ANZ Research

NZ Pre-election Economic & Fiscal Update

12 September 2023

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More debt, more bonds, more deficits

Summary

- The Pre-election Economic and Fiscal Update was close to our expectation. The Treasury has downgraded the fiscal outlook largely as expected, but the economic outlook has had a small upgrade, which is a surprise.
- While these forecasts incorporate lower discretionary fiscal spending (announced a few weeks ago), core Crown expenses are still expected to be higher than forecast in the Budget Update, reflecting rephasing, higher funding costs and other small tweaks here and there.
- The Treasury's updated economic forecasts are rosy, suggesting a downward skew of risks around the tax and broader fiscal outlook, and therefore upside risk to NZDM's bond issuance guidance.
- On that front, NZDM have lifted their signalled issuance by $9bn over the forecast horizon.

Issuance guidance ($bn)

	Jun-24	Jun-25	Jun-26	Jun-27	Jun-24 to Jun-27
Bonds					
2023 Pre-election	36	35	30	28	129
2023 Budget Update	34	32	30	24	120

- As expected, the forecast return to OBEGAL surplus has been pushed out a year to 2026/27. That would mark seven consecutive years in deficit following COVID and Cyclone Gabrielle – one more year in deficit than followed the Global Financial Crisis and Canterbury earthquakes. And if downside economic risks materialise, or fiscal settings are loosened after the election, we wouldn't be surprised to see this pushed out again (the 2027/28 forecast year will be added at the upcoming Half-Year Update in December).
- When it comes to monetary policy implications, it's the near-term signal that really matters, especially when the upcoming election means the policy mix could change meaningfully by Budget 2024. After accounting for the usual reshuffling of Government spending between fiscal years (owing to delays etc) and automatic stabilisers, today's figures don't look like a game changer. Fiscal policy is still expansionary in the near term, potentially problematically so from an inflation-fighting perspective, but this was signalled at Budget.
- Importantly, today's forecasts do not account for 'party policies' such as the removal of GST on fresh fruit and veggies or income tax cuts, meaning the overall fiscal stance could look a little different in December's Half-Year Update once the election result is known and the Treasury has adequate certainty to factor these in.
- All up, our take is that the Pre-election Update forecasts leave the door open to further downgrades to the books further down the track. And it's likely that risks will materialise before the books are back in surplus. In short, the current forecast return to surplus has a 'best-case scenario' look about it.
- To help put the Pre-election Update into perspective, we include the three appendices from our PREFU Preview, updated for today's data: 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 New Zealand's Sovereign credit ratings.

Treasury’s economic outlook slightly upgraded, with recession still not expected

Surprisingly, The Treasury’s updated economic outlook is stronger than in the Budget Update. This reflects an upgraded migration assumption, the cyclone recovery boosting business investment more than previously expected, and a stronger near-term house price outlook. There is no recession in the Treasury’s forecast, with the economy expanding 1.3% across the 2024 fiscal year.

The Treasury has built in a larger net migration assumption, close to 100,000 in the year to September 2023. House prices are expected to rise sooner than expected at the Budget Update (figure 2), supported by net migration. Despite this, The Treasury's forecast is weaker than our forecast for a 3% rise by the end of this year (which to be fair is already looking a little on the low side). Unemployment is expected to rise to a peak of 5.4%, versus the current level of 3.6% (we see it rising to 5.2%).

Treasury has revised down its terms of trade forecast consistent with ongoing soft demand from China. Their macroeconomic forecasts were finalised on 2 August, before much of the recent large falls in dairy and meat prices. This is reflected in the current account forecast, which we believe is still too optimistic and is well above ANZs. Recent falls in dairy prices, the increased likelihood of drought conditions this summer and consequent effects on demand in rural communities could well have been sufficient to tip the Treasury’s forecasts into recession had they been able to be fully incorporated (the fiscal update process necessitates early finalisation of macroeconomic forecast numbers).

