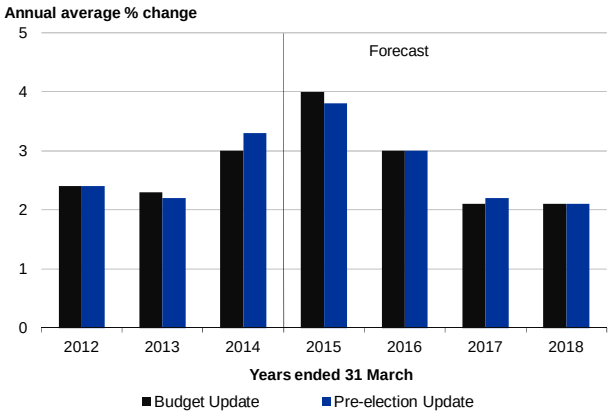
Executive Summary

- The New Zealand economy is expanding at a robust pace, although growth momentum has eased from earlier in the year. Looking forward, real production gross domestic product (GDP) is forecast to grow by 2.8% on average over the four years to March 2018, essentially unchanged from the *Budget Update.* The near-term outlook remains for growth faster than potential driven by residential investment, positive migration inflows and still-high terms of trade.

- Real GDP growth for the year ending March 2014 was faster than expected in the *Budget Update* – 3.3% compared with 3.0% forecast – while growth for the year ending March 2015 is forecast to be lower at 3.8% (compared with 4.0% in the *Budget Update*). Growth is expected to slow later in the forecast period as the factors currently supporting growth decline and monetary conditions tighten (Figure 1).

- Rising construction activity is expected to be a key driver of growth, with earthquake rebuilding supplemented by a rebound in residential construction in Auckland in response to pent-up demand. Business investment is also forecast to pick up as productive capacity is more heavily utilised.

Figure 1 – Real GDP growth



Sources: Statistics New Zealand, the Treasury

- Net migration inflows continue to rise, adding to both demand and the productive capacity of the economy. The net inflow is expected to reach 42,500 this year and overall to add an additional 3,500 to the population compared with the *Budget Update,* with risks skewed to the upside.

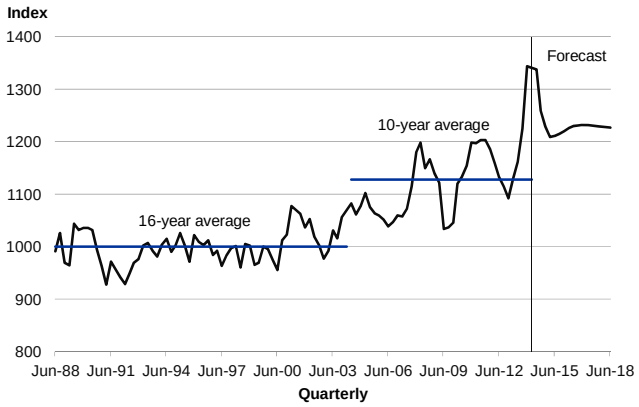
- Household income growth is underpinning consumption and residential investment activity. Over the forecast period household disposable incomes are forecast to increase 4.0% on average per year, after an estimated 7.1% increase in the year to March 2014. Employment and wage growth is expected to be the main driver of this growth, with labour income growing by 4.6% on average over the next four years.

- Recent falls in commodity prices (mainly dairy and forestry) have occurred earlier than envisaged in the *Budget Update*. As a result, the forecast decline in the goods terms of trade is occurring sooner than previously expected and consequently will provide less support to growth. The terms of trade are forecast to stabilise during 2015, recovering some of the decline currently being seen. Over the forecast period the terms of trade are expected to remain above the average experienced over the past decade

(Figure 2). A more substantial and sustained short-term decline in export prices is an area of downside risk for the forecasts.

- The global backdrop to these forecasts is steady, but uneven, economic growth. 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, with heightened geopolitical tensions adding to economic uncertainties.

Figure 2 – Goods terms of trade (SNA basis)



Sources: Statistics New Zealand, the Treasury

- The exchange rate has remained elevated for some time, but is assumed to depreciate as the global outlook improves, foreign interest rates rise and the terms of trade fall from their recent peaks.

- The current account deficit is forecast to increase from around 2.6% of GDP in mid-2014 to 4.8% in the year to March 2015 owing to lower export volumes in the near-term and a decline in the terms of trade. The deficit is forecast to stabilise at 6.4% of GDP from late 2016.

