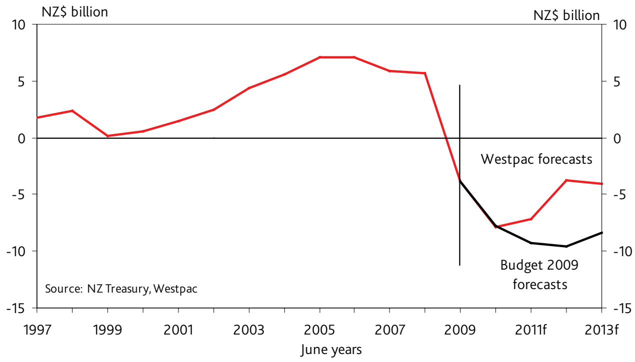
10 December 2009

Lighter shade of red

Preview of the Government's Half Year Economic and Fiscal Update (HYEFU)

- **The Half Year Economic and Fiscal Update will be released on December 15.**
- **We expect marked upward revisions to the economic and fiscal forecasts.**
- **It will be some time before the Government's coffers reap the full benefit of the economic recovery. We expect an operating deficit of around $8bn in the year ended June 2010, similar to that forecast in the Budget.**
- **Operating deficits should narrow sharply from the June 2011 year, relative to the Budget forecasts. That will see a lower borrowing requirement in future years and a slower build up in debt.**

Figure 1: Operating Balance (excludes gains and losses)



The Half Year Economic and Fiscal Update (HYEFU) will be released by the Government on Tuesday, 15 December at 1pm NZT. The 2010 Budget Policy Statement (BPS) will also be released at this time, and will set out the broad priorities for Budget 2010.

Since the Budget was released in May, there has been a wholesale improvement in the outlook for the New Zealand economy. On the global front, forecasts for growth in NZ's major trading partners have been consistently revised higher and credit markets have freed up. Back home, business and consumer confidence have soared, net migration has doubled, house prices have risen rapidly, and commodity prices have recovered (dairy especially). And, while the unemployment rate has risen to its highest in level in 9 years, the rise hasn't been as great as feared. Even inflation has proved more resilient that thought.

Events have well and truly run counter to the prolonged recession Treasury projected in the 2009 May Budget. Back then, real GDP was forecast to contract by 1.7% in the year ended March 2010, following an estimated 0.9% contraction in the year ended March 2009 (actual was -1.1%). Moreover, the weakness was expected to persist – a return to above trend GDP growth was not forecast until 2012. At the time, we believed the Treasury's forecasts to be conservative, providing plenty of room for upside surprises. That belief has proved to be correct, and we expect material upward revisions to Treasury's economic and fiscal forecasts when the HYEFU is released next week.

On the upside

Our assessment of recent economic developments is that activity is tracking slightly above that projected in the Budget's upside scenario. Under that scenario, real GDP was forecast to contract by 1.2% in the year to March 2010. Our forecasts put real GDP growth at -0.1% in the year to March 2010, and we expect Treasury to forecast something similar. Indeed, Treasury have already conceded the near term strength, confirming in their October Monthly Economic Indicators report that they now expect annual GDP growth of around 2% in the second half of 2009.

From March 2010, the upside scenario projected a strong recovery, with GDP growing by 3.5% and 4.3% in the years ended March 2011and March 2012, respectively. The nominal GDP track was forecast to be even stronger, boosted by a higher terms of trade and more persistent inflation. By the end of the forecast period (June 2009 to June 2013), nominal GDP was projected to be higher by a cumulative $37bn. We anticipate a similar GDP profile will be presented in the HYEFU.

Despite this, the fiscal projections are unlikely to fully reflect those given in the upside scenario. The Government's Financial Statements for the four months to October 2009 show that tax revenues are currently running a massive $1.6bn below Budget

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forecasts, resulting in the operating deficit excluding gains and losses (OBEGAL) being $1.2bn higher than forecast (at $3.3bn). Moreover, Treasury believe that tax revenues, particularly corporate tax, are unlikely to respond to improving economic conditions before the end of the fiscal year (June 2010). That is because the build-up of tax losses through the recession lowers business income taxes in the early stages of a recovery as the tax losses are progressively used to offset subsequent profits. Thus, Treasury now expect total tax revenue in the year ended June 2010 to be lower than forecast in the Budget, despite the recovery in economic growth. That suggests that unless non-tax revenue or expenses can better forecasts dramatically (which is doubtful), the OBEGAL in the June 2010 year will be at least as ugly as the $7.7bn deficit forecast at the time of the Budget.

The ability of firms to use past losses to offset profits in the future is also expected to constrain growth in tax revenues through the 2011 fiscal year. However, thereafter we expect tax revenue growth to outpace growth in the general economy.

On the expense front, we expect the Government to maintain a tight rein on future spending, despite the underlying improvement in the economy. As the Finance Minister pointed out in a recent report, baseline government spending has increased by 45% in the past five years – three times the pace of nominal GDP. If we are to avoid a blow out in government debt, that situation is unsustainable. The 2009 Budget made some progress toward reducing the overall spending burden by lowering future operational spending allowances. But with an allowance still totalling $12.5bn over the next four years, further reductions are clearly possible. Still, we are not convinced that the Government will commit to lower future spending allowances just yet. Instead, we suspect they will continue to focus on the reprioritisation of spending.

