14 DECEMBER 2017

THE TREASURY

Kaitohutohu Kaupapa Rawa

HYEFU BASICS

Our Half Year Economic and Fiscal Update (HYEFU) 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/hyefubasics

ISBN: 978-1-98-853463-3

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 HYEFU 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.

Government commitments

With the change in Government there are a range of new policies which have needed to be considered for HYEFU.

Commitments outside the 100-Day Plan

The expectation in HYEFU is that commitments outside the 100 day plan will funded by the new Budget operating and capital allowances set by the Government.

What the Treasury says

The forecasts separate the costs of policies the Government will implement in the first 100 days (called "the 100-Day Plan") from other spending commitments yet to be finalised. A summary of the estimated fiscal costs of the 100-Day Plan are outlined in table below.

Operating costs in relation to the 100-Day Plan are estimated to be $8.4 billion but these are offset by reversing the 2017 tax cuts. So the net operating cost of the Plan is minimal.

New capital expenditure (mostly KiwiBuild and contributions to the New Zealand Superannuation Fund) is expected to be just under $5 billion.

Year ending 30 June $million	**2018 Forecast**	**2019 Forecast**	**2020 Forecast**	**2021 Forecast**	**2022 Forecast**	**Total Forecast**
Families package	(80)	1,157	1,309	1,525	1,616	5,527
Tertiary education package	342	469	535	597	628	2,571
Other operating commitments	28	134	78	37	37	314
Reversing Budget 2017 tax cuts	(486)	(1,904)	(1,904)	(1,993)	(2,077)	(8,364)
Net operating (savings)/expense	**(197)**	**(143)**	**18**	**166**	**204**	**48**
KiwiBuild	100	900	1000	0	0	2,000
NZSF contributions	500	1,000	1,500	16	330	3,346
Tertiary education package	(155)	(123)	(86)	(44)	(26)	(434)
Other capital commitments	3	3	0	0	0	6
Net capital spending	**448**	**1,780**	**2,414**	**(28)**	**304**	**4,918**
Net estimated fiscal cost	**251**	**1,636**	**2,432**	**138**	**508**	**4,965**

Note: Numbers in the table may not add exactly to the stated totals owing to rounding.

HYEFU 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.

HYEFU 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 expected income (largely from tax), and how the government is expecting to spend 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

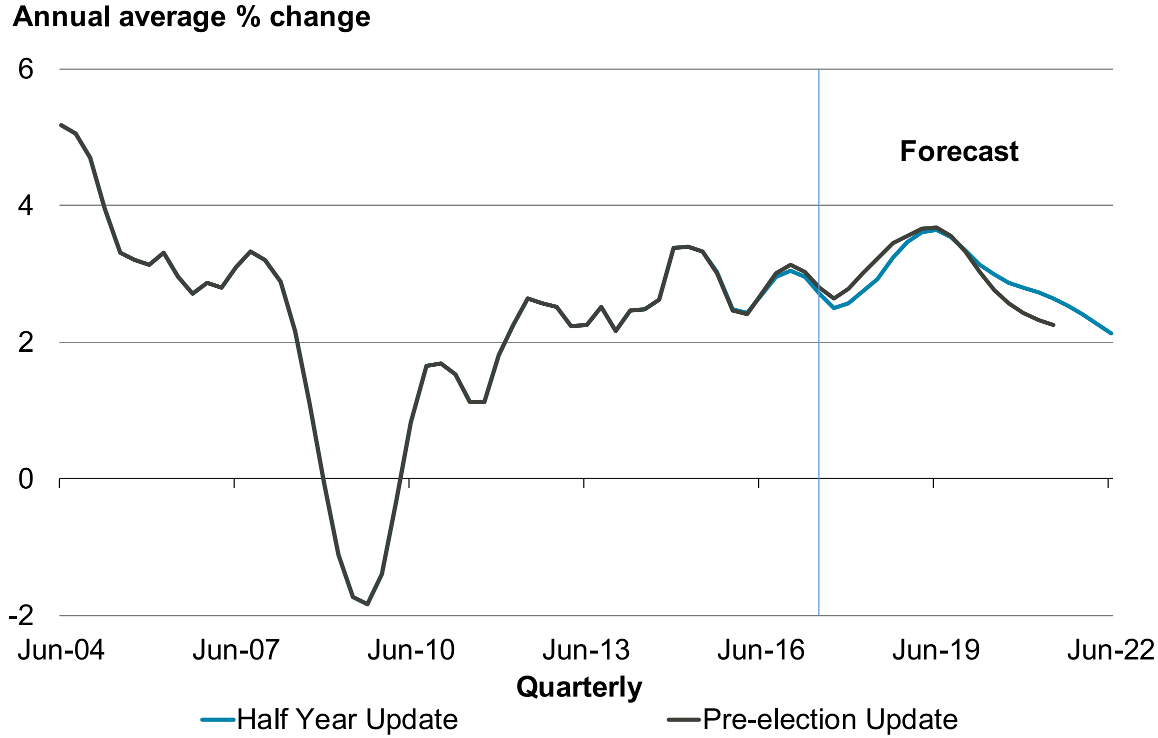
Nominal GDP is estimated at *current* prices and is a good indicator for how much tax will be generated by all the individuals and businesses in the economy.

