

NEW ZEALAND ECONOMICS

NEW ZEALAND GOVERNMENT BUDGET 2010

20 May 2010

CONTRIBUTORS

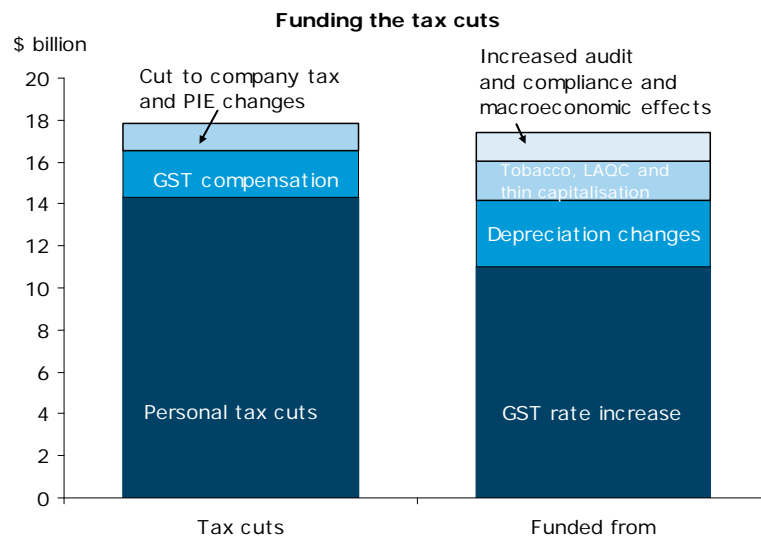
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IMPROVED FISCAL POSITION AND ENOUGH FOR TAX CUTS FOR ALL

KEY POINTS

- An improved growth outlook has flowed through into an improved fiscal situation over the forecast period, resulting in an expected return to surplus by the 2015/16 fiscal year.
- As expected, personal tax cuts will be delivered in 1 October 2010. In a surprise move, the Government has also announced a reduction in the company tax rate to 28 percent from the 2011/12 income year.
- The overall tax package is being funded mainly by an increase in GST from 12.5 percent to 15 percent from 1 October, and changes to depreciation rules for property investment as well changing the tax rules for loss attributing qualifying companies (LAQCs). The IRD will be given more resources to target property speculators.
- Reflecting the improved overall fiscal position, the DMO's bond tender programme is \$2bn lower over the forecast horizon. The bond tender programme for 2010/11 is \$12.5bn, dropping to \$10.5bn in 2011/12, \$10.0bn in 2012/13 and \$6bn in 2013/14. The DMO is considering reintroducing inflation-indexed bonds next financial year, as well as a new nominal bond, most likely to have a March 2019 maturity.
- Overall, the Budget is moving in the right direction by encouraging saving and enterprise, while lessening the attractiveness of consumption and investment in property. In an environment of growing concerns over sovereign debt, today's Budget should differentiate New Zealand in a positive light.

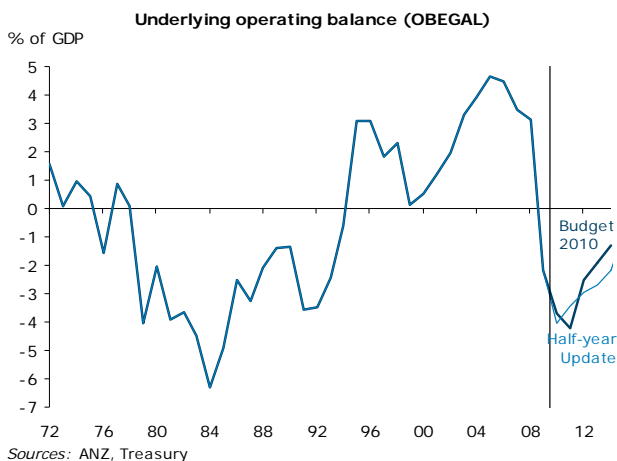


Sources: ANZ, National Bank, Treasury

BUDGET 2010 REVIEW

STANDING OUT

Not many governments around the world at present are able to improve their fiscal position, return to surplus within five or so years, and deliver across the board tax cuts – including reducing the company tax rate. The fiscal forecasts revealed in today's Budget will be the envy of most Finance Ministers (with the exception of the Australian Treasurer). A large underlying deficit is expected for the 2010/11 fiscal year of 4.2 percent of GDP (up from 3.5 percent forecast at the Half-year Update), but improving thereafter with a surplus expected by 2015/16. Contrast this with the deficit in the Euro area for example (which is 6.3 percent and rising), where there is a lot of angst at present over sovereign debt. Gross debt in New Zealand is expected to peak at 32.8 percent of GDP in 2010/11, significantly lower than the 78.7 percent in the Euro area for 2009.



