B.1 and B.6

Hon Dr Michael Cullen
TREASURER
MINISTER OF FINANCE

• BUDGET POLICY STATEMENT 2002 •

• DECEMBER ECONOMIC AND FISCAL UPDATE 2001 •

18 DECEMBER 2001

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Statement of Responsibility

On the basis of the economic and fiscal information available to it, the Treasury has used its best professional judgement in supplying the Minister of Finance with this Economic and Fiscal Update. The Update incorporates the fiscal and economic implications both of Government decisions and circumstances as at 26 November 2001 that were communicated to me, and of other economic and fiscal information available to the Treasury in accordance with the provisions of the Fiscal Responsibility Act 1994.

Dr Alan Bollard
Secretary to the Treasury
12 December 2001

This Economic and Fiscal Update has been prepared in accordance with the Fiscal Responsibility Act 1994. I accept overall responsibility for the integrity of the disclosures contained in this Update, and the consistency and completeness of the Update information in accordance with the requirements of the Fiscal Responsibility Act 1994.

To enable the Treasury to prepare this Update, I have ensured that the Secretary to the Treasury has been advised of all Government decisions and other circumstances as at 26 November 2001 of which I was aware and that had material economic or fiscal implications.

Hon Dr Michael Cullen
Treasurer and Minister of Finance
12 December 2001

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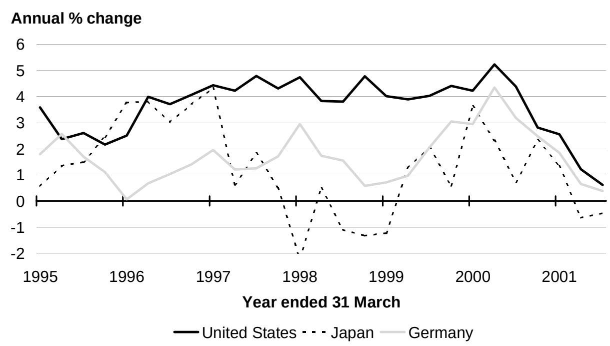
Economic and Fiscal Overview

Economic Outlook

Despite the slowing global economy, New Zealand has continued to hold up well…

- The extent of the global slowdown has been greater than anticipated. Despite this, the New Zealand economy has performed well through 2001.
- Underlying the global weakness is the synchronised nature of the downturn, with both the US and Japanese economies slipping into recession, and growth slowing markedly across the Euro-zone. Following the terrorist attacks, sentiment around global growth prospects changed markedly for the worse.

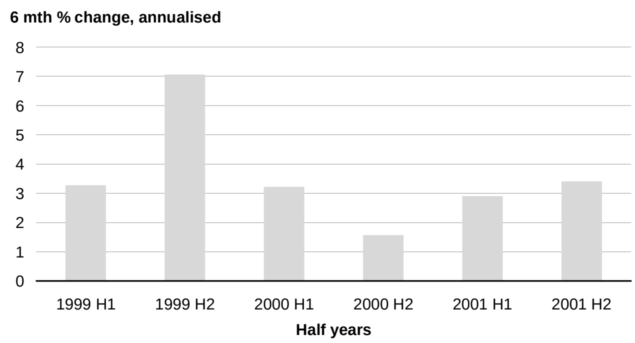
Figure 1.1 – Synchronised downturn



Source: Primark Datastream

- Since the 2001 Budget was published, trading partner growth prospects have been revised down from 2.4% to 1.4% in 2001, and from 3.6% to 1.9% in 2002.
- *Consensus* forecasts project a recovery in global growth in the second half of 2002.
- Importantly for New Zealand, downward revisions to Australian growth prospects have been more moderate.
- Looking forward, the New Zealand economy seems somewhat better positioned than in past downturns to cope with weaker world growth. Recent export success and employment and wage growth have led to strong farm and household income gains. Export commodity prices have held up well, the exchange rate is competitive, interest rates have been cut, and oil prices have fallen.

