Economic Note

Budget 2020 Review

14 May 2020

Huge support, huge debt

- Overall, Budget 2020 showed an appropriately large COVID-19 spending package. As expected, the wage subsidy was extended and made more targeted, training spending was boosted to go on top of the health and education spending already announced.
- The Government has also kept its powder dry with the announcement of the $50bn COVID Response and Recovery Fund (CRRF), albeit $30 of the fund has already been earmarked. This makes the Budget more stimulatory than anticipated. As a result, there is now a small amount of upside risk to our growth projections. At the margin, there's also more support for idea the RBNZ will not have to cut the OCR to negative anytime soon.
- Unsurprisingly, and given the magnitude of the extra spend, net debt rises sharply, and bond issuance also jumps massively. Bond yields have jumped on the back of the bond issuance outlook.

Summary

First off, this Budget is big. We expected an extra $15 to $20bn of spending, and got an additional $15.9bn on top of that previously announced. Indeed, the magnitude of the spending meets our 'appropriately big' test as we alluded to in our Budget preview.

And there's more to come, as the Minister of Finance says the rolling maul of spending initiatives will continue. The Government unexpectedly announced today a $50bn fund, the COVID Response and Recovery Fund (CRRF), which is similar to the fund created in the wake of the Christchurch earthquakes. $20bn is yet to be allocated. Expect more initiatives to come out as they get developed. And, over time, there will be bandwidth to focus strategically on the longer term.

Aside from size **there was (as expected) a mix of effective and less-effective policies**. We got the expected extension ($3.2bn) of the wage subsidy and it has also been targeted as we hinted that it might be. We also got a boost to training spending via a $1.4bn trades and apprenticeships package. We see both these as appropriately targeting to COVID-related job losses. Some others seem more as coming off the long-standing policy wish-list rather than expressly countering the economic devastation COVID is creating.

Looking to the future, **the Minister of Finance reiterated his commitment to fiscal prudence (although the goalposts for this have shifted to completely different playing field now!)**. NZ's debt levels will still shape up well compared to many countries. But there is much water still to go under the COVID bridge. Furthermore, at first glance the Treasury's longer-term growth outlook (and tax base) looks very rosy, opening up a lot of uncertainty about the future health of the Crown accounts. If reality doesn't meet those lofty expectations, at some point in the future we may have to look hard at the sustainability of some of the more expensive lines of government spending.

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The key policies

One of the most significant policy announcements was an extended wage subsidy, which will continue to keep as many people as possible on the payrolls as the economy picks itself up off the mat over coming months. $20bn of the newly-announced COVID Response and Recovery Fund (CRRF) remains to be allocated. There is also a lot more work for the Government to do to plan out a long-term economic vision for the economy.

Key initiatives:

From Covid-19 Response and Recovery Fund (CRRF), over 5 years		
Initiative	*$*	*Notes*
Business Support Package	4.0bn	Includes wage subsidy extension and $400m Tourism Recovery Fund
Wage Subsidy Extension	3.2bn	For businesses with turnover drop of over 50%; 8-week duration
Infrastructure & 8,000 Public House Build Programme	3.0bn	
Trades and Apprenticeships Training Package	1.4bn	
Environmental Jobs Package	1.0bn	
Core Services, including Health and Education	3.3bn	
Other Budget 2020 Initiatives		
Health	5.6bn	This investment includes $3.9 billion of operating funding for the 20 DHBs
Education	0.96bn	Includes tertiary
Defence	1.77bn	Operating and Capital funding
Rail Investment	1.2bn	

Source: The Treasury, ASB.

In this time of quantity, the quality of fiscal spend still matters

While it was important that Budget 2020 was big, the quality of the spend was still important. In this regard, we believe that COVID-driven spending should be targeted at the groups most impacted as well as be fast-acting. In addition, spending should be temporary or easy to reverse once conditions improve or else have an eye to the future in terms of boosting productivity and/or wellbeing.

We also note that with the fiscal strings loosened, the Government should be careful not to allow spending initiatives for the sake of it, coming back to the point that spending quality matters. Indeed, the spending bar should be high, with the opportunity cost of returning taxes to struggling households and businesses a useful guide.

Using this framework, Budget 2020 included a mix of effective and less-effective policies. In the effective bracket was the expected extension ($3.2bn) of the wage subsidy. The wage subsidy extension was further targeted (for businesses with a 50% hit to turnover) and temporary (for eight weeks). We also got a boost to training spending via a $1.4bn trades and apprenticeships package, which will help those forced out of work due to COVID-19 to find new jobs.

On the less-effective or less-targeted side, Budget 2020 included for example a $1bn environmental jobs package. While job creation is necessary to aid the recovery, we don't think the Government is well-placed to choose where the jobs occur – we think businesses are better-placed to do that. Hence the money could have been better spent on a broader business tax cut, such as further accelerating depreciation rates on businesses' capital expenditure, for example.