In the Treasury’s forecasts, the OCR is assumed to peak at 5.5% (it’s already there, but we expect another hike), remaining contractionary for longer compared to the Budget Update’s forecast peak of 5.25%. Aggressive cuts from mid-2024 are expected, which we think are unlikely to occur, barring a large unforecastable shock.

In our view Treasury’s GDP outlook would be unlikely to bring about sufficient slack in the New Zealand economy to return inflation to 2% in a timely fashion. We believe the economy will need to soften well into recessionary territory one way or another to bring inflation down, whether that’s due to external shocks or because the RBNZ has to keep hiking into next year beyond our current 5.75% OCR forecast.

Figure 1. Real GDP forecast

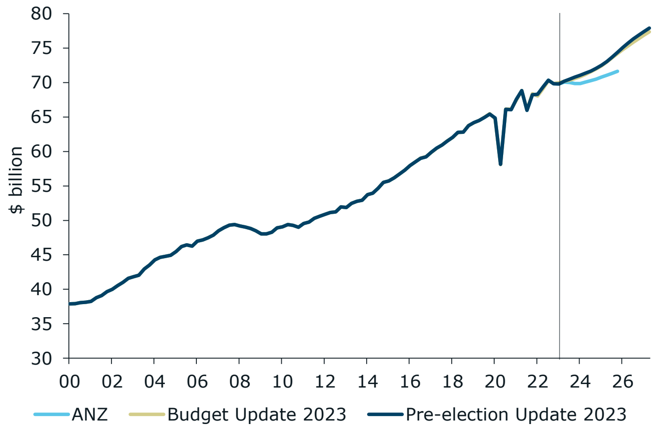


Figure 2. House price forecast

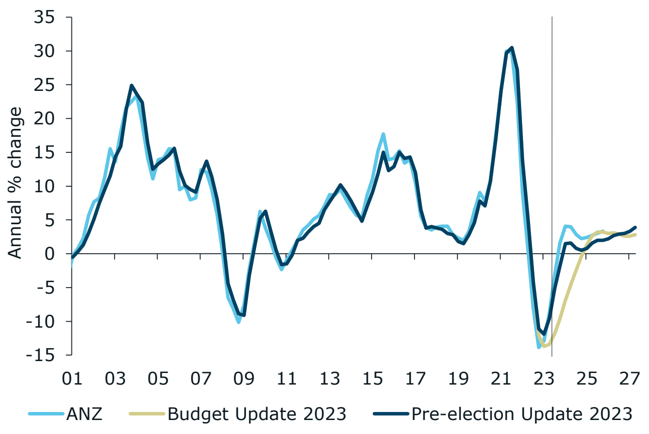


Figure 3. CPI inflation forecast

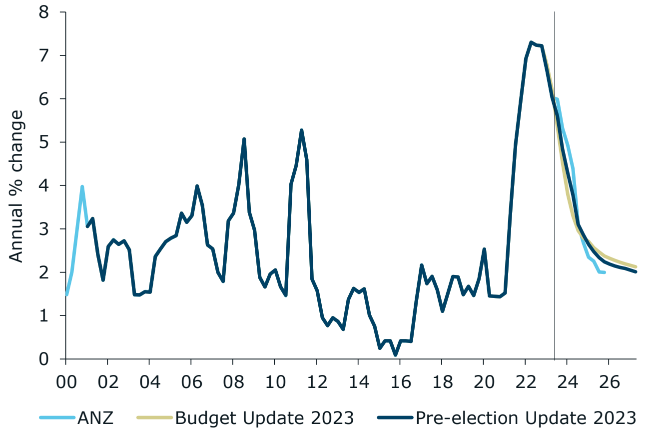
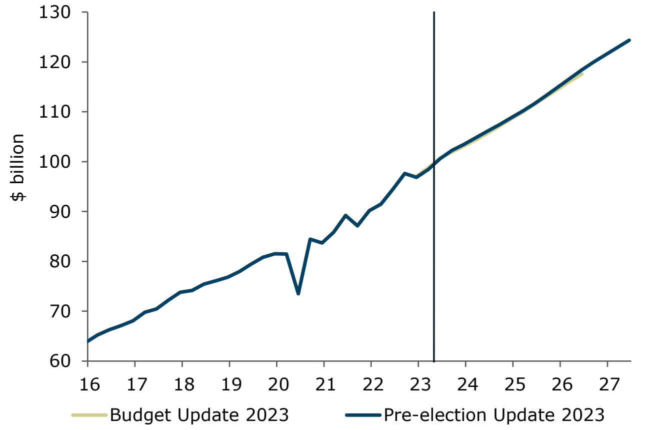


