New Zealand Half Year Economic and Fiscal Update 2020.

16 December 2020

Seeing the light – NZ Half-Year Economic and Fiscal Update, December 2020.

- The Half-Year Economic and Fiscal Update (HYEFU) featured a significant improvement in the Treasury's forecasts, in light of the economy's faster than expected rebound.
- We see scope for a further upgrade to the outlook, barring any renewed Covid risks.
- Even so, further deficits and rising debt are likely over the next few years, leaving the fiscal accounts in a weak starting point for dealing with the long-term challenges.

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HYEFU 2020 forecasts

	2020	2021	2022	2023	2024	2025
	Actual	F/cast	F/cast	F/cast	F/cast	F/cast
GDP growth, ann ave % (June year)						
HYEFU	-2.1	1.5	2.6	3.7	3.8	3.2
Changes since Pre-Election Update	1.0	2.0	-1.0	-0.2	-0.3	-
Total Crown OBEGAL, $bn (June year)						
HYEFU	-23.1	-21.6	-16.4	-10.3	-7.5	-4.2
Changes since Pre-Election Update	0.3	10.1	5.7	3.9	4.9	-
Net debt, % of GDP (June year)						
HYEFU	26.4	39.7	49.1	52.6	50.7	46.9
Changes since Pre-Election Update	-1.2	-3.3	-0.8	-0.9	-4.6	-
Bond programme, $bn (June year)						
HYEFU	29.0	45.0	30.0	30.0	30.0	25.0
Changes since Pre-Election Update	0.0	-5.0	-5.0	-5.0	-5.0	-

As expected, the Treasury has significantly upgraded its economic and fiscal outlook for the next few years, in recognition of the New Zealand economy's rapid rebound from the Covid-19 restrictions. The fiscal accounts are still in rough shape, with large deficits projected for several years to come, but the picture is less challenging than it was earlier in the year.

The Treasury's activity forecasts remain on the soft side compared to our own view, although the gap has narrowed. Moreover, the Treasury recognises that the risks around the economy's momentum lie to the upside (whereas its downside scenario relates more to the risk of a renewed Covid outbreak). We see scope for further upgrades to the outlook by Budget time next May.

Fiscal projections.

The Treasury now expects the economy to grow by 1.5% over the year to June 2021, compared to a 0.5% contraction in the Pre-Election Economic and Fiscal Update (PREFU) in September. The quicker rebound means that the pace of growth in future years is lower, but nevertheless the level of activity is higher across the forecast period.

GDP is expected to be around 2% below its pre-Covid level by the end of this year, and won't return to its previous level until early 2022. Those figures suggest that the domestic economy is more or less running at its full potential, with the shortfall being due to the ongoing closure of the international border.

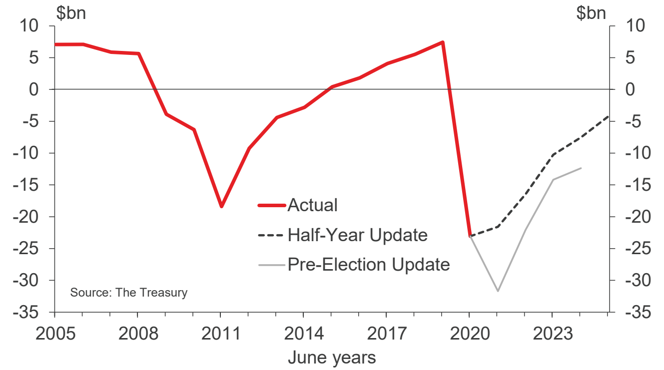
A higher level of GDP translates to substantially smaller operating deficits in the coming years. The cumulative deficits projected over the next four years are more than $24bn less than in the PREFU. Over $17bn of that is due to higher tax revenue, reflecting the stronger than expected economy. The remaining $7bn or so is due to lower spending, most of which relates to lower Covid-related spending in the current fiscal year.

The Treasury has scaled back its assumption about the size of the Covid response and recovery programme to around $50bn, compared to $58bn in the PREFU (out of approved funding of $62bn). The programme was a welcome pro-active response at the time it was announced – at around 20% of annual GDP, it was maybe the largest fiscal support package in the world.

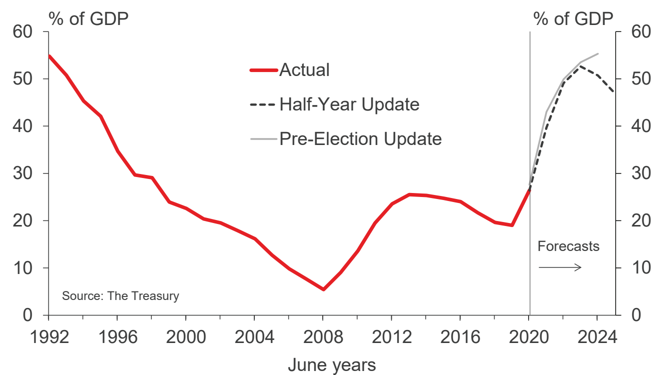
But with the economy rebounding much faster than the Government expected, we think it will be increasingly difficult to find things to spend this money on that could reasonably be labelled a 'Covid response'. Many of the programmes announced in the May Budget had a strong job-creation element, based on forecasts of mass unemployment that haven't panned out. The HYEFU acknowledges this, noting that "plans for Covid-19-related expenditure have continued to evolve and will likely continue to do so for some time, and the exact timing and costs of these plans remain uncertain."

