

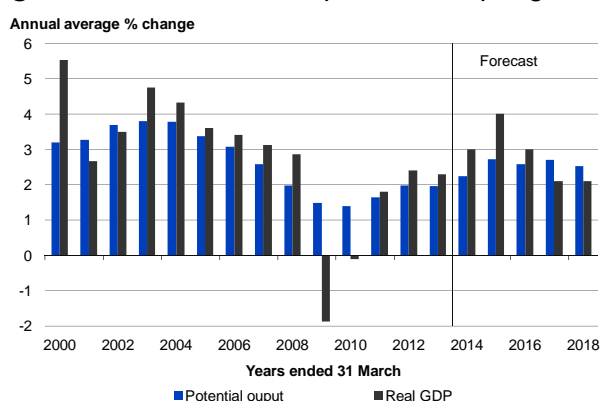
Executive Summary

- The economy is entering its fourth year of expansion with real gross domestic product (GDP) estimated to be currently growing at around a 4% annualised pace. Employment is increasing and both annual Consumers Price Index (CPI) inflation and the current account deficit are low at present. Growth has become more broad-based, although it is still dominated by domestic demand.

- Following estimated real GDP growth of 3.0% in the year to March 2014, 4.0% growth is forecast this March year, 3.0% in the year to March 2016, then easing to around 2% in the last two years of the forecast period. Over the five years to March 2018, real GDP growth averages 2.8%, a little above the Treasury’s estimate of potential output growth over this period. The latter is forecast to increase from a low of around 1.5% during the recession to around 2.6% on average over the forecast period, as a result of lower unemployment, strong growth in the working-age population and a rebound in trend productivity growth on the back of higher investment.

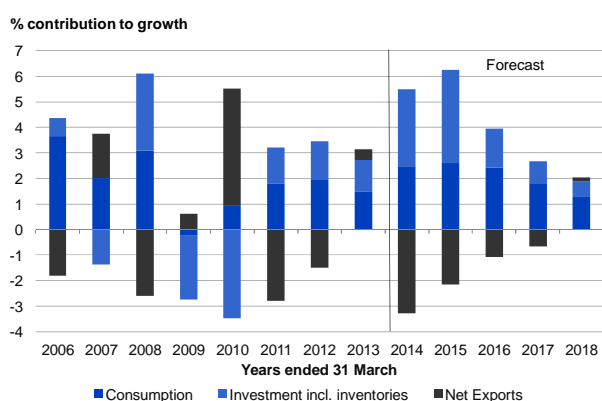
- The Canterbury rebuild, near record-high terms of trade, strong net migration and stimulatory monetary policy settings are all contributing to robust household and firm spending, while fiscal policy and the elevated exchange rate are providing some offset. Real private spending growth is forecast to accelerate to nearly 7% during the year ahead, supported by higher income growth and asset prices, application of insurance payouts and high consumer and business confidence. Credit growth is increasing but remains moderate.

