



Budget Policy Statement 2012

Hon Bill English, Minister of Finance

16 February 2012

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Budget Policy Statement

Executive Summary

The Government has set out a clear plan for the next three years, which involves returning to budget surplus in 2014/15. This will in turn enable us to start reducing net government debt as a proportion of GDP.

Within these fiscal parameters, the Government's plan involves pushing ahead with a wide-ranging programme of microeconomic reforms; driving better results and better value for money from public services; and rebuilding Christchurch.

Budget 2012 is about sticking to that plan.

The updated fiscal forecasts show we are on track to post a surplus of \$370 million in 2014/15, keep net debt below 30 per cent of GDP and reduce this to 20 per cent of GDP by 2020/21.

Given events in Europe, and the weakened outlook for global growth, this surplus is understandably smaller than was forecast in the *Pre-election Update*. But the Government still remains on its fiscal track.

This *Budget Policy Statement* confirms operating allowances of \$800 million for Budgets 2012 and 2013, returning to \$1.2 billion for Budget 2014 and growing thereafter at 2 per cent per annum. To stick to these operating allowances we will continue to reprioritise spending into higher-priority areas and require government departments to find efficiencies as part of their four-year budget plans.

This *Budget Policy Statement* also confirms net zero capital allowances. New capital spending over the next five Budgets will be funded from the proceeds of the mixed ownership model, which is expected to free up \$5 to \$7 billion for new investment in public assets through the Future Investment Fund. This is \$5 to \$7 billion, therefore, that the Government does not have to borrow.

The economic outlook for New Zealand, while somewhat weaker than forecast in the *Pre-election Update*, remains positive. New Zealand's terms of trade are expected to remain at elevated levels; our largest trading partners are amongst the stronger-performing countries in the world; and the rebuilding of Christchurch will provide a substantial impetus to economic activity over coming years. Nonetheless, there remains a risk that economic events offshore, particularly in Europe, could have a significant negative effect on the New Zealand economy. The Government continues to monitor global events very carefully.

Economic Context

The New Zealand economy continued its expansion in 2011. The economy has now grown in nine of the past 10 quarters, despite a number of factors weighing on this growth, including the European sovereign debt crisis and the Canterbury earthquakes. An increased level of household saving has also weighed against economic activity in the short term, although it is a necessary foundation for more sustainable growth in the medium and longer terms.

Looking ahead, New Zealand faces a set of circumstances and opportunities that provide impetus for solid growth over the next four years. The rebuilding of Christchurch will be a key driver of domestic activity and is expected to add 1¼ percentage points to annual growth in each of the 2012 to 2016 calendar years. New Zealand's two largest trading partners – Australia and China – are forecast to maintain strong growth rates. The terms of trade, although expected to weaken, will remain at historically elevated levels on the back of demand from emerging markets for our major export commodities.

A summary of the Treasury's updated economic forecasts can be found in the accompanying *Economic Outlook*. These show weaker trading partner growth than was forecast in the *Pre-election Update*, particularly in the near term, as a result of the ongoing turmoil in Europe. In addition, the earthquakes of 23 December 2011 and subsequent seismic activity have led the Treasury to push out the anticipated impact of some Christchurch rebuilding activity which was expected to occur this year.

As a result, growth is expected to be somewhat weaker in the near term than was previously forecast but to pick up over time. Growth in the year to March 2012 is now expected to be 1.9 per cent, down from 2.3 per cent in the *Pre-election Update*. Growth in the year to March 2013 is expected to be 2.8 per cent (down from 3.4 per cent) and in the year to March 2014 expected to be 3.8 per cent (up from 3.3 per cent).

Despite these weaker near-term forecasts, New Zealand is still expected to grow more strongly over the next two years than the euro area, the United Kingdom, Japan, the United States and Canada.

There are risks to these forecasts, however. Global growth could be weaker than the Treasury and others are forecasting, depending on how effective European policymakers are in addressing the debt and economic growth challenges that face the euro area. There is also a real possibility that the European crisis could lead to another global recession. Further seismic activity in Christchurch could also push rebuilding activity back further.

A full Economic and Fiscal Update will be provided with Budget 2012.

Budget Priorities

The Government has a comprehensive policy agenda, which will guide Budget priorities over the parliamentary term. Our main priorities are:

- 1 Responsibly managing the Government's finances.
- 2 Building a more productive and competitive economy.
- 3 Delivering better public services within tight financial constraints.
- 4 Rebuilding Christchurch, our second-biggest city.

1 *Responsibly managing the Government's finances*

Structural fiscal deficits and rising debt are not sustainable, nor conducive to higher national saving, rebalancing the economy toward tradable activity or lifting medium-term potential growth. Budget 2011 set a course for fiscal consolidation that would see a return to surplus and over time reduce debt to prudent levels.

Eliminating the fiscal deficit and reducing debt to prudent levels will help the economy cope with future economic and fiscal shocks, including managing risks to the economy flowing from New Zealand's high net external debt position; increase national saving and support higher investment; and directly reduce future borrowing and finance costs. By better controlling government spending, we are freeing up resources in the domestic economy to go to more productive uses. This is a key lever for minimising pressures on interest and exchange rates, especially as Christchurch's rebuilding gets into full swing.

