

UPDATED OUTLOOK FOR THE NEW ZEALAND ECONOMY AND ITS IMPACT ON THE FISCAL POSITION

7 November 2008

What this note contains

We have revised our macroeconomic forecasts, incorporating the latest financial market developments and weaker world growth outlook that have materialised since the PREFU. This note provides a summary of the updated draft macroeconomic forecasts, estimates of the likely movements in forecast tax revenue, benefits and finance costs, and how these movements are likely to impact the major fiscal indicators. For convenience the updated forecasts are referred to as NEFU (short for November Economic and Fiscal Update).

An important caveat to this information is that it is being provided at a very preliminary stage before our full QA processes have been worked through. The fiscal outlook, in particular, should be regarded as indicative only and is based on current policy settings. This is still being worked through with more comprehensive estimates due for completion by Friday 14 November - significant changes are possible.

A separate note contains more details on international financial and economic developments since PREFU.

Key Points

- The global financial market turmoil that began last year has intensified over the past two months, leading to an expectation of much weaker global economic growth.
- The New Zealand economy will be affected via weaker export demand, lower commodity prices, reduced asset values and weaker confidence.
- Lower export and investment growth is likely to contribute to lower real GDP growth over the 2010 and 2011 March years than was forecast in PREFU.
- Lower growth will flow through to weaker labour demand with unemployment now expected to peak at 5.7% (compared to 5.1% in PREFU).
- Falling commodity prices and weaker demand pressures mean that overall price growth in the economy is likely to be weaker than forecast in PREFU. This combined with weaker real GDP growth sees the level of nominal GDP \$2 billion to \$4 billion per year lower than PREFU, with the cumulative difference over the 2009 to 2013 June years totalling \$15 billion.
- Given the current international environment, considerable uncertainty surrounds the economic outlook and hence the fiscal implications below.
- OBEGAL and residual cash are expected to be weaker than the PREFU by around \$1.5 billion per annum from 2010/11 onwards. In total across the next five years cash deficits are forecast to worsen by around \$5 billion, which is driven primarily by a reduction in tax forecasts due to the weaker economic outlook.
- Net core Crown debt and gross sovereign-issued debt are expected to increase relative to PREFU by around \$5 billion by 2012/13.

Economic Outlook

Global financial market turmoil has led to a weaker outlook for world activity...

The intensification of the global financial market turmoil over September and October and its expected impact on real economies abroad has seen the growth outlook for our trading partners significantly pared back relative to that incorporated in the PREFU forecasts. Growth of our top 20 trading partners over the 2009 calendar year is now assumed to slow to 1.8%, sharply down from the 2.8% assumed in PREFU.

Table 1 – Real GDP growth in New Zealand's top 20 trading partners

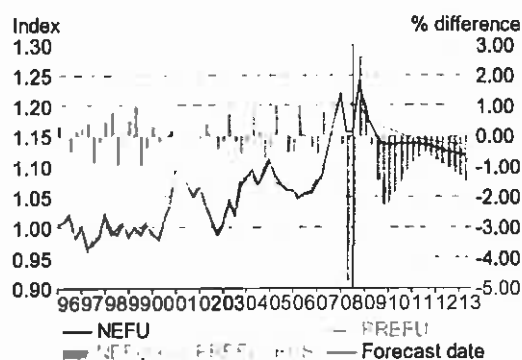
Annual Average Growth (%) over calendar year	NEFU	PREFU
2006	3.9	3.9
2007	4.2	4.2
2008	2.8	2.9
2009	1.8	2.8
2010	3.0	3.6
2011	3.5	3.6
2012	3.6	3.5

Source: Consensus Economics, The Treasury

... and seen large falls in commodity prices

Weaker demand in the world's major economies is putting significant downward pressure on commodity prices. For New Zealand this is likely to mean steeper and larger falls for world dairy prices. More positive for New Zealand are the large falls in world oil prices. The draft NEFU forecasts assume a price for WTI oil in the US\$70 to US\$84 per barrel range, down from the US\$114 to US\$118 per barrel range in the PREFU forecasts. Overall, the outlook for the merchandise terms of trade is a bit stronger over the remainder of 2008 and start of 2009 (as the large fall in oil prices dominates), but is generally weaker than in PREFU by 1% to 2%.

