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RBNZ's Fiscal Lesson

Fiscal Restraint Helps RBNZ Begin Pivot

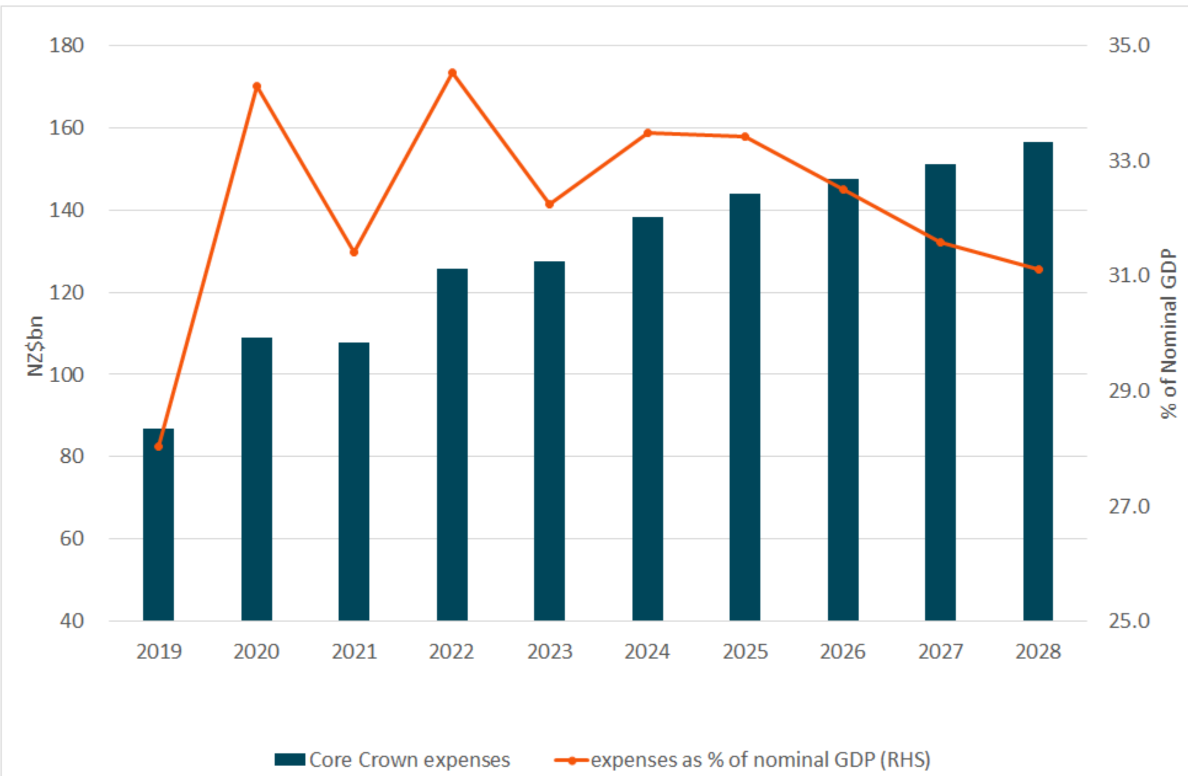
- Public sector restraint impacting demand
- APAC public spending holding back demand
- Productivity impact of fiscal spending also matters

Central banks need to stay vocal on fiscal

The RBNZ is widely considered to have shifted toward a more dovish stance with this week's decision. At this stage in the cycle, "non-dovish" central banks are already in the minority so steering market expectations toward easing is not a surprise. However, what sets the RBNZ apart is its clear acknowledgement that fiscal restraint is now playing a role in the pivot. In the statement, the RBNZ noted that "current and expected government spending will restrain overall spending in the economy." In the summary of the meeting, it elaborated that this was because "government expenditure is forecast to decline as a share of the economy in coming years…[and] lower government spending has already been contributing to weaker demand and will continue to do so." It is now clear that Prime Minister Luxon was serious when he described the budget as "the tightest…by any reasonable measure in the last five years," and its effects are now being felt.

