Westpac Institutional Bank

19 August 2014

Slim pickings

Pre-election Economic and Fiscal Update Review

- Treasury's latest update of its fiscal and economic forecasts contained few surprises.
- Slight downgrades to revenue projections mean the Treasury is now expecting smaller surpluses in 2014/15 and beyond, giving any future Governments less wriggle room for new spending plans.
- While we agree with the broad thrust of Treasury's economic forecasts, we anticipate a cycle of greater amplitude.

Treasury forecasts

	2014	2015	2016	2017	2018
GDP growth, ann avg % (March years)					
PREFU	3.3	3.8	3.0	2.2	2.1
Change since May Budget	0.3	**-0.2**	0.0	0.1	0.0
Total Crown OBEGAL, $m (June years)					
PREFU	-2,595	297	818	1,851	2,964
Change since May Budget	**-148**	**-75**	**-444**	**-518**	**-521**
Net debt, % of GDP (June years)					
PREFU	25.9	26.8	26.7	25.8	25.0
Change since May Budget	**0.1**	**0.4**	**0.8**	**0.9**	**1.2**

The Pre-election Economic and Fiscal Update (PREFU) is largely an update of the economic assumptions underpinning the government's financial accounts. Its timing, coming ahead of the September 20 election, means it doesn't traditionally include major new policy announcements by the incumbent government (though it will incorporate any Cabinet decisions made since the Budget Update). Consequently, the focus is on how Treasury's forecasts have evolved since the May Budget and any implications of these changes on revenue and expenditure projections.

As widely expected, the Treasury downgraded its revenue forecasts on the back of a weaker nominal GDP forecasts, which in turn were driven by a faster than expected fall in the terms of trade, lower inflation and a higher NZ dollar.

And with no significant changes to spending plans, Treasury is now expecting smaller surpluses in 2014/15 and beyond. The much vaunted promise of a return to surplus in 2014/15 remains intact, though the Government continues to skate on thin ice (with the ice getting even thinner in the latest set of forecasts). The 2014/15 surplus is now expected to be just $297m (compared to $372m in the Budget). Beyond this, the surplus is expected to continue to expand, but not quite as quickly as previously envisioned.

With slightly smaller surpluses, net core Crown debt is now expected to peak at 26.8% of GDP in 2014/15, compared to 26.4% in the Budget. Fortunately, this is still well below the 30% line in the sand. In addition, net debt is now forecast to decline more slowly than previously anticipated.

Treasury's outlook for the economy, particularly in the near term, seems reasonable to us and in many ways echoes our own view. The fundamental drivers of the outlook are unchanged and despite the (largely anticipated) deterioration in the terms of trade, growth is expected to remain reasonably robust in the near term, supported by strong migration, an improving labour market, ongoing growth in construction and still elevated business and consumer confidence. This in turn will generate increasing pressure on resources and eventually result in rising inflation and further rate hikes by the RBNZ.

But while we concur with the broad themes, we do think the Treasury may have undercooked their forecasts in a couple of areas. Although net migration projections have been revised up, the new peak of around 42,500 continues to look on light in comparison to our own forecast which tops out closer to 50,000 new migrants per annum. However, this doesn't translate to a similar discrepancy in our outlook for the housing market, where we remain more convinced than Treasury on the role of rising interest rates. We are more downbeat than Treasury about the outlook for the house prices from 2016 and beyond.

Treasury has adjusted its terms of trade forecast to reflect faster than expected declines in dairy and forestry prices since the Budget. However, the new forecast doesn't incorporate a significantly larger total fall than three months ago. That said, the downside risks to the outlook for the terms of trade were once again highlighted by an alternative scenario (though surprisingly, given the extent of recent falls in export prices, one a bit less severe than a similar exercise done in the Budget). For our part, we remain more optimistic than Treasury about prospects for a recovery in the terms of trade over the medium term where we think strong demand from China and other fast growing developing economies will continue to underpin prices for New Zealand's key commodity exports.

If we're right on the outlook for the terms of trade, the government might find a little more money than they expected in the kitty for a couple of years. But over a longer horizon (beyond 2017), we suspect the risks lie in the opposite direction. Relative to our own forecasts, Treasury is more sanguine about the growth slowdown that will eventuate as the Canterbury rebuild unwinds, higher interest rates take a bit out of activity and (in our view) global growth enters distinctly less friendly territory.

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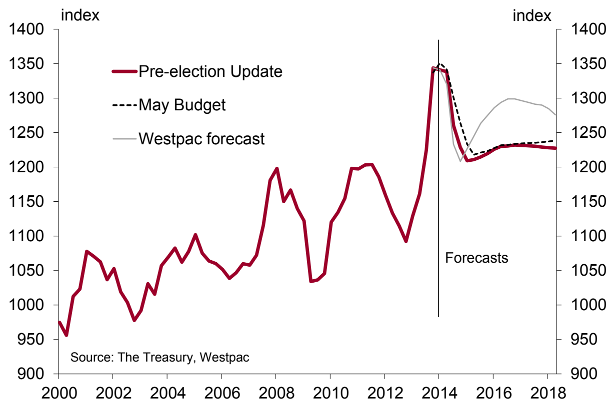
Terms of trade



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