NZ Pre-Election Economic and Fiscal Update.

16 September 2020

Learning the lessons of lockdown.

- The Pre-Election Economic and Fiscal Update (PREFU) recognised that the New Zealand economy has bounced back surprisingly quickly from the Covid-19 lockdown.
- However, the Treasury has downgraded its GDP forecasts over the longer term, resulting in lower tax revenue, more persistent unemployment, and large deficits.
- We regard the Treasury's longer-term economic forecasts as too pessimistic. Consequently, we think that in time the fiscal position will prove to be less dire than the PREFU suggests.

Michael Gordon, Senior Economist
+64 9 336 5670

The Treasury's update of its fiscal and economic forecasts, ahead of the 17 October election, was a mixed bag. Compared to the May Budget, both the economy and the Government's books have fared better than expected in the short term. However, the Treasury continues to anticipate rising debt and large operating deficits for years to come.

It's good see the Treasury acknowledge the surprising resilience of the economy over the shorter term. However, we still think the Treasury is being too pessimistic about the longer-run outlook for New Zealand. 2020 has been a lesson about the economy's dynamism, with activity bouncing back readily as Covid restrictions have been lifted. As a result, our view is that the nation's fiscal outlook, while still challenging, will not prove to be as dire as the PREFU portrays.

The economic forecasts for the May Budget were prepared under the 'fog of war' of the Alert Level 4 lockdown in April. Consequently, the Treasury assumed an extremely severe hit to the economy, with GDP predicted to plunge by 23.5% in the June quarter and to recover only about half of that in the second half of the year.

We now know that the economy suffered less from the lockdown than expected and bounced back far more readily, so an upgrade to the near-term outlook was necessary. The Treasury now estimates that June quarter GDP fell by 16% – still a weaker outcome than market forecasts, which have had the benefit of additional data that was published in the last couple of weeks. The Treasury has also revised up its forecasts for the level of GDP for the immediate post-lockdown period.

Beyond that, however, the Treasury expects the pace of growth to slow markedly, with the level of GDP even lower in the longer term compared to its Budget forecasts. This is based on a view that Covid-19 will have a more persistent impact on the economy, both here and globally, than previously assumed. That's even with the international

borders re-opening from the start of 2022 (implying widespread vaccination by that point, which itself would be a major stimulus to the world economy).

That downbeat view on the level of GDP in turn leads to forecasts of lower tax revenue, persistently higher unemployment, and large operating deficits for years to come. By the year to June 2024 the deficit is still expected to be over $10bn, or more than 3% of GDP.

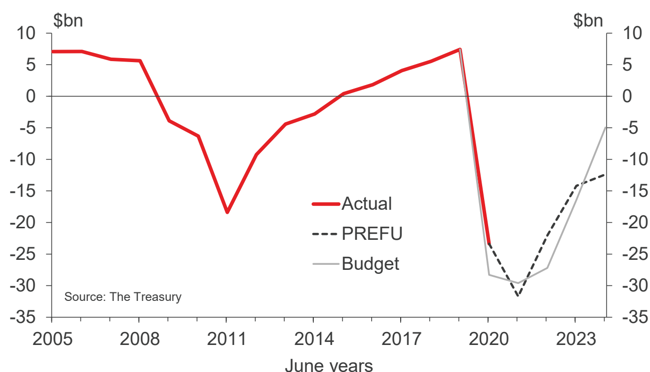
We regard the Treasury's view on the extent of the rebound to be too pessimistic. For example, by the end of 2022 – after a year of reopened borders – the Treasury expects the level of GDP to return to around its pre-Covid level. This is about 6% below what was forecast in the December Half-Year Update, its last set of pre-Covid forecasts. That seems on the weak side, given that we've already seen that at Alert Level 1 – with the borders closed – the economy can operate at about 5% below its potential.