As "the last five years" were extraordinary in a fiscal sense for all governments around the world due to the pandemic, the bar for budget restraint is not high. Even with the current budget in New Zealand, we can see that core Crown expenses are expected to continue rising through the coming five years but start declining as a share of GDP from 2025 on. That the RBNZ is already reacting in this way suggests that the impact is coming through somewhat earlier than expected, but the broader surprise is that more governments are not helping to complement central banks' relatively tight monetary policy by exercising restraint. Measures such as government price guarantees during the emerging situation of 2022 were understandable, but New Zealand has been an outlier in a government openly pushing for a reversal. Furthermore, central banks appear reluctant to push fiscal restraint as well. This was evident during ECB President Lagarde's Sintra speech this year, which made no mention of public sector spending and the impact on wage growth. In contrast, last year she explicitly referred to employment growth in the public sector as a contribution to wage persistence. There are political considerations in play, especially in Europe, but we stress that such pressures cannot be ignored indefinitely and the RBNZ's pivot should serve as a template of complementary monetary and fiscal policy to bring down inflation.

Exhibit #1: New Zealand fiscal outlook

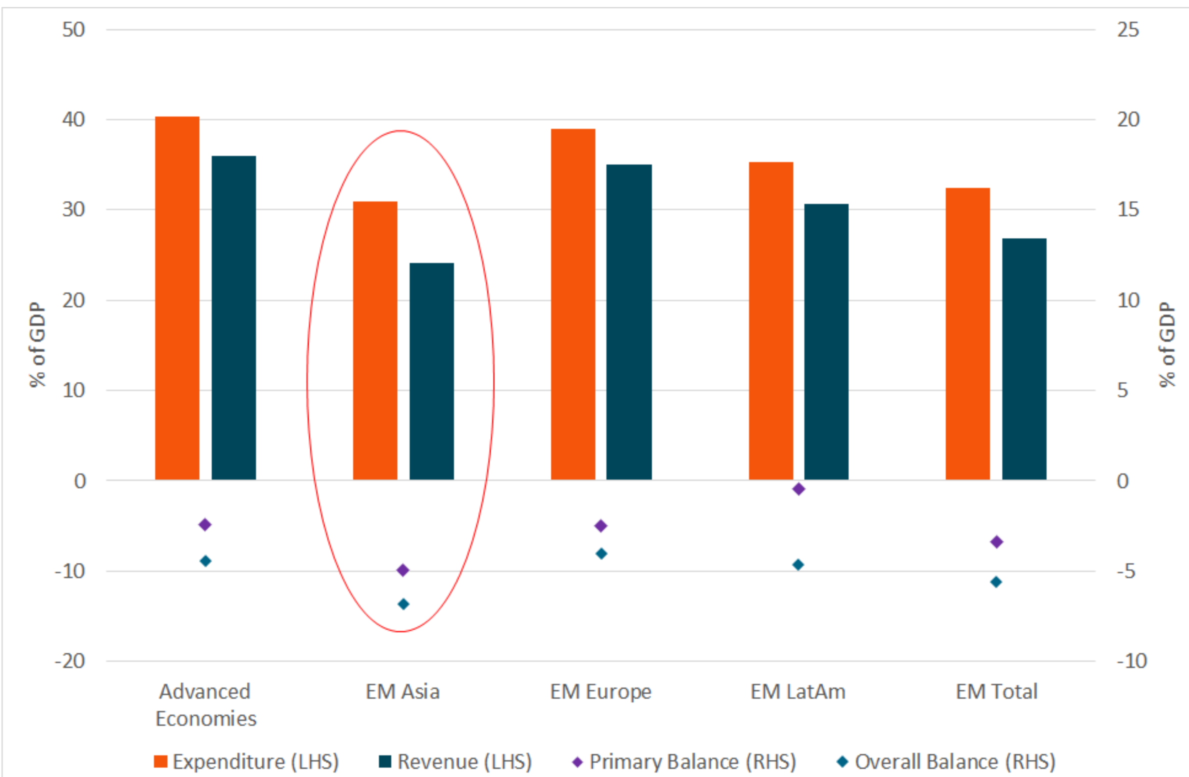


Source: New Zealand Treasury, BNY

Looking at current spending patterns globally, the International Monetary Fund's (IMF) latest fiscal monitor clearly shows that advanced economies continue to generate the strongest fiscal impulse, and EM Europe is not far behind. This is no surprise as Central and Eastern European (CEE) economies were heavily affected by the energy crisis in 2022, and their governments spent heavily on cost-of-living support. Latin America, in contrast, showed greater restraint and even generated a flat primary balance. Complemented by very hawkish central banks in the region, real rates in Latin America remain some of the highest globally. If lack of fiscal restraint is generating inflation, we can see that these dynamics work in the opposite direction as well, but they also serve as a warning when fiscal restraint becomes excessive.

