ANZ Research

NZ Pre-election Economic & Fiscal Update Preview

5 September 2023

Contact

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Pre-election Update predictions

Summary

- Risks we flagged at the Budget Update appear to have materialised. The Treasury's economic and tax forecasts are due a downgrade and we suspect that will push the forecast return to OBEGAL surplus out by another year (to 2026/27).
- Pre-election Economic and Fiscal Updates are intended to inform the public and the incoming Government about the state of the books ahead of the election. They are not typically a platform for government policy announcements, so we don't expect any on the day.
- That said, the Minister of Finance has recently signalled a $4bn reduction in spending over the next four years compared to May's Budget Update.
- Turning to the Treasury's economic outlook, the recent deterioration in export prices and the weaker-than-expected starting point for GDP suggests we'll see a weaker activity outlook overall. But the Treasury is also likely to upgrade its house price forecast, and that could bring some meaningful offsets via both residential investment and private consumption. A slightly rosier economic outlook than our own would not surprise on the day.
- But there is no hiding from the fact that the fiscals are in a much weaker position than forecast at Budget in May. Government financial statements for the 11 months to May 2023 show tax revenue running more than $2bn below forecast. Given the weaker economy, that forecast miss isn't looking temporary – it'll need to be baked into the outlook.
- NZDM's funding requirement is expected to lift meaningfully. We have pencilled in a $10bn uplift in bond issuance over the forecast. And while a lot of that pressure appears front loaded, we suspect NZDM will do their darndest to smooth the increased funding requirement across the forecast horizon (as markets appear nervous about the prospect of a sharp lift in supply for the current fiscal year).

Table 1. NZDM bond issuance guidance ($bn)

Year to June	Jun-23	Jun-24	Jun-25	Jun-26	Jun-27	Total (24-27)
2023 Budget Update	28	34	32	30	24	120
Pre-election Update (ANZ central expectation)	**28**	**36**	**34**	**34**	**26**	**130**
Smoother scenario (if NZDM deem it achievable)	28	35	35	35	25	130

Source: The Treasury, ANZ Research

- All up, it's been a wild ride for fiscal policy though the pandemic. To help put the Pre-election Update into perspective, we include three appendices: a brief history of post-pandemic EFUs; fiscal policy through crises (differences between the pandemic and the Global Financial Crisis); and what it means for NZ's Sovereign credit ratings.

The detail

The Treasury will open up the Government's books on 12 September ahead of the General Election (to be held 14 October), with the publication of the Pre-election Economic and Fiscal Update (henceforth 'Pre-election Update').

The Pre-election Update will outline the Treasury's take on the current economic and fiscal situation, and how they expect this to unfold over the next four years or so.

While the election result will certainly matter for policy settings, the Treasury's forecasts will assume that only Government decisions taken at the time of forecast finalisation will be carried through the forecast period. That is, party policies will not be included in the forecast, but government policies will be. In practice, the lines can become a little blurry between the two, and perhaps more so this time around given the Government has recently reacted to the deteriorating outlook by cutting its spending plans. But as a general rule, if it's party policy (such as removing GST on fresh fruit and veggies) it won't be in the Treasury's latest forecast. If it has gone through Cabinet and is current policy (such as reduced Budget allowances for 2026 and 2027) then the Treasury's forecast will capture it.

On that score, it is a little unusual for a Pre-election Update to include major changes to discretionary fiscal policy settings, as there is no typical accompanying Budget process this time of year, ie no Budget Policy Statement (such as at the Half-Year Update). That said, the Government can signal changes to its spending plans whenever it chooses, and the Treasury is required to incorporate that if it's "official Government policy" at the time. Regardless, importantly, decisions made today about spending over the next four years will not necessarily come to pass. As appendix 1 shows, spending increases happen.

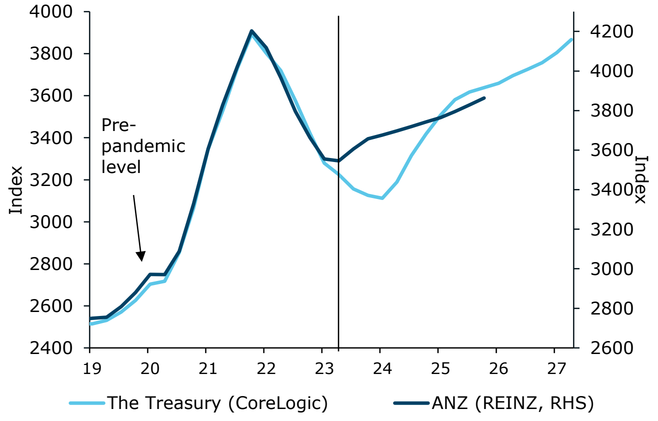
Any implementation of party policies after the election will be included in the Treasury's Half-Year Update forecasts in December.

