THE TREASURY

Kaitohutohu Kaupapa Rawa

13 DECEMBER 2018

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 five years (our forecast horizon)

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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 Zealanders' 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 five 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 wellbeing.

The Framework's organising principles underpin **He Puna Hao Pātiki: 2018 Investment Statement**. The assets and liabilities on the Crown's balance sheet provide resources which the Government can draw on for raising wellbeing, now and into the future. And in 2016 we presented a living standards perspective that stretches over the next 40 years. **He Tirohanga Mokopuna: 2016 Statement on the Long-term Fiscal Position**, sets out 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

The Treasury is committed to delivering first-rate economic and financial advice, and providing it in ways that help New Zealanders 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.

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

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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 manage its debt.

Fiscal Outlook

We use some key indicators to tell us what's happening with the 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 to run the agencies that provide those services and interest costs from borrowing money. (It excludes Crown entity and SOE expenses.)
- **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 is generated by all the individuals and businesses in the economy.

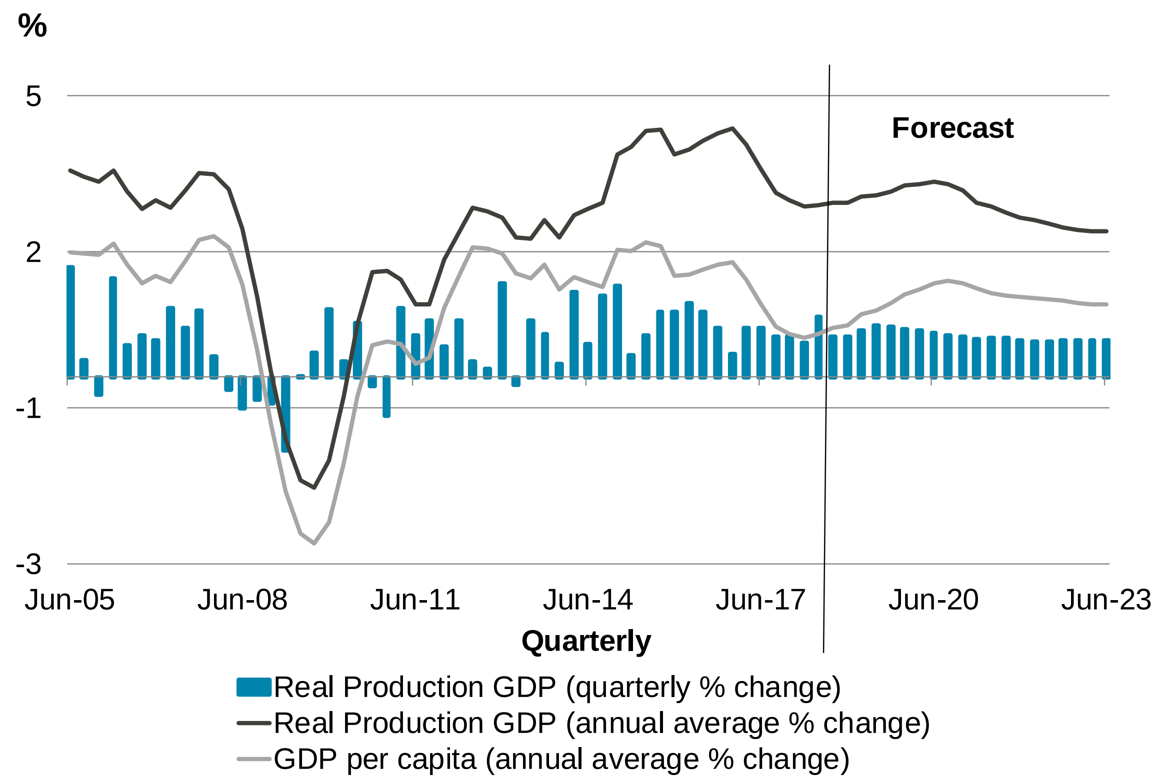
Real GDP is estimated at *constant* prices so it takes account of inflation. How real GDP changes over time is a good measure for how fast the economy is growing.

