Economic Review

New Zealand

6 October 2008

Open partnerships
Open possibilities

PREFU Review: Well into the red and then some

Key points

> **Underlying fiscal deficits forecast until 2017/18, as the Treasury shaves its growth and tax forecasts.**

> **And this is before any election promises are factored in.**

> **Crown balance sheet still strong but scope for further pump priming of the economy, should it be needed, is reduced.**

> **Size of the DMO's bond tender programme increased significantly and projected to surpass $9 billion in 2010/11. This is a non-trivial increase, but a positive is that it could help revive the local bond market.**

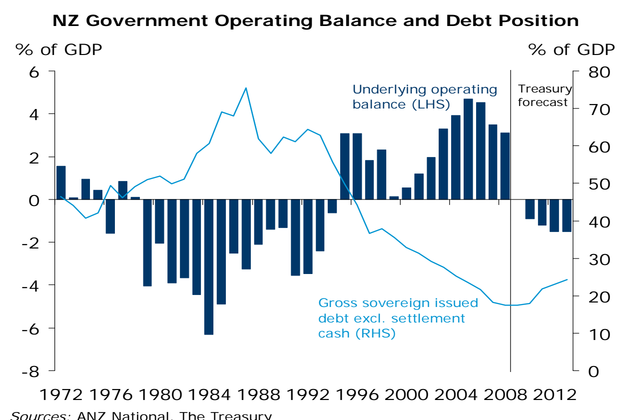
The Government's books are in a worse state than we thought. Today's *Pre-election Economic and Fiscal Update* (*PREFU*) projects a deteriorating underlying fiscal position, with the OBEGAL going from 3.1% of GDP in 2007/08 to -1.5% by 2011/12. As a result, gross debt (excluding settlement cash) is forecast to rise from the current 17.4% of GDP to 24.3% by 2012/13. Based on longer-term forecasts which the Treasury included in today's numbers, gross debt is expected to peak at 30% of GDP in 2017/18. Indeed, based on this longer term outlook, the OBEGAL is not expected to return to surplus until 2017/18.

Less tax revenue and higher spending led to the deteriorating forecast fiscal position. It is important to note that the *PREFU* only incorporates updated forecasts. No new policies have been announced, and the forecasts do not include any pre-election promises. The Treasury has shaved their economic growth forecasts, resulting in tax revenues which are now forecast to be around $0.9 billion lower compared to the *Budget* forecasts in each of the next three years. On the expenditure side, the major drivers for the increased forecast spending are due to $0.5 billion more spending per annum on benefits, $0.48 billion more per annum due to higher take-up of the Government's 20-hours free childcare policy and KiwiSaver, and $0.5 billion more for higher debt servicing costs.

Higher cash deficits see significantly increased bond tender programme. The weaker fiscal outlook in today's *PREFU*, where the cash deficit has been revised from $3.5 billion at the *Budget* to $7.3 billion today's, has seen the DMO increase the 2008/09 domestic bond programme by $600 million to $4 billion. This rises to $6 billion in 2009/10, $9.1 billion in 2010/11 and $9.2 billion in 2011/12 and 2012/13. This is a non-trivial increase, and we suspect the market will welcome the additional supply. Indeed, it could help revive the lacklustre NZ bond market, and might even see the NZ yield curve revert towards a more normal curve, particularly given our expectations that the RBNZ has more work to do over the coming months.

The overall Crown's balance sheet still remains strong. We have been so used to the Government running large surpluses, it is easy to become unduly pessimistic about the state of the public finances. Looked at from a historical perspective, while operating deficits are never welcome, those forecast today are still small compared to those run over the 1980s and early 1990s. And while gross debt as a percent of GDP is reversing the downward trend of the past decade, it remains at low and manageable levels still. Indeed, compared to many other OECD countries, NZ's fiscal position is still one of the strongest, albeit less so compared to May.

NZ Government Operating Balance and Debt Position



Sources: ANZ National, The Treasury

Collectively, it's a message that the fiscal cupboard is empty. On the face of it, the next government is in a fiscal straitjacket in terms of what it can, and cannot, do or promise. However, we would also note that the forecasts implicitly

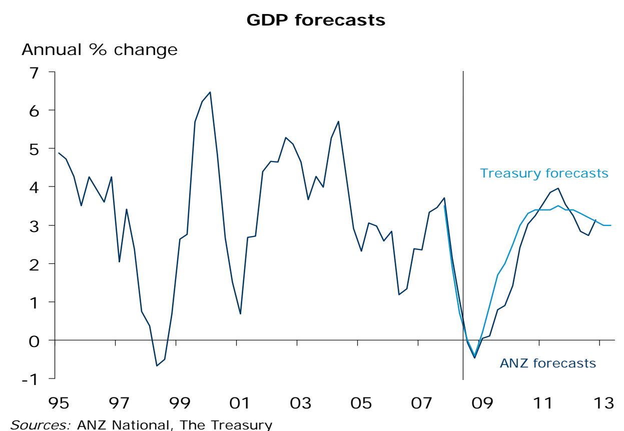
include provisions for future initiatives in subsequent budgets of $1.8 billion per annum, so any fiscal creep or funding for tax reductions can easily (or partly) be absorbed within these provisions. But clearly, the more these provisions are used for "spending" style initiatives, the less they are available for tax policy. In addition, the size of these provisions are tight relative to what we have been seeing over the past few years.

