The Treasury

Budget 2020 Information Release

July 2020

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[DRAFT]

HYEFU 2019 Fiscal Strategy

Budget Matters

22nd October 2019

Purpose and outline

Purpose: These slides outline our fiscal strategy advice. You will receive detailed advice incorporating fiscal forecasts on 30 October. Given the short time available for decisions between receiving this advice and the deadline for Budget Ministers or Cabinet agreement on 4 November, we are seeking your early thinking now.

Outline of this slide pack:

1. Fiscal and economic context
2. Macroeconomic judgements
3. Options for the multi year capital allowance
4. Options for operating allowances
5. Scenario analysis

Our advice to date

- In late August you requested advice on fiscal stimulus.
- Our fiscal strategy advice of **September 4** noted some uncertainty, but expected the economic outlook to be only slightly weaker. We advised that the case for looser fiscal policy would rest on support offered to monetary policy and long-term confidence.
- You requested further advice on specific stimulus options, which we provided on **September 26**. This summarised several options, but recommended particular consideration be given to:

  s9(2)(f)(iv)

  – Increased capital expenditure
- Follow-up advice in the week of **7 October** provided you more detail on a subset of these options.

[DRAFT]

Key points from this slide pack

Fiscal and economic context:

- The economic outlook has weakened since Budget.
- Current fiscal forecasts show net core Crown debt will likely exceed 20% of GDP in 2021/22. *[Subject to finalisation of preliminary fiscal forecasts]*
- OBEGAL deficits in the forecast period are possible, depending on what the preliminary fiscal forecasts show and what risks eventuate.

Macroeconomic judgements

- Conventional monetary policy has limited scope to support the economy if growth slows further.
- Fiscal stimulus would need to be significant to support monetary policy.
- Capacity and capability constraints will likely inhibit any large short-run increase in government capital or operational expenditure.
- Fiscal policy should aim to be sustainable – meaning net debt between 15-25% and avoiding persistent OBEGAL deficits.

Options for the multi year capital allowance (MYCA)

- Options include keeping the MYCA at current levels, or increasing by $5 to $15 billion.

Options for operating allowance

- There are options around whether to change or retain the operating allowances signalled at Budget 2019.

s9(2)(f)(iv) [redacted]

The Roadcheck report on 30 October will:

- Update this advise on the basis of the preliminary fiscal forecasts,
- Consider the case for looser fiscal policy to support monetary policy and business confidence and investment,
- Present recommendations for operating allowances over the forecast period, and for the multi year capital allowance, and

s9(2)(f)(iv) [redacted]

[DRAFT]

Questions for discussion today

Fiscal strategy

- What is your comfort with core Crown net debt exceeding 20% of GDP in 2021/22?
- What is your comfort with OBEGAL deficits in the forecast period?

Capital allowance

- Are you planning to announce any capital projects in the Budget Policy Statement?
- If so, which projects are being considered, and when are the decisions around the projects being made?

Operating allowances

- The forecast period in the Budget Policy Statement will include an additional year (2023/24). What is your view on an operating allowance of $2.6 billion for Budget 2023?
- For Budgets 2020 to 2022, what are your views on signalling the same operating allowances as announced at Budget 2019?

s9(2)(f)(iv)

[redacted]

Aside from the preliminary fiscal forecasts, is there any more advice you need to take decisions on fiscal strategy for the Budget Policy Statement?

Next steps

- **The Roadcheck report will be sent to you on the 30th of October.**

Following this advice, how do you wish to engage with Cabinet and Budget Ministers?

  – Budget Ministers have been delegated the authority to agree to any changes in allowance settings.

  – By **Monday 4 November** we require decisions on:

    - The level of operating and capital allowances (by Budget Ministers)

    s9(2)(f)(iv) [redacted]

  – Decisions on allowances are required to allow finalisation of the economic and fiscal forecasts.

How would you like to seek the agreement of Budget Ministers to any change in allowances?

s9(2)(f)(iv) [redacted]

Would you like us to prepare a draft Cabinet paper prior to the roadcheck advice that can be lodged if required?

  – A subsequent Cabinet paper on the detail of any planned capital projects would also be required.