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 is expected to grow at an average rate of 2.9% per year over the next 5 years, with a peak of 3.6% in 2019. Population growth, low interest rates, increased government spending, a positive international outlook and high terms of trade are supporting this growth.

The longer term forecast sees real GDP growth lowering to 2.1% in 2022 as interest rates rise, population growth slows, and Government spending growth slows.



Migration

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

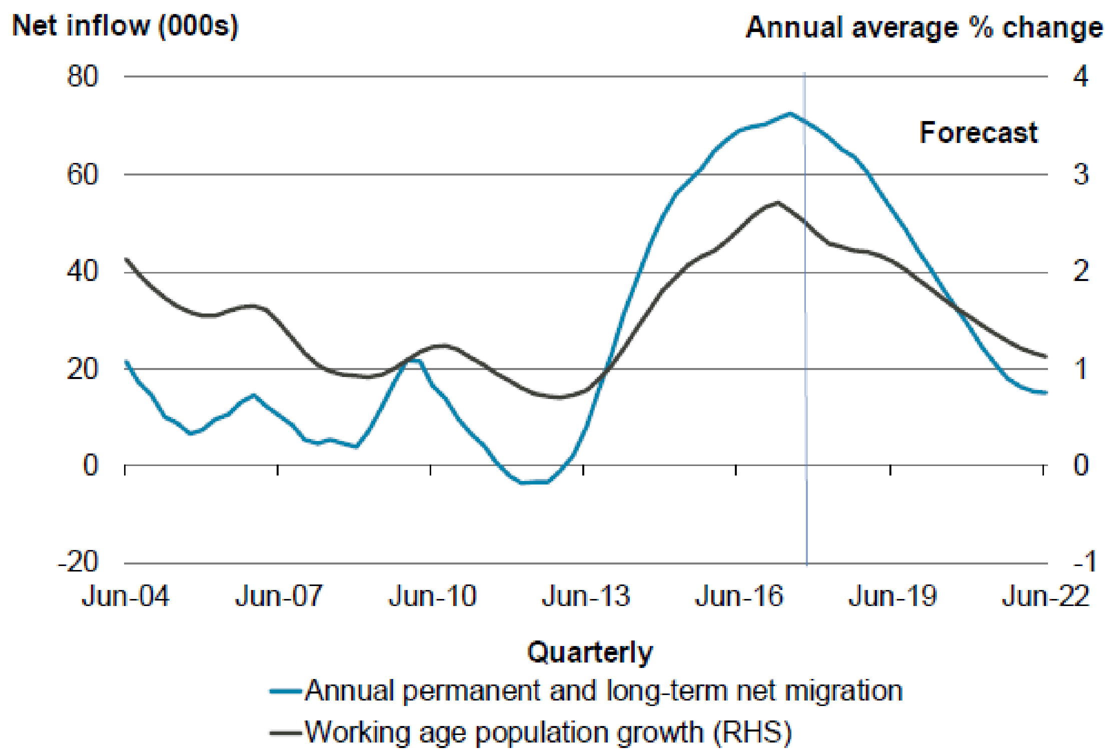
New Zealand vs Australia

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

We assume annual net migration to fall steadily from its current level of 71,000 to Statistics New Zealand's assumption of 15,000 in 2022. Under this assumption net migration falls by around 27,000 by the end of 2019. The composition of immigration may change, with fewer students and more work visas, including the proposed KiwiBuild visa.

