

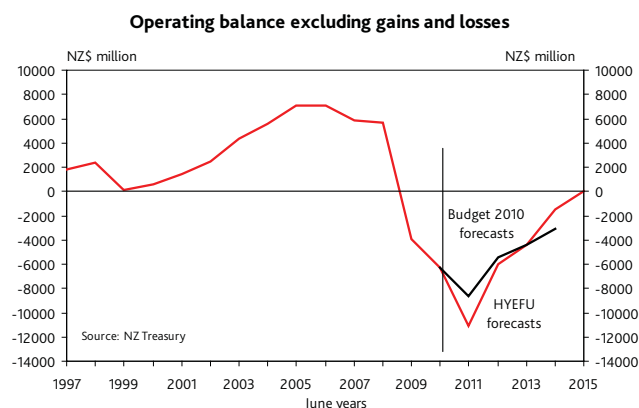
Short-term pain

2010 Half Year Economic and Fiscal Update

- **Operating deficit excluding gains and losses (OBEGAL) to widen from 3.3% of GDP in June 2010 to 5.5% of GDP in June 2011.**
- **Economic growth forecasts have been pared back in the near term, with modest growth forecast from 2012. That will see the OBEGAL deficit narrow in the year to June 2012, with the Government forecasting a return to surplus in the year to June 2015.**
- **Cash deficits are forecast to reach close to \$16bn this year, and remain large over the forecast horizon. Government borrowing is expected to be a cumulative \$10.5bn higher than forecast in the Budget.**
- **Net government debt is forecast to rise from 14.1% of GDP currently to a peak of 28.5% by 2015.**
- **Relative to Budget 2010, fiscal policy is forecast to move from a slightly more expansionary stance in 2011 to a slightly less contractionary stance in subsequent years. Overall, we expect that to have little impact on monetary policy decisions in the near term.**

Treasury revised down its economic forecasts relative to Budget. The Government has taken a conservative stance on the growth outlook. With the exception of 2012, real GDP growth has been revised back in every year, with the peak in the rate of growth expected to be well below that achieved in previous upturns at just 3.4%. Beyond 2012, growth is expected to average slightly below 3% per year. Nominal GDP is also forecast to be lower as a result of softer real economic activity and less domestic inflation pressure. By end June 2014, nominal GDP is projected to be lower by a cumulative \$5.2bn. We see upside risks to growth over the forecast period. Our forecasts are for GDP growth of 4.3% in 2012, and averaging just over 3% thereafter.

Revenues to take a hit. In the year to 2014, the tax take is expected to be around \$3.2bn lower than forecast in the Budget, with slower nominal GDP growth accounting for about two-thirds of that. The remainder is partly due to the accumulation of tax losses by businesses during the recession (which sees tax



revenues lag the pick up in the rest of the economy), but also the re-estimation of average effective tax rates.

Expenses still rising, but not as rapidly. Core Crown government expenses are forecast to rise by over 18% between June 2010 and June 2014, largely as a result of rising benefit costs (due to higher indexation costs as inflation rises and as the population ages), higher finance costs, and the commitment to the \$1.1bn operational spending allowance from June 2011, growing at 2% per annum thereafter. At first glance, this suggests that the Government has done little to further tighten up spending. However, as always the devil is in the detail. Relative to the Budget forecasts, core crown government expenses are lower by around \$1.1bn, and in GDP terms fall from a peak of 34.9% in 2011, to 32.1% in 2014 (although we would put that down to good fortune rather than active management as most of the improvement comes from lower inflation forecasts relative to Budget). But perhaps of more significance is that from Budget 2011 the Government plans to set aside a portion of the \$1.1bn new spending allowance in order to more prudently manage 'expense volatility' (i.e., expenses that arise as a result of fluctuating demand and/or cost pressures such as Kiwisaver expenses). In the past, these expenses have fallen outside of the operational spending allowance and as a result have flowed directly through to the operating deficit leaving the fiscal position exposed to these expense risks. Thus, the decision to manage these risks more

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Half Year Economic and Fiscal Update – December 2010

