1

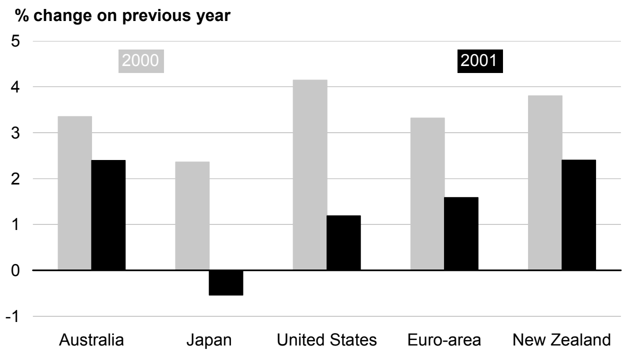
Economic and Fiscal Overview

Economic Outlook

The New Zealand economy has weathered the slowdown in global growth well

- The New Zealand economy has evolved somewhat better than expected at the 2001 *December Economic and Fiscal Update (December Update).*
- Quarterly GDP growth averaged around 0.4% over the second half of 2001, with the economy growing 2.4% in the year to December 2001. Growth in both the September and December quarters was characterised by strong domestic demand, partially offset by a weaker external sector.

Figure 1.1 – Real GDP growth



Sources: Datastream, Statistics New Zealand

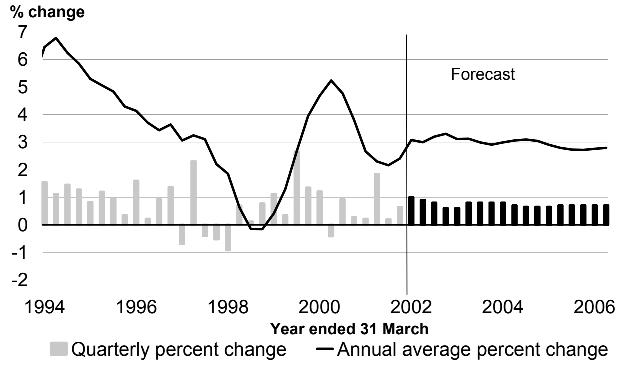
- The economy looks to have grown by around 1% in the March quarter, driven by household spending and a rebound in exports.
- Since the *December Update,* expected trading partner growth for 2002 has been revised up from 1.9% to 2.6%, owing to a better than expected end to last year and start to 2002, rather than stronger growth going forward. While growth for 2002 is expected to be stronger than actual growth in 2001, trading partner growth remains below trend.

Economic growth is set to remain robust…

- Looking forward, New Zealand's GDP growth is expected to be 3.1% to March 2003, which is significantly better than the 1.9% expected in the *December Update*.

- One of the key changes since December is a substantial turnaround in net migration. In the short term, the impact is likely to be more on demand than supply, putting pressure on the economy's capacity. Over the medium term, the demand and supply effects of the increase in net migration will become more balanced as migrants enter the labour force.

Figure 1.2 – GDP growth



Sources: Statistics New Zealand, The Treasury

…although domestic demand is expected to slow

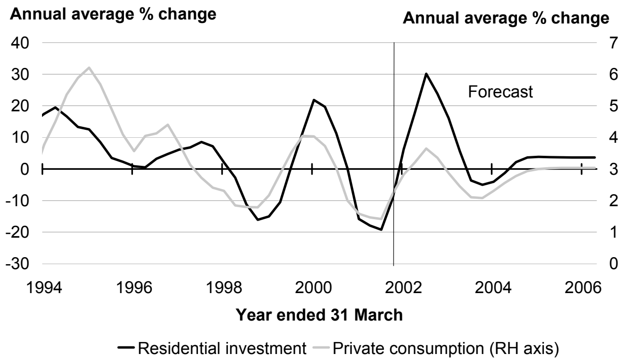
- After displaying strong growth over the second half of 2001 and the first quarter of 2002, employment growth is forecast to slow over the rest of 2002 as some of the drivers over the past year are not repeated and as firms seek to improve productivity. Nevertheless, the labour market is expected to remain tight by historical standards, with the unemployment rate staying close to current levels. Wage growth is expected to rise slightly.

- After accelerating over the year to March 2002, quarterly consumption growth is expected to moderate over the year ahead, reflecting slower growth in labour income, a decline in farm income and rising interest rates.

