

23 AUGUST 2017



**THE TREASURY**

**Kaitohutohu Kaupapa Rawa**

# PREFU BASICS

Our Pre-election Economic and Fiscal Update (PREFU) gives an outlook for the New Zealand economy and the Government's finances over the next four years (our forecast period)

<http://www.treasury.govt.nz/budget/forecasts/prefubasics>

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New Zealand Government

TREASURY BASICS –  
Making sense of New Zealand's economic and  
fiscal landscape

# Our Economic and Fiscal Updates

The Treasury is New Zealand's economics and finance ministry. We advise on the direction of New Zealand's economic policy with the aim of achieving a strong and sustainable economy, and raising New Zealand living standards. We also advise the Government on its fiscal strategy, report on the revenue and expenditure of the Government (fiscal outlook), and assist to ensure spending is fit for purpose and can improve outcomes for New Zealanders.

## Sharing what we do

The Treasury is responsible for economic and fiscal forecasts. We release these every six months. We have an annual [Budget Economic and Fiscal Update](#) (BEFU) and an annual [Half-Year Economic and Fiscal Update](#) (HYEFU). In the 20-30 days before a general election we also prepare a [Pre-election Economic and Fiscal Update](#) (PREFU).

This PREFU provides context about the economy and the Government's finances for the 2017 general election. It primarily outlines what the Treasury observes in our current economic and fiscal climate, what we might see in the future, and what risks we may face over the next four years. This gives an indication of what the economy is most likely to do and what the fiscal situation is most likely to be, to inform decision making.

## Making it New Zealander-centric

Our advice is not just based on facts and figures. Improving outcomes means we need to understand which outcomes to improve, and what is important to New Zealanders. We use the [Treasury's Living Standards Framework](#) to recognise the different aspects of New Zealanders' living standards and well-being.

We took this approach further and last year presented a living standards perspective that stretches over the next 40 years. [He Tirohanga Mokopuna: 2016 Statement on the Long-term Fiscal Position](#), shares our take on long-term fiscal issues facing New Zealand. We know that sustainable government finances are a requirement to improving long-term living standards, and vice versa.

## Understanding what we do

Along with *delivering* first-rate economic and financial advice, we are *committed* to providing it in a way that New Zealanders can understand how we work to achieve our goals. This plain English version of our economic outlook and fiscal overview is a contribution to the [Open Budget](#) initiative.

# PREFU Basics

This overview is split into two parts – economic and fiscal.

The **Economic outlook** is how our country is expected to do economically. It is the **big picture** that helps us position ourselves as a country to earn, grow, spend wisely, and pay off debt.

## Economic Outlook

We use some key indicators to tell us what's happening in the economy:

- **Gross Domestic Product (GDP)** is one way we keep track of how an economy is doing. It measures the value of goods and services produced in an economy in a period of time. When GDP increases the economy is growing. If GDP falls for two quarters in a row we call it a recession.
- **Net Migration** is the number of people coming to New Zealand for more than a year, less the number of people who leave New Zealand for other countries for more than a year. More people here increases demand for goods, services and infrastructure, and the amount of tax paid. Generally an increase in the workforce means that production can increase and therefore the economy grows.
- **Unemployment** is the number of people actively looking for work who are not currently in jobs.
- **Household Spending:** Households choose to spend most of their income on goods and services (including housing). Households also save. When demand in the economy is greater than businesses' ability to provide the goods and services, prices can increase (inflation).
- **Housing investment** is about 90% house building and 10% the transactions involved with house buying and selling.

# PREFU Basics

This overview is split into two parts – economic and fiscal.

The **Fiscal outlook** is about the health of our **public purse**. It looks at the government's income (largely from tax), and how the government is spending and managing its debt.

## Fiscal

We use some key indicators to tell us what's happening with government's revenue and expenditure trends:

- **Tax revenue** is the income the government receives from taxpayers (eg, income tax, GST, companies tax).
- **Core Crown Expenses** are the day-to-day spending of the government to provide services to New Zealanders (eg, health and education), as well as run the agencies that provide those services and interest costs from borrowing money. (It excludes Crown entities and SOEs.)
- **OBEGAL** stands for Operating Balance before Gains and Losses and is what's left after expenses are deducted from revenue. It includes profits/losses from Government controlled entities such as ACC and New Zealand Post, as well as the tax revenue and core Crown expenses discussed above.
- **Net Debt** is what the central government has borrowed less what it owns (assets) that can be used to pay off debt if required (referred to as financial assets). Examples of financial assets are cash and share investments.

# GDP

**Gross Domestic Product (GDP)** is a measure of the size of the economy. There are two ways we look at GDP – nominal and real.

## NOMINAL vs REAL

**Nominal GDP** is estimated at *current* prices and is a good indicator for how much tax will be generated by all the individuals and businesses in the economy.