The 2011 *Fiscal Strategy Report (FSR)* set the long-term objective of restoring the fiscal buffer against future shocks by ensuring that net debt is brought back to no more than 20 per cent of GDP by the early 2020s. The *FSR* also set the short-term intention of returning the operating balance to surplus by no later than 2015/16, subject to any shocks. It is our intention to achieve this one year earlier – 2014/15 – in accordance with our commitment to the electorate.

Achieving the fiscal strategy requires disciplined control of expenditure. We are confirming future operating allowances, reserved for new expense or revenue initiatives, at \$800 million per annum for Budgets 2012 and 2013 and then returning to \$1.2 billion per annum, growing at 2 per cent, thereafter. We also confirm commitment to a net zero capital allowance for each of the next five Budgets, requiring new investments to be funded from capital freed up from the balance sheet rather than additional borrowing.

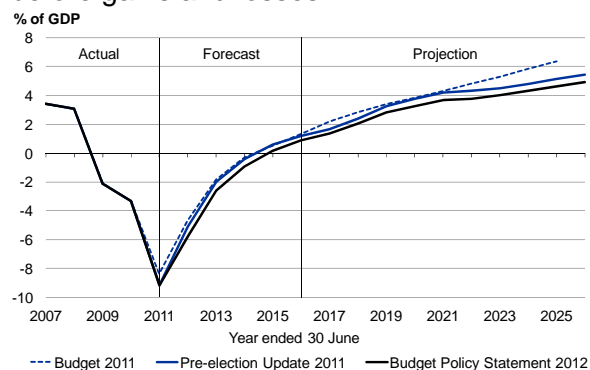
The Government has shown it is capable of delivering Budgets within tight fiscal parameters. Budget 2011 included a net zero operating allowance, which delivered forecasts showing the Government meeting its fiscal objectives while spending on the Christchurch rebuild and reprioritising expenditure toward improved health and education services.

The *Pre-election Update* presented a fiscal outlook that was consistent with our fiscal objectives, despite a weaker economic outlook than in Budget 2011. The Treasury's updated fiscal forecasts show this continues to be the case (see Table 1). The Treasury is currently forecasting an operating surplus of \$370 million in 2014/15. Net debt is forecast to peak at 29.6 per cent of GDP in 2015/16 and is projected to be brought back to 20 per cent of GDP by 2020/21.

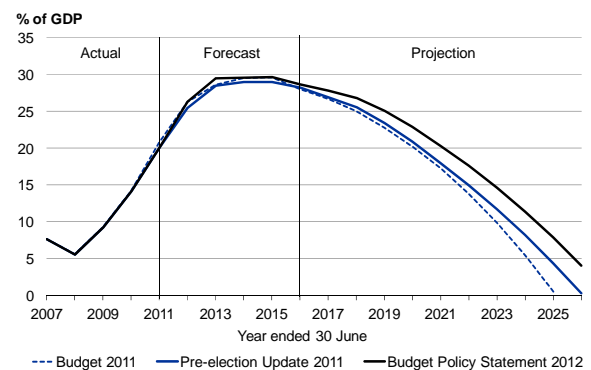
Table 1 – Updated fiscal forecasts

| June Years % of GDP (unless otherwise stated) | 2011 Actual | 2012 Forecast | 2013 Forecast | 2014 Forecast | 2015 Forecast | 2016 Forecast |
|--|----------------|------------------|------------------|------------------|------------------|------------------|
| Operating balance before gains and losses (\$m) | (18,396) | (12,084) | (5,631) | (2,155) | 370 | 2,242 |
| <i>Pre-election Update (\$m)</i> | | (10,809) | (4,438) | (943) | 1,450 | 3,076 |
| Operating balance before gains and losses | -9.2 | -5.8 | -2.6 | -0.9 | 0.2 | 0.9 |
| <i>Pre-election Update</i> | | -5.1 | -2.0 | -0.4 | 0.6 | 1.2 |
| Core Crown revenue | 28.7 | 28.7 | 29.6 | 29.8 | 30.1 | 30.5 |
| <i>Pre-election Update</i> | | 28.9 | 29.6 | 30.1 | 30.4 | 30.8 |
| Core Crown expenses | 35.2 | 35.4 | 32.8 | 31.4 | 30.8 | 30.3 |
| <i>Pre-election Update</i> | | 35.2 | 32.3 | 31.1 | 30.7 | 30.4 |
| Core Crown net debt | 20.0 | 26.3 | 29.4 | 29.6 | 29.6 | 28.6 |
| <i>Pre-election Update</i> | | 25.4 | 28.5 | 28.9 | 29.0 | 28.2 |
| Total net worth attributable to the Crown | 40.4 | 31.1 | 28.3 | 26.8 | 26.7 | 27.5 |
| <i>Pre-election Update</i> | | 32.2 | 29.7 | 28.8 | 29.0 | 30.1 |

Source: The Treasury

Figure 1 – Total Crown operating balance before gains and losses

Source: The Treasury

Figure 2 – Core Crown net debt

Source: The Treasury

The updated fiscal forecasts reflect the Treasury's updated economic forecasts, with slightly lower nominal GDP leading to weaker tax revenue and slightly higher than forecast unemployment resulting in increased benefit expenses. In addition, based on initial indications of the damage caused, the direct costs of the December 2011 earthquakes have added about \$300 million to the operating deficit in the current year relative to the *Pre-election Update*. The extension of the mixed ownership model has also been incorporated into these fiscal forecasts.¹ Some offset comes from lower interest rates reducing expected finance costs and lower CPI inflation reducing some automatic adjustments.