- Fiscal policy is expected to exert a dampening influence on economic activity over the forecast horizon as slow growth in spending, combined with rising tax revenue, see the fiscal balance improve. The average fiscal impulse over the forecast period is unchanged from the *Budget Update* at -0.4% of GDP, but the timing and magnitude have changed with the impact of weaker tax receipts and changes in the expected timing of some forecast expenditure.

- Despite higher than forecast growth, annual Consumers Price Index (CPI) inflation in June 2014 was 1.6%, below the *Budget Update* forecast of 1.8%. With real GDP growth exceeding our estimate of potential growth, upward pressure on resources is forecast to continue to increase and lead to higher inflation. We forecast annual CPI inflation to peak at 2.5% in late 2016 before declining to around 2% by the end of the forecast period.

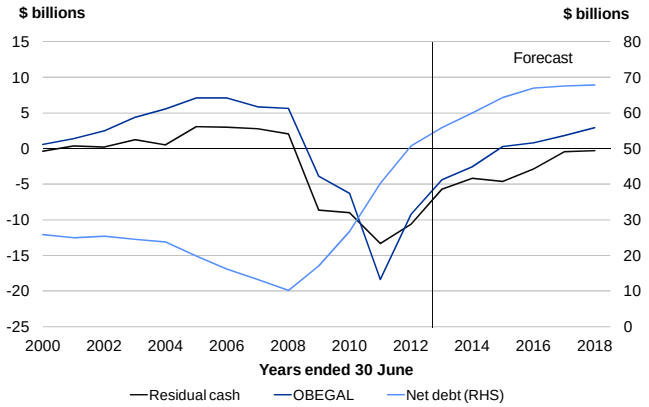
- Reflecting increased inflation pressures, we expect further increases in the Reserve Bank's Official Cash Rate (OCR) over the forecast period. Ninety-day interest rates are forecast to rise to 5.3% by late 2017.

- Nominal GDP increased 7.0% in the year to March 2014, 0.3 percentage points higher than expected in the *Budget Update*. In contrast, forecast growth for the year to March 2015 is 0.5 percentage points lower at 5.2% taking the level of nominal GDP below that forecast in the *Budget Update.* This mainly reflects the earlier decline in the terms of trade. The lower level of nominal GDP is expected to continue over the remainder of the forecast period. See the box Real and Nominal GDP on page 7 for an explanation of the different measures.

- The operating balance before gains and losses (OBEGAL) is forecast to move from an estimated $2.6 billion deficit in the year ending June 2014 to a surplus of $0.3 billion this fiscal year, and increasing thereafter to $3.0 billion in the year ending June 2018 (Figure 3). The OBEGAL surplus is $0.5 billion lower in the year ending 2018 than forecast in the *Budget Update*.

- Core Crown tax revenue for the year to June 2014 has been revised downward from that expected in the *Budget Update*. While still expected to increase across the forecast period, core Crown tax revenue is forecast to be below the *Budget Update* forecasts each year as a result of lower forecast nominal GDP. Forecast core Crown expenses remain largely unchanged from the *Budget Update*, declining to 30.0% of GDP by the end of the forecast period.

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



Source: The Treasury

- Net core Crown debt is forecast to peak at 26.8% of GDP in the year ending June 2015 – slightly higher than 26.4% in the *Budget Update*. Thereafter, net debt is expected to reduce more slowly than in the *Budget Update,* reflecting a lower forecast path for core Crown residual cash (which is now expected to return to surplus in the year ending June 2019). In dollar terms, net debt is forecast to peak at $67.9 billion in June 2018, $2.4 billion higher and a year later than forecast in the *Budget Update*.

- In addition to the risks noted above, there are other upside and downside risks to the judgements underpinning the forecasts. These include the size and pace of the Canterbury rebuild, the path and pass-through of the exchange rate and the saving behaviour of households. The potential impacts of some of these judgements evolving differently from the main forecast are highlighted in the Risks and Scenarios chapter. One scenario assumes that growth in the United States (US) is stronger, along with stronger domestic price pressures. Another scenario explores the impact of weaker short-term domestic demand combined with a larger decline in the terms of trade.