	2010	2011		2012		2013		2014		2015	
	Actual	HYEFU	Budget	HYEFU	Budget	HYEFU	Budget	HYEFU	Budget	HYEFU	Budget
Economic forecasts – March yrs											
Real GDP ann ave % chg	-0.4	2.2	3.2	3.4	3.1	2.9	2.9	2.7	3.0	2.7	-
Unemployment rate %	6.0	6.1	6.2	5.2	5.5	4.9	5.1	4.6	4.6	4.5	-
CPI ann % chg	2.0	4.5	5.9	2.9	2.4	2.6	2.4	2.2	2.4	2.0	-
Fiscal forecast \$mn – June yrs											
Total Crown OBEGAL	-6,315	-11090	-8,632	-5984	-5,406	-4371	-4,394	-1501	-3,038	39	-
% GDP	-3.3	-5.5	-4.2	-2.8	-2.5	-1.9	-1.9	-0.6	-1.3	0.0	-
Net debt (% GDP)	14.1	20.8	19.6	24.2	23	26.5	25.3	27.8	26.5	28.5	-
Bond programme	12,500	13,500	12,500	13,500	10,500	13,000	10,000	9,500	6,000	10,500	-
Fiscal stimulus	1.7	1.5	1.2	-1.5	-1.6	-1.1	-1.3	-0.9	-0.7	-0.7	-

explicitly is a positive step, and potentially means even less money will be available for 'new' spending.

Operating deficits remain large, but narrow from 2012. The operating deficit excluding gains and losses is forecast to peak at \$11bn in 2011 (5.5% of GDP), before narrowing from 2012. Importantly, the Government remains on track to achieve a small surplus in 2015.

Larger cash deficits, more borrowing. Cash deficits are forecast to reach \$15.6bn in the year to June 2011 (up from \$3.3bn in the Budget), and remain large over the forecast horizon. Bigger cash deficits, combined with:

- a \$1.2bn reduction in EQC holdings of Government securities;
- a decision by the NZ Debt Management Office to pre-funding of the April 2015 bond maturity (\$3.5bn); and
- a \$2bn increase in the tranche size of the April 2013 bond;

saw a larger than expected increase in the domestic borrowing requirement. In total the domestic borrowing requirement is \$10.5bn higher than forecast in the Budget (see Table for details).

Net debt rising. Net government debt is forecast to rise from 14.1% of GDP currently to 28.5% by 2015. That is slightly higher than forecast in the Budget, but broadly in line with our expectations. The forecast return to operating surplus and continued expenditure restraint is expected to see net debt peak in 2015.

Shift in policy stance from 2012. Over the forecast period, the fiscal impulse is expected to be less negative than forecast in the Budget. The fiscal stimulus for the year to March 2011 has been revised from +1.2% to +1.5%. In subsequent years, fiscal policy is forecast to move from expansionary to contractionary, although the HYEFU forecasts portray a less contractionary stance than in the Budget.

Budget Policy Statement and Investment Statement. Today also saw the release of the 2011 Budget Policy Statement

or the BPS (setting out the broad priorities for the 2011 Budget) and the inaugural Investment Statement (setting out how the Government plans to manage its large and growing investment in taxpayers' assets). In the end, there was little fanfare around either. The BPS reiterated the Government's six point plan for a stronger economy, with the focus for the 2011 Budget being ongoing reprioritisation of existing spending, managing expense volatility and improving the management of the Crown's balance sheet. In terms of the latter, the Investment Statement highlighted the significant and ongoing investment in assets (a further \$34.4bn will be invested in assets over the next five years), as well as key areas where efficiency gains can be made with education, housing and defence specific examples.

Market implications

Overall, the deterioration in the fiscal position is broadly in line with our expectations, and as a result the market reaction was fairly muted. The ten-year government bond yield rose by 3bps to 5.81%, while the NZD was unchanged. Importantly, for ratings agencies such as Standard and Poor's, there is unlikely to be anything new in these numbers, with the deterioration in the current fiscal year already well flagged.

Overall, our assessment is that the Government has been relatively conservative in their outlook for economic growth. As such, we see room for upside surprises on growth, although the benefits of that are unlikely to be seen in revenues until the 2012 year. The Government has also maintained its commitment to spending restraint, with most government departments facing no new funding or even funding cuts over the next few years. Still, we see that as the prudent course of action in the current environment.

For the RBNZ, a less contractionary fiscal stance over the next few years will likely be met with some concern. However, on its own, we do not expect today's update to alter the RBNZ's planned course of action in the near term.

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