A better performing economy and a tight rein on core government spending are behind the improved fiscal profile. The Government has committed to the \$1.1bn operating allowance for additional spending in this Budget, with the bulk of it (\$0.8bn) going into health, education and a range of science and R&D initiatives. Some \$1.8bn of spending over four years have been reprioritised from within existing baselines. Most government departments have effectively had their baselines frozen.

TAX CUTS FOR ALL...

The flagship Budget policy has been the tax package. As was well flagged in advance, all the personal income tax rates are being reduced, effective from 1 October 2010. The tax cuts are larger than what we had been expecting. The

income thresholds remain unchanged, with the top marginal tax rate dropping from 38 percent to 33 percent.

Income Band	Current Rates	From 1 October
\$0 - \$14,000	12.5%	10.5%
\$14,001 - \$48,000	21.0%	17.5%
\$48,000 - \$70,000	33.0%	30.0%
Over \$70,000	38.0%	33.0%

In a surprise move, the Government has also announced that the company tax rate will drop from 30 percent to 28 percent from the 2011/12 income year. This is ahead of when Australia's company tax rate is due to be reduced¹, and is a welcome policy as it will ensure that New Zealand can stay competitive in attracting or retaining businesses. The top PIE tax rate will also reduce to 28 percent from 1 October for those that pay tax at investor's marginal tax rates. This will be effective from the 2011/12 income year for other savings vehicles.

... BUT SOMEONE HAS TO PAY FOR IT

The overall tax package has been designed to be fiscally neutral. As such, revenue has to be raised from somewhere to pay for the almost \$4.5bn per annum tax package. The bulk of this is from an increase in GST from 12.5 percent to 15 percent, effective from 1 October. Beneficiaries will be compensated for the GST increase by having their benefit rates increased by 2.02 percent.

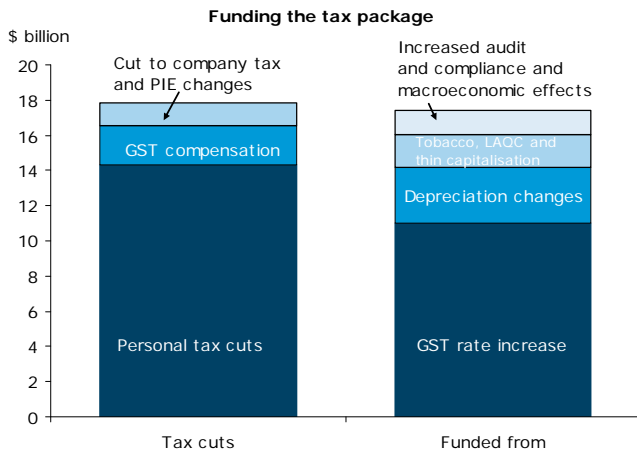
Depreciation rules for property investment will change. From the 2011/12 income year, tax depreciation will be set to 0 percent for all buildings with an estimated useful life of 50 years or more. The 20 percent depreciation loading will be removed for assets purchased after 20 May 2010 (today). In addition, loss attributing qualifying companies (LAQCs) will become flow-through entities for tax purposes, similar to limited partnerships. However, investment losses will be excluded from the definition of income for the purposes of calculating Working for Families entitlements from 1 April 2011.

The thin capitalisation threshold is being lowered. The 75 percent safe harbour in the inbound thin capitalisation rules applying to the

¹ The company tax rate in Australia goes to 29 percent from 2013/14 and 28 percent from 2014/15. For small businesses the tax rate is cut to 28 percent from 2012/13.

