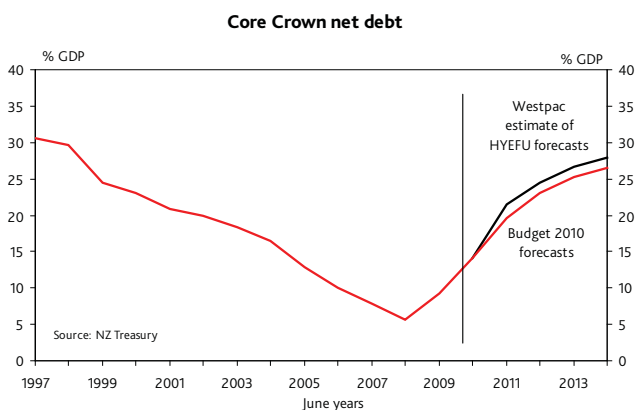
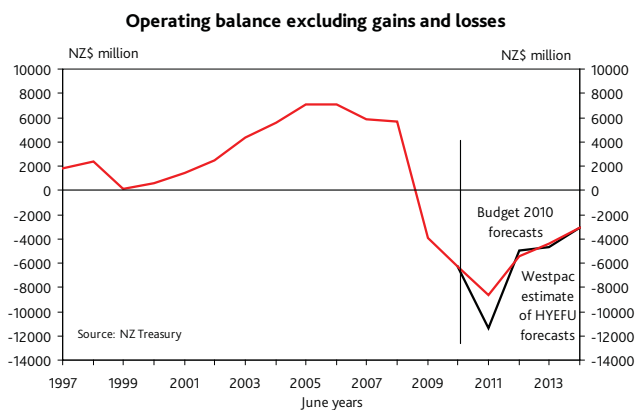


The walls are closing in

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

- **The Government releases its six monthly update of the economic and fiscal situation on December 14. The 2011 Budget Policy Statement will also be released, as will their inaugural Investment Statement, stating how the Government plans to manage its large and growing investment in taxpayers' assets.**
- **Relative to Budget 2010, the fiscal picture will not be pretty. We expect a downgraded economic outlook to knock a chunk off revenues, while the costs associated with the Canterbury earthquake will boost already bloated expenses.**
- **In the near term, that means a further widening of the operating deficit (to around 5.5% of GDP in FY2011), and more borrowing.**
- **The Government will forecast a gradual improvement in economic activity from March 2011. But the peculiarities of our tax system mean it will take some time for that to be fully reflected in revenues.**
- **Strong growth in government expenses in recent years has limited the Government's choices. New Zealand will require some degree of fiscal austerity in coming years if we are to avoid a blow out in debt. We expect the 2011 Budget Policy Statement to outline what measures the Government intends to put in place to ensure they achieve their goal of returning to surplus by 2016.**

The economic backdrop has been disappointing. Expect downward revisions to the near term real economic forecasts. The economic backdrop since the Budget was released in May has been largely disappointing, and has certainly been weaker than Treasury projected. Real GDP growth grew by just 0.7% in the first half of 2010 against a Budget forecast of 1.6%. And growth in the third quarter is also likely to undershoot the 1.6% forecast in the Budget (our current forecast is for 0.3%q/q). The major culprits have been much weaker than expected consumer spending and more subdued growth in residential investment. Although we expect quarterly GDP growth to pick up the pace from the December quarter this year (our forecasts see GDP growth averaging 1.2% in the next



three quarters to June 2011) the upshot is that GDP growth is now likely to be closer to 2.0% in the year ended March 2011 than the 3.2% forecast in the Budget.

A return to above average real GDP growth rates from early 2011 is on the cards. From March 2011, we expect Treasury to forecast a return to above average growth rates. To be sure, our forecasts see GDP growth of 4.3% in 2012 (bolstered partly by an earthquake effect as rebuilding gets underway), 3.0% in 2013 and 3.1% in 2014. We note though that our forecasts are at the top-end of consensus expectations. As such, we would expect Treasury's growth forecasts to be more conservative, with growth of closer to 3.5% forecast for March 2012.

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Operating deficits to widen in near term. The Government's Financial Statements for the four months to October 2010 illustrate vividly the impact of weaker economic activity. Tax revenues are already running \$1.1bn below Budget forecasts. Some offset was provided by lower than forecast Core Crown expenses (\$440m). However, the net \$1.5bn additional expense lodged against EQC as a result of the Christchurch earthquake, saw an operating deficit excluding gains and losses (OBEGAL) of \$4.4bn - \$1.9bn higher than forecast.

Tax revenues slow to reap benefits of economic recovery.

Tax revenues, particularly corporate tax, are unlikely to respond to improving economic conditions before the end of the fiscal year (June 2011). 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, we expect total tax revenue in the year ended June 2011 to be lower than forecast in the Budget, despite the anticipated stronger pace of economic growth from end 2010. On our estimates, assuming there is little offset from non-tax revenues and/or lower expenses, that means the OBEGAL deficit in the June 2011 year will be in excess of \$11bn (or 5.5% of GDP), up from the Budget forecast of \$8.6bn (or 3.7% of GDP).

Deficits should begin to narrow from 2012. We expect the OBEGAL deficits to begin to narrow in the June 2012 year as the stronger economy bolsters revenue growth and expense growth is reined in. We expect the Treasury to forecast an OBEGAL deficit of around \$5.0bn in 2012 (2.3% of GDP), and narrowing to around \$3.0bn by June 2014 (1.5% of GDP), leaving the OBEGAL broadly in line with that forecast in the Budget by the end of the period. Still, the Global Financial Crisis, and sovereign debt concerns in many of the European economies have highlighted how important it is for the Government to maintain a tight control over spending. On this front, NZ will not be immune.