Figure 1 – Merchandise terms of trade



Source: Statistics New Zealand, The Treasury

Overall, the outlook for the merchandise terms of trade is a bit stronger over the remainder of 2008 and start of 2009 (as the large fall in oil prices dominates), but is generally weaker than in PREFU by 1% to 2%.

Global conditions will impact on demand for New Zealand's exports...

Weaker growth in our trading partners will also impact on export demand. Relative to PREFU, growth in export volumes is most affected in the 2010 and 2011 March years, with growth of only 0.6% and 2.9%, down 4.1% and 2.0% respectively when compared with PREFU. Growth in services exports volumes is likely to be particularly affected as consumers abroad cut back on large discretionary expenditures such as travel to New Zealand. Despite current global conditions, there are factors helping to support New Zealand exports over this period. We expect a recovery in agricultural export volumes in the 2010 March year, given the 2009 March year is affected by drought. In addition

the depreciation in the exchange rate, which has occurred more rapidly than was incorporated in PREFU, will provide some cushioning for exports.

... and tighten the availability of credit, constraining investment

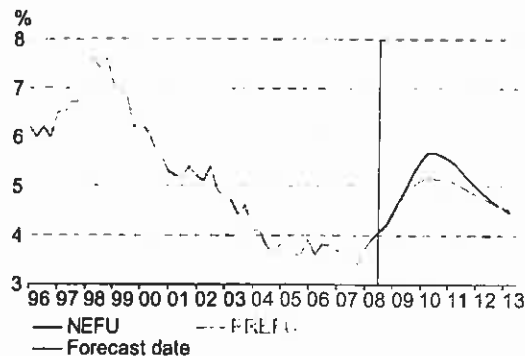
The financial market turmoil is limiting the availability of credit, with banks more reluctant to lend to businesses and new mortgage customers. Bank funding costs also remain elevated, meaning that credit is relatively expensive to obtain. Such factors mean that the outlook for investment is weak. Residential investment has been in decline since late 2007 and this decline is expected to continue with real residential investment falling nearly 22% in the year to March 2009 and nearly a further 10% the following year. Residential investment is then expected to increase significantly in later years as the housing market shows signs of recovery with lower interest rates and continued population growth important factors.

Business investment has been holding up well in 2008, supported by heavy investment in oil exploration and production. With business confidence severely dented and finance harder to come by, we expect real market investment to decline by just over 13% in the 2010 March year, contributing to a 9% decline in non-residential (or 'other') investment in the 2010 March year. On a quarterly basis, it is unlikely that market investment will show much sign of a sustained recovery until the second half of calendar 2010. The impact of this decline on GDP is somewhat diluted by the fact that import growth is also expected to be weaker in the 2010 March year.

Firms are likely to demand less labour, causing unemployment to rise...

A tougher trading environment for businesses will influence their demand for labour with employment expected to exhibit greater falls than were forecast in PREFU. This contributes to the unemployment rate now being forecast to increase to 5.7% during the middle of 2010, before falling back to 4.5% by the end of the forecast period. Higher unemployment, coupled with slightly weaker wage growth, means that the forecast level of labour income is lower than in the PREFU forecasts.

