

Economic Review

New Zealand

15 December 2009

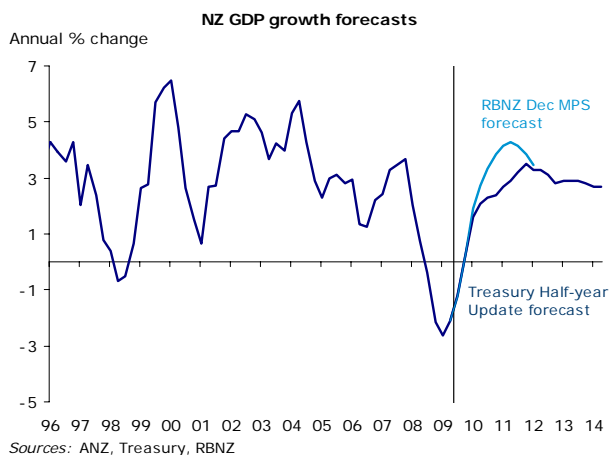
Budget Policy Statement and Half Year Economic and Fiscal Update

Key points

- > The fiscal forecasts have been revised higher on the back of a better economic outlook.
- > Yet there are still a number of challenges to turn around what are structural deficits.
- > The documents were strong in rhetoric in regards to where NZ needs to head, yet there was a lack of details on how this will be achieved.
- > We await the New Year and *Budget 2010* for more specifics.
- > There is no new information in today's release in so far as monetary policy is concerned.

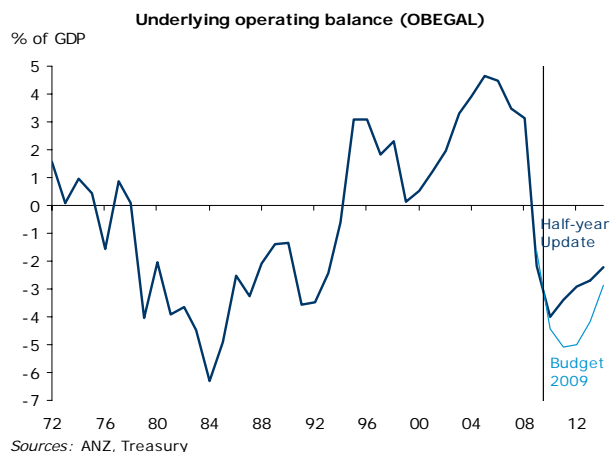
First up, there appeared to be little in the way of surprises from today's *Half-Year Update* and *Budget Policy Statement*. Our main take-out from the *Statement* itself was one that was full of rhetoric in regards to NZ achieving "a *step-change*" in economic performance and making NZ "stand out". Admirable goals of course and hinting of considerable change! But one where there was also a lack of substance and details for how this would be achieved.

Turning to the forecasts themselves, as expected, the Treasury have revised up their growth expectations. GDP growth is expected at -0.4 percent in March 2010 and 2.4 percent in March 2011. The unemployment rate is expected to peak at 7 percent, rather than around 8 percent as forecast in the *Budget* and trend down to 4.5 percent. We view the Treasury's growth forecast as conservative in the near-term and lower than our own (and much lower than the RBNZ's December *MPS*). However, Treasury also appear to be maintaining a rather lofty view of potential growth (3 percent) out to 2017.



Better economic growth is expected to flow through into a better fiscal position. The underlying operating deficit (OBEGAL) is forecast at

\$7.5 billion in 2009/10 (4.0 percent of GDP) and \$6.7 billion in 2010/11 (3.4 percent of GDP). This compares with *Budget* forecasts of 4.5 percent and 5.2 percent of GDP for 2009/10 and 2010/11 respectively. In line with smaller operating deficits, net debt rises at a slower rate than forecast in the *Budget*, although it still reaches 29 percent of GDP by 2013/14. But putting this aside, core operating deficits are still expected until 2015/16. While a return to surplus is expected to occur two years earlier than forecast in this year's *Budget*, today's updated forecasts still highlight that current policy settings are unsustainable and changes are needed.