The main difference between the Treasury's forecasts and our own is a more subdued rise in household consumption. But that's precisely where we've seen activity spring back rapidly as the alert levels have been reduced. The Treasury also has a weaker outlook for house prices, a major factor in households' wealth and hence their willingness to spend. We have recently moved away from forecasting further house price declines; the economy's rapid rebound and record-low mortgage rates are proving to be the dominant drivers.

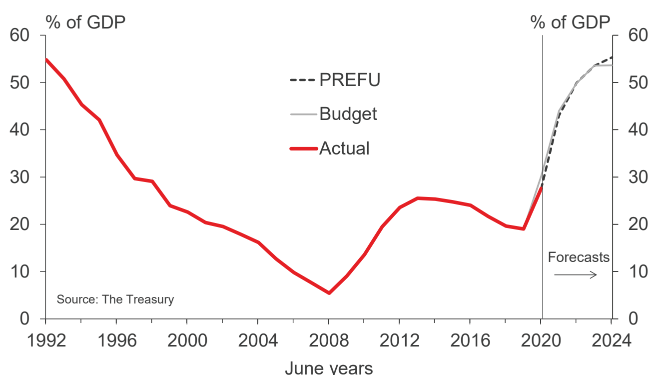
The May Budget included the Government's $62bn Covid response and recovery package, with the full amount incorporated into the fiscal forecasts (though not the economic forecasts, which were finalised earlier). The Government has since said that some of this would be held back unless conditions worsened, and the PREFU assumes that $4bn of this will be unspent. This has contributed to a small improvement in the operating balance forecasts as a whole. However, the deficit for the June 2021 year is now larger than previously forecast, with some of the package expected to be brought forward into that year.

The Government's borrowing requirement has been reduced, with planned bond issuance revised down by $10bn for this year and $5bn for next year. This was right in line with our expectations, and importantly has no implications for our forecasts of the Reserve Bank's bond purchase programme. By June 2022 there are expected to be $168bn of Government bonds on issue (previously $179bn). By that date the RBNZ expects to own $100bn of them, or about 60%, which we regard as the practical upper limit. Consequently, we expect that by next year the RBNZ will have to start pivoting away from bond purchases towards other means of monetary easing, such as a negative OCR.

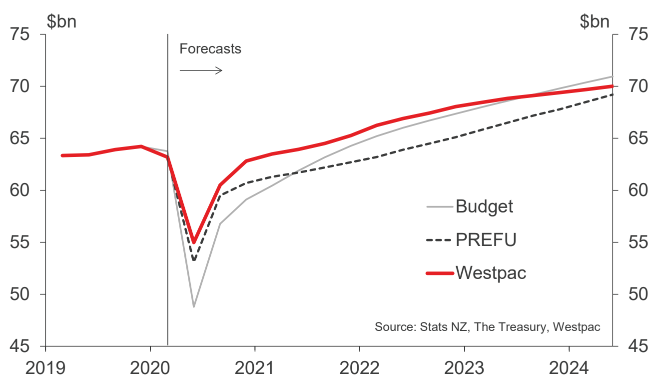
Operating balance before gains and losses



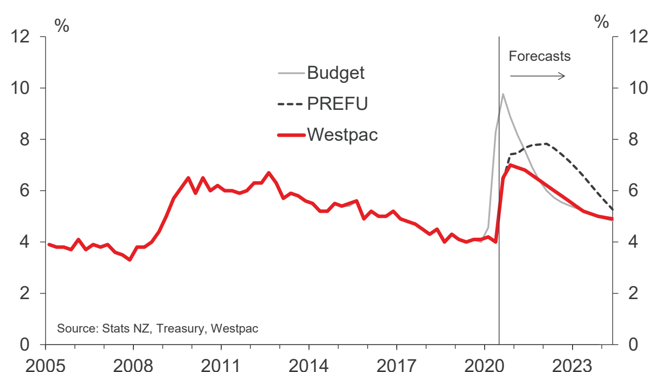
Net core Crown debt as a % of GDP



Real GDP level



Unemployment rate



Contact the Westpac economics team.

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

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