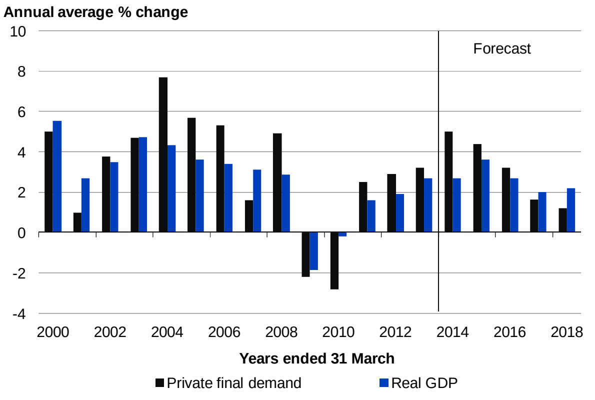
Executive Summary

- The economic expansion is becoming increasingly embedded, with growth becoming more broad-based although still dominated by domestic demand.

- Growth in the second half of 2013 appears to have been stronger than expected at Budget time with real gross domestic product (GDP) estimated to be growing at around a 3% annualised pace. Real GDP growth is expected to be 3.6% in the 2015 March year, but eases to around 2% in the last two years of the forecast period. Over the five years to March 2018, real GDP growth averages 2.6%, a little above the Treasury's estimate of potential growth over this period.

Figure 1 – Real GDP and private final demand*



Sources: Statistics New Zealand, the Treasury

*Private final demand comprises private consumption, residential and market investment spending.

- A stronger economy sees the underlying fiscal position improve faster than in the *Budget Update*, although developments outside the core Crown see the overall total Crown operating balance before gains and losses (OBEGAL) being little changed this year and next. OBEGAL is forecast to move from a deficit of $4.4 billion last year to a small surplus of $0.1 billion in the year ending June 2015, and to $5.6 billion in the year ending June 2018.

- Government net core Crown debt peaks a year earlier and at a lower level than previously forecast at $64.5 billion in the year ending June 2016.

- The main influences on the outlook for the economy are broadly similar to those in the *Budget Update.*

- The Canterbury rebuild remains a key driver of demand, along with a high terms of trade and strengthening labour market conditions supporting income growth and associated household and firm spending. Credit growth is increasing but overall remains moderate.

- Higher-than-expected net migration and household wealth inflows are also contributing to near term demand, as are stimulatory monetary policy settings, although all are forecast to diminish in importance over the forecast period. Private spending growth is forecast to accelerate to over 5% in the year ahead.

- The *Half Year Update* sees a continuation of low government spending growth. This, together with some recovery in effective tax rates sees fiscal policy exerting a restraining influence on demand and interest rates, notwithstanding planned reductions in Accident Compensation Corporation (ACC) levies in the June 2015 and 2016 years.

- The global backdrop for these forecasts is for steady, but uneven, economic growth with the possibility of further economic and financial market turbulence. It is likely to be some time yet before the major advanced economies begin to “normalise” monetary and fiscal conditions, contributing to an elevated New Zealand dollar in the meantime.

- The exchange rate is assumed to remain high for much of the forecast period, acting as a drag on export and import-competing sectors but spreading the income gains from the high terms of trade to the broader economy. Growth in imports, partly associated with strong investment growth, means net exports make a negative contribution to GDP growth over the first three years of the forecast period.

- In sum, the economy is expected to be operating at, or above capacity over most of the forecast period, leading to some increase in price pressures and the current account deficit. The unemployment rate is forecast to decline to below 5%, annual Consumers Price Index (CPI) inflation to move back to around the middle of the 1% to 3% target band and the current account deficit to increase to around 6.5% of GDP.

