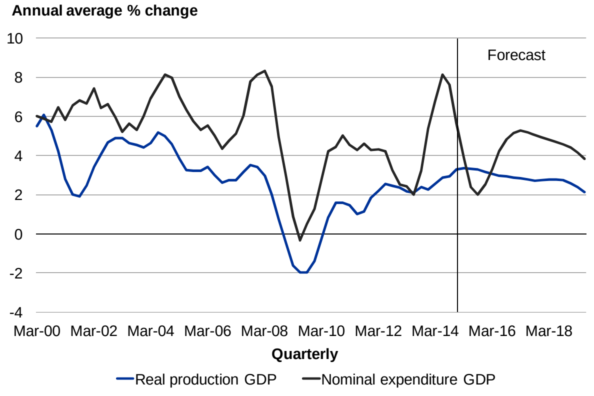
Executive Summary

- New Zealand's economic expansion has continued to strengthen. Real gross domestic product (GDP) grew 3.3% in the year ended December 2014, the fastest pace of growth since 2007 and one of the strongest growth performances in the Organisation for Economic Cooperation and Development (OECD).

- Looking forward, real GDP growth is forecast to average 2.8% per year over the four years to 2019, consistent with the forecasts in the *Half Year Update*. Low interest rates, robust investment activity, strong population growth and historically high terms of trade remain the key factors supporting the growth outlook. Sluggish global growth, drought and restraint in government spending provide partial offsets. The high New Zealand dollar acts as a constraint on export growth, although households and businesses benefit from increased purchasing power.

- Nominal GDP growth is forecast to soften during 2015, reaching a low of 2.0% in the year to September, before strengthening later this year to average 4.3% per year over the four years to 2019 (Figure 1). Compared to the *Half Year Update*, nominal GDP growth is weaker in 2016 and 2017 owing to a softer outlook for inflation, but is stronger in 2018 and 2019.

Figure 1 – Real and nominal GDP growth



Sources: Statistics New Zealand, the Treasury

- The fiscal position continues to strengthen, although at a more modest rate than forecast in the *Half Year Update*. A slightly larger deficit is forecast for the current 2014/15 fiscal year, while surpluses from 2015/16 are smaller than previously anticipated. On average, the Government's fiscal stance is mildly contractionary over the forecast horizon.

- Several economic judgements underpin this *Budget Update*. The most significant relate to the prospects for trading partner growth, the future path of oil and dairy prices, the extent and duration of the current net migration boom and the amount of spare capacity in the economy and its relationship with inflation.

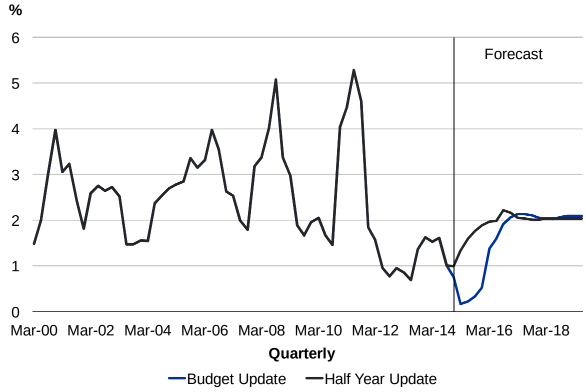
- The global economic recovery is forecast to continue at a gradual pace. The recovery remains on track in the US, and growth is picking up from a slow pace in the euro area and Japan. However, Australian growth is expected to remain below trend for longer, while China's growth is forecast to slow as housing demand weakens further.

- After remaining low for most of this year, oil prices are assumed to rise gradually and by the end of the forecast period are back at levels similar to those forecast in the *Half Year Update*. Dairy prices are forecast to recover from current low levels in the second half of 2015, in line with the *Half Year Update*. Recent oil and dairy price movements are broadly consistent with this outlook.

- Net migration inflows reached a record high in March this year, and have exceeded the forecasts in the *Half Year Update*. Annual net inflows are now expected to peak at around 57,000, before returning to the long-run average net inflow of 12,000 by 2017.

