New Zealand Government Budget 2020.

14 May 2020

New Zealand Budget 2020 – A bold move.

- The Government has significantly expanded its Covid-19 economic support and recovery package, bringing it to a combined $62bn or around 20% of annual GDP.
- We think that going hard and going early is the right response, to reduce the long-term impact of Covid-19 on the economy.
- But being bold is risky. This could saddle future taxpayers with onerous debts.
- We expect that low interest rates will keep the debt burden manageable, but that would change if interest rates rose.
- The Treasury's forecasts seem too optimistic on the long-run outlook. If Covid-19 scars the economy as we expect, the debts could be harder to repay.
- The fiscal support package is generally timely and well-targeted, but may not prove temporary.
- Today's announcement was more stimulatory than we expected. That diminishes the case for more monetary stimulus via a negative OCR.

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The 2020 Budget was dominated by the Government's response to the Covid-19 pandemic. With the world economy facing its biggest shock since the Great Depression, the required fiscal response was inevitably going to be well beyond anything seen in our lifetimes. Indeed, it turned out to be even larger than we had allowed for.

With today's announcements, the Government has committed a total of $62bn for economic support and recovery, equivalent to around 20% of annual GDP. Of this, around $26bn had already been announced before today's Budget, another $16bn was unveiled today, and the remaining $20bn will be allocated to specific programmes at a future date.

The package will require a significant lift in Government borrowing over the coming years. The bond issuance programme has been expanded to $190bn over five years, compared to $42bn in the Half-Year Update in December. Net core Crown debt is expected to rise from around 20% currently to a peak of 53.6% of GDP, close to the record high that New Zealand reached in the early 1990s.

The Government has chosen to go hard and go early in its response. On the whole we think this was the right thing to do – the economy needs support, and the Reserve Bank is struggling to provide it. This Budget will reduce the risk that Covid-19 causes permanent damage to the economy, and opens a much clearer path to recovery.

But this approach is not without its risks. New Zealand has long been staring down the barrel of massive increases in Government spending due to the aging population. That means future governments will either have to spend less or tax more, which could sap the economy's dynamism. Taking on more debt now puts us in an even weaker position to deal with this challenge. We, and most other economists, expect interest rates to remain low for some time. But if interest rates were to unexpectedly rise, the debts being taken on today could become a very heavy burden to future taxpayers.

We've noted before that to mitigate these risks, fiscal stimulus measures should be timely, targeted and temporary. Today's Budget generally scores fairly well on these criteria, though it's not perfect. There's no question about timeliness – the additional spending is heavily front-loaded to support households and businesses during the downturn, and then to hasten the speed of recovery. The spending was also fairly well-targeted, with the wage subsidy available to only the hardest-hit firms. But we are not so sure that the measures announced today are sufficiently temporary.

The Government has set itself the ambitious target of bringing the unemployment rate down to its pre-Covid level of 4.2% within two years, from a peak of 9.8% this year. To that end, a lot of the measures announced today had a focus on job support and creation:

- The wage subsidy scheme has been extended for an additional eight weeks for those firms that can show a 50% drop in revenue (the criteria for the first 12 weeks was a 30% drop). While not stated explicitly, this is most likely to cover firms in the tourism and hospitality sectors.
- An initial $3bn increase in infrastructure spending, and funding to build 8,000 more public houses, to stimulate the construction sector and create jobs.
- $1.6bn for trades and apprenticeship training.
- $1.1bn for jobs in environmental projects.
- Expanding the free and healthy school lunch programme. A worth initiative in itself, but again described in terms of the jobs created.

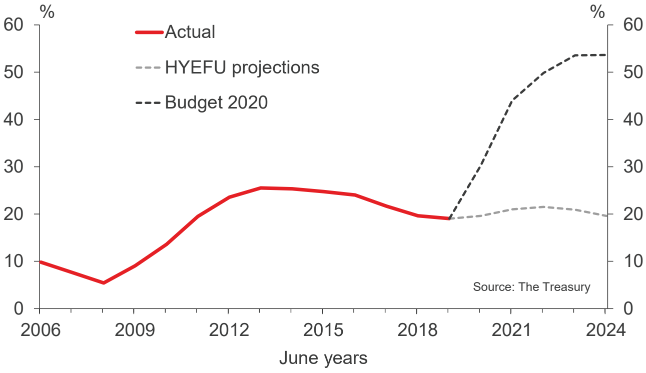
Some of this is very good – for instance, funding for training will allow workers to pivot away from sectors where the Covid-19 pandemic will have long-term impacts, such as tourism. However, government job creation schemes, however 'temporary' they may be, often prove hard to back away from, so some of these schemes could become permanent. Of course, other aspects of recent Government spending decisions have not been temporary at all – such as the tax changes, benefit increases, and increases in health spending.