Spending consolidation holds the key to sustained improvement.

As the Finance Minister continues to point out, 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. Already the Government has proved that it can be tough when it comes to making spending decisions. Growth in Core Crown spending in the past year has been virtually flat with spending on core services taking a notable hit, consistent with the Government's intention of reprioritizing spending and ultimately ensuring they get the biggest bang for buck. Even so, Budget 2010 forecast operating expenses to grow by close to 5% per annum on average over the next four years. That suggests there is still some room for improvement. We expect the 2011 Budget Policy statement to outline the Government's broad intentions for further reductions in the growth of spending over the next few years. The recently established Welfare Working Group suggests benefit reform will be a key area targeted for expenditure control.

Higher deficits all else equal means more borrowing.

With 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 2011 fiscal year has also increased. 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 around \$800mn higher than forecast in the Budget.

Our forecasts suggest the Government's cash deficit is likely to have blown out to around \$16bn in the current fiscal year, from \$13.3bn forecast in the Budget. While we expect some of that increase will be met by a rundown in financial assets (already underway), an increase in the 2010/11 domestic bond programme is also likely. The NZDMO is already well ahead of its forecast issuance, with \$7.3bn raised as at 9 December,

Half Year Economic and Fiscal Update – December 2010

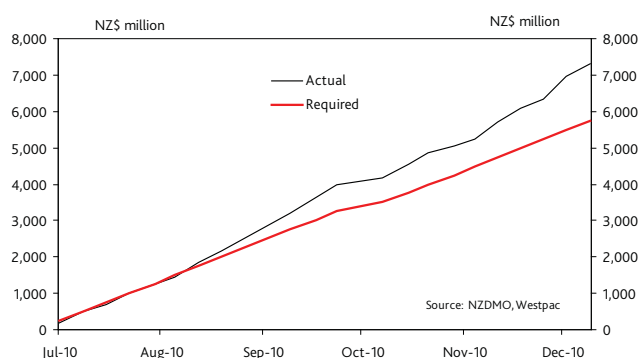
	2010		2011		2012		2013		2014	
	Actual	Budget	Budget	HYEFU	Budget	HYEFU	Budget	HYEFU	Budget	HYEFU
Economic forecasts – March yrs										
Real GDP ann ave % chg	-0.4	-0.3	3.2	1.8	3.1	3.5	2.9	3.0	3.0	2.8
Unemployment rate %	6.0	7.1	6.2	6.0	5.5	5.1	5.1	5.0	4.6	5.1
CPI ann % chg	2.0	2.2	5.9	4.5	2.4	1.9	2.4	2.5	2.4	2.6
Fiscal forecast \$mn – June yrs										
Total Crown operating balance	-4,509	-3,179	-7,067	-9,700	-3,579	-3,200	-2,402	-2,600	-828	-1,000
Total Crown OBEGAL	-6,315	-6,927	-8,632	-11,300	-5,406	-5,000	-4,394	-4,600	-3,038	-3,000
Core Crown OBEGAL	-7,797	-8,385	-10,391	-13,100	-6,995	-6,500	-5,694	-6,000	-4,193	-4,200
Core Crown residual cash	-9,000	-9,069	-13,327	-16,000	-9,666	-9,200	-7,499	-7,700	-5,983	-6,000
Core Crown net debt	26,738	26,642	39,965	43,190	49,638	52,600	57,054	60,300	63,014	66,400
Bond programme	12,500	12,500	12,500	14,000	10,500	11,000	10,000	10,500	6,000	6,000

HYEFU forecasts are Westpac's estimate of Treasury forecast

against forecast issuance of \$5.75bn. Thus by issuing \$250m per week over the remainder of the fiscal year, the NZDMO could achieve total issuance of \$14bn for the 2010/11 year.

A narrowing in operating deficits from 2012 will take some of the pressure off cash deficits. However, we expect additional capital expenditure (largely associated with the Canterbury Earthquake) to also raise bond issuance by \$500m in each of the 2012 and 2013 years. Together that implies a domestic bond programme of \$14bn in 2011, \$11bn in 2012 and \$10.5bn in 2013. The bond programme is forecast to reduce to around \$6bn in 2014.

NZGB issuance ahead of target



Net core crown debt will rise. The higher borrowing requirement in the near term and a rundown in financial assets means that the build up of net debt will be faster than that forecast back in May. On our forecasts net core crown debt will reach \$66bn or 28% of GDP by 2014 (up from 14.1% in the year ended June 2010).

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, particularly given the recent downgrade to the outlook on New Zealand's sovereign debt rating from stable to negative by Standard and Poor's.

Our focus will be on any changes to the Government's future operating and capital spending allowances, and the projections of the fiscal stimulus. We do not expect any major changes to forecast future operating spending in the HYEPU (the \$1.1bn spending cap is likely to be retained), but any hint of the Government's intention to further rein in government expenses over the next few years would be seen as a positive for the market.

The Treasury's Budget estimate of the fiscal stimulus was 1.2% of GDP for the 2011 June year moving to -1.6% in the year to June 2012. We expect the stimulus to be revised up in the HYEPU update for FY2011, with less of a contraction in FY2012.

Overall, higher deficits and greater fiscal stimulus will likely be met with some trepidation by the RBNZ after they delivered a clear message in the latest *Monetary Policy Statement* that a faster return to surplus would be in the best interests of the NZ economy.

The Investment statement will be something new for the market to digest. It may well present the required depreciation and new capital spending requirements over the next five years. These numbers could potentially reinforce the large ongoing funding requirement.

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