- Solid growth in economic activity has reduced the amount of spare capacity in the economy, with several indicators suggesting it is now mostly exhausted. Even so, annual consumer price inflation has weakened, slipping to 0.1% in the March 2015 quarter. A mix of factors have contributed to the recent low inflation outturns, including falling oil prices, the high New Zealand dollar and heightened retail competition. Overall, inflation is now expected to be much weaker in 2015 and 2016 relative to the *Half Year Update*, before rising to 2.0% in late 2016 as capacity pressures develop (Figure 2).

Figure 2 – CPI inflation



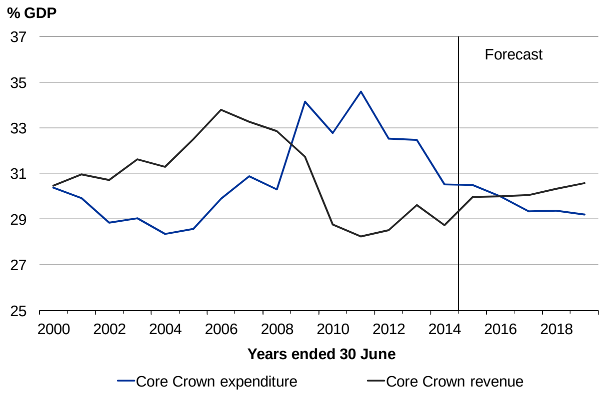
Sources: Statistics New Zealand, the Treasury

- Low inflation and further increases in labour supply are expected to lead to subdued nominal wage growth over the coming year. However, lower inflation means that, in real terms, purchasing power increases more rapidly in the near term compared to the *Half Year Update*. Over time, wage growth is forecast to strengthen as employment growth continues and the unemployment rate falls.

- A weaker outlook for inflation means interest rates are expected to remain lower for longer than anticipated in the *Half Year Update,* with recent developments raising the prospect of interest rate reductions in the coming year. However, New Zealand's relatively strong growth and high interest rates are assumed to keep upward pressure on the exchange rate, with the trade-weighted index (TWI) higher than in the *Half Year Update* across the forecast horizon.

- Core Crown tax revenue is expected to rise in each of the next four years, reaching $80.5 billion or just above 28% of GDP in 2018/19. With the exception of 2014/15, growth in tax revenue is expected to be slower than in the *Half Year Update* owing largely to downward revisions to the outlook for nominal GDP growth, wage growth and interest rates.

Figure 3 – Core Crown revenue and expenses



Source: The Treasury

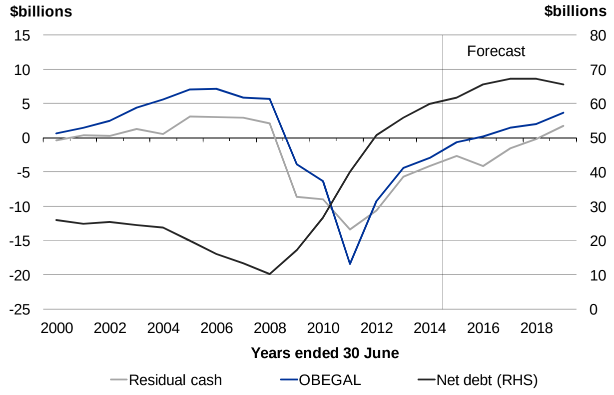
- Core Crown expenses are forecast to continue to decline as a share of GDP, falling from 30.5% in 2013/14 to 29.2% in 2018/19. Future operating allowances remain unchanged from the *Half Year Update* at $1.0 billion for Budget 2016, rising to $2.5 billion in Budget 2017 and reducing to $1.5 billion in Budget 2018.

- In addition to the Budget 2015 package, the Government has also signalled further reductions in Accident Compensation Corporation (ACC) levy rates of around $1.5 billion across the forecast period. On average, the reductions are expected to lower the operating balance before gains and losses (OBEGAL) by $0.6 billion per year from 2016/17.

- OBEGAL is forecast to move from a deficit of $0.7 billion this fiscal year, to a surplus of $0.2 billion in 2015/16 and $3.6 billion in 2018/19 (Figure 4).

