

# NEW ZEALAND ECONOMICS PRE-ELECTION ECONOMIC AND FISCAL UPDATE REVIEW

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## CONTRIBUTORS

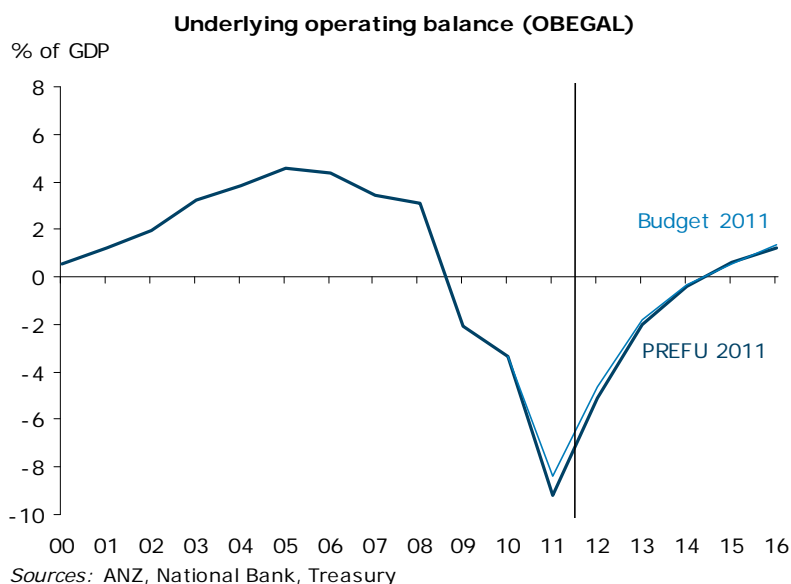
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## OPENING OF THE BOOKS REVEALS LITTLE CHANGE TO BUDGET FORECASTS

### KEY POINTS

- Treasury's latest forecasts did not contain much by way of surprises. The growth profile is broadly similar to the Budget forecasts, as is the expectation of a return to surplus by 2014/15.
- The battleground to achieve a surplus by that date will be fought on two levels. First, whether real GDP growth can average 2.9 percent over the next five years as Treasury forecasts. Historically, this has been easy to achieve, but more questionable in a deleveraging and bumpy global environment. The earthquake rebuild will add to growth, but if supply-side capacity is not what it was, then this impetus will displace growth in other sectors. Second, whether sustained government spending restraint can be achieved in an ongoing manner. Further restraint in some areas will get into diminishing returns.
- These suggest a return to surplus could potentially be delayed by a year. In the overall scheme of things, we do not think this matters much with the spirit of fiscal austerity more critical.
- No matter who wins the election, all political parties are in a fiscal straitjacket for the next five years.
- We see greater coordination between fiscal policy and monetary policy over the coming years, which will assist the RBNZ in keeping interest rates lower than would otherwise be the case.
- With a largely unchanged fiscal forecast, the DMO's bond tender programme is unchanged. The decision to delay the issuance of linkers is disappointing, but understandable in light of current market conditions.

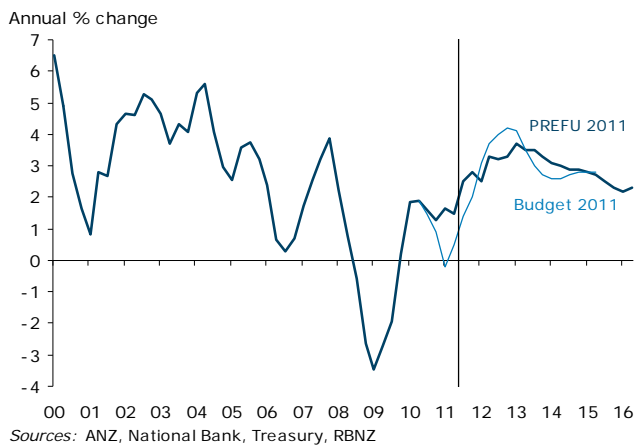


# PRE-ELECTION ECONOMIC AND FISCAL UPDATE REVIEW

## COMMENT AND ASSESSMENT

Today's opening of the books, as the Pre-election Economic and Fiscal Update (PREFU) is sometimes known as, contains few surprises. Indeed, there is nothing in the Treasury's latest forecasts to excite markets. For a start, the overall GDP growth and fiscal forecasts are not too different from the Budget forecasts released in May. Stronger growth in the near-term is offset by weaker growth over 2012. The level of nominal GDP by the end of the forecast period is marginally higher compared to the Budget forecasts.