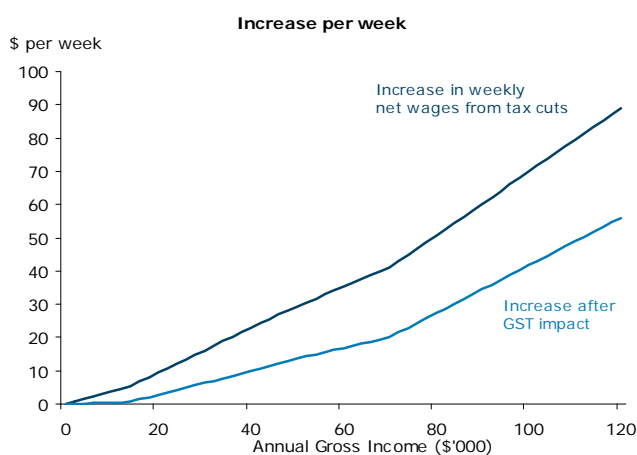
BUDGET 2010 REVIEW

New Zealand operations of foreign multinationals will be reduced to 60 percent from the 2011/12 year.



Sources: ANZ, National Bank, Treasury

On balance, most salary and wage earners should be better off. How much any individual or household will be better off by will depend on their spending patterns, making a general assessment difficult. The graph below shows how much extra a week that can be expected for various income levels, assuming that all net income is spent. Those that save more as a proportion of their income will benefit more. Property investors that rely on claiming depreciation to offset their rental property income will of course be negatively impacted. As will those who spend beyond their means by borrowing.



Sources: ANZ, National Bank, Treasury

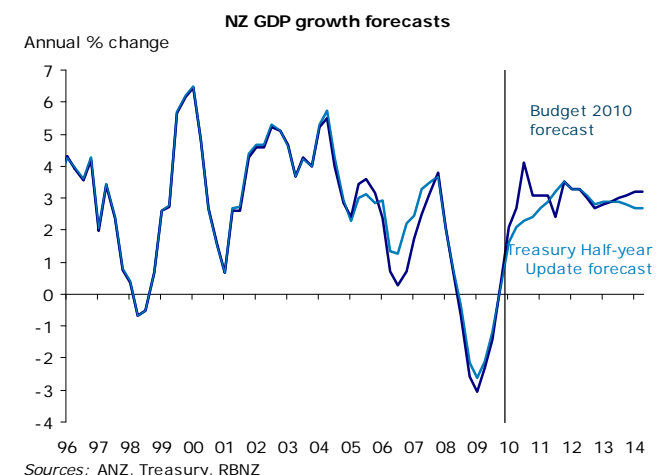
If there is any quarrel that we have, it is the expected revenue to be raised from increased IRD audit and compliance activity, and from the assumed macroeconomic effects from the tax package. In essence, the IRD will be given more resources (\$119.3 million over four years) to target property speculators and improve tax

compliance and audits. This initiative is expected to bring in around \$200 million a year. In addition, the tax package is expected to spur additional economic activity which will raise around \$670 million in revenue over four years. Almost 8 percent of the total tax package is to be funded from these two areas, and there is a risk that the expected increased revenue will not eventuate.

A STRAIGHT LINE?

In addition, the Treasury has consistently strong growth forecasts over the projection period, with not much of a cycle built in. Growth of around 3 percent is expected over the next five years. This does not leave much room for error if current global ructions spill over. Relative to our expectations, we think Treasury is underestimating growth next year (not much of a Rugby World Cup impact has been factored in) but overestimating it further out.

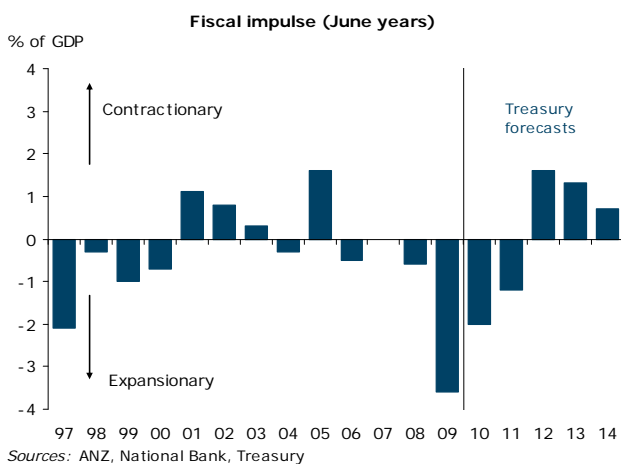
The Treasury does not seem to be expecting much rebalancing in the economy. The current account deficit is forecast to rise past 7 percent of GDP by the March 2013 year. We doubt that in the current environment, New Zealand will be allowed to return towards running external balances of that size. As the RBNZ Governor noted in yesterday's Financial Stability Report, "A rebalancing of the economy towards higher national savings, and less reliance on external financing, remains highly desirable to stabilise New Zealand's net external indebtedness at or near current levels, even if it means growth rates will be relatively moderate in coming years." Under the Treasury's forecasts, New Zealand's net international liability position increases from 90 percent of GDP currently towards 100 percent of GDP by mid-2014. We do not think such a scenario will be allowed to eventuate.



