Executive Summary

***The economic and fiscal outlook has deteriorated since the* Budget Update**

In the five months since the *Budget Update* was finalised, we have witnessed a number of significant domestic and international developments: in particular, the deepening of the international financial crisis, the slowing housing market, and growing pressure on households and businesses. These developments are key factors in our updated view of the economy and the government's finances set out in this *Pre-election Update*.

We are now expecting weaker economic growth over the next few years, resulting in slower growth in tax revenue and higher government expenditure. Combined with increases in the costs of some existing policies, these factors lead to sustained operating balance deficits and higher debt-to-GDP ratios.

The economic outlook is weaker …

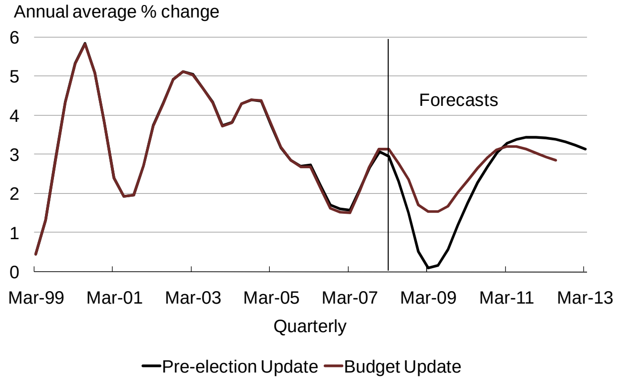
Imbalances have built up during nearly a decade of sustained growth, including inflation pressures, an overvalued housing market, high household debt and a large current account deficit, with implications for interest rates and the exchange rate. With the economy slowing, these imbalances are starting to unwind – as are imbalances in the global economy – but there is a long way to go.

As expected in the *Budget Update*, the drought has had a significant negative influence on the economy, and was a chief factor in the recession in the first half of 2008 – reducing dairy production, hydro electricity generation and manufacturing output.

Figure 1 shows a much weaker economic outlook than in the *Budget Update*, driven by a number of developments:

- The domestic slow-down has been sharper than expected, with declines in consumption and residential investment.
- Households and businesses have come under increasing cost pressures – electricity, interest rates, fuel and food – which are dampening private consumption

Figure 1 – Real GDP growth



Sources: Statistics New Zealand, The Treasury and firm profitability. It will take time for these pressures to dissipate, though some relief in terms of oil prices and interest rates has emerged since the finalisation of our economic forecasts.

- The housing market has weakened more quickly than expected. It will remain depressed over the next year as a result of high effective interest rates, low net migration flows and falling consumer confidence, which will affect private consumption and residential investment.
- The international financial crisis has deepened and is having an adverse impact on global economic growth. New Zealand is expected to feel the effects of the financial crisis principally through the tighter availability and increased costs of credit, but also through a fall in business and consumer confidence, falling asset values and lower demand and prices for our exports.

While there are some positive factors for growth in the short term – eg, recovery from the drought and personal tax cuts boosting consumption – the factors above point to the recovery being gradual.

A more sustained pick-up in growth is forecast from mid-2009. We expect impetus to come particularly from the export sector, as primary export volumes increase and a lower exchange rate stimulates demand for manufactured products and services.

Table 1 – Major economic parameters

March years (annual average % change)	**2008/09 Forecast**	**2009/10 Forecast**	**2010/11 Forecast**	**2011/12 Forecast**	**2012/13 Forecast**
Real GDP	0.1	1.8	3.3	3.4	3.1
Employment	0.3	(0.3)	0.4	1.3	1.8
Unemployment	4.4	5.1	5.1	4.8	4.6
Wages	5.5	4.3	4.0	3.8	3.5
Consumer prices	4.5	2.3	2.4	2.4	2.4

Note: Employment is on a full-time equivalent basis; unemployment is a percentage of the labour force, March quarter, seasonally adjusted; consumer price inflation is measured as an annual percentage change.

Source: The Treasury

… meaning lower tax revenue and higher government spending

The weaker economic growth that we are forecasting is reflected in reductions in our tax revenue forecasts. Compared with the *Budget Update*, we expect tax revenue to be on average around $900 million lower for each of the next three years.

- The weak outlook for the household sector will have a direct impact through GST, which is forecast to grow by around 4% per annum over the next five years, compared with 7.5% over the six years to 2007.
- With firms' margins under pressure and profitability low, underlying corporate income tax is forecast to decline by 3% in the 2009 June year, and growth is expected to be negligible in 2010 as accumulated tax losses offset profits.
- A relatively robust forecast for wages over the next few years helps to keep underlying growth in PAYE up at around 5% per annum.