More people 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.



Sources: Statistics New Zealand, the Treasury

Employment

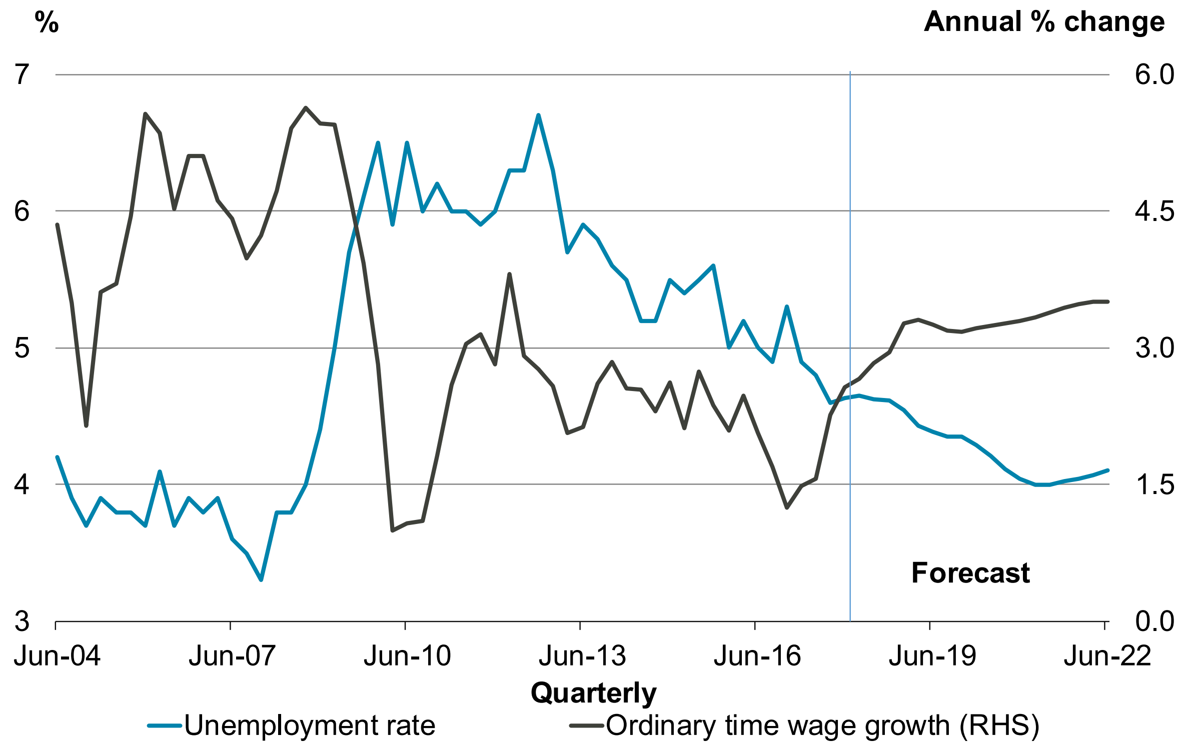
We measure the health of our employment situation by measuring unemployment.

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

As economic activity keeps growing, the unemployment rate is expected to drop gradually to around 4%. Rising inflation and greater competition to hire employees will support a pick-up in wage growth, as will the Government's policy to increase the minimum hourly wage to $20 by 2021.



Housing

The demand for houses will continue to increase.

