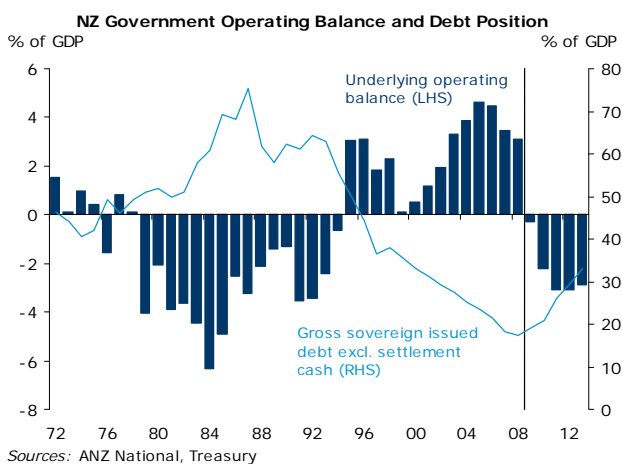


Budget Policy Statement and Updated Economic and Fiscal Forecasts

Key points

- > Fiscal forecasts revised lower on the back of a weaker economic outlook.
- > Yet, the central economic forecasts still look too optimistic.
- > Further downgrades to come at next year's *Budget*, putting more strain on the fiscal position.
- > *Fiscal Strategy Report* next year to present concrete steps to ensure today's projections do not eventuate. Ratings agencies are likely to hold judgement until then.
- > The fiscal stance is more expansionary, but not sufficiently so as to alter our view of monetary policy, and a lot looks technical with no new concrete announcements.
- > It will be a major challenge to meet the objectives of providing fiscal policy support to the economy versus arresting growing structural deficits.
- > The size of the DMO's bond tender programme increases significantly to \$15 billion by 2011/12 and \$15.9 billion in 2012/13. This is a considerable amount of issuance for the market to absorb.

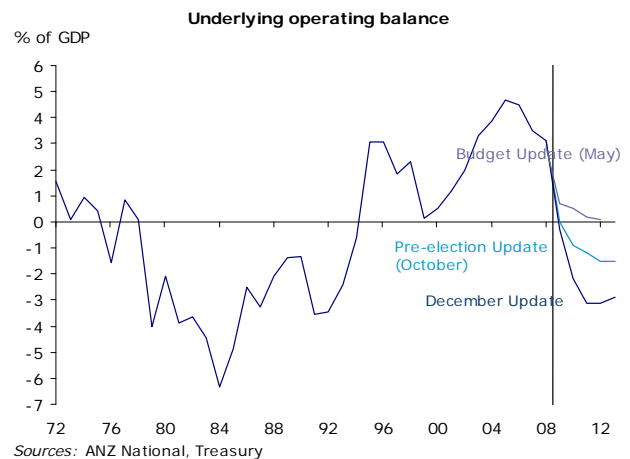
The Government's books show a deterioration from the one presented at the *Pre-election Update* in October. Underlying operating deficits (OBEGAL) are now expected to more than double, rising to 3.1 percent of GDP by 2010/11. Cash deficits are forecast to exceed \$10 billion, or in excess of 5 percent of GDP, by 2010/11, and continue to rise beyond that. As a result, gross Government debt (excluding settlement cash) is forecast to reach 33.1 percent of GDP by 2012/13.



Longer-term projections are more bleak, suggesting a return to structural deficits if no concrete policy action is taken. At the *Pre-election Update*, the Treasury forecast a decade of deficits, with a return to underlying operating surpluses from 2017/18. Today's update however, shows that the underlying operating balance never returns into the black, stabilising at -2 percent of GDP from 2018/19. This results in gross debt

surpassing 50 percent of GDP, a level we have not seen since the early 1990s. **This is clearly an unacceptable outcome, and the Finance Minister was quick to note that the Treasury's projections will not be allowed to eventuate.**