Timeline:

- Draft Cabinet paper *(if required)*
  – 25 October
- Roadcheck report
  – 30 October
- Cabinet paper lodged *(if required)*
  – 31 October
- Cabinet meeting
  – 4 November
- Budget Policy Statement
  – 11 December

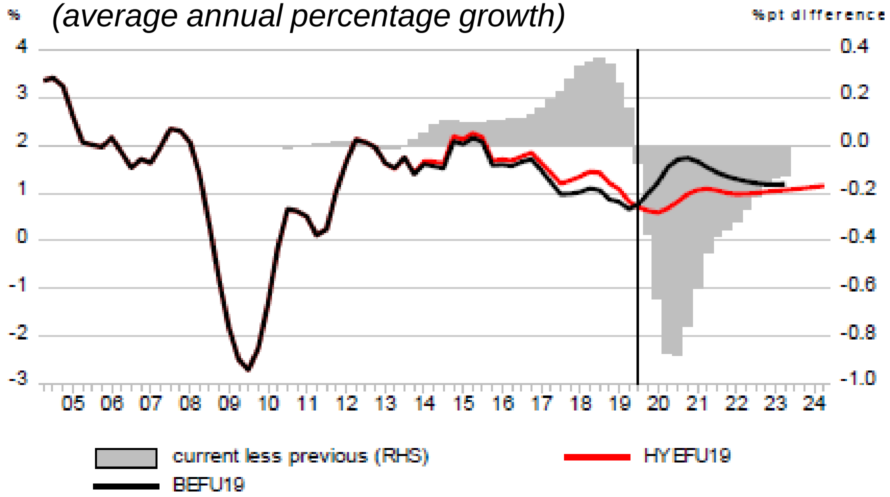
Fiscal and economic context

[DRAFT]

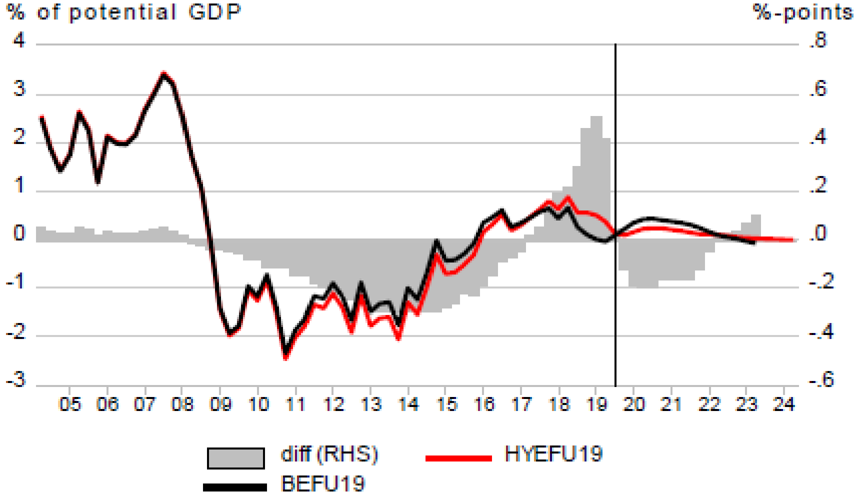
Economic growth slowing, but (just) above potential…

- Preliminary forecasts show GDP growth per capita slowing to 0.6% for 2019, increasing to 1% p.a. in subsequent years.
- Aggregate growth is also lower at 2.2% in 2019/20.
- The labour market will remain relatively tight, with unemployment rising to 4.3%.
- CPI inflation remains below 2%, but we forecast it to return to the midpoint of the RBNZ's target range by 2022.
- Government spending continues to be an important factor supporting economic growth.
- The output gap has been revised down, but remains slightly positive across the forecast period.

Real production GDP per capita (average annual percentage growth)