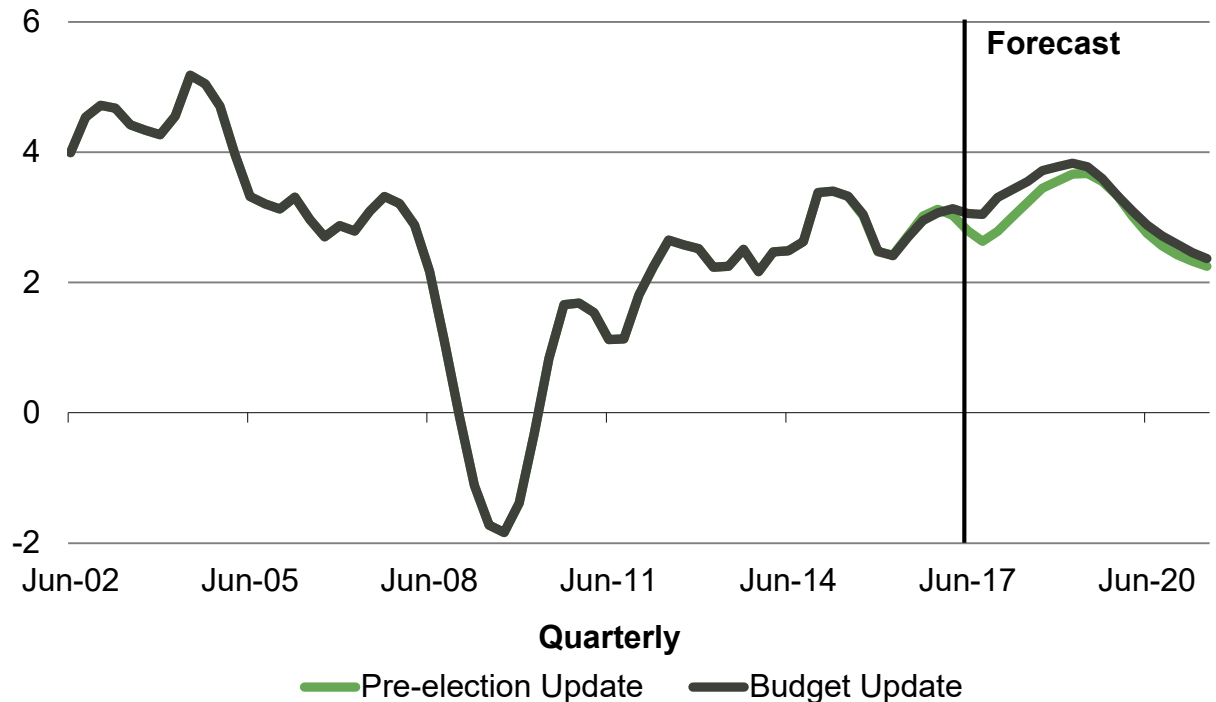
**Real GDP** is estimated at *constant* prices so it takes account of inflation. How real GDP changes over time is a good measure for how fast the economy is growing.

## What the Treasury says

Overall our economy is growing steadily. Annual real GDP growth is expected to rise to a peak of 3.7% in 2019, from about 3% at the moment. Migration-led population growth, low interest rates, an upturn in the international economy, and stimulus provided by Budget 2017 initiatives are supporting this growth.

The longer term forecast sees real GDP growth slow to 2.3% in 2021 as population growth slows, interest rates rise, and the contribution to growth from residential investment gets smaller.

### Annual average % change



# Migration

Net migration moves in cycles over time. It is an important economic indicator, and one that is monitored quite frequently.

## New Zealand vs Australia

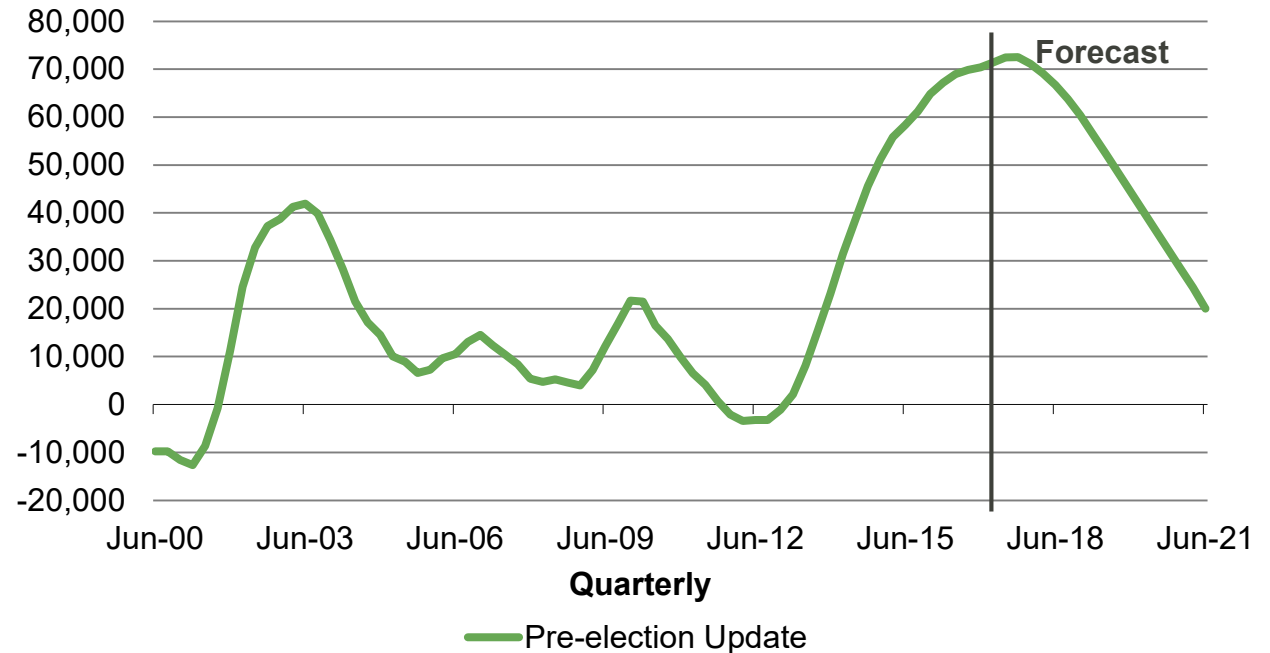
Historically more Kiwis leave New Zealand, mostly for Australia, than come back to New Zealand. Recently more Kiwis than usual have come home and fewer have left. Over time we assume the normal pattern to resume.