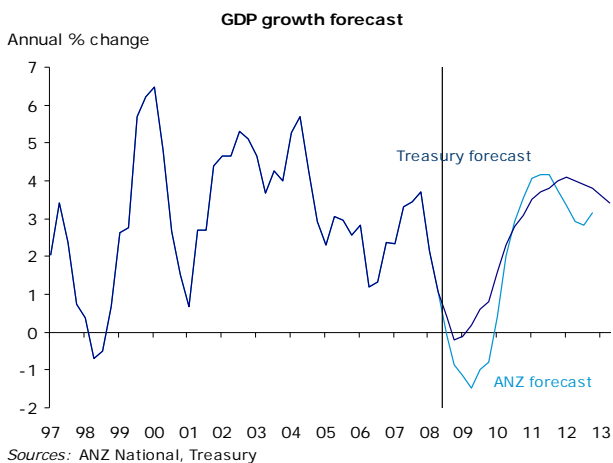
However, we will have to wait until the 2009 *Fiscal Strategy Report* is released next year to see what concrete steps will be taken to address the deteriorating fiscal position. To be fair, the Government inherited probably the worst fiscal position since the Bolger administration in the early 1990s. They will need time to work through the appropriate policy response, which is not helped by the pace with which the forecasts are being revised, or the pressure on fiscal policy to respond to the current economic climate.



That the Treasury's fiscal forecasts showed a doubling of the underlying deficit within a space of two months – driven primarily from a

downgrade to the economic outlook – reveal the severity of the situation. Indeed, since the *May Budget* this year, the forecast for the underlying fiscal position has gone from a small positive to -3 percent of GDP, mainly on the back of changes to the economic outlook. And yet, we fear that the true extent of the near-term fiscal position will be worse than what the Treasury has portrayed today.

The Treasury’s central economic forecasts still look far too optimistic. While much is made of 0.3 percent growth in the year to March 2009, the reality is that this year is close to three-quarters complete, so this is pretty well in the bag as opposed to a forecast. It is the Treasury’s rebound over 2009 (and growth to March 2010 of close to 1 percent) that looks odd given the economic environment. Our own expectation is for growth in the year to March 2010 to be weaker than the year to March 2009. To be fair, their forecasts were finalised on 20 November, and the dataflow has continued to deteriorate since then, particular internationally. **But clearly, downside growth risks spell further downside (i.e. larger deficits) to the fiscal position.**

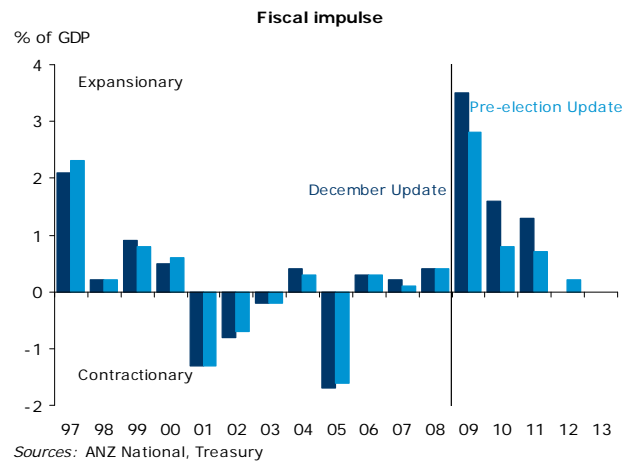


The Finance Minister also stated the Government is taking immediate steps to “establish the true nature of the fiscal risks that exist.” Given that today’s updated economic and fiscal forecasts are supposed to do just that, we wonder if this was due to the Government’s wariness over any other “surprises” in the books, such as the unfunded ACC liability issue they had to contend with. Certainly, there is no scope at all for the fiscal accounts to absorb any surprises of these sorts. Particularly when there is bound to be more downside revisions to tax revenue still to come.