Housing/Debt/GDP

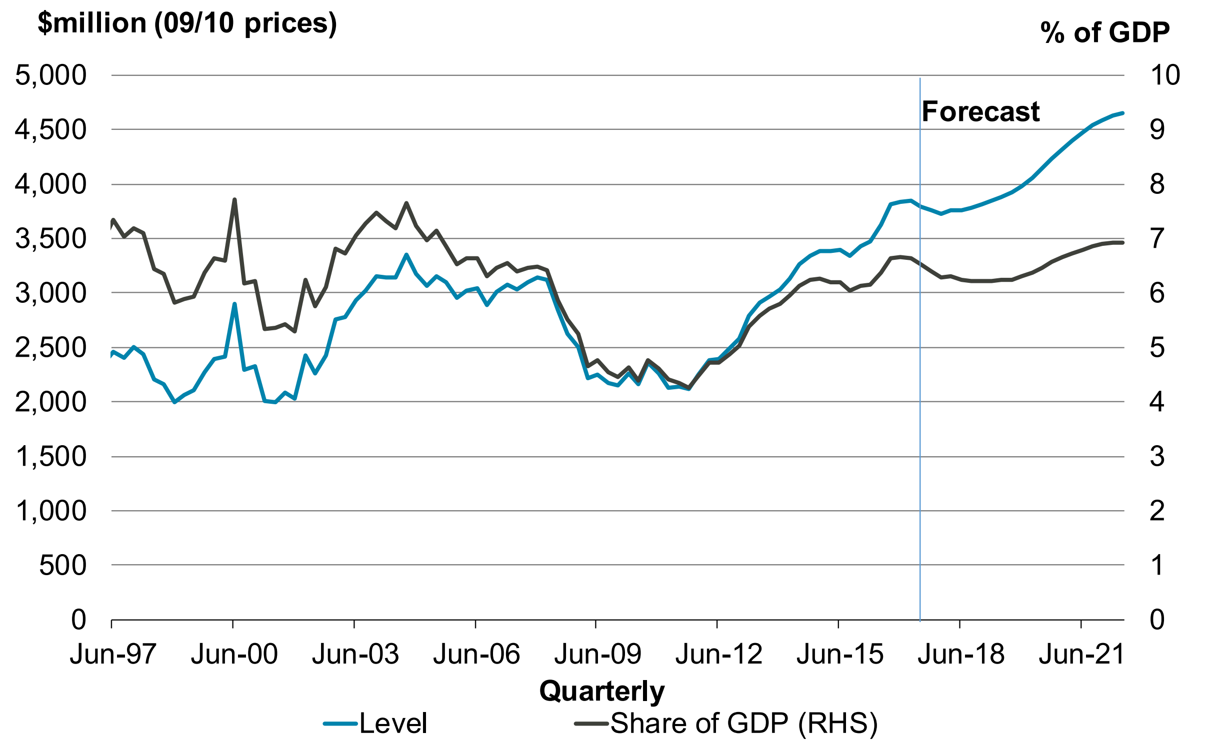
The growth in the housing market has seen household debt increase. At the end of last year, household debt reached 168% of household disposable income.

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

We expect housing investment growth to remain relatively weak in the near term. There is still a lot of housing investment happening, and strong population growth and low interest rates are still driving demand. But the construction sector faces constraints. There is a shortage of skilled labour to build houses, construction costs are high, and property developers and investors are finding it more difficult to borrow money.

The Government will invest an initial $2 billion as part of its KiwiBuild programme. We assume nominal housing investment will be about 10% higher in 2022 than it would otherwise have been and is cumulatively around $5 billion higher across the forecast period.



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.