- Residential investment is expected to display ongoing growth over much of 2002, before contracting over late 2002 and early 2003.

- Business investment is forecast to accelerate over 2002 and early 2003, growing at around 2% in the year to March 2003 underpinned by two good years of economy-wide profit growth and strong growth in domestic demand. Investment growth loses momentum in the second half of 2003 as profit growth slows.

Figure 1.3 – Consumption and residential investment



Sources: Statistics New Zealand, The Treasury

Solid export volume growth in the year ahead

- The recent recovery of merchandise export volumes, largely in dairy and meat exports, will become more modest in the year ahead. Non-commodity manufactured exports are projected to display robust quarterly growth, benefiting from the delayed impact of the depreciation in the currency and stronger trading partner growth.
- The projected strength in services exports in the year ahead reflects tourism picking up after the fall following 11 September, as "normal" travel patterns resume more quickly than was assumed in the *December Update*.
- The full impact of the sharp drop in global growth on export prices has still to be felt, with world export prices forecast to decline through until the second half of 2002, and New Zealand dollar export prices expected to fall by 12% in the March 2003 year.

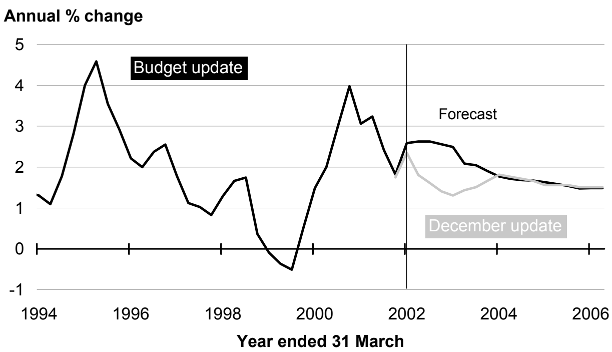
Inflation remains persistently high over 2002

- Annual CPI inflation has been strong recently, and is expected to remain at or above 2.5% over the remainder of 2002. This reflects some one-off price increases, recent wage growth in excess of productivity, together with strong GDP growth in the year ahead which allows some room for firms to rebuild margins. Inflation is likely to reduce going into 2003, largely because of slowing unit labour cost growth.
- With growth set to remain strong in the year to March 2003, the Reserve Bank is assumed to move monetary policy back to a more neutral footing, by taking the Official Cash Rate (OCR) to 6% by the end of 2002.

GDP growth remains robust in the medium term

- With trading partner growth accelerating to 3.6% in 2003, as well as the economy benefiting from business investment and employment growth, GDP growth of 3% is expected in the year to March 2004. Growth converges back to around the economy's long-run trend towards the end of the forecast period.

Figure 1.4 – CPI inflation

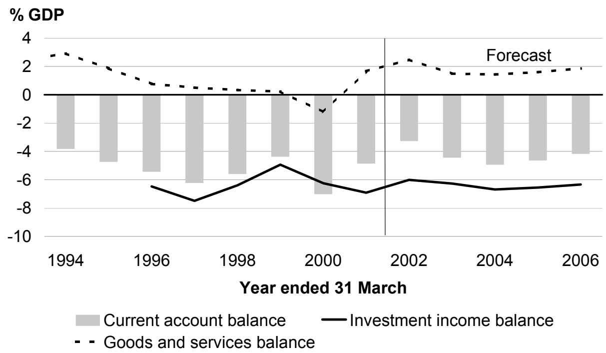


Sources: Statistics New Zealand, The Treasury

The current account deficit is expected to increase over the short term

- Despite total export volumes gaining some momentum in the year ahead, the current account deficit is expected to increase to around 4.5% of GDP in the second half of 2002 and to around 5% in 2003/04. This is largely due to the impact of stronger consumption and investment on import growth over the March 2003 year. Government defence spending also adds to the import profile over the forecast horizon.