A weaker starting point for the economy, but it's not one-way traffic

The economy is clearly underperforming the Treasury's Budget Update forecasts. Real GDP came in a little weaker than expected in Q1 (-0.1% q/q vs the Budget Update forecast of +0.2%), which, given the scope for cyclone-induced volatility, isn't a big miss by any means. Meanwhile, the global economy is certainly looking softer (particularly in China), and that's likely to result in a softer outlook for the terms of trade, and everything that hangs off it, such as national incomes, investment, employment, and tax receipts. Conversely, the house price outlook has improved since the Budget Update (figure 1), suggesting a decent upgrade could be on the cards. That could have flow-on implications for the domestic activity outlook, including residential investment, private consumption, employment, and GST (ie providing a partial offset to the weaker global economy). The starting point for net migration is also stronger than the Budget Update assumption, but we don't think that presents a challenge to the Treasury's medium-term assumption for annual inflows of around 40k over the back half of the forecast.

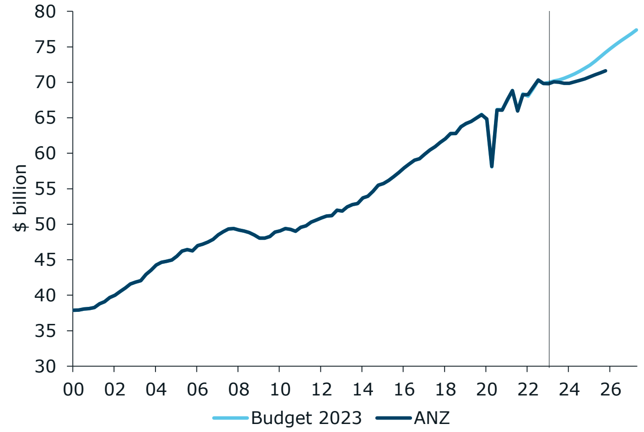
All up, we think changes to the Treasury's activity outlook are going to be in the same vein as those we recently made to our own outlook, with a relatively robust (but still soft) domestic demand pulse and a weaker net exports recovery than previously. Netting it off, we expect to see a downgrade to the Treasury's real GDP forecast overall. But we wouldn't be surprised to see this land on the rosy side of our outlook (figure 2).

Figure 1. House price forecast



Source: The Treasury, REINZ, ANZ Research

Figure 2. Real GDP forecast



Source: The Treasury, Stats NZ, Macrobond, ANZ Research

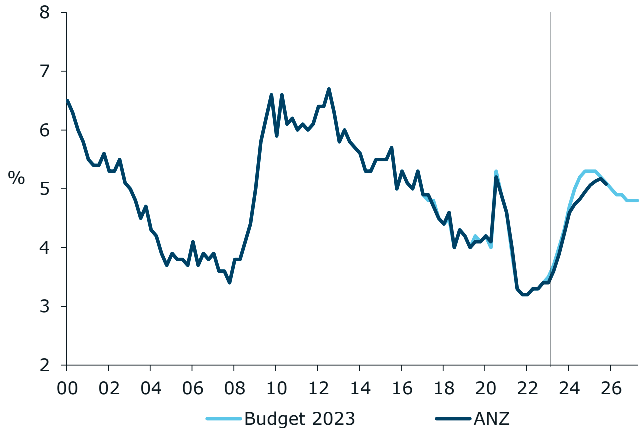
A weaker fiscal outlook

The starting point for the Government's books is weaker than was expected at the Budget Update. In the 11 months to May, core Crown tax revenue was running $2.2bn below forecast, reflecting the weaker-than-expected economy. Expenses were tracking very close to forecast.

Looking forward, it's fair to assume that the starting point for weaker revenues genuinely reflects the underlying state of the economy, meaning this forecast miss will likely be carried through the forecast horizon to some extent. But whether that gap widens or narrows over the forecast horizon will depend largely on how optimistic or pessimistic the Treasury's updated economic outlook turns out to be.

On the spending side, in an unusual move for a Pre-election Update, the Government has announced a reduction to the tune of $4bn over the next four years. That's about $1bn per year, so not a huge relief when it comes to pressure on CPI inflation and interest rates, but every little bit helps. For context, Budget 2023 increased Government spending (capex and opex) by a little over $5bn (around 1.4% of GDP) for the 2023/24 fiscal year alone. There's also a risk that non-discretionary spending (eg automatic stabilisers, such as unemployment benefits) are revised higher over the forecast horizon owing to a weaker economy. That said, the Treasury's unemployment outlook in the Budget Update doesn't look optimistic compared to ours.

Figure 3. Unemployment rate forecasts



Source: The Treasury, ANZ Research

In terms of the operating balance (OBEGAL), we expect the return to surplus to be pushed out another year to 2026/27. At Budget the OBEGAL was forecast to come in at $3.2bn in the 2026/27 fiscal year. We suspect that will probably be revised below $1bn, which is wafer thin. Anything lower than a couple of billion could easily be revised away with some relatively minor changes to the Treasury's economic forecast assumptions.

In terms of the bigger picture, as we noted when the Government introduced its new fiscal rules, OBEGAL is now the only major constraint on Government policy, and given the recent 'out-of-cycle' spending reduction, it appears to be a binding one. That suggests if surpluses are blown away in the winds of another economic outlook downgrade at some point in the future, the Government could cut its spending plans once again, just as higher-than-expected revenues in the past allowed upgrades to spending while still forecasting a return to surplus. However, pegging spending to cyclical changes in tax revenue is pro-cyclical, ie it makes both booms and busts bigger. It's a bit of a head scratcher from a macroeconomic stabilisation perspective, raising the question of whether the Government's fiscal strategy is appropriate when it comes to avoiding unnecessary pressure on CPI inflation and interest rates (ie accounting for where we are in the business cycle and considering fiscal-monetary policy interaction).