Abstracting from cyclical influences, hitting the fiscal forecasts appears to be critically dependent on two aspects:

- > NZ still has a trend real GDP growth rate of 3 percent, which we consider to be a stretch at present; and
- > there is the required delivery on spending restraint. Fitch Ratings hit the nail on the head this afternoon when commenting about the release stating that "...this is a cyclical adjustment that has brought about improvements. We are still looking for some

structural (our emphasis) shifts coming through.”

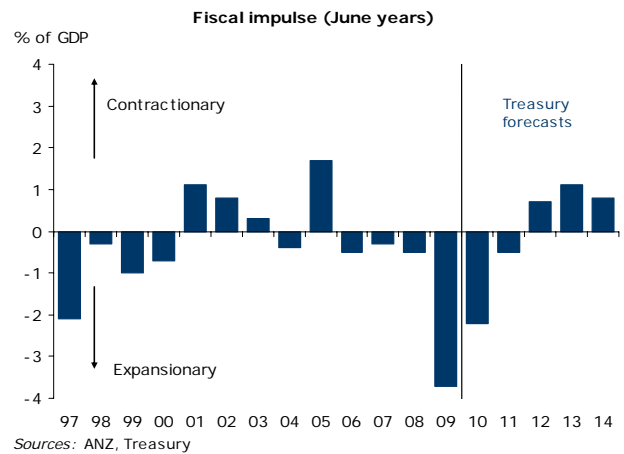
All up, an improved economic backdrop has bought the government a little time and flexibility to weigh up its options. But we should be under no illusions; current and projected operating deficits are inherently structural, and returning the fiscal position to a more sound footing – thereby reducing the potential burden on the next generation – requires structural changes across the economy. This is both in terms of the delivery of government services and getting a better balance to growth. Treasury’s forecasts themselves are somewhat problematic in regards to the latter with projected current account deficits being sustained around 7 percent of GDP.

The *Budget Policy Statement* attempts to hit all the right notes. There was talk about getting a permanent lift in growth rates, making NZ globally competitive, and reducing government spending as a share of GDP. All these are welcome. But as we mentioned already, there was a lack of specifics in how these goals will actually be achieved. The only exception was an outline of the six key areas for achieving “a step-change” in economic performance, which are:

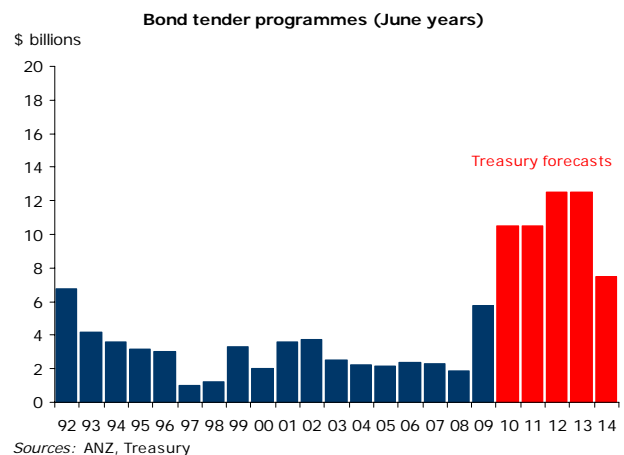
- > investment in productive infrastructure;
- > removing red tape and improving regulation;
- > supporting business innovation and trade;
- > improving education and lifting skills;
- > lifting productivity and improving services in the public sector, and;
- > strengthening the tax system.

We will have to wait until *Budget 2010* for detailed policies to be outlined. The government said that the recommendations from the various taskforces will be carefully considered, and it remains to be seen whether we will get major changes in policies through in terms of the tax system and/or in the areas of government spending. This is still an area we will be watching very closely.

For now, the government is sticking to their \$1.1 billion operating allocation for next year’s *Budget*, which will be a tough ask in itself. The *Budget Policy Statement* noted that “most agencies will receive no new money for several years.” Following on from rhetoric from the Minister of Finance over recent weeks, it is clear that *Budget 2010* will be a very tight affair. All the improvements seen in the economic growth forecasts, and therefore to tax revenue forecasts, flow straight through into the operating balance. After being highly expansionary, the Treasury’s measure of the fiscal impulse turns contractionary in 2011/12. Whether or not this is early enough to influence the RBNZ’s decisions is a very grey area.