What the Treasury says

Overall our economy is growing steadily. Annual real GDP is expected to grow at an average rate of 3.0% per year over the next 2 years. 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 easing to 2.3% in 2023 as interest rates rise, population growth slows, and net export growth returns to average.

Annual average % change in real GDP and GDP per capita



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

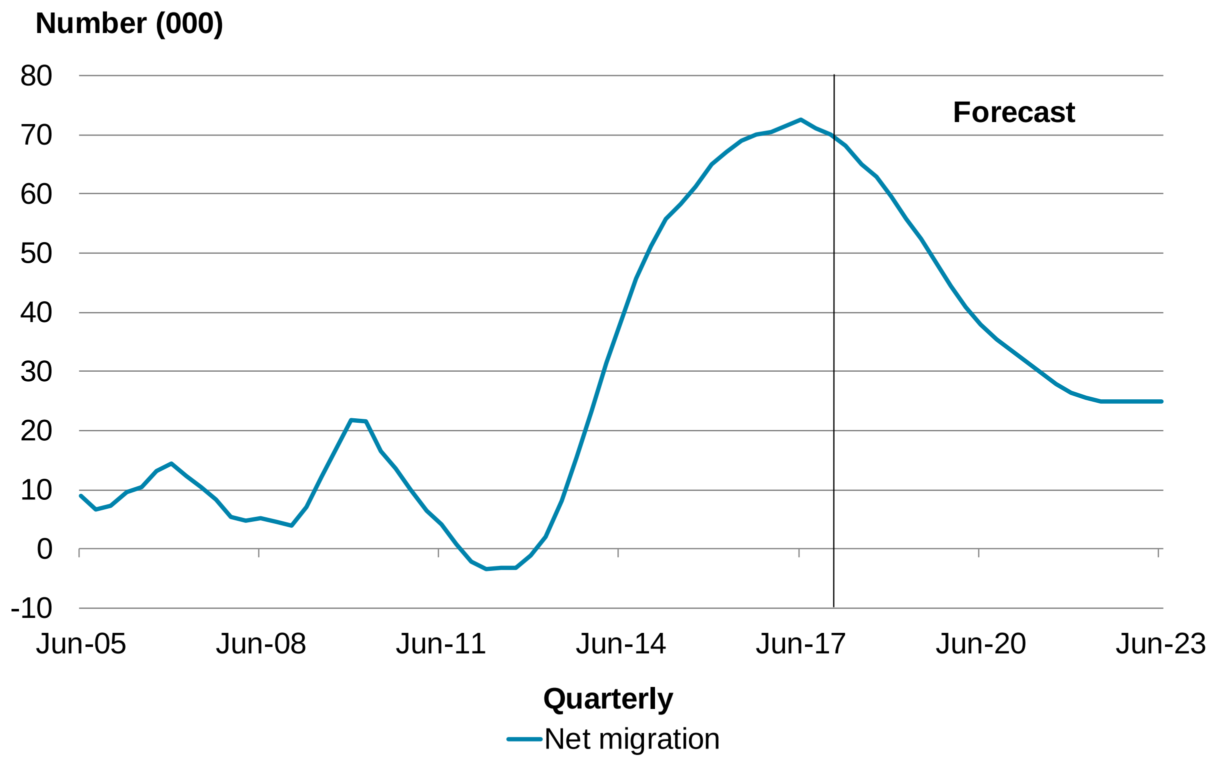
Historically more Kiwis leave New Zealand, mostly for Australia, than come back to New Zealand. Recently more Kiwis than usual have come home and fewer have left. Over time we assume the normal pattern to resume.

What the Treasury says

Net migration has eased over the past year and is assumed to fall steadily from its current level of 63,000 people to 25,000 in 2023.

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.

Annual total net migration



Employment

The unemployment rate is one indicator of the state of the labour market.