Figure 1.2 – New Zealand GDP growth profile



Sources: Statistics New Zealand, The Treasury

*2001 H2 Treasury forecast

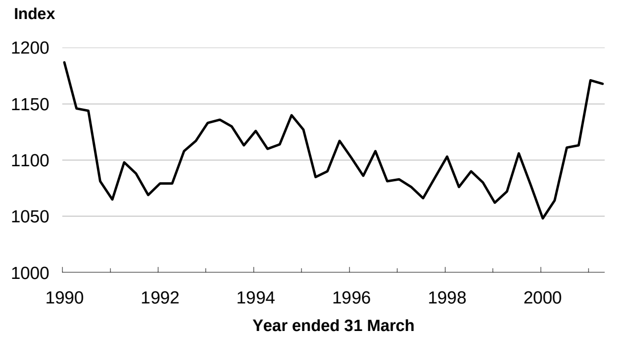
- In the year to March 2002, we expect New Zealand's GDP growth of 3.1% to outperform the OECD average.

…although weaker world growth will affect export prices, volumes and domestic confidence

- Nevertheless, New Zealand is beginning to feel the impact of weaker world growth with lower tourist arrivals, weaker export prices, and negative shocks to domestic business and consumer confidence.

- Looking forward, we expect export demand and prices will continue to weaken over the short term, and for this drop in export income to flow through into the domestic economy. Underlying our Central Forecast is a considerable deterioration in the terms of trade as prices for our commodity exports are expected to fall away quicker than import prices.

Figure 1.3 –Terms of Trade

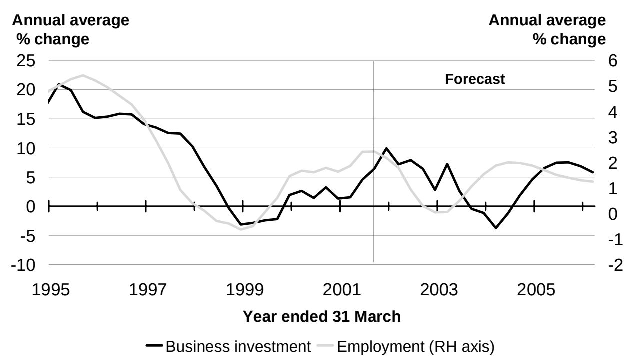


Sources: Statistics New Zealand, The Treasury

- Going into the first half of 2002, greater uncertainty and softening incomes have an impact on the willingness of both businesses and households to employ, spend and invest.

- Firms may re-evaluate their investment decisions in light of increased uncertainty and expected lower income growth, and defer investment projects until global growth picks up from mid-2002. We therefore expect a fall in business investment over the next few quarters. However, recent high levels of capacity utilisation, healthy balance sheets, lower interest rates and the expectation of a recovery all provide some offset.

Figure 1.4 – Investment and employment



Sources: Statistics New Zealand, The Treasury

- We also expect firms to be more cautious about taking on additional employees over the short term. However, the extent of the slowing in employment growth is likely to be more modest than in previous downturns given the relatively tight labour market. The unemployment rate is expected to peak at just under 6% in late 2002 and early 2003.

- Households also adopt a "wait and see" attitude and consumption is expected to remain subdued throughout 2002 as the labour market weakens. However, recent income gains, falling interest rates and falling oil prices suggest that consumption should remain positive.

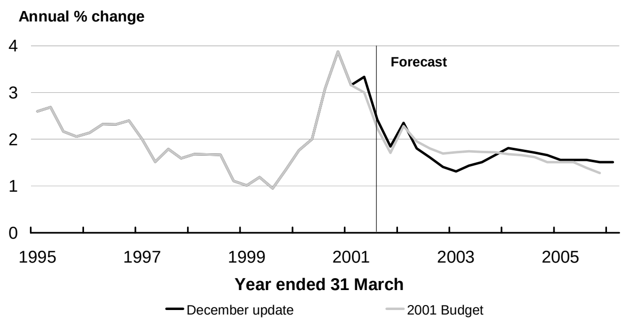
Growth is expected to pick up towards the end of 2002, as global growth recovers

- As global growth begins to recover in the second half of 2002, the New Zealand economy regains momentum in late 2002 as export growth resumes and business investment picks up. While domestic confidence rebounds, we still expect firms to tread cautiously, and growth in market investment remains modest until 2003. As firms resume hiring, consumption also picks up strongly in 2003, reinforced by low interest rates. Together with inward migration, this provides support to residential investment.