In line with the improvement in the fiscal accounts, the bond tender programme further out has been reduced, though the amount for this current year has been increased to \$10.5 billion. The bond tender programme for 2010/11 has been set at \$10.5 billion, \$12.5 billion for 2011/12 and 2012/13, before reducing to \$7.5 billion in 2013/14. The latter is around half the level expected in the *Budget*.



Interestingly, the government flagged possible changes to future fiscal strategy, with possibly the introduction of some kind of expenditure cap, and introducing a new fiscal indicator in the form of net worth. Again details were light, but any changes that seek to better manage the Crown’s balance sheet and introduce greater discipline to government spending decisions are to be welcomed in our opinion. We will await further details of this next year, but at this stage, it remains a work in progress.

Financial market implications

The forecasts themselves are encouraging, particularly when read against 10 percent plus fiscal deficits being reported by other nations. While still facing a degree of structural spending realignment, NZ’s fiscal position is considerably stronger than other peers, a factor that supports our credit rating despite an otherwise poor external net liabilities position. In fact, S&P reaffirmed NZ’s credit rating

this afternoon stating that *“The successful delivery of its fiscal consolidation strategy, or returning the operating position to surpluses over the (business) cycle and maintaining low debt, is consistent with maintaining the AA+ foreign currency rating on New Zealand.”*

There is nothing new in today’s documents, and we see no implications for the RBNZ.

Whether a more aggressive fiscal consolidation strategy is run, and any tax changes are pushed through, will have an important bearing on monetary policy next year. At this stage, we are none the wiser, although the government appears to be flagging that a host of changes are pending. But there is simply little substance to back this up at present in terms of answering how the “step-change” in performance is going to be achieved. Minor tinkering will not cut it.

At this stage all that can be said is that the government look to be keeping their cards close to their chest. This is hardly surprising and prudent as they await all the various reviews to report over the coming months. The rhetoric (*“a step change”, “stand out”*) is strong on where New Zealand needs to head. Whether that translates into truly differentiating policy initiatives remains the million dollar question.

Economic and Fiscal Forecasts – Treasury’s December Update forecasts (BEFU 2009 forecasts in brackets)						
March Years	2008/09 (a)	2009/10	2010/11	2011/12	2012/13	2013/14
Real GDP (ann. ave. % chg., production)	-1.1 (-0.9)	-0.4 (-1.7)	2.4 (1.8)	3.2 (2.9)	3.0 (4.0)	2.8 (n/a)
Current account deficit (% of GDP)	-8.1 (-8.6)	-2.9 (-6.9)	-5.4 (-5.4)	-6.8 (-5.5)	-7.1 (-5.5)	-7.1 (n/a)
Unemployment rate (%)	5.0 (5.0)	7.0 (7.5)	6.9 (7.5)	6.0 (6.3)	5.3 (5.1)	4.8 (n/a)
CPI (ann. % chg.)	3.0 (3.0)	2.5 (2.3)	2.3 (2.4)	2.2 (2.4)	2.3 (2.4)	2.0 (n/a)
June Years	2008/09 (a)	2009/10	2010/11	2011/12	2012/13	2013/14
Operating Balance – \$ million	-10,505 (-9,303)	-4,794 (-5,729)	-5,128 (-7,111)	-4,153 (-7,115)	-3,728 (-5,773)	-2,673 (n/a)
- % GDP	-5.8 (-5.2)	-2.6 (-3.3)	-2.6 (-3.9)	2.0 (-3.7)	1.7 (-2.9)	1.2 (n/a)
OBEGAL - \$ million	-3,893 (-2,916)	-7,465 (-7,739)	-6,684 (-9,265)	-6,000 (-9,583)	-5,775 (-8,423)	-4,867 (n/a)
- % GDP	-2.2 (-1.8)	-4.0 (-4.5)	-3.4 (-5.2)	-2.9 (-5.0)	-2.7 (-4.1)	-2.2 (n/a)
Net core crown debt - % of GDP	9.5 (8.7)	14.8 (15.6)	20.0 (21.8)	24.1 (27.1)	26.9 (30.9)	29.0 (n/a)
Bond tender - \$ billion	5.5 (5.9)	10.5 (8.5)	10.5 (11.5)	12.5 (15.0)	12.5 (15.0)	7.5 (n/a)

– (a) actual

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- Financial Markets Operations Association; and
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- 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.

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- 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.

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- 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.

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