Figure 1.5 – Current account balance



Sources: Statistics New Zealand, The Treasury

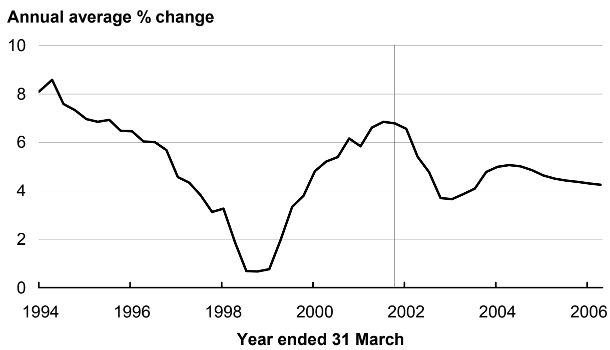
- Following the forecast increase in the current account deficit over the March 2003 and 2004 years, the current account deficit is expected to reduce somewhat towards the end of the forecast horizon. The initial improvement in the deficit is driven by a slowdown in import growth, as consumption and investment growth slows in the March 2004 year and into 2005. A continued steady improvement in services exports also helps to underpin the decrease in the current account deficit.

Nominal GDP growth is more cyclical

- While the near-term profile for GDP growth is relatively flat, nominal GDP growth is considerably more cyclical, owing to movements in the GDP deflator accentuating the cycle in GDP.

- After growing 6.6% in the year to March 2002, nominal GDP growth is forecast to slow to 3.7% in the year to March 2003, before rising to 5% in the year to March 2004.

Figure 1.6 – Nominal GDP



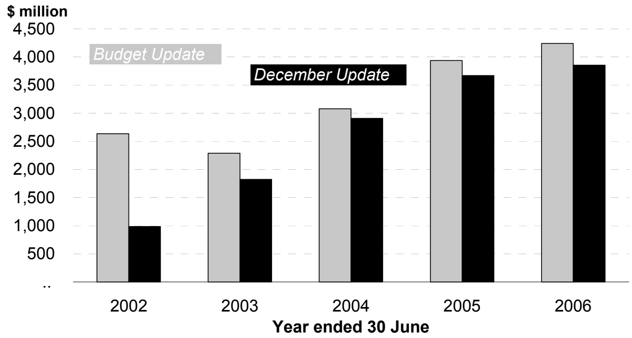
Sources: Statistics New Zealand, The Treasury

- Over the last two years of the forecast horizon the nominal economy is expected to grow at around 4% to 5%, owing to the combination of steady GDP growth and inflation around the mid-point of the Reserve Bank's target band. The higher level of nominal GDP throughout the entire forecast period, compared with the *December Update*, underpins the solid growth in tax revenue feeding through to an improved fiscal position.

Fiscal Outlook

The fiscal outlook has improved since the December Update

Figure 1.7 – Operating balance (comparison with the *December Update*)



Source: The Treasury

- The *December Update* forecasts reflected a weaker position from the 2001 *Budget Economic and Fiscal Update*, largely reflecting changes to the economic forecasts, particularly the world outlook. The fiscal forecasts are much improved on those in the *December Update*, driven in large part by the economic forecasts discussed in the previous section.

- Tax revenues are higher by at least $600 million per year, largely representing the unwinding of the downwards revisions in the *December Update*, driven by changes to the nominal economy forecasts. The forecasts for nominal GDP are between 1-1.5% higher than they were in the *December Update.*

- Benefit expenses continue to fall but are more than offset by increases in education expenses owing to demographic forecast changes, and a $200 million impact on the operating balance from 2003/04 resulting from Budget 2002 decisions.

- Positive net ACC and GSF valuation changes of $570 million since the *December Update* have also increased the operating balance in the 2001/02 year.

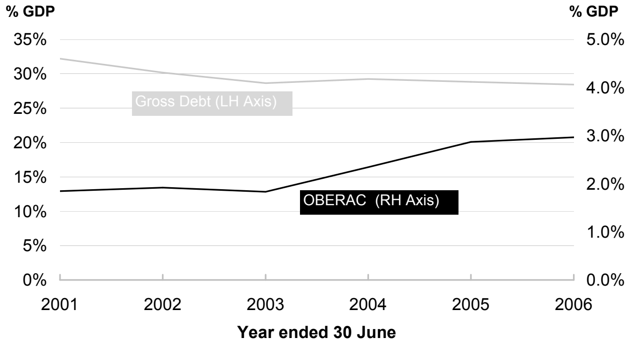
- Relative to the *December Update* the forecast cash outflows for the period 2001/02 to 2005/06 have reduced by a net $2.4 billion, reflecting improved cash flows from operations. As a result, both gross and net debt decrease relative to the *December Update.*

- A consequence of the cash flow improvements is that the 2001/02 bond programme has been reduced by $350 million (accommodated by the cancellation of the 20 June 2002 bond tender). The 2002/03 bond programme has been established at $3.4 billion, significantly lower than the $5.1 billion signalled in the *December Update.*

- Much of the change to the fiscal forecasts since the *December Update* bring the operating balance forecasts broadly back to the levels in the 2001 *Budget Update* from 2002/03.