The inflation outlook remains relatively benign

- With reduced growth and weaker global price pressures (including for oil) the outlook for inflation in the short term is relatively benign. Our Central Forecast has CPI inflation falling back to the mid-point of the Reserve Bank's target range by the end of 2002, as pricing pressures ease on the back of weaker unit labour costs and softer world export and import prices.
- As growth picks up over 2002/03, the Reserve Bank is expected to steadily return the Official Cash Rate to our assumed neutral level of around 6.0%.

Figure 1.5 – CPI inflation

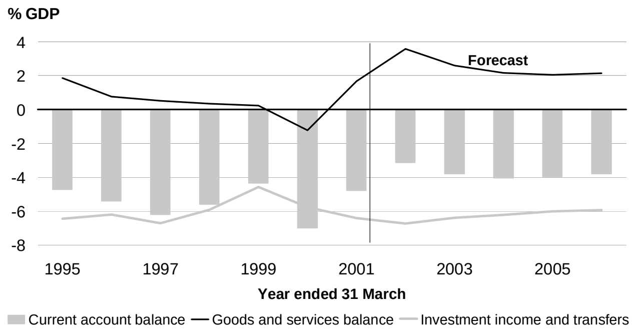


Sources: Statistics New Zealand, The Treasury

The rate of improvement slows in the current account deficit

- Slower export volume growth in the short term, together with the expected fall in the terms of trade, sees a modest reversal in recent improvements in the current account deficit. The deficit is expected to improve to about 3% of GDP in the year to March 2002, largely on the back of recent good export volume and price growth. However, as weaker world growth begins to impact on export volumes and prices and investment flows, the current account deficit deteriorates, although this is slightly offset by lower imports as a result of weaker domestic demand. The deficit is expected to be about 4% of GDP in 2004 and 2005. Further out, a continued steady improvement in service exports underpins an improvement in the current account balance at the end of the forecast.

Figure 1.6 – Current account



Sources: Statistics New Zealand, The Treasury

Nominal GDP growth is more cyclical in the short term

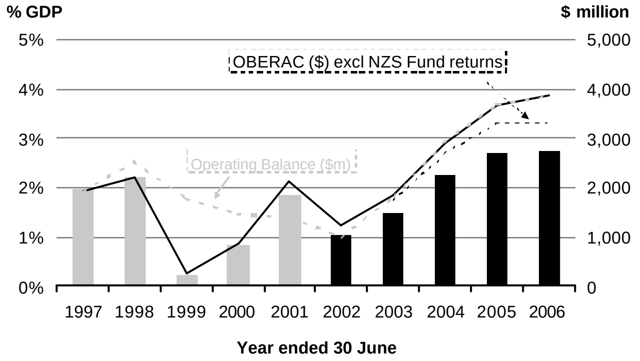
- The profile for nominal GDP growth is more cyclical than in the 2001 Budget. Nominal growth in the year to March 2002 is forecast to be 5.9%, partly as a result of the strong June quarter outturn. In the year to March 2003, lower real growth and inflation leads nominal growth to fall to 2.6%, before picking up to solid growth of 4% to 5% further out. This increased cyclical nature of nominal GDP flows through to the profile for tax revenue.

Fiscal Outlook

Operating balance rises over the forecast horizon…

- The forecast 2001/02 operating balance is $1.0 billion (0.8% of GDP), including ACC and Government Superannuation Fund (GSF) liability movements of $200 million and $40 million respectively.
- Excluding the ACC and GSF valuations, the OBERAC (operating balance excluding revaluations and accounting policy changes) for 2001/02 is $1.2 billion (1.0% of GDP).

