

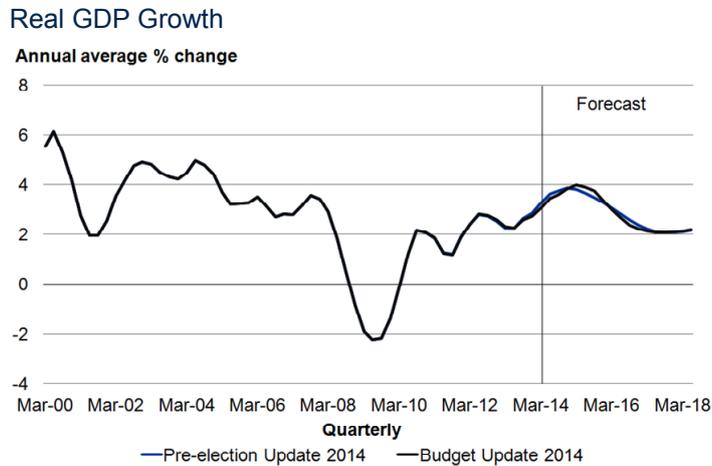
Pre-election Economic and Fiscal Update 2014

Speech delivered by Gabriel Makhlouf,
Secretary to the Treasury

Tuesday 19 August 2014

Welcome to the Treasury and thank you for coming. I want to ensure you have plenty of time to read the document so I will keep my presentation short before the Pre-election Update 2014 is distributed to you for an hour's reading time. There will, as always, be analysts here to answer any technical questions that you have during that reading time. The Minister, Hon Bill English, will arrive shortly after 11 to give his presentation and open the floor to questions.

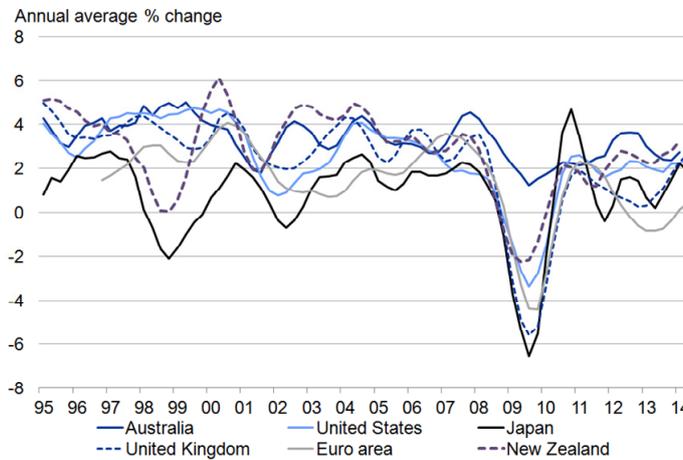
The economy is expanding above potential



The economy is growing strongly. Factors supporting growth include **strong residential construction investment in Auckland and in Christchurch, strong net migration inflows and associated population growth – factors which expand both supply and demand in the economy – and still historically high terms of trade** (that is the ratio of export prices to import prices). Recent quarterly growth rates of 1% have eroded spare capacity. That is why the Reserve Bank again raised its Official Cash Rate on 24 July – the fourth consecutive interest rate rise since March.

The Treasury's assessment is that the economy is expanding at a rate above its sustainable long term capacity to grow – and that means inflationary pressures are building up underlining the importance, among other things, of fiscal restraint in a growing economy.