Figure 1 – Real GDP and potential output growth



Sources: Statistics New Zealand, the Treasury

Figure 2 – Contributions to real GDP growth

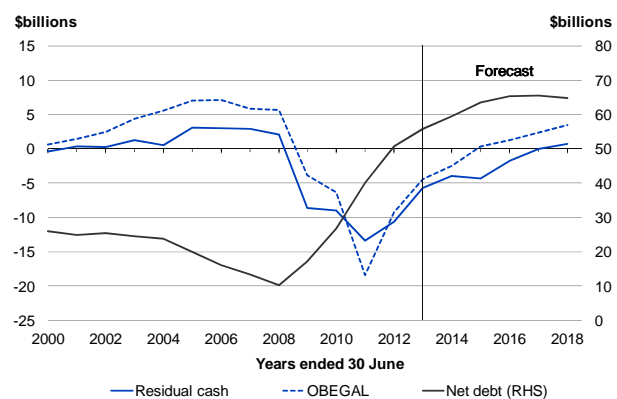


Sources: Statistics New Zealand, the Treasury

- Looking forward, the strength of some of the positive influences on GDP growth are expected to moderate, including monetary policy moving to a more neutral stance in response to emerging inflationary pressures. The latter reflects the expectation that the economy will be operating at or above capacity over much of the forecast period. Further increases in the Official Cash Rate (OCR) are expected, leading to a gradual but steady increase in short-term interest rates through 2014 and 2015, the precise pace depending on how inflation pressures evolve.
- The global backdrop to these forecasts is steady, but uneven, economic growth, notwithstanding stronger growth in advanced economies. Trading partner growth is likely to be similar to that recorded in the mid-2000s with moderate inflation. Risks overall remain skewed to the downside.
- Global financial conditions continue to be very accommodating. While the US Federal Reserve has begun to reduce its asset purchases, so-called “tapering”, it is likely to be some time yet before central banks in the major advanced economies begin to increase their policy interest rates.
- The unemployment rate is forecast to decline to below 5%, annual CPI inflation to move back to around the middle of the 1% to 3% target band and the current account deficit to increase to over 6% of GDP by the end of the 2017/18 forecast period. 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.
- Fiscal policy restraint and the high exchange rate imply interest rates are lower than would otherwise be the case. The recent application of Loan-to-Value Ratios (LVRs) is also reducing the amount of work monetary policy needs to do over the short term. In the absence of these downward forces, the impetus to demand from the Canterbury rebuild and the high terms of the trade would have likely forced interest rates to rise earlier and by more.
- The operating balance before gains and losses (OBEGAL) is forecast to move from a deficit of \$2.4 billion this fiscal year to a surplus of \$0.4 billion in the year ending June 2015, and to \$3.5 billion in the year ending June 2018. Net core Crown debt is forecast to peak at \$65.5 billion in June 2017 from \$59.4 billion in June 2014.

- Budget 2014 incorporates net new operating initiatives of \$1 billion per annum on average over the next four years. The indicative operating allowance for Budget 2015 and beyond is \$1.5 billion per annum, growing at 2% per Budget. Increasing tax receipts mean core Crown operating cash flows are forecast to return to surplus in the year ending June 2015. When combined with net capital spending, core Crown residual cash returns to surplus in the year ending June 2018 (one year later than forecast in the *Half Year Update* of December 2013). This includes \$4.7 billion of gross proceeds from completion of the Government Share Offer programme.

Figure 3 – OBEGAL, core Crown residual cash and net core Crown debt



Source: The Treasury

- Following a decline over recent years, the Crown’s share of net worth is expected to increase modestly over the forecast period, as the Government begins to record surpluses and the growth in assets outpaces liabilities. Within the balance sheet, financial assets are forecast to increase (particularly the Crown’s investment portfolios) to over 50% of total Crown assets and around 50% of GDP. Liabilities begin to fall in nominal terms by the end of the forecast period as earthquake obligations are settled and the Crown begins to pay back debt.
- There is a mix of upside and downside risks, including the size and pace of the Canterbury rebuild, the size and duration of the current upswing in net migration, 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.
- The *Budget Update* contains two alternative scenarios to illustrate how the economy could evolve if some of the judgements underpinning the main forecasts turn out differently. One scenario maps out a stronger net migration driven cycle, while the other shows the impact of a larger fall in the terms of trade.
- In addition to the fiscal impact of changes to economic activity, the Government is exposed to other fiscal risks that could impact both the operating balance and the balance sheet. For example, the Crown’s financial position is susceptible to market movements in variables such as interest rates, exchange rates and equity prices. The final fiscal cost of the Canterbury earthquakes is also still uncertain. There are also a number of contingent liabilities and fiscal risks outlined in the Specific Fiscal Risks 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	2.3	3.0	4.0	3.0	2.1	2.1
Unemployment rate ²	6.2	5.9	5.4	5.1	4.8	4.4
CPI inflation ³	0.9	1.5	1.8	2.5	2.3	2.0
Current account balance ⁴	-3.9	-3.1	-4.4	-5.9	-6.2	-6.3
Fiscal (June years, % of GDP)						
Total Crown OBEGAL ⁵	-2.1	-1.1	0.2	0.5	0.9	1.3
Net debt ⁶	26.2	25.8	26.4	25.9	24.9	23.8

- Notes:
- 1 Real production GDP, annual average percentage change
 - 2 Percent of labour force, March quarter, seasonally adjusted
 - 3 CPI, annual percentage change, outturn for March 2014
 - 4 % of GDP
 - 5 Total Crown operating balance before gains and losses (OBEGAL)
 - 6 Net core Crown debt excluding the New Zealand Superannuation Fund and advances

Sources: Statistics New Zealand, the Treasury

Finalisation Dates for the Update

Economic data	16 April 2014
Economic forecasts	17 April 2014
Tax revenue forecasts	22 April 2014
Fiscal forecasts	29 April 2014
Specific fiscal risks	29 April 2014
Text finalised	7 May 2014
