

New Zealand Government *Budget*

Key points

- > Tax cuts worth \$10.6 billion over four years the key policy plank in today's *Budget*.
- > Fiscal policy far more stimulatory, with the Government almost completely running down the underlying surplus. There is nothing left in the kitty.
- > The underlying cash position is deficits of \$3.5 billion per year.
- > The fiscal position is now looking even more vulnerable should growth undershoot the Treasury's central forecast, which we believe there is a reasonable chance of.
- > Bond tender programme increased to \$3.4 billion due to the higher fiscal spending and lower tax forecasts.
- > While the economy is in a pothole, and we doubt tax cuts will be the economy's saviour, we suspect the RBNZ will be more inclined to leave rates on hold for longer to assess the impact of fiscal policy. We are inclined to push out the timing of the easing cycle to December.

Assessment

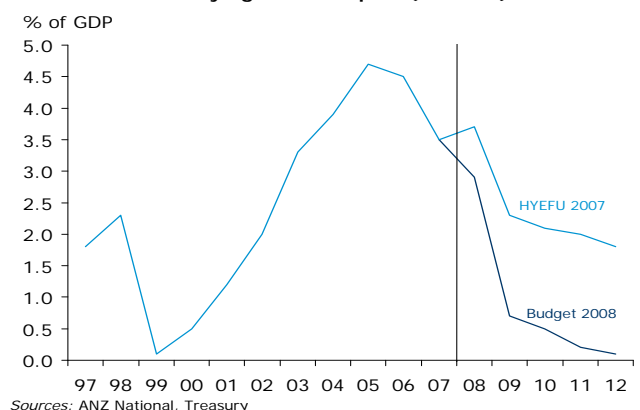
A substantial tax cut package is the major plank of *Budget 2008*. It will be implemented in three phases starting from 1 October 2008, when the bottom tax rate will be reduced to 12.5 percent from 15 percent, and the thresholds increased by between \$2,000 and \$10,000. This will see someone on the average wage (around \$47,000 per annum) get an extra \$16.54 a week, with those on incomes of \$70,000 per annum and above getting the maximum \$28.08 a week.

Further threshold adjustments on April 2010 and April 2011 will see a maximum of \$55.19 a week extra for someone on \$80,000 a year. As a result of the tax changes, those on New Zealand Superannuation will also receive an increase of \$22.94 a week for married couples and \$11.92 a week for a single person living alone. In addition, the inflation adjustment of the Working for Families income abatement threshold will be brought forward from 1 April 2009 to 1 October this year, at a more modest cost of \$115 million. The annual inflation indexation of the petrol levy has been suspended, though this will have no immediate impact on petrol prices.

Tax rates and thresholds				
Current	15%	21%	33%	39%
	\$0-\$9.5k	\$9.5-\$38k	\$38k-\$60k	\$60k+
New	12.5%	21%	33%	39%
1 Oct 2008	\$0-\$14k	\$14k-\$40k	\$40k-\$70k	\$70k
1 Apr 2010	\$0-\$17.5k	\$17.5k-\$40k	\$40k-\$75k	\$75k
1 Apr 2011	\$0-\$20k	\$20k-\$42.5k	\$42.5k-\$80k	\$80k

Another big policy announcement is \$500 million to facilitate high speed broadband in urban areas and extend the reach of broadband into under-served regions. Of this, a new Broadband Investment Fund will be established that will have \$325 million operating and \$15 million capital funding, from which any legal entity (including network operators, local authorities and community-based organisations) will be able to apply to access funding. The other large spending initiatives are in areas already pre-announced, which includes a boost to the Ministry of Foreign Affairs, \$700 million for the New Zealand Fast Forward Fund to boost innovation in pastoral and food industries, and the usual increases in baseline funding for health and education.