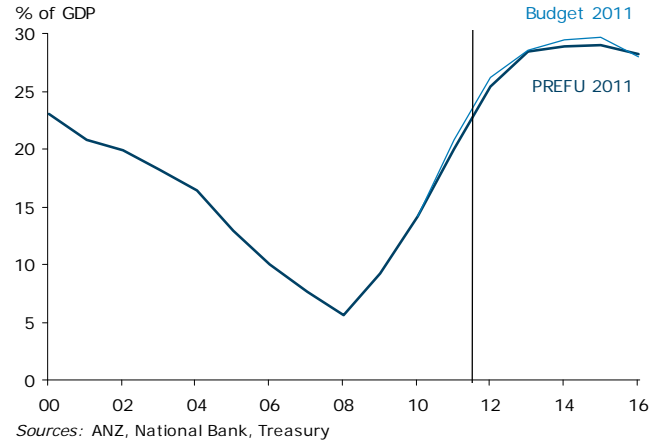
Treasury GDP growth forecasts



Given the deteriorating global situation, it may seem surprising that the Treasury's forecasts are so little changed. The economic story in the Treasury's forecasts is similar to the consensus on a number of levels. There are three key judgements underpinning the forecasts, which are: (a) the timing of the Canterbury rebuild, (b) ongoing household caution, and (c) a weaker global outlook. The Treasury has revised higher the estimated damage from the earthquakes from \$15bn to \$20bn, with the timing of the rebuild delayed until H2 2012. We see little to argue with here and suspect the final cost will end up higher still. Nor do we see any quarrel with the Treasury's expectations of further improvement in household savings, where we think a structural shift is underway after years of overspending.

Treasury's tax revenue forecasts are only slightly lower over the forecast period though this is offset by lower expenses from lower finance costs. The end result is an underlying fiscal position that is very similar to the Budget forecasts. **A return to surplus by 2014/15 is still expected, and the net debt track is very similar to the Budget forecasts as well – peaking at below 30 percent of GDP.**

Net core Crown debt



However, the real battleground to achieve the return to surplus by 2014/15 will be fought on two levels.

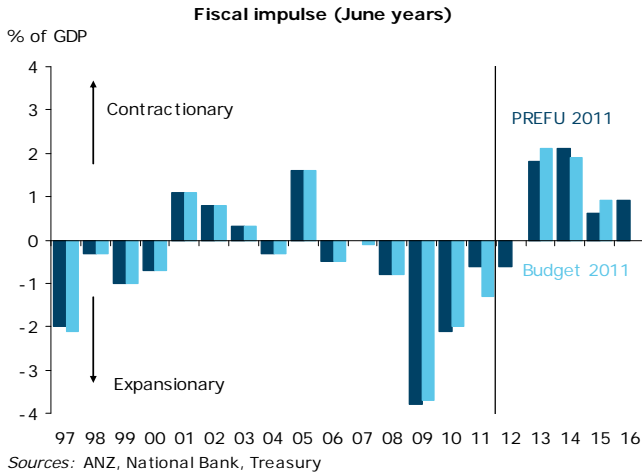
First, whether real GDP growth can average 2.9 percent over the next five years as forecast by Treasury. Even if we abstract from the global scene (and that is a big if!), the implication here is that there is either: (a) huge spare capacity across the economy, and/or (b) the trend growth rate of the economy is still pretty solid. Ultimately, it is the trend rate of growth that matters. Historically, 3 percent has been easy to achieve when the economy is below trend, but it is more questionable in a deleveraging and bumpy global environment. For sure, the economy has spare capacity at present. But if we strip out Treasury's estimate of the output gap (-0.9 percent which divided by five is just below 0.2 percentage points per year of "rebound" growth), Treasury looks to be implicitly assuming trend growth of around 2¾ percent. This looks high to us. While the earthquake rebuild will certainly see a cyclical boost to growth, this counts for little if the supply-side of the economy does not have the capacity to cope. Once supply restrictions are reached, growth from the earthquake rebuild will need to displace others.

The second level is whether sustained government spending restraint can be achieved in an ongoing manner. Further restraint in some areas will experience diminishing returns.

**A broadly unchanged set of macro and fiscal forecasts delivers a fiscal impulse that is not much different from the 2011 Budget forecasts.** Fiscal policy will start to exert a contractionary impact on aggregate demand from FY2012, thereby providing the RBNZ with greater scope to take its time. If the revenue line disappoints, the risk is that

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the Government crunches expenditure by more, further taking pressure off monetary policy.



Given the largely unchanged fiscal forecasts, the DMO's bond tender programme has been left unchanged. Planned issuance of linkers has been pushed out to the second half of the 2011/12 fiscal year owing to uncertain market conditions. The maximum tranche size for 2013s and 2015s has also been increased from \$10bn to \$12bn.