Figure 4. Nominal GDP forecast



Source: Stats NZ, REINZ, CoreLogic, The Treasury, ANZ Research

More spending and a lower, but optimistic, tax take

Despite the slightly stronger economic outlook, core Crown tax revenues are expected to come in $6.4bn below the Budget Update forecast over the next four years. At the same time, core crown expenses are $6.8bn above the Budget Update forecast over the next four years. This is mainly due to higher transport spending from the most recent Government Policy Statement and higher interest rates on more government debt.

Turning to tax, The Treasury's forecast for the nominal economy is similar to that in the Budget Update. We see the risks around tax revenue skewed to the downside. The GDP outlook for the 2024 and 2025 fiscal years are very rosy and we think the Treasury will continue to be surprised by the tax take coming in lower than forecast. This is especially likely since the tax revenue forecasts were finalised in early August, meaning that the large falls in dairy prices since then have not been incorporated. The Treasury's inflation forecast is a bit higher in the medium term than we believe the Reserve Bank would be comfortable with. Despite being in the target band at the end of next year, CPI inflation does not return to 2.0% until March 2027, suggesting interest rates may need to remain elevated for longer than the Treasury expects and posing downside risk to the tax take and upside risk to expenses in the out-years.

Figure 5. Core Crown tax revenue

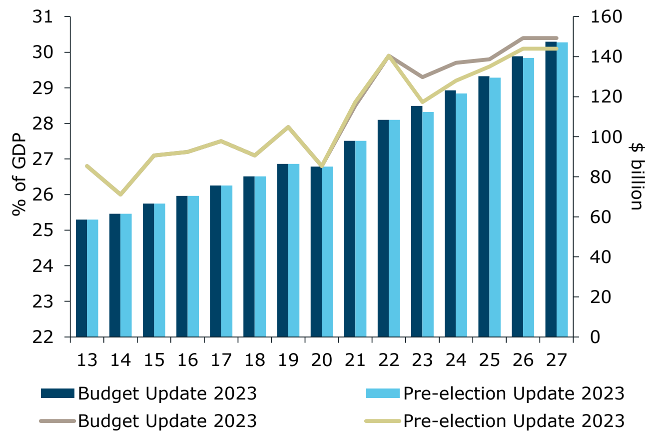
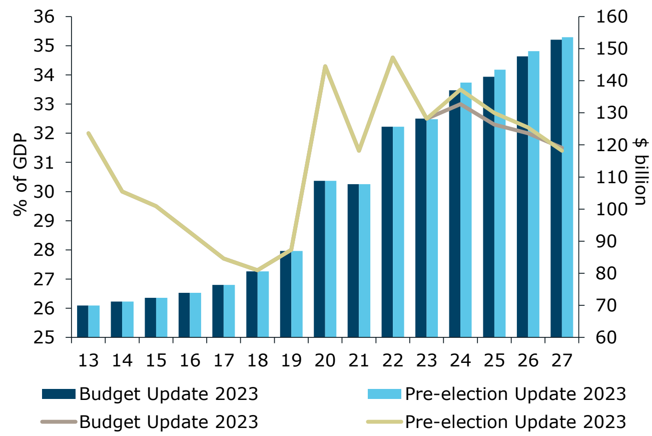


Figure 6. Core Crown expenses



Source: The Treasury

Forecast surplus pushed out another year to 2026/27

The Treasury is forecasting the return to OBEGAL surplus will be delayed until the 2026/27 fiscal year (figure 7), but at just $2.1bn we'd still consider this forecast surplus vulnerable to being revised to a deficit if the economic outlook underperforms the Treasury's forecast or the next Government significantly loosens fiscal settings.