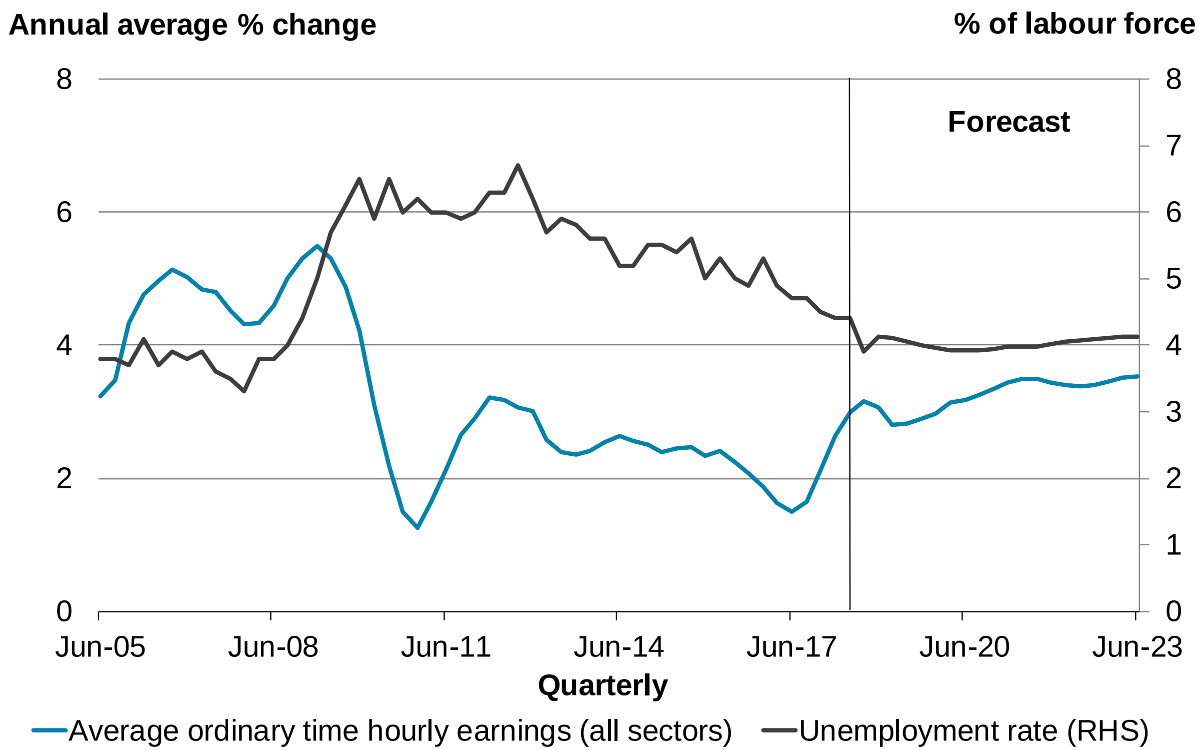
Unemployment and wages

When the unemployment rate is relatively high there is less pressure on businesses to raise wages. When the unemployment rate is relatively low there is more pressure on businesses to raise wages.

What the Treasury says

The unemployment rate is forecast to remain around 4.0%. With more people in work, wage growth is expected to pick up and to contribute to rising inflation pressure. Wage growth also receives support from a range of labour market policies, including fair pay agreements, pay equity settlements and minimum wage increases. We expect annual hourly wage growth of around 3.5% over the forecast period.

Unemployment rate and % change in ordinary time wage growth



Housing

The demand for houses will continue to increase.