Is it a problem? We certainly hope not! No doubt we will see the usual innuendos and jibes about borrowing to fund tax cuts, but the fact cash deficits are now forecast to be more than $7 billion means it is already occurring. There are also some disconcerting trends across the forecasts in terms of how quickly the projected surplus has disappeared (and we know from history that such trends are hard to turn around) and how long they are projected to stay in deficit. There is going to have to be some major policy initiatives in terms of the efficiency of public sector services if the deficits are going to be turned around. However, we also need to appreciate the starting position for fiscal policy. Net and gross debt are still remarkably low relative to our major trading partners although the size of the jump between years is not immaterial.

We await rating agencies' response. For sure, NZ is now expected to be running "twin deficits", which will no doubt raise a few eyebrows in some quarters. And rating agencies did have NZ on watch during the Asian crisis and also noted post Budget that a strong fiscal position and robust financial sector underpinned a stable outlook. The former (robust fiscal position) is now questionable, although the starting position this time around in terms of the balance sheet "stocks" of debt is far lower, and NZ's economic framework (monetary policy and floating currency) are responding to the economic environment. Technically, if you include NZ Super Fund assets into the debt calculation, we remain a net creditor. 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. However, the size of the turnaround in the fiscal position in merely five months and the prospect of fiscal deficits for the next 10 years is not encouraging.

Policymakers should not be afraid to use fiscal policy and the Government balance sheet as a stabilisation instrument, and hence the debate over "borrowing" is largely irrelevant. By virtue of having the largest balance sheet, the government has greater flexibility and ability to absorb swings in the economic cycle relative to households and businesses. Frequently we tend to look towards monetary policy as the stabilisation instrument for the economy, when in reality, fiscal policy can also play a role. This is certainly already occurring with tax cuts beginning from October 1, and we're already seeing calls for more. The Minister of Finance himself has said the government has room to expand the deficit to prop up the economy. In our minds the merits of policy itself should always dominate the funding debate, and we hope this ensues over the coming weeks as we head into the election.

Treasury's growth forecasts similar to ours for the March 2009 year, but we see downside risks the following year. Given the turbulence in global financial markets and the Treasury's optimistic growth forecasts at the time of the May *Budget*, it was no surprise to see a substantial downward revision to their growth forecast from 1.5 percent for the March 2009 year to 0.1 percent. This is similar to our forecast. However, the Treasury expects a faster rebound in growth than we have incorporated. Hence, we think there is still some downside risk to Treasury's growth forecast, and therefore their fiscal forecasts as well. But at least the economic forecasts are more believable this time around compared to their *Budget* forecasts. In fact, the Treasury's downside scenario is probably closer to our central track, and this sees the OBEGAL deficit deteriorating to 1.8 percent of GDP by 2008/09.



Sources: ANZ National, The Treasury

Financial market implications

From a markets perspective there is not much to get excited about. The Finance Minister has been prepping the public as well as the market about a weaker fiscal position, although the size of the deterioration was definitely at the upper end, particularly the projected bond tender programmes. Looking at the big picture, there is set to be a clear switch in the funding of NZ's current account deficit, away from the private sector, and towards the Government.

