

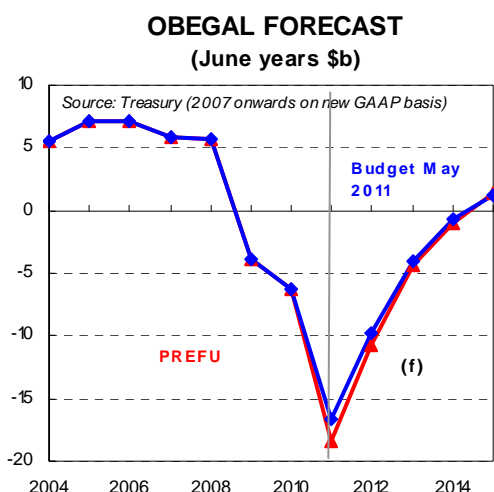
Little change, but wary of downside risks

- Earthquake-related costs increase deficit in 2012, but balance recovers swiftly from 2013.
- Tax revenue projection revised lower on weaker GDP growth in 2013.
- Expenses also lower, largely due to lower interest rates and reduced debt financing costs.
- Net debt profile and the Bond Tender Program unchanged.

The Treasury's pre-election update of the economic and fiscal outlook did not result in any material change in the overall net debt position. In the near term (2012) the fiscal deficit has increased, largely due to the change in timing of earthquake-related costs. However, beyond this, the fiscal position improves relatively swiftly.

The key economic revisions included downward revisions to growth (in 2013) and inflation, largely reflecting the weaker global economic outlook, along with downward revisions to interest rates. In addition, the timing of earthquake rebuilding activity has been delayed (although the overall size of rebuilding revised up). Overall, the economic and interest rates forecast revisions resulted in lower debt servicing costs more than offsetting the impact of lower tax revenue. As a result, the fiscal balance recovers swiftly to leave the net debt position largely unchanged from the May Budget. In addition, there have been no changes to the Bond Tender Programme.

Overall, the revisions to economic assumptions were relatively mild, though the Treasury was mindful of the downside risks surrounding the outlook stemming from the Eurozone debt crisis. Given the heightened uncertainty, the Treasury ran an alternative downside scenario. In this, net debt would increase to 35% of GDP in 2016, up from the current projections of 28.2%.



FISCAL PROJECTIONS	% of GDP				
	12	13	14	15	16
OBEGAL	-5.1	-2.0	-0.4	0.6	1.2
<i>(Budget 2011)</i>	-4.7	-1.8	-0.3	0.5	
Core Revenue	28.9	29.6	30.1	30.4	30.8
<i>(Budget 2011)</i>	29.2	29.8	30.5	31.0	
Core Expenses	35.2	32.3	31.1	30.7	30.4
<i>(Budget 2011)</i>	34.9	32.5	31.7	31.3	
Net core crown debt	25.4	28.5	28.9	29.0	28.2
<i>(Budget 2011)</i>	26.2	28.5	29.5	29.6	
Sovereign Debt (gross)	37.7	36.1	37.7	35.4	34.9
<i>(Budget 2011)</i>	37.2	35.5	37.9	35.0	

The Fiscal Outlook

Fiscal balance recovers swiftly, from larger 2012 deficit.

Swift improvement in fiscal balance from 2013

From 2013, core crown revenue projections are around \$1 billion a year lower compared to projections in Budget 2011. Meanwhile, expenses are higher in 2012, resulting in a larger fiscal deficit that year. However, from 2013, expenses are lower than previously forecast, which enables a quick turn around in the fiscal balance and allowing a surplus to still be achieved by 2015.

Tax revenue revised lower from 2013.

Revenue forecasts lower on weaker tax expectations

Revenue forecasts have been reduced relative to Budget 2011, largely due to weaker tax revenue forecasts from 2013 as a result of weaker nominal GDP expectations in that year. The Treasury continues to expect tax receipts to increase over the projection period due to higher levels of employment, increased GST revenue, and a recovery in corporate earnings.

Lower interest rate bill reduces expenses outlook.

Expense revised lower, lower interest rates reduce financing costs

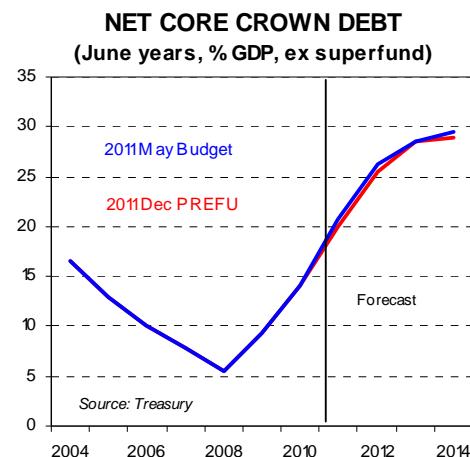
In 2012, the forecast for core expenses has increased. This is largely due to \$1.2 billion of Canterbury earthquake-related costs now booked in the 2012 year, deferred from 2011. From 2013, core expenses are lower than previously forecast. Driving much of the cost savings, relative to Budget 2011, are lower expectations for debt financing costs as a result of a lower interest rate assumption.