- Other key features relative to the 2001 *Budget Update* are:
  - The operating balance for the 2001/02 year is higher, mainly owing to higher tax revenue and GSF valuation movements ($420 million).
  - Debt is lower in all years reflecting the stronger 2001/02 year and the improved opening debt position reflected in the actual 30 June 2001 Crown financial statements.

Figure 1.8 – Gross debt and OBERAC as a % of GDP



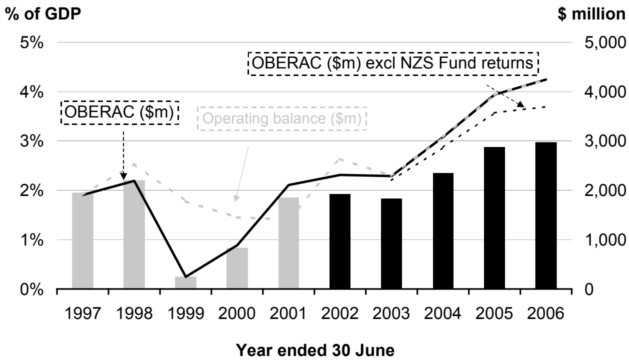
Source: The Treasury

- The positive operating balances are sufficient to enable gross debt to remain just below the Government's debt target of 30% of GDP, given the level of investment activity. The factors contributing to this are discussed in the following sections.

Operating balance rises over the forecast horizon…

- The forecast 2001/02 operating balance is $2.6 billion (2.2% of GDP).
- Excluding the ACC and GSF valuations, the OBERAC (operating balance excluding revaluations and accounting policy changes) for 2001/02 is $2.3 billion (1.9% of GDP).
- The OBERAC falls in 2002/03 as a percentage of GDP.
- The operating balance is expected to rise to 3% of GDP by 2005/06 ($4.2 billion).

Figure 1.9 – OBERAC (% of GDP and $ million)

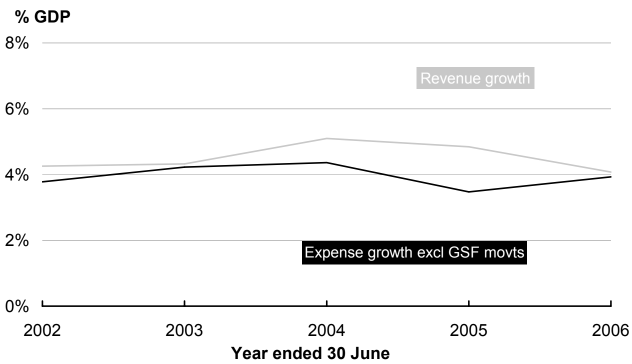


Source: The Treasury

…due to tax revenue growth remaining higher than expense growth…

- Tax continues to grow by an average of 4.5% across the forecast period. The strong growth continues in line with previous updates, but is moderated by reduced (but still positive) growth in business tax in 2001/02.
- Expense growth averages around 4% per annum over the forecast period.

Figure 1.10 – Revenue and expense growth



Source: The Treasury

- Health and education demographics continue to be a key driver in expense growth in addition to the forecast new spending.

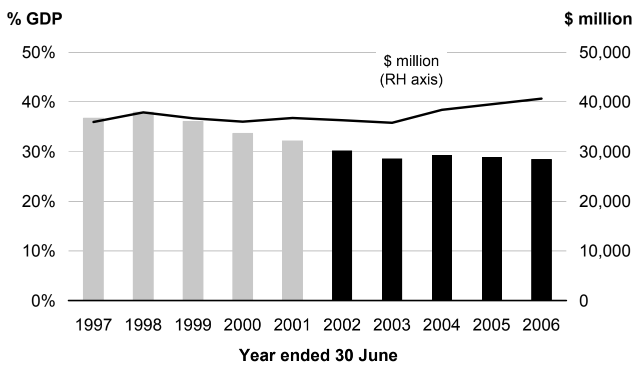
...enabling the Government to continue to apply surplus cash to its investment programme