The largest single change in government spending in the *Pre-election Update* is an increase in the expected costs of benefits. Compared with the *Budget Update*, benefit expenses are around $500 million per annum higher, reflecting both an increase in numbers of beneficiaries as a result of the slowing economy, and the impact of higher inflation on the costs of indexing benefits.

The cost of some existing policies is higher …

The cost of some existing policies has increased since the *Budget Update*, particularly:

- education spending is around $200 million per annum higher, driven by higher-than-expected take-up of the 20 hours free early childhood education initiative, and
- KiwiSaver costs are higher, reaching an extra $280 million per annum by 2012, driven by higher-than-expected take-up rates.

… and debt servicing costs have increased

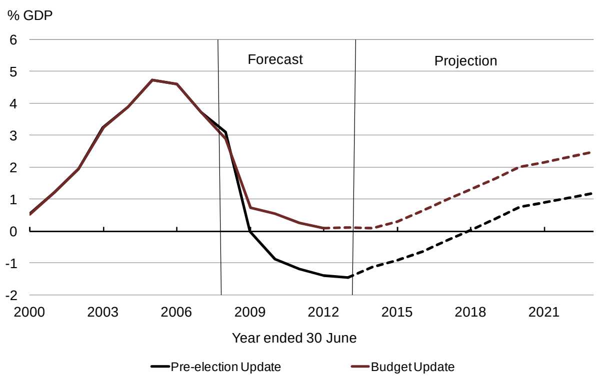
As a result of the various factors set out above, the government's debt outlook deteriorates. This leads to higher debt servicing costs, which are forecast to be around $500 million per annum higher.

These developments lead to a sustained period of operating balance deficits …

As a result of the combination of weakening tax revenue and higher expenditure outlined above, we are forecasting the operating balance before gains and losses (OBEGAL) excluding New Zealand Superannuation (NZS) Fund retained revenue to move into a deficit of $31 million in the current year, which worsens to $3.2 billion by 2012/13. Projections beyond this do not return to surplus until 2017/18.

This contrasts with the position in the *Budget Update*, where we were expecting a track of modest surpluses through time.

Figure 2 – OBEGAL excluding NZS Fund retained revenue



Source: The Treasury

Figures 2 to 4 show the *Pre-election Update* forecasts (solid lines) and projections (dotted lines) of key fiscal indicators.[1]

[1] Fiscal forecasts cover the years 2008/09 to 2012/13; they include decisions taken in recent Budgets (eg, the three tranches of personal tax cuts in 2008, 2010 and 2011), and allowances for new spending in future Budgets. Projections cover the subsequent 10 years (2013/14 to 2022/23); they extrapolate from the final year of the forecasts, based on assumptions about how particular elements will evolve. More detail on forecasts, projections and the assumptions used is included in the *Fiscal Outlook* chapter.

… and larger cash deficits, leading to higher levels of debt

The deterioration in the operating outlook results in a worsening of the government's residual cash outlook. We are forecasting a cash deficit of $5.9 billion in 2008/09, growing to $7.3 billion in 2012/13.

These larger cash deficits flow through into higher gross sovereign-issued debt (GSID) excluding Reserve Bank Settlement Cash. By 2012/13 we forecast GSID excluding Settlement Cash to rise to 24.3% of GDP.

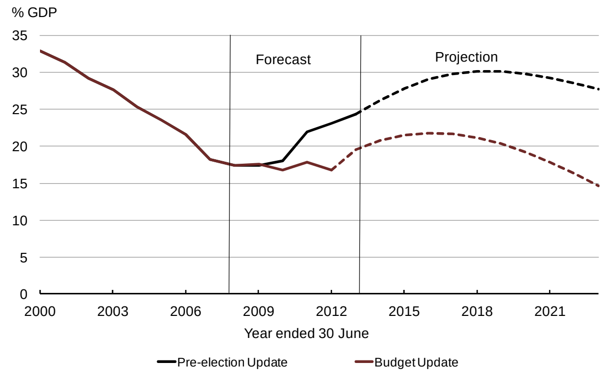
Beyond 2012/13, we project GSID excluding Settlement Cash to rise to 30.1% of GDP in 2018/19 before falling to 27.7% of GDP in 2022/23.

The outlook for net debt has also weakened. We now forecast net core Crown debt excluding NZS Fund assets to rise to 13.2% of GDP by the end of the forecast period, and we project it to peak at 20.3% of GDP in 2018/19.

