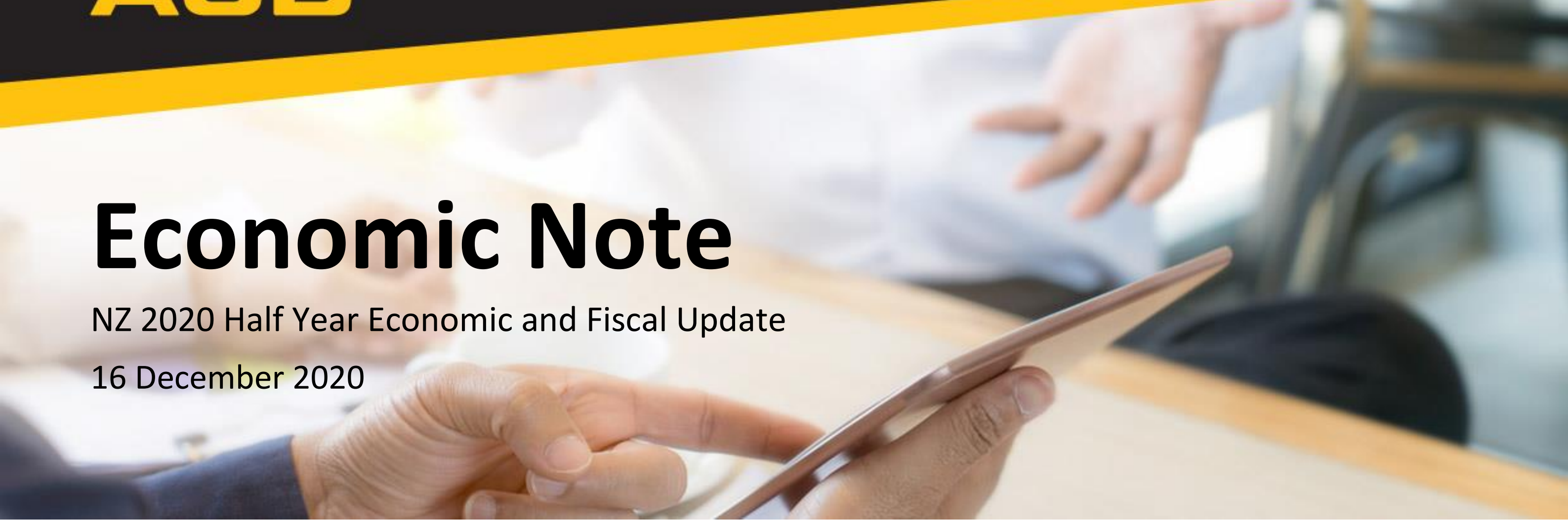

Economic Note

NZ 2020 Half Year Economic and Fiscal Update

16 December 2020

Improved fiscal outlook demonstrates NZ's resilience

- The HYEFU reveals an improved economic and fiscal outlook, and lower government borrowing.
- Fiscal policy has played a key role in supporting the NZ economy over a difficult period. This in turn has reduced the COVID-19 hit to the fiscal position.
- While things are moving in the right direction, we are still climbing out of a deep economic and fiscal hole and the outlook is inherently uncertain. In time, more may need to be done to restore the public finances to a sounder position and to meet future challenges. This, however, is a conversation for another day.

The Half Year Economic and Fiscal Update (HYEFU) shows an improved economic outlook compared to the Budget and Pre-election Economic and Fiscal Update (PREFU)**, linked to NZ's apparent success at containing COVID-19**. Policy support has played a key role. with fiscal policy doing much of the heavy lifting, resulting in large fiscal deficits and climbing public debt. **However, as the Treasury have cautioned, the outlook is still inherently uncertain, with COVID-19 a clear risk to the economic outlook and to the Crown balance sheet as well.**

The stronger economic outlook has translated into an improved fiscal outlook. The pace of the reduction in OBEGAL deficits is now expected to be faster than previously expected, with an average $6bn annual improvement over the projections and an OBEGAL deficit of 'just' $4.2bn in 2024/25. This is a huge improvement on the $23.1bn deficit for 2019/20 but is still large in the context of NZ's history and underscores the challenges facing the economy.