¹ The Government's primary indicator of the budget balance, the operating balance before gains and losses (OBEGAL), excludes profits now expected to be attributed to minority shareholders. Further information about the impact of the mixed ownership model can be found on page 6.

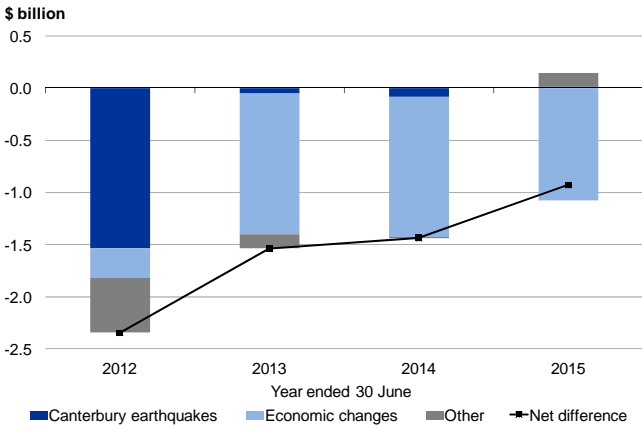
As shown in Figure 3, the main driver of changes to the forecast operating balance relative to Budget 2011 relate to changes in the economic outlook. The large increase in earthquake costs in 2011/12 reflects delays in expenditure from 2010/11, together with the impact of the December earthquakes.

The forecast surplus for 2014/15 is not large and is therefore vulnerable to further revisions in forecast tax revenue or expenses. In this highly uncertain global environment, some measure of policy flexibility is needed while maintaining fiscal policy credibility. If the international outlook worsens between now and the Budget, the Government will look at what would be required to meet the surplus target. The Government is aware, however, that 2014/15 is still three years away and that forecast revisions can fluctuate over time both on the upside and the downside.

If the economy were hit by a very severe negative shock, the Government would look at whether retaining the surplus target would actually harm the economy by forcing a sharp reduction in demand. Outside that scenario, we remain firmly committed to achieving a budget surplus in 2014/15.

The supply and confidence agreement between the National and ACT parties recognises that legislative change would constrain excessive future increases in government spending. A spending limit would restrain growth in core government expenses (excluding unemployment benefits, emergencies and interest payments) to no higher than the rate of inflation and population growth. The fiscal strategy with respect to the objectives for the operating balance and debt would be consistent with such a limit.

Figure 3 – Change in forecast operating balance (before gains and losses) relative to Budget 2011



Source: The Treasury

Note: 'Economic changes' captures changes to tax revenue and benefit expenses as a result of changes to the economic forecasts.

Extending the Mixed Ownership Model

The Government intends to sell up to 49 per cent of its shareholdings in the State-owned enterprises Mighty River Power, Meridian, Genesis Energy and Solid Energy and reduce the Crown's current shareholding in Air New Zealand.

Mighty River Power is the first company being prepared for mixed ownership, via an Initial Public Offering, most likely in the third quarter of 2012, subject to market conditions. New Zealanders will be at the front of the queue for shares, and the Government expects New Zealand ownership of the companies will be around 85 to 90 per cent.

Table 2 below outlines the forecast fiscal impacts of the mixed ownership model. The forecast assumption is for total proceeds of \$6 billion, which is the midpoint of the estimated range of \$5 to \$7 billion.

Table 2 – Estimated fiscal impact of extending the mixed ownership model

| June Years \$ million | 2012 Forecast | 2013 Forecast | 2014 Forecast | 2015 Forecast | 2016 Forecast |
|---|------------------|------------------|------------------|------------------|------------------|
| Net debt | | | | | |
| Forecast cash proceeds | - | (1,500) | (1,500) | (1,500) | (1,500) |
| Forecast forgone dividends | - | 50 | 100 | 150 | 200 |
| Estimated finance cost savings | - | (54) | (93) | (172) | (266) |
| Annual reduction in net debt | - | (1,504) | (1,493) | (1,522) | (1,566) |
| Cumulative reduction in net debt | - | (1,504) | (2,997) | (4,519) | (6,085) |
| Operating balance | | | | | |
| Forecast forgone profits to minority shareholders | - | (90) | (180) | (270) | (360) |
| Estimated finance cost savings | - | 54 | 93 | 172 | 266 |
| Net decrease in operating balance before gains and losses | - | (36) | (87) | (98) | (94) |
| Forecast gain on sale | - | 200 | 200 | 200 | 200 |
| Increase in operating balance | - | 164 | 113 | 102 | 106 |

Estimated finance costs are based on average bond yields.

Profits include dividends paid in cash to shareholders and earnings that are retained by the company.