It's also worth noting that if the Treasury does downgrade its economic and tax outlook in the future (eg in December's Half-Year Update or perhaps Budget 2024), there will be an additional forecast year added from the upcoming Half-Year Update. That means that even if the 2026/27 surplus is revised to a deficit in the Half-Year Update (due December 2023), the Government could theoretically continue to show a 'forecast surplus' – just a year later, in 2027/28. Of course, forecasting surpluses by signalling lower spending well into the future is one thing; actually delivering surpluses is quite another. A more binding fiscal target would be to aim for a surplus in a particular year (subject to economic conditions).

Other than what's already been announced by the Government, we don't expect any new policy or fiscal strategy announcements to accompany the Pre-election Update. This is a Treasury document (not the Government of the day's) and is about informing the public about the state of the books ahead of the election and ensuring that the incoming Government isn't met with any major surprises when they take office after the election. It's a politically neutral document that isn't intended as a stage for electioneering.

Another increase to NZDM's bond issuance guidance expected

As always, there's a lot to consider when it comes to guesstimating NZDM's bond issuance guidance:

- A weaker outlook for tax revenue, with only a partial offset from lower discretionary spending, means the Government will need to borrow more, and that means more issuance.
- NZDM's guidance at Budget included a $7bn increase in funding for Kāinga Ora. However, the Government had not at that time made a decision on how Kāinga Ora bonds maturing after 2023 would be managed (eg possibly rolled into NZDM's borrowing programme). If these Kāinga Ora maturities are included (which presumably will happen at some point), this would add a further $7.6bn to NZDM's funding requirement, potentially with a legacy all the way out to 2040. But only $3.2bn of this matures within the Treasury's current forecast horizon to June 2027. We aren't expecting NZDM's updated guidance to include these bonds, but it is possible. Any further increases in Kāinga Ora spending from here is also expected to be funded by NZDM – but decisions on that front would be very unusual at a Pre-election Update.

- Interest rates have surprised the Treasury's Budget forecasts to the upside, meaning less cash in the door for a given face value of bonds that go out.

Weighing it all up as best we can, our central estimate in the table below lands on an extra $10bn of bond issuance over the four years to June 2027.

NZDM bond issuance guidance ($bn)

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Source: The Treasury, ANZ Research

It's important to note that we have assumed NZDM smooths bond issuance over the forecast horizon. It does, after all, prefer stability between fiscal years. But fair to say, with the 2022/23 fiscal year falling short, there is some front-loaded pressure on issuance. But at the same time, NZDM will be cognisant that markets can only take down so many bonds before government funding costs push meaningfully higher, or worse, excess supply induces a bout of market dysfunction. So if NZDM does have reasonably painless options to smooth issuance between fiscal years, we think they will use them. But as noted in the list below, some options are more of a 'last resort' nature.

In pursuit of a smoother bond programme, we'd put the NZDM's preferences in the following order:

- Increase short-term issuance (T-bills and ECP). Obviously, there are natural limits here too before things start to get messy, but it makes sense to lift short-term funding if pressures on bond issuance is higher, particularly if that pressure on bonds is relatively front loaded (as we think it will be).

- As outlined quite some time ago now, NZDM's funding programme already incorporates the maintenance of a 'cash buffer'. We don't think NZDM will change the average target level ($15bn) over the medium term, but they could allow this to fluctuate a little between fiscal years (one or two billion between fiscal years wouldn't be the end of the world).

- The Treasury has a $5bn overdraft facility with the RBNZ. It doesn't tend to rely on this now that there is a very large liquidity buffer, but if NZDM was running out of options and was concerned about how many bonds the market could take down before something breaks, then this could be utilised. Given NZDM has plenty of liquid assets currently, we'd put a very low probability on the overdraft being used.

- Lastly, if things were truly looking at risk of becoming dysfunctional, the Treasury could always work with the RBNZ to alter the pace of QT, which is currently running at $5bn per year. We'd see this option as a last resort, and extremely unlikely given the need for the RBNZ to maintain tight monetary conditions.

As always, it's not just our best guess of the Treasury's updated economic and fiscal forecasts that matter for bond issuance guidance. As alluded to above, there are lots of moving parts to consider. Accordingly, we'd place a fairly wide uncertainty band around our expectation for an overall lift in issuance of $10bn – anything between $8-12bn wouldn't surprise.

But one thing we're a little more confident about is that NZDM will likely seek to smooth bond issuance across the forecast horizon where they can, avoiding a very sharp spike in the current fiscal year, but lifting the out-years by more than otherwise.

Markets holding their breath as supply glut worries weigh on sentiment

The prospect of a sharp rise in bond issuance over the second half of the fiscal year (first half of calendar 2024) is a valid concern for markets. As mentioned previously, we think pressure on NZDM's funding requirement has some front-loaded elements to it. And if the bond programme for the current fiscal year is upgraded by significantly more than we think, markets will be left contemplating either a sharp lift in the weekly run rate of tender issuance, more or lumpier syndications, or both.