- Net capital spending is forecast to exceed operating cash flows until 2018/19, while core Crown residual cash returns to surplus in the 2018/19 year. Over the entire forecast period, a residual cash shortfall of $6.9 billion is expected and is funded through additional borrowing and reductions in financial assets. Net core Crown debt is expected to peak at 26.3% of GDP in 2015/16, before reducing to 22.9% of GDP in 2018/19.

Figure 4 – OBEGAL, core Crown residual cash and net core Crown debt



Source: The Treasury

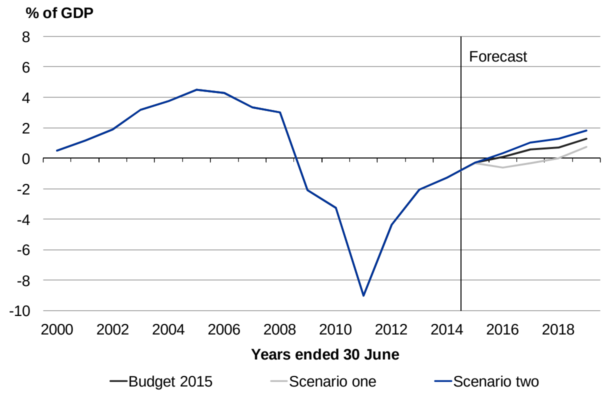
- The government bond programme is expected to raise funds of $36.5 billion over the forecast period, while $34.8 billion of existing debt will be repaid, providing net cash proceeds of $1.7 billion.

- Following a decline over recent years, the Crown's 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. Net worth is forecast to be $93.6 billion in 2018/19 or 32.8% of GDP.

- Within the balance sheet, financial assets are forecast to increase (particularly the Crown's investment portfolios) to around 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 reduce debt.

- The main economic and fiscal risks associated with the central forecast relate largely to the key judgements in this *Budget Update*. The Risks and Scenarios chapter provides two scenarios to illustrate how sensitive the central forecasts are to some of these judgements (Figure 5).

Figure 5 – OBEGAL scenarios



Source: The Treasury

- Scenario one is based on a larger fall in New Zealand's export commodity prices, and consequently a lower terms of trade, and weaker global inflation. In this scenario, the OBEGAL does not return to surplus until the June 2018 year, two years later than the central forecast. Scenario two considers the domestic demand impact from a larger household spending response to the low inflation environment and higher net migration. In this scenario, the OBEGAL returns to surplus in the 2015/16 year, the same as in the central forecast, but the surplus is larger.

- 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. A number of contingent liabilities and fiscal risks are outlined in the Specific Fiscal Risks chapter.

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

	2014 Actual	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast	2019 Forecast
Economic (March years, %)						
Real GDP growth[1]	2.5	3.3	3.1	2.8	2.8	2.4
Unemployment rate[2]	6.1	5.6	5.1	4.7	4.5	4.5
CPI inflation[3]	1.5	0.2	1.4	2.1	2.0	2.1
Current account balance[4]	-2.6	-4.1	-5.6	-4.9	-5.1	-5.3
Fiscal (June years, % of GDP)						
Total Crown OBEGAL[5]	-1.3	-0.3	0.1	0.6	0.7	1.3
Net core Crown debt[6]	25.6	25.7	26.3	25.5	24.4	22.9

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 (NZS Fund) and advances.

Sources: Statistics New Zealand, the Treasury

Finalisation dates for the *Budget Update*

Economic data	10 April 2015
Economic forecasts	10 April 2015
Tax revenue forecasts	17 April 2015
Fiscal forecasts	1 May 2015
Specific fiscal risks	1 May 2015
Text finalised	12 May 2015

Note: Data releases since the finalisation of the economic forecasts show that in the March 2015 quarter annual Consumers Price Index (CPI) inflation was 0.1% and that the unemployment rate was steady at a revised 5.8%. These and other recent developments have not significantly changed the outlook presented in this *Budget Update*. The changes to ACC levies announced on 11 May 2015 were decided in time to be included in the fiscal outlook but not the economic outlook. The economic impact of the ACC levy reduction is not expected to significantly alter the economic outlook.