Source: The Treasury

The overall fiscal impact of mixed ownership is:

- a reduction in net debt. Proceeds will fund new capital purchases, thereby reducing the Crown's borrowing requirement. Forgone dividends increase net debt but are offset by estimated finance cost savings
- a small reduction in the operating balance before gains and losses. Profits attributable to minority shareholders (forgone profits) reduce the surplus. This is offset somewhat by a reduction in finance costs resulting from the reduced net debt
- a small increase in the operating balance over the forecast horizon. Gains on sales are forecast, reflecting an expectation that sale prices will be greater than the book value of the net assets to be sold.

Over the mixed ownership programme, the forecast finance cost savings exceed the forecast forgone dividends. However, the forecast finance cost savings are less than the forecast forgone profits. This is because State-owned enterprises are expected to act as profitable companies and therefore over time to earn an appropriate commercial rate of return that reflects the risk of owning such companies. In effect, the Crown is exchanging an expected stream of income for a (risk adjusted) equivalent amount of cash now.

Mixed ownership, which is the model under which Air New Zealand currently operates, has a number of benefits, including:

- freeing up capital for the Government to invest in other public assets, without having to borrow to do so
- improving the pool of investments available to New Zealand investors and deepening capital markets
- allowing the mixed ownership companies to access capital and grow without depending entirely on the Government
- allowing for external oversight, which places sharper discipline and more transparency on a company's performance, increasing the incentive for improved performance.

Assumptions

The inclusion of the mixed ownership model in the Treasury's forecasts is on the basis that the policy has been sufficiently progressed to enable reasonable forecast assumptions to be formulated and the Government recently confirmed it would be proceeding with the programme after receiving a mandate by its re-election.

These estimates are based on a high-level set of assumptions spread evenly across the forecast period to ensure the forecasts do not compromise the Crown in a material way in relation to particular sales (as required by the Public Finance Act 1989). The timing of each individual sale and the amount of sale proceeds may differ from these forecasts.

2 Building a more productive and competitive economy

New Zealand's economic prospects ultimately determine the living standards we can afford. To achieve higher incomes and more jobs, the economy needs to be more internationally competitive and productive. The New Zealand economy lost competitiveness over the 2000s and our high-level aim is to first restore and then exceed the economic performance achieved over the 1990s.

Lifting economic performance requires many specific actions to improve the environment for businesses to grow, invest and hire workers. The Government has a 120-point action plan that will improve the competitiveness and productivity of the New Zealand economy.

A broad range of microeconomic reforms are focused on removing roadblocks that prevent firms from taking advantage of growth opportunities. Reducing the regulatory burden on businesses and individuals is a key means of improving productivity and competitiveness. We have already streamlined much regulation. Specific regulatory reform initiatives under way include thorough reviews of the Building Act, the Resource Management Act (RMA) and the regulatory costs imposed on exporters. Other initiatives in the 120-point plan include:

- pursuing an ambitious programme of free-trade agreements, such as the Trans-Pacific Partnership
- overhauling our securities law to improve investors' confidence in New Zealand's financial markets
- setting a six-month time limit for the consenting of medium-sized projects under the RMA
- reducing the costs and bureaucracy of the collective bargaining wage-setting process, and lowering the barriers to work for our youngest workers
- encouraging oil and gas exploration with a competitive new system for processing permits.

In addition, Budget 2012 will lift investment in science and innovation. Industrial Research Limited (IRL) will be transformed into an advanced technology institute to work alongside the high-tech manufacturing and services sector. We will establish funding for a series of National Science Challenges to find innovative solutions to some of the most fundamental issues New Zealand faces in its future development.

In delivering this action plan, the Government will ensure policy supports macroeconomic stability, investment and saving. As well as returning government accounts to surplus, we will ensure that core Crown expenses are reduced to around 30 per cent of GDP and implement policy that is conducive to lifting domestic saving. We are committed to a broad-based, low-rate tax system, and substantially reformed the tax system in Budget 2010.

The extension of the mixed ownership model will allow a large reprioritisation of capital for use in upcoming Budgets through the establishment of the Future Investment Fund. The Future Investment Fund will invest in new public assets and modern infrastructure, including the building of 21st Century Schools.

New state highways, ultra-fast broadband and the Rural Broadband Initiative continue to be rolled out. More generally, the Government is determined to make more efficient use of the Crown balance sheet so that it contributes to improved economic performance. The Crown balance sheet contains \$245 billion worth of assets, so small gains in efficiency have the potential to have significant positive impacts on both the fiscal position and economic performance. We will continue to concentrate on making the most out of what is already owned.

A more efficient and innovative public sector can make a contribution to overall economic performance. Public provision of goods and services makes up about a quarter of the economy, so higher productivity in the public sector directly contributes to improved economy-wide productivity. An efficient public sector also means resources are freed up so they can more easily flow to sectors exposed to international competition.

3 Delivering better public services within tight financial constraints

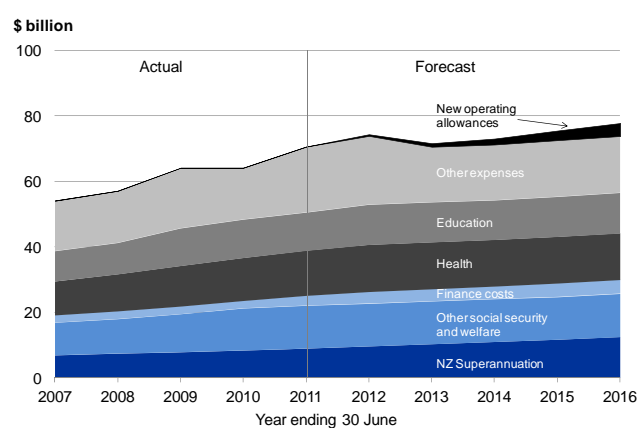
The Government is committed to delivering high-quality public services. A more effective and efficient public sector is central to delivering on this objective, while achieving the fiscal strategy and lifting economic performance.