Housing/Debt/GDP

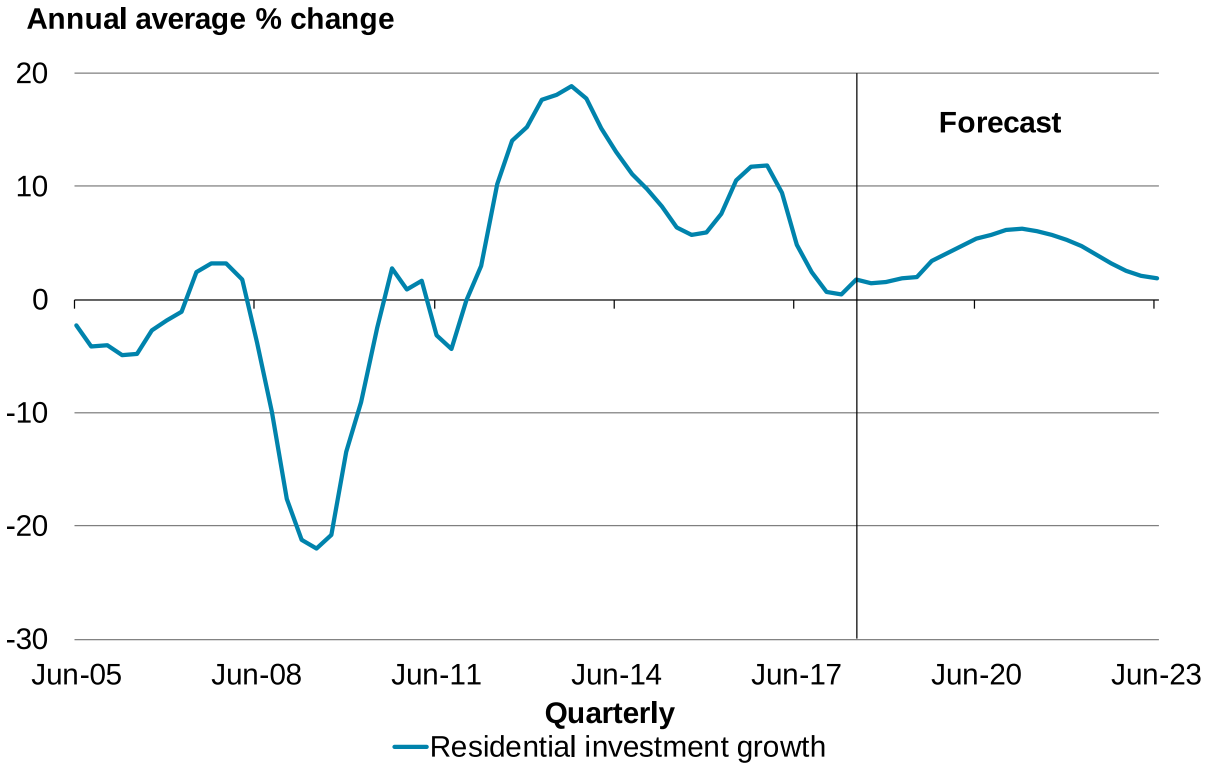
The growth in house prices has seen household debt increase. In 2018, household debt reached 133% of household disposable income.

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 growth.

What the Treasury says

We expect housing investment growth to pick up over the forecast period. There is a lot of housing investment happening, and strong population growth and low interest rates are driving demand. But the construction sector faces constraints. There is a shortage of skilled labour to build houses, construction costs are high, and finance for property developers and investors is constrained. KiwiBuild is expected to support growth. The demand for housing remains strong but supply is increasing.