Net core Crown debt is forecast to peak in the June 2024 fiscal year at $194.2bn, lower than the $201.1bn in the Pre-Election Economic and Fiscal Update (PREFU) and $200.8bn in the 2020 Budget. The Treasury expects net public debt to start declining by the end of 2024/25, notwithstanding the obvious uncertainties in looking that far ahead. As a % of GDP, net core Crown debt is expected to peak at 52.6% of GDP in 2022/23, which is streets ahead of the 55.3% 2023/24 level in the PREFU. As a result, forecast gross government bond issuance has been trimmed by $20bn over the 2021/24 period (to $135bn).

Fiscal policy has played a key role in supporting the NZ economy through a tough period. In turn, the more resilient NZ economic backdrop has supported the fiscal position. This is a welcome circularity, but the fiscal position has taken a significant hit. Continued progress in putting the public finances in a stronger position will help to lower the bill that will have to paid by existing workers and future generations. Continued focus will need to be made on ensuring government spending delivers its best bang for buck. More crown revenue would not go amiss either and moves to raise income tax rates of high wage and salary income earners from next April look to be the start.

Improved Economic outlook

The economic assessment in the Half Year Economic and Fiscal Update (HYEFU) was largely as we had expected, depicting a stronger short-term outlook relative to the Pre-election Economic and Fiscal Update (PREFU) and Budget 2020 forecasts. However, the Treasury acknowledges that the outlook is still inherently uncertain, with COVID-19 a clear risk to the economic outlook and to the Crown balance sheet as well. The Treasury kept matters objective, with the HYEFU presenting both an upside and downside forecast scenario.

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As the Treasury noted, NZ's success in containing COVID-19 has meant that the initial economic impacts of the outbreak, while still large, have been less severe than anticipated, with a relatively swift recovery taking place. The economy has also proved to be more adaptable and resilient to the COVID-19 hit than earlier assumed. Policy support is also expected to have a prolonged impact in propping up the economy, with $37bn of the $62.1bn in fiscal policy support measures to bolster the economy from 20/21. Household spending has been strong, given the robust housing market and as kiwis have run down savings accumulated during higher alert levels. Key supports, such as NZ's terms of trade, have been robust and are expected to remain near record highs. The employment outlook has improved, with a lower forecast peak in unemployment and a faster recovery in labour force participation.

Moreover, in the Treasury's view, the NZ economy is not entirely out of the woods. In their view, some of the rebound in household spending could have been driven by savings accumulated during higher alert levels and may not be sustained. Over the near-term, investment will likely be constrained by high levels of uncertainty. The global outlook is likely to remain subpar given the impacts of COVID-19. Treasury's working assumption is that Alert Level 1 restrictions will remain in place until the end of 2021, although they note recent trial results for several COVID-19 vaccines are promising and present upside risk. As a result, economic growth is forecast to continue at a slower pace over 2021, and then pick up from 2022 as New Zealand's border reopens.

Improving fiscal outlook and easing debt to GDP at end of projections

FISCAL PROJECTIONS - Half-Year Update 2020						
June years	2020	2021	2022	2023	2024	2025
Core Revenue ($bn)	**91.9**	**95.0**	**95.9**	**103.8**	**109.7**	**116.2**
(Prefu 2020)	*91.8*	*91.3*	*91.0*	*99.5*	*105.9*	
Core Expenses ($bn)	**108.8**	**114.2**	**109.1**	**112.0**	**115.3**	**118.7**
(Prefu 2020)	*108.8*	*119.5*	*109.9*	*111.7*	*116.1*	
OBEGAL ($bn)	**-23.1**	**-21.6**	**-16.4**	**-10.3**	**-7.5**	**-4.2**
(Prefu 2020)	*-23.4*	*-31.7*	*-22.1*	*-14.2*	*-12.4*	
OBEGAL (% GDP)	**36.7**	**27.5**	**22.0**	**19.0**	**17.1**	**16.4**
(Prefu 2020)	*-7.7*	*-10.5*	*-6.9*	*-4.2*	*-3.4*	
Net core crown debt (%GDP)	**26.4**	**39.7**	**49.1**	**52.6**	**50.7**	**46.9**
(Prefu 2020)	*27.6*	*43.0*	*49.9*	*53.5*	*55.3*	

