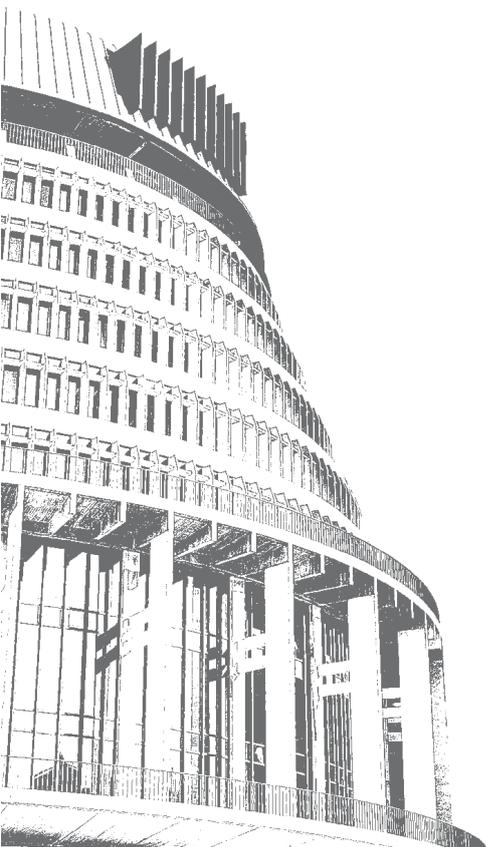




Hon Dr Michael Cullen
MINISTER OF FINANCE



Half Year Economic & Fiscal UPDATE 2007

18 December 2007

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 5 December 2007 that were communicated to me, and of other economic and fiscal information available to the Treasury in accordance with the provisions of the Public Finance Act 1989.



John Whitehead
Secretary to the Treasury

5 December 2007

This Economic and Fiscal Update has been prepared in accordance with the Public Finance Act 1989. 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 Public Finance Act 1989.

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 5 December 2007 of which I was aware and that had material economic or fiscal implications.



Hon Dr Michael Cullen
Minister of Finance

5 December 2007

Executive Summary

The short-term economic and fiscal outlook for New Zealand has strengthened since the *Budget Update*. The New Zealand economy is expected to grow solidly over 2007/08. The fiscal position is forecast to strengthen further with the operating balance before gains and losses (OBEGAL) and excluding New Zealand Superannuation (NZS) Fund net revenue expected to come in at \$6.4 billion over 2007/08.

Economic growth is forecast to slow in 2008/09 before rebounding in later years to around its medium-term trend. Consumer price inflation is expected to be near the top of the 1% to 3% per annum target range through much of the forecast period. This economic outlook will see the fiscal position continue to strengthen, notwithstanding a forecast fall in the OBEGAL towards a level more consistent with the Government's long-term fiscal objectives. This fall reflects past and prospective Budget decisions, including the incorporation of a contingency for a reduction in tax revenue. The latter is assumed to be directed at personal income tax cuts and to take effect from 1 April 2009.

The economic and fiscal forecasts are subject to greater-than-usual uncertainty, with current turmoil in global financial markets and the future path of the terms of trade being the main sources of risk.

Economic Outlook

The economic expansion of the past nine years is forecast to continue with real Gross Domestic Product (GDP) growth of 2% to 3% per annum over the next five years. Real GDP growth is expected to rise to 3% in the March 2008 year, reflecting the recent upturn in domestic demand, before easing to around 2% a year later as high interest rates weaken domestic demand growth. Higher growth in exports relative to imports is forecast to lift real GDP growth back to almost 3% per annum from the March 2010 year.

Table 1 – Major economic parameters

March years (annual average % change)	2007/08 Estimate	2008/09 Forecast	2009/10 Forecast	2010/11-2011/12 Forecast
Real GDP	3	2	3	3
Employment	1½	1	1	1
Wages	4	4½	4½	4
Consumer prices	3	3	2½	2½

Note: Figures have been rounded to the nearest ½%; consumer price inflation is measured as an annual % change.

Source: The Treasury

High dairy prices mean the terms of trade are expected to be a lot stronger than previously forecast, providing a large boost to export receipts and activity in the next year and beyond. Solid global growth is expected to underpin the economic forecasts, but there are downside

risks to this outlook owing to renewed volatility in financial markets and signs of lower growth in the United States and some other regions of the world. A slowing of global growth would have a negative impact on demand for New Zealand exports and the terms of trade.