The operating allowances are used to fund additional net operating expenses, with the exception of finance costs and social entitlement payments. The operating allowances represent only a fraction of total core Crown expenses (see Figure 4), which totalled more than \$70 billion in 2010/11 and are forecast to rise to \$78 billion by 2015/16.

Together health and education expenses are currently around \$27 billion, just less than 40 per cent of total core Crown expenses. Social security and welfare expenses are around \$23 billion or 30 per cent of the total. The demographic pressures of an ageing population mean that over time spending on New Zealand Superannuation will absorb an increasing share of total expenses.

The increase in expenses in 2010/11 and 2011/12 includes the effects of one-off items relating to the Canterbury Earthquake Recovery Fund and the weathertight homes package, as well as the introduction of new sectors into the Emissions Trading Scheme.

Figure 4 – Core Crown expenses



Source: The Treasury

In delivering better public services in this challenging fiscal environment, the Government is committed to ensuring there is value for money across the total base of government expenditure and in the management of Crown assets. The past three Budgets identified savings of \$9 billion over five years, which were used to fund higher priority spending and reduce the deficit. We are continuing to challenge government departments to operate within four-year budget plans by delivering efficiency savings and innovations in service delivery and to advise the Government on how to prioritise resources to have the largest impact on New Zealanders' living standards.

As well as giving departments and other agencies responsibility for adapting to medium-term fiscal constraints, we have been developing the tools and capability of agencies to respond to this challenge. For example, the annual benchmarking of administrative and support services provides valuable management information for agencies on the cost, efficiency and effectiveness of these services. This has led to opportunities for cross-agency improvement in a number of administrative and support functions. This exercise has now been extended to policy advice and service delivery performance.

In many parts of the state sector, initiatives are delivering greater efficiency and innovation through different ways of working. These include:

- District Health Boards (DHBs) focusing on productivity and smarter procurement. They are delivering on the Government's key health targets, including shorter waiting times for cancer treatment and elective surgery. At the same time, DHB deficits have been cut from \$155 million in 2008/09 to \$16 million in 2010/11

- agencies finding new ways to provide services to affected communities following the Canterbury earthquakes. This includes remote working for staff, using community facilities, sharing staff and resources and maximising flexible working. These were driven by necessity but in many cases showed that doing things differently can result in better services and is leading to new approaches nationwide by some of these agencies
- shifting ACC's focus toward early intervention and contracting private providers to manage clients. This has generated both significant improvements in rehabilitation outcomes and substantial cost savings
- the Defence Force reprioritising cumulative savings of \$142 million by stopping non-essential activities, outsourcing others and changing the way it organises itself
- establishing the Social Housing Unit in the Department of Building and Housing to make more and better use of alternative providers to meet the housing needs of those who have difficulty accessing housing in the private market.

The challenge is to embed these sorts of practices across the state sector so the Government can deliver on its priorities. Before Budget 2012, the Government will announce the next steps for state sector reform, following the recommendations of the Better Public Services Advisory Group. This will be critical for helping the Government to deliver better public services within tight financial constraints.

The Government will also be putting a strong focus on welfare reform. Reducing long-term welfare dependency will contribute to fiscal, economic and social objectives. We intend to introduce changes that will create new benefit categories, with a greater proportion of beneficiaries required to make themselves available for work. At the same time, we will do more to help beneficiaries into work, through services such as childcare, training, workplace support and access to health and disability support.

4 *Rebuilding Christchurch, our second-biggest city*

Our fourth priority is to get on with rebuilding Christchurch and its surrounds. In 2011, the main priority was addressing the damage caused by the destructive earthquakes that hit the region. In 2012, it is about starting to rebuild a vibrant, strong city.

The Government is totally committed to the reconstruction of Canterbury. Budget 2011 put aside \$5.5 billion in the Canterbury Earthquake Recovery Fund and created a new government department, the Canterbury Earthquake Recovery Authority, to lead the recovery effort.

Rebuilding Christchurch and its surrounding areas is an unprecedented project – without doubt the biggest economic undertaking in New Zealand's history. The commercial redevelopment of Christchurch is under way. Residential housing reconstruction should be moving up a gear from this month, subject to risks from further seismic activity.

As the rebuilding grows, the demand for workers and materials in Christchurch will be huge. The Government's strong focus will be on removing roadblocks so that demand can be met.

Conclusion

Budget 2012 will be about sticking to the plan the Government has set out for the next three years.

The global economic environment remains uncertain and this makes it even more important to maintain clear and credible fiscal settings.

The Government is committed to returning the operating balance to surplus in 2014/15 and reducing net debt as a proportion of GDP. That will help to take pressure off interest rates and the exchange rate and is crucially important for New Zealand's credibility with international financial markets.