## What the Treasury says

The number of people coming to New Zealand relative to those leaving continues to be at record levels, and higher than we had expected. Over the next four and a half years we assume migration will add 212,000 people to the population. After the end of our forecast period, Stats NZ assumes net migration will reduce to 15,000 per year by 2022.

More people also adds to the amount of goods and services people want. To meet this demand businesses may need to hire more people. But it also means more demand for items like housing and meeting extra housing demand in a short amount of time is difficult. We assume flows of migrants into New Zealand will return to the Stats NZ assumption in 2022.

### Annual total



# Employment

We measure the health of our employment situation by measuring unemployment.

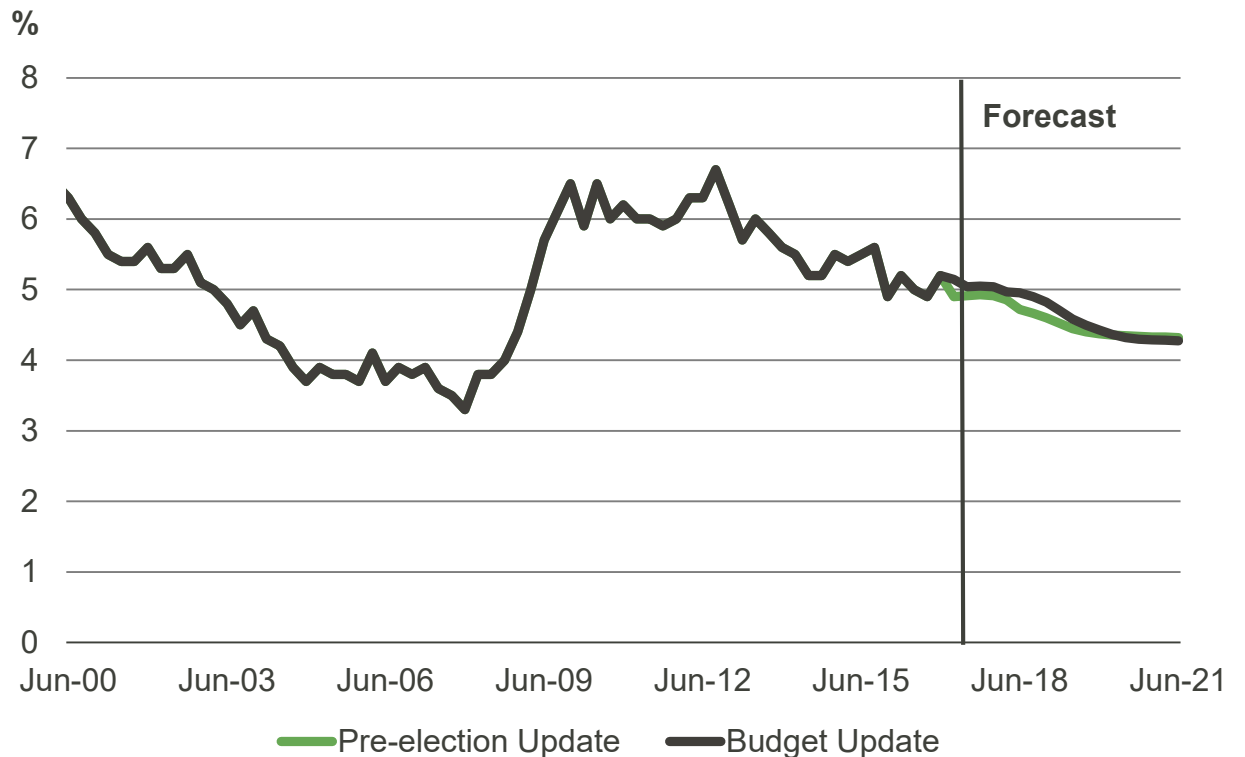
## Unemployment and wages

When the unemployment rate is relatively high there is less pressure on businesses to raise wages. Because of that prices for goods and services don't go up as fast either.

