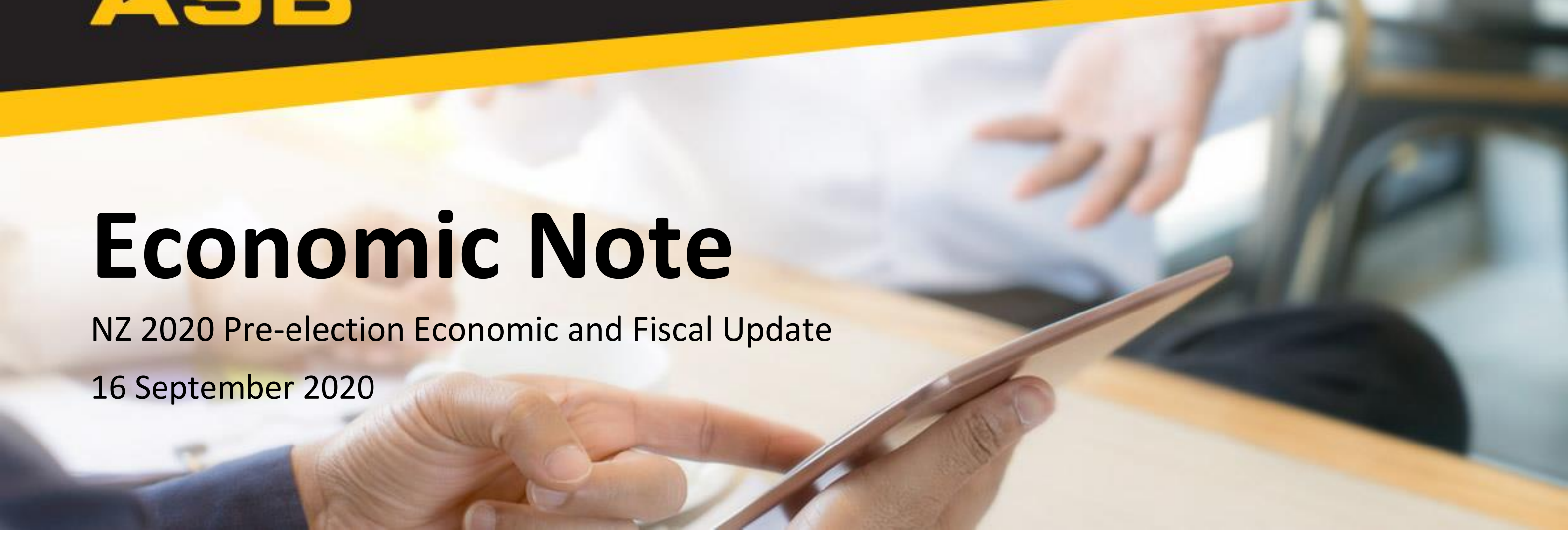

Economic Note

NZ 2020 Pre-election Economic and Fiscal Update

16 September 2020

Same, same, but similar

- The 'money' line for the Pre-Election Update is that the core Crown debt outlook is similar to the Budget's.
- A better near-term but milder long-term economic outlook has slightly reduced the nominal GDP forecast.
- Heading into the election, the outlook as presented has few surprises for political parties and their policies.

The Pre-election Economic and Fiscal Update (PREFU) turned out to be surprisingly similar to the Budget for the numbers that arguably matter the most. **Net core Crown debt is forecast to finish the June 2024 fiscal year at $201.1 billion, barely higher than $200.8 billion in the Budget outlook.** The ratio of debt to GDP for 2024 has lifted nearly 2 percentage points to 55.3%, primarily because the level of nominal GDP is forecast to be slightly lower than previously forecast.

Largely as we expected, the **economy is forecast to hold up better in the near term** relative to Budget expectations, **but with a milder recovery over the longer term**. The changed economic outlook means a slightly smaller overall starting point for operating deficits, but a more gradual recovery over the longer term to the point that the 2024 operating deficit is now expected to be larger than in the Budget forecast.

With only a marginal shift in the debt outlook, the revised fiscal position offers few last-minute surprises to political parties as they prepare their policy offerings heading into the October election. However, there are a couple of things politicians and the voting public should keep in mind. The size of the future debt outlook is substantial, and will fall on future generations to repay. The outlook is also incredibly uncertain. Treasury has done several alternative scenarios to cover some of the possibilities. Our own economic forecasts still have a lower level of nominal GDP than the latest Treasury forecast (by slightly more than the downward revision Treasury has just made), highlighting the risks to future revenue growth. The core message is, even as debt levels lift and the figures look increasingly abstract in size, for **the sake of future generations we need to make sure we get the best bang for buck right now**.