The forecast OBEGAL deficit for the current fiscal year has been revised wider by around $3bn to $10bn, reflecting the weaker tax revenue starting point. Including capital expenditure, the core Crown residual cash deficit has been revised wider by $3bn in 2023/24 to $25.6bn. That shortfall in funding adds to debt and means NZDM has a larger funding task at hand.

At $102.6bn, net debt is expected to be around $13.5bn higher by the end of the forecast than at the Budget Update (figure 8). Although valuation changes (largely driven by the NZ Super Fund's performance) can make forecast comparisons a little messy between updates, the deterioration appears to largely reflect the underlying fiscal outlook.

Figure 7. Total Crown OBEGAL

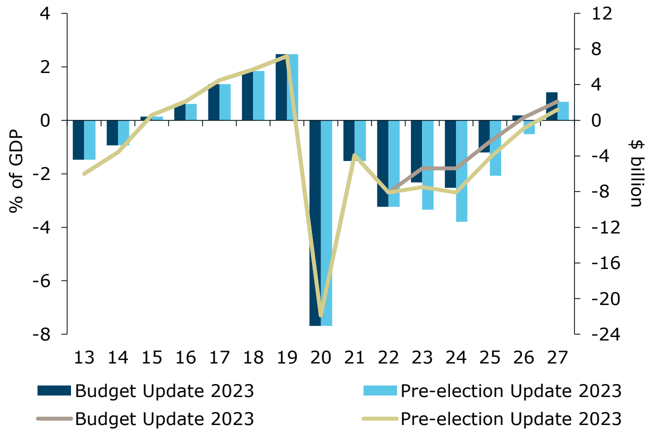
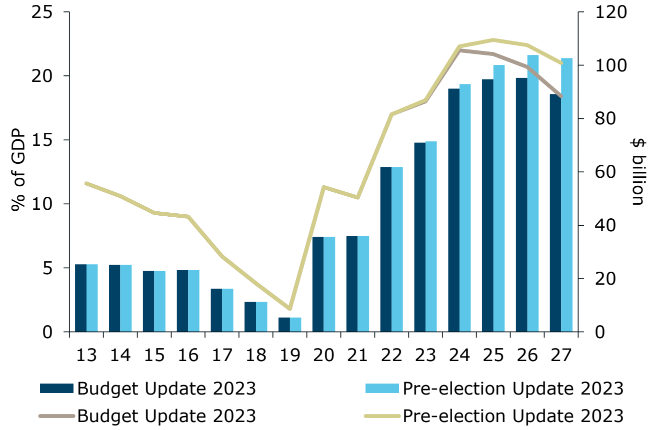


Figure 8. Net debt



Source: The Treasury

A $9bn increase to bond issuance guidance, and we see upside risks

Market participants went into today's Budget expecting another sizeable increase in NZDM's bond issuance guidance. In the end, it was lifted by $9bn over the next four years (Table 1), $1bn less than our expectation.

As expected, NZDM have smoothed their forecast bond programme across fiscal years, with larger increases in the out years (on balance). As expected, guidance for 2023/24 has been increased $2bn to $36bn, 2024/25 has been increased $3bn to $35bn ($1bn higher than we expected), 2025/26 is unchanged at $30bn ($4bn lower than expected), and 2026/27 was lifted $4bn to $28 ($2bn higher than expected). The overall increase in issuance guidance is close to our expectation. But no matter how you cut it, this is a lot of bonds for the market to absorb. If demand for NZGBs softens, the taxpayer could be on the hook for higher financing costs.