Output gap



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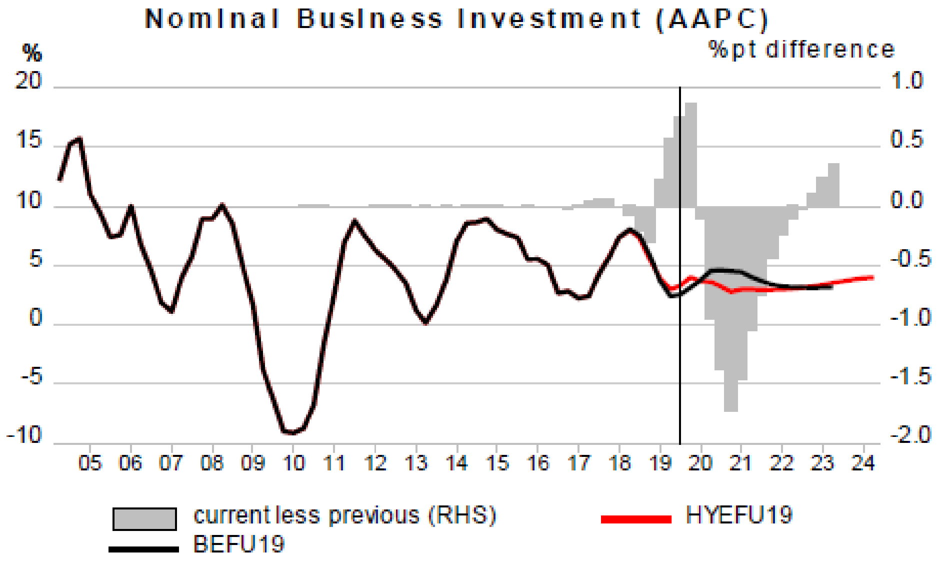
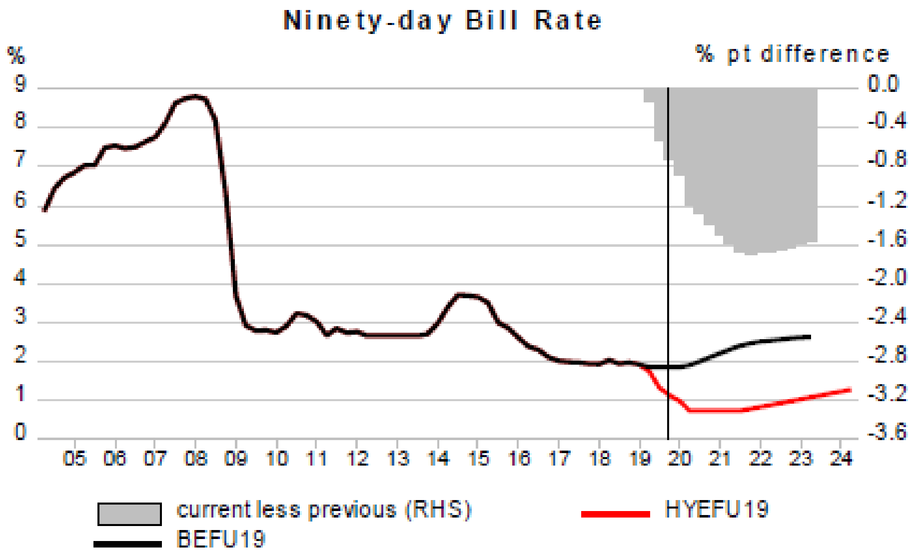
…and there are risks to the downside





- **Business investment** growth is forecast to slow, from the already lower post-GFC levels.
- This reflects a continuation of low business confidence levels due in part to global factors, and feeds through to lower growth.
- If global uncertainty worsens, there is a risk this falls further.
- **Monetary policy** has loosened substantially recently, and we (and the market) expect interest rates to remain low for an extended period after further reductions in the next year.
- There is a risk the OCR drops to zero or below if growth is worse than we)or the RBNZ) forecast; or if there is a sustained deflationary shock overseas.