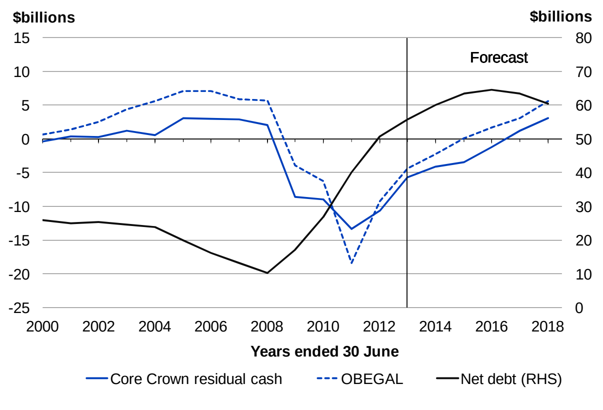
- Higher inflation will lead to an eventual withdrawal of macroeconomic stimulus. Short-term interest rates are expected to begin increasing next year and to rise gradually thereafter.

- Fiscal policy restraint and the high exchange rate imply interest rates are lower than otherwise would be the case. The recent application of macro prudential tools also assists monetary policy over the short term. In the absence of these downward forces, the size of the Canterbury rebuild would likely force interest rates to rise earlier and by more.

- The estimated size of the Christchurch rebuild is unchanged from the *Budget Update* at $40 billion, although the precise timing of activity remains a key uncertainty. The Government’s fiscal costs are currently assessed to be $14.9 billion.

- Core Crown operating cash flows also return to surplus in the year ending June 2015, but when combined with net capital spending, core Crown residual cash does not return to surplus until the year ending June 2017 (both a year earlier than in the *Budget Update*).

Figure 2 – OBEGAL, core Crown residual cash and core Crown net debt



Source: The Treasury

- There is a mix of upside and downside risks, including the size and pace of the Canterbury rebuild, the extent of the turnaround in net migration currently underway, the path of the terms of trade, the path and pass-through of the exchange rate and the saving behaviour of households, particularly in light of current house price increases.

- Global risks, although more even than in recent years, remain skewed to the downside, which if crystallised, would act to accentuate the domestic orientation of forecast growth.

- We see a risk of a more cyclical path for the economy, with stronger domestic demand driven growth in the short to medium term, necessitating a stronger macro policy response and eventual slowing in growth.

- The *Half Year Update* contains two alternative scenarios to illustrate some of the risks to the main forecasts. One scenario maps out a more pronounced domestic demand driven cycle while the other shows the impact of weaker Asian trading partner growth.

- In addition to the fiscal impact of changes to economic activity, the Government is exposed to other fiscal risks. For example, the Crown's financial position is susceptible to market risk with regards to movements in market variables such as interest rates, exchange rates and equity prices. There are also a number of contingent liabilities and fiscal risks outlined in the Specific Fiscal Risk chapter.

Table 1 – Summary of the Treasury's main economic and fiscal forecasts

	2013 Actual	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast
Economic (March years, %)						
Economic growth[1]	2.7	2.7	3.6	2.7	2.0	2.2
Unemployment rate[2]	6.2	5.8	5.6	5.4	5.2	4.7
CPI inflation[3]	0.9	1.4	2.4	2.4	2.3	2.2
Current account balance[4]	-4.5	-4.2	-5.5	-6.3	-6.5	-6.4
Fiscal (June years, % of GDP)						
Total Crown OBEGAL[5]	-2.1	-1.0	0.0	0.7	1.2	2.1
Net debt[6]	26.2	26.3	26.5	25.8	24.4	22.3

Notes: 1 Real production GDP, annual average percentage change
2 Percent of labour force, March quarter, seasonally adjusted
3 Annual percentage change
4 % of GDP
5 Total Crown operating balance before gains and losses (OBEGAL)
6 Net core Crown debt excluding the New Zealand Superannuation Fund (NZS Fund) and advances

Sources: Statistics New Zealand, the Treasury

Finalisation Dates for the Update

Economic data	11 November
Economic forecasts	11 November
Tax revenue forecasts	18 November
Fiscal forecasts	3 December
Specific fiscal risks	3 December
Text finalised	11 December