Our misgivings about Governments having to wind back spending or increase taxation is accentuated by the Treasury's economic forecasts. As the next section describes, we think the Treasury is too optimistic on the long run outlook for the economy. If the economy actually ends up smaller than the Treasury is factoring in, then today's debts will prove harder to repay.

A general risk with using fiscal policy to provide stimulus to the economy is lack of flexibility. If the Reserve Bank finds it has overstimulated the economy, it can easily reverse course by increasing interest rates. Governments cannot fine-tune in this way. The current economic situation is especially uncertain. While we and most other economists believe that the size of the impending economic downturn requires massive stimulus, we could be wrong. If the economy does prove surprisingly resilient, the Government could find that it has overstimulated the economy. Leaving $20bn of the support and recovery fund unspent does mitigate this risk – in theory, some of that spending could be cancelled. But if the Government did end up providing too much stimulus, the RBNZ would have to run with tighter monetary policy than otherwise.

The overall size of the stimulus measures announced today was larger than we expected, and larger than what the Reserve Bank assumed in this week's *Monetary Policy Statement*. That casts some doubt on our forecast of a negative OCR, for two reasons. First, more fiscal stimulus means less need for additional monetary stimulus. Second, more Government debt issuance gives the RBNZ more scope to buy Government bonds and expand its quantitative easing programme rather than lowering the OCR.

Net core Crown debt as a % of GDP



Source: The Treasury

Budget 2020 economic forecasts

	2019 (a)	2020	2021	2022	2023	2024
	Actual	F/cast	F/cast	F/cast	F/cast	F/cast
Economic (June years, %)						
Real GDP growth	2.8	-4.6	-1.0	8.6	4.6	3.6
Unemployment rate	4.0	8.3	7.6	5.7	5.2	4.8
CPI inflation	1.7	1.3	0.8	1.5	1.8	1.9
Current account balance	-3.4	-2.0	-5.7	-4.2	-3.8	-3.6
Fiscal						
(June years, % of GDP)						
Total Crown OBEGAL	2.4	-9.6	-10.1	-8.3	-4.7	-1.3
Net core Crown debt	19.0	30.2	44.0	49.8	53.6	53.6
(June years, $ billion)						
Core Crown revenue	93.5	89.5	87.0	94.6	104.0	109.9
Core Crown expenses	87.0	114.0	113.5	119.8	118.6	113.0
Bond programme	-	25	60	40	35	30

Economic Forecasts: The Treasury and Westpac.

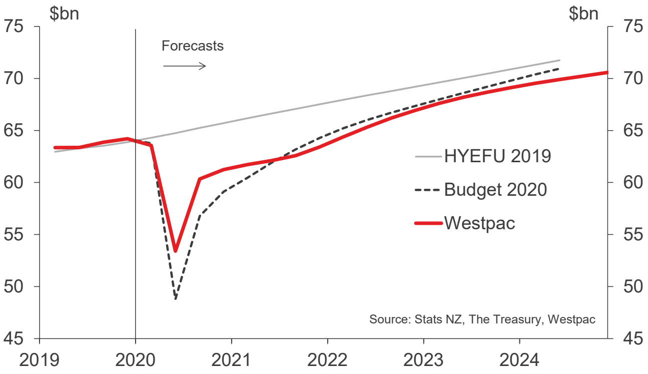
The Treasury's near-term forecasts are similar to ours. The Treasury assumes a sharper downturn through mid-2020, but that's followed by a faster pickup. Overall, our forecast for the coming year are quite similar. Note that neither the Treasury's central forecasts nor our forecasts fully account for the size of the Government's spending package, which was much bigger than expected and will tend to accelerate the recovery.