Figure 1.7 – OBERAC (% of GDP and $ million)



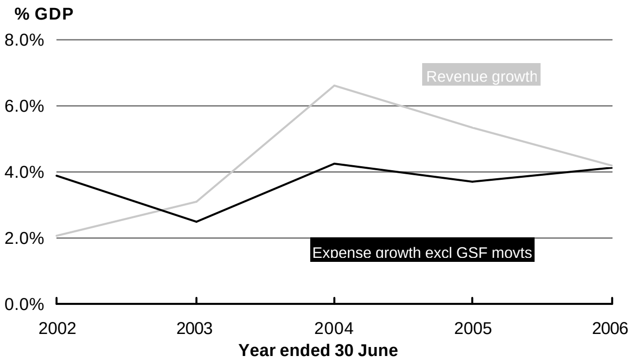
Source: The Treasury

- While the operating balance decreases from 2000/01, over the forecast period, the operating balance is expected to rise to 2.7% of GDP in 2005/06 ($3.8 billion).
- Updated operating balance forecasts are lower than 2001 Budget, with the biggest change occurring in 2002/03.

…due to tax revenue growth remaining higher than expense growth despite an economic downturn…

- The forecast increase in tax revenue has reduced across all years relative to the 2001 Budget owing to lower forecast economic growth.
- Lower tax revenue has been partly offset by lower benefit expenses of an average of around $250 million across all years, owing largely to lower unemployment benefit payments.
- Health expenses are a key feature of the *December Update* with an extra $2.4 billion committed over the next three years. This is in addition to funding to meet demographic and other forecast changes.

Figure 1.8 – Revenue and expense growth



Source: The Treasury

- Total revenue growth averages around 5% per annum, while expense growth averages around 4% per annum over the forecast period.

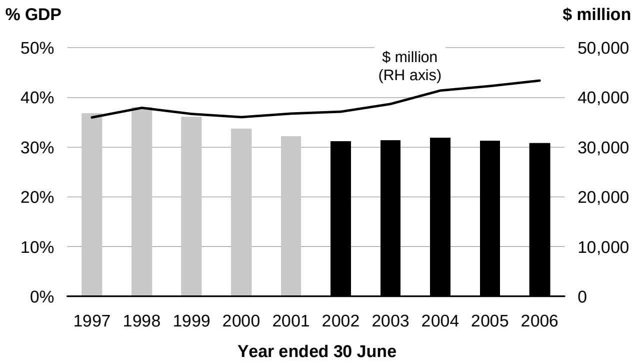
...enabling the Government to continue to apply surplus cash to its investment programme

- The rising operating surplus translates to a similar level of cash flows from operations, generating approximately $13.2 billion operating cash surpluses over the forecast period to fund investing activity.
- Investment outlays of $23.6 billion outweigh operating cash surpluses by $10.6 billion. These outlays include: maintaining and improving the existing asset base ($9.1 billion) and providing injections of around $1 billion (mostly related to hospitals and the establishment of Kiwibank); investing in the New Zealand Superannuation Fund ($7.9 billion); and funding advances ($5.7 billion). The advances comprise student loans of $3.9 billion with the remaining $1.8 billion relating to refinancing Crown entity private sector debt (DHBs and Housing New Zealand Corporation) and other miscellaneous advance activity.
- Relative to the 2001 Budget, the forecast cash outflows for the period 2000/01 to 2004/05 have increased by around $1.5 billion. This primarily reflects the Air New Zealand recapitalisation package (around $1 billion), higher student loan advances and refinancing of DHB debt (around $0.7 billion combined), partially offset by higher than expected surplus cash position of $0.5 billion in 2000/01.

Debt as a percentage of GDP rises slightly, before falling again

- Gross debt increases by $6.6 billion in nominal terms over the forecast period. This, in conjunction with a decrease in marketable securities and deposits of $3.9 billion, will fund the shortfall between operating cash flows and investment outlays.
- Over the period, gross debt falls as a percentage of GDP from around 32% at the start of the forecast period to slightly under 31% by 2005/06. For the same period, net debt starts at 17.5% of GDP and is 17.6% by 2005/06.