The Treasury’s fiscal impulse estimate shows a more expansionary fiscal stance, which could help assist monetary policy in stabilising the economy. At first blush, the size of the fiscal impulse for the 2008/09 fiscal year, equivalent to 3.5 percent of GDP, looks impressive, as do the out-year expectations of 1.6 and 1.3 percent of

GDP. All are broadly 0.7 percentage points higher than earlier flagged. However, it looks to be a case of reclassification of how the previous Government’s KiwiSaver changes were treated in the fiscal impulse calculation. Previously, this was omitted from the calculation since workers could not spend the money. But now that the KiwiSaver money is being used to fund tax cuts, this has now been included in the fiscal impulse measure.

Beyond this, there was no new policy announced today, with the operating allowance being kept at \$1.75 billion for the 2009 Budget and beyond. But the capital allowance is being increased. The pre-election promises made by the Government, including the tax cut package, have been funded mainly from re-prioritisation (changes to KiwiSaver and dropping the R&D tax credit). The only “new” spending as such is in capital, with an increase in the capital allowance from \$0.9 billion to \$1.45 billion from the 2009 to 2012 Budgets, rising to \$1.65 billion in the 2013 Budget.



The bond tender programme has been significantly increased. The deteriorating fiscal position and sizeable increase in the cash deficit has led to the DMO increasing the size of the bond tender programme. The programme will be \$4.5 billion for 2008/09, \$7.5 billion in 2009/10, rising to \$15 billion by 2011/12. This is a very sizeable increase, which is far beyond the \$2-2.5 billion annual tenders we have become accustomed to. The DMO will have a huge job ahead in trying to sell this large issuance offshore, given that there is an insufficient domestic savings pool to absorb it. The DMO is also seeking to increase bond market liquidity by:

- > increasing the target size of each bond maturity from \$4.5 billion to \$5 billion;
- > introduce a new long-term bond following consultation with market participants; and
- > move to a weekly bond tender from 15 January 2009 (with less frequent tap tenders going forward).

We await the rating agencies' response.

Operating deficits as far as the eye can see, and no near term improvement in the country's external position, will make rating agencies increasingly nervous. But we suspect that they will hold judgement until the Government reveals their concrete plans to address the deteriorating fiscal position next year. After all, New Zealand is hardly unique in the current environment, with sovereigns around the world grappling with deteriorating fiscal positions.

Financial market implications

The worsening fiscal outlook was well flagged in advance, and there was no new policy announcements made, so market reaction was muted. The bond market was already bracing itself for a larger bond tender programme. Even with the larger than anticipated issuance announced by the DMO, the bond market took the news in its stride.

While fiscal policy is set to provide a lot of assistance to the economy over the coming years, there looks to be little new information (despite a more expansionary fiscal stance but with no major new initiatives being announced) to alter our expectations that monetary policy still has considerable work ahead of itself.

Economic and Fiscal Forecasts – Treasury's December Update forecasts (Pre-election Update forecasts in brackets)						
March Years	2007/08 (a)	2008/09	2009/10	2010/11	2011/12	2012/13
Real GDP (ann. ave. % chg., production)	3.2	0.3 (0.1)	0.8 (1.8)	2.9 (3.3)	3.9 (3.4)	3.8 (3.1)
Nominal GDP (ann. ave. % chg.)	7.5	1.5 (3.1)	1.3 (3.0)	4.7 (4.6)	5.8 (5.1)	5.6 (5.0)
Current account deficit (% of GDP)	-7.4	-9.4 (-8.0)	-8.6 (-6.5)	-6.9 (-5.8)	-5.2 (-5.3)	-4.9 (-5.0)
Unemployment rate (%)	3.7	4.7 (4.4)	6.4 (5.1)	6.2 (5.1)	5.4 (4.8)	4.6 (4.6)
CPI (ann. % chg.)	3.4	3.4 (4.5)	2.4 (2.3)	1.9 (2.4)	1.9 (2.4)	1.9 (2.4)
June Years	2007/08 (a)	2008/09	2009/10	2010/11	2011/12	2012/13
Operating Balance – \$ million	2,384	-4,329 (1,909)	-1,990 (374)	-3,598 (-71)	-3,609 (-396)	-3,333 (-382)
- % GDP	1.3	-2.4 (1.0)	-1.1 (0.2)	-1.9 (-0.0)	-1.8 (-0.2)	-1.5 (-0.2)
OBEGAL - \$ million	5,637	-550 (-64)	-4,110 (-1,746)	-6,008 (-2,481)	-6,305 (-3,092)	-6,325 (-3,374)
- % GDP	3.1	-0.3 (-0.0)	-2.2 (-0.9)	-3.1 (-1.2)	-3.1 (-1.5)	-2.9 (-1.5)
Core Crown residual cash - \$ million	2,057	-6,633 (-5,909)	-8,134 (-5,300)	-10,868 (-6,603)	-10,921 (-6,815)	-11,384 (-7,307)
Gross Sovereign-Issued Debt - % of GDP	17.5	19.2 (17.4)	21.0 (18.0)	26.0 (21.9)	29.4 (23.1)	33.1 (24.3)
Bond tender - \$ million	1,757	4,565 (4,048)	7,740 (6,070)	11,245 (9,114)	15,009 (9,189)	15,881 (9,216)