While syndications are a very effective way to get volume away, they can leave a supply overhang in the market, especially if they are held at close intervals. NZDM has already completed one syndication this fiscal year. Based on current numbers, we expect two more, with the next likely to be in February, and the third some time before 30 June. That said, if we're right about the likely issuance profile being lifted slightly (as laid out in table 1), it'll be touch and go whether a fourth syndication will be required, or if NZDM will target a little more volume at the next two. If the funding requirement for 2023/24 proves to be greater than we expect, that would significantly lift the likelihood that we see three more syndications over the February to June period. Under that scenario, NZDM may consider a November syndication. That may not be ideal, given that coalition agreements may not be finalised, and a new Government formed by then, bearing in mind that that all recent syndications have been flagged in the relevant month's tender schedule, and the November tender schedule will be published on 25 October, just 11 days after the election. But practical considerations may force NZDM's hand.

Whatever the finer details, bond markets are bracing for increased supply. The pain is coming, it's just a question of intensity.

In sum

All up, the Pre-election Update should come and go with little fanfare. A downgrade to the Treasury's economic and fiscal outlook shouldn't come as a surprise, so it's all now a question of magnitude, and the risk profile around that. More bonds will be added to NZDM's guidance, and it's very likely we'll continue to characterise the risks around that as to the upside. But there's a lot of water to potentially flow under the bridge on the fiscal policy front between the Pre-election Update and the Half-Year Update, as the latter will need to accompany updated Government policy following the election result. So we'll be doing this all again in December.

Appendix 1: A brief history of post-pandemic EFUs

The post-pandemic era has been wild in terms of forecast accuracy, the size of the policy response, and the extreme wonkiness that has resulted across the economy (eg international tourism and education grinding to a halt, a boom-to-bust housing market, surging CPI inflation, and the blowout in the current account deficit). To help put the Pre-election Update into perspective, let's take a look at how our and the Treasury's thinking and outlook has evolved through the years since COVID:

- **May 2020:** The Government had already provided significant economic support by the time Budget 2020 was released. But the consensus view heading into Budget was that more would be needed. At the time, we labelled Budget 2020's $50bn package as a 'big umbrella' and the pandemic as 'a monsoon'. That is, in May 2020 our sense was that the fiscal response seemed appropriate. We all thought the pandemic was going to have a much more significant and long-lasting impact on the economy than it actually did. The Treasury was forecasting the unemployment rate to peak just shy of 10%, and CPI inflation to trough at 0.4% y/y (and not rise above 2% y/y at any point over the forecast horizon). The outlook was dire, with the Treasury noting "many countries, including New Zealand, are expecting their largest economic downturns in living memory". Our outlook at the time concurred with that. The Treasury's forecast horizon extended to 2023/24 at this point, and an OBEGAL deficit of $4.9bn (1.3% of GDP) was pencilled in for that year.
- **September 2020:** The Treasury published the Pre-election Update. Changes to the economic and fiscal outlook were relatively small, but downgraded overall. COVID uncertainty was still extreme. There were no major adjustments to discretionary fiscal policy settings (as is normal for a Pre-election Update). The OBEGAL forecast for 2023/24 (which was still the last forecast year) was downgraded to a deficit of $12.4bn (3.4% of GDP).
- **December 2020:** The Half-Year Update showed the Government's books in better shape than in September. Economic and fiscal data had been surprising to the upside, and that was carried into the Treasury's outlook. There were no changes made to discretionary fiscal policy settings at this point because the Budget Policy Statement (which usually accompanies the Half-Year Update) was delayed. The forecast OBEGAL deficit for 2023/24 was revised to $7.5bn (2.0% of GDP), and the addition of the 2024/25 fiscal year into the forecast horizon pegged it at $4.2bn (1.0% of GDP).
- **May 2021:** Come Budget 2021, the economic and tax outlook was revised higher once again. Unemployment was now expected to peak well below GFC levels, with both GDP and tax receipts revised higher. Despite there now being less need for fiscal support, Government spending was increased significantly. And while the Treasury's CPI inflation forecast at the time showed inflation peaking within the 1-3% target band, evidence was building that capacity pressures were beginning to bite. Our Budget 2021 Review noted "with capacity pressures becoming more and more of a limit in pockets of the economy, the Government needs to be thinking more about fixing the supply side of the equation than about adding to demand. Too much focus on the latter is likely to do little more than crowd out private sector activity and drive up prices" adding that "it's becoming clear that the strength of the economic recovery means that additional macro stimulus is no longer needed." The better economic outlook more than offset higher government spending and the forecast OBEGAL deficit for 2024/25 was revised to $2.3bn (0.6% of GDP).