At the same time, the Government is continuing to address New Zealand's significant economic challenges, including a sustained rebalancing of the economy towards the internationally competitive sectors of the economy. A broad range of targeted microeconomic reforms will help to lift productivity and competitiveness in the economy.

Budget 2012 will also contribute to the Government's priorities of delivering better public services and of rebuilding Christchurch.



Hon Bill English
Minister of Finance

16 February 2012

Annex 1

Long-term fiscal objectives and short-term fiscal intentions

The Government remains committed to the long-term fiscal objectives set out in *Fiscal Strategy Report 2011* – as shown below in Table A1. These long-term objectives are consistent with the principles of responsible fiscal management.

The Government's short-term fiscal intentions have been revised since Budget 2011, consistent with the revisions to the fiscal forecasts (see Table A2). The short-term intention for the operating balance has also been revised consistent with the Government's intention to return the operating balance (before gains and losses) to surplus no later than 2014/15, subject to any significant shocks. These revised fiscal intentions are consistent with the Government's long-term fiscal objectives.

Table A1 – Long-term fiscal objectives

Fiscal Strategy Report 2011

Debt

Manage total debt at prudent levels. Over the short to medium term it is prudent to allow an increase in debt to deal with the current economic and fiscal shock.

However, we need to ensure that this increase is eventually reversed and that we return to a level of debt that can act as a buffer against future shocks.

We will do this by ensuring that net debt remains consistently below 35% of GDP, and is then brought back to a level no higher than 20% of GDP by the early 2020s. We will work towards achieving this earlier as conditions permit.

Operating balance

Return to an operating surplus sufficient to meet the Government's net capital requirements, including contributions to the New Zealand Superannuation Fund, and ensure consistency with the debt objective.

Operating expenses

To meet the operating balance objective, the Government will control the growth in government spending so that over time, core Crown expenses are reduced to around 30% of GDP.

Operating revenues

Ensure sufficient operating revenue to meet the operating balance objective.

Net worth

Ensure net worth remains at a level sufficient to act as a buffer to economic shocks. Over the medium term, net worth will continue to fall as the impact of the global financial crisis unfolds. Consistent with the debt and operating balance objectives, we will start building up net worth ahead of the demographic change expected in the mid-2020s.

Table A2 – Short-term fiscal intentions

| <i>Budget Policy Statement 2012</i> | <i>Fiscal Strategy Report 2011</i> |
|--|---|
| <p>Debt</p> <p>Gross sovereign-issued debt (including Reserve Bank settlement cash and Reserve Bank bills) is forecast to be 36.9% of GDP in 2015/16.</p> <p>Core Crown net debt (excluding NZS Fund and advances) is forecast to be 28.6% in 2015/16.</p> | <p>Debt</p> <p>Gross sovereign-issued debt (including Reserve Bank settlement cash and Reserve Bank bills) is forecast to be 37.2% of GDP in 2014/15.</p> <p>Core Crown net debt (excluding NZS Fund and advances) is forecast to be 29.6% in 2014/15.</p> |
| <p>Operating balance</p> <p>Our intention is to return the operating balance (before gains and losses) to surplus as soon as practical and no later than 2014/15, subject to any significant shocks.</p> <p>Based on the operating allowance for the 2012 Budget, the operating balance (before gains and losses) is forecast to be -2.6% of GDP in 2012/13. The operating balance (before gains and losses) is forecast to be 0.2% of GDP in 2014/15. This is consistent with the long-term objective for the operating balance.</p> <p>The operating balance is forecast to be -1.5% of GDP in 2012/13.</p> | <p>Operating balance</p> <p>Our intention is to return the operating balance (before gains and losses) to surplus as soon as practical and no later than 2015/16, subject to any significant shocks.</p> <p>Based on the operating allowance for the 2011 Budget, the operating deficit is forecast to be 3.5% of GDP in 2011/12. The operating balance is forecast to be 1.9% of GDP in 2014/15. This is consistent with the long-term objective for the operating balance.</p> <p>The operating deficit (before gains and losses) is expected to be 4.7% in 2011/12.</p> |
| <p>Expenses</p> <p>Our intention is to support a return to fiscal surplus by restraining the growth in core Crown expenses – so that they are reduced to around 30% of GDP by 2015/16.</p> <p>Core Crown expenses are forecast to be 30.3% of GDP in 2015/16.</p> <p>Total Crown expenses are forecast to be 39.8% of GDP in 2015/16.</p> <p>This assumes a new operating allowance of \$800 million per annum for Budgets 2012 and 2013, then returning to \$1.19 billion, growing at 2% for Budgets thereafter (GST exclusive).</p> | <p>Expenses</p> <p>Our intention is to support a return to fiscal surplus by restraining the growth in core Crown expenses – so that they are reduced to around 31% of GDP by 2014/15.</p> <p>Core Crown expenses are forecast to be 31.3% of GDP in 2014/15.</p> <p>Total Crown expenses are forecast to be 40.5% of GDP in 2014/15.</p> <p>This assumes a new operating allowance of \$800 million per annum for Budgets 2012 and 2013, then returning to \$1.19 billion, growing at 2% for Budgets thereafter (GST exclusive).</p> |
| <p>Revenues</p> <p>Total Crown revenues are forecast to be 40.9% of GDP in 2015/16.</p> <p>Core Crown revenues are forecast to be 30.5% of GDP in 2015/16.</p> <p>Core Crown tax revenues are forecast to be 27.8% of GDP in 2015/16.</p> | <p>Revenues</p> <p>Total Crown revenues are forecast to be 41% of GDP in 2014/15.</p> <p>Core Crown revenues are forecast to be 31% of GDP in 2014/15.</p> <p>Core Crown tax revenues are forecast to be 27.8% of GDP in 2014/15.</p> |
| <p>Net worth</p> <p>Total Crown net worth is forecast to be 27.5% of GDP in 2015/16. Core Crown net worth is forecast to be 8.2% of GDP in 2015/16.</p> | <p>Net worth</p> <p>Total Crown net worth is forecast to be 34.1% of GDP in 2014/15. Core Crown net worth is forecast to be 7.9% of GDP in 2014/15.</p> |

