

PREFU Preview: Back in the Red

(14:30 NZDT on Monday 6 October 2008)

Key points

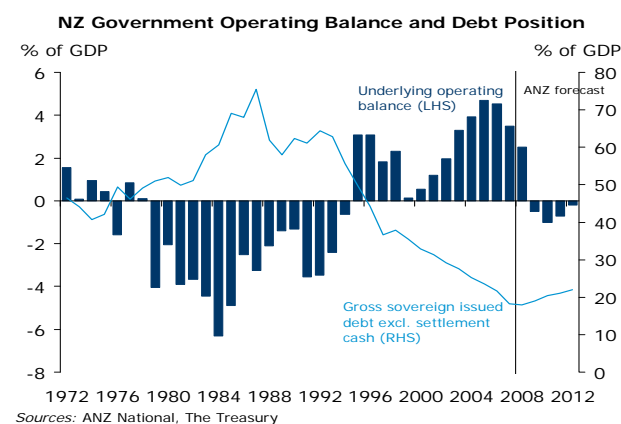
- > **Fiscal accounts to be back in the red for the first time since 1994.**
- > **The kitty is bare.**
- > **More downside risk to the fiscal position remains given we are yet to fully see the impact of the global financial market turmoil.**
- > **Size of the bond tender programme to be expanded, giving the NZ bond market some much needed liquidity.**

Monday's opening of the books will confirm what most already know - that the coffers are bare. The *Pre-election Economic and Fiscal Update* (PREFU) will show that the strong operating surpluses seen over the past few years are no more. In their place will be deficits, which were last seen in 1994. And this is even before a single cent of any pre-election promise has been factored in. For the 2008 fiscal year, valuation changes resulting from mark-to-market losses from the various Crown Financial Institutions (such as the NZ Super Fund, GFS and ACC) will throw the headline operating balance around. The underlying operating balance will provide a better indication, though we expect this to be lower than what was initially forecast. We are looking at a peak in the underlying (ie the OBEGAL) deficit of around 1 percent of GDP for the 2010 fiscal year, which is small when compared with the deficits of the 1980s.

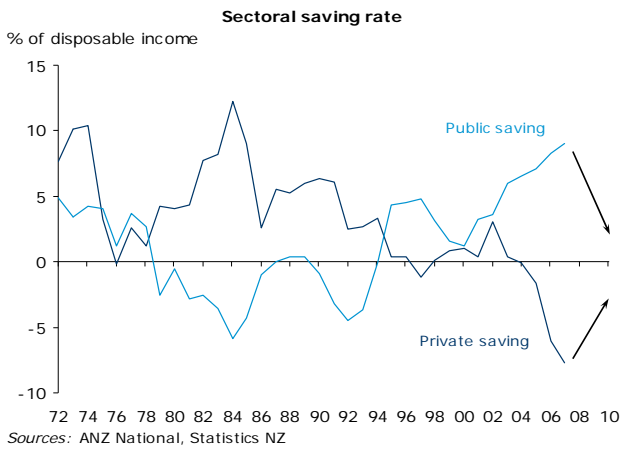
either tax cuts, investment, spending, or the NZ Super Fund contributions (most likely a combination of all of them). It is important to note that the fiscal projections also include allowances and provisions for future policy initiatives, to the tune of \$1.8 billion per year for future Budgets. Hence, the debate at this juncture is not necessarily about whether additional initiatives need to be financed via even more borrowing than what will be flagged, but rather what type of initiatives (tax versus spending) those provisions are allocated to. Obviously, more of one implies less growth and scope for the other.

Abstracting from short-term weakness in flow variables, the fiscal accounts remain strong when looking at the stock. The government's balance sheet remains solid. We expect gross debt of around 18 percent of GDP for the 2008 fiscal year, rising to 22 percent of GDP by 2012. While this reverses the downward trend seen over the past decade, it is coming off a very low base and is at a very manageable level. The government is expected to remain a net creditor when all its assets are taken into account (including the NZ Super Fund). From both a historical and cross-country perspective, NZ's public debt is at very low levels, and remains the envy of many other countries.

We doubt rating agencies will be overly concerned. A commitment to prudent fiscal management and strong macroeconomic settings should ensure that NZ's credit ratings are maintained, despite discomfort at the still large current account deficit and the prospect of a return to "twin deficits" in NZ. Indeed, it would be truly ironic if NZ was penalised on this front, at a time the US is running massive twin deficits, and seeing considerable pressure on its financial system, yet had its rating affirmed.

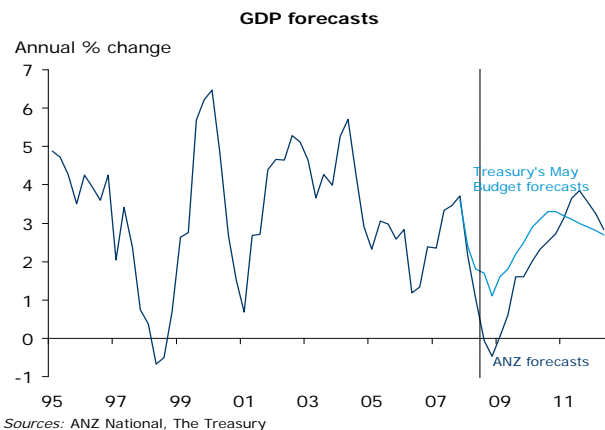


We expect to see sizeable cash deficits, to the tune of \$5 billion (previously flagged as \$3.5 billion in the *Budget*). An explicit implication from this is that the government is already borrowing to fund



Policymakers should not be afraid to use fiscal policy for stabilisation purposes. Fortuitously, the tax cut policies contained in this year's May *Budget*, of which the first tranche came into effect on 1 October, are coming at a time when the economy needs it. By virtue of having the largest balance sheet, the government has greater flexibility and ability to absorb swings in the economic cycle. From a macro perspective, with business cashflows coming under pressure and households going through consolidation, we are going to see a switch between public and private savings, where the latter falls and the former improves. This is part and parcel of the rebalancing that the economy needs to go through. Indeed, if the adjustment were to be entirely borne by the private sector, we will no doubt see a much faster adjustment, but the impact on the real economy would be more severe.