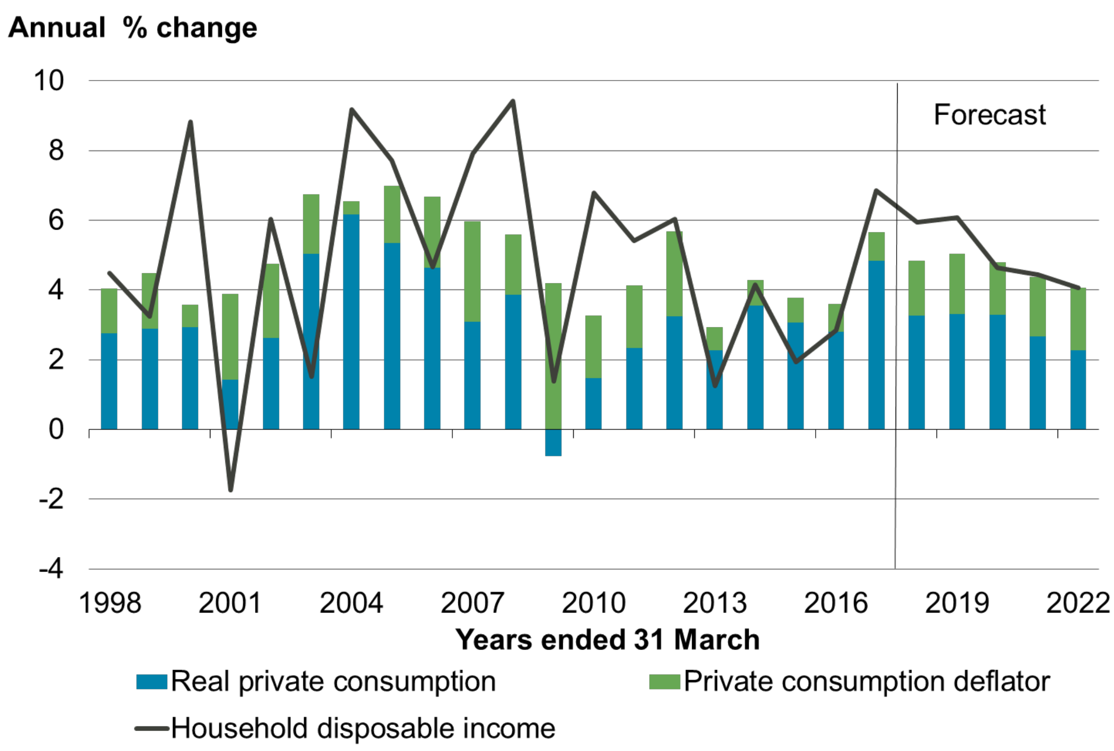
But we also understand that we all have our own particular preferences and these change when economic conditions change.

What the Treasury says

For the next year or so 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 fewer people migrating here.

Thereafter, the Families Package and other Government commitments give a boost to household income growth and private consumption. Nonetheless, slower population growth and increasing interest rates will mean consumption growth eases later in the forecast period.

We assume the household saving rate will rise and remain positive.