IMF data show that EM Asia's expenditure levels are the lowest among the major blocs. A major fiscal push by China could change the situation, of course, but expectations are quite muted ahead of the upcoming plenum. However, when fiscal is excessively tight, growth falls below potential, fiscal revenue is affected and deflation sets in and, as Japan's experience shows, becomes very difficult to dislodge. We can see that despite low levels of government expenditure, both EM Asia's primary balance and overall balance are the lowest among the economic blocs. Debt sustainability is perhaps less of an issue due to large savings, but EM Asia will struggle and fears over the middle-income trap will persist.

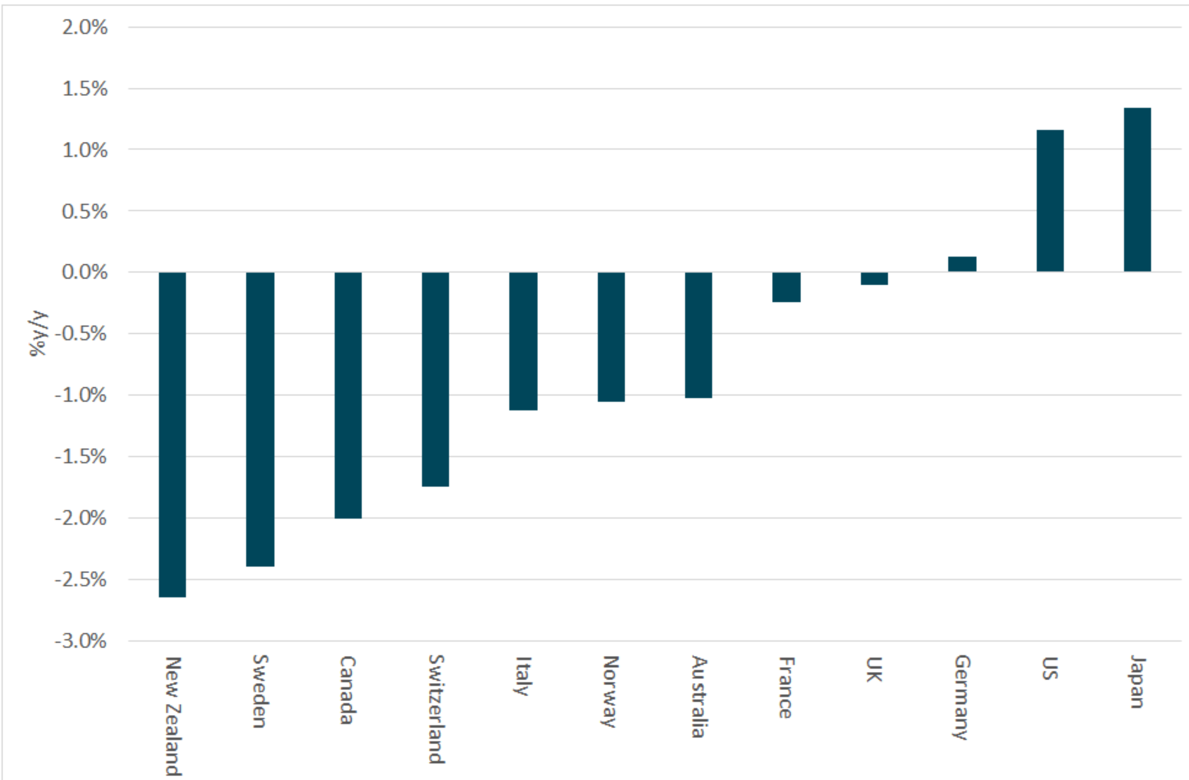
Exhibit #2: Budget balances by economic group



Source: International Monetary Fund Fiscal Monitor, BNY

For now, the market's focus is perhaps on the US and Europe, as fiscal impulse is only likely to increase. Recent elections in the UK and France will result in expansionary governments, and there is no prospect of fiscal retrenchment in the US, though the dollar and US Treasury's reserve status in their respective markets does neuter the impact of large primary balances. There other ways in which government policies can impact the price channel, such as productivity. The new UK government has made boosting productivity a priority, though by comparison the country is not faring too poorly in the OECD (exhibit 3). By contrast, New Zealand has faced extremely poor productivity growth over the past year, and the RBNZ stated overnight that the inflation outlook would be subject to “government regulatory reforms [that] may affect pricing behavior in several sectors and the productive capacity of the economy.”