No material changes have been made to NZDM's liquidity strategy (to maintain a buffer of around $15bn). But NZDM have made an adjustment to include Kāinga Ora bonds that mature within the Treasury's forecast horizon (to June 2027). That's about $3.2bn of funding that we had previously flagged as an upside risk to NZDM's guidance that can now be put to bed. Kāinga Ora bonds maturing outside of the Treasury's forecast horizon (about $4.4bn) are yet to be incorporated.

Short-term borrowings guidance (Treasury bills and Euro-Commercial Paper) has been kept stable at $9bn at the end of each fiscal year. NZDM note that intra-year short-term borrowings are expected to vary from $6bn to $15bn, noting that the composition will include a minimum of USD1bn of ECP and NZD2bn of T-bills.

Table 1. Issuance guidance ($bn)

	Jun-24	Jun-25	Jun-26	Jun-27	Jun-24 to Jun-27
Bonds					
2023 Pre-election Update	36	35	30	28	129
2023 Budget Update	34	32	30	24	120
Short-term borrowings (T-bills and ECP)					
2023 Pre-election Update	9	9	9	9	
2023 Budget Update	9	9	9	9	

Source: The Treasury

NZDM has signalled an intention to syndicate two new nominal bonds before the end of the fiscal year: a May 2035 and a May 2054. No further details have been provided.

All up, we'd continue to characterise risks to bond issuance guidance as to the upside. The Treasury's economic and therefore tax forecasts look optimistic to us, and there's always plenty of scope for discretionary fiscal policy changes on the other side of the election that would require a little more debt.

Markets went into the Pre-election Update expecting a decent lift in forecast bond issuance, and that's what they got. But as unwelcome as that news was, NZGB spreads to swaps had already moved a long way, and our sense going into today was that the hurdle for a surprise was high. We note, for example, that the asset swap spread on the 10-year bond (the NZGB 4/33) has widened from around -28bps at year-end to around +15bps at yesterday's close. That's not as wide as that spread got to at the peak of the COVID crisis, but it is historically wide, representing a decent risk premium. It therefore wasn't surprising that the market reaction today was muted, with the yield on the 4/33 bond unchanged an hour after the release, and the Kiwi unperturbed.

If there has been good news for the bond market of late, it is that overall bid cover at NZDM's weekly NZGB tenders has improved over the past three weeks. That has occurred against the backdrop of an expectation that issuance would be lifted substantially today, adding to our sense that markets were well priced for the deteriorating fiscal outlook. But even so, issuing large volumes of bonds week in, week out does leave the market vulnerable if demand gets patchy, as it did late last year and earlier this year, when NZDM experienced two under-allocated tenders. NZDM's best defence against patchy demand is to rely on syndications to get a large volume of bonds away, rather than upping the volume of weekly tender issuance.

In terms of the pace of issuance, with $36bn of bonds to be issued this year and NZDM confirming that we'll 'only' get two more new bonds this fiscal year (a new May 2035 nominal and a new May 2054 nominal), we think NZDM can stick with a $500m/week pace of tender issuance. With $10bn of issuance 'in the tin' (including tomorrow's already-announced tender) and allowing for the usual pattern of no tenders between mid-December and the third week of January and on syndication weeks, continuing tenders at a $500m/week pace will leave them with $8.5bn of issuance to do via syndications. We think that's easily achievable, especially if we pencil in, say, a $5bn issue of the new May 2035 bond and a $3.5bn issue of the new May 2054 bonds, recalling that NZDM saw in excess of $12bn of bids for the recent $5bn tap of the April 2033 bond.

In terms of the timing of syndications, we think it is more likely than not that the next syndication doesn't occur till February. November is a possibility, and we wouldn't rule it out. However, it seems unlikely given NZDM's past pattern of announcing the timing of syndications no later than the relevant month's tender schedule announcement, and with the November schedule due to be published on 25 October, just 11 days after the election, the calendar looks very tight. Post-election coalition negotiations may be completed by then, but we doubt NZDM will want to count on that being the case.