Source: Treasury

The payoff from the more-resilient-than-expected economic outlook is an improved fiscal outlook. Core Crown tax revenues are forecast to be about $4.2bn higher on average each year compared to the PREFU forecasts. The increase is mainly a result of the movements in source deductions, goods and services tax (GST) and corporate tax. The Government's decision on a new top tax rate of 39% for personal income earned over $180,000 is forecast to increase tax revenue by $2.2 billion across the forecast period.

Core Crown expenses are expected to be lower across the forecast period as benefit expenses and COVID-19 Response and Recovery Fund (CRRF) related expenditure are lower than previously forecast, particularly in the near term. However, the Government have been careful to keep something in reserve in case of another outbreak. Funding of $10.3 billion remains unallocated from the COVID-19 Response and Recovery Fund (CRRF), which has been included in the fiscal forecasts

As such, the forecast operating balances in all years are expected to be better than previously forecast in the PREFU to the tune of roughly $6bn per year. The operating balance before gains and losses (OBEGAL) deficit is forecast at $21.6bn in 2020/21 and for the deficit profile to ease over the forecast period, with an OBEGAL deficit of just $4.2bn by 2024/25.

The improvement in OBEGAL flows through to the forecasts for core Crown residual cash and net core Crown debt. As such, net core Crown debt is expected to peak at 52.6% of GDP in 2022/23 before easing to 46.9% in 2024/25. This is compared to 55.3% of GDP by 2023/24 in the PREFU.

Bond tender outlook reduced further

As a consequence of the improved fiscal outlook, NZ Debt Management (NZDM) announced a lower bond tender programme. Issuance in the year to June 2021 was nudged down to $45b from $50b, with issuance also $5bn lower each year through to 23/24. All up, cumulative issuance through to 2023/24 was revised down by $20bn (to $135bn) compared to the PREFU. This tinkering was more than what we'd expected and largely mirrors the direction of changes to the deficit profile. Forecasts for gross issuance over 2024/25 were also published, and these were lower than prior years at $25bn, taking cumulative issuance over the 5-year period to $160bn.

The reduced debt demands in the near term also reflect the stronger-than-expected syndication run-rate since the Budget. Of interest in this regard was the NZDM's announcement that 2 new nominal bonds (May 2026 and a longer dated bond) will be launched via syndication before the end of June next year.

HYEFU Bond Programme (PREFU forecasts in brackets)	2020/21	2021/22	2022/23	2023/24	2015	4-year Total (21/24)
Gross NZGB issuance $bn	45 (50)	30 (35)	30 (35)	30 (50)	25	135 (155)
NZGBs outstanding $bn	128.1 (133)	158.1 (168)	172.2 (187)	188.7 (210)	200	NA

Source: Treasury

All up, NZGB issuance and hence total outstanding were marked lower relative to the HYEFU forecasts. Notably, this means there will be around $10bn fewer bonds in the market (in the year to June 2022) for the RBNZ to buy as part of its Large-Scale Asset Purchase Programme (LSAP). Still, with RBNZ Government bond purchases just over $40bn at present, the 60% indemnity limit and the $100bn LSDAP ceiling remains some way off an does not represent a significant barrier to the RBNZ altering their programme, which has been tapering down of late anyway. RBNZ asset purchases should continue to play a role in keeping the NZ Government bond yields lower (and the yield curve flatter) than they would otherwise be.

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