in addition to that already legislated. The Bill seeks:

- up to $24bn for operational expenses,
- up to an extra $15bn in capital expenditure, and
- up to an extra $2bn for capital injections.

That's $41bn all up. However, not all of this can be considered potential new spending over and above that included in the Treasury's medium-term Budget forecasts. For example, some essentially frees up the Government to spend funds that are probably already baked into the outlook, but not necessarily allocated to this fiscal year, and some represents fiscally neutral adjustments. At a minimum, it looks like the pot of potential new spending in here could be closer to half that amount.

It's important to note that this Bill merely gives the Government the option to spend more. It's not a guarantee that it actually will. Whether or not that happens will depend on a few key factors: how long the lockdown goes on for (assuming current support measures are maintained for the duration), how the economy evolves, and discretionary fiscal policy decisions.

Being prepared to spend a little more in the event that downside risks materialise is prudent. However, debt has to be paid back, with the burden borne by younger generations particularly. In that light, it is unfortunate that such a small contingency was left going into this lockdown: only $5bn left unallocated in the $62bn COVID Response and Recovery Fund (CRRF), with another $3bn or so available from underspending.

On top of this, there is the better-than-expected economic position, which boosts fiscal revenues and reduces spending on the likes of the unemployment benefit, relative to previous forecasts. However, the Treasury will not formally update their forecasts for another month or so – first with their preliminary Half-Year Update forecasts (which do not get published, but go to Ministers), then with their final numbers, which usually get locked down in November (for publication in December). That means the Minister probably doesn't have a formal estimate from the Treasury yet as to what the updated economic outlook means for tax revenues and expenses going forward. We estimate this could be up to another $10bn or so in additional wiggle room for the current lockdown.

Then, if the Government really wanted to, it could take a good hard look at decisions already made, and reprioritise spending from existing baselines.

Overall, we estimate there's around $15-20bn in the kitty before the Government needs to borrow more. But understandably, the Minister has signalled the coffers hold closer to $8bn as he does not yet know what the Treasury's updated forecasts might give him. It's in that context that the move to clear the path to further spending should be seen.

What could additional spending do to the forecast Government debt position?

In short, there are too many moving parts to know for sure.

To put a stake in the ground, we can simply add $20bn to the stock of net debt forecast at the Budget Update (ie assume the Government lifts spending by this much and the Treasury doesn't update their economic outlook at all). All else equal, this would see net Core Crown debt peak just over 55% of GDP in the year to June 2023 – that's up from a forecast peak of just under 50% at the 2021 Budget Update in May, and not much higher than the Treasury's Budget 2020 forecast. The key difference is this would be against a much stronger economic backdrop.

But 55% of GDP is hopefully more of a worst-case scenario, given the Treasury have a stronger fiscal starting point and are likely to forecast a larger nominal economy in 2023 at the Half-Year Update, improving the ratio via the denominator. We'll leave it up to you to decide whether the Government will actually spend what it's making available.

At this early stage, we certainly don't have enough information to forecast that net debt is going to peak at 55% of GDP; we're merely outlining how high it might be projected to go if spending increases and/or more is added to the CRRF as a contingency for future lockdowns. The latter could be announced at the Half-Year Update, and could once again make a hefty chunk of the government spending outlook quite binary.

In the big picture, as long as net debt remains under 60% of GDP, it may not cause too many people to blink an eye, particularly if they're comparing New Zealand to other advanced economies. We still look like a model of fiscal rectitude compared to most. But there are good reasons why we should maintain relatively low levels of Government debt and thereby policy flexibility:

- we're a small open economy susceptible to global shocks;
- household debt is high, we run persistent current account deficits (ie we have a negative international investment position),
- we have an ageing population,
- we face hefty upcoming bills for climate change mitigation and adaptation, and
- we're vulnerable to natural disasters.

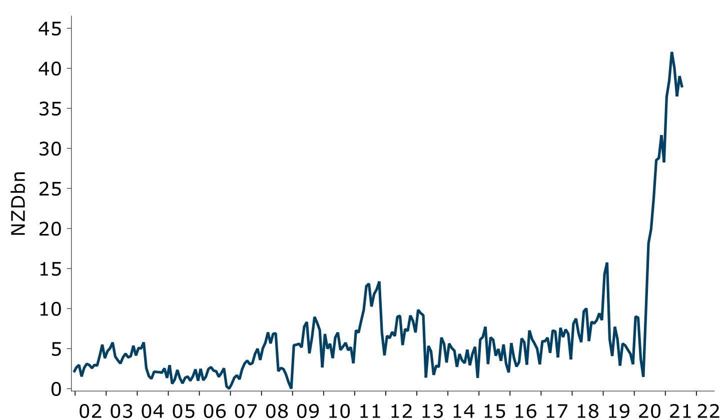
What a cheery list.

However, debt around 20-25% of GDP (pre-COVID days) is unlikely to be something we see again for a very, very long time (if at all). Perhaps the new post-COVID 'prudent' debt ratio will be considered to be something close to, or even slightly north of, 30%. We'll just have to wait and see how interest rates evolve in a structural sense, what advice the Treasury comes up with over coming years, and the Government's post-crisis fiscal strategy.

What about the implications for bond issuance?