## What the Treasury says

The unemployment rate is expected to decline gradually over the next year. It hovers around 5% because even though there are more people looking for jobs, there are also more jobs. Employment growth and wage growth are forecast to be slightly stronger than what we thought they would be in the *Budget Update*.

Further out, we expect the number of people with a job will grow faster than the number of people looking for employment. This will lower the unemployment rate to about 4.3%. As this happens, businesses will find that competition for job openings decreases and they will need to raise wages to attract people.



# Housing

The demand for houses will continue to increase.

## Housing/Debt/GDP

The growth in the housing market has seen household debt increase. At the end of last year, household debt reached 168% of household disposable income.

If incomes don't rise or interest rates rise sharply then paying off mortgages could be difficult for some. If this happens then people may spend less, or buy or build fewer houses, reducing GDP.

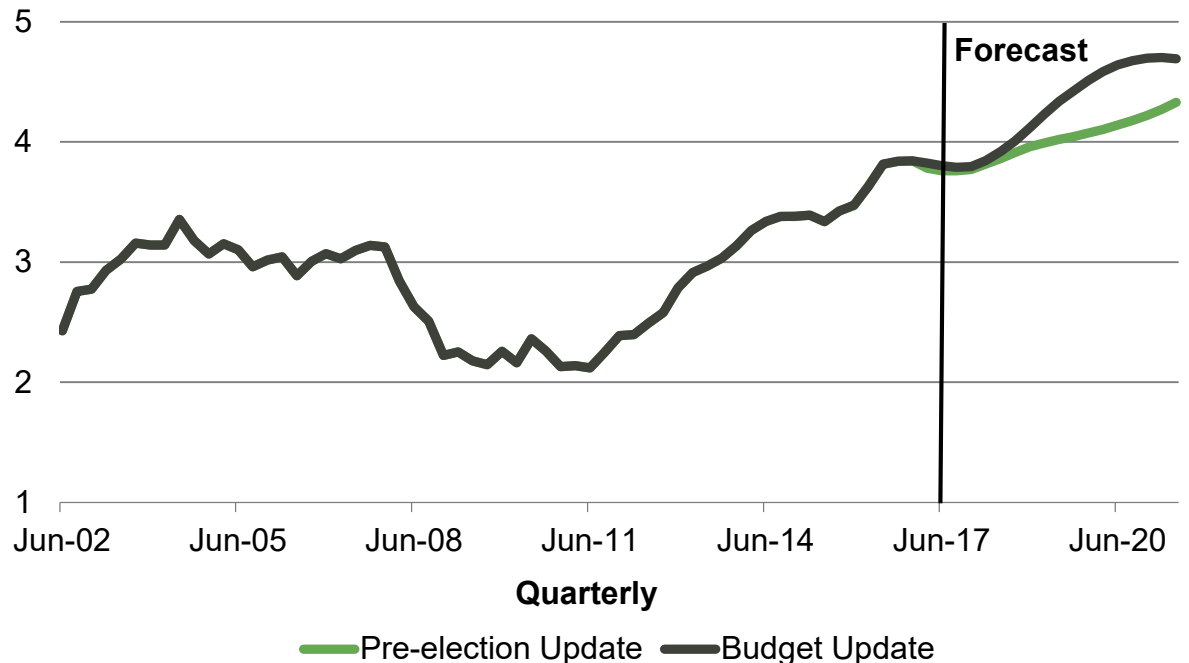
## What the Treasury says

The housing market has cooled in recent months.

We don't expect housing investment to increase as quickly as we did in the Budget Update. In fact we think it will level out for a while. This is because there are tighter restrictions on banks lending for housing, there is uncertainty around the Auckland Unitary Plan, there is a shortage of skilled labour to build houses, and property developers are finding it more difficult to borrow money. But we think most of these factors will be just temporary – and further on we expect the built-up demand for housing will encourage an increase in house building.

House prices will continue to rise but not as quickly, as more houses are built to meet some of the demand.

**\$billions (09/10 prices)**





# Household Spending

How households choose to spend their income makes a big difference to an economy.

## Not all households are the same

In these forecasts we assume households will increase the amount they spend at about the same rate as their income increases.

