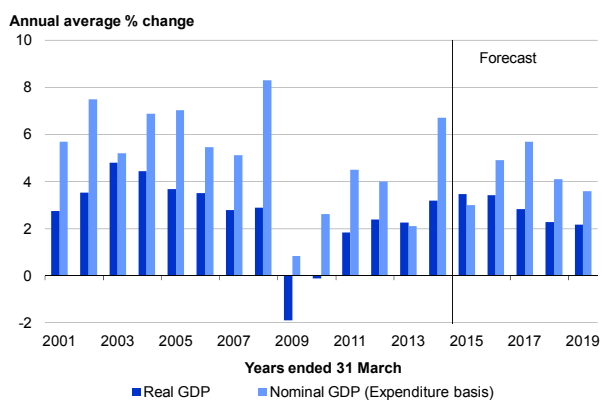


## Executive Summary

- The New Zealand economy is in its fifth year of expansion. Economic activity is continuing to expand at a solid rate and the short-term outlook is for more of the same. Continued growth in employment and real wages is expected, and the unemployment rate is forecast to fall further. We expect the economy to be resilient to the changes in the drivers of demand currently underway, and policy to be effective in managing risks and uncertainties.
- The Government operating balance before gains and losses (OBEGAL) is expected to increase through time but at a slower pace than forecast in the *Pre-election Update*. Forecasts of tax revenue have been revised lower reflecting downward revisions to the path of interest rates and economy-wide income and spending growth. A small deficit is forecast for the current 2014/15 fiscal year followed by a small surplus next year. Government debt is nearing a peak and is expected to be declining by the end of the five-year forecast horizon.
- After real gross domestic product (GDP) growth of 3.2% over the year to March 2014, growth of around 3.5% is forecast for the current March 2015 year and the following year, before slowing to a little above 2% in the last year of the Treasury's five-year forecast period.
- Domestic drivers of demand are becoming more important. This transition was underway at the time the *Pre-election Update* forecasts were being put together but it has gathered pace since, underpinned by the sharper and more protracted fall in key export prices and the stronger outlook for net migration inflows. The former will reduce spending in the primary sector, especially dairy, and the rural economy more broadly, while the latter will boost domestic activity relative to what we expected previously.
- The sharp fall in international dairy prices over the past six months will reduce the growth in the dollar value of income and expenditure (nominal GDP) this year, notwithstanding some offset from lower oil prices. Dairy prices are forecast to recover around 25% by the start of 2016, although at present the risks appear tilted towards a slower recovery. Lower forecast export prices this year and next contribute to the overall size of the economy being smaller than was forecast in the *Pre-election Update*.

**Figure 1 – Real and nominal GDP growth**

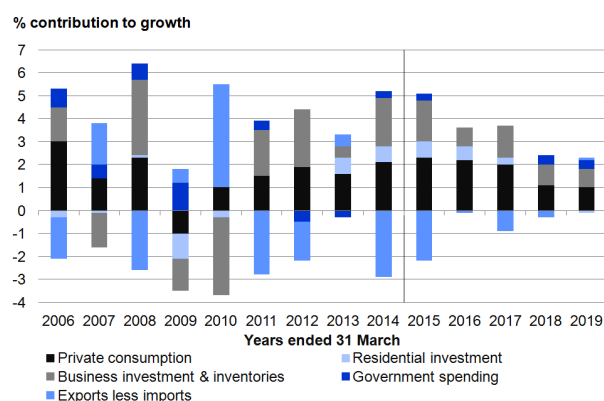


Sources: Statistics New Zealand, the Treasury

- The stronger net migration outlook highlights the strength of the New Zealand economy relative to many other countries. A gradual and uneven recovery continues to characterise the global economy. Global growth has slowed recently and forecasts have been revised down as growth in Europe and Japan in particular has been lower than expected, offsetting faster growth in the United States (US) and the United Kingdom (UK). Given the muted pace of recovery in growth and employment, together with low inflation, monetary policy settings in the major economies are expected to remain highly stimulatory for some time.
- High net migration inflows, high labour force participation and higher investment expenditure have all contributed to increasing the rate at which the economy can grow without generating rising inflation over recent years, so-called potential growth. Given recent information on prices and wages, it is likely that potential growth is currently higher than previously expected and the amount of spare capital and labour greater.
- Annual Consumer Price Index (CPI) inflation fell to 1% in the September quarter – lower than expected. A greater ability for the economy to grow appears to have muted the flow-through to CPI inflation of recent strong GDP growth. This has been reinforced by persistent low global inflation. With these factors expected to continue, and recent unexpected falls in oil prices expected to lower tradable inflation, we have revised down forecast CPI inflation throughout the forecast period. As a result, interest rates are forecast to stay low for a longer period. We expect monetary policy to provide stimulus to economic activity out to 2017, notwithstanding increases in the Official Cash Rate (OCR) earlier this year. Given the growth outlook, annual CPI inflation is forecast to return to around the middle of the 1% to 3% target band in late 2015 or early 2016 and a gradual increase in short-term interest rates is expected to begin in late 2015.

- Household consumption and business investment spending are expected to be the major sources of demand growth over the forecast period. The contribution from residential investment is also material. The contribution coming from exports increases in the second half of the forecast period.