The forecast for finance costs have been reduced by \$1 billion in the June 2015 year, to \$4.3 billion, largely due to lower forecast interest rates. The Treasury has revised down its 10-year bond yield forecast (for 2015) to 5.2% from 6%. This compares to our own forecast of 5.3%. The Treasury noted the credit rating downgrade occurred after the interest rate forecasts were completed, but do not expect it to have a material impact on debt financing costs (bond yields rose 12 basis points on the day of the downgrades, and remain low).

Net debt profile largely unchanged from May Budget.

Net debt profile largely unchanged

The net debt profile (as % of GDP) is largely in line with Budget 2011 expectations (although slightly lower at the margin). Net debt peaks in 2015, at 29% of GDP, from 20% currently. Gross debt peaks at 37.7% in 2015, up from 36.2% in 2011. The increase in gross debt is muted relative to the increase in net debt, because the Government has prefunded part of its borrowing requirements through large bond issuance in the June 2011 year. The added issuance took advantage of good market conditions, and resulted in gross debt jumping from 28.3% of GDP in 2010 to 36.2% currently.



Bond tender programme also unchanged.

Given there has been little change in the net debt outlook, the Debt Management's Office bond tender programme is unchanged from Budget 2011.

Bond tender programme	\$bn				
Period Ending June	2012	2013	2014	2015	2015
PREFU 2011	13.5	12.0	10.0	8.0	5.0

Economic Backdrop

Revised rebuilding assumptions underpin forecast revisions.

Revisions to rebuilding drive economic growth forecast changes

The bulk of the revisions to the Treasury's growth forecasts reflect revisions to its expectations of rebuilding activity. The Treasury had revised up its estimate of the cost of rebuilding to \$20 billion, from the \$15 billion estimated in the May 2011 Budget. In addition to the greater amount of rebuilding, the Treasury now also expects rebuilding activity to start later.

GDP Growth Forecasts

March years, annual average

	Treasury	ASB
2012	2.3	2.4
2013	3.4	3.7
2014	3.3	3.0

Reflecting these changes, the Treasury's forecasts for residential investment have been revised down over 2012 and 2013, but revised up over the latter part of the projection. Relative to our forecasts, the Treasury's expectations is for a slower start to the rebuilding programme.

Export outlook deteriorates on global weakness.

The Treasury highlights the deteriorating outlook for the Western economies. As a result, its forecasts for export growth have been revised down over the projection. Nonetheless, the Treasury expects export growth to hold up, reflecting the growing importance of the more robust Asian economies as key trading partners.

Inflation forecasts trimmed.

The Treasury has pared back its inflation forecast slightly. Relative to our forecasts, the Treasury is more optimistic, with its forecast of annual inflation remaining below the top of the RBNZ's target band throughout the projection. Part of this is likely to reflect its expectations the NZ dollar will hold up over the coming years, which would likely weigh on tradable inflation.

Economic Forecasts	2011 Actual	2012			2013			2014			2015		2016 PREFU
		PREFU	ASB	Budget	PREFU	ASB	Budget	PREFU	ASB	Budget	PREFU	Budget	
March years (ann avg)													
GDP	1.6	2.3	2.4	1.8	3.4	3.7	4.0	3.3	3.0	3.0	2.9	2.7	2.4
Private consumption	2.0	2.1	1.8	1.4	2.2	2.6	2.6	2.9	2.8	3.4	2.9	2.9	2.2
Govt consumption	3.8	1.8	0.8	1.0	-1.5	-0.7	-0.8	-0.2	-0.4	-0.4	0.5	0.6	0.7
Residential Invest	2.3	-8.4	-6.9	0.8	37.6	41.6	53.5	34.9	9.0	17.4	14.2	2.7	5.5
Non-market Invest	5.0	1.1	6.1	10.0	-8.8	8.8	-6.7	3.2	5.4	-3.1	5.7	4.7	3.4
Market investment	7.8	8.9	4.3		9.8		13.0	10.3		9.8	4.1	2.5	-0.3
Exports	1.9	2.8	3.6	3.0	2.3	2.6	2.9	1.9	3.8	2.2	1.7	2.1	1.8
Imports	10.5	3.6	5.0	2.5	6.1	5.9	6.9	8.0	3.8	6.8	4.3	1.7	0.7
Inflation (ann % chg)	4.5	2.8	2.6	3.1	2.2	2.4	2.4	2.4	3.2	2.5	2.5	2.6	2.7
90-day bank bills*	3.0	2.9	3.1	3.0	3.7	4.2	3.9	4.3	4.2	4.7	5.0	5.0	5.3
TWI*	67.2	70.0	71.2	66.7	70.1	69.5	64.5	69.6	69.5	60.3	67.2	56.0	63.3

Interest rates outlook lower.

Reflecting expectations that the OCR will now remain on hold for longer and the tightening cycle will be more gradual, the Treasury has revised down its 90-day bank bill rate forecast over the 2012 to 2014 period.