Economic Outlook

The Treasury is responsible for the preparation of the following overview of its latest economic forecasts, which represent a refresh of the *Pre-election Update* and have been used to support the *Budget Policy Statement*. Although not a full economic and fiscal update, the economic forecasts are the Treasury's current view of the outlook and have been used to update taxation revenue, welfare benefit expenditure and finance cost forecasts.

The *Pre-election Update* outlined the five major forces we saw influencing the path of the economy over the 2011/12 to 2015/16 forecast horizon: the global economy, particularly economic and financial developments in Europe; commodity prices; the rebuilding of Canterbury; the degree of household saving; and the withdrawal of monetary and fiscal stimulus. The discussion below outlines the judgements around the impact of each of these forces and how they have changed since *Pre-election Update* was prepared.

Table A3 – Updated economic forecasts*

| March Years | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|--|--------|----------|----------|----------|----------|----------|
| | Actual | Forecast | Forecast | Forecast | Forecast | Forecast |
| Real GDP (annual average % change) | 1.2 | 1.9 | 2.8 | 3.8 | 3.1 | 2.6 |
| Unemployment rate (March quarter, s.a.) | 6.6 | 6.2 | 5.7 | 5.1 | 4.9 | 4.6 |
| CPI inflation (annual % change, March quarter) | 4.5 | 2.0 | 2.0 | 2.3 | 2.4 | 2.5 |
| Current account balance (% of GDP) | -3.6 | -4.1 | -4.8 | -6.5 | -6.9 | -6.9 |

* Forecasts finalised 19 January 2012

Sources: The Treasury, Statistics New Zealand

Global growth prospects have weakened...

Global growth prospects have weakened further since the *Pre-election Update* was released in October and the risks to global stability from the European debt crisis have intensified. To date, the downward movement in the outlook, although significant, is well short of the lower trading partner growth forecasts assumed in the downside scenario in the *Pre-election Update*.

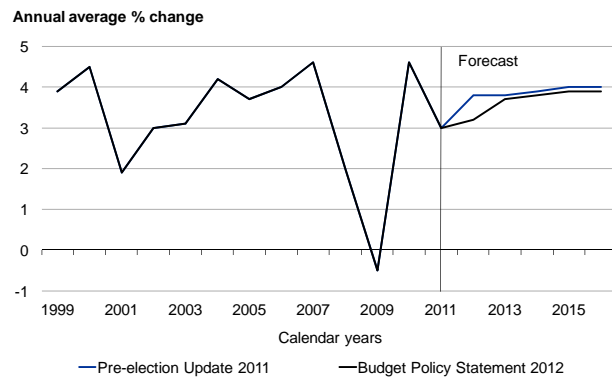
The euro area has been the main driver of the weaker global outlook. Continuing sovereign debt concerns, particularly around Greece but also for larger economies such as Italy, have increased global risk aversion. Bond yields in riskier countries have become elevated, raising concerns about the sustainability of government finances and the impact on banks. The central case is that the euro area remains intact and manages through the crisis but with a recession this year now expected. There are also signs of slower growth and lower forecasts elsewhere, including China and other parts of Asia.

...and will impact the New Zealand economy...

Global developments are expected to be a drag on New Zealand's growth relative to the *Pre-election Update*. The degree to which global events affect New Zealand will depend on the severity of the decline in international growth and financial market disruption. The main channels (and impacts) are:

- Confidence, which has so far been relatively resilient to recent global developments. Nevertheless, confidence measures have generally fallen and are expected to result in lower growth in consumption and investment in the near term than previously expected.
- Terms of trade. World export prices for New Zealand's commodity exports are down 9 per cent from a peak in May 2011. While prices for food products are expected to be underpinned by demand from emerging markets, further falls are forecast, owing to weaker global demand. Together with oil prices holding up, owing to threatened supply restrictions, the terms of trade are now expected to weaken sharply in 2012 from recent historically high levels.
- Export demand. Commodity export volumes are currently benefitting from strong agricultural production as a result of good growing conditions. However, non-commodity exporters, such as manufacturers and tourism operators, will not fare as well as previously expected with weaker global demand and a relatively high exchange rate.
- Funding costs. New Zealand banks' ability to source funds from overseas has become more difficult and expensive as a result of a global re-rating of bank riskiness. Banks are reasonably well funded at present and with credit demand quite muted, there has been little impact on lending. We assume bank funding costs over the next year will be higher than previously assumed. If bank funding pressures intensify we would expect to see more impact.