Sources: ANZ, Treasury, RBNZ

BUDGET 2010 REVIEW

The Government has indicated that any improvements in tax revenue as a result of a stronger economy will be used to reduce the deficit. The reverse will also apply, should tax revenues fall short of forecasts. But there is sufficient buffer in terms of a low level of debt to be able to ride through any near-term bumps along the way. However, there is still some way to go in addressing the structural deficit that still exists. This will require further restraints in core government spending.

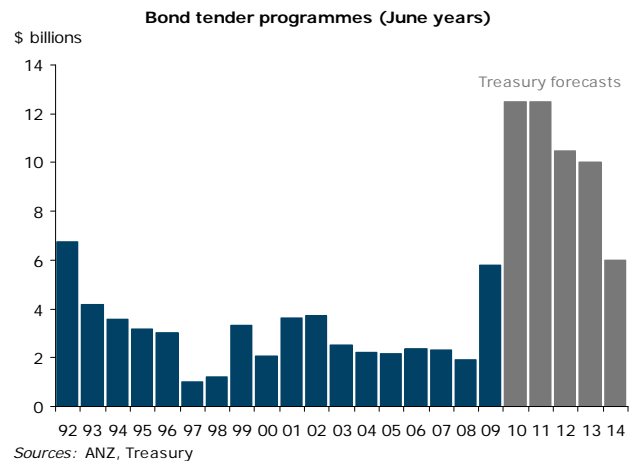


According to Treasury estimates, the fiscal position is still expansionary heading into next fiscal year, before turning contractionary in 2011/12. We suspect the expansionary impact will not be as large. Given that most of the tax cuts are being directed towards higher income earners who tend to have a higher marginal propensity to save, we suspect more of the tax cuts will be saved rather than spent. The changes to depreciation rules and LAQCs, on the face of it, should be negative for the property market. However, the actual changes were not as bad as what some had feared (e.g. no ring fencing of losses). Hence, we suspect that a recovery in volumes (though not necessarily prices) could eventuate as pent-up demand is unleashed now that policy uncertainty has been cleared up. The lowering of the company tax rate should encourage more business investment as the economy recovers and profits pick up.

LINKERS TO MAKE A COMEBACK

Reflecting the improved overall fiscal position, the DMO's bond tender programme is \$2bn lower over the forecast horizon. This is in addition to the fact that the DMO are \$2bn ahead of schedule this fiscal year, which means that total issuance over the next four years actually falls by \$4bn.

The bond tender programme for 2010/11 is \$12.5bn, dropping to \$10.5bn in 2011/12, \$10.0bn in 2012/13 and \$6bn in 2013/14. The DMO is considering reintroducing inflation-indexed bonds next financial year, as well as a new nominal bond, most likely to have a March 2019 maturity. We expect there to be good demand for these.



IMPLICATIONS

Overall, today's Budget is moving in the right direction by encouraging saving and enterprise, while lessening the attractiveness of consumption and investment in property. The Government is embarking on a series of steps as opposed to a big-bang approach. Next year's Budget looks to mainly deliver on regulatory reform as opposed to further big changes to the tax system. Incremental steps can work if they move consistently in the right direction, though it will be some time before we will see the impact on New Zealand's economic performance.

We do not see the Budget as having a major impact on the RBNZ. The decision of whether or not to remove policy stimulus in June rests largely on how offshore developments (sovereign debt concerns and the general impact on global markets) play out in the coming weeks.

In an environment of growing concerns over sovereign debt, today's Budget should differentiate New Zealand in a positive light.