Looking ahead, we don't see much scope for asset swap spreads to correct a long way given the wall of issuance that lies ahead in coming years. Rather, we think the bond market is going to "muddle through" for the foreseeable future. There are a lot of bonds coming, and while we don't think NZDM will have any genuine problems getting bonds away (especially now that the price has adjusted), the fact that issuance in the out years has been lifted by more than it has in the current year will be well received by markets. Sure, it kicks the proverbial can down the road, but with the market almost stretched to capacity absorbing the Budget estimate of $34bn of bonds, any significant lift in 2023/24 issuance may have risked episodic market dysfunction. But we think a lift to $36bn is manageable (and as noted earlier, it's what we expected).

Wrapping it all up then, while there's nothing here for bond markets to be all that happy with, a sense of relief is likely to be evident in coming days. The lift in issuance didn't exceed our expectations, we don't think the pace of weekly issuance will increase, and if we are right that the next syndication won't occur till February, markets can take a bit of a breather, especially since they had already moved a long way before today.

Summary

All up, the Pre-election Update came in roughly where we thought it would. The Treasury's fiscal outlook is softer, but risks to the economic outlook are to the downside, representing downside risk to the fiscal outlook as well. In terms of discretionary fiscal policy, these forecasts certainly don't leave a lot of wiggle room for any significant post-election loosening in fiscal settings. Risks appear skewed towards the return to surplus being pushed out yet again and NZDM needing to issue more bonds than today's guidance. But there's a lot of water to potentially flow under the bridge on the fiscal policy front between now and December's Half-Year Update, as the latter will incorporate any changes to policy settings following the election.

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 Pre-election Update. The Treasury has downgraded the fiscal outlook. The return to OBEGAL surplus has been pushed out another year (to 2026/27), which would mark seven consecutive deficits in a row. That's one more year in deficit than following 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 September 2023, it had been pushed out three years to 2026/27, as increases in government spending have tended to more than offset changes in revenue on balance.
- 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.

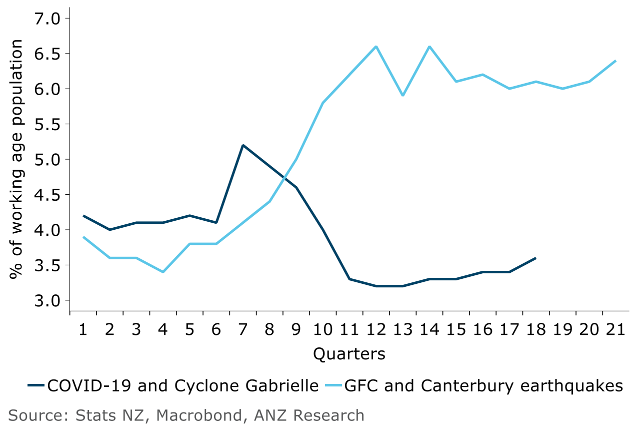
Appendix 2: Fiscal policy through crises (differences between the pandemic and the Global Financial Crisis)

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.

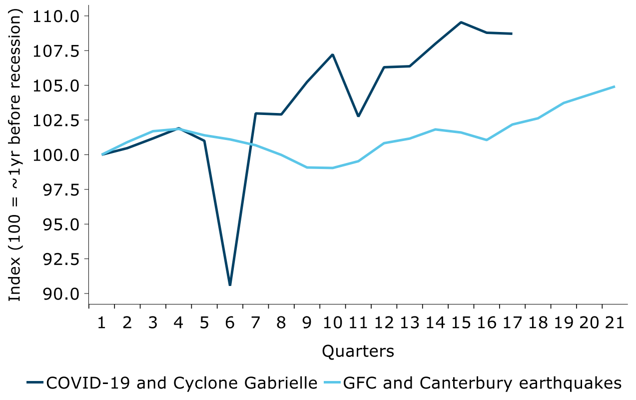
The COVID era got off to a dramatic start, with lockdowns resulting in unprecedented falls in activity. But not least because of monetary and fiscal stimulus, the unemployment rate then hit a record low, GDP bounced back strongly, spare capacity was exhausted quickly and domestic inflation (which tends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