Underlying Fiscal Surplus (OBEGAL)



The Government's previously strong fiscal position is no more. A combination of much higher spending and lower tax forecasts has seen the underlying operating balance (OBEGAL) run down from \$5.2 billion (2.9 percent of GDP) in 2007/08 to just \$0.2 billion in 2011/12 (0.1 percent of GDP). In short, there is no longer any fiscal headroom to absorb any shocks or unexpected shortfalls in tax revenues.

In light of the current uncertain economic environment, and the fact that we believe Treasury's economic and tax forecasts are on the optimistic side, this is a very risky fiscal strategy to run.

Granted, from a balance sheet perspective, the position is still one of strength. Gross sovereign issued debt is expected to stay under the Government's 20 percent of GDP target, declining towards 16.8 percent by 2012. And the Crown is expected to be in a positive net asset position (including the NZ Super Fund) of 6.1 percent of GDP. Yet, we remain uneasy with the sudden shift in the Government's past policy of running decent surpluses. While recent years has shown that Treasury tax forecasts tended to be too low, the law of averages suggest that they are due to be too high at some stage. Past experience has shown that this tends to occur during slowdowns.

We agree with the general thrust of the Government's initiatives, particularly in the tax arena. The shift to more tax based policy initiatives has the potential to deliver greater supply side benefits to the economy via raising the returns to work. We still see more to be done in terms of actually lowering the tax rates themselves, particularly to align or at least narrow the gap between the company tax rate and the top marginal tax rate.

However, we note with some irony that the scale of the tax cut package does not seem to meet the four tests put forth by the Minister of Finance.

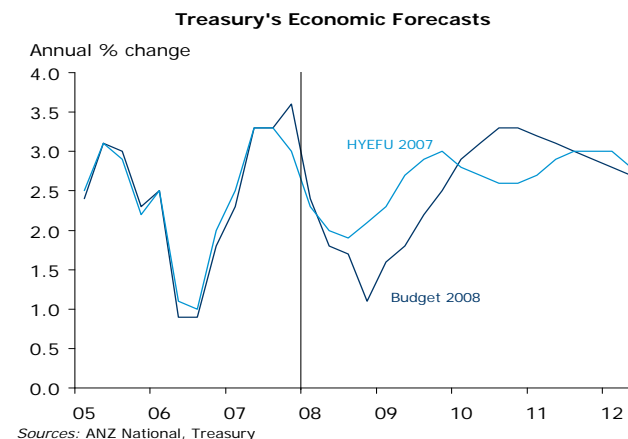
Debt is being increased to fund the additional tax cuts, as evidence by the rundown in the underlying operating surplus resulting in higher cash deficits, requiring an increase in the bond tender programme. In addition, the allocations of future Budgets has been pared back from \$2 billion a year to between \$1.75 and \$1.8 billion per annum, meaning there will be less for spending on core government services than initially provided for. Indeed, on recent trends, *Budget* packages of this scale would appear remarkable to achieve, suggesting further downside risk to the fiscal forecasts.

The economy

Treasury has revised down their near-term economic growth forecasts, though we suspect by not enough. March 2009 year GDP growth is forecast at 1.5 percent, which we view as optimistic despite the large tax cut package (which Treasury estimates will boost GDP by 0.3 percent). The biggest deviation from our view is on private consumption and residential investment, which we expect to be far weaker, even when accounting for the tax cuts.

Inflation forecasts peak at 3.7 percent in the September quarter, which we view as light given the rise in world oil prices. We expect inflation to surpass 4 percent by the end of the year. The incorporation of the Government's emissions trading scheme (ETS) from 2010 adds 0.4 percentage points to headline inflation, which sees the Treasury's inflation forecasts

stay elevated near the top of the RBNZ's target band at 2.8 percent for most of the forecast period.



To be fair, the Treasury's forecasts were finalised before the March quarter employment and retail sales print, and the surge in global oil prices. We suspect that were the Treasury to rework their forecasts now, the near-term growth forecast will have been lower and the near-term inflation profile higher. However, the Treasury's forecast for the current account deficit will be a hard sell in the current global environment. They forecast the deficit to remain at 7.2 percent of GDP for the next few years, improving to 6.6 percent by 2012. Given the altered credit environment, we doubt the economy will be able to get away with such a large deficit for a sustained period. This implies the economic cycle the Treasury is forecasting is insufficient to fully purge the imbalances in the economy. Something has to give.

