

The Treasury

Budget 2017 Information Release

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Treasury Report: Scene setting for the Budget Economic and Fiscal Update 2017

Date:	2 February 2017	Report No:	T2017/120
		File Number:	BM-3-6-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Steven Joyce)	Note the important influences on the Budget forecasts. Indicate to the Treasury any other areas of interest.	Fiscal Issues on 7 February 2017
Associate Minister of Finance (Hon Simon Bridges)	Note the contents of this report.	Fiscal Issues on 7 February 2017
Associate Minister of Finance (Hon Amy Adams)	Note the contents of this report.	Fiscal Issues on 7 February 2017

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Peter Mawson	Principal Advisor, Forecasting	[39]	N/A (mob) ✓
Angela Mellish	Manager, Forecasting	[23]	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Scene setting for the Budget Economic and Fiscal Update 2017

Executive Summary

The Treasury will report to you on its preliminary economic and tax forecasts in early March. Coupled with the broader preliminary fiscal forecasts that follow, these forecasts will form the base for our fiscal policy advice to you at the end of March. This report outlines areas where developments and judgements will play key roles in influencing these forecasts and represents an opportunity to also seek your views on any other areas of interest. We are scheduled to meet with you to discuss these at Fiscal Issues on 7 February.

There are a number of risks and uncertainties in the global environment including political developments in the United States and the United Kingdom, their impact on global trade, as well as the response of markets to these developments. Economic developments in Australia and China also remain key given the size of New Zealand's trade flows.

Interpretation of a stronger-than-forecast September quarter growth outturn, following downward revisions to some earlier production GDP data, together with the latest labour market data, will be an important influence on our assessment of the extent of spare capacity in the economy. This, alongside stronger-than-forecast tax revenue will inform our views on the extent of momentum in the economy in 2017.

Population growth is an important component of growth in aggregate activity. Net migration continues to reach new highs at 70,600 in the year to December 2016. We are likely to revise our net migration assumption higher, although there will remain a great deal of uncertainty about the forward path wherever we land.

After a number of years of monetary policy easing, attention has now turned to the possibility of monetary policy tightening in New Zealand and further tightening in the US following the Federal Reserve's move last December. The relative timing of any moves will influence exchange rate dynamics and demand in the economy.

The behaviour of households, including the response of those in rural regions to the likely recovery in farm incomes, and accelerating house prices in several areas outside of Auckland will be important influences on demand growth and the extent to which it can be sustained.

The Kaikōura earthquakes may introduce some volatility into quarterly data that is difficult to quantify owing to the offsetting forces of disruption to normal activity and increased activity associated with relief and recovery efforts. As additional information on the likely fiscal costs of the earthquake becomes available, we will incorporate this into the economic forecasts. Likewise, major Budget policy decisions will also be included ahead of the finalisation of the forecasts in late April.

Recommended Action

We recommend that you:

- a **note** that judgements and developments in the following areas will have important influences on the Budget Update economic and tax forecasts:
- global risks and uncertainty;
 - GDP revisions and spare capacity;
 - net migration;
 - the re-emergence of inflation in New Zealand and abroad;
 - household spending and saving behaviour; and
 - the impact of the Kaikōura earthquakes.
- b **indicate** to the Treasury any other areas of particular interest to you that are relevant for the economic outlook contained in this year's Budget forecasts, and
- c **note** that the Treasury will report to you at various stages of the forecast process with the next key milestone being a report on the preliminary economic and tax forecasts in early March.

Angela Mellish
Manager, Forecasting

Steven Joyce
Minister of Finance

Purpose of Report

1. This report provides an overview of some of the key issues that will influence the Budget economic and tax forecasts. It represents the first stage in our reporting to you on the Budget forecasts. We will also report to you when we complete the preliminary economic and tax forecasts. These will be an input into the preliminary fiscal forecasts and will also inform our advice at the end of March on our recommended stance for fiscal policy given the Government's fiscal objectives.
2. Final economic and tax forecasts will be provided in late April and will update the preliminary forecasts for new economic and tax developments as well as incorporating any key Budget decisions. Along with chapters on the final economic and fiscal forecasts, we also consider risks and alternative scenarios, given the inherent uncertainty involved with forecasts. Indicative dates for key reporting milestones in the forecast process are provided in Table 1 and will be finalised once the date of this year's Budget is announced.