Economic and Fiscal Forecasts – Treasury's *PREFU* forecasts (*Budget* 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	0.1 (1.5)	1.8 (2.3)	3.3 (3.2)	3.4 (3.0)	3.1 (..)
Nominal GDP (ann. ave. % chg.)	7.5	3.1 (3.6)	3.0 (3.2)	4.6 (4.9)	5.1 (5.0)	5.0 (..)
Current account deficit (% of GDP)	-7.4	-8.0 (-7.2)	-6.5 (-7.2)	-5.8 (-7.1)	-5.3 (-6.6)	-5.0 (..)
Unemployment rate (%)	3.7	4.4 (3.7)	5.1 (4.4)	5.1 (4.5)	4.8 (4.3)	4.6 (..)
CPI (ann. % chg.)	3.4	4.5 (3.2)	2.3 (2.8)	2.4 (2.8)	2.4 (2.8)	2.4 (..)
June Years	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**
Operating Balance - $ million	2,384 (2,559)	1,909 (3,105)	374 (3,009)	-71 (2,779)	-396 (2,734)	-382 (..)
- % GDP	1.3 (1.4)	1.0 (1.7)	0.2 (1.6)	-0.0 (1.4)	-0.2 (1.3)	-0.2 (..)
OBEGAL - $ million	5,637 (5,227)	-64 (1,318)	-1,746 (1,004)	-2,481 (493)	-3,092 (154)	-3,374 (..)
- % GDP	3.1 (2.9)	-0.0 (0.7)	-0.9 (0.5)	-1.2 (0.2)	-1.5 (0.1)	-1.5 (..)
Core Crown residual cash - $ million	2,057 (908)	-5,909 (-3,478)	-5,300 (-3,302)	-6,603 (-3,447)	-6,815 (-3,457)	-7,307 (..)
Net Core Crown Debt - % GDP	-0.0 (1.0)	2.8 (2.5)	5.3 (3.8)	8.0 (5.0)	10.6 (6.2)	13.2 (..)
Gross Sovereign-Issued Debt - % of GDP	17.4 (17.6)	17.4 (17.5)	18.0 (16.8)	21.9 (17.8)	23.1 (16.8)	24.3 (..)
Bond tender - $ million	1,757 (2,453)	4,048 (2,459)	6,070 (2,487)	9,114 (2,507)	9,189 (2,497)	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.

NEW ZEALAND DISCLAIMER

The Bank does not provide investment advice tailored to an investor's personal circumstances. It is the investor's responsibility to understand the nature of the security subscribed for, and the risks associated with that security. To the maximum extent permitted by law, the Bank excludes liability for, and shall not be responsible for, any loss suffered by the investor resulting from the Bank's investment advice.

Each security (including the principal, interest or other returns of any security) the subject of investment advice given to the investor by the Bank or otherwise, is not guaranteed, secured or underwritten in any way by the Bank or any associated or related party except to the extent expressly agreed in the terms of the relevant security.

This document is provided for informational purposes only and does not constitute an offer to sell or solicitation to buy any security or other financial instrument. No part of this document can be reproduced, altered, transmitted to, copied to or distributed to any other person without the prior express permission of the Bank.

This document is a necessarily brief and general summary of the subjects covered and does not constitute advice. You should obtain professional advice before acting on the basis of This document has been prepared by ANZ
National Bank Limited.

any opinions or information contained in it. The information contained in this document is given in good faith, has been derived from sources perceived by it to be reliable and accurate and the Bank shall not be obliged to update any such information after the date of this document. Neither the Bank nor any other person involved in the preparation of this document accepts any liability for any opinions or information (including the accuracy or completeness thereof) contained in it, or for any consequences flowing from its use.

UNITED STATES DISCLAIMER

This document is being distributed in the United States by ANZ Securities, Inc. ("ANZ S") (an affiliated company of Australia and New Zealand Banking Group Limited ("ANZBG") and the Bank), which accepts responsibility for its content. Further information on any securities referred to herein may be obtained from ANZ S upon request. Any US person(s) receiving this document and wishing to effect transactions in any fixed income securities referred to herein should contact ANZ S 1177 Avenue of the Americas, New York, NY 10036 USA, Tel: 1-212-801-9160, Fax: 1-212-801-9163, not its affiliates.

This document is issued on the basis that it is only for the information of the particular person to whom it is provided. This document may not be reproduced, distributed or published by any recipient for any purpose. This document does not take into account your personal needs and financial circumstances. Under no circumstances is this document to be used or considered as an offer to sell, or a solicitation of an offer to buy.

In addition, from time to time ANZBG, the Bank, ANZ S, their affiliated companies, or their respective associates and employees may have an interest in any financial products (as defined by the Australian Corporations Act 2001), securities or other investments, directly or indirectly the subject of this document (and may receive commissions or other remuneration in relation to the sale of such financial products, securities or other investments), or may perform services for, or solicit business from, any company the subject of this document. If you have been referred to ANZBG, the Bank, ANZ S or their affiliated companies by any person, that person may receive a benefit in respect of any transactions effected on your behalf, details of which will be available upon request.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable. The views expressed in this document accurately reflect the author's personal views, including those about any and all of the securities and issuers referred to herein. The author however makes no representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this document and are subject to change without notice. No part of the author's compensation was, is or will be directly or indirectly related to specific recommendations or views expressed in this document. ANZBG, the Bank, ANZ S, their affiliated companies, their respective directors, officers, and employees disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation.

ANZ (part of ANZ National Bank Limited), Level 7, 1 Victoria Street, Wellington 6011, New Zealand Phone 64-4-802 2000 Fax 64-4-496 8639 http://www.anz.co.nz e-mail ecnmcs@anz.com