Turning to the tax forecasts, downward revisions of \$1 billion in total across the forecast period has been made. This appears rather light to us. Indeed, the Treasury has made no material changes to their corporate tax forecasts, which is a key source of downside risk given the sharp deterioration in profit expectations from recent business surveys.

The fiscal stance

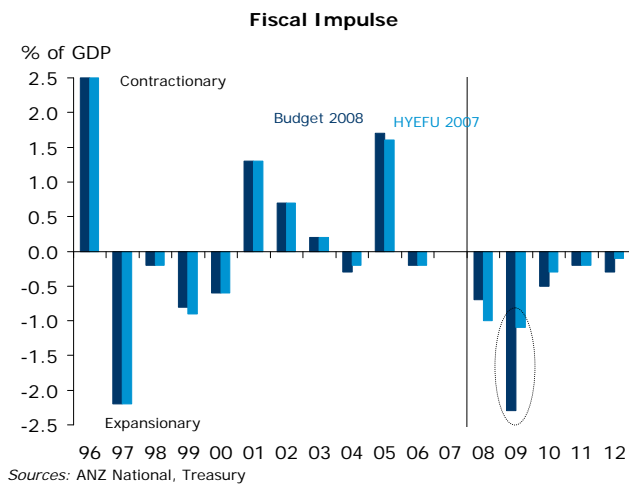
Budget 2008 is more expansionary than expected. Compared to the *Half-year Update* (HYEFU) in December last year, the Government is spending a total of \$5.7 billion more over four years. The largest increase is from personal tax cuts worth \$10.6 billion over four years, which is more than double what was set aside at the *HYEFU*. The larger size of the tax cut package accounts for the entire additional increase in spending.

The playing down of expectations by the Minister of Finance in the lead-up to the Budget appears to be all a pretence. The size of the fiscal stimulus has increased from 1.1 percent of GDP at the *HYEFU* to 2.3 percent in 2008/09. This is the largest fiscal stimulus since the 1997 tax cuts. Even with the deteriorating economic outlook, such a sizeable package will have the RBNZ on notice. Not enough for them to hike, but certainly enough for them to be wary

of the potential reflationary role fiscal policy could play.

June years	2009	2010	2011	2012	Total
HYEFU 2007					
Allocation	2.0	2.0	2.0	2.0	8.0
Revenue Contingency	0.4	1.5	1.6	1.7	5.2
Total	2.4	3.5	3.6	3.7	13.2
Budget 2008					
Tax cuts	1.5	2.3	3.1	3.8	10.6
Other spending	2.2	2.0	2.0	2.0	8.2
Total	3.7	4.3	5.1	5.8	18.9
Difference	1.3	0.8	1.5	2.1	5.7

Note: Does not include the Business Tax Reform package, which was already announced in last year's Budget.



While the economy is in a pothole, we doubt tax cuts will be the economy's saviour. The stone cold reality is that \$12 to \$28 a week of tax support from 1 October barely covers the recent rises in the cost of milk, bread and petrol for a typical family.

Bond tender programme

The DMO has increased the bond tender programme to \$3.4 billion in 2008/09 and outyears. Given the increased spending on tax reductions, larger cash deficits are now expected to be run, requiring the increase in the bond tender programme. DMO is also introducing additional initiatives aimed at increasing liquidity by:

- > Introducing tap tenders from 1 July 2008
- > Introducing reverse tap tenders with implementation as soon as possible after 1 July 2008 once detailed arrangements are finalised

The DMO hopes that the tap tenders will give it flexibility to issue bonds outside of the regular tender schedule when pockets of demand occur.