However, Treasury's longer-term forecasts appear too optimistic to us. The Treasury has assumed that overall economic activity will rise back towards its previous trend as we approach the middle part of the decade. In contrast, we expect that the economy will be left with some long-lasting scars from the current downturn. The legacy of Covid-19 will sap productivity growth in the 2020s due to factors such as reduced investment, lost skills due to unemployment, domestication of supply chains and increased barriers to trade and travel. There's also the likelihood of higher taxation in future years to repay the current increases in Government spending. As a result, we're more doubtful that the economy will get back to its pre-Covid-19 trend. And that means that the debt we are taking on now will need to be repaid by a smaller economy than the Treasury expects.

Digging into the details of the Treasury's forecast a couple of areas stand out. First is residential investment. The Government did announce spending on 8,000 new public and transitional homes. Even so, the pick up in home building the Treasury is forecasting looks unrealistically fast to us. We expect that reductions in privately funded home building will drag down residential investment through 2021 and will also cap the pace of recovery further ahead.

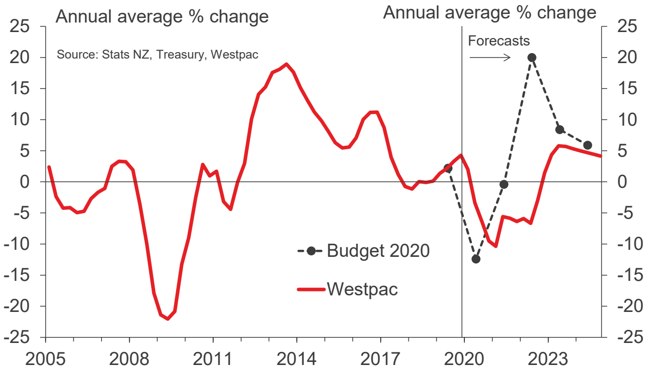
The Government is also planning to ramp up infrastructure spending and has been searching for 'shovel ready' projects. But while there is a large pipeline of planned work, we expect that many of the planned projects will be slow to get off the ground, as we have seen with many other projects in recent years.

Real GDP level



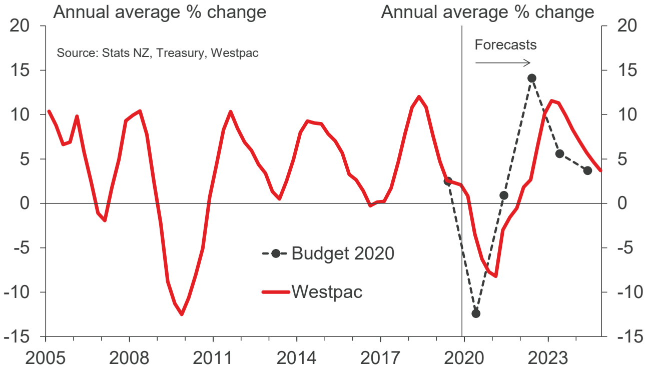
Source: Stats NZ, The Treasury, Westpac

Residential investment



Source: Stats NZ, Treasury, Westpac

Non-residential investment



Source: Stats NZ, Treasury, Westpac

Economic Forecasts: The Treasury and Westpac

	Actual	Treasury					Westpac				
June years	2019	2020	2021	2022	2023	2024	2020	2021	2022	2023	2024
Real GDP growth	2.8	-4.6	-1.0	8.6	4.6	3.6	-2.8	0.0	4.2	5.2	3.1
Annual CPI inflation*	1.7	1.3	0.8	1.5	1.8	1.9	1.6	1.3	0.8	0.9	1.3
Unemployment rate*	4.0	8.3	7.6	5.7	5.2	4.8	9.5	7.4	6.5	5.3	4.7
Nominal GDP growth	3.6	-3.0	0.0	11.6	7.3	6.2	0.0	1.4	6.0	6.9	4.8
90-day interest rate**	1.7	0.5	0.5	0.5	0.5	0.5	0.3	-0.2	0.4	1.0	1.5
TWI exchange rate**	72.7	66.0	67.1	68.1	68.2	70.0	67.5	70.4	72.0	72.4	72.6

*Quarter over same quarter last year, **Quarter average

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