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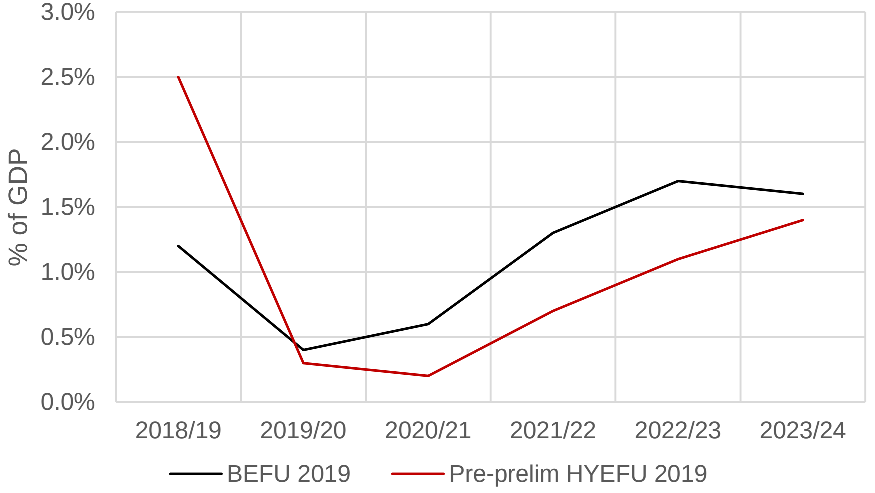
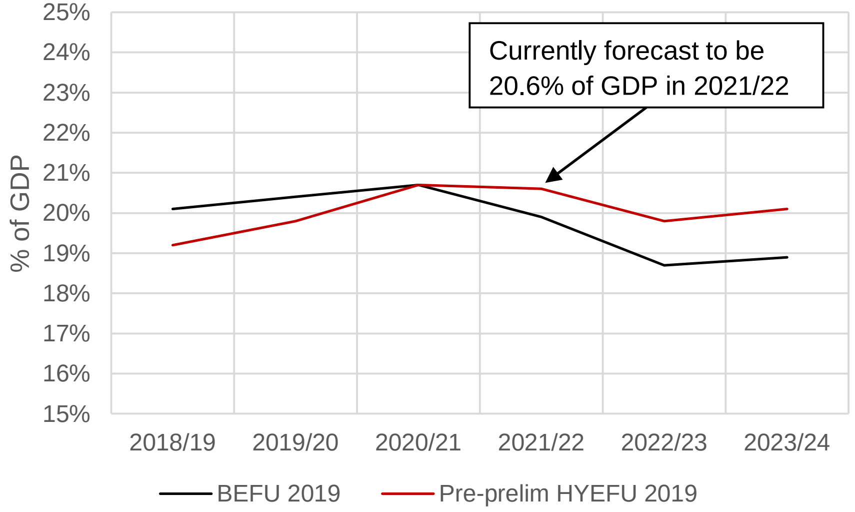
The fiscal outlook has weakened…

OBEGAL, based on prelim economic and tax forecasts



Net core Crown debt, based on prelim economic and tax forecasts



- Based on preliminary economic and tax (but not expenditure) forecasts, and current allowance levels:
  - OBEGAL is likely to fall, but remain in surplus
  - Net core Crown debt will rise above the 20% target for 2021/22

  These results will change with the preliminary fiscal forecasts next week. Fiscal risks are weighted to the downside, so we expect the position to weaken further.

- The better than forecast results announced at the financial statements of government will be largely reversed by weaker tax revenue due to slower economic growth.
- The small surpluses in 2019/20 and 2020/21 ($800m and $600m, respectively) also mean there is a relatively high probability of a deficit in either this or subsequent forecasts.
- Due to the slightly positive output gap, this is may show as a structural deficit in the cyclically adjusted balance – but will likely return to surplus by 2021/22.

What is your comfort with core Crown net debt exceeding 20% of GDP in 2021/22?

[DRAFT]

Summary

- Growth is slowing, driven by lower investment and productivity, but offset by higher population growth.
- Conventional monetary policy has limited space to further support the economy.
- Under the Budget 2019 fiscal policy settings (below):
  - OBEGAL is (just) in surplus throughout the forecast, but likely to weaken further when fiscal forecasts are finalised.
  - Net debt will likely be above 20% in 2021/22, but still around the 20% level.

	Budget 2019	Budget 2020	Budget 2021	Budget 2022	Budget 2023
Multi-year capital allowance	$10.4 billion	← $4.4 billion (unallocated) →			To be set in *Budget Policy Statement 2020*
Operating allowance	$3.8 billion	$3.0 billion	$2.4 billion	$2.4 billion	

The Roadcheck report will advise on the fiscal position in light of the updated preliminary fiscal forecasts.

Macroeconomic judgements

[DRAFT]

Is there a case for looser fiscal policy?

- Weakening growth and global economic narrative have highlighted this question over the past months.
- A positive output gap and ongoing signs of capacity constraint mean the conventional criteria aren’t met.
- Requires weighing up:
  - Capacity constraints
  - Monetary policy interaction
  - The fiscal position remaining prudent

Capacity and capability constraints remain an issue

- Business talks and survey measures continue to indicate that capacity remains stretched across the economy, but particularly in construction.
- This reflects some <u>cyclical</u> issues, such as skilled labour shortages due to a tight labour market. It also reflects <u>structural</u> issues, such as long-term shortages of certain skill-sets (e.g. construction project management).
- **This will limit any short term increase in capital spending.** In the current environment, there is a short-term capital expenditure will not be delivered, or drive cost inflation. However, as the multiyear capital allowance will be allocated over the next 4 years, longer term increases may be feasible if these constraints ease.
- Additionally, **public sector capability may be constrained in the short term**. The pool of skilled public sector workers is small and is facing high demand, with 4,200 specialist FTE sought in Budget 2019 (of which 2,000 were funded). There is particular pressure on senior policy capability, social workers, data analytics capability, asset management and Māori capability.
- These pressures are being monitored. However, they are likely to place a limit on how many workforce-intensive policy bids can be delivered from Budget 2020, limiting growth in operating expenditure.