Despite the improved fiscal outlook, the Government's operating balance is still expected to be in deficit by 2025. Net debt is expected to peak at around 53% of GDP in 2023, compared to a low of 19% before Covid. That doesn't leave much room to accommodate any further shocks that might arise in the coming years. Nor does it leave the Government in a strong starting point to deal with the longer-term age-related pressures on the fiscal accounts, which were apparent long before Covid struck.

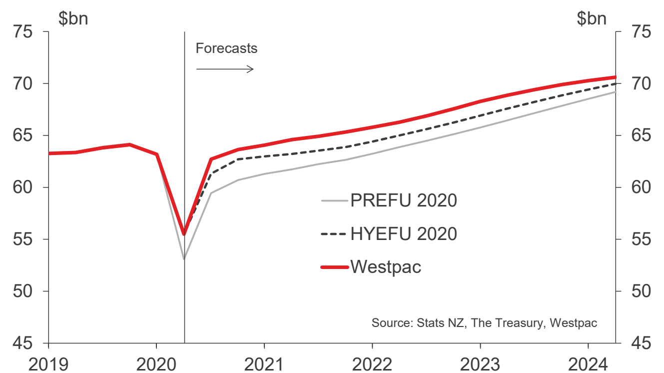
Operating balance before gains and losses



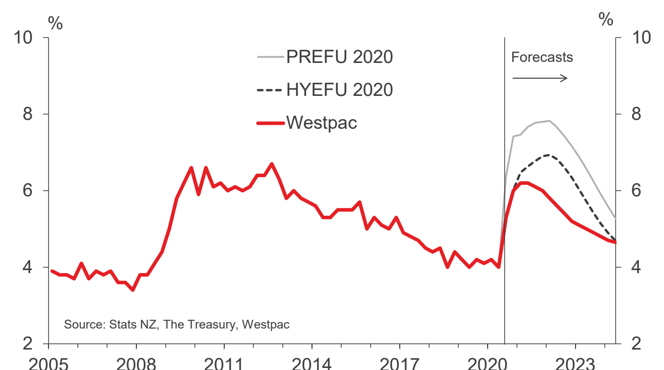
Net core Crown debt as a % of GDP



Quarterly real GDP



Unemployment rate



Comparison of economic forecasts.

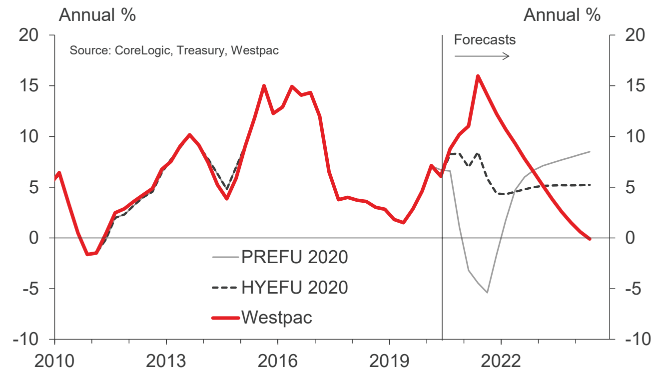
The Treasury has made a large upwards revision to its forecasts for economic activity. Nevertheless, we still think that their forecasts are too pessimistic. Indeed, the HYEFU actually noted that the near-term risks for GDP are to the upside with economic indicators continuing to come in above expectations since the Treasury finalised their economic forecasts on 13 November. The Treasury also highlighted the recent positive news regarding vaccine development and the possibility that border restrictions could be relaxed faster than they have assumed. On that front, the Prime Minister has recently indicated that travel restrictions with Australia are likely to be relaxed in the March quarter.

Digging into the details of the HYEFU forecasts, much of the difference with our own projections is due to the Treasury's expectations for a subdued rise in household consumption. Putting aside the near-term risks highlighted above, part of the reason why we are more optimistic about household spending appears to be our forecast for continued strength in the housing market (which tends to be closely related to household spending in New Zealand). The HYEFU assumes that house price inflation will peak around 8% at the end of this year and then slow to around 5% by the end of 2021. That's in part due to the slowdown in population growth already in train, as well as the expected strength in home building.

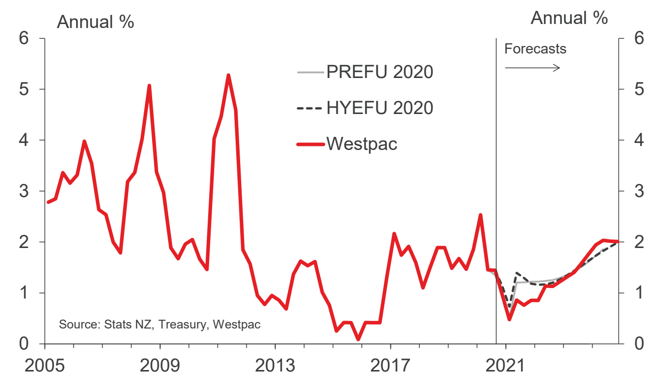
While we're conscious of such supply side factors, we actually think there is a lot more momentum in the housing market than the Treasury is assuming. That's due to the very low level of interest rates, which we expect will be a feature of the economic landscape for some time yet and will buoy demand from both owner-occupiers and investors. Consistent with that, the latest REINZ House Price Index has shown a further acceleration in house price growth in late 2020.

Another feature of the HYEFU forecasts is the Treasury's expectation that inflation will linger below 2% through to the end of 2024 (largely unchanged from the PREFU). While there are some near term differences between our forecasts, we also expect an extended period of muted inflation. And like us, this continued low-inflation environment means that the Treasury is also forecasting an extended period of very low interest rates. It's notable that since the Treasury finalised its forecasts, the New Zealand dollar has continued to push higher, signalling downside risk to their forecast for imported inflation over the year ahead.

House prices



Inflation



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