- **December 2021:** Half-Year Update time and the Treasury was once again upgrading its economic and tax outlook. By this point CPI inflation was accelerating sharply, with the Treasury's forecast expecting it to peak at 5.6%. Surging CPI inflation was starting to significantly bolster tax revenues. By this point, we, the RBNZ, and the Treasury were forecasting a positive output gap, meaning it was very clear that there was no spare capacity in the economy to accommodate additional demand from Government without putting upward pressure on CPI inflation and therefore interest rates. But the Government once again increased its spending plans. At the time we noted "there are now very good cyclical and structural arguments against loosening the fiscal purse strings any further". Despite the increase in spending, the better tax outlook meant the Treasury was now forecasting an OBEGAL surplus for 2023/24 ($2.1bn or 0.5% of GDP), the first forecast surplus in the post-pandemic era. By 2025/26 (the last forecast year at the time), that surplus was expected to widen to $8.2bn (1.8% of GDP).
- **May 2022:** Budget 2022 was a little different in that it marked the first Budget since COVID that the Government was operating under its new (and current) fiscal strategy, which is materially looser than that prevailing before the pandemic, particularly with regards to debt. The Treasury's updated forecasts included a downgrade to the medium-term outlook for activity, but more oomph was added to the inflation outlook. In other words, the economy had run out of resource to grow, and with demand significantly outstripping supply, CPI inflation was running rampant. But high inflation supported an upgrade to the tax revenue outlook, and that was met with another meaningful increase in Government spending. We called this one a 'Big Budget', noting that "with economic capacity already stretched, the RBNZ might need to "make room" for government spending by inflicting higher interest costs on businesses and households". Higher spending contributed to the forecast OBEGAL surplus being pushed out a year to 2024/25 ($2.6bn or 0.6% of GDP). By the end of the forecast (2025/26) a surplus of $7.0bn (1.5% of GDP) was expected.
- **December 2022:** The Half-Year Update forecasts included higher interest rates, weaker economic activity, and even more inflation. The latter once again provided a bump to the outlook for tax revenues. This time around the Government started looking at spending reprioritisations to fund its initiatives, as opposed to increasing operating allowances further. The RBNZ had recently hiked the OCR by a whopping 75bps in order to tame inflation, meaning the trade-offs associated with increased government spending were becoming increasingly real. However, the Government's capital spending plans were increased, adding a little more oomph to the fiscal impulse. By this point, macroeconomic imbalances had become extreme. Inflation was surging, the labour market was extremely stretched, and the current account deficit had widened well beyond sustainable levels (illustrating that New Zealand was not living within its means, and that had become a threat to the longer-run prosperity of the country). An OBEGAL surplus was still being forecast for 2024/25, but it was a little smaller than at Budget 2022 ($1.7bn or 0.4% of GDP). The forecast horizon was extended by a year to 2026/27, and that showed a surplus of 9.3bn (1.9% of GDP).
- **May 2023:** Budget 2023 was another big one, but this time was different: a response to cyclone Gabrielle was required, with parts of the country in desperate need of support. But because the Government had been in a pattern of spending positive tax revenue surprises (that were the result of high inflation) up until recently, it had less fiscal headroom to respond than otherwise. Spending reprioritisations were made, but after accounting for these, and the usual reshuffling of Government spending between fiscal

years (owing to delays etc), Budget 2023 injected a little more than $5bn of additional spending (opex and capex) into the economy in the year to June 2024 compared to the Half-Year Update. That's an extra 1.4% of GDP, which once again will add to CPI inflation pressures, meaning greater-than-otherwise pressure on the OCR. To prevent putting more pressure on CPI inflation with the cyclone response, the Government would have had to make larger spending reprioritisations or lifted taxes. The lift in spending contributed to the OBEGAL surplus being pushed out by another year to 2025/26 ($0.6bn or 0.1% of GDP). The 2026/27 surplus was downgraded significantly to $3.2bn (0.7% of GDP).

- **September 2023:** This brings us to the upcoming Pre-election Update. The Treasury is expected to downgrade the economic and fiscal outlook, and the Government has signalled a $4bn reduction in spending over four years (not a huge amount compared to prior spending increases). The return to OBEGAL surplus is expected to be pushed out another year (to 2026/27), which would mark seven consecutive deficits in a row. If we're right about that, that would be one more year in deficit than what followed either the GFC or the Canterbury earthquakes, despite these events being very different in terms of their macroeconomic impacts and the consequent appropriateness of persistent fiscal stimulus (see Appendix 2).

Summing up

- Initially, COVID-19 was expected to be a once-in-a-generation economic disaster, and while it was for some households and businesses, that turned out to be incorrect in aggregate.
- The first post-pandemic surplus was forecast in December 2021. It was expected to occur next fiscal year (2023/24). By May 2023, it had been pushed out two years to 2025/26, as increases in government spending more than offset changes in revenue.
- December 2021 also marks a key milestone: by this point it was unambiguously clear that there was no excess capacity in the economy to accommodate further fiscal expansion without adding to inflation and putting upwards pressure on interest rates.
- Despite that, inflation-driven upgrades to the tax outlook have frequently been met with increases in spending. On the one hand, high inflation has increased the cost of delivering key public services, while on the other, further fiscal expansion has added to aggregate demand, and therefore inflation pressures. Of course, Budget 2023 was different in that there was a cyclone to respond to, but there were less-inflationary options available (eg higher taxes and/or further spending reprioritisations).
- So far, the Government's post-COVID fiscal strategy to keep surpluses within a band of 0 to 2 percent of GDP to ensure new day-to-day spending is not adding to debt appears to only bind them in the forecast horizon, rather than in terms of immediate spending decisions. That is, as we've noted before, forecasting surpluses is easy: just tell the Treasury you won't spend more next year, and wait for them to add another forecast year to their forecast horizon. Actually achieving a surplus is another thing entirely, and may require the Government to adopt a 'point in time' surplus target. Furthermore, spending positive cyclical revenue surprises and then cutting spending plans when revenue forecasts deteriorate suggests fiscal policy is moving with the business cycle, opposed to being counter-cyclical. That can result in fiscal policy working against monetary policy, and is why the interaction between fiscal and monetary policy is a key pillar of the principles of responsible fiscal management within the Public Finance Act.