Treasury has also revised down its longer-term interest rate forecasts, although much of this is likely to reflect current market conditions. In the May Budget, the Treasury forecast the 10-year government bond yield would rise from 5.6% in June 2011, to 6% by June 2015. However, over the past 5 months, government bond yields have fallen sharply on global growth concerns. Treasury now assumes a 10-year bond yield of 4.4% in June 2012, rising to 5.4% in 2016. The credit rating downgrades occurred after Treasury forecasts were finalised. However, the Treasury estimates the downgrades had an impact on bond yields of around 15 basis points and still considers its forecast for 10-year bond rates appropriate in light of the muted impact of the downgrade.

Downside scenario considered given heightened uncertainty.

Eurozone downside risk scenario

The Treasury's central forecast for nominal GDP is stronger than ours. However, the Treasury notes there are strong downside risks to these forecasts. These risks stem from a significant increase in risk aversion should European leaders fail to come up with a clear resolution to the debt crisis, the potential for a protracted global recession, and an increase in funding costs as a result of housing market corrections in a number of Asian economies.

Results in higher net debt.

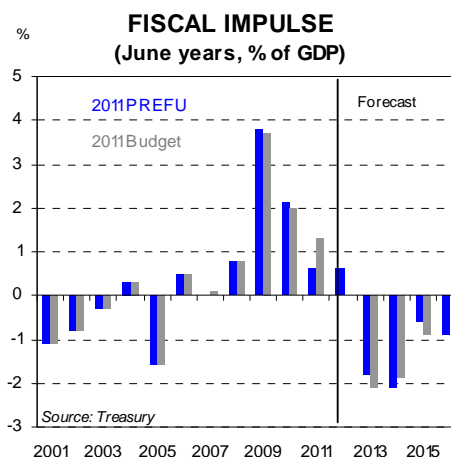
In Treasury's downside scenario, NZ nominal GDP would be \$35 billion lower over the five-year forecast period compared to its central forecast, and net debt would increase to 35% of GDP in 2016, up from the current projections of 28.2%.

The Treasury estimates there is a one in five chance tax revenues underperform relative to the revenue results in the downside scenario. This is based off historical forecast performance, heightened uncertainty and the view that risks are skewed to the downside. This is a surprisingly high probability.

Fiscal net stimulus to remain positive over 2012.

Fiscal Impulse

The fiscal impulse (the net stimulus on the economy of the Government's activities) is expected to remain positive in the 2012 fiscal year, with core Crown discretionary fiscal policy expected to add net stimulus of 0.6% of GDP. Beyond that, it turns into a contractionary impact of 1.8% in 2013 and 2.1% in 2014.



Implications and market reaction

Treasury revises growth expectations lower.

Treasury has revised its economic forecasts lower in 2013, reflecting a weaker export outlook and the delayed timing of Canterbury earthquake rebuilding. As a result, tax revenue is expected to be lower due to the slower pace of nominal GDP growth. Nonetheless, the slight downward revision to the revenue outlook over the forecast horizon has been more than offset by downward revisions to expenses, due to lower interest rate expectations and financing cost forecasts.

But still achieves surplus by 2015.

The upshot is the Government still achieves an operating surplus in 2015 – and of similar magnitude to that predicted in the May Budget. There is little change in the net debt profile, and the bond tender programme also unchanged.

Limited market implications.

There are limited implications for the NZ credit rating outlook, particularly given the forecasts show little material difference from those produced in May. Both S&P and Fitch downgraded NZ's credit rating last month, to AA (from AA+).

The market reaction to the update was very muted, with bond yields falling a few basis points.

ASB Economics & Research			Phone	Fax
Chief economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659	(649) 302 0992
Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5660	
Economist	Christina Leung	christina.leung@asb.co.nz	(649) 301 5661	

<https://reports.asb.co.nz/index.html>

ASB Economics
Level 9, 135 Albert Street, Auckland

Disclaimer

This document is published solely for informational purposes. It has been prepared without taking account of your objectives, financial situation, or needs. Before acting on the information in this document, you should consider the appropriateness and suitability of the information, having regard to your objectives, financial situation and needs, and, if necessary seek appropriate professional or financial advice.

We believe that the information in this document is correct and any opinions, conclusions or recommendations are reasonably held or made, based on the information available at the time of its compilation, but no representation or warranty, either expressed or implied, is made or provided as to accuracy, reliability or completeness of any statement made in this document. Any opinions, conclusions or recommendations set forth in this document are subject to change without notice and may differ or be contrary to the opinions, conclusions or recommendations expressed elsewhere by ASB Bank Limited. We are under no obligation to, and do not, update or keep current the information contained in this document. Neither ASB nor any person involved in the preparation of this document accepts any liability for any loss or damage arising out of the use of all or any part of this document.

Any valuations, projections and forecasts contained in this document are based on a number of assumptions and estimates and are subject to contingencies and uncertainties. Different assumptions and estimates could result in materially different results. ASB does not represent or warrant that any of these valuations, projections or forecasts, or any of the underlying assumptions or estimates, will be met.