Table 1: Key forecast reporting dates

Date	Report date
Friday 3 March	Preliminary Economic and Tax Forecasts
Monday 27 March	Preliminary Fiscal Forecasts
Friday 31 March	Treasury Report on Fiscal Strategy advice in light of preliminary BEFU forecasts
Thursday 27 April	Final Economic and Tax Forecasts
Thursday 4 May	Final Fiscal Forecasts

Analysis

3. The economic growth outlook presented in the Half Year Update was supported by an increasing number of people arriving in New Zealand, to live, work, study and visit. Low interest rates were seen as supporting consumer spending, housing construction, other building and investment. As economic growth abroad picked up, the positive contribution to growth from migration was anticipated to wane, while spare capacity in the New Zealand economy was absorbed, leading to a fall in the unemployment rate, but also increased (albeit still modest) inflationary pressures and a gradual unwinding of interest rates from record lows.
4. The outlook for global growth was subdued, with growth in China slowing at a steady pace and uncertainty associated with political developments in the United States and the United Kingdom.

5. A recovery in dairy prices over the near term and subdued growth in import prices underpinned an increase in the terms of trade (the ratio of export prices to import prices) and, combined with an increase in inflation, were important contributors to nominal GDP growth.
6. The likely evolution of the factors above will remain key considerations in the production of the Budget forecasts and associated economic narrative.
7. An initial scene-setting discussion within Treasury emphasised the importance of developments in the following areas:
 - Increased uncertainty and risks associated with policy developments in the United States and the exit of the United Kingdom from the European Union;
 - The most recent and revised GDP data and the degree to which there is spare capacity in the economy;
 - Continued strength in net migration gains and implications for growth in the labour force and output;
 - The early signs of a re-emergence of inflation and the implications for interest rates in New Zealand and abroad;
 - The spending behaviour of households in the wake of a pick-up in house price inflation in some areas outside of Auckland (and likely moderation in Auckland) and a recovery in farm incomes in light of the deterioration in household saving over the past two years;
 - The impact of the Kaikōura earthquakes on activity;

Global risks and uncertainty

8. A continuation of volatility associated with political developments in the United States and the United Kingdom is likely. Markets initially reacted negatively to the US election result, but this very quickly reversed as markets focussed on likely changes to fiscal policy and the associated fiscal stimulus. More recently, this positive impetus has abated, with greater focus being placed on the potential for trade disruption and the negative impacts of stricter immigration policies. Exactly how trade is affected is an area of uncertainty, as is the extent to which any negative impacts from US actions are offset by the potential for enhanced cooperation elsewhere.
9. The impact on the United Kingdom from the vote for Brexit has, to date, been less disruptive than originally feared, with the considerable depreciation in the pound helping support activity. However, uncertainty remains as the exit is yet to occur. Additional uncertainty is also associated with elections in other major European countries.

10. While political developments in the US and the UK continue to make headlines, economic developments in Australia and China will remain of particular importance for New Zealand.
11. Global sentiment and attitudes to risk are important influences on the exchange rate, which is currently over 3% higher than assumed in the Half Year Update. Our assessment of the forward path of the exchange rate will influence our views on export returns, the cost of imports and evolution of the current account.