Figure 2 – Unemployment rate



Source: Statistics New Zealand, The Treasury

... but there are some positives for households including lower petrol prices and lower mortgage rates

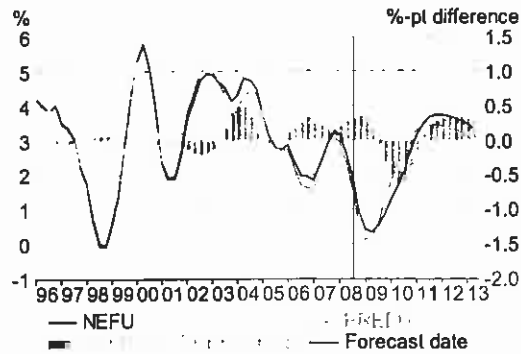
However, several developments since PREFU have been more positive for households. Petrol prices have fallen by 26% from their peak earlier in the year. Rising petrol prices played an important role in putting increasing pressure on household finances, so this fall represents welcome relief. In response to the weaker international outlook, the official cash rate has been lowered by 175 basis points since July to 6.5%, with mortgage interest rates now significantly lower than was incorporated in the PREFU forecasts and further rate cuts likely. Such factors mean

that the rate of real private consumption growth is only slightly lower than that contained in the PREFU forecasts. Nevertheless, the overall rate of private consumption growth is expected to remain sufficiently weak that real private consumption on a per capita basis falls in each of the 2009, 2010 and 2011 March years.

Real GDP growth weaker in 2010 and 2011 March years...

Overall, real production GDP is expected to grow by 0.4% in the March 2009 year, followed by 1.3% in the 2010 March year and 3.1% in 2011. Relative to the PREFU forecasts growth is 0.5% weaker in the March 2010 year and 0.2% weaker in 2011. The 2009 figure is stronger than PREFU, mainly reflecting revisions and the stronger June quarter figure (when GDP fell by less than expected). The increase in annual average real GDP growth to more than 3% over the 2011 to 2013 March years is associated with an increase in export growth due to the weaker exchange rate which declines to under 53 on a trade weighted basis and an improvement in growth in our trading partners. In addition, concerns around current financial market turmoil are expected to ease over the next year, which together with falls in interest rates, helps promote a resurgence in investment growth. Real private consumption growth is also expected to show a modest increase.

Figure 3 – Real production GDP growth

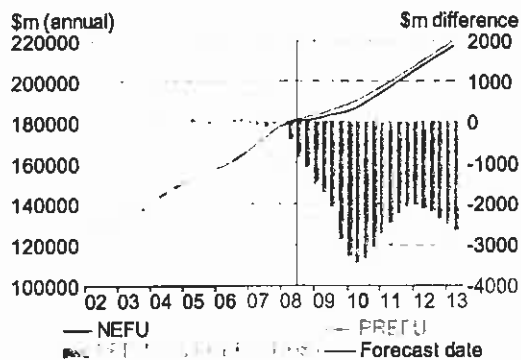


Source: Statistics New Zealand, The Treasury

...and weaker price growth contributes to significantly weaker nominal GDP

With falls in commodity prices and a weaker demand environment over the next couple of years, inflation is expected to ease much more rapidly than was predicted in the PREFU. Combined with a weaker terms of trade, as well as the outlook for real activity, this means that the level of nominal GDP is lower than in the PREFU forecasts. Over the 2009 to 2013 June years this results in nominal GDP being about \$15 billion dollars lower than was predicted in the PREFU.

Figure 4 – Nominal GDP (level)



Source: Statistics New Zealand, The Treasury

Forecasts should be considered in the context of considerable uncertainty

The economic forecasts discussed above should be considered in the context that all forecasts produced in the current environment are subject to considerably greater than normal uncertainty given recent international developments.

There is uncertainty surrounding exactly how developments in financial markets to date will ultimately impact on the world's economies. There is also uncertainty associated with how quickly issues in financial market will be resolved. Views on the international economy are still being revised down and international lending to New Zealand has not yet resumed. While we have tried to make some allowance for even further weakness in economic data, given the extent to which new data is influencing people's perceptions for the economic outlook in New Zealand and abroad, there is the distinct possibility that future revisions to our forecasts will be to the downside.