Figure A1 – Top-16 trading partner growth



Sources: IMF, The Treasury

...but how the other key drivers of the outlook evolve is also important

Earthquake-related rebuilding is expected to provide substantial impetus to economic activity in coming years, even though recent aftershocks are likely to delay some rebuilding by 1 to 2 quarters. We continue to assume earthquake damage to property, contents and infrastructure of around \$20 billion in today's prices, with only modest additional damage from the earthquakes since 23 December 2011. Total costs, including business disruption or additional costs from inflation, insurance administration or rebuilding to higher standards than existed before the earthquakes, will be higher than this at around \$30 billion.

Household saving became positive (0.2 per cent of household disposable income) in the March 2011 year for the first time since 2000 and only the second time since 1993. Household saving is expected to continue increasing over the forecast period. Uncertainty about global developments and their impact on New Zealand could see additional saving. Firms may also be more cautious about growth prospects and delay some employment and investment plans.

Monetary conditions are expected to gradually become less stimulatory as interest rates rise to keep inflation in check. However, interest rates have fallen since the *Pre-election Update* with the weaker outlook, offshore issues and a fall in CPI inflation to 1.8 per cent in the year to December 2011. The exchange rate had fallen in line with higher global risk aversion and lower commodity prices, although has rebounded in early 2012. Easier monetary conditions, if sustained, will provide some additional support to growth.

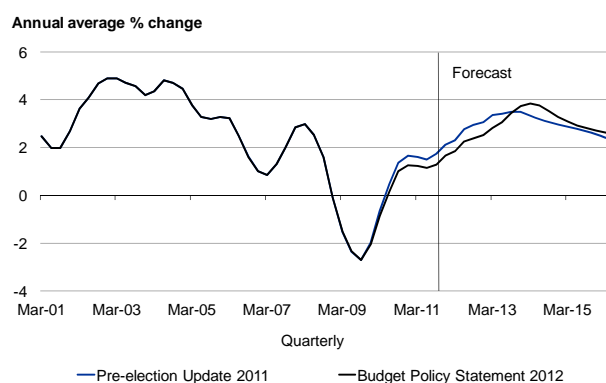
Outlook weaker for 2012/13

Economic growth in the second half of 2011 appears to have developed broadly in line with the *Pre-election Update* forecasts in 2011. Economic growth in the September 2011 quarter of 0.8 per cent was marginally lower than the 0.9 per cent expected in the *Pre-election Update*. However, revisions to previously published data mean the recovery has been weaker than previously thought and has affected annual growth rates. Growth in the March 2011/12 year is expected to be 1.9 per cent, down from 2.3 per cent in the *Pre-election Update*.

On balance, we expect real GDP growth for New Zealand will be lower in 2012 than in the *Pre-election Update*, leading to growth in the 2012/13 March year of 2.8 per cent rather than 3.4 per cent. We see particular risk around the first half of 2012 as it falls between the positive impacts from the World Cup in late 2011 and the assumed ramp-up of rebuilding in Canterbury from late 2012.

Growth is then expected to be higher in the 2013/14 March year than previously expected, owing to the later rebuild and a more general recovery in the economy in line with an assumed rebound in trading partner growth. An easing of growth towards 2½ per cent is expected by the end of the forecast period.

Figure A2 – Real production GDP



Sources: Statistics New Zealand, The Treasury

The Consumers Price Index (CPI) rose 1.8 per cent in the year to December, well below the *Pre-election Update* forecast of 3.1 per cent, as food and travel prices fell sharply. Weaker economic growth will also contribute to softer near-term inflation. A strengthening in the economy is expected to reduce spare capacity and put upward pressure on inflation. An assumed depreciation of the exchange rate lifts inflation towards the end of the forecast period.

The unemployment rate was 6.6 per cent in the September quarter, compared with 6.3 per cent in the *Pre-election Update* but wages and hours worked were stronger. The weaker economic outlook in 2012/13 is expected to flow through to a slower improvement in labour market conditions.

The annual current account deficit is expected to be larger than we expected in the *Pre-election Update* in the short term, owing to the terms of trade not peaking as high and higher income outflows (eg, bank profits). In the medium term, the deficit rises above 6 per cent of GDP, as previously expected, owing partly to the increase in investment associated with the rebuilding in Canterbury. As the rebuilding in Canterbury winds down, and assuming the exchange rate depreciates as in these forecasts, the current account deficit would be expected to return to more sustainable levels of around 4 per cent of GDP.

Risks are still large

Risks to the economic outlook remain skewed to the downside. In particular, there is a possibility of much worse outcomes for the euro area, which could lead to the global economy moving back into recession. Domestically, further seismic activity in Christchurch could push rebuilding activity back further and/or reduce the overall level of reinvestment that takes place. Other risks remain, including changes in weather conditions or changes in other important trading partners' economies.

With high levels of uncertainty about the outlook, volatility in financial markets is likely to remain a feature of the coming year. We continue to expect bouts of relative optimism and pessimism as policymakers attempt to convince markets they have the euro debt crisis and other threats to global stability and growth under control. This also means that economic forecasts could be subject to large changes within short periods of time. A full Economic and Fiscal Update will be provided with Budget 2012.