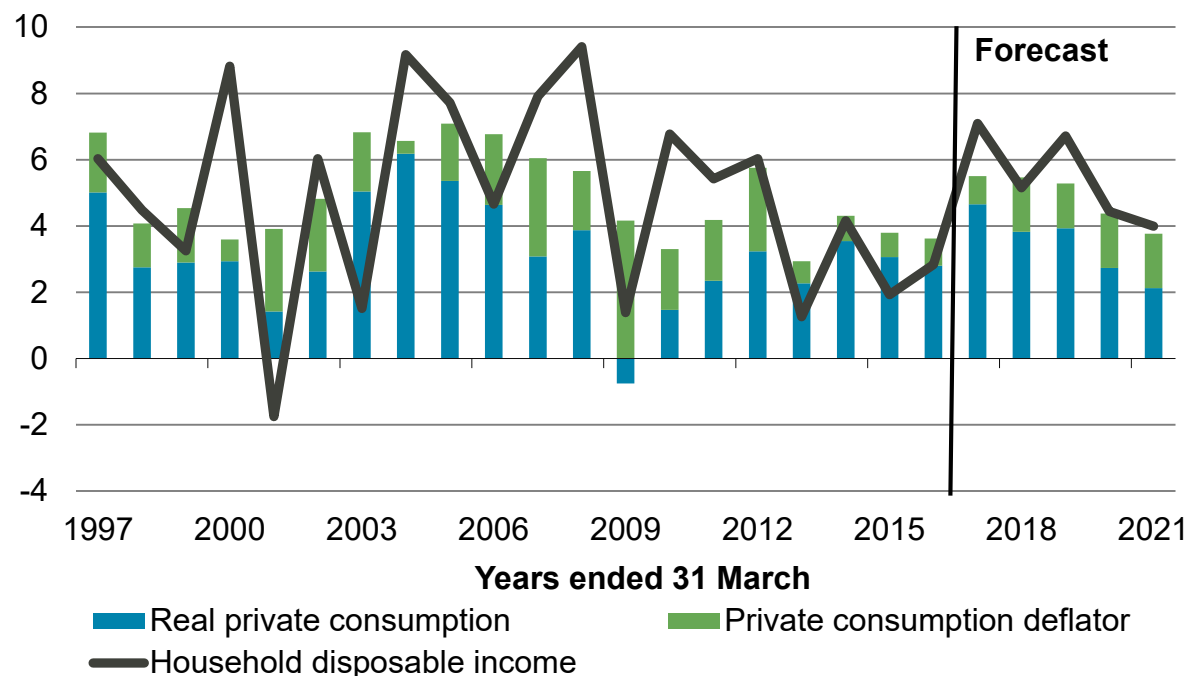
But we also understand that we all have our own particular preferences and these change when economic conditions change.

## What the Treasury says

We expect growth in household spending will stay high over the next few years. High population growth, low interest rates so people can borrow and spend more, and rising farm incomes all help boost spending. The government has also introduced in Budget 2017 a Family Incomes Package, which will increase incomes from 2018 onwards. We expect the majority of people will spend this rather than save.

From 2019 household spending growth slows. The reasons? We forecast interest rates to rise, people to start saving more, growth in house prices to ease, and population growth to slow down with less people migrating to our shores.

### Annual % change



# Tax Revenue

Core Crown tax revenue is earned by the Government from various sources (eg, income tax, GST, motor vehicle fees)

## Tax expenditure

As well as forecasting tax revenue the Treasury also calculates the impact tax deductions and tax credits have on reducing tax revenue (referred to as tax expenditure).

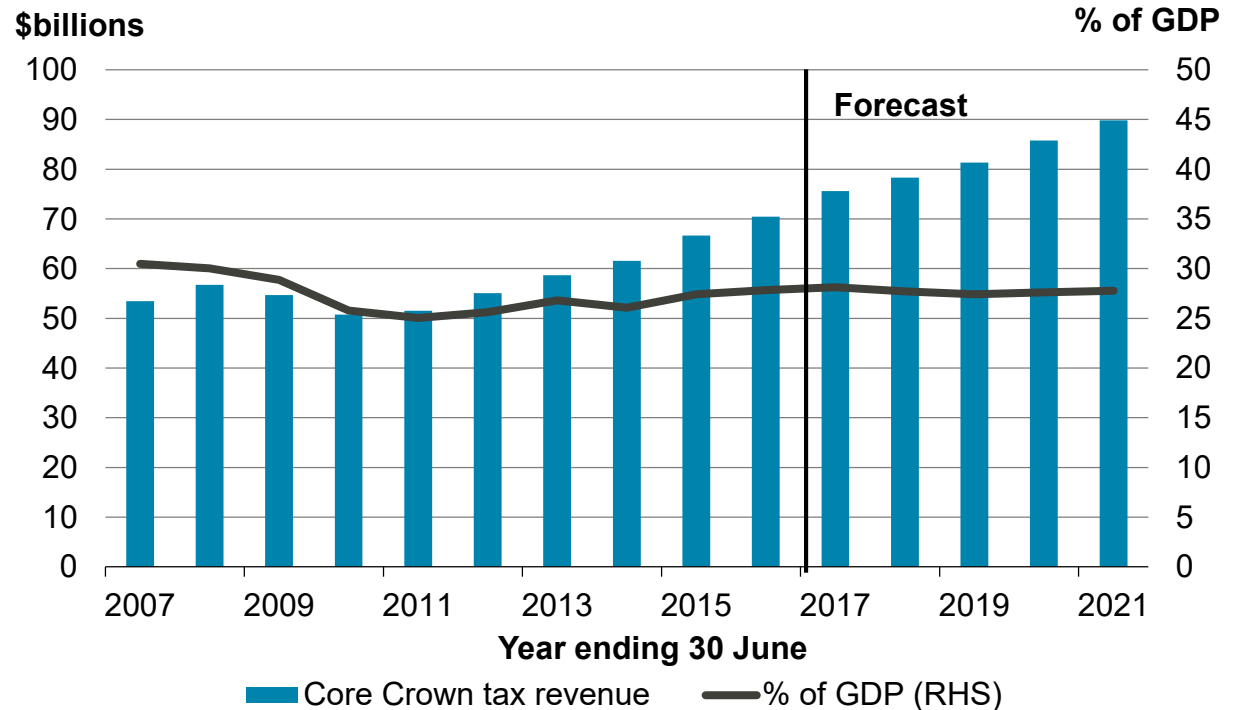
## What the Treasury says

When the final results for the 2016/17 fiscal year are known in early October, we expect they will be stronger than last year and what was forecast in the Budget Update. This improvement is largely on the back of strong growth in tax revenue.