The market will welcome the increased bond issuance, and we expect the additional supply will be easily filled. The size of recent programmes at \$2.5 billion was insufficient to satisfy demand, particularly from offshore. The increase in the size of the programme announced today, together with the tap tenders, should help to improve liquidity in the bond market. However, we continue to expect offshore holdings of bonds to dominate, still leaving a small proportion available to be freely traded in the market.

The upshot

On balance, we are now becoming more inclined towards the RBNZ maintaining a vigilant stance for a longer period to assess the impact of the tax cuts when they are implemented from 1 October. This is despite clear signs that the economy is going backwards over the first half of this year. Hence, we will be reviewing our interest rate view with a bias towards pushing the easing cycle further out, beginning December as opposed to September.

Contrary to previous Budgets, the market reaction was large, with the currency up over 100 pips and the swaps curve selling off up to 16bps as the easings priced in over this year get unwound. The market will now take the view that the prospects for any easings will be pushed out. Strictly speaking, this tightening in financial conditions has gone a long way to offsetting some of the stimulus that will be provided via fiscal policy to the economy.

We will be closely watching the tax take over the coming months. For one, it will give an idea where the economy sits in regard to the speed of the slowdown. Second, whether the proposed tax package is actually feasible given the potential for the tax take to turn sharply. Finally, despite S&P reaffirming NZ's credit ratings following today's Budget, we suspect they (and other rating agencies) will be eying closely the underlying strength of the fiscal position. The experience of earlier years shows that it can deteriorate very quickly. With the current account deficit still uncomfortably high, the solid fiscal surplus is an essential element maintaining NZ's current rating.

Treasury Economic Forecasts – Budget 2008 (HYEFU 2007 forecasts in brackets)

March Years	2006/07 (a)	2007/08	2008/09	2009/10	2010/11	2011/12
Real GDP (ann. ave. % chg., production)	1.5 (1.7)	3.1 (3.0)	1.5 (2.1)	2.3 (2.8)	3.2 (2.7)	3.0 (2.9)
Nominal GDP (ann. ave. % chg.)	5.0 (4.7)	7.9 (7.3)	3.6 (5.4)	3.2 (4.1)	4.9 (4.2)	5.0 (4.6)
Current account deficit (% of GDP)	-8.2 (-8.3)	-7.4 (-7.4)	-7.2 (-6.4)	-7.2 (-7.2)	-7.1 (-7.0)	-6.6 (-6.5)
Unemployment rate (%)	3.7 (3.7)	3.5 (3.8)	3.7 (3.8)	4.4 (3.9)	4.5 (4.1)	4.3 (4.1)
CPI (ann. % chg.)	2.5 (2.5)	3.4 (3.1)	3.2 (2.8)	2.8 (2.7)	2.8 (2.6)	2.8 (2.5)

Fiscal Forecasts – Budget 2008 (HYEFU 2007 forecasts in brackets)

June Years	2007/08	2008/09	2009/10	2010/11	2011/12
Operating Balance - \$ million	2,559 (7,388)	3,105 (6,053)	3,009 (5,924)	2,779 (6,094)	2,734 (6,228)
- % GDP	1.4 (4.1)	1.7 (3.2)	1.6 (3.0)	1.4 (3.0)	1.3 (2.9)
OBEGAL - \$ million	5,227 (6,574)	1,318 (4,327)	1,004 (4,062)	493 (3,984)	154 (3,850)
- % GDP	2.9 (3.7)	0.7 (2.3)	0.5 (2.1)	0.2 (2.0)	0.1 (1.8)
Net Core Crown Debt - % GDP	1.0 (1.1)	2.5 (0.9)	3.8 (0.9)	5.0 (0.9)	6.2 (1.0)
Gross Sovereign-Issued Debt (% of GDP)	17.6 (18.7)	17.5 (17.7)	16.8 (16.3)	17.8 (17.0)	16.8 (15.6)
Bond tender - \$ million	2,415 (2,453)	3,314 (2,459)	3,393 (2,487)	3,394 (2,507)	3,365 (2,497)

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