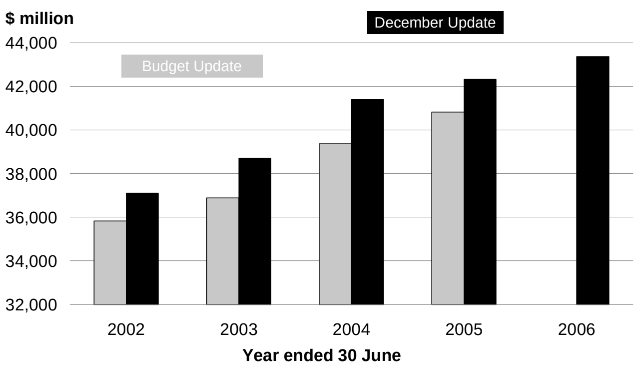
Figure 1.9 – Gross debt (% of GDP and $)



Source: The Treasury

- Gross and net debt rise slightly in the middle of the forecast period. This is mainly due to lower economic growth in earlier years and bringing forward capital spending to better meet expected demands (refer to page 54 for a fuller description).
- Both gross and net debt increase relative to the 2001 Budget. The key changes in funding requirements for the comparable period (2001/02 to 2004/05) are due

Figure 1.10 – Gross debt (comparison with the 2001 Budget*)*



Source: The Treasury

mainly to lower forecast cash generated from operating surpluses, higher than forecast student loans and the increase in the capital provisions to accommodate the Air New Zealand recapitalisation package.

- The domestic bond programme has been revised from $3.5 billion to $4.1 billion for 2001/02. For a full explanation of the revision refer to page 56 of the Fiscal Outlook chapter.

Government policy decisions

- In addition to the Health package mentioned earlier, the Government has allocated a further $176 million of the $6.126 billion three-year fiscal provision since the 2001 Budget. Table 1.1 provides a breakdown of the Government's three-year fiscal provision since 1999/2000 to 2002/03:

Table 1.1 – Fiscal provisions

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
December 2001 Health package	-	-	-	400	400
Budget 2002 provision[1]	-	-	89	450	539
Total	420	1,201	1,806	2,699	6,126

1: $20 million of the Budget 2002 provision has been rephased from 2001/02 to 2002/03.

- As part of the 2001 Budget, the Government set capital provisions of $850 million for 2003/04 and 2004/05 (and $550 million has been set for the new 2005/06 financial year). In addition, a further $1 billion has been added to the capital provisions to accommodate the Air New Zealand recapitalisation package.

- Spending in 2004/05 and 2005/06 has, however, been rephased into 2002/03 and 2003/04 to better reflect planned commitments. The key capital pressures are in the social sector (hospitals and schools), prisons, developing the Government's transport strategy, re-equipping the Defence Force and recapitalising Air New Zealand.

Table 1.2 – Capital provisions

Capital provisions ($ million, GST inclusive)	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**Total**
Capital provision - Budget 2001	315	360	850	850	-	2,375
Establish 2005/06 provision					550	550
December Update decisions	76	27	1	-	5	109
Remaining provision	239	333	849	850	545	2,816
Increase to provision for Air New Zealand	1,035	-	-	-	-	1,035
December Update rephasing of provision	-	413	89	(387)	(115)	-
Capital provision - *December Update*	**1,274**	**746**	**938**	**463**	**430**	**3,851**

NOTE: The amount of capital provision in Table 1.2 does not exactly reconcile to the level of capital provision contained in the fiscal forecasts due to rounding.