Tax Revenue

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

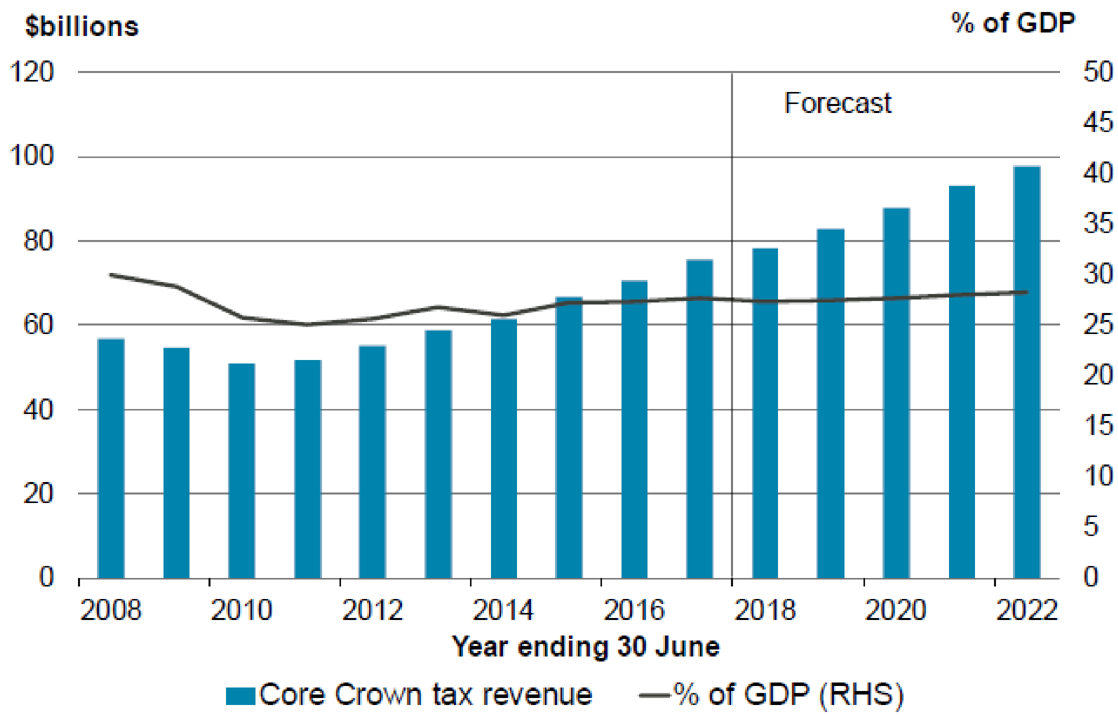
Tax expenditure

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

We are forecasting core Crown tax revenue to rise in dollar terms each year for the next five years, while staying about the same as a percentage of GDP. By 2021/22, core Crown tax revenue is expected to reach $97.8 billion, $22.2 billion higher than in 2016/17. This is in line with a growing economy.

There are several things driving the rise in tax revenue in dollar terms. These include more employment, higher wages, more people in higher tax brackets, higher domestic spending, greater company profits, and base erosion and profit shifting measures for multinational corporations operating in New Zealand.



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

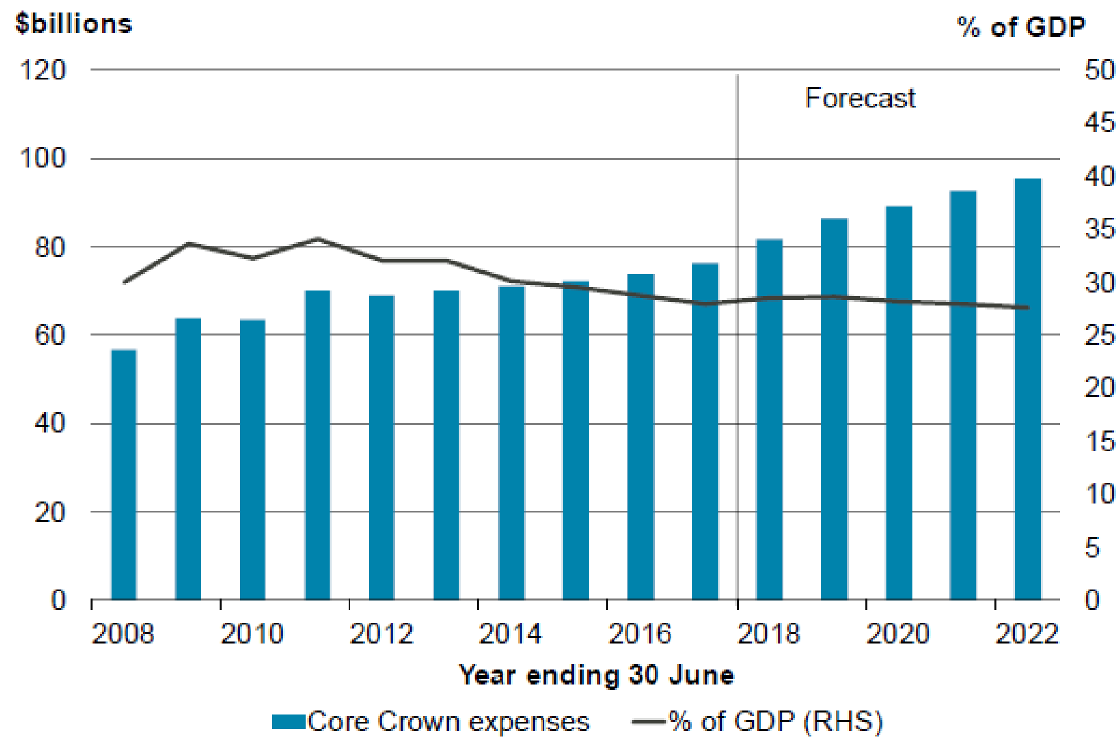
In 2016/17 core Crown expenses were around $15,839 per capita. By 2021/22 we expect that to have risen to $18,511 per capita.

What the Treasury says

Core Crown expenses are expected to increase by $19.0 billion over the forecast period from $76.3 billion in 2016/17 to $95.3 billion in 2021/22, an increase of around $4 billion each year.

A lot of this increase is due to past Budget decisions, the impact of new Government policies, and increased spending on Superannuation and social assistance. Social security and welfare, health and education represent the largest types of spending.

Because the economy is expected to grow faster than core Crown expenses, the expenses fall as a percentage of GDP from 28.0% in 2016/17 to 27.6% of GDP in 2021/22.