There is a strong tax result in 2016/17. After that core Crown tax revenue is forecast to rise in dollar terms in every year for the next four years as the economy grows.

However, we are not expecting tax to grow at quite the pace it did in 2016/17 as some of the tax revenue came from particularly high investment returns which are not expected to continue.

In the last four years of the forecast we expect tax revenue (as a percentage of nominal GDP) to remain fairly flat.



# Core Crown Expenses

Core Crown expenses are day-to-day government spending such as maintaining government services like health, benefit payments, public servants' salaries, and paying interest on debt.

## On the rise

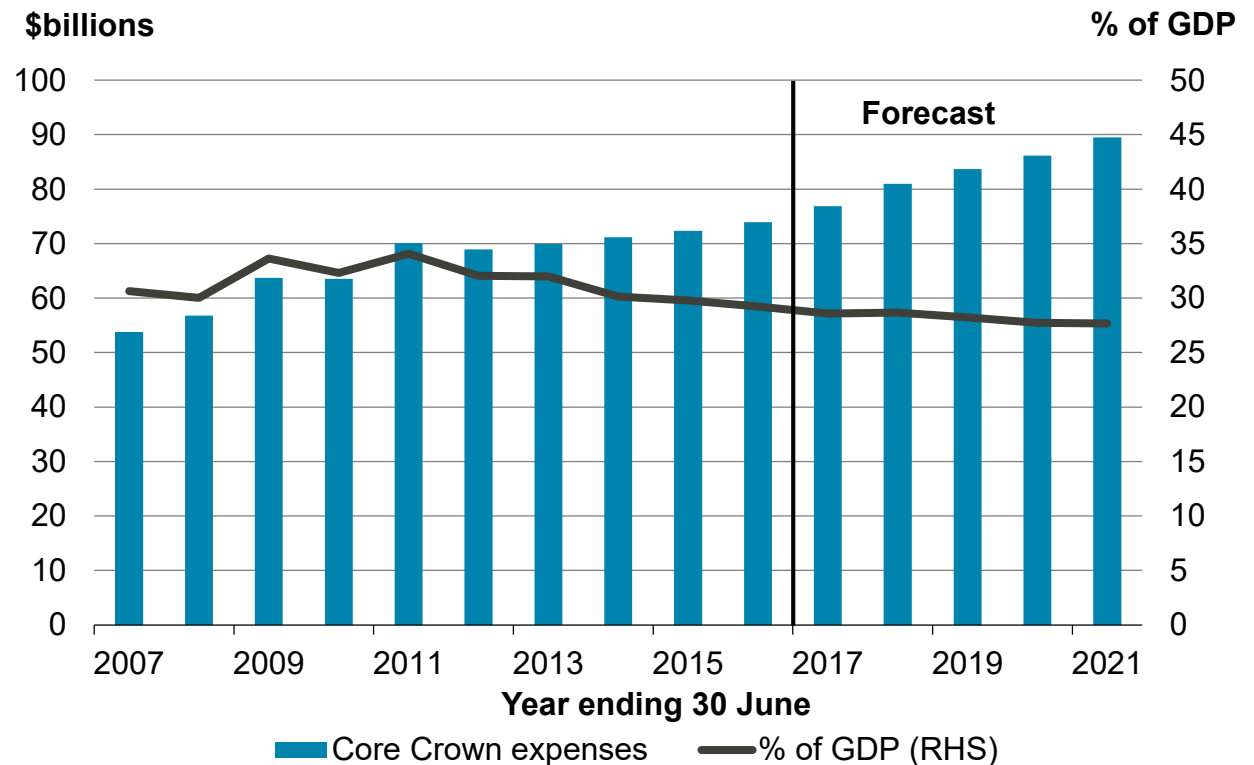
In 2011/12 core Crown expenses were around \$15,640 per capita. By 2020/21 we expect that to have risen to \$17,511 per capita.

## What the Treasury says

Core Crown expenses are expected to increase by \$15.5 billion over the forecast period from \$74.0 billion in 2015/16 to \$89.5 billion in 2020/21, an increase of around \$3 billion each year.

A lot of this increase is due to past Budget decisions, new spending set aside by the Government for future Budgets, and increased spending on Superannuation and social assistance.

Because the economy is expected to grow faster than core Crown expenses, they fall as a percentage of GDP from 29.2% in 2015/16 to 27.7% of GDP in 2020/21.



# OBEGAL

OBEGAL is the difference between revenue the Government (and the entities it controls) earns and expenses it pays.