Treasury's economic forecasts to be revised down to reality but will it be enough? A large downward revision to the Treasury's near term growth forecasts is the main reason why the forecast fiscal position is heading into the red. We said at the time that the Treasury's May *Budget* forecasts were too optimistic. But even with a downward revised track on Monday, we suspect the risks will still lie to the downside.



The Treasury's forecasts would have been finalised prior to the recent bout of global financial market volatility. And while the jury is still out on the impact of this, our feeling is that the Treasury will continue to expect a return to trend growth from early next year. We are not so sure of this, as we remain wary of the impact of the global de-leveraging process. Indeed, we already see downside risks to our current below consensus growth forecasts for next year.

Sticky expenditure and falling revenue poses a challenge for the next government. As many businesses know, revenue can fall quickly but costs tend to stay sticky. With the automatic stabilisers set to kick in with a slowing economy and yet high near term inflation, government spending is set to rise even without any new spending policies. This is because welfare spending tends to increase as the number of people on benefits rises (albeit off a very small base this time), and benefit indexation will be higher than originally forecast due to higher CPI inflation. Ongoing wage demands from the public sector, as well as the popularity of KiwiSaver (over 800,000 people signed up as of mid-September) will also keep upward pressure on the spending line. With tax revenues slowing in line with the economy, the risks to the operating balance are tilted to the downside.

Cyclical vs structural debate. At the moment, we are viewing the operating deficits as cyclical in nature, that is, they will be temporary and the government's accounts will return to the black once the economy recovers. In reality, it is very hard to identify when a deficit (or surplus for that matter) is cyclical or structural (ie permanent) and history is littered with examples of nations overstating the structural element of the fiscal position. Given how quickly the fiscal position is going into the red, it may seem that the surpluses of the last few years might have been purely cyclical after all. What is clear is that the next government will have some tough choices to make. Spending promises will need to be funded from reprioritisation of existing spending, and the reality is that it is extremely difficult to claw back baseline spending that has already been committed. But this needs to be done if the deficits are to remain cyclical and not turn structural. The lesson of the 1980s taught us that it is extremely difficult and costly to rein in structural deficits.

Bond tender programme to be increased. In line with an increase in the cash deficit, we now expect the size of the DMO's bond tender programme to be increased to \$5.0 billion. The increase is coming at a time when demand for safe haven assets is increasing, and we expect strong support for the additional issuance.

Financial market implications

We do not expect much market reaction to the *PREFU* numbers. There will be no new Government policies to be announced. And the Finance Minister has been prepping the public as well as the market about a weaker fiscal position. The only question is by how much and for how long. The bond market is already anticipating a larger bond tender programme. Global developments will continue to dominate.

Economic and Fiscal Forecasts – Expected <i>PREFU</i> forecasts (ANZ forecasts in brackets)					
March Years	2007/08 (a)	2008/09	2009/10	2010/11	2011/12
Real GDP (ann. ave. % chg., production)	3.2	0.5 (0.1)	1.9 (1.5)	2.5 (2.7)	3.2 (3.6)
Nominal GDP (ann. ave. % chg.)	7.5	2.5 (2.2)	4.0 (4.1)	4.5 (4.6)	5.0 (5.5)
Current account deficit (% of GDP)	-7.4	-7.0 (-9.1)	-6.8 (-7.0)	-6.6 (-7.3)	-6.5 (-6.3)
Unemployment rate (%)	3.7	4.2 (4.6)	5.0 (5.5)	5.2 (5.8)	5.2 (5.7)
CPI (ann. % chg.)	3.4	4.5 (4.7)	3.0 (3.2)	2.8 (2.5)	2.8 (2.6)
June Years	2007/08	2008/09	2009/10	2010/11	2011/12
Operating Balance - \$ billion	2.0 (2.0)	-0.3 (-0.5)	0.5 (-1.0)	1.7 (1.5)	2.5 (2.0)
- % GDP	1.1 (1.1)	-0.3 (-0.3)	0.3 (-0.5)	0.8 (0.7)	1.2 (0.9)
OBEGAL - \$ billion	4.5 (4.5)	-0.8 (-1.0)	-1.2 (-1.9)	-0.3 (-1.5)	0.3 (-0.5)
- % GDP	2.5 (2.5)	-0.4 (-0.5)	-0.6 (-1.0)	-0.1 (-0.7)	0.1 (-0.2)
Net Core Crown Debt - % GDP	1.1 (1.1)	2.1 (1.9)	3.0 (2.6)	4.0 (3.5)	5.0 (4.0)
Gross Sovereign-Issued Debt (% of GDP)	18.0 (18.0)	18.5 (19.0)	19.5 (20.5)	20.5 (21.0)	21.5 (22.0)
Bond tender - \$ million	2,500 (2,500)	4,000 (4,000)	4,500 (4,500)	5,000 (5,000)	5,000 (5,000)

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