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.

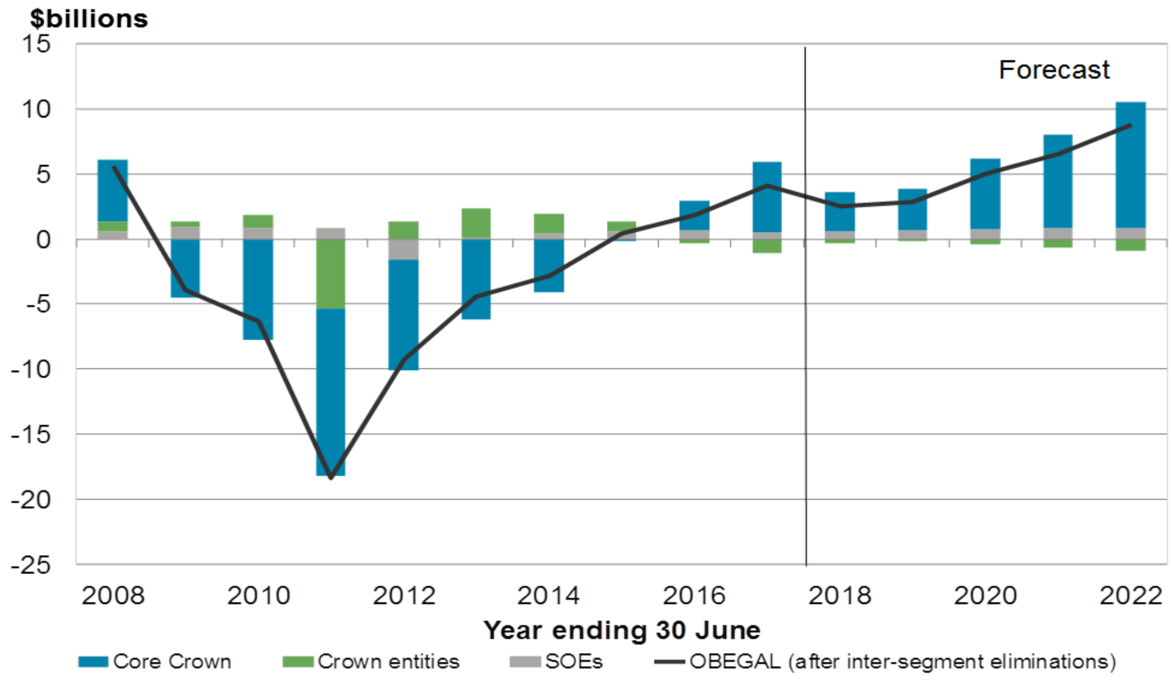
What the Treasury says

OBEGAL is expected to decrease initially, followed by steady growth over the next four years. By 2021/22, OBEGAL is forecast to reach a surplus of $8.8 billion.

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).

Operating allowances are higher than forecast at the Pre-election update, now set at $2.6 billion for Budget 2018 and $1.875 billion in Budgets 2019 – 2021.

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.