The increase in net core Crown debt in the forecast period is more pronounced than the increase in GSID excluding Settlement Cash. This is because some of the cash deficits in the forecast period are financed by a reduction in financial assets which have built up in recent years. These financial assets are captured in net core Crown debt, but not in GSID excluding Settlement Cash.

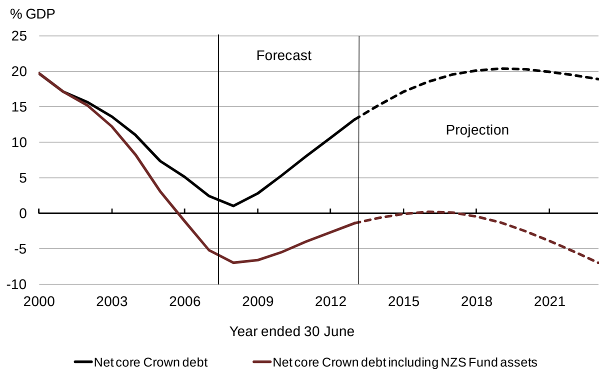
Projections of debt are particularly sensitive to assumptions: small changes can compound and have large impacts in the future. For example, as illustrated in Figure 5, if real GDP growth from 2013/14 onwards was 3% rather than the assumed 2.5% because productivity was higher, by 2022/23 this would reduce GSID excluding Settlement Cash as a percentage of GDP by ten percentage points. This is because in the projections the higher productivity would lead to higher wages, GDP and tax revenue, but most government spending is assumed to continue to grow at 2% per annum.

Figure 3 – GSID excluding Reserve Bank Settlement Cash



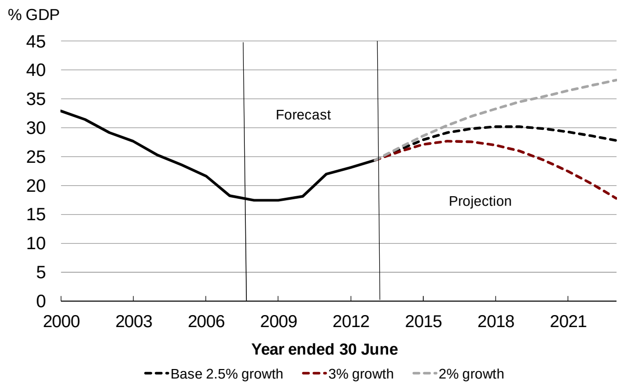
Source: The Treasury

Figure 4 – Net core Crown debt, net core Crown debt including NZS Fund assets



Source: The Treasury

Figure 5 – Sensitivity of GSID projections to assumptions: changing the real GDP growth rate in the projection period



Source: The Treasury

Table 2 – Summary of fiscal aggregates

June years	2008/09 Forecast	2009/10 Forecast	2010/11 Forecast	2011/12 Forecast	2012/13 Forecast
Operating balance ($bn)	**1.9**	**0.4**	**(0.1)**	**(0.4)**	**(0.4)**
% of GDP	1.0	0.2	(0.0)	(0.2)	(0.2)
OBEGAL excl. NZS Fund ($bn)	**(0.0)**	**(1.7)**	**(2.4)**	**(3.0)**	**(3.2)**
% of GDP	(0.0)	(0.9)	(1.2)	(1.4)	(1.5)
Residual cash ($bn)	**(5.9)**	**(5.3)**	**(6.6)**	**(6.8)**	**(7.3)**
% of GDP	(3.2)	(2.8)	(3.3)	(3.2)	(3.3)
GSID excl. Settlement Cash (% of GDP)	**17.4**	**18.0**	**21.9**	**23.1**	**24.3**
Net core Crown debt (% of GDP)	**2.8**	**5.3**	**8.0**	**10.6**	**13.2**
Net core Crown debt incl. NZS Fund (% of GDP)	**(5.7)**	**(4.5)**	**(2.9)**	**(1.5)**	**(0.2)**

Source: The Treasury

Further risks remain

These forecasts are subject to a number of risks, which are discussed in the *Risks and Scenarios* and *Specific Fiscal Risks* chapters. It is worth highlighting a couple of risks:

- The international financial crisis has been moving rapidly, and considerable uncertainty remains. Developments subsequent to the finalisation of our economic forecasts on 28 August, while not leading us to change our overall view of the economy, have increased the risks of a sharper downward correction.
- The funding allowances for future Budgets, particularly for Budget 2009, are expected to come under considerable pressure. (Details of charges against future Budgets are set out on page 28.) The fiscal forecasts assume that spending and revenue pressures can be managed within these funding allowances. If they cannot, the fiscal position would deteriorate further.