**We note with interest that Treasury is projecting the current account deficit to return to 7 percent of GDP by the end of the forecast period.** There is no doubt that we will see a widening in the current account deficit as the earthquake rebuild gets going. What is more interesting to us is the underlying message that such a current account forecast conveys. The Treasury sees an element of household behaviour as being cyclical as opposed to structural. We are more in the latter camp.

**Overall, the main story is that there is little room for fiscal slippage. A return to surplus will require expenditure restraint, and there is no scope for an election lolly scramble.**

### IMPLICATIONS

**On the face of it, a broadly unchanged set of economic and fiscal forecasts, with a marginally better net debt track, is welcome. However, we see the risk to the Treasury's economic forecasts as being to the downside** due to the global situation and also what we regard as an overly optimistic terms of trade profile. We see little in today's PREFU numbers to excite markets given marginal changes to the Treasury's macro forecasts and debt issuance profile.

**The fact that Treasury are sticking to a return to surplus by 2014/15 tells us something about the success the Government is having in reprioritising spending and finding savings.**

With an assumed discretionary spending cap of \$800 million in the 2012 and 2013 Budgets, and \$1.2bn for 2014 (+2 percent growth thereafter), the baseline spending assumptions are incredibly tight.

**Realistically, once all the low hanging fruit has been picked, getting further reprioritisation and savings will get increasingly more difficult.**

Especially when areas such as health and superannuation are likely to remain off the "political" radar indefinitely.

**The news flow today on the bond supply front is clearly positive.** We always knew that the DMO had done substantial pre-funding in the 2010/11 fiscal year, which would act as an offset to EQC cost increases. Nonetheless, there was some uncertainty about how much pre-funding was "built" into the \$13.5bn bond programme for the current fiscal year that was announced in the Budget in May. The fact that the DMO have confirmed that this year's bond programme will not increase will be something of a relief to the market.

How this news will filter down to the market (and swap spreads) depends on the maturity date in question. This is because the DMO have also announced that the maximum tranche size of the 2013s and 2015s will be increased by \$2bn to \$12bn. As a result, we are likely to see more issuance of 2013s and 2015s, whereas these issues were previously close to being "full". The 2019s and 2023s were always going to be the focus of new issuance, but we expected that 2013 issuance in particular was over given that it matures in the next fiscal year. We suspect this move is a response to strong demand by liquidity books and reinsurers to roll their holdings of 2011s.

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## Economic and Fiscal Forecasts – Treasury's *PREFU 2011* forecasts (*Budget 2011* forecasts in brackets)

March Years	2010/11(a)	2011/12	2012/13	2013/14	2014/15	2015/16
Real GDP (ann. ave. % chg.)	1.6	2.3 (1.8)	3.4 (4)	3.3 (3)	2.9 (2.7)	2.4 (..)
Nominal GDP (ann. ave. % chg.)	5.7	5.5 (4.7)	4.7 (6.4)	5.8 (5.4)	5.1 (4.9)	4.5 (..)
Current account deficit (% of GDP)	-3.6	-2.4 (-4.1)	-3.6 (-5.2)	-5.4 (-6.8)	-6.4 (-6.9)	-6.9 (..)
Unemployment rate (%)	6.5	5.8 (5.7)	5.2 (4.8)	4.9 (4.8)	4.7 (4.6)	4.7 (..)
CPI (ann. % chg.)	4.5	2.8 (3.1)	2.2 (2.4)	2.4 (2.5)	2.5 (2.6)	2.7 (..)
June Years	2010/11(a)	2011/12	2012/13	2013/14	2014/15	2015/16
OBEGAL - \$bn	-18.4	-10.8 (-9.7)	-4.4 (-4.1)	-0.9 (-0.7)	1.5 (1.3)	3.1 (..)
- % of GDP	-9.2	-5.1 (-4.7)	-2 (-1.8)	-0.4 (-0.3)	0.6 (0.5)	1.2 (..)
Operating Balance – \$bn	-13.4	-12.6 (-7.3)	-2.4 (-1.4)	1.6 (2.3)	4 (4.6)	5.7 (..)
- % of GDP	-6.7	-6 (-3.5)	-1.1 (-0.6)	0.7 (1)	1.6 (1.9)	2.2 (..)
Core Crown Residual Cash - \$bn	-13.3	-13.6 (-13.5)	-9.9 (-9)	-5 (-5.4)	-4.1 (-4.1)	-1.6 (..)
- % of GDP	-6.6	-6.4 (-6.4)	-4.4 (-4)	-2.1 (-2.3)	-1.6 (-1.6)	-0.6 (..)
Net Core Crown Debt - % of GDP	20.0	25.4 (26.2)	28.5 (28.5)	28.9 (29.5)	29 (29.6)	28.2 (..)
Bond tender - \$ bn	19.5	13.5 (13.5)	12 (12)	10 (10)	8 (8)	5 (..)

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