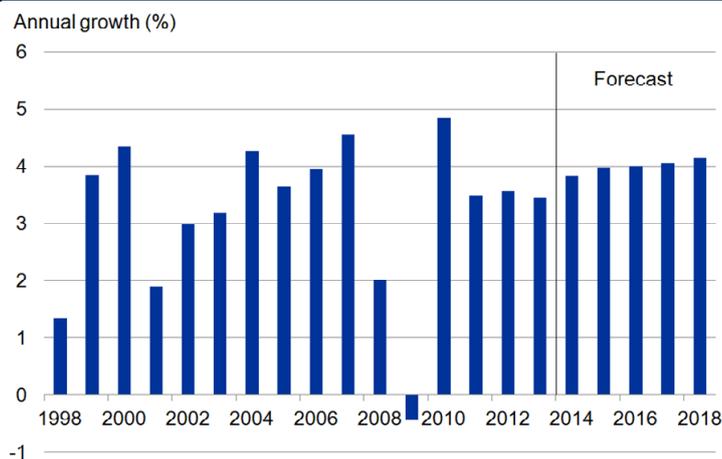
Recent trading partner developments



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In aggregate, New Zealand's main trading partners' economies grew much as expected in the first quarter of 2014, although there were some offsetting variances from the Budget Update forecasts. The United States economy contracted in the March quarter while the Japanese and United Kingdom economies performed better than expected in the first three months of the year.

Outlook for trading partners

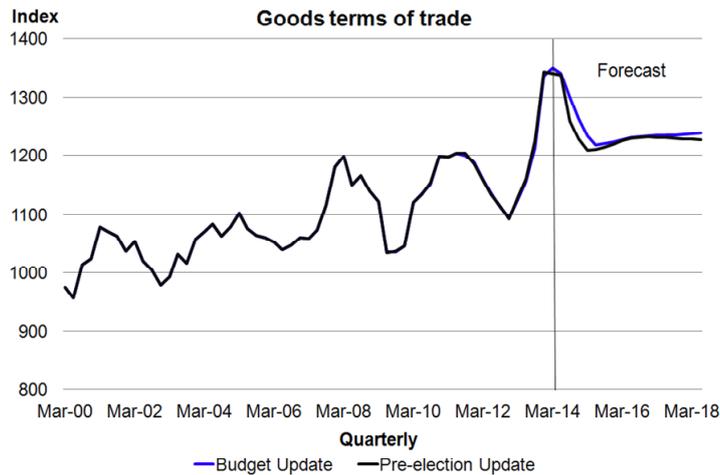


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The outlook for New Zealand's main trading partners has not changed significantly since the *Budget Update*. The **Australian economy** recorded above-trend growth in the first quarter as export volumes increased sooner than expected, however, domestic demand remains weak; **China's** annual growth picked up in the June quarter with some

fiscal stimulus and monetary easing, but authorities continue to face a trade-off between boosting growth in the short term and rebalancing the economy and reducing credit risk over the medium term. There is a discussion on recent developments and the outlook for our main trading partners in the *Update*

NZ's goods terms of trade



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The *Pre-election Update* forecasts New Zealand's **merchandise terms of trade to ease back earlier than had been anticipated** in the *Budget Update*. In terms of the bigger picture, however, the Treasury's **central forecast remains for the terms of trade to remain above historic average levels over the forecast period** and the overall picture in this *Update* for the period to June 2018 is similar to the outlook outlined in the *Budget Update*.

Outlook over forecast period

- Solid real GDP growth over forecast period
- Significant investment continues
- There are benefits from fiscal restraint in a growing economy
- There are long term benefits in utilising the upswing to strengthen the Crown balance sheet

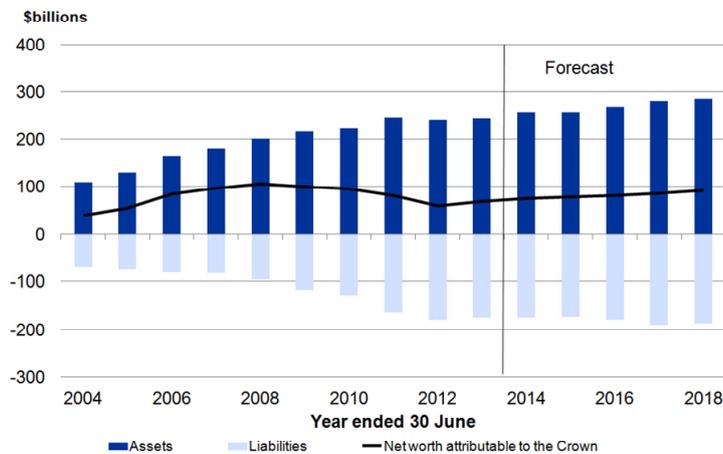
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Real production GDP is forecast to grow by 2.8% on average over the four years to March 2018, essentially unchanged from the outlook at Budget.