High short-term interest rates, in response to ongoing inflation pressure, have contributed to slower domestic demand growth since mid-2007 and that is forecast to continue. Lower net migration, high fuel prices and lower house price growth are also likely to have a dampening effect. Partially offsetting these forces are high farm incomes, a tight labour market that sees ongoing income growth, and an assumption of personal tax cuts from 1 April 2009.

Throughout the forecast period, the economy is expected to be operating at, or above, capacity. As a result, price pressures and the current account deficit that have built up over recent years are expected to persist and unwind only gradually. The exchange rate is forecast to fall from mid-2008 back towards its long-run equilibrium late in the forecast period.

Nominal GDP is forecast to be much higher than in the *Budget Update* throughout the forecast period. The key drivers of this stronger outlook are the higher terms of trade, driven by high world dairy prices, and a higher inflation outlook.

Fiscal Outlook

The OBEGAL excluding NZS Fund net revenue is forecast to rise to \$6.4 billion (3.6% of GDP) in the current June 2008 year before declining to \$4.1 billion next year and \$3.8 billion the year after. After making allowance for capital expenditure, a small cash surplus is forecast for 2007/08 with small deficits thereafter. Accumulated cash deficits are \$2.6 billion in the forecast period, compared to \$5.7 billion forecast at the *Budget Update*.

Table 2 – Summary of fiscal aggregates

June years	2007/08 Forecast	2008/09 Forecast	2009/10 Forecast	2010/11 Forecast	2011/12 Forecast
OBEGAL (\$b) ^a	6.4	4.1	3.8	3.7	3.5
% of GDP	3.6	2.2	2.0	1.8	1.7
Residual cash	0.8	(0.8)	(0.8)	(0.9)	(0.9)
% of GDP	0.4	(0.4)	(0.4)	(0.4)	(0.4)
GSID (% of GDP) ^b	18.7	17.7	16.3	17.0	15.6
Net core Crown debt (% of GDP) ^c	(7.4)	(8.7)	(10.0)	(11.3)	(12.4)

Note: a) excludes NZS Fund net revenue; b) excludes Reserve Bank Settlement Cash; c) includes NZS Fund

Source: The Treasury

Core Crown revenue is forecast to fall from 35.0% of GDP in the June 2008 year to 34.3% in the June 2012 year, which reflects the Business Tax Reform announced in Budget 2007 and an assumed revenue reduction contingency. This contingency is assumed to be around \$1.5 billion per annum from 1 April 2009.

Core Crown expenses are forecast to increase by around 1% of GDP between the June 2008 year and the June 2012 year. The increase in expenses largely arises from recent initiatives such as the enhancements to KiwiSaver announced in Budget 2007. Gross sovereign-issued debt (GSID) excluding Reserve Bank Settlement Cash falls from 18.7% to 15.6% of GDP by the end of the forecast period.

Economic and fiscal forecasts – Finalisation dates and key assumptions

Finalisation dates	
Economic data	2 November
Economic forecasts (refer <i>Chapter 1</i>)	8 November
Tax revenue forecasts	14 November
Fiscal forecasts (refer <i>Chapter 2</i>), including:	5 December
– Government decisions and circumstances	5 December
– Actual asset revaluations	31 October
– Foreign exchange rates	31 October
Specific fiscal risks (refer <i>Chapter 4</i>)	5 December
Contingent liabilities and commitments (refer <i>Chapter 4</i>)	31 October

Key assumptions

Global economic activity – forecasts for global economic growth, inflation and interest rates were taken from the October 2007 *Consensus Forecasts*. Economic growth for our top 20 trading partners is expected to decline from an estimated 4.0% in 2007 to 3.5% in 2011, compared with stable growth of 3.6% throughout the period in the *Budget Update*. There are considerable risks associated with this outlook which are discussed in the *Economic and Tax Outlook* and *Risks and Scenarios* chapters.