BUDGET 2010 REVIEW

Economic and Fiscal Forecasts – Treasury's Budget 2010 forecasts
(Half-year Update 2009 forecasts in brackets)

March Years	2008/09 (a)	2009/10	2010/11	2011/12	2012/13	2013/14
Real GDP (ann. ave. % chg., production)	-1.4	-0.3 (-0.4)	3.2 (2.4)	3.1 (3.2)	2.9 (3.0)	3.0 (2.8)
Current account deficit (% of GDP)	-7.9	-2.6 (-2.9)	-4.4 (-5.4)	-6.1 (-6.8)	-7.0 (-7.1)	-7.3 (-7.1)
Unemployment rate (%)	5.0	7.1 (7.0)	6.2 (6.9)	5.5 (6.0)	5.1 (5.3)	4.6 (4.8)
CPI (ann. % chg.)	3.0	2.2 (2.5)	5.9 (2.3)	2.4 (2.2)	2.4 (2.3)	2.4 (2.0)
June Years	2008/09 (a)	2009/10	2010/11	2011/12	2012/13	2013/14
Operating Balance – \$ million	-10,505	-3,179 (-4,794)	-7,067 (-5,128)	-3,579 (-4,153)	-2,402 (-3,728)	-828 (-2,673)
- % GDP	-5.7	-1.7 (-2.6)	-3.5 (-2.6)	-1.7 (-2.0)	-1.1 (-1.7)	-0.3 (-1.2)
OBEGAL - \$ million	-3,893	-6,927 (-7,465)	-8,632 (-6,684)	-5,406 (-6,000)	-4,394 (-5,775)	-3,038 (-4,867)
- % GDP	-2.1	-3.7 (-4.0)	-4.2 (-3.4)	-2.5 (-2.9)	-1.9 (-2.7)	-1.3 (-2.2)
Core Crown Residual Cash - \$ million	-8,639	-9,069 (-10,091)	-13,327 (-11,349)	-9,666 (-10,353)	-7,499 (-8,681)	-5,983 (-7,443)
- % GDP	-4.7	-4.8 (-5.5)	-6.5 (-5.9)	-4.5 (-5.1)	-3.3 (-4.1)	-2.5 (-3.3)
Net core crown debt - % of GDP	9.3	14.1 (14.8)	19.6 (20.0)	23.0 (24.1)	25.3 (26.9)	26.5 (29.0)
Bond tender - \$ billion	5.5	12.5 (10.5)	12.5 (10.5)	10.5 (12.5)	10.0 (12.5)	6.0 (7.5)

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The Bank (in respect of itself and its principal officers) makes the following investment adviser disclosure to you pursuant to section 41A of the Securities Markets Act 1988.

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The Bank is a registered bank and, through its staff, is experienced in providing investment advice about its own securities and, where applicable, the securities of other issuers. The Bank has been selling securities, and providing investment advice on those securities, to customers as a core part of its business for many years, drawing on the extensive research undertaken by the Bank and its related companies and the skills of specialised staff employed by the Bank. The Bank is represented on many bank, finance and investment related organisations and keeps abreast of relevant issues by running seminars and workshops for relevant staff and having its investment adviser staff attend external seminars where appropriate. The Bank subscribes to relevant industry publications and, where appropriate, its investment advisers will monitor the financial markets.

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The Bank is a member of the following professional bodies relevant to the provision of investment advice:

- New Zealand Bankers Association;
- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

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The Bank (and its subsidiaries), through its ultimate parent company Australia and New Zealand Banking Group Limited, has professional indemnity insurance which covers its activities including those of investment advisers it employs.

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- Convicted of an offence under the Securities Markets Act 1988, or the Securities Act 1978 or of a crime involving dishonesty (as defined in section 2(1) of the Crimes Act 1961);
- A principal officer of a body corporate when that body corporate committed any of the offences or crimes involving dishonesty as described above;
- Adjudicated bankrupt;
- Prohibited by an Act or by a court from taking part in the management of a company or a business;

- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

Fees

At the time of providing this disclosure statement it is not practicable to provide accurate disclosure of the fees payable for all securities that may be advised on. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

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When a security is sold by the Bank, the Bank may receive a commission, either from the issuer of a security or from an associated person of the Bank. Whether that commission is received and, if received, its value depends on the security sold. At the time of providing this disclosure statement it is not practicable to provide a detailed list of each security that may be advised on, the name of the issuer of that security and the rate of the commission received by the Bank. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

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- Equity securities such as listed and unlisted shares;
- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

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If you wish to pay investment money to the Bank you can do this in several ways such as by:



IMPORTANT NOTICE

- Providing cash;
- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

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Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

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The Bank will keep adequate records of the deposit of investment moneys or property and all withdrawals and dealings with such money or property, using the account/investment number allocated to your investment. You may have access to those records upon request.

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