## Operating vs capital

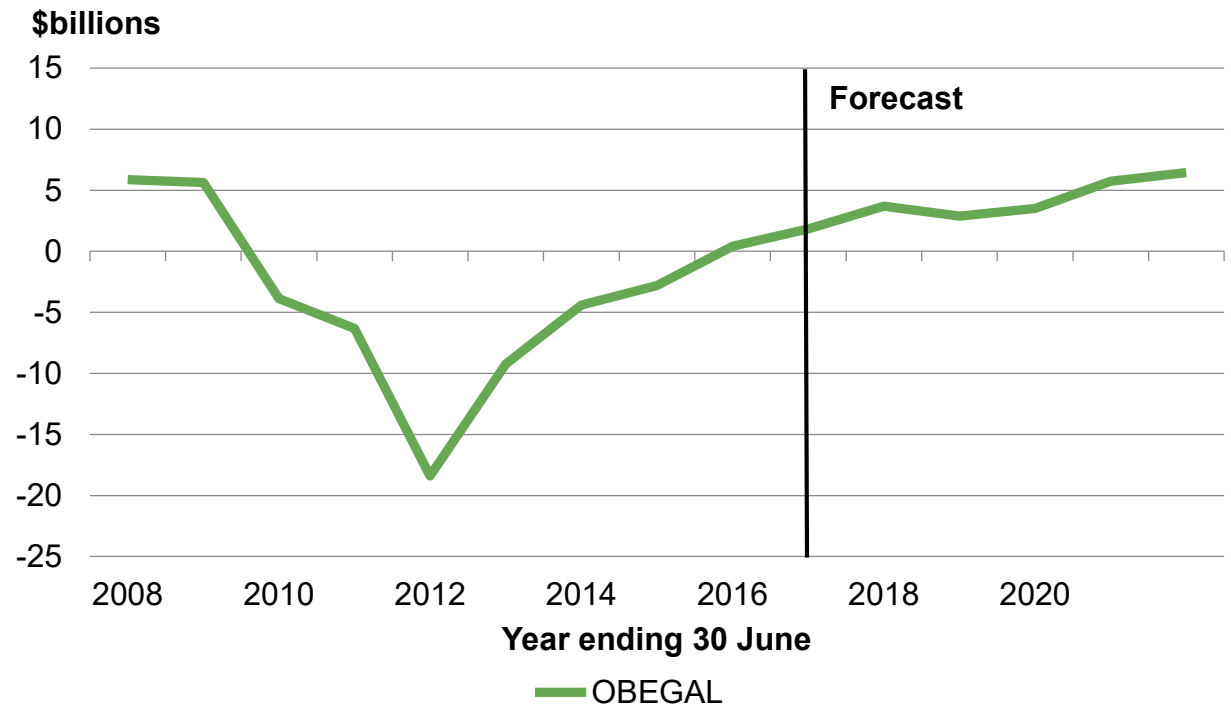
OBEGAL includes operating expenses of the Government but doesn't include spending on capital items such as building state highways or prisons.

## What the Treasury says

We estimate the final figure for the 2016/17 OBEGAL surplus will be \$3.7 billion, which is higher than expected in the Budget Update. Based on existing spending and revenue settings, we expect the Government to continue running OBEGAL surpluses over the four-year forecast period.

The increase over time is mostly a reflection of the growing economy – as the economy grows people earn more and spend more, increasing the taxes they pay (and the government earns). By 2020/21 OBEGAL is forecast to reach \$6.4 billion, fairly close to the Budget Update.

OBEGAL also includes the results of Crown entities (such as ACC) and State-owned enterprises (such as New Zealand Post).



# Net Debt

The amount the Government owes to others less the assets it has on hand to pay off that debt.

## Gross vs Net Debt

The **gross debt** is the total amount of money the government has borrowed.

