Summary

After annual average growth of 3.1% in the year to March 2008, the economy is forecast to record two years of sub-trend growth of 1.5% in the year to March 2009 and 2.3% in the year to March 2010. These *Budget Update* forecasts show a more cyclical path for the economy than in the *Half Year Update*.

The operating balance before gains and losses (OBEGAL) is forecast to fall from 2.9% of GDP in the year to June 2008 to 0.7% in the year to June 2009, consistent with keeping gross sovereign-issued debt excluding Reserve Bank Settlement Cash around 20% of GDP. The fall in OBEGAL reflects past and *Budget 2008* decisions, including the incorporation of a cut in personal taxes from 1 October 2008.

In addition to the usual risks to any economic and fiscal forecast, there are now greater risks on the downside, particularly those arising from a lack of stability in global financial markets.

Economic Outlook

The New Zealand economy is expected to grow by 2.5% per annum on average during the forecast period, somewhat below the 3.1% per annum experienced over the past decade. Real GDP growth is expected to fall from 3.1% in the year to March 2008 to 1.5% the next year because of factors such as recent drought conditions, high interest rates, falling house prices and higher petrol and food prices. From the year to March 2011, real GDP growth is forecast to rebound to around 3% per annum.

Table 1 – Major economic parameters

March years (annual average % change)	**2007/08 Estimate**	**2008/09 Forecast**	**2009/10 Forecast**	**2010/11 Forecast**	**2011/12 Forecast**
Real GDP	3.1	1.5	2.3	3.2	3.0
Employment	1.4	1.4	0.2	0.3	1.0
Wages	4.1	4.2	4.7	4.4	4.0
Consumer prices	3.4	3.2	2.8	2.8	2.8

Note: Employment is on a full-time equivalent basis; consumer price inflation is measured as an annual % change.

Source: The Treasury

Domestic demand slowed from mid-2007, and is forecast to remain subdued, as a result of factors such as higher interest rates, falling house prices, lower net migration inflows and higher prices for petrol and food. Interest rates have been elevated because of ongoing inflation pressures and global credit constraints. Personal income tax cuts, growing labour incomes and high farm incomes (albeit lower owing to drought) partially offset these forces.

The recent drought in much of the country will negatively affect agricultural production and commodity exports in the coming year. Weaker growth in the world economy is also expected to dampen export growth. However, strong export prices are expected to provide a large boost to export receipts. Higher world prices for dairy products boosted the terms of trade to a 33-year high in late 2007 and are forecast to fall but stay relatively high.

Consumer price inflation is expected to remain elevated despite a period of sub-trend growth in the economy. Ongoing inflation reflects high food and energy prices and a decline in the exchange rate from early 2009.

Nominal GDP growth is forecast to slow over the next two years, largely as a result of lower growth in real GDP. Nevertheless, strong terms of trade, driven by high world dairy prices, and an outlook for relatively high inflation continue to support nominal GDP.

There are a number of risks to the forecasts. These include the usual upside and downside risks to any economic and fiscal forecast such as different profiles for the terms of trade, the exchange rate and domestic demand. There is also a set of more extreme risks, albeit with a smaller probability, that could arise if recent financial market turmoil is more prolonged and/or deeper than we have assumed in the main forecast.

Fiscal Outlook

The fiscal position has strengthened over recent times, and operating and cash surpluses have risen to a level in excess of that required to meet the Government's long-term fiscal objectives.

Looking forward, core Crown revenue (excluding the New Zealand Superannuation (NZS) Fund), while continuing to grow in nominal terms, is forecast to fall from 34.3% of GDP in the June 2008 year to 32.6% in the June 2012 year. This fall primarily results from last year's decision to cut the corporate tax rate and the incorporation of the cut in personal taxes announced in *Budget 2008*.

Core Crown expenses are forecast to increase by around 1.2% of GDP between the June 2008 year and the June 2012 year. The increase in expenses largely arises from recent initiatives and KiwiSaver costs.

As a result, OBEGAL falls and cash surpluses become deficits. These deficits are met with a reduction in financial assets while gross sovereign-issued debt (GSID) excluding Reserve Bank Settlement Cash falls from 17.6% to 16.8% of GDP by the end of the forecast period.