Figure 1. Unemployment rate



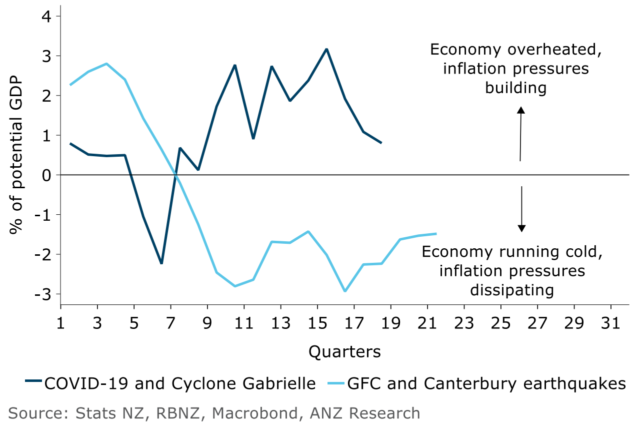
Source: Stats NZ, Macrobond, ANZ Research

Figure 2. Real GDP



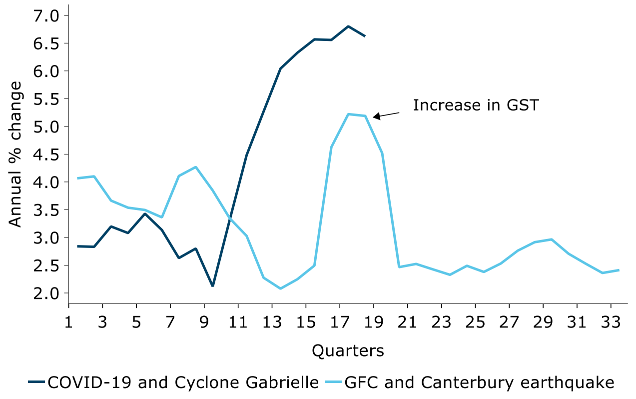
Source: Stats NZ, Macrobond, ANZ Research