The outlook for economic activity is slightly weaker than at Budget 2014 in nominal GDP terms, however, as weaker terms of trade compound the impact of lower domestic prices – and this will impact on the Crown’s finances. The Treasury **forecasts the Crown to run growing operating surpluses over the forecast period, starting in the current financial year, although the profile is weaker** than anticipated in the *Budget Update*.

A key driver of the change in the profile since Budget 2014 is the **Treasury’s lower tax forecasts largely reflecting the lower nominal GDP profile**. Prudent, careful management of the Crown’s finances remains a priority as the Crown looks to maintain annual surpluses and remain on track to pay down debt.

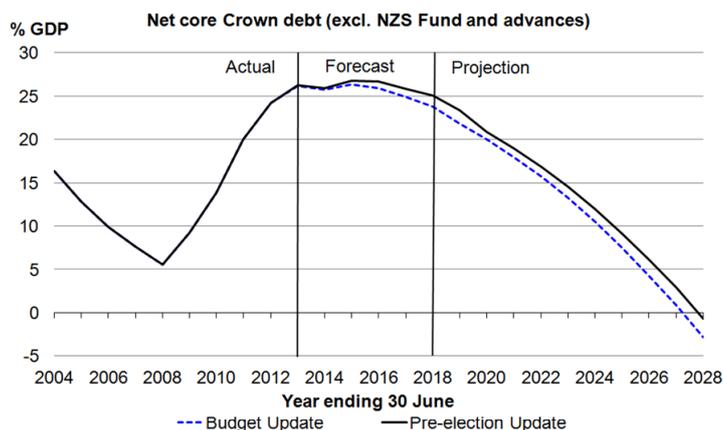
Outlook for the Crown balance sheet



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Net worth attributable to the Crown is forecast to grow steadily in nominal terms across the forecast period largely owing to forecast operating balance surpluses. Beyond June 2014, net worth is expected to grow by \$17.6 billion to stand at \$92 billion or around 33.9% of GDP by 2017/18.

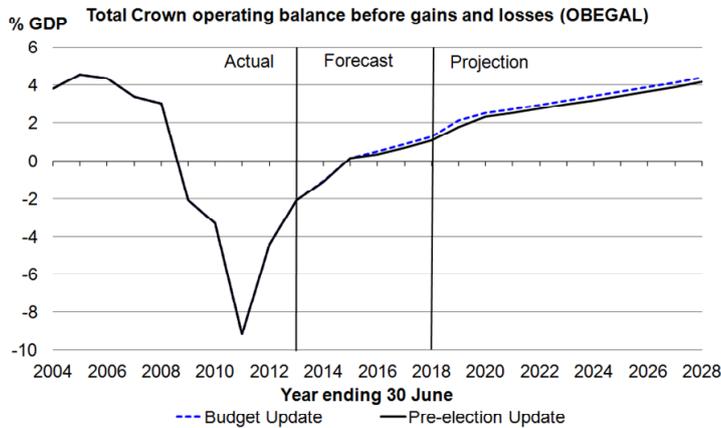
Crown finances since GFC



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We are putting more distance between us and the *Global Financial Crisis* and the Canterbury earthquakes.

Total Crown operating balance



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Based on existing spending and revenue settings, the Treasury **forecasts the Crown to run growing operating surpluses over the forecast period.**

The *Financial Statements of the Government* for the June 30 2014 fiscal year are not due until October, but the Treasury's forecast is for the deficit in that year will stand at 1.1% of GDP – the same ratio to GDP for the deficit that had been forecast in the *Budget Update*.