GDP revisions and spare capacity

12. The release of September quarter GDP data in December last year included material revisions to earlier data. Different processes and data sources are used for producing annual and quarterly GDP statistics, with the quarterly approach being more timely, while the annual approach is more comprehensive but less timely. The September quarter figures made use of the latest annual data through to March 2016.
13. The headline real production GDP measure was revised down over the past four years by 1% by June 2016, while real expenditure GDP was revised up by 0.6%, predominantly reflecting upward revisions to private consumption, partially offset by downward revisions to residential investment. These revisions also affected nominal GDP, the key driver of tax revenue, which was generally revised higher over most of the past four years, with the upward revisions to consumer spending more consistent with trends in GST data.
14. Data revisions, as well as a stronger-than-forecast September quarter growth outturn, which offset the downward revision to June quarter production GDP growth, will be important influences on our assessment of the extent of spare capacity in the economy. This assessment in turn influences the extent to which output in the economy can grow without creating excessive inflation pressures. Our starting view is that a degree of spare capacity still exists in the economy, in part reflecting growth in the labour force, but we will be testing this view as the forecast round progresses and new data become available. This week's labour market data were consistent with this view.
15. As well as views on aggregate capacity, views on the relative extent of capacity across industries, particularly construction, will also be important. Construction demand remains elevated, reflecting housing demand associated with population growth and ongoing earthquake-related and infrastructure spending.
16. Upward revisions to nominal GDP also resulted in small reductions to variables expressed as a percentage of GDP, such as the current account deficit which, in dollar terms, was in line with the Half Year Update forecasts but, at 2.9%, was fractionally lower when expressed as a percentage of nominal GDP.

Net migration

17. Net migration inflows have supported population growth and GDP. Net migration continues to reach new highs at 70,600 in the year to December 2016. We are likely to revise our net migration assumption higher, although there will remain a great deal of uncertainty about the forward path wherever we land. Current political developments in a number of countries may also influence the relative attraction of New Zealand.
18. A feature of the current migration cycle is the more-balanced effect on aggregate demand and supply relative to past cycles. Judgements around the extent of these inflows and their broad economic impacts (including on consumer and housing demand, the labour force, wages and average productivity) will continue to have an important bearing on the outlook, including the overall size of the economy and thus the projected tax base.

The re-emergence of inflation in New Zealand and abroad?

19. Inflation in the year to December 2016 increased to 1.3%, the first time above 1% in over two years. This was in part due to earlier petrol price decreases falling out of the annual calculation, a feature shared in most other countries. After a number of years of monetary policy easing, attention has now turned to the possibility of monetary policy tightening in New Zealand and further tightening in the US following the Federal Reserve's move in December.
20. In New Zealand, market pricing is factoring in the possibility of an Official Cash Rate increase in the September quarter, much earlier than was forecast in our Half Year Update forecasts and the Reserve Bank's November Monetary Policy Forecasts.
21. The likely evolution of monetary policy in New Zealand and abroad can have important implications for the economic outlook and the exchange rate, as well as for tax revenue on interest returns. While market attention has shifted towards the possibility of rate rises, we are yet to see economies successfully shift to what would be deemed more-normal monetary conditions, with this transition likely to take some time.

Household spending and saving behaviour

22. A feature of the current cycle had been the relatively muted growth in private consumption, particularly on a per capita basis. Households appeared to have been more cautious, with a greater focus on saving than in the mid-2000s, when relatively high rates of dissaving were the norm. There also appears to be less evidence of households using wealth gains from rising house prices to fund their expenditure. As a result, household spending has appeared more sustainable than in the past.

23. A combination of data revisions and an additional year's data than was available at the Half Year Update potentially challenges this view, with households dissaving 2.2% of their disposable income in the year to March 2016. The behaviour of households, their response to the likely recovery in farm incomes and accelerating house prices in several areas outside of Auckland will be important influences on demand growth and the extent to which it can be sustained.

Kaikōura earthquakes

24. As more information becomes available on the likely fiscal costs of the earthquake response, we will incorporate this into the forecasts. The earthquakes may introduce some volatility into quarterly data that may be difficult to quantify. December quarter GDP is likely to be negatively affected, on balance, but will reflect offsetting forces associated with the disruption and closure of business, and increased activity associated with early repairs and relief efforts.

Next Steps

25. Our internal scene-setting discussion represented the beginning of the Budget forecast round. As the round progresses, we will form and test our judgements related to the areas above before reporting to you on the preliminary economic and tax forecasts on 3 March.
26. We will discuss this report with you at Fiscal Issues next week and are interested in hearing any other areas or issues that you are particularly interested in.