Prices for a number of commodities have also been subject to extreme volatility, which makes forecasting price movements in an economy even more difficult. Hence there exists additional uncertainty about the outlook for nominal GDP over and above that of real activity, which is itself very uncertain.

Fiscal Outlook

In light of the revisions to the macroeconomic forecasts we have reassessed tax, benefit and finance costs since the PREFU. In addition we have also updated the fiscal forecast to incorporate the impact of the outturn to 30 September 2008.

The revisions in the fiscal forecast are only high level estimates at this stage, and should be interpreted as indicative rather than firm estimates. We aim to have more comprehensive estimates by the end of Friday 14 November.

In summary, our indications are that both the operating balance before gains and losses (OBEGAL) and residual cash deficits are expected to be weaker by around \$1.5 billion per annum from 2010/11 onwards, primarily driven by forecast reductions in tax revenues. As a consequence debt is expected to increase by about \$5 billion by 2012/13.

The forecast reductions in tax revenues relate mainly to income taxes, (source deductions, largely PAYE; corporate tax; and other persons tax) including resident withholding tax. Consumption forecasts are around \$1 billion lower than PREFU, so GST is forecast to reduce by around \$100 million each year.

The weaker economy leads to a more prolonged period in which firms are making losses. As firms can use these losses to offset future tax obligations, this means that the impact of weaker profit growth on corporate tax revenue appears later than in the PREFU.

There are negative risks around the tax forecasts, including the extent to which stalling profits will hit business income taxes, directly and immediately through tax on profits, but also less directly and later through the build up of tax losses.

There are also positive risks around the tax forecasts. For example, PAYE is continuing to show some resilience, currently growing at around 10% p.a. despite the weakening labour market.

Benefit expenditure is expected to stay broadly as forecast at the PREFU. There are changes expected to individual benefit types, resulting from two offsetting factors, namely a weaker inflation track and higher recipient numbers. Across all benefit types and all forecast years, these two effects tend to cancel one another out.

Finance costs are expected to have a minimal impact on the fiscal position as the increase in finance costs associated with the higher debt position is offset by interest rates being lower than expected at the PREFU.

Table 2 – Fiscal Indicators

	2008 Actual \$m	2009 Forecast \$m	2010 Forecast \$m	2011 Forecast \$m	2012 Forecast \$m	2013 Forecast \$m
Core Crown tax revenue						
NEFU	56,747	55,782	56,653	57,798	60,508	63,681
PREFU	56,747	56,058	57,415	59,268	61,893	65,084
	-	(276)	(762)	(1,470)	(1,385)	(1,403)
OBEGAL						
NEFU	5,637	(163)	(2,208)	(3,851)	(4,527)	(5,027)
PREFU	5,637	(64)	(1,746)	(2,481)	(3,092)	(3,374)
	-	(99)	(462)	(1,370)	(1,435)	(1,653)
Operating balance						
NEFU	2,384	(444)	(88)	(1,441)	(1,831)	(2,035)
PREFU	2,384	1,909	374	(71)	(396)	(382)
	-	(2,353)	(462)	(1,370)	(1,435)	(1,653)
Residual cash						
NEFU	2,057	(5,955)	(5,766)	(8,077)	(8,358)	(8,093)
PREFU	2,057	(5,909)	(5,300)	(6,603)	(6,815)	(7,307)
	-	(46)	(466)	(1,474)	(1,543)	(1,786)
Gross sovereign issued debt (excl RBSC)						
NEFU	31,390	32,133	34,912	45,807	52,155	58,981
PREFU	31,390	32,087	34,400	43,821	48,626	53,666
	-	(46)	(512)	(1,986)	(3,529)	(5,315)
Gross sovereign issued debt (excl RBSC) - % of GDP						
NEFU	17.5%	17.6%	18.7%	23.3%	25.1%	27.1%
PREFU	17.4%	17.4%	18.0%	21.9%	23.1%	24.3%