Figure 3. Output gap



Source: Stats NZ, RBNZ, Macrobond, ANZ Research

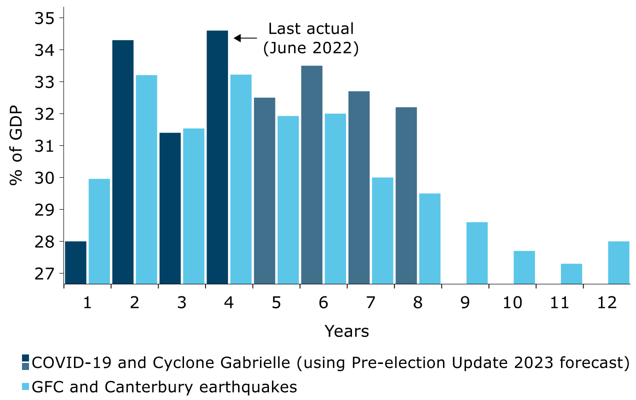
Figure 4. Non-tradable inflation



Source: Stats NZ, Macrobond, ANZ Research

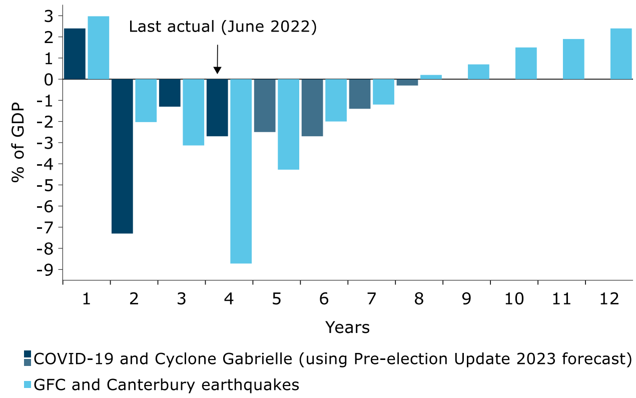
Meanwhile, despite the fact that the economy is still clearly stretched and the RBNZ is having to inflict pain on households and businesses via a higher OCR, core Crown expenditure as a share of GDP is expected to remain at elevated levels for quite some time. The GFC and Canterbury earthquakes were met with six consecutive years of OBEGAL deficits. The Pre-election update forecasts suggest clocks this at seven years in deficit (figure 6).

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.

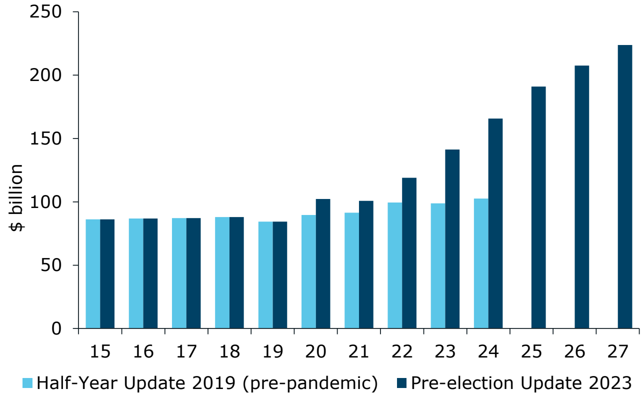
The only long-run source of sustainable real income growth is labour productivity improvements, and while governments can certainly influence that (eg through education, health policy, smart immigration policy, and getting incentives right), procyclical fiscal policy probably isn't going to help. Absolutely, 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 New Zealand'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.

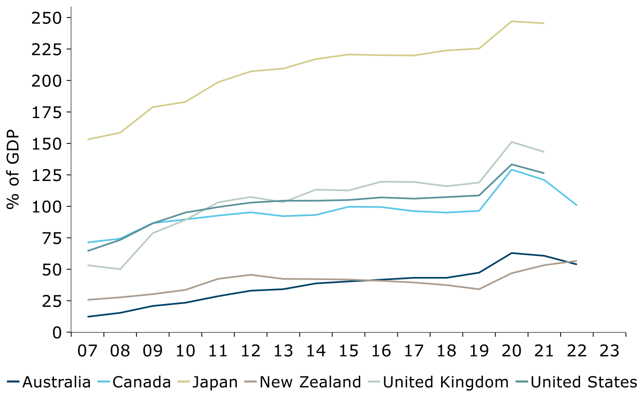
First, it's important to note that NZ's government books are in a great position relative to other advanced economies. That said, the latest OECD data show that as of 2022, NZ no longer has bragging rights over Australia (figure 2).

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



Source: The Treasury, ANZ Research

Figure 2. Gross public debt (OECD measure)

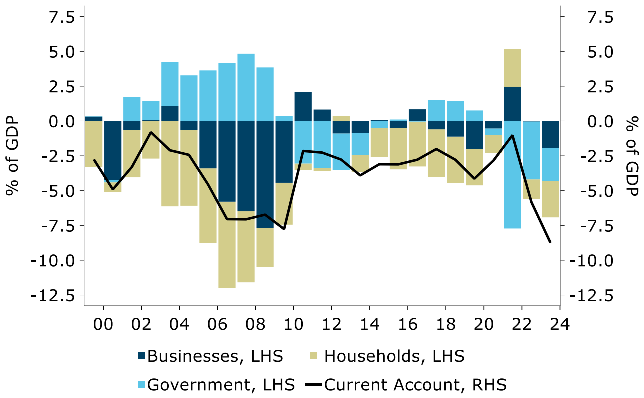


Source: OECD, Macrobond, ANZ Research

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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