Economic outlook

The economic assessment was largely as we had expected, depicting a stronger short-term outlook relative to the Budget forecasts, but a weaker medium-term trajectory for the economy. As the Treasury noted, the initial economic impact of COVID-19, while still large, has been less severe than anticipated in Budget 2020, with a faster-than-expected move down alert levels. The Treasury also notes the quicker than expected pick-up in activity from high-frequency activity indicators.

What's more, we can see clear upside risk to the Treasury forecast for Q2 GDP (-16% qoq versus ASB -10.8% qoq) and the June 2020 year in general.

The Treasury has also flagged that housing market activity has been more resilient than expected in the Budget Update, supported by pent-up demand and record-low mortgage interest rates. Extensive fiscal support measures were also cited as having played a large role in supporting household incomes and spending as well as keeping people

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employed. The Treasury has assumed that in addition to the $18bn in fiscal support in the June 2020 year, an additional $58.5bn of fiscal support was put in place of 2023/24. Moreover, NZ interest rates are forecast to remain very, very low over the forecast horizon.

The Treasury medium-term growth projections remain reasonably upbeat, with growth in a 3.5% to 4.2% annual average range over the projection period. This is more upbeat than our current economic forecasts for GDP from 2022 onwards. However, when compared to the Budget forecasts, the level of real GDP in the PREFU projections is expected to remain 2.5% lower than forecast in the June 2024 quarter, with the level of nominal GDP $10 billion lower. From its lower starting point, the unemployment rate is expected to peak at a lower rate (just under 8% in 2021) but decline more slowly than in the Budget projections, reaching 5.3% by mid-2024.

A number of factors are expected to contribute to the weaker Treasury medium-term outlook:

- First, the effects of the COVID-19 pandemic are now expected to be more persistent. The Treasury's working assumption is that border restrictions will linger around for longer, not being lifted until 1 January 2022, nine months later than assumed in the Budget Update. This will prolong the hit to services exports and will delay the forecast recovery in net immigration.
- Second, the Treasury appears increasingly concerned about the global outlook, making the observation that even when borders are reopened, the pace of the recovery in New Zealand is expected to be slower than forecast in Budget due to the "economic scarring and the greater degree of uncertainty in the world economy" caused by COVID-19. Overseas tourism to NZ will be particularly hard-hit, while the weaker global backdrop will also constrain NZ investment demand, and lower NZ export commodity prices and the Terms of Trade.
- Finally, growth is expected to slow as policy support measures (including the wage subsidy) roll off. The Treasury fiscal impulse is set to move from above +4% of GDP in the current fiscal year into contractionary territory over the forecast period.

What's more, the outlook remains highly conditional on how the COVID-19 pandemic evolves. To illustrate the huge uncertainties, the Treasury created 3 alternative COVID-related scenarios. These included an upside scenario in which exports of services recover more quickly, alongside two downside scenarios that covered extended border controls and the resurgence of community transmission. The level of nominal GDP ranges from 1.9% above to 3.0% below the central scenario by mid-2024, illustrating the sensitivity of the outlook to a range of plausible outcomes.

Economic Forecasts	2020			2021			2022			2023		
June years (ann avg)	PREFU	ASB	Budget	PREFU	ASB	Budget	PREFU	ASB	Budget	PREFU	ASB	Budget
GDP (nominal)	-0.4	0.8	-4.8	0.2	1.1	-0.9	5.8	2.3	8.7	6.3	4.2	4.7
GDP (Production)	-3.1	-1.8	-4.6	-0.5	0.2	-1.0	3.6	1.1	8.6	3.9	2.8	4.6
Private consumption	-2.4	-2.4	-6.4	1.2	0.3	4.7	3.6	1.4	5.9	2.6	3.6	3.8
Govt consumption	5.3	5.5	6.0	4.8	6.5	1.9	1.6	1.9	1.7	1.5	1.3	1.5
Residential Invest	-12.5	-4.9	-12.4	-5.0	0.2	-0.4	7.5	-2.3	20.0	10.3	-4.4	8.4
Non-residential Invest	-10.1	-6.2	-12.4	-0.6	0.4	0.9	5.3	0.7	14.1	5.0	7.4	5.6
Exports	-7.0	-7.0	-8.7	-15.4	-13.6	-16.1	8.0	3.8	20.2	6.9	11.4	9.5
Imports	-5.7	-5.5	-7.7	-7.7	-8.9	-5.9	6.7	2.9	14.0	6.6	11.7	6.2
Inflation (ann % chg)	1.5	1.5	1.3	1.2	1.3	0.8	1.2	1.4	1.5	1.4	1.4	1.8
Unemployment	4.0	4.0	8.3	7.7	7.8	7.6	7.6	7.1	5.7	6.6	6.9	5.2
90-day bank bills*	0.3	0.3	0.5	0.1	-0.5	0.5	0.1	-0.5	0.5	0.1	-0.5	0.5
TWI*	69.7	71.4	66.0	70.0	68.0	67.1	70.0	67.7	68.1	70.0	67.7	68.2

Smaller near-term deficits, but more gradual long-term recovery

The update also suggested the Government's near-term operating deficit was not doing quite as badly as previously forecast. The Total Crown Operating Balance Excluding Gains and Losses (OBEGAL) for 2020 is sitting at -$23.4bn, an improvement of about $4.9bn on what was signposted in the May Budget.