In the June 2018 financial year, the annual operating surplus is now forecast to be around \$3.0 billion, equal to around 1.1% of GDP in the 12 month period ending 30 June 2018 – a smaller sized surplus as a share of the economy than expected in the *Budget Update*.

Alternative scenarios and risks

- There are always risks to forecasts
- These are discussed in the Risks & Scenarios Chapter
- While the scenarios look at *what if* scenarios, the Treasury's assessment is the economy will more likely evolve along the central forecasts

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When economists publish forecasts for growth, the forecast represents a midpoint, or the **Treasury's assessment of the *most probable* outcome based on information currently at hand.**

In the real world there are, of course, always risks and uncertainties around any set of forecasts.

The Treasury **outlines the primary economic risks and uncertainties in the Risks and Scenarios chapter which I would recommend journalists to read, along with the Specific Fiscal Risks chapter which discloses where policies, including those under active consideration, which are not certain enough** (in terms of their likely timing or measurement) to incorporate into the fiscal forecasts.

There are always risks: there are **geopolitical risks** that could impact the international trading environment; there are **risks around how households respond to the recent (and expected future) interest rate rises**; there remain **risks around the exact pace of the Canterbury rebuild**; there are **risks in some emerging market economies** regarding how they might be impacted once the major economies such as the United States start to tighten monetary conditions.

Because there are always degrees of uncertainty around forecasts, the chapter includes, as usual, a **couple of alternative scenarios** to help you think about potential alternative ways that the economy could pan out and why. The Treasury's next set of economic and fiscal forecasts are due to be published in the *Half Year Update* before Christmas.

Economic data after forecast finalisation

- Net migration inflows close to forecast
- RBNZ raised OCR again, as expected
- Dairy prices fall more than expected
- Unemployment rate falls to 5.6% in June quarter (versus forecast of 5.9%)

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Since the finalisation of the macroeconomic forecasts on 18 July, the **Reserve Bank** has raised its OCR, **Statistics New Zealand** has published further data (including June quarter labour market data) and there was a **Global Dairy Trade auction** held on 6 August NZ time.

The Treasury's **central forecast assessment is that weakness in global dairy markets recently is more reflective of short term demand, including related high stocks in China, rather than an indication of greater-than-forecast structural weaknesses.**

The latest dairy price falls are not inconsistent with the direction of the Treasury's central forecasts – they reinforce the *Pre-election Update's* **central outlook for economic growth to be slightly weaker in the short term than had been forecast in the *Budget Update*, as weaker terms of trade compound the impact of lower domestic consumer prices.**

Should dairy prices continue to fall in the next few months, however, this **could have negative implications for the economy and the Crown accounts** over the forecast period.

One scenario in Risks and Scenario Chapter examines some of the **implications that would arise in the event of a more significant, earlier weakening in our terms of trade than in the central forecasts combined with weaker domestic activity.**

There will be **another four months of data before the *Half Year Update* is prepared – we will have a clearer picture by that time as to how much of the recent market decline in prices is due to shorter term factors and how much of it might be more structural.**

The recent volatility in dairy prices is a timely reminder that, as a small trading economy with a large commodity export sector, New Zealand is strongly influenced by changes in international trading conditions. **Market volatility reinforces how important it is to utilise economic upswings to strengthen the Crown's overall balance sheet and to build up buffers against any future adverse international economic or financial events, or natural disasters at home.**

New Zealand Public Finance Act

- A full pre-election update is required by law
- Glossary of terms in the *Update*
- Analysts available to answer your questions
- Embargo on all materials lifts at noon
- The Minister is expected after 11am

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Treasury staff will shortly distribute the *Pre-election Update* – hard copies and on USB. The Glossary of Terms in the *Update* should, I hope, assist you as you navigate the document and there are, as always, analysts available to answer any technical questions or enquiries that you might have. I expect the Minister will be here shortly after 11am to talk before opening the floor to your questions.

Happy reading.