Overall, we expect the operating deficits to begin to narrow from June 2011. We expect the Treasury to forecast an OBEGAL deficit of around $7.0bn in 2011, and reaching $4.0bn by June 2013. That compares with the Budget forecast of a $9.3bn deficit in June 2011, and $8.4bn in June 2013.

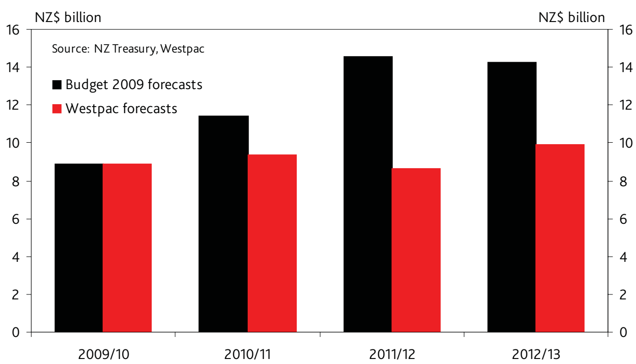
Borrowing requirement

Despite the OBEGAL running well below forecast in the four months to October, our updated estimates of the cash position suggest that the borrowing requirement for the 2010 fiscal year remains largely unchanged (assuming no change to the capital spending allowance for 2010). That view is supported by the Government's Financial Statements for the four months to October, which revealed that the residual cash deficit (the key determinant of the borrowing requirement) is currently running below the Treasury's Budget forecast by around $250mn.

That said, current market conditions remain highly supportive of bond issuance and the demand for Government Bonds is still relatively strong. As such, we believe that there is a reasonable risk that the NZDMO take the opportunity to issue more bonds than required in the current fiscal year in order to pre-fund some of the borrowing requirement for future years. Certainly, the announcement earlier today that the target level for each bond maturity has been raised to $8bn from $6bn could be seen as supporting that view.

From 2011, our expectation of smaller operating deficits will take some of the pressure off the cash position, resulting in a smaller borrowing requirement. We expect future bond issuance to be lower than the $45bn predicted in the Budget, but still sizeable. Our forecasts see total issuance averaging $9.3bn per year between 2011-2013, down from the average $13.4bn estimated in the Budget.

Figure 2: Bond programme estimates



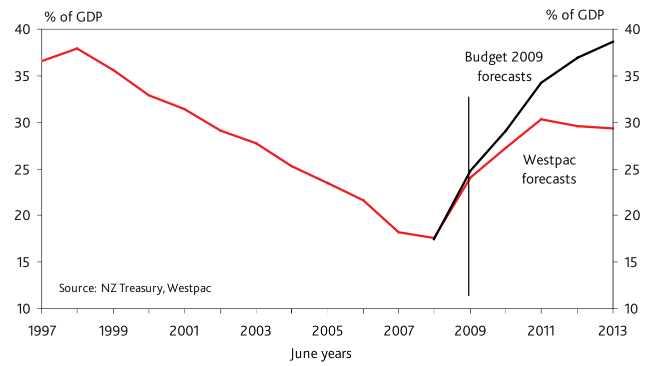
A lower borrowing requirement in future years is expected to result in a much slower build up in debt than projected in the Budget. On our forecasts Gross Sovereign Issued Debt reaches around $66bn (30%of GDP) by the end of the forecast period. That compares with a forecast of $78bn (38.7% of GDP) in the Budget.

Half Year Economic and Fiscal Update – December 2009

	2008/09	2009/10		2010/11		2011/12		2012/13	
	Actual	HYEFU	Budget	HYEFU	Budget	HYEFU	Budget	HYEFU	Budget
Real GDP - ann ave % chg	-0.9	-0.2	-1.7	3.5	1.8	4.0	2.9	3.4	4.0
CPI - ann % chg	3.0	2.6	2.4	2.3	1.7	2.2	1.2	2.2	1.6
Unemployment - %	5.0	6.5	7.5	5.9	7.5	5.0	6.3	4.6	5.1
OBEGAL $mn	-3893	-7,900	-7,739	-7,200	-9,265	-3,700	-9,583	-4,039	-8,423
GSID - % GDP	24.1	28.0	29.1	31.0	34.2	30.0	36.9	30.0	38.7
Bond programme $mn	5,800	8,900	8,900	9,300	11,400	8,700	14,500	9,900	14,200

HYEFU forecasts are Westpac's estimate of Treasury forecast
Economic Forecasts are March years, Fiscal forecasts are June years

Figure 3: Gross sovereign-issued debt



Market implications

The immediate focus for markets will be on the profile for government debt and the associated borrowing requirements of the NZ Debt Management Office. Recent discussions with market participants suggest that an outcome on our expectations (i.e. a lower but still sizeable borrowing requirement in future years, ensuring bond market liquidity is maintained) would be greeted favourably by the market. A lower debt to GDP track will also likely be pleasing to the rating agencies.

Our focus will be on any changes to the Government's future operating and capital spending allowances, and the projections of the fiscal stimulus. As mentioned above, we do not expect any major changes to be announced to the spending allowances in the HYEFU, but we cannot rule it out. A commitment to further reining in government expenses over the next few years would again be seen as a positive for the market.

The Treasury's Budget estimate of the fiscal stimulus was 3.3% of GDP in both the 2010 and 2011 June years. We expect that to be revised back in the HYEFU update as the Government maintains tight control over spending. Reduced stimulus from the Government ultimately means less work for the RBNZ.

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