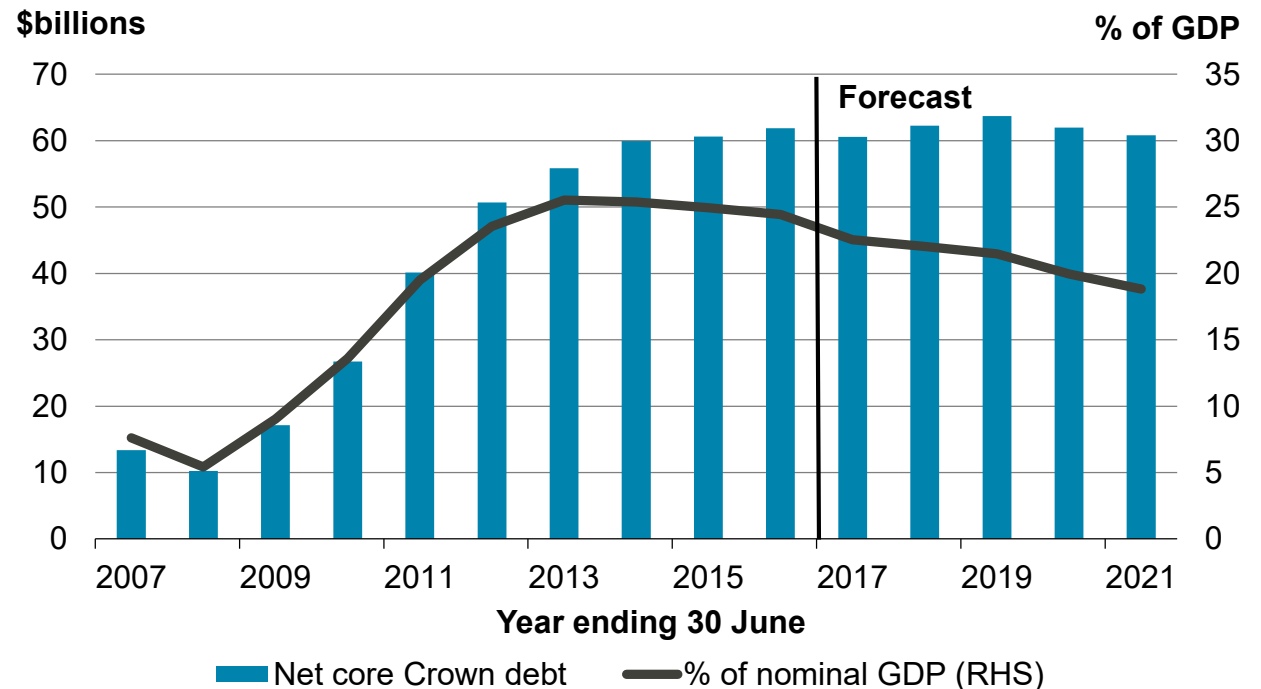
**Net debt** is the amount borrowed less cash and investments the government holds.

## What the Treasury says

Over the forecast period the Government is expecting to receive more from tax and other sources than it pays out in operating expenses. The surplus cash is expected to be used to pay off net debt.

The chart below shows that in some of the forecast years net debt will be higher in dollar terms, but when you compare it to the size of the economy (which is expected to grow) net debt as a percentage of GDP falls.

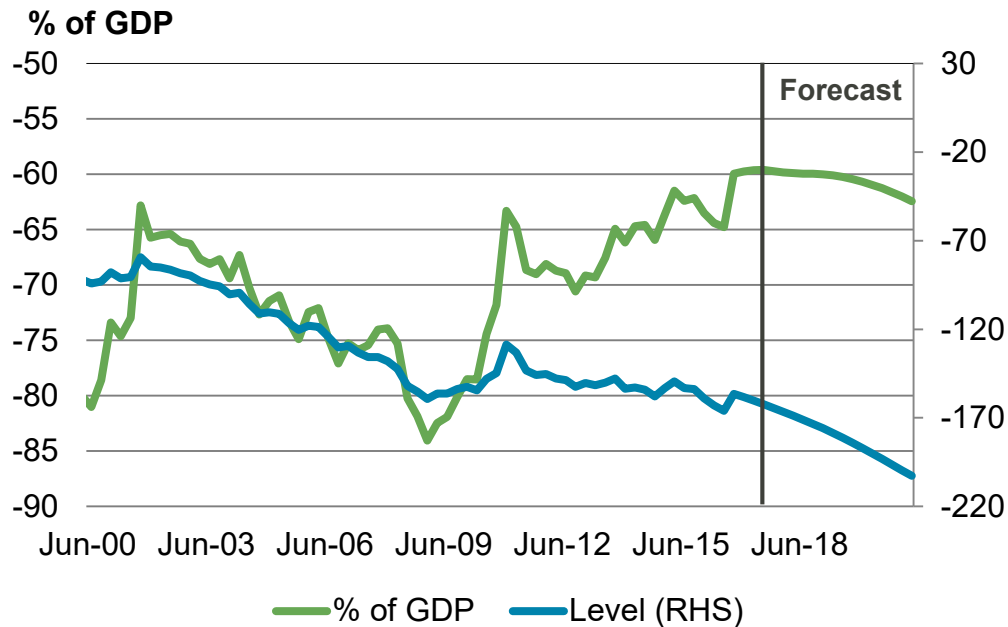
Largely as a result of the anticipated improvement in the 2016/17 fiscal results, net debt is estimated to be \$2.0 billion lower than we thought in the Budget Update by 2020/21 to stand at 18.8% of GDP. Contributions to the New Zealand Superannuation Fund are forecast to resume that year. Looking beyond 2020/21, PREFU projections show net debt as a share of GDP to keep falling to within the range of 10 – 15% by 2025.



# Resources

## ABOUT FORECASTING

Forecasting is a combination of understanding trends, applying our forecasting model and using assumptions. It is based on the realistic assumption that the economy itself is complicated. You can understand more about how we forecast [here](#).



[www.treasury.govt.nz](http://www.treasury.govt.nz)

Need to access our [glossary](#)?

## Need to dive deeper?

You can access the different chapters of our full PREFU here:

1. [Executive Summary](#)
2. [Economic Outlook](#)
3. [Fiscal Outlook](#)
4. [Risks and Scenarios](#)
5. [Specific Fiscal risks](#)
6. [Forecast Financial Statements](#)
7. [Core Crown Expense Tables](#)



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