NEW ZEALAND DISCLOSURE INFORMATION

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.

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

Qualifications, experience and professional standing

Experience

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.

Relevant professional body

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.

Professional indemnity insurance

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.

This insurance covers issues (including 'prior acts') arising from staff fraud, electronic crime, documentary fraud and physical loss of property. The scope of the insurance also extends to third party civil claims, including those for negligence. The level of cover is of an amount commensurate with the size and scale of the Bank.

The insurer is ANZcover Insurance Pty Limited.

Dispute resolution facilities

The Bank has a process in place for resolving disputes. Should a problem arise, you can contact any branch of the Bank for more information on the Bank's procedures or refer to any of the Bank's websites.

Unresolved complaints may ultimately be referred to the Banking Ombudsman, whose contact address is PO Box 10-573, Wellington.

Criminal convictions

In the five years before the relevant investment advice is given none of the Bank (in its capacity as an investment adviser and where applicable an investment broker) or any principal officer of the Bank has been:

- 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.

Other interests and relationships

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.

In addition to the interest that the Bank has in products of which it is the issuer, the Bank, or an associated person of the Bank, has the following interests or relationships that a reasonable person would find reasonably likely to influence the Bank in providing the investment advice on the securities listed below:

- ANZ Investment Services (New Zealand) Limited (ANZIS), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. ANZIS may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- UDC Finance Limited (UDC), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. UDC may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- The Bank has a joint venture relationship with ING (NZ) Holdings Limited (ING). ING and its related companies may receive remuneration from a third party relating to a security sold by the Investment Adviser.

Securities about which investment advice is given

The Bank provides investment advice on the following types of securities:

- Debt securities including term and call deposits, government stock, local authority stock, State-Owned Enterprise bonds, Kiwi bonds and corporate bonds and notes;
- 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.

PROCEDURES FOR DEALING WITH INVESTMENT MONEY OR INVESTMENT PROPERTY

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

- 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.

Investment property (other than money) may be delivered to the Bank by lodging the relevant property (for example, share certificates) with any branch of the Bank offering a safe custody service, or by posting (using registered post) the documents or other property to a branch of the Bank, identifying your name, account number and investment purpose.

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.

Record Keeping

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.

Auditing

The Bank's systems and operations are internally audited on a regular basis. The financial statements of the Bank and its subsidiaries are audited annually by KPMG. However, this does not involve an external audit of the receipt, holding and disbursement of the money and other property.

Use of Money and Property

Money or property held by the Bank for a specific purpose communicated to the Bank (e.g. the purchase of an interest in a security) may not be used by the Bank for its own purposes and will be applied for your stated purpose. No member of the Bank's staff may use any money or property deposited with the Bank, for their own purposes or for the benefit of any other person. In the absence of such instructions, money deposited with the Bank may be used by the Bank for its own purposes, provided it repays the money to you upon demand (or where applicable, on maturity), together with interest, where payable.

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