Residential investment



Household Spending

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

Not all households are the same

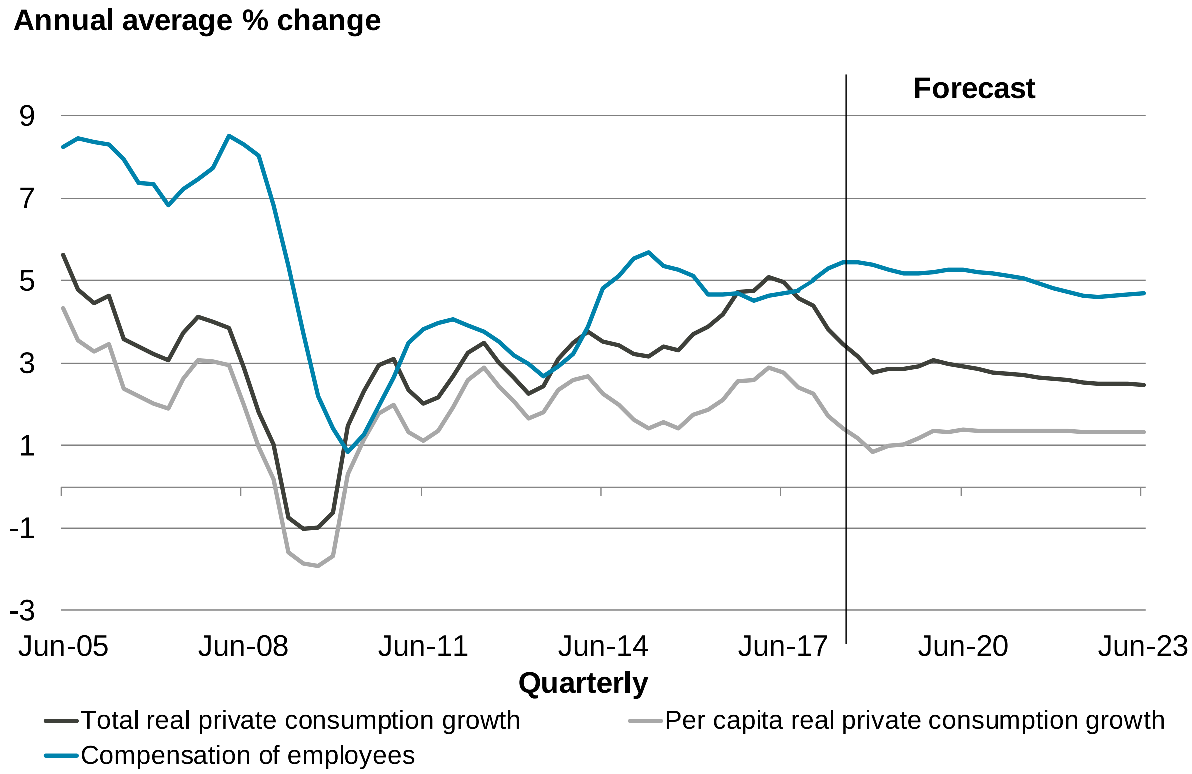
In these forecasts we assume households will increase the amount they spend slightly less than the rate of increase in incomes, leading to an increase in saving.

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

What the Treasury says

Real household income growth rises, bolstered by a tight labour market. The implementation of the Families Package, fair pay agreements, pay equity settlements and minimum wage increases also support income growth.The contribution of private consumption to overall GDP growth is expected to decline gradually over the forecast period as net migration eases and interest rates rise.

