Pre-election Economic and Fiscal Update 2011

Hon Bill English, Minister of Finance

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Other Information

On the Treasury's website is a series of other information that contains detailed economic forecast tables and additional financial information. This information provides users of the *Pre-election Economic and Fiscal Update 2011* with further detail and should be read in conjunction with the published document. It can be accessed at:

http://www.treasury.govt.nz/budget/forecasts/prefu2011

Statement of Responsibility

On the basis of the economic and fiscal information available to it, the Treasury has used its best professional judgement in supplying the Minister of Finance with this Economic and Fiscal Update. The Update incorporates the fiscal and economic implications both of Government decisions and circumstances as at 11 October 2011 that were communicated to me, and of other economic and fiscal information available to the Treasury in accordance with the provisions of the Public Finance Act 1989.

Gabriel Makhlouf
Secretary to the Treasury

18 October 2011

This Economic and Fiscal Update has been prepared in accordance with the Public Finance Act 1989. I accept overall responsibility for the integrity of the disclosures contained in this Update, and the consistency and completeness of the Update information in accordance with the requirements of the Public Finance Act 1989.

To enable the Treasury to prepare this Update, I have ensured that the Secretary to the Treasury has been advised of all Government decisions and other circumstances as at 11 October 2011 of which I was aware and that had material economic or fiscal implications.

Hon Bill English
Minister of Finance

18 October 2011

Executive Summary

Real economic growth of 2.3% is forecast for the year ending March 2012 and an average growth rate of 2.9% per year is forecast for the years ended March 2012 to March 2016. The unemployment rate is forecast to fall from 6.5% in June 2011 to 4.7% in March 2016. A return to surplus in the operating balance (before gains and losses) is forecast for the year ending June 2015 and the ratio of net debt-to-GDP is forecast to peak in the same year.

These forecasts represent the outcome of judgements around likely developments in, and interactions between, five major forces that are influencing the economy:

- The world economy is slowing and concerns about sovereign debt and the stability of the banking system have unsettled financial markets. In a number of advanced countries the outlook for an upturn in growth is constrained by their need to reduce public debt to sustainable levels. We assume that European governments manage the region's debt issues and stabilise financial markets.
- Income growth in China and east Asia has increased demand and world prices for New Zealand's exports. Developments in these economies will be a major determinant of New Zealand's export performance.
- The pace and magnitude of the rebuild in Canterbury.
- The progressive withdrawal of domestic monetary and fiscal stimulus.
- The magnitude of an anticipated move away from household dis-saving.

At present, export prices are high, business confidence remains firm and the Rugby World Cup has provided some temporary support for consumption and for services exports. Partly offsetting these positive impulses, growth in the world's largest developed economies is slowing and financial market volatility has increased. We have revised down our estimates of trading partner growth and there is a significant risk that medium-term growth slows further than is built into our forecasts. The implications of even slower trading partner growth are captured in the Risks and Scenarios chapter.

The reconstruction work in Canterbury will gather momentum over 2012 and into 2013, generating higher employment and business investment, helping to insulate the economy from the impacts of slowing trading partner growth. The Treasury's estimates of damage from the Canterbury earthquakes have been revised up from $15 billion in the *Budget Economic and Fiscal Update* (*Budget Update*) to $20 billion in this *Pre-election Economic and Fiscal Update* (*Pre-election Update*) and our forecast of the scale and duration of the rebuild is also higher.

As the rebuild and broader economic recovery gather pace, spare capacity is drawn into production and monetary policy stimulus will be progressively withdrawn. Fiscal policy stimulus is also forecast to be withdrawn and operating deficits replaced by surpluses in the year ending June 2015. As capacity becomes stretched, the pace of annual average growth slows to 2.4% by the end of the five-year forecast period (Table 1).

A return to positive household saving, defined as aggregate household incomes being higher than consumption, is estimated in the year ended March 2011, for the first time in more than a decade. The rate of household saving is expected to continue to strengthen as households in aggregate move to strengthen their net asset positions. This results in more moderate consumption growth in the current upturn than was experienced in the previous cyclical upturn. In spite of this, the Treasury anticipates that the current account deficit will widen, driven by investment related to the Canterbury rebuild and partly funded by earthquake insurance payments.

The fiscal forecasts are largely in line with the *Budget Update* and continue to show a return to surplus in the year ending June 2015. Core Crown revenue increases as a percentage of GDP over the forecast period while core Crown expenses decline as a percentage of GDP. While the operating deficit continues for the next three years, this trend in revenue and expenses results in a surplus in the fourth year (Table 1).

When capital spending is deducted from operating cash flows, residual cash deficits persist throughout the forecast period. As a result, net debt rises throughout the forecast period and peaks at 29% of GDP in the year ending June 2015 before falling as a percentage of GDP. The decline in net debt as a percentage of GDP continues in the medium-term projections.

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

	2011 Actual	**2012 Forecast**	**2013 Forecast**	**2014 Forecast**	**2015 Forecast**	**2016 Forecast**
Economic (March years, %)						
Economic growth[1]	1.6	2.3	3.4	3.3	2.9	2.4
Unemployment rate[2]	6.5	5.8	5.2	4.9	4.7	4.7
Fiscal (June years, % of GDP)						
Operating balance[3]	-9.2	-5.1	-2.0	-0.4	0.6	1.2
Net debt[4]	20.0	25.4	28.5	28.9	29.0	28.2

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

Sources: Statistics New Zealand, The Treasury

The risks to our main forecasts are skewed to the downside. In an illustrative downside scenario, in which we assume a sharper slowdown in trading partner growth and lower terms of trade, we estimate that New Zealand's nominal GDP could be a cumulative $35 billion lower over the five-year forecast period to the year ending June 2016. We estimate that there is at least a one-in-five chance that the New Zealand economy performs worse than in this scenario.

The Crown's net worth is expected to decline in each of the next two fiscal years, before experiencing moderate growth over the remainder of the forecast period. Due to the upwards revision of the fiscal costs arising from the Canterbury earthquakes, this fall is now sharper than previously forecast in the *Budget Update*. Net worth is expected to be slightly below the current level in the year ending June 2016, at $77.2 billion, despite strong gross asset growth across the balance sheet over the forecast period.

The medium-term fiscal projections, covering the decade beyond the end of the forecasts, are similar to those included in the 2011 *Fiscal Strategy Report*. After first attaining a surplus in the year ending June 2015, the operating balance before gains and losses continues to strengthen over the projection period. Core Crown net debt steadily declines over the projection period, largely as a function of increasing surpluses being used to retire debt.

Finalisation Dates for the Forecasts

Economic forecasts	26 September
Economic data	26 September
Tax revenue forecasts	30 September
Fiscal forecasts	11 October
Specific fiscal risks	18 October
Text finalised	18 October

Note on 18 October the Government announced a decision to proceed with KiwiSaver auto-enrolment subject to a return to surplus. As this decision was taken after the forecasts were finalised the impacts of this policy change are not reflected in these economic forecasts. The change is included as a specific fiscal risk in chapter 4.