Budget 2020 incorporated an 8,000 public house building programme. Expanding social housing and taking steps to reduce the cost of housing in NZ are good long-term initiatives – they do need to be done. We expect private demand for housing construction will plummet this year as a result of COVID-19. The second half of 2020 will be an opportune time for the Government to ramp up its home building programme to prevent job losses and idle resources.

Operating Surpluses

As anticipated, **the weaker economy and additional fiscal support results in large fiscal deficits**, with the operating balance (OBEGAL) in deficit at close to 10% of GDP over 2020/21 and 2021/22. By 2023/24 the deficit narrows to under 5% of GDP.

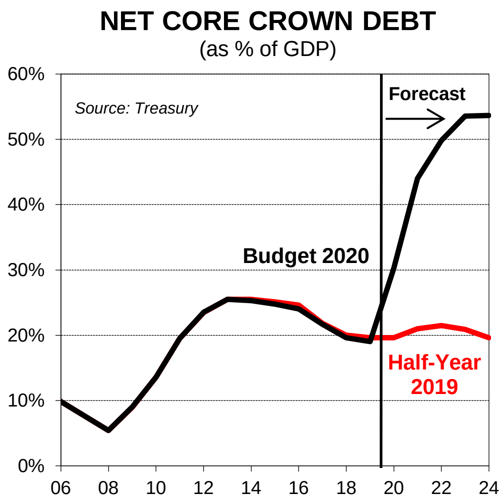
The contrast is stark with the Half-Year Update late last year. Over the first three years of the forecast period, OBEGAL averages at $27bn lower than forecast back in December 2019's Half-Year Update. The deficits owe to both lower forecast tax revenue due to the slumping economy and the additional government spending announced prior to the Budget as well as that announced today.

Nonetheless, **the Government's books were in good shape prior to COVID-19 and can absorb this hit**. Indeed, the Minister of Finance has referred to the COVID outbreak as a 'rainy day' and that the Government is particularly well-placed for such a day. We'd characterise COVID-19 more like a monsoon.

Net debt

As expected, Budget 2020 shows net Government debt increasing dramatically. From 19.0% as at June 2019, net core Crown debt spikes to 53.6% of GDP by 2022/23 and it stays at this level in 2023/24.

Beyond the five-year forecast period net debt begins to fall as a % of GDP. Also, importantly, while debt levels rise dramatically, **debt servicing costs are forecast to remain low** at around 1.2% of GDP at the net debt peak. This forecast servicing cost is the same as what the government incurred over 2018/19.



Bond programme

Subsequently, the Debt Management Office (DMO) has made a massive $150bn increase in the Government bond programme compared to the December 2019 Half-Year Update. **Gross issuance is expected to total $190bn over the next five years.** The bond programme has been frontloaded with increased issuance of $50bn in 2020/21 and 2021/22, and by $32bn in 2021/22. Issuance falls incrementally over 2022/23 and 2023/24, but remains very high. Note, the $15bn increase over 2019/20 was previously announced in conjunction with the Government's initial COVID-19 economic response package.

Gross NZGB issuance $bn	2019/20	2020/21	2021/22	2022/23	2023/24	5-year Total
Budget 2020	**25.0**	**60.0**	**40.0**	**35.0**	**30.0**	**190.0**
Half-Year Update 2019	*10.0*	*10.0*	*8.0*	*6.0*	*6.0*	*40.0*
Change in issuance	15.0	50.0	32.0	29.0	24.0	150.0
NZGB's on issue (% of GDP)	31%	47%	55%	56%	57%	n/a

Source: The Treasury, ASB

Market reaction

Government bond yields have risen in reaction to the NZ Debt Management's higher than expected issuance forecasts ($60b in 2020/21 vs. our expectations of $45b). Bond yields are up as much as 10-15bps following the Budget's release, with the increases larger for long-dated tenors. Swap rates have been dragged up around 2-5bps. If this lift in interest rates continues, we'd expect the RBNZ to again step in and increase its weekly purchases of government bond yields. There is plenty of room to do so now that the quantitative easing 'cap' has been raised from $33b to $60b. The NZ dollar was broadly unchanged.