Real private consumption and compensation of employees



Tax Revenue

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

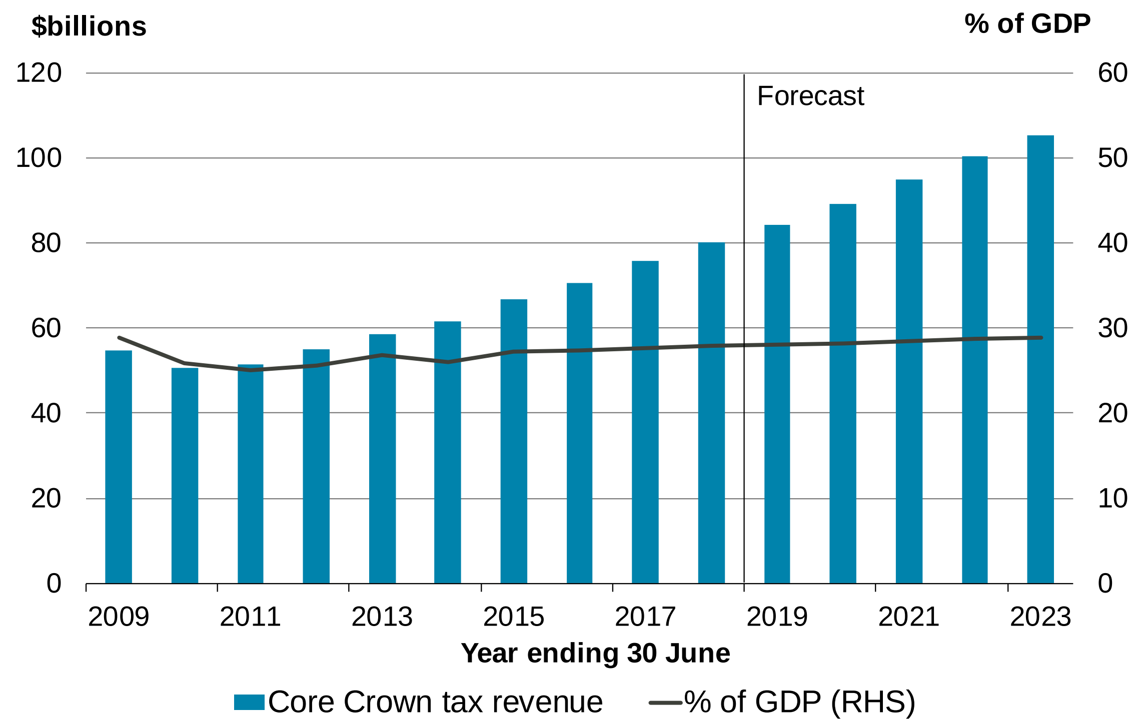
Tax expenditure

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 2023, core Crown tax revenue is expected to reach $105.3 billion, around $25 billion higher than in 2018. 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 and greater company profits.



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

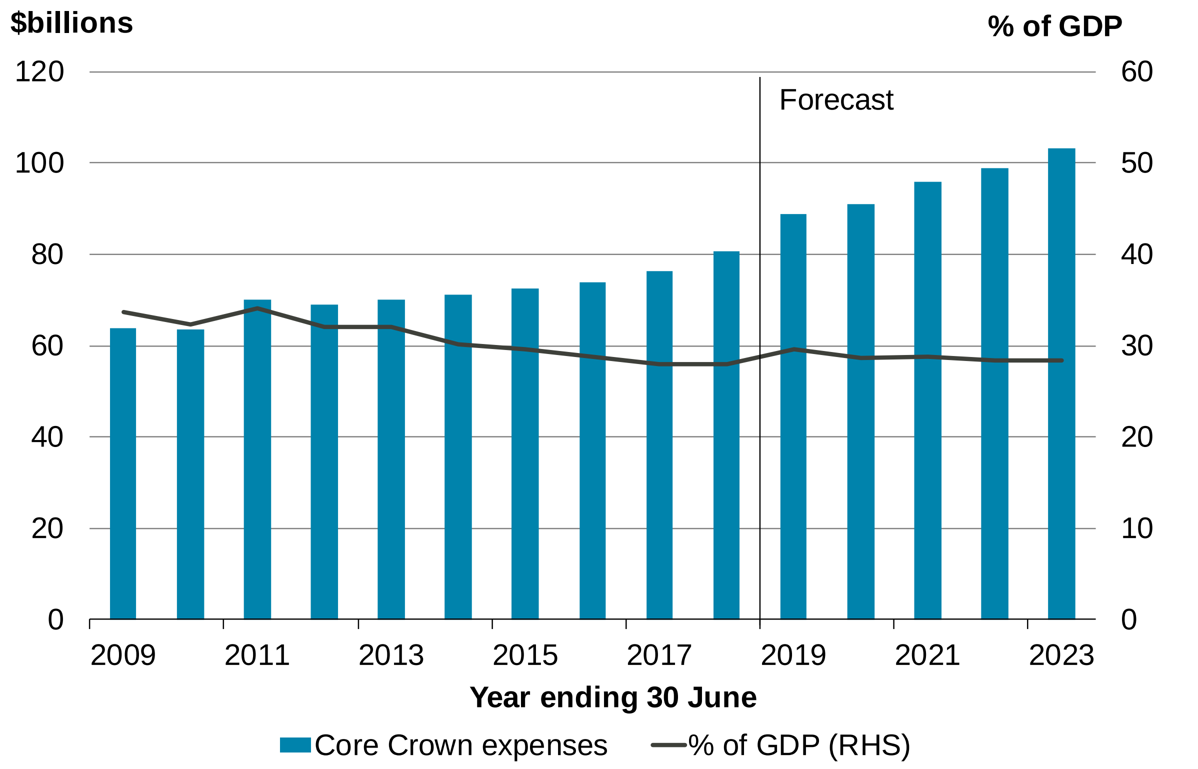
In 2017/18 core Crown expenses were around $16,495 per capita. By 2022/23 we expect that to have risen to $19,753 per capita.

What the Treasury says

Core Crown expenses are expected to increase over the forecast period from $80.6 billion in 2018 to $103.2 billion in 2023.

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 and core Crown expenses are expected to grow at a similar rate, the expenses remain relatively stable as a percentage of GDP (between 28.3% and 29.5%).



OBEGAL

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

Operating vs capital