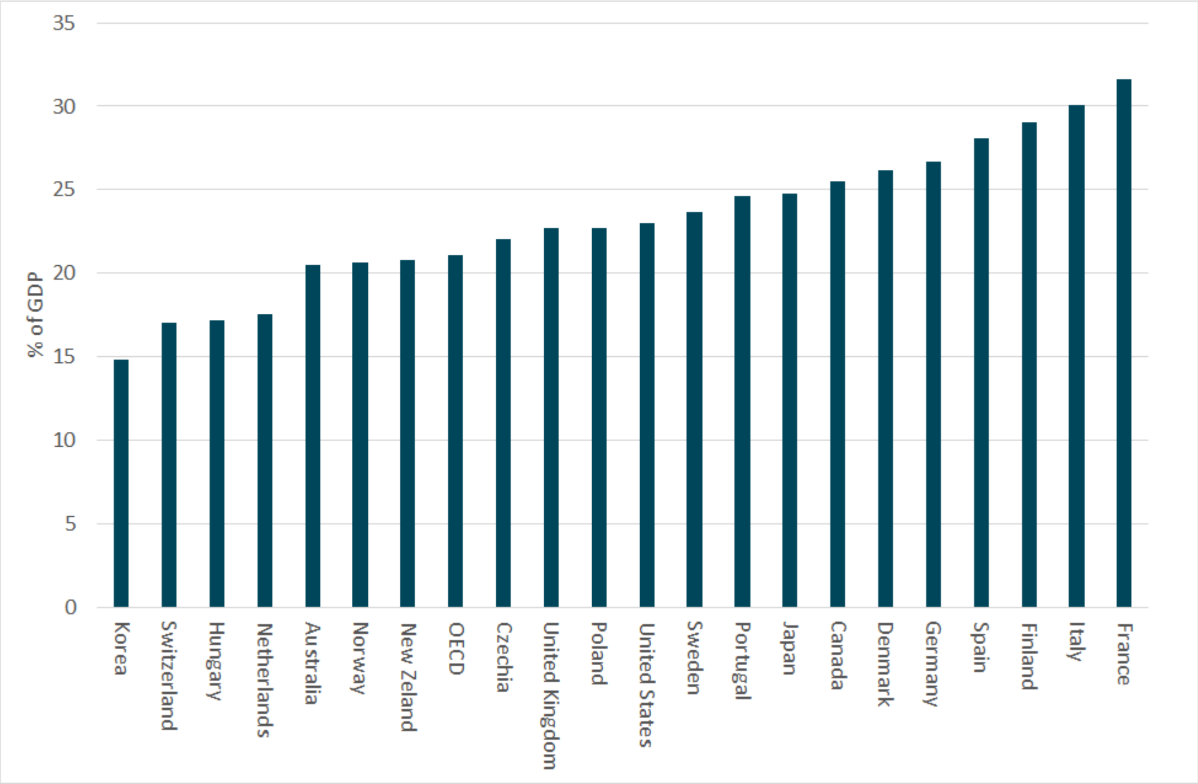
Exhibit #3: Productivity growth



Source: OECD - latest four-quarter growth rate, BNY

Regulatory reform and public investment are often seen as positive forces for productivity growth. Returning to President Lagarde’s Sintra speech in 2023, she stated that the Eurozone’s public sector had also “seen a decline in productivity” and this was a push factor in inflation. As such, as we focus on the impact of government policies on inflation outcomes ahead, the distribution of government expenditure is as important as its size. This is where politics come into play, especially during an election year when candidates are loath to talk about cuts in social spending, which is arguably the least productive part of government spending. On this note, the risks are clearly congregating around Europe and France. Social spending by Paris as a share of GDP is already the highest in the OECD. Market expectations for the next French government remain volatile, but social spending is widely expected to increase. Demographic pressures also mean that the natural direction of travel is higher as well for much of the developed world. Whatever capacity remains for other forms of spending, it must be done efficiently and additive to productivity. The RBNZ's fiscal pivot may prove the outlier at present, but deep down central banks will hope that it becomes the norm.

Exhibit #4: Social spending as % of GDP



Source: OECD (2022), BNY

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