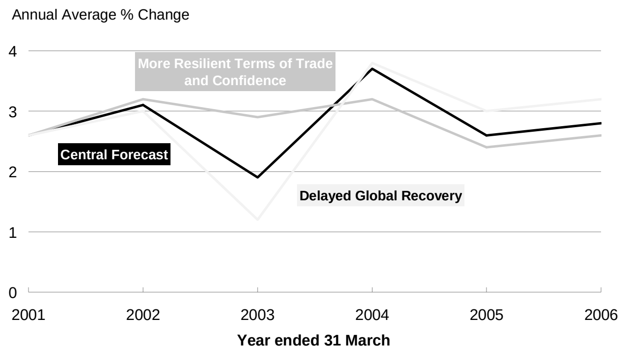
The fiscal forecasts are highly sensitive to risks around the economic forecasts

- Underpinning our Central Forecast are the international assumptions of *Consensus* forecasts, and key judgements made about the "transmission mechanisms" through which weaker global growth is transmitted to New Zealand, including through lower export volumes and prices, and weaker confidence feeding into domestic demand.

- However, events may turn out differently from our Central Forecast.

- World growth may evolve differently from that currently built into *Consensus* forecasts. Growth may not rebound as quickly as expected and remain sub-trend for most of 2002, with a more accelerated pick-up in 2003 and 2004. In this scenario, weaker world demand would negatively affect export volumes and prices, with the lower export income feeding through into the domestic economy.

Figure 1.11 – Real GDP growth

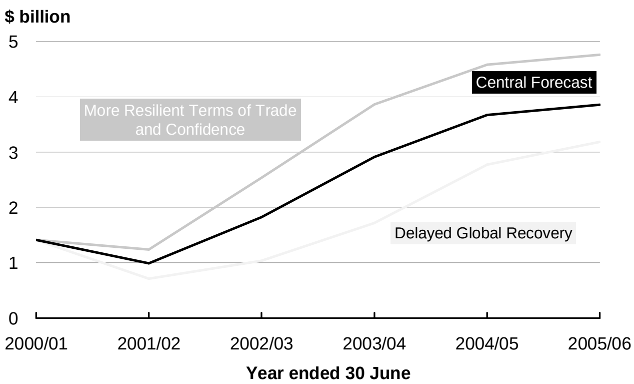


Sources: Statistics New Zealand, The Treasury

- Alternatively, weaker world growth may have a less pronounced impact on the New Zealand economy. In this case, our export prices may not fall as much, and domestic confidence could rebound quickly, feeding into stronger domestic demand.

- These effects will flow through into the Government's operating balance. Weaker world growth will lead to a lower operating balance, as lower economic growth and inflation both reduce nominal GDP relative to the Central Forecast, and expenses increase with higher unemployment. However, if stronger domestic demand occurs the operating balance will be higher throughout the forecast period.

Figure 1.12 – Operating balance



Sources: Statistics New Zealand, The Treasury

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

Summary Tables

Table 1.3 – Economic indicators[1]

(Annual average % change, March years)	2001 Actual	2002 Forecast	2003 Forecast	2004 Forecast	2005 Forecast	2006 Forecast
Consumption	0.3	2.1	1.7	3.2	2.4	2.6
Investment	(0.4)	4.5	(1.1)	7.4	5.8	3.3
Stock change[2]	(0.3)	(1.1)	0.7	0.1	0.0	0.0
Gross National Expenditure	**(0.2)**	**1.4**	**1.7**	**4.2**	**3.1**	**2.7**
Exports	6.8	2.9	2.3	7.3	5.4	4.5
Imports	0.4	0.2	1.4	9.8	7.3	4.7
GDP (Production Measure)	**2.6**	**3.1**	**1.9**	**3.7**	**2.6**	**2.8**
- *annual % change*	1.1	2.8	3.1	3.2	2.6	2.8
Employment[3]	2.2	1.5	(0.1)	2.3	1.5	1.3
Unemployment[4]	5.4	5.6	5.7	5.2	5.2	5.2
Wages[5]	2.4	3.7	3.7	3.4	3.5	3.1
CPI inflation[6]	3.1	2.4	1.3	1.8	1.6	1.5
Current account balance[7]	(4.8)	(3.1)	(3.8)	(4.0)	(4.0)	(3.8)
TWI[8]	50.5	49.3	51.3	53.9	55.0	55.0
90-day bank bill rate[8]	6.4	4.8	5.8	6.0	6.0	6.0