Annex

Preliminary NEFU 2008 Economic Forecasts

SUMMARY OF ECONOMIC FORECASTS

(Annual average percent change, unless specified otherwise)

March Years	2005	2006	2007	2008	2009	2010	2011	2012	2013
Private consumption	5.0	4.7	2.9	3.3	0.0	0.5	0.8	1.4	1.7
Public consumption	4.2	5.1	4.0	4.1	3.7	4.5	4.0	3.2	2.7
TOTAL CONSUMPTION	4.8	4.8	3.1	3.5	0.8	1.4	1.6	1.9	2.0
Residential investment	2.9	-5.2	-2.7	3.8	-21.7	-9.6	15.3	12.4	9.4
Other investment	11.2	7.2	-1.7	4.5	2.3	-9.2	4.5	8.1	5.9
TOTAL INVESTMENT	9.3	4.4	-1.9	4.3	-2.6	-9.3	6.2	8.9	6.5
Stocks (contribution to GDP growth)	0.2	-0.5	-0.9	1.0	0.2	-0.3	-0.2	-0.1	0.1
GROSS NATIONAL EXPENDITURE	6.0	4.2	1.1	4.6	0.2	-1.4	2.4	3.3	3.1
Exports	4.6	0.0	3.1	2.3	-0.2	0.6	2.9	5.4	5.1
Imports	12.5	4.2	-1.6	9.7	2.9	-7.7	0.4	4.0	3.9
EXPENDITURE ON GDP GDP (PRODUCTION MEASURE)	3.8	2.9	2.5	2.4	-0.5	1.4	3.2	3.8	3.5
Nominal GDP (Expenditure Basis)	7.1	4.9	5.2	7.5	1.8	2.3	4.9	5.6	4.9
Labour Market									
Employment (full-time equivalent)	3.6	2.7	2.0	0.8	0.2	-0.7	-0.3	1.4	2.3
Unemployment Rate (March quarter s.a.)	3.8	3.9	3.7	3.7	4.4	5.5	5.5	5.0	4.5
Wages (QES ave hourly ord time earnings)	3.3	4.7	4.8	4.2	5.3	4.3	3.9	3.2	2.9
Inflation and Monetary Conditions									
90-day Bank Bill Rate (March quarter ave)	6.9	7.6	7.8	8.8	8.3	5.2	5.0	5.6	6.0
TWI (March quarter ave)	69.6	68.3	68.8	71.9	58.8	57.4	55.7	54.0	52.5
CPI Inflation (ann % change, March quarter)	2.8	3.3	2.5	3.4	3.8	2.0	2.4	2.1	2.0
House Price Inflation (ann. % chg, Mar qtr)	13.4	12.3	11.7	2.8	-13.0	0.1	1.6	2.8	2.9
Current account									
Current account balance (% of GDP)	-6.8	-8.3	-8.3	-8.0	-8.3	-7.1	-6.5	-6.9	-5.4

Change versus PREFU2008

CHANGE IN FORECASTS FROM PREVIOUS ROUND
(Annual average percent change, unless specified otherwise)