- As well as the fiscal impact of changes in 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 Christchurch 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 Actual	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast
Economic (March years, %)						
Economic growth[1]						
Pre-election Update	2.2	3.3	3.8	3.0	2.2	2.1
Budget Update	2.3	3.0	4.0	3.0	2.1	2.1
Unemployment rate[2]						
Pre-election Update	6.2	6.0	5.6	5.2	4.8	4.5
Budget Update	6.2	5.9	5.4	5.1	4.8	4.4
CPI inflation[3]						
Pre-election Update	0.9	1.5	1.7	2.4	2.3	2.1
Budget Update	0.9	1.5	1.8	2.5	2.3	2.0
Current account balance[4]						
Pre-election Update	-3.9	-2.8	-4.8	-6.2	-6.4	-6.4
Budget Update	-3.9	-3.1	-4.4	-5.9	-6.2	-6.3

	2013 Actual	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast
Fiscal (June years, % of GDP)						
Total Crown OBEGAL[5]						
Pre-election Update	-2.1	-1.1	0.1	0.3	0.7	1.1
Budget Update	-2.1	-1.1	0.2	0.5	0.9	1.3
Net debt[6]						
Pre-election Update	26.2	25.9	26.8	26.7	25.8	25.0
Budget Update	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, 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

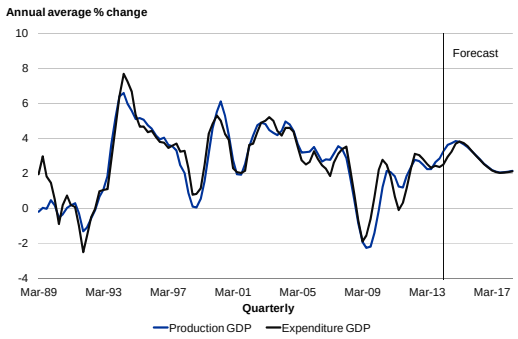
Sources: Statistics New Zealand, the Treasury

Real and Nominal GDP

Gross domestic product (GDP) is a measure of the added value of goods and services produced in an economy in a quarter or a year. Changes in the level of GDP between time periods are a measure of economic growth. Quarterly GDP figures for New Zealand are produced on both a production and an expenditure basis. ***Production GDP*** measures the contribution of an industry as the value of output in that industry less the value of intermediate inputs sourced from local industries or abroad. ***Expenditure GDP*** measures the value of final demand in the economy as a whole (ie, consumption, investment, exports and any increase in stocks) minus imports. Income GDP is measured only on an annual basis in New Zealand.

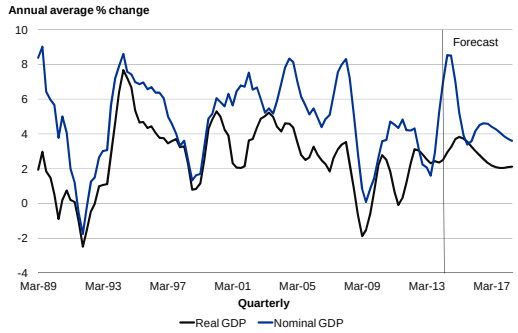
The two quarterly measures of GDP correspond closely over time as they are different ways of measuring the same thing (Figure 4). However, they may diverge in the short term because of differences in data and estimation techniques. In New Zealand, production GDP is the preferred measure of growth in GDP. The Treasury forecasts expenditure GDP, but assumes that growth in production and expenditure GDP will be similar in the medium term.

Figure 4 – Production and expenditure GDP growth



Sources: Statistics New Zealand, the Treasury

Figure 5 – Real and nominal GDP growth



Sources: Statistics New Zealand, the Treasury

In addition to the distinction between production and expenditure GDP, GDP can be measured in real and nominal terms. ***Real GDP*** is a measure of the value added in the economy adjusted for price changes and is sometimes referred to as a volume or constant price measure of GDP. The level of value added is expressed in the prices of a base period, currently the 1995/96 March year. ***Nominal GDP*** is a measure of the value added in the economy including price changes and is expressed in current dollars. Quarterly real GDP is calculated on both a production and an expenditure basis, but quarterly nominal GDP is calculated only on an expenditure basis.

Price indices or deflators account for the difference between nominal and real GDP and are calculated for each of the components of expenditure GDP, eg, consumption, investment, exports and imports. The aggregate GDP price deflator reflects movements in all those components and is a wider measure of price changes in the economy than the CPI. The ratio of the exports price deflator to the imports price deflator is referred to as the terms of trade and is part of the overall GDP price deflator and therefore affects nominal GDP. The terms of trade measure the volume of imports that can be purchased for a given volume of exports. The Treasury forecasts both real and nominal expenditure GDP (Figure 5). Nominal GDP is the measure of value added that is used to forecast tax revenue as taxes are paid on current dollar values.