Economic Forecasts

The Budget economic growth forecasts show a large hit to the economy early on. In Q2, Treasury expects real GDP to decline by 23%, compared to our own expectation of a 17% drop. Given the very high degree of uncertainty we aren't too fussed about near-term assumptions. **It's the pace of recovery over 2021 and 2022 which has raised our eyebrows.** Given the drawn-out nature of the pandemic and its enduring impacts on productivity and balance sheets, we think it is highly unlikely the economy will be recovering quite as strongly as the Treasury believes during 2021 and 2022. Indeed, we believe that ongoing travel restrictions and persistently-high unemployment will be key handbrakes on economic growth during this period. **The Treasury's extremely bullish growth forecast places the level of its nominal GDP 10% above our own forecasts by March 2024** – and is likely creating a flattering picture of debt to GDP forecasts at this horizon. Our own nominal GDP forecasts sit closer to the Treasury's "slower recovery" scenario – in this scenario the Treasury projects core crown debt reaching 64% of GDP by 2024.

Naturally, the Treasury's stronger economic growth assumptions filter through to a faster labour market recovery. The risk that the unemployment rate remains higher for longer further reinforces the risk that debt is likely to be higher than the Treasury is forecasting.

Furthermore, **these optimistic growth forecasts are even before the full extent of the Government's COVID-19 support package was incorporated**. The Treasury's economic forecasts were finalised on 17 April and incorporate only $35 billion of discretionary fiscal support, compared to the full $62.1 billion of COVID-19 fiscal support included in the fiscal forecasts, which were finalised on 23 April.

To be fair – we have not yet incorporated the full spending package into our own GDP forecasts, and once we do our own economic forecasts are likely to be stronger than they are today. Nonetheless, we are wary that much of the fiscal spending is required simply to stop the outlook from being even worse. To some extent, our forecasts implicitly assume fiscal support is coming to the party and doing all it can - precisely because the global and domestic economic fundamentals are extremely challenging. Even if NZ eliminates the virus, there is the risk the global pandemic rages for years, not months, in which case there would be a limit to how strong the NZ economy can grow during this period. **To give credit, the Government is bringing fiscal stimulus to the party – the fiscal impulse, estimated by Treasury,** reaches over 6% in 2020. To provide context, this impulse is around double that of the Government's response for the Global Financial Crisis.

Economic Forecasts	2020			2021			2022		
June years (ann avg)	HYEFU	ASB	Budget	HYEFU	ASB	Budget	HYEFU	ASB	Budget
GDP (nominal)	5.1	-0.5	-3.0	5.2	-2.9	0.0	5.3	3.5	11.6
GDP (Production)	2.3	-3.2	-4.6	2.9	-2.6	-1.0	2.6	2.7	8.6
Private consumption	2.3	-3.4	-6.4	2.6	-4.7	4.7	2.9	1.9	5.9
Govt consumption	3.6	6.4	6.0	2.3	8.3	1.9	1.3	2.9	1.7
Exports	0.6	-8.6	-8.7	3.0	-14.5	-16.1	2.5	7.4	20.0
Imports	1.7	-4.2	-7.7	3.2	-9.6	-5.9	3.1	2.0	14.0
Inflation (ann % chg)	1.9	1.3	1.3	1.9	0.7	0.8	2.0	0.7	1.5
Unemployment	4.3	9.0	8.3	4.2	8.6	7.6	4.2	6.9	5.7
90-day bank bills*	1.0	0.3	0.5	1.0	0.3	0.5	1.2	0.3	0.5
TWI*	70.8	63.7	66.0	70.8	71.9	67.1	71.6	71.9	68.1

Source: The Treasury, ASB

The warning for the future

The Government looks to have nailed the public healthcare policy response to COVID-19 and we stack up very well in relation to how the outbreak has been managed compared to other countries. Hopefully, the outbreak will remain contained in NZ and the number of cases does not flare up as restrictions are eased, as has occurred overseas.

There is considerable uncertainty over the economic path ahead, but by our reckoning the economic forecasts provided by the Treasury look to be overly optimistic. This, in turn results in the Treasury depicting a better fiscal outlook than we expect will likely eventuate. The Budget forecasts have net core Crown debt peaking at just over 50% of GDP by 2012/24 and then modestly declining thereafter. In an environment of very low interest rates this level of debt is manageable and will leave NZ's fiscal accounts amongst the best of the world. **But the relatively rosy picture being depicted risks that many of the tough choices and prioritisations that need to be made simply get delayed**.

Such is the scale of the economic hit posed by COVID-19 that the prognosis for the NZ economy and the public finances is grim. We do not expect a typical V-shaped recovery to unfold. If we are right, this will result in a considerably less rosy fiscal outlook than suggested in the Budget forecasts. In that case, **at some point in the future tough conversations around policy options and trade-offs will have to be made**. A few topical areas we can think of include raising the NZ retirement age; ditching zero interest rates on student loans, and the NZ Government making contributions to the NZ Super Fund rather than paying down debt.

There will nonetheless be other areas where greater scrutiny will be made over whether government spending is delivering the best value for money for current and future generation of taxpayers. The burden of the COVID response – necessary though it is – will largely be borne by future generations, and we need to ensure we make the best decisions we can over the next few years.

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