Looking ahead, the Treasury also made some lumpy adjustments to its OBEGAL projections for the next four years, lowering the forecast deficit for 2022 and 2023, but widening it for 2021 and 2024. The upshot is that a double-digit deficit is now expected to linger for longer. The forecast deficit for 2024 is now projected to be -$12.4bn, nearly two-and-a-half times what was projected in the May Budget.

The adjustments to the deficit forecasts were in sync with the Treasury's broader revisions for economic activity – stronger than previously forecast in the near term, but softer than forecast over time. That's reflected in the revenue projections, which show a higher-than-anticipated tax take in 2020, but a downward revision from 2022 onwards.

On the expenses side of things, revisions to the forecasts have been driven by an underspend in 2020, along with changes to the timings associated with the COVID-19 Response and Recovery Fund. The soggier medium-term economic outlook has also led to higher forecast beneficiary numbers and payments over time, such that by 2024, forecast benefit expenses are $5.8bn higher than in the May update.

FISCAL PROJECTIONS - Pre-election Update 2020					
June years	**2020**	**2021**	**2022**	**2023**	**2024**
Core Revenue ($bn)	**91.8**	**91.3**	**91.0**	**99.5**	**105.9**
(Budget 2020)	*82.3*	*80.1*	*87.3*	*96.5*	*102.1*
Core Expenses ($bn)	**108.8**	**119.5**	**109.9**	**111.7**	**116.1**
(Budget 2020)	*114.0*	*113.5*	*119.8*	*118.6*	*113.0*
OBEGAL ($bn)	**-23.4**	**-31.7**	**-22.1**	**-14.2**	**-12.4**
(Budget 2020)	*-28.3*	*-29.6*	*-27.2*	*-16.5*	*-4.9*
OBEGAL (% GDP)	**-7.7**	**-10.5**	**-6.9**	**-4.2**	**-3.4**
(Budget 2020)	*-9.6*	*-10.1*	*-8.3*	*-4.7*	*-1.3*
Net core crown debt (%GDP)	**27.6**	**43.0**	**49.9**	**53.5**	**55.3**
(Budget 2020)	*30.2*	*44.0*	*49.8*	*53.6*	*53.6*

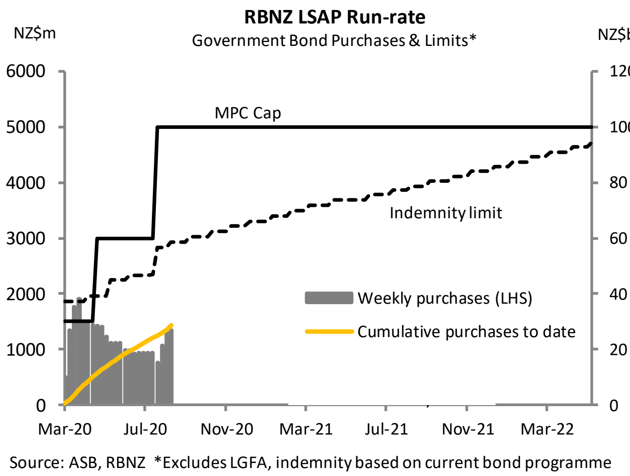
Bond tender outlook tweaked down

NZ Debt Management (NZDM) announced some small changes to the bond tender programme. Issuance in the year to June 2021 was nudged down to $50b from $60b, but the 2024 issuance forecast was lifted slightly to $35b. This tinkering was very much in the directions we'd expected and largely mirrors the direction of changes to the deficit profile.

The reduced debt demands in the near term also reflects the stronger-than-expected syndication run-rate since the Budget. Of interest in this regard was the NZDM's announcement that a new 2028 nominal bond will be launched via syndication sometime before the end of the year.

PREFU Bond Programme (Budget forecasts in brackets)	2020/21	2021/22	2022/23	2023/24	4-year Total
Gross NZGB issuance $bn	50 (60)	35 (40)	35 (35)	35 (30)	155 (165)
NZGBs outstanding $bn	133 (139)	168 (179)	187 (198)	210 (213)	NA

All told, NZGB issuance and hence total outstandings were left slightly lower relative to the Budget. Notably, this means there will around $10b 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. As a result, the RBNZ's indemnity limit is now a shade lower than it was (see chart to the right).



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