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]	**5.2**	**1.4**	**1.0**	**0.5**	**0.2**
% of GDP	2.9	0.7	0.5	0.3	0.1
Residual cash	**0.9**	**(3.5)**	**(3.3)**	**(3.4)**	**(3.5)**
% of GDP	0.5	(1.9)	(1.7)	(1.7)	(1.6)
GSID (% of GDP)[b]	**17.6**	**17.5**	**16.8**	**17.8**	**16.8**
Net core Crown debt (% of GDP)[c]	**(6.2)**	**(6.1)**	**(6.1)**	**(6.1)**	**(6.1)**

Note: a) excludes NZS Fund; b) gross sovereign-issued debt excluding Reserve Bank Settlement Cash; c) includes NZS Fund financial assets.

Source: The Treasury

Economic and Fiscal Forecasts – Finalisation Dates and Key Assumptions

Finalisation dates

Text finalised	14 May
Economic data	15 April
Economic forecasts (refer *Chapter 1*)	1 May
Tax revenue forecasts	2 May
Fiscal forecasts (refer *Chapter 2*), including:	9 May
• Government decisions and circumstances	9 May
• Actual asset revaluations	29 Feb
• Foreign exchange rates	29 Feb
Specific fiscal risks (refer *Chapter 4*)	7 May
Contingent liabilities and commitments (refer *Chapter 4*)	31 Mar

Key assumptions

Global economic activity – Economic growth for our top 20 trading partners (eg, Australia, the United States, China) is expected to fall from an estimated 4.0% in 2007 to 3.0% in 2008 and 3.2% in 2009, compared with 3.8% in 2008 and 3.7% in 2009 in the *Half Year Update*. Trading partner growth forecasts are based on March 2008 Consensus Forecasts with additional judgements. We assume trading partner growth will be 0.3 percentage points lower than March 2008 Consensus Forecasts in 2008 and 2009 because Consensus Forecasts tend to adjust slowly during a slowdown of growth. 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 previous robust economic growth and rising prices for food and energy, inflation among our major trading partners is expected to be higher than at the time of the *Half Year Update*. However, the outlook is for lower interest rates in the United States, Japan and the Euro area because of the weaker economic outlook. The outlook is for higher rates in Australia than in the *Half Year Update* owing to recent high inflation outturns.

Oil prices – We have assumed the price of West Texas Intermediate (WTI) crude oil will rise from US$98 per barrel in the March 2008 quarter to US$111 per barrel in the June 2008 quarter and then fall to just above US$100 per barrel in the first quarter of 2012. These projections, which are based on the futures prices from the New York Mercantile Exchange recorded on 15 April 2008, are around 35% higher than in the *Half Year Update* over the forecast period. There are upside risks to this forecast, at least in the short term, as oil prices rose over US$125 in May 2008, after these forecasts were finalised.

Terms of trade – Forecasts for the goods terms of trade (measured on a System of National Accounts basis) are similar to the *Half Year Update*. The terms of trade are expected to have peaked in the first quarter of 2008 and decline 8% by the end of the forecast period.

Monetary conditions – It is assumed that the New Zealand dollar exchange rate will decline from 71.9 on the Trade Weighted Index (TWI) in the first quarter of 2008 to 56.3 at the end of the forecast period. Ninety-day interest rates were 8.8% in the March 2008 quarter and are assumed to remain around this level until the first quarter of 2009, when they will start to decline, reaching 7.1% at the end of the period.

Net migration – The net inflow of permanent and long-term migrants is expected to decline to around 4,000 in the year to September 2008, before recovering to around 6,000 in the year to March 2009, 8,000 in the year to March 2010 and 10,000 per annum in subsequent years (its average over the past decade).

Emissions Trading Scheme (ETS) – The economic forecasts now include a 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. 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.

Climate – Following the recent drought, agricultural growing conditions and the level of hydro electricity storage lakes are assumed to be normal over the remainder of 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 Budget Update 2008 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 data for fiscal forecasts

	2007/08		2008/09	2009/10	2010/11	2011/12
June years	**HYEFU**	**BEFU**	**BEFU**	**BEFU**	**BEFU**	**BEFU**
Real GDP (ann avg % chg)	2.7	2.8	1.6	2.7	3.2	2.9
Nominal GDP ($m)	178,199	180,137	185,478	192,125	201,802	211,800
CPI (ann avg % change)	2.7	2.9	3.2	2.7	2.9	2.7
Govt 10-year bonds (ann avg %)	6.4	6.4	6.3	6.3	6.2	6.1
90-day bill rate (ann avg %)	8.6	8.8	8.6	8.0	7.9	7.3
Unemployment rate (ann avg %)	3.8	3.5	3.7	4.4	4.5	4.4
Full-time equivalent employment (ann avg % change)	1.3	1.5	1.2	0.1	0.5	1.1
Current account (% of GDP)	-6.9	-6.8	-7.2	-7.3	-6.9	-6.3

Source: The Treasury