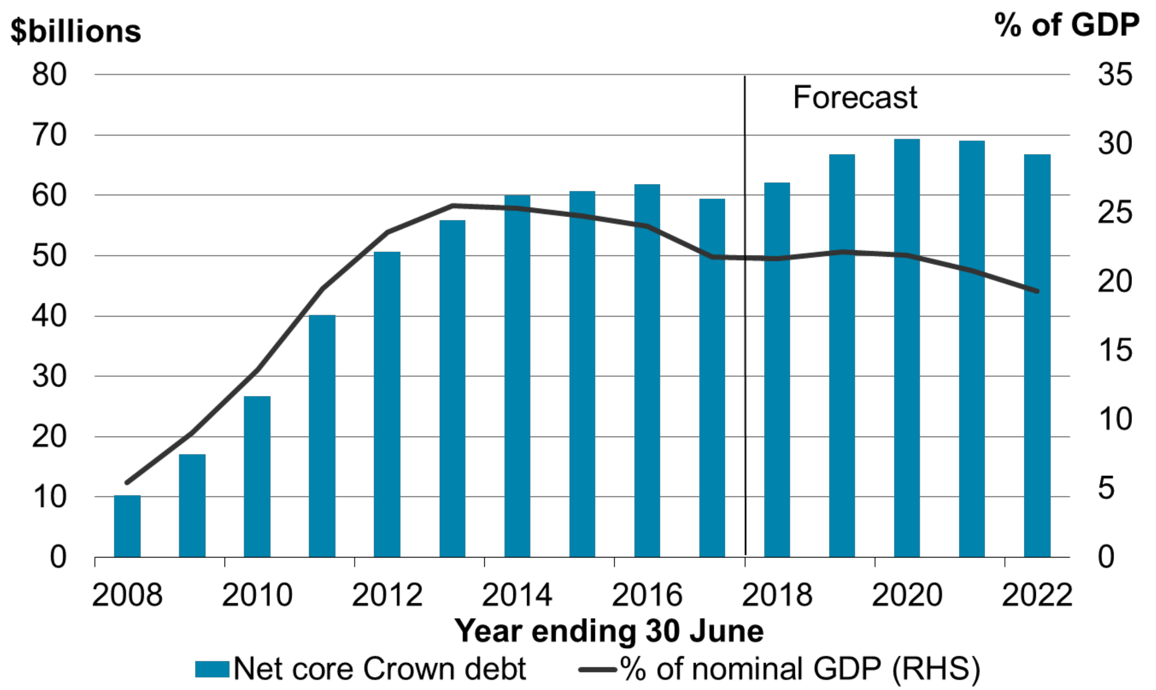
Net debt is the amount borrowed less cash and investments the government holds.

What the Treasury says

In the first few years of the forecast, spending is expected to be more than receipts and the Government is expected to have a cash deficit. From 2020/21 the Government is expecting to receive more from tax and other sources than it pays out in operating expenses and capital payments. 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 remains about the same or falls.

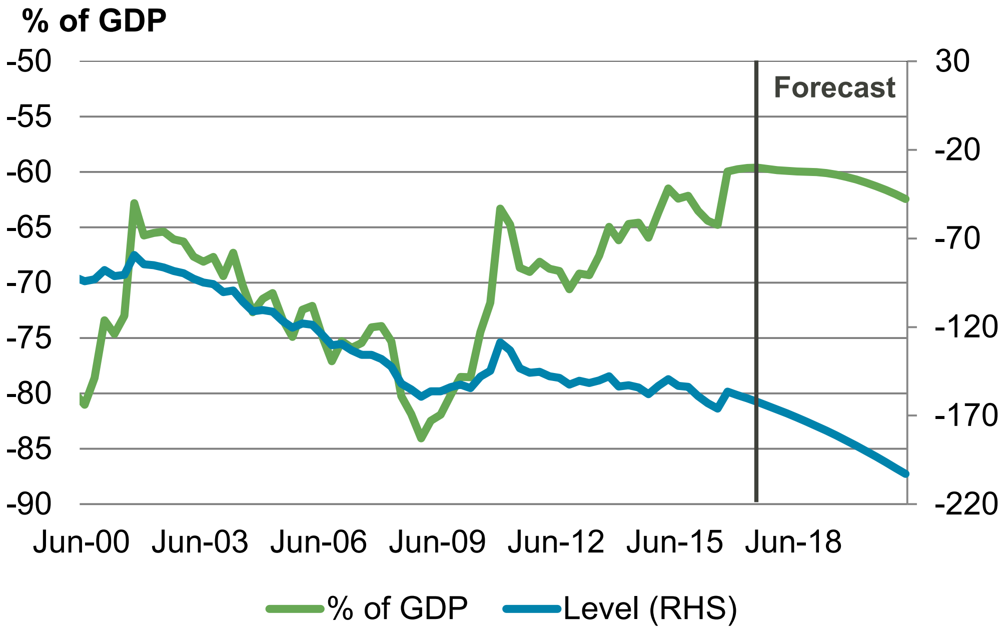
We expect net debt to decline as a percentage of GDP from 21.8% in 2016/17 to 19.3% 2021/22. Overall, we see net debt rising in the short term and peaking in dollar terms at $69.4 billion in 2019/20 before reducing to $66.8 billion in 2021/22.



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.



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Need to dive deeper?

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