25 October 2011

Westpac Institutional Bank

Good from the bad

Pre-Election Economic and Fiscal Update review

- **The Treasury's latest economic and fiscal projections suggest that the government accounts remain on track for a return to surplus in 2015, and that net debt will remain below 30% of GDP.**
- **A weaker outlook for the global economy is expected to weigh on domestic growth to some degree, but is also seen as substantially lowering finance costs, with lower world interest rates for years to come.**
- **A larger than expected reconstruction job in Christchurch will support activity over coming years.**
- **There are no immediate implications from the PREFU for monetary policy or financial markets, although the risks to the fiscal position seem slanted to the downside.**

Summary

The Pre-Election Economic and Fiscal Update (PREFU), finalised on 18 October, hit much the same marks as the Budget in May. The operating balance (excluding investment gains and losses) is expected to return to surplus in the June 2015 fiscal year, net core debt is expected to peak just below 30% of GDP at the same date, and the borrowing requirement for this year is unchanged.

The weaker world outlook relative to the Budget is seen as being largely offset by a stronger than expected starting point for the domestic economy, a larger and longer boost from the rebuild of Christchurch, and some favourable consequences for New Zealand as a result of the global situation. We see the latter factor as the most significant downside risk to the Treasury's forecasts, and there is still a chance that next year's Budget could result in further caps on spending growth.

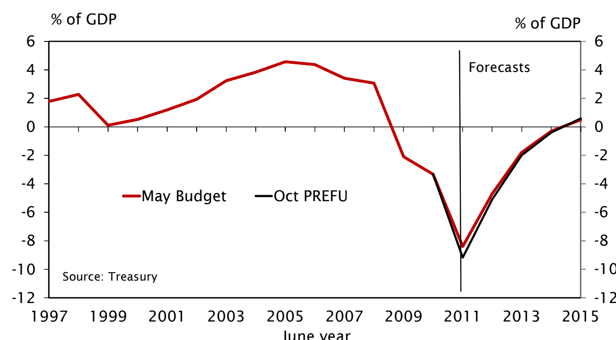
But for now, the implication of this fairly benign assessment of the fiscal position is that the current government, if re-elected, could continue with the fiscal plans it outlined in last May's Budget. We were anticipating something gloomier from the Treasury that might have presaged a further round of fiscal tightening (and less monetary tightening as a consequence), and therefore we regard this as a small positive surprise.

Details

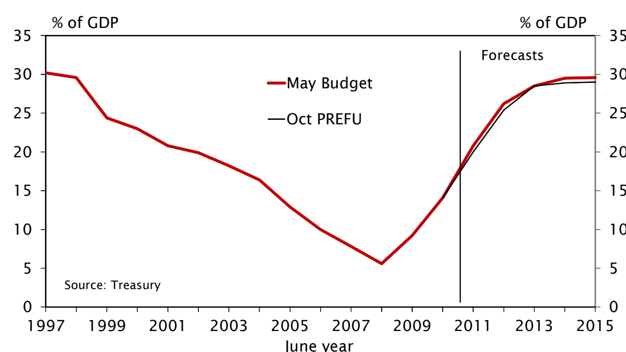
The Treasury's economic forecasts showed a flatter path for GDP growth compared to the Budget, with stronger growth in the near term but a lower and later peak. The first aspect is partly due to a stronger starting point, which in turn is partly a product of upward revisions in the GDP data since May. GDP is expected to grow by 2.3% in the year to March 2012, accelerating to 3.4% in 2013 and 3.3% in 2014. In comparison, the Budget forecasts had growth peaking at 4.0% in March 2013.

Forecasts for global growth were revised down – pitched slightly below the IMF's recent projections – weighing on the expected pace of domestic growth in the later years. However, with the estimated cost of the Christchurch earthquakes having been revised up from $15bn to $20bn, the expected boost to activity from reconstruction is now both larger and longer-lived. Another key pillar of support is the terms of trade, with the forecast actually substantially stronger than in the Budget. Export commodity prices are expected to drop as the world economy slows, but import prices are expected to fall further, this has been partly offset by a softer forecast for import prices, adding up to a fall in the terms of trade of just 4% over the coming year before picking up again.

Operating balance (excluding gains and losses)



Core Crown net debt



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In terms of the fiscal forecasts, the profile for the operating balance excluding gains and losses (OBEGAL) is little changed from the Budget, though with overs and unders within its components. The deficit is expected to narrow to $10.8bn in the current fiscal year, up from the Budget projection of $9.7bn due to delays in some of the quake recovery spending that was budgeted for in the previous year. The balance is expected to return to a $1.5bn surplus in 2014/15, slightly larger than the previous estimate of $1.3bn.

Tax revenue and ACC levies are expected to be lower, and costs related to the ETS are higher, across the forecast horizon. However, benefit payments are expected to be lower, and the recently announced increase in EQC levies will recover a fraction of the earthquake costs.

Most significantly, finance costs are expected to be much lower than assumed in the Budget, due to lower forecasts for international and domestic interest rates. Treasury expects the ten-year bond yield to rise only 1 percentage point to 5.4% by the end of the forecast horizon in 2016.

Net core Crown debt is expected to peak at 29.0% of GDP in 2014/15, slightly lower than the 29.5% peak in the Budget. Rightly or wrongly, keeping net debt below 30% of GDP is seen as crucial for keeping bond investors and credit rating agencies satisfied, and even though two of the three major agencies have already lowered our sovereign rating (and all three have a stable outlook), the government will be keen to avoid further unwanted attention.

The bond tender programme is unchanged for the 2011/12 year, as the pre-funding done last year is seen as sufficient to cover the increase in quake-related costs. The launch of a new inflation-indexed bond is now likely to be delayed until next year, due to uncertain global market conditions.

The PREFU devoted a chapter to an alternative downside scenario with a more severe global downturn, with Treasury putting 20% odds on something at least this bad occurring. The focus on downside risks is understandable, as an undershoot of the central projections would likely be much more problematic for the fiscal accounts than an overshoot of the same scale.

In our view, the greater point of vulnerability in the Treasury's forecasts is not the possibility of a weaker world economy, but the fiscal implications of the world growth track that they already have. Lower interest rates for years to come, lower imported inflation, and only a modest hit to domestic growth mean that the downgrade to the global outlook actually comes across as a net positive for the domestic fiscal position. We fear that interest rates may rise by more than The Treasury is forecasting.

Implications

While Treasury's GDP forecasts are not too far from our own, the fiscal implications of these forecasts are more optimistic than we would have pegged them – we don't think that a weaker world economy will be quite as helpful to New Zealand as the Treasury suggests. A downgrade to the fiscal projections would have meant – depending on the priorities of the government at the time – either larger operating deficits in future Budgets, or even tighter controls on spending growth (which in turn would reduce the required amount of monetary tightening). But as it stands neither will be necessary, so the PREFU has no major implications for monetary policy or financial markets.

There was no discernible market reaction to the release, except for a slightly stronger bid tone in government bonds.

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