- The rising operating surplus translates to a similar level of cash flows from operations, generating approximately $15.8 billion operating cash surpluses over the period 2001/02 to 2005/06 to fund investing activity.
- Investment outlays of $24.1 billion outweigh operating cash surpluses by $8.3 billion. These outlays include: maintaining and improving the existing asset base and providing injections (e.g. for the Air New Zealand recapitalisation package); investing in the New Zealand Superannuation Fund (NZS Fund); and funding advances (which mainly include student loans and Crown entity private debt refinancing).

Debt is relatively flat as a percentage of GDP, although rises in nominal terms

- Over the period, gross debt falls as a percentage of GDP from around 32% at 30 June 2001 to 30.2% in 2001/02. Thereafter it averages around 29% and is 28.4% by 2005/06. For the same period, net debt averages around 17% of GDP before falling to 15.5% by 2005/06.
- Gross and net debt rise slightly in the middle of the forecast period. This is mainly due to the timing of planned capital spending.
- Gross debt increases by $3.9 billion in nominal terms from 30 June 2001 to the end of the forecast period. This, in conjunction with a decrease in marketable securities and deposits of $4.8 billion, funds the shortfall between operating cash flows and investment outlays.
- The domestic bond programme for 2002/03 has been set at $3.4 billion, down from the forecast $5.1 billion in the *December Update*. For a full explanation of the revision refer to page 84 of the Fiscal Outlook chapter.

Figure 1.11 – Gross debt (% of GDP and $ million)



Source: The Treasury

Government Budget decisions

- The Government has allocated all but $230 million of the $6.1 billion fiscal provision since Budget 2000. The $230 million is set aside as a contingency to manage risks in between the 2002 and 2003 Budgets. The tables below provide a breakdown of the Government's three-year fiscal provision from 1999/2000 to 2002/03 for both operating and capital:

Table 1.1 – Fiscal provisions to 2002/03

Fiscal provisions ($ million, GST inclusive)	**1999/2000**	**2000/01**	**2001/02**	**2002/03**	**Total**
Budget 2000 decisions	420	1,050	1,060	1,120	3,650
2000 contingency decisions	-	99	74	78	251
Budget 2001 decisions	-	52	532	526	1,110
2001 contingency decisions	-	-	51	125	176
Budget 2002 decisions	-	-	(7)	715	707
2002 contingency provision	-	-	-	230	230
Total	**420**	**1,201**	**1,710**	**2,794**	**6,124**

Source: The Treasury

Table 1.2 – Capital spending to 2002/03

Capital provisions ($ million, GST inclusive)	**1999/2000**	**2000/01**	**2001/02**	**2002/03**
Capital provision - *December Update*	(69)	639	2,291	1,585
Budget 2000 decisions	(54)	827	576	568
December Update 2000 decisions	(15)	(58)	(4)	40
Receipts from spectrum sale	-	(135)		
Budget 2001 decisions	-	5	369	204
December Update 2001 decisions	-	-	76	27
Budget 2002 Decisions	-	-	1,151	407
Total decisions to date	(69)	639	2,168	1,246
Planned commitments pre-Budget 2002	-	-	123	339
Budget 2002 rephasing of commitments	-	-	(123)	(119)
Budget 2002 increase to forecast commitments	-	-	-	-
Forecast capital commitments	-	-	-	220
Total provision to 2002/03	**(69)**	**639**	**2,168**	**1,466**

Source: The Treasury

- In the next parliamentary term, the Government plans to revise the provisions framework to ensure the focus will be on the operating and debt tracks and their consistency with the fiscal objectives. This compares with the current focus on a set nominal limit for the electoral term.

- Looking forward, the Government will balance the operating and capital components alongside NZS Fund contributions.