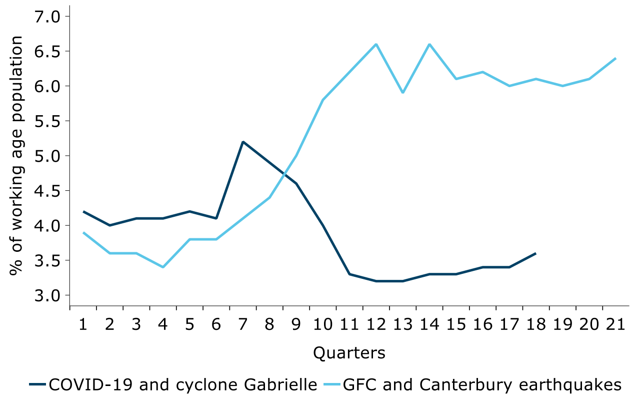
Appendix 2: Fiscal policy through crises (differences between the pandemic and the Global Financial Crisis)

In its early stages, the pandemic was often referred to as the biggest economic shock of a generation. Forecasters across the board anticipated dire and long-lasting economic impacts. History (and the latest economic data) has proven that quite wrong – there was no widespread destruction of wealth or income. Nonetheless, parallels are often drawn between the pandemic and the Global Financial Crisis (GFC), despite macroeconomic conditions following the two events turning out to be chalk and cheese. In hindsight, more capital spending in the years following the GFC would have been appropriate, but in the wake of COVID, less fiscal expansion would have resulted in less domestic (non-tradables) CPI inflation pressure and therefore less pressure on interest rates. And lower public debt, of course.

The following charts show how key economic variables evolved through the pandemic vs the GFC. For COVID-19, we start the clock at the beginning of 2019, meaning the first 4 quarters in the below charts are 'normal'. For the GFC we do the same thing, starting at the beginning of 2007, meaning we can compare the two shocks side by side to show just how differently the economy performed.

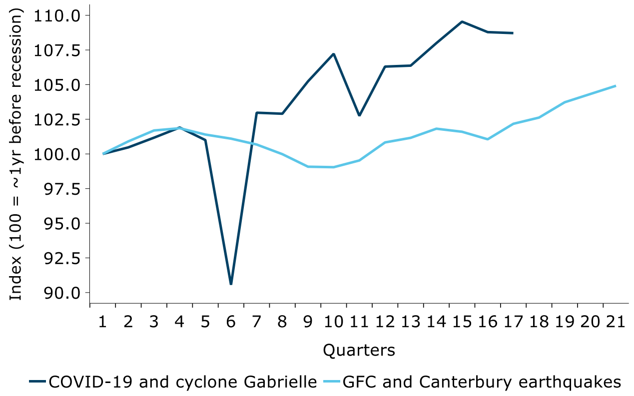
The COVID era got off to a dramatic start, with lockdowns resulting in unprecedented falls in activity. But not least because of monetary and fiscal stimulus, the unemployment rate then hit a record low, GDP bounced back strongly, spare capacity was exhausted quickly and domestic inflation (which tends to be sticky and accounts for about half the CPI) shot to the moon.

Figure 1. Unemployment rate



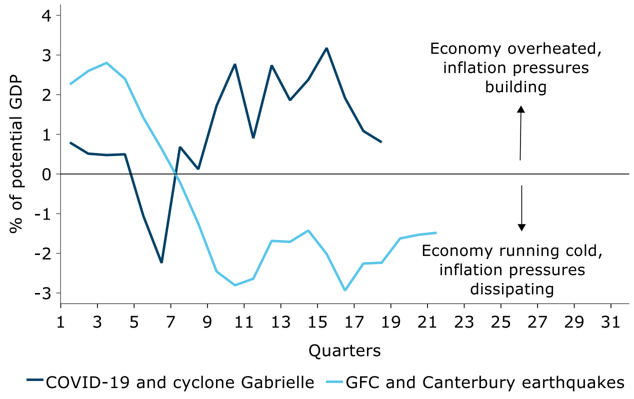
Source: Stats NZ, Macrobond, ANZ Research

Figure 2. Real GDP



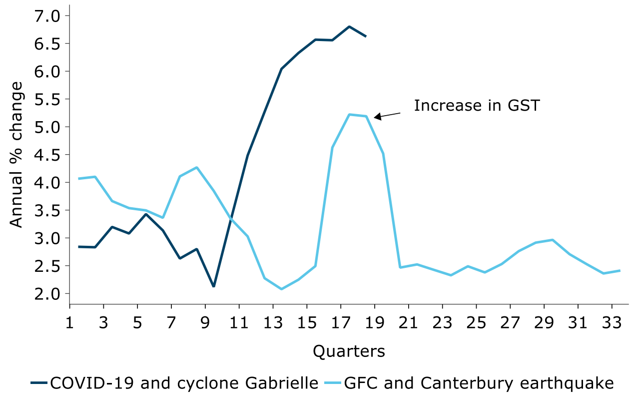
Source: Stats NZ, Macrobond, ANZ Research