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Fiscal policy can support monetary policy, but material support would need significant fiscal stimulus…

- The OCR is currently 1.00%, with markets expecting further cuts in the near term.
- **Fiscal stimulus can support monetary policy by supporting inflation and employment, in turn putting upward pressure on the OCR.**
- This could help reduce the likelihood of more OCR cuts and hitting the OCR's effective lower bound, and therefore the need for unconventional monetary policy.
- **How supportive fiscal policy can be will depend on:**
  - **Composition of spend:** government consumption and tax will be more stimulatory than imported investment goods.
  - **Phasing of spend over time:** front loading spend leads to sharper, but shorter OCR increases.
  - **Position in the cycle:** how inflationary fiscal stimulus may be (which influences the response of the OCR) depends on the amount of spare capacity in the economy.
- **Our rough rule of thumb suggests the OCR would increase by around 30 basis points in response to a 1% of GDP (~$3bn) fiscal stimulus, dependent on the above.**
- There are risks to this approach. **In particular, supporting monetary policy through short term stimulatory fiscal policy will not be sustainable in the long run if neutral interest rates remain low.**

Key judgement: considering the interaction of monetary and fiscal policy, looser fiscal policy would be able to offer some support in the short-term. However, the loosening would need to substantive – for example, around a $6bn increase in one year to offset current expected OCR cuts.

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Net debt of around 20% of GDP remains prudent

- **Our analysis suggests 30% of GDP is a prudent upper limit for net debt to provide a buffer against a significant shock**
  - Net debt is likely to become welfare reducing beyond 50-60% of GDP.
  - A 20 percentage point of GDP buffer below this ensures resilience against a large negative shock, although depends on risk preferences and views around the size and frequency of future risks.

- **At Budget 2019, the Government extended its long-term objective for net debt following our advice on prudent debt (blue=addition)**
  - The Government will reduce the level of net core Crown debt to 20 per cent of GDP within five years of taking office and maintain it at prudent levels thereafter. **Prudent levels of net core Crown debt are within a range of 15 to 25 per cent of GDP (subject to any significant shocks to the economy).**

- **Advantages of the 15-25% target range for net debt**
  - Maintaining net debt within a range recognises that there is no specific level of net debt that is prudent but rather there is a range of levels that meet the Public Finance Act requirements of prudent fiscal management.
  - A range of 15 to 25 per cent of GDP for net core Crown debt recognises that current debt levels are prudent, while providing a degree of flexibility for the Government to use debt to progress high-value investments in New Zealand.

- **Fiscal discipline is also supported by the Government's other long-term objectives, including the commitments to sustainable operating surpluses and managing expenditure within the recent historical ratio of spending to GDP.**

Key judgement: keeping net core Crown debt in the range of 15% to 25% of GDP remains prudent in the current economic context.

Any loosening will be constrained by maintaining a prudent OBEGAL position

[DRAFT]

- **Objectives:** The path of OBEGAL should support fiscal sustainability, macroeconomic stability, and the Government's relevant policy objectives. It should also be set with regard to managing the Crown's resources effectively and efficiently.