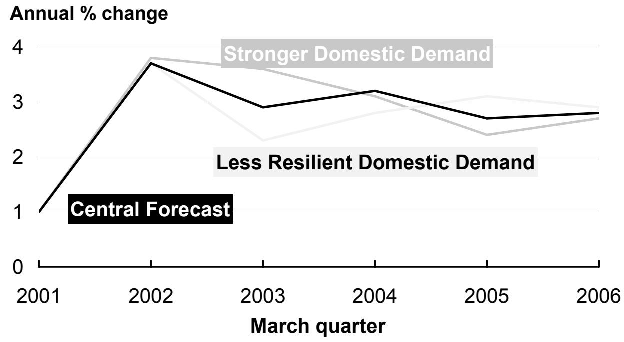
- Under current operating balance projections, the Government could accommodate core operating expense growth of around 2.5% per year and capital investment on average of around $500 million to $600 million per year. This is consistent with making contributions to the NZS Fund as planned. The forecasts reflect amounts for forecast future new spending consistent with this approach.

The fiscal forecasts are highly sensitive to risks around the economic forecasts

- The Central Forecast is determined by balancing both the upside and downside risks facing the economy, to provide the best assessment of the way the economy is likely to evolve. Some of the key judgements or risks may evolve differently, resulting in the economy deviating from the Central Forecast.

- If domestic demand is stronger than assumed in the Central Forecast, a possible growth path for the economy is one where private consumption and residential investment hold up through 2002/03 by more than anticipated, and where the turnaround in net migration adds less to productive capacity. This would see GDP growth accelerate to 3.5% in 2002/03 compared with 3.1% in the Central Forecast. However, with the economy growing above capacity, inflationary pressures would build up and monetary conditions tighten to bring inflation to within the target band. This would lead to slower growth in the following years.

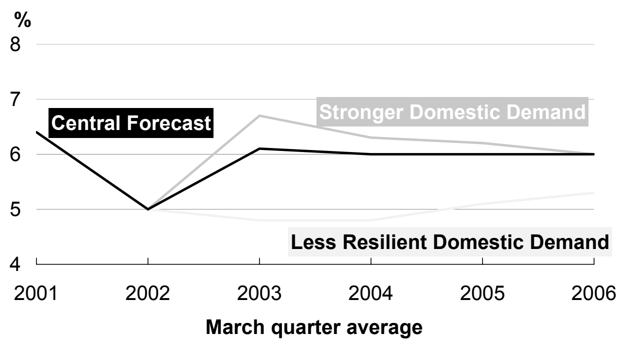
Figure 1.12 – Real GDP growth



Sources: Statistics New Zealand, The Treasury

- Alternatively, domestic demand may lose its momentum more quickly, with lower consumption, residential investment and employment growth in the near term compared with the Central Forecast. Under this scenario, GDP growth would slow to 2.7% in 2002/03 and 2.3% in 2003/04. Growth would recover to 3.3% in 2004/05 as monetary conditions remain stimulatory for longer.

Figure 1.13 – Operating balance



Sources: Statistics New Zealand, The Treasury

- These effects will flow through into the Government's operating balance. Under a Stronger Domestic Demand scenario, a higher nominal GDP relative to the Central Forecast will result in a higher operating balance throughout the forecast period. However, if domestic demand were less resilient, the operating balance would be lower throughout the forecast period compared with the Central Forecast.

- The changes in the operating balance will also have an impact on gross debt. A higher operating balance would lead to lower gross debt as a percentage of GDP, because both GDP and operating surpluses would be higher. The converse is true in the case of a lower operating balance.

Table 1.3 – Economic indicators[1]

(Annual average % change, March years)	2001 Actual	2002 Forecast	2003 Forecast	2004 Forecast	2005 Forecast	2006 Forecast
Consumption	0.7	2.7	2.8	2.7	2.6	2.7
Investment	(0.1)	7.8	5.5	4.1	4.2	3.0
Stock change[2]	(0.4)	(0.3)	(0.1)	0.2	0.0	0.0
Gross National Expenditure	**0.2**	**3.3**	**3.3**	**3.2**	**2.9**	**2.7**
Exports	6.8	1.8	6.6	6.1	4.7	3.8
Imports	0.4	3.5	5.9	6.7	5.2	3.9
GDP (Production Measure)	**2.7**	**3.1**	**3.1**	**3.0**	**2.9**	**2.8**
- annual % change	1.0	3.7	2.9	3.2	2.7	2.8
Employment[3]	2.2	2.5	2.0	1.0	1.5	1.3
Unemployment[4]	5.4	5.3	5.4	5.1	5.2	5.3
Wages[5]	2.4	3.5	3.8	3.5	3.6	3.0
CPI inflation	3.1	2.6	2.5	1.8	1.6	1.5
Current account balance	(4.8)	(3.2)	(4.4)	(4.9)	(4.6)	(4.1)
TWI[6]	50.5	51.6	54.0	54.6	55.0	55.0
90-day bank bill rate[6]	6.4	5.0	6.1	6.0	6.0	6.0

