Economic Bulletin.

8 May 2020

Preview of 2020 Budget, 14 May 2:00pm.

- New Zealand's fiscal position will be dramatically worsened by the Covid-19 crisis.
- We expect operating deficits of close to 10% of GDP for each of the next two fiscal years.
- On top of the already-announced support measures during the lockdown, the Government is expected to announce billions of dollars of new spending to bolster the economy's recovery phase.
- Tax revenue will fall sharply during the downturn and is likely to remain permanently lower than the Treasury's previous projections.
- Government bond issuance could rise by more than $100bn over the coming years, and is likely to be front-loaded.
- The Government will need to demonstrate a credible path towards stabilising the fiscal accounts over the long term.

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A billion here, a billion there, soon you're talking real money. It's easy to lose perspective on the amounts that are being spent to manage the economy through the Covid-19 pandemic. The Government has so far committed over $20bn to cushion the economy through the lockdown phase. Next Thursday's Budget will include billions more in new spending and investment to support the recovery phase, and it's likely that even that won't be the end of it. What's more, a drop in tax revenue means that the Government will have to borrow billions more just to cover its existing spending programmes, let alone its new ones.

What's most astounding is that these multi-billion dollar measures may be the least costly option. Without them, the damage to New Zealanders' livelihoods and wellbeing would be immense, and the consequences would be felt for many years. The Government is using its strong balance sheet to take some of the burden off the balance sheets of households and businesses.

Our estimates of what to expect from next week's Budget are only meant to be indicative; realistically we could be out by several billion dollars for any given year. Indeed, the need to settle on a central forecast for Budget purposes will have been an unenviable task. Recently published advice from the Treasury showed a range of scenarios for the New Zealand economy, with widely differing implications for both the revenue and spending projections and for the appropriate scale of fiscal stimulus measures.

We expect to see operating deficits of close to $30bn, or nearly 10% of GDP, for both the current fiscal year (up to June 2020) and the following fiscal year. Beyond that, we expect the operating balance to be on an improving path, but still not returning to surplus within the five-year forecast horizon.

The current fiscal year will be partly rescued by the fact that much of it was complete before the lockdown; indeed, figures released today show that tax revenue was ahead of forecasts up to March. However, the fiscal support package was heavily front-loaded, most notably the wage subsidy scheme which exceeded $10bn and was paid to employers as a lump sum. The next fiscal year will be hit particularly hard by a loss of tax revenue, along with the ongoing cost of existing support measures and whatever new measures are announced next week.

The Government has given only a few hints as to what new measures it will bring in to support the economy through the recovery phase. Investment in transport infrastructure is one, on top of the $12bn capital spending package that was already announced at the end of last year. The Government also appears keen to get involved in housing construction in a more direct way (although it won't try to resurrect Kiwibuild). Finally, the Finance Minister has discussed the need for strong public services, which suggests a boost in funding for areas such as health, social welfare and economic development.

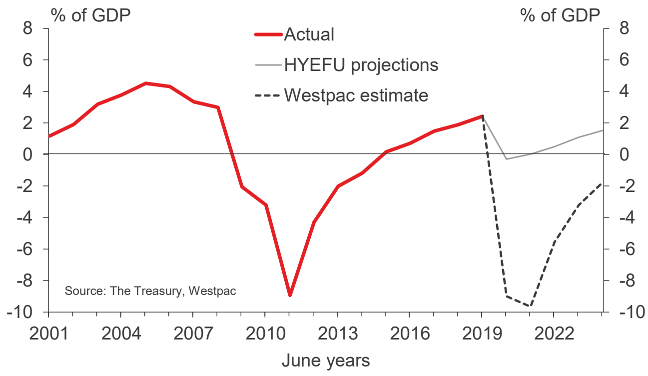
Based on our estimates of operating deficits and increased capital spending, we expect the Budget projections to show net core Crown debt reaching about 50% of GDP after five years, compared to around 20% today. That suggests the Government will need to issue more than $100bn of additional debt over that time, and perhaps half of that in the next year alone.

While the previous Budget Responsibility Rules are obviously out the window, the Government will still need to demonstrate that it has a credible path towards stabilising the fiscal accounts. The long-term debt projections for New Zealand have never been all that flattering. The government debt to GDP ratio was set to explode higher over the coming decades as age-related spending mounts up, even before Covid-19 came along.

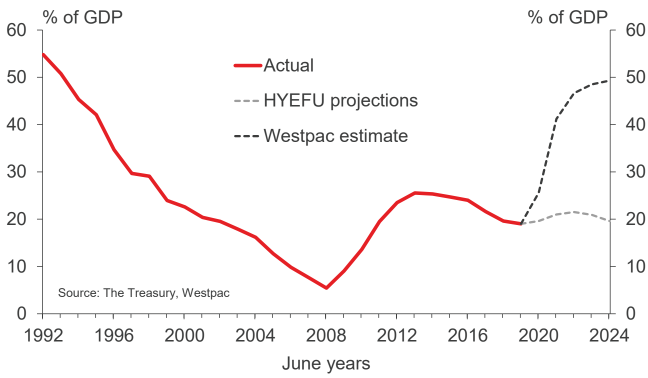
The Covid-19 crisis means that those long-term projections will be coming from a much worse starting point. That's not just because of the additional spending during the crisis and recovery phase. As we detailed in our recent *Economic Overview*, Covid-19 will inevitably result in some economic 'scarring', putting the economy (and therefore tax revenue) on a permanently lower path compared to the Treasury's previous assumptions.

This suggests that at some point later this decade we'll see some combination of belt-tightening and a hunt for new sources of revenue. We don't think that any tax changes will be announced just yet, lest it undermine confidence during the recovery phase. But over time, it's increasingly likely that new or increased taxes will enter the conversation.

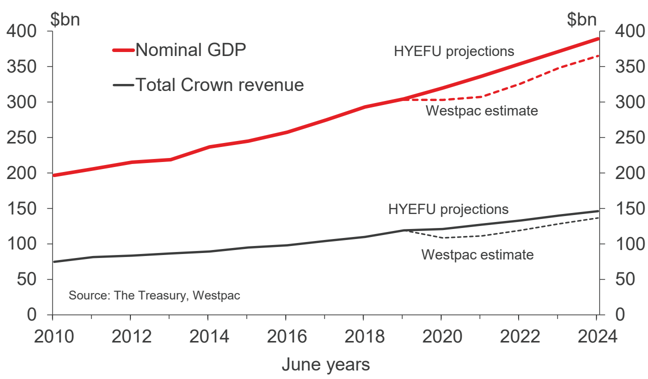
Operating balance as a % of GDP



Net core Crown debt as a % of GDP



Nominal GDP and Government revenue



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