In the wake of the COVID crisis New Zealand Debt Management (the operational side of the Treasury) has accumulated quite a sizeable buffer of liquid assets by issuing more debt than Government operations required (reflected in the Crown settlement accounts, figure 1). In broad terms, this surplus cash is an asset to the Crown, so doesn't negatively impact net core Crown debt (in practice it's a little more complicated, but not worth getting into). Some of this accumulation was intentional (to mitigate against the risk that fiscal policy moves faster the Treasury can fund it) and some of it reflects a relatively rigid issuance programme against a better-performing economy than expected.

Figure 1. Crown settlement account

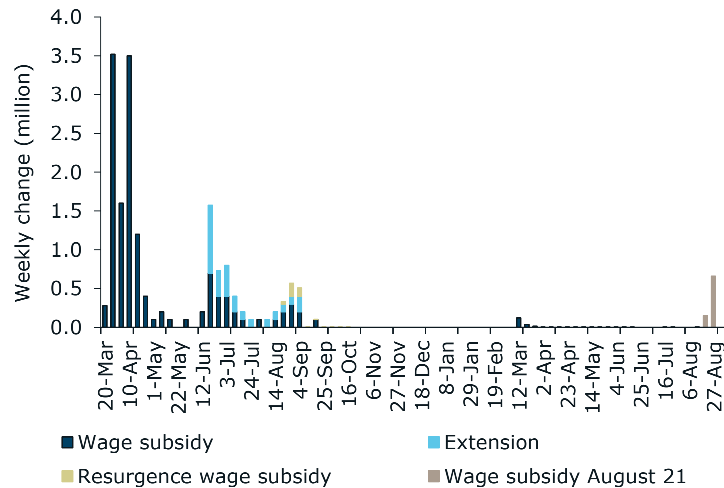


Source: RBNZ, Bloomberg, Macrobond, ANZ Research

The net result is that the Treasury has plenty of cash to facilitate upcoming government policy decisions. At the May Budget, Debt Management noted "further guidance on the expected level of enduring [asset] balances will be provided at future Economic and Fiscal Updates". Simply put, we know Debt Management is sitting on more cash than it initially anticipated, but we don't know whether it plans to run this down, and if so, to what level, how, and over what timeframe. All these things could impact on their expected issuance profile going forward and the Crown settlement account. And it could provide an offset to higher funding requirements.

Prior to renewed lockdown measures, we were thinking NZ Debt Management could shave $5-10bn off its Half-Year Update annual issuance guidance on the back of the better-performing economy and NZDM's elevated cash buffer. But as things stand right now, it's looking more likely bond issuance guidance won't be downgraded come the Half-Year Update. But absent information on the Government's spending plans, and the NZDM's liquidity strategy, it's a hard call whether issuance guidance will be lifted. We'll just have to keep a close eye on outgoings (such as wage subsidy payments, figure 2) and policy announcements in the lead-up to the Half-Year Update.

Figure 2. Wage subsidy payments



Source: MSD

The macroeconomic policy lens: A new era of pro-cyclical fiscal policy?

In the good old days before COVID-19, the Treasury's Macroeconomic and Fiscal policy advice tended to go a little something like this. If the economy is running hot, adding fuel to the fire (via increased government spending or tax cuts) will likely do little more than put upward pressure on inflation and interest rates, rather than boost growth and employment. That's because there's unlikely to be available resources in the economy for additional stimulus to utilise, and you'll just crowd out private sector activity – with price the rationing mechanism. That would waste taxpayer dollars.

This interaction between fiscal and monetary policy (and a whole bunch of other stuff about maintaining prudent debt levels in the good times) is clearly embedded in the Public Finance Act and the principles of responsible fiscal management within it. However, the Act also has a carve-out, allowing the Government to temporarily depart from the principles when it makes sense to do so (eg during a crisis when private demand is very weak).

But this crisis isn't your average demand shock. Both we and the RBNZ estimate that the economy was running hot going into this latest lockdown – that's why we're forecasting OCR hikes. Further, because lockdowns bring about a significant negative supply shock, it's our expectation that the economy will remain stretched through this lockdown and beyond.

And this is where things get tricky. Through a pure macroeconomic lens, the above fiscal principles say one shouldn't inject additional fiscal stimulus into a resourced-constrained economy. However, there are two key additional considerations:

- Some businesses and households really, really struggle through lockdown and need fiscal support (including to prevent a spike in unemployment), and it's clear that the economic recovery to date hasn't benefitted everyone equally.
- If the economy does slow more than expected, the RBNZ's ability to add more stimulus is very limited at present.

So with that counterfactual in mind, adding additional fiscal stimulus now to get through another level 4 lockdown is not a bad move. However, it needs to be surgically targeted, for both the sake of those carrying the debt burden, and to avoid significantly boosting already-high inflation pressures in an economy that has limited scope to deliver.

In moderation, a little extra inflation pressure would put the RBNZ in a better-than-otherwise position to normalise monetary policy – and hopefully before the next crisis comes along. And rebalancing the mix of stimulus away from the monetary policy housing channel is not a bad thing. But given sky-high household debt, there are significant risks in a scenario where the RBNZ ends up scrambling to rein in runaway inflation pressures – a hard landing in the housing market will only boost the fortunes of those would-be first home buyers who still have a job, after all.

It's a lot easier for Government to stimulate demand than it is to fix supply-side problems such as the MIQ bottleneck and shipping disruptions. But policy can help by focusing on addressing both near- and longer-term supply side bottlenecks such as freeing up more land for housing and cutting red tape. Government spending tends to get most of the attention, but it's only half the solution.

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