Sources: Statistics New Zealand, Primark Datastream, The Treasury

NOTES:
1 Finalised 21 November 2001.
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 This is the CPI-consistent series targeted by the Reserve Bank. Annual percentage change, March quarter.
7 Year to 31 March, percentage of GDP
8 Average for the March quarter

Table 1.4 – Fiscal indicators

($ million)	2001 Actual	2002 Forecast	2003 Forecast	2004 Forecast	2005 Forecast	2006 Forecast
Operating Balance						
Revenue	39,492	40,290	41,531	44,283	46,630	48,582
Expenses						
Allocated expenses	(38,186)	(39,513)	(40,097)	(41,301)	(42,368)	(43,263)
Unallocated provisions for future initiatives	-	(90)	(450)	(975)	(1,475)	(2,376)
SOE/CE surpluses	103	298	839	901	883	911
Operating Balance	**1,409**	**985**	**1,823**	**2,908**	**3,670**	**3,854**
Less revaluations	698	243	-	-	-	-
OBERAC	**2,107**	**1,228**	**1,823**	**2,908**	**3,670**	**3,854**
Less contributions and returns on NZS Fund	-	(614)	(1,291)	(2,010)	(2,472)	(2,709)
Available after NZS Fund Requirements	**2,107**	**614**	**532**	**898**	**1,198**	**1,145**
Less						
Unallocated capital provisions	-	(1,269)	(740)	(938)	(463)	(435)
Physical asset purchases and other	(682)	(1,077)	(1,391)	(1,285)	(806)	(878)
Movement in Net Debt	**1,425**	**(1,732)**	**(1,599)**	**(1,325)**	**(71)**	**(168)**
Net Debt	**21,396**	**21,703**	**23,302**	**24,627**	**24,698**	**24,866**
Net Debt (% of GDP)	**17.5%**	**18.2%**	**18.9%**	**19.0%**	**18.2%**	**17.6%**
Domestic Bond Programme[1]	3,572	**4,100**	5,070	5,620	3,730	874
Nominal GDP	114,275	118,980	123,271	129,725	135,373	141,076
Fiscal Indicators as a % of GDP						
Gross debt	32.2%	31.2%	31.4%	31.9%	31.3%	30.7%
Net debt	17.5%	18.2%	18.9%	19.0%	18.2%	17.6%
Net worth	10.0%	10.5%	11.6%	13.2%	15.4%	17.5%
Revenue	34.6%	33.9%	33.7%	34.1%	34.4%	34.4%
Expense	33.4%	33.3%	32.9%	32.6%	32.4%	32.4%
OBERAC	1.8%	1.0%	1.5%	2.2%	2.7%	2.7%
Operating balance	1.2%	0.8%	1.5%	2.2%	2.7%	2.7%
New Zealand Superannuation Fund						
Fund asset returns (after tax)[2]	-	14	91	210	372	559
Fund assets (year end)	-	614	1,904	3,914	6,379	9,091
% of GDP	0.0%	0.5%	1.5%	3.0%	4.7%	6.4%

1 The figure for 2002 is the face value of the bond programme. The actual cash raised by the programme is forecast to be $4,156 million, as the bonds are forecast to be issued at a premium. 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.

Stop press – additional policy decisions

Since the finalisation of the fiscal forecasts on 26 November 2001 the decisions outlined below have been finalised by the Government. These decisions have not been incorporated into the forecasts.

- Paid Parental Leave – On 3 December, the Government formalised the arrangements for Paid Parental Leave, which will be implemented from 1 July 2002. The costs are expected to be around $40 million per year from 2002/03, which will be met by from the remaining fiscal provision (which is included in the forecasts and therefore have no impact on the operating balance or debt.
- Teachers Pay Settlement – Agreement was reached on 6 December with the Post Primary Teachers Association on a new Secondary schools teachers collective employment contract. Although the costs have yet to be finalised they are expected to be around $30 million per year from 2002/03. The costs will be met from the remaining fiscal provision and therefore have no impact on the operating balance or debt.