**Figure 2 – Contributions to real GDP growth**



Sources: Statistics New Zealand, the Treasury

- Labour income is forecast to grow by more than 5% this year and over 4% in each following forecast year, implying sustained increases in real household disposable income given low consumer inflation. We expect most household and business spending to be funded out of income growth, although lower farm incomes will see some pull-back in the aggregate household saving rate. Private sector credit growth is likely to remain moderate, albeit increasing. Earthquake reconstruction is forecast to continue to contribute to growth in the March 2015 and 2016 years and then remain at a high level, providing ongoing support to construction, manufacturing and service sector activity.
- Fiscal policy is forecast to exert a mild constraining influence on demand over the forecast period as a whole, although somewhat less this year and next than was the case in the *Pre-election Update*. The New Zealand dollar (NZ dollar) is also acting as a headwind to growth. While the NZ dollar has fallen recently, it remains high and continues to be a drag on growth in manufactured and services exports and export receipts more broadly.

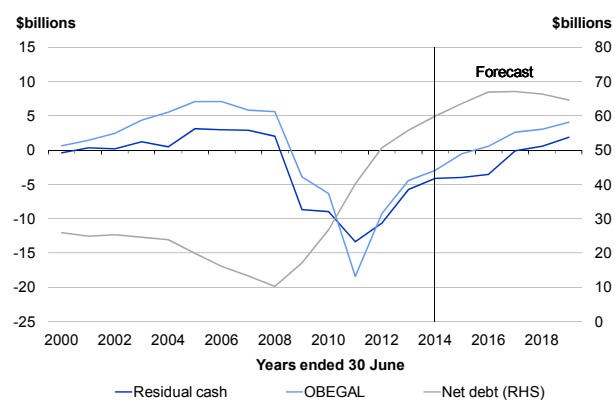
- Although the direct effects of lower commodity export prices have been limited to date, export revenues are expected to decline significantly in coming quarters. The current-account deficit is forecast to increase to around 6% of GDP, reflecting the mix of robust domestic demand growth, the decline in the terms of trade and moderate export volume growth. The level of investment is forecast to increase to nearly 25% of GDP, alongside national saving rising to around 19%.
- Global long-term interest rates remain very low and markets appear to assign a low probability to the prospect of significant increases in interest rates. These conditions are being reflected in higher asset prices and fluctuations in capital flows between countries. Sharp, unanticipated changes to interest rate settings in the major economies could adversely affect the global economy. Geopolitical risks also remain elevated.
- An OBEGAL deficit of \$572 million is forecast in the current 2014/15 fiscal year, followed by a surplus of \$565 million in 2015/16, rising to \$4.1 billion in 2018/19.
- Forecasts of tax revenue have been revised lower reflecting downward revisions to many of the economic drivers of tax. These reduce forecasts of goods and services tax (GST), income taxes and resident withholding tax (RWT). Relative to *Pre-election Update* forecasts, core Crown tax revenue forecasts are lower by approximately \$0.6 billion in 2014/15 notwithstanding revenue to date being over \$0.2 billion above the *Pre-election Update* forecast. Forecast tax revenue is \$1.0 billion lower in the 2015/16 year ending June 2016, \$0.5 billion in 2016/17 and \$0.3 billion in 2018/19.

- Core Crown expenses are forecast to continue to fall as a share of GDP. Operating allowances have been re-phased from \$1.5 billion per Budget to \$1.0 billion, \$1.0 billion and \$2.5 billion for Budgets 2015 to 2017 respectively.

- After combining taxes and expenses with net capital spending, core Crown residual cash is forecast to be in surplus in 2017/18, although it remains relatively static over the next few years. Net debt is forecast to be 26.5% of GDP in 2014/15 and 2015/16, before falling to 22.5% of GDP in 2018/19. Net debt in dollar terms is forecast to peak at around \$67.0 billion in 2016/17, up from \$60.0 billion in June 2014.

- There is a range of risks and uncertainties attached to these forecasts, relating to both forecasts of key variables and economic and fiscal relationships. Amongst the main ones are downside risks to export prices, upside risk to net immigration and uncertainty about the extent of spare capacity in the economy and future inflation pressures. Since the *Pre-election Update*, the balance of economic risks around the short-term outlook has shifted downward.

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



Source: The Treasury

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

	2014 Actual	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast	2019 Forecast
<b>Economic (March years, %)</b>						
Economic growth <sup>1</sup>	3.2	3.5	3.4	2.8	2.3	2.2
Unemployment rate <sup>2</sup>	6.0	5.4	5.1	4.7	4.5	4.5
CPI inflation <sup>3</sup>	1.5	1.3	2.0	2.1	2.0	2.0
Current account balance <sup>4</sup>	-2.7	-5.3	-6.2	-5.8	-5.7	-5.9
<b>Fiscal (June years, % of GDP)</b>						
Total Crown OBEGAL <sup>5</sup>	-1.3	-0.2	0.2	1.0	1.1	1.4
Net debt <sup>6</sup>	25.6	26.5	26.5	25.2	24.0	22.5

- Notes: 1 Real production GDP, annual average percentage change  
 2 Percent of labour force, March quarter, seasonally adjusted  
 3 CPI, annual percentage change, March quarter  
 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	10 November
Economic forecasts	10 November
Tax revenue forecasts	17 November
Fiscal forecasts	24 November
Specific fiscal risks	24 November
Text finalised	9 December

#### National accounts data

The economic numbers and forecasts in the Economic Outlook chapter pre-date the release of annual national accounts data for the March 2014 year by Statistics New Zealand on 21 November 2014. These new data incorporated new data, methodology and measurement changes which resulted in nominal GDP for the March 2014 year being revised higher by \$5.1 billion (2.2%). The revised data will be fully incorporated into the Economic Outlook chapter of the 2015 *Budget Update*.

To reflect best practice, however, the revised nominal GDP data have been used in the calculation of the fiscal ratios to GDP throughout the Fiscal Outlook chapter. The higher denominator has the effect of reducing the fiscal ratios, with an impact on net core Crown debt of 0.6% of GDP in the year ended June 2014.