Figure 3. Output gap



Source: Stats NZ, RBNZ, Macrobond, ANZ Research

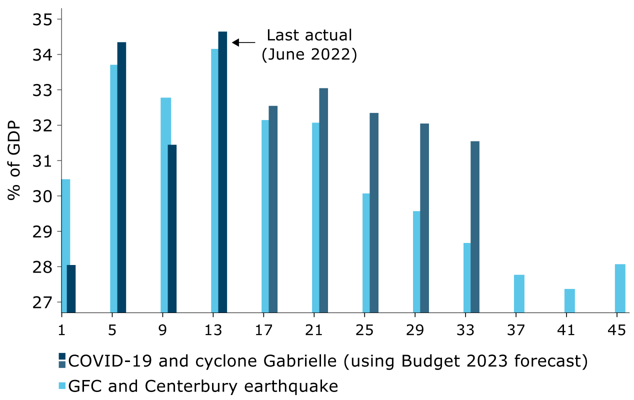
Figure 4. Non-tradable inflation



Source: Stats NZ, Macrobond, ANZ Research

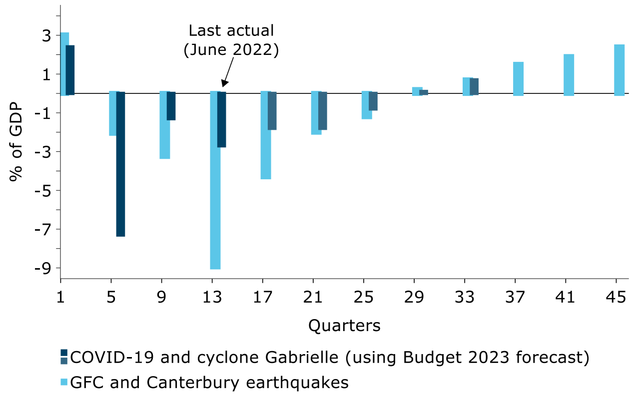
Meanwhile, despite the fact that the economy is still clearly stretched and the RBNZ is having to inflict pain on households and businesses via a higher OCR, core Crown expenditure as a share of GDP is expected to remain at elevated levels for quite some time. The GFC and Canterbury earthquakes were met with six consecutive years of OBEGAL deficits, the same number of years as forecast in May's Budget Update (figure 6), but the Pre-election Update forecast is expected to clock in at seven consecutive years.

Figure 5. Core Crown expenses



Source: New Zealand Treasury, Macrobond, ANZ Research

Figure 6. OBEGAL



Source: New Zealand Treasury, Macrobond, ANZ Research

All up, the data show fiscal policy through the post-pandemic era has been at the pro-cyclical end of the spectrum (spending has increased repeatedly at a time when there's been little to no spare economic capacity to accommodate it), meaning fiscal policy has been working against the RBNZ's efforts to tame CPI inflation and guide the labour market to sustainable levels.

Some might argue that exceptionally low unemployment through this period means it was all worthwhile, but there is a very good reason why the RBNZ is tasked with contributing to 'maximum *sustainable* employment' (which would currently be consistent with an unemployment rate between 4-4.5%). Run the labour market too tight, and domestic inflation pressures surge, meaning inflation-adjusted household incomes can go backwards. That is, pro-cyclical fiscal policy doesn't help in a macroeconomic sense with the cost-of-living crisis, though of course the targeted individuals may be better off for a time.

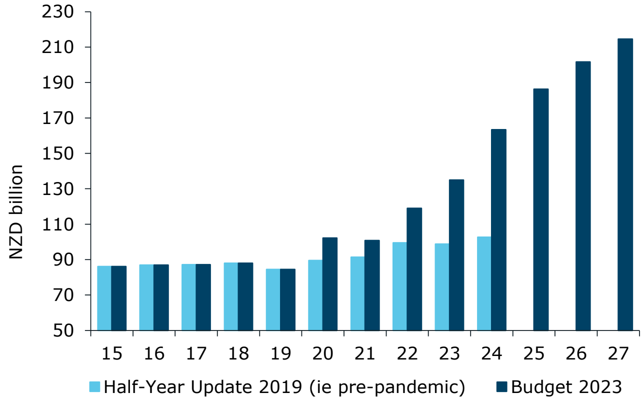
The only long-run source of sustainable real income growth is labour productivity improvements, and while governments can certainly influence that (eg through education, health policy, smart immigration policy, and getting incentives right), procyclical fiscal policy probably isn't going to help. Absolutely, some people will have gained valuable new skills from the fact that firms had to get seriously creative in terms of their employment decisions in recent years. But labour productivity growth could actually be hindered now that the RBNZ is having to change incentives for businesses to invest in R&D and capital more broadly by hiking interest rates – and the associated economic volatility doesn't help either. In other words, while there might be short-run gains from running the labour market hotter than what's sustainable, New Zealand can end up poorer in the long run because of this.