Global inflation and interest rates – as a result of the recent robust growth for most of our major trading partners, inflation is also expected to be higher than at the time of the *Budget Update*. The outlook for interest rates is mixed, with lower rates expected in the United States; rates are expected to stay low for longer in Japan in the light of low inflation outturns, but the outlook is for higher rates in the near term in the euro area and Australia.

Oil prices – we have assumed that the price of West Texas Intermediate (WTI) crude oil will decline from an estimated US\$90 per barrel in the fourth quarter of 2007 and level off just below US\$75 per barrel in the fourth quarter of 2010. These projections, which are based on the average futures prices recorded in the month before finalisation of the forecast, range from one-third higher than in the *Budget Update* in the near term to around 12% higher later in the period. This projection of oil prices is a risk, as discussed in the *Risks and Scenarios* chapter.

Terms of trade – higher export prices, especially for dairy products, are expected to lift the goods terms of trade (measured on a System of National Accounts basis) throughout the forecast period by an average of 8% compared with the *Budget Update*. The terms of trade peak in the final quarter of 2008 and decline 5% by the end of the forecast period.

Monetary conditions – it is assumed that the New Zealand dollar exchange rate will decline from 71 on the Trade Weighted Index (TWI) in the final quarter of 2007 to 57 at the end of the forecast period. Ninety-day interest rates are assumed to average 8.5% from the first quarter of 2008 until the third quarter of 2009, after which they will start to decline, reaching 7.3% at the end of the period.

Net migration – the net inflow of permanent and long-term migrants is expected to decline from 8,300 in the year to September 2007 to 6,200 in the year to March 2008, before recovering to 7,400 in the following March year and returning to its average over the past decade of 10,000 per annum in subsequent years.

Revenue reduction contingency – the forecast incorporates a contingency for a reduction in tax revenue of \$1.5 billion per annum from April 2009, rising to \$1.7 billion in the year to June 2012 largely owing to income growth. The impact of this reduction, which we have assumed will be applied to personal taxes, is discussed in the *Economic and Tax Outlook* chapter.

Emissions Trading Scheme (ETS) – the economic forecast does not include any provision for the ETS which is being introduced by the Government to encourage efforts to reduce greenhouse gas emissions and to help meet New Zealand's obligations under the Kyoto Protocol. Final decisions on the scheme had not been taken when the forecasts were finalised in early November 2007. At an aggregate level, the scheme is considered unlikely to lead to any significant reduction in output, but there will be different effects on different sectors of the economy and it will result in higher prices for carbon-sourced energy. The economic impacts of the scheme will be incorporated in the 2008 *Budget Update*. For details of its fiscal implications, see the *Fiscal Outlook* chapter.

Climate – agricultural growing conditions and the level of hydro electricity storage lakes are assumed to be normal over the forecast period.

Fiscal forecasts – the fiscal forecasts have been prepared in accordance with the Public Finance Act 1989. They are based on the Crown's accounting policies and assumptions. The financial statements presented in the *Half Year Update 2007* have been prepared in accordance with New Zealand equivalents to International Financial Reporting Standards. A summary of the key economic assumptions that are particularly relevant to the fiscal forecasts is provided below (Table 3). These figures are on a June-year-end basis to align with the Crown's balance date of 30 June. The figures in Table 1 above and in the *Economic and Tax Outlook* chapter are for the year to 31 March.

Table 3 – Key economic assumptions for fiscal forecasts

June years	2007/08		2008/09	2009/10	2010/11	2011/12
	BEFU	HYEFU	HYEFU	HYEFU	HYEFU	HYEFU
Real GDP (ann avg % chg)	2.3	2.7	2.3	2.8	2.7	2.9
Nominal GDP (\$m)	173,187	178,199	186,956	194,528	202,865	212,364
CPI (ann avg % change)	2.4	2.7	2.9	2.7	2.6	2.5
Govt 10-year bonds (ann avg %)	6.1	6.4	6.5	6.6	6.6	6.4
90-day bill rate (ann avg %)	7.9	8.6	8.5	8.3	8.0	7.5
Unemployment rate (ann avg %)	3.9	3.8	3.9	3.9	4.1	4.1
Full-time equivalent employment (ann avg % change)	1.3	1.3	0.9	1.1	0.9	0.9
Current account (% of GDP)	-7.2	-6.9	-6.4	-7.2	-6.8	-6.3

Source: The Treasury