- **There is a range of options for OBEGAL consistent with meeting these objectives**
  - **Fiscal sustainability.** A range of paths for OBEGAL are consistent with fiscal sustainability, with net debt well within 15 to 25% of GDP.
    - Sustainability is a long-term concept, so OBEGAL in a particular year is less important than the broader trend.
    - Different views of a sustainable path for OBEGAL include: OBEGAL sufficient to stabilize or pay down net debt, running a balanced budget, or avoiding persistent deficits.
  - **Macroeconomic stability** concerns support looser than otherwise fiscal policy to reduce the risk of unconventional monetary policy being employed and to support business confidence and investment.
  - **The Government's policy objectives:**
    - Budget Responsibility Rules:
      - *Operating balance:* Deliver a sustainable operating surplus across an economic cycle.
      - *Net debt:* The Government will reduce the level of net core Crown debt to 20 per cent of GDP within five years of taking office (2021/22) and maintain it at prudent levels thereafter (15-25% of GDP).
      - *Expenditure*. The Government will maintain its expenditure to within the recent historical range of spending to GDP ratio (core Crown expenditure peaked at 34% in 2011).
    - Prefunding future NZ Superannuation (NZS) expenses.
      - If the intent behind the NZS Fund is to smooth tax revenue, NZS Fund contributions should be funded from current revenue. This implies OBEGAL surpluses need to be at least as large as NZS Fund contributions.

- **Overall, there is a trade-off** between stimulating the economy (lower OBEGAL), and supporting fiscal sustainability and achieving the Government's policy objectives (higher OBEGAL).

[DRAFT]

Options for OBEGAL

Stabilise or decrease net debt *(around 1%)* – this effectively means paying for capital spending (incl. NZ Superannuation Fund contributions) with current revenue. Will depend on levels of capital spending.

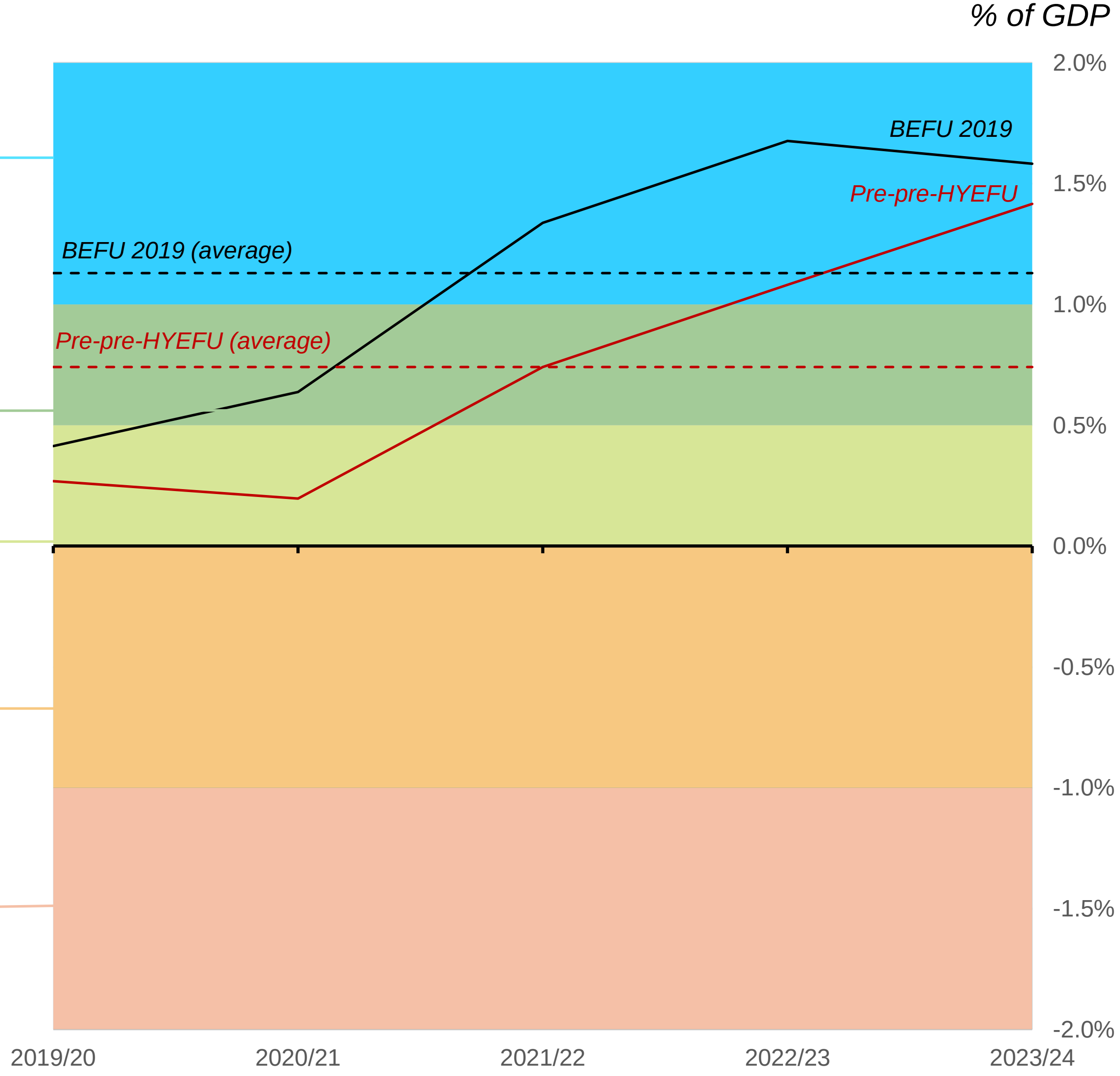
Run surplus with high confidence *(1% or greater)* – forecasts are a best guess. Most of the time actual outturns are within ±2% of GDP of the most recent forecast.