Appendix 3: What does it mean for NZ's Sovereign credit ratings

We're often asked if the projection for gross government debt to more than double between 2019 (pre pandemic) and 2027 (the Treasury's last forecast year, figure 1) is going to result in a sovereign credit rating downgrade. The answer is, it's complicated.

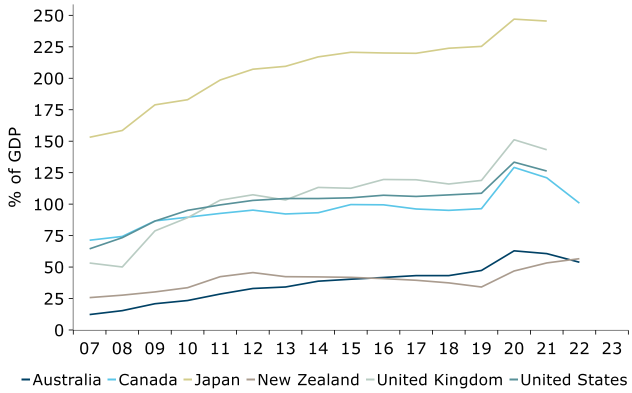
First, it's important to note that NZ's government books are in a great position relative to other advanced economies. That said, the latest OECD data show that as of 2022, NZ no longer has bragging rights over Australia (figure 2).

Figure 1. Gross debt pre- vs post-pandemic forecasts



Source: The Treasury, ANZ Research

Figure 2. Gross public debt (OECD measure)

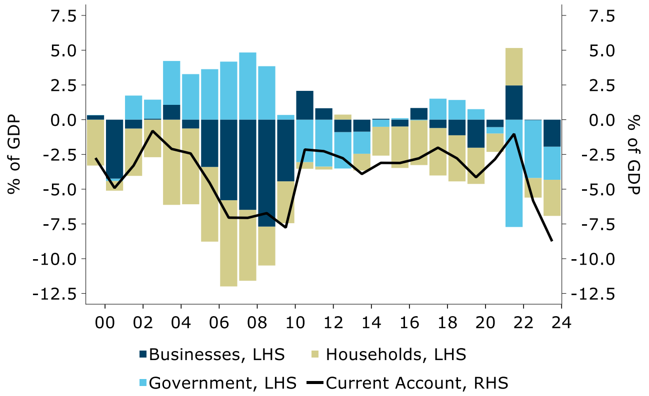


Source: OECD, Macrobond, ANZ Research

Importantly, because New Zealand is relatively vulnerable to natural disasters, is a small open economy (so can't hide from global economic shocks), has an ageing population, and has a sizable net external liability position (ie NZ has borrowed a lot from the rest of the world over the years), low Government debt is often seen as necessary. Indeed, if a sovereign ratings downgrade does occur, it won't be because the level of Government debt is high; it will be because overall New Zealand is running an unsustainable net external position.

As we noted in our latest Quarterly Economic Outlook, with the current account deficit looking wider for longer, it's worth questioning whether New Zealand is one material terms of trade shock away from a sovereign credit ratings downgrade. It is in this context that risks around additional fiscal expansion are quite worrying. Government dis-saving in recent years has been a meaningful driver of the widening current account deficit (figure 3) (which has filled the hole left by the loss of tourism and foreign student revenue, but also added to domestic demand – along with monetary policy – bolstering imports), meaning if there is a downgrade owing to New Zealand's overall external position, this will be partly a function of historical fiscal policy settings.

Figure 3. Sector contributions to current account deficit



Source: Stats NZ, Macrobond, ANZ Research

Sovereign credit rating agencies do focus on New Zealand's ability to pay its way in the world, and we doubt any of them would be feeling comfortable with recent current account outturns. The good news is that ratings agencies tend to be forward-looking, and the outlook is for New Zealand's imbalance to improve, but risks are skewed to wider-for-longer deficits. But credit ratings tend to be a *relative* concept over the longer run too, meaning it's not just New Zealand's performance relative to history that matters, but also relative to the rest of the world. And on that score, we aren't doing well, with the widest deficit across OECD economies as at Q1 2023.

We'll never be in a position to forecast a change in sovereign credit rating, as there are a number of qualitative assessments that contribute to these, but risks are feeling heightened. Hopefully New Zealand manages to grind away at the too-wide current account deficit over coming years, but the longer this takes, the longer the economy will be vulnerable to a significant terms of trade shock that could trigger a sovereign ratings downgrade, or worse, necessitate a very sharp correction in domestic investment activity (as the country is forced to abruptly live within its means).

With the New Zealand economy having lived so far outside of its means in recent years, there are clear risks emerging that the NZD undergoes a meaningful depreciation and/or New Zealand experiences structurally higher interest rates (reflecting a higher risk premium when seeking foreign capital). For households and businesses, that would make imports more expensive than otherwise, and add to borrowing costs. But a lower NZD would certainly assist net exports.

All up, the fiscal position isn't likely to trigger a sovereign ratings downgrade *per se*, but if a downgrade does happen because of New Zealand's external position, it would be fair to say that post-COVID fiscal settings have played a part in that.

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