THE TREASURY
Kaitohutohu Kaupapa Rawa

Opening Statement

Parliament's Finance & Expenditure Select Committee

Delivered by Gabriel Makhlouf, Chief Executive and Secretary to the Treasury

17 June 2015

Good morning. It's been a few weeks since the release of the Budget, and longer since the forecasts for the Treasury's *Budget Economic and Fiscal Update* were finalised in mid-April. I'd like to take a moment to briefly update you on some of the key economic developments in that time.

Overall, we are continuing to see solid growth in economic activity. At the same time the Government's finances are improving, and Core Crown Debt is expected to peak as a percentage of GDP in the next financial year. Within that context, I'd like to briefly touch on what's been happening to...

- dairy prices
- the exchange rate
- inflation, and
- the global economy

...and what it all means for New Zealanders.

Dairy prices

Dairy prices have fallen at each of the five Global Dairy Trade auctions since the Treasury's forecasts were finalised for the *Budget Economic and Fiscal Update*. Fonterra has twice revised down its farm gate milk price for the season just finished. As of this morning, the Whole Milk Powder Price was $2,327 US dollars per metric tonne, down slightly from the last auction.

While we anticipated continuing weakness in dairy prices in our forecasts, there is now a greater risk that prices could take longer to pick up, with the recovery starting later this year or in early 2016, rather than in the second half of this year as anticipated. While this may not affect production levels and economic activity, it would lower the terms of trade and slow growth in the total dollar value of goods and services, i.e. nominal GDP.

Even taking account of the recent fall in dairy prices, the Treasury's Budget forecasts are similar to the Reserve Bank latest GDP forecasts, which also include the impact of lower interest and exchange rates.

The exchange rate

The current low dairy prices have been offset to some degree by shifts in the exchange rate. The New Zealand dollar has depreciated against the US dollar, largely reflecting the improving outlook for the US economy, an expectation that interest rates will soon be rising there, and monetary policy easing here.

Inflation

The Reserve Bank's OCR reduction last week reflects an expectation that inflation may stay low for some time yet.

Consumer Price Inflation was slightly lower in the March quarter than we were expecting, at 0.1 percent, compared to our forecast of 0.2 percent. Petrol prices have risen five percent since our forecasts were finalised, which along with the depreciation of the New Zealand dollar is adding inflationary pressure. We are now expecting inflation for the year to June to be slightly higher, at 0.4 percent, but that's still very low in the scheme of things.

Certainly, inflation is lower than we would normally expect at a time when the economy is growing as strongly as it is right now. That's partly because the engine of the economy is bigger – we've got more productive capacity, partly as a result of the migration boom and record high levels of workforce participation.

We're also not seeing a lot of inflation pressure outside the labour market – even though production levels are high and capacity pressures are increasing, businesses expect inflation to stay low, and aren't planning significant price increases.

The global economy

Apart from conditions here, another key reason inflation is low is the state of the global economy.

As I mentioned, the US economy is showing increasing signs of self-sustaining growth, in spite of a weak March quarter resulting from the harsh winter. Job numbers for May, released earlier this month, exceeded expectations.

But globally, demand is still weak, inflation is low, and growth among New Zealand’s main trading partners is subdued.

The economic outlook for Europe has improved, but negotiations between Greece, the EU and the IMF remain inconclusive, and the risks of Greece defaulting on its debt repayments have increased. The implications of such a default are uncertain. As the President of the ECB, Mario Draghi said, these are “uncharted waters”.

In Australia, the Budget released shortly before New Zealand’s included a downward revision to their growth forecasts, as the move from mining to more broad-based economic activities is expected to take longer than previously thought.

China’s growth has also slowed a little, although its focus on encouraging more consumption-led growth will be positive for New Zealand in the long term as a premium food producer.

What does this mean for New Zealanders?

So what does this mean for New Zealanders?

The weak global economy is something of a double-edged sword, in that it means we’re getting less for our exports as commodity prices stay low, but we’re also paying relatively less for imported goods, and it’s helping to keep inflation down. This means the economy can sustain stronger growth before undesirable effects start to kick in.

There has been some variation from what we anticipated, but overall these developments are consistent with the assumptions underpinning our forecasts in the *Budget Economic and Fiscal Update*. As always, there are risks – for example, on the downside, global growth and dairy prices could stay weak for longer. On the upside, New Zealand’s strong position compared to other countries could see high levels of net migration continue, boosting demand at home. Low inflation could also provide a bigger boost to domestic consumption.

What’s clear is that New Zealand is in a better position than many other countries, with higher levels of employment and low increases in the cost of living.

The growing economy is helping to close the gap between what the Government earns and spends. There have been some shifts in the accounts but it’s important to keep these in context – they are movements at the margins of two very large numbers. What’s important is the longer-term trend and the consistent overall improvements in the Crown’s financial position.

With that in mind, the Government needs to stay disciplined about where it invests on behalf of taxpayers. It will be important to keep to our fiscal strategy and ensure we have a stable macroeconomic environment, not just to further strengthen the Crown’s books, but to also give businesses the confidence to invest and underpin growth. A more productive, sustainable and inclusive society is the key to prosperity over the long-run, and the Treasury will continue to focus on how we can get the best results for New Zealanders.