Surpluses sufficient to meet NZ Superannuation (NZS) Fund contributions *(0.5-0.7%)* – If NZS Fund contributions should be funded from current revenue, this implies OBEGAL surpluses need to be at least as large as NZS Fund contributions.

'Golden rule' *(0%)* – run a balanced budget, where current expenditure is met by current revenue.

Avoid persistent deficits *(max deficit of around 1% in 2019/20)* – sustainability is a long-term concept, so OBEGAL in a particular year is less important than the broader trend.

Large but unsustainable fiscal stimulus *(deficits greater than 1%)* – will provide significant support for the economy, but risks persistent structural deficits and an unsustainable debt trajectory.



Key judgements

Given debt is at prudent levels, do not run persistent large surpluses.

Average level of OBEGAL should remain in surplus across the forecast period.*

Conditional on this, modest temporary deficits are acceptable if OBEGAL returns to surplus.

Continue to avoid large or sustained deficits while output remains above potential.

Note: - The numbers presented here will change with the preliminary fiscal forecasts.
Changes in capital spending will not have significant implications for OBEGAL.

**Larger surpluses may be run to fund NZS contributions – but this is largely a distributional judgement.*

[DRAFT]

Summary of judgements

- **In summary:**
  - **There remains space for debt to rise by up to 4% of GDP** over the forecast period; but larger increases risk variations outside the prudent range.
  - If aiming to run a surplus in every year of the forecast, there is no space for further operating spending until 2021/22. Based on tax and economic forecasts only, there remains **0.5 to 0.7% of GDP space while still maintaining an prudent OBEGAL surplus** on average over the forecast period. Some of this space will be reduced if the fiscal forecasts weaken.
  - Capacity constraints will likely limit short term spending, especially operational expenditure, but may ease in the longer term.
  - Expansionary fiscal policy will have benefits in supporting monetary policy, but would need to large (>1% of GDP) to do so meaningfully.

The Roadcheck will likely advise against tightening fiscal policy, which would be counterproductive in the current economic context.

The Roadcheck report will consider the case for looser fiscal policy.

[DRAFT]

Options for the multiyear capital allowance

[DRAFT]

Background & approach to setting the MYCA

When Cabinet agreed to move to an MYCA, they agreed to:

- The size of the envelope to reflect capital investments over four Budgets;
- For the envelope to roll forward each year (rather than be for a fixed period);
- To consider the impact of the procurement profile of expenditure on net core Crown debt as part of the decision-making; and
- To count the full cost of capital expenditure decisions against the four-year envelope.

To avoid confusion it is worth noting that:

- ***The MYCA does not change the accounting treatment or how initiatives are counted under the Fiscal Management Approach,*** (i.e. the approach is not, in practice, different to the single-year capital allowance approach).
- However, ***the MYCA gives the perception that initiatives are not being traded-off against one another to fit within a "small" single-year allowance.*** i.e. it creates a signal to agencies that the pool of funding available for initiatives is now larger for a given budget, which can incentivise the development of initiatives.

Criteria to assess an appropriate MYCA level:

1) Does the MYCA represent a credible amount of capital that the government will and can commit to over the next four Budgets (based on the capital pipeline and market capacity)?
2) Does the MYCA align with the government's fiscal strategy (significantly increase public investment, net debt around 20% of GDP, maintain OBEGAL surpluses)?
3) Does the MYCA provide a strong signal to agencies that there is funding available for high-value initiatives, while minimising the risk of funding low-value initiatives?

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Options for operating allowances

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