March Years	2005	2006	2007	2008	2009	2010	2011	2012	2013
Private consumption	0.0	0.0	0.1	0.0	0.0	-0.1	-0.1	0.0	0.2
Public consumption	-0.1	0.0	-0.3	-0.1	-0.4	0.7	0.2	0.0	0.0
TOTAL CONSUMPTION	0.0	0.0	0.0	0.0	-0.1	0.1	0.0	0.0	0.2
Residential investment	0.0	0.0	0.0	0.0	-4.3	-0.2	7.4	2.4	0.5
Other investment	0.0	0.0	0.0	1.6	5.2	-12.9	-2.8	2.3	0.1
TOTAL INVESTMENT	0.0	0.0	0.0	0.1	-1.3	-4.9	3.1	3.2	0.5
Stocks (contribution to GDP growth)	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.1
GROSS NATIONAL EXPENDITURE	0.0	0.0	0.0	0.0	-0.4	-1.0	0.7	0.7	0.3
Exports	0.0	0.1	0.0	-0.1	2.3	-4.1	-2.0	0.7	1.0
Imports	0.1	0.1	0.1	0.0	2.4	-5.2	0.1	1.6	0.7
EXPENDITURE ON GDP	0.0	0.0	-0.1	0.0	-0.2	-0.4	0.0	0.4	0.4
GDP (PRODUCTION MEASURE)	0.0	0.1	0.3	0.2	0.3	-0.5	-0.2	0.3	0.3
Nominal GDP (Expenditure Basis)	0.0	0.0	0.0	0.0	-1.3	-0.8	0.3	0.5	-0.1
Nominal GDP level (\$ billion)	0.0	0.0	0.0	0.0	-2.3	-3.8	-3.4	-2.7	-3.1
Labour Market									
Employment (full-time equivalent)	0.0	0.0	0.0	0.0	0.0	-0.4	-0.7	0.1	0.5
Unemployment Rate (March quarter s.a.)	0.0	0.0	0.0	0.0	0.1	0.4	0.4	0.2	0.0
Wages (QES ave hourly ord time earnings)	0.0	0.0	0.0	0.0	-0.2	0.0	-0.1	-0.6	-0.6
Inflation and Monetary Conditions									
90-day Bank Bill Rate (March quarter ave)	0.0	0.0	0.0	0.0	-1.3	-1.8	-1.7	-0.9	-0.3
TWI (March quarter ave)	0.0	0.0	0.0	0.0	-3.9	-2.2	-1.4	-1.0	-1.1
CPI Inflation (ann % change, March quarter)	0.0	0.0	0.0	0.0	-0.7	-0.2	0.0	-0.3	-0.4
House Price Inflation (ann. % chg, Mar qtr)	0.0	0.0	0.0	0.0	-3.0	0.8	0.3	0.2	0.0
Current account									
Current account balance (% of GDP)	0.0	0.0	-0.2	-0.2	-1.4	-0.6	-0.7	-0.6	-0.3

Core Crown Tax Revenue Forecasts

2008 NEFU forecasts of major tax types

\$ millions	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Source deductions	23,356	23,147	23,578	24,043	25,019	26,559
Other persons tax	3,601	3,421	3,601	3,572	3,770	3,995
Corporate taxes	10,443	9,317	9,302	9,650	10,331	10,843
Interest RWT	2,699	2,781	2,517	2,235	2,255	2,457
GST	11,115	11,572	11,894	12,392	13,097	13,626
Other	5,533	5,544	5,761	5,906	6,036	6,201
Total 2008 NEFU forecast	56,747	55,782	56,653	57,798	60,508	63,681
apc	7.9%	-1.7%	1.6%	2.0%	4.7%	5.2%
Nom GDP, apc	6.2%	1.8%	2.4%	5.4%	5.5%	4.8%

Changes since 2008 PREFU

\$ millions	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
2008 PREFU	56,747	56,058	57,415	59,268	61,893	65,084
% of GDP	31.5%	30.4%	30.1%	29.7%	29.4%	29.5%
<i>Forecasting changes</i>						
Source deductions	-	65	-133	-376	-506	-651
Other persons tax	-	-57	-190	-232	-132	-2
Corporate taxes	-	-85	-101	-447	-269	-269
Interest RWT	-	-41	-149	-259	-316	-262
GST	-	-115	-130	-84	-90	-136
Other	-	-43	-59	-72	-72	-83
<i>Total forecasting changes</i>	-	-276	-762	-1,470	-1,385	-1,403
Other changes	-	-	-	-	-	-
<i>Total change</i>	-	-276	-762	-1,470	-1,385	-1,403
2008 NEFU	56,747	55,782	56,653	57,798	60,508	63,681