Sources: Statistics New Zealand, Datastream, The Treasury

NOTES:
1 Finalised 10 May 2002.
2 Contribution to GDP growth.
3 Household Labour Force Survey, full-time equivalent employment.
4 Household Labour Force Survey, percentage of the labour force, March quarter, seasonally adjusted.
5 Quarterly Employment Survey, average hourly ordinary time earnings.
6 Average for the March quarter.

Table 1.4 – Fiscal indicators (current presentation)

($ million)	**2001 Actual**	**2002 Forecast**	**2003 Forecast**	**2004 Forecast**	**2005 Forecast**	**2006 Forecast**
Operating Balance						
Revenue	39,492	41,172	42,952	45,142	47,329	49,259
Expenses						
Allocated expenses	(38,186)	(39,148)	(40,957)	(42,285)	(43,297)	(44,146)
Forecast for new spending	-	-	(230)	(700)	(1,180)	(2,080)
SOE/CE surpluses	103	612	523	921	1,085	1,209
Operating Balance	**1,409**	**2,636**	**2,288**	**3,078**	**3,937**	**4,242**
Less revaluations	698	(326)	-	-	-	-
OBERAC	**2,107**	**2,310**	**2,288**	**3,078**	**3,937**	**4,242**
Less contributions and returns on NZS Fund	-	(600)	(1,290)	(2,009)	(2,379)	(2,667)
Available after NZS Fund Requirements	**2,107**	**1,710**	**998**	**1,069**	**1,558**	**1,575**
Less						
Forecast new capital investment	-	-	(220)	(800)	(500)	(360)
Physical asset purchases and other	(682)	(1,901)	(1,551)	(1,421)	(1,215)	(1,201)
Movement in Net Crown Debt	**1,425**	**(191)**	**(773)**	**(1,152)**	**(157)**	**14**
Net Crown Debt	**19,971**	**20,162**	**20,935**	**22,087**	**22,244**	**22,230**
Net Crown Debt (% of GDP)	**17.5%**	**16.8%**	**16.8%**	**16.8%**	**16.2%**	**15.5%**
Domestic Bond Programme[1]	3,572	3,703	**3,400**	5,559	3,933	3,822
Nominal GDP	114,145	120,309	124,964	131,293	137,201	143,026
Fiscal Indicators as a % of GDP						
Gross debt	32.2%	30.2%	28.6%	29.2%	28.8%	28.4%
Net Crown debt	17.5%	16.8%	16.8%	16.8%	16.2%	15.5%
Net Crown debt plus assets of NZS Fund	17.5%	16.3%	15.2%	13.9%	11.6%	9.3%
Net worth	10.0%	11.8%	13.2%	14.9%	17.2%	19.4%
Revenue	34.6%	34.2%	34.4%	34.4%	34.5%	34.4%
Expense	33.5%	32.5%	33.0%	32.7%	32.4%	32.3%
OBERAC	1.8%	1.9%	1.8%	2.3%	2.9%	3.0%
Operating balance	1.2%	2.2%	1.8%	2.3%	2.9%	3.0%
New Zealand Superannuation Fund						
Fund asset returns (after tax)[2]	-	14	90	209	368	550
Fund assets (year end)	-	600	1,890	3,898	6,277	8,944
% of GDP	0.0%	0.5%	1.5%	3.0%	4.6%	6.3%

1 The figure for 2003 is the face value of the bond programme. The actual cash raised by the programme is forecast to be $3,392 million, as the bonds are forecast to be issued at a discount. Further out the bond programme is an estimate of the cash expected to be raised. For the reconciliation between the bond programme and operating cash flows see the Statement of Cash Flows.

2 Returns on fund assets are recorded as revenue from investments in the operating balance (see Note 3 of the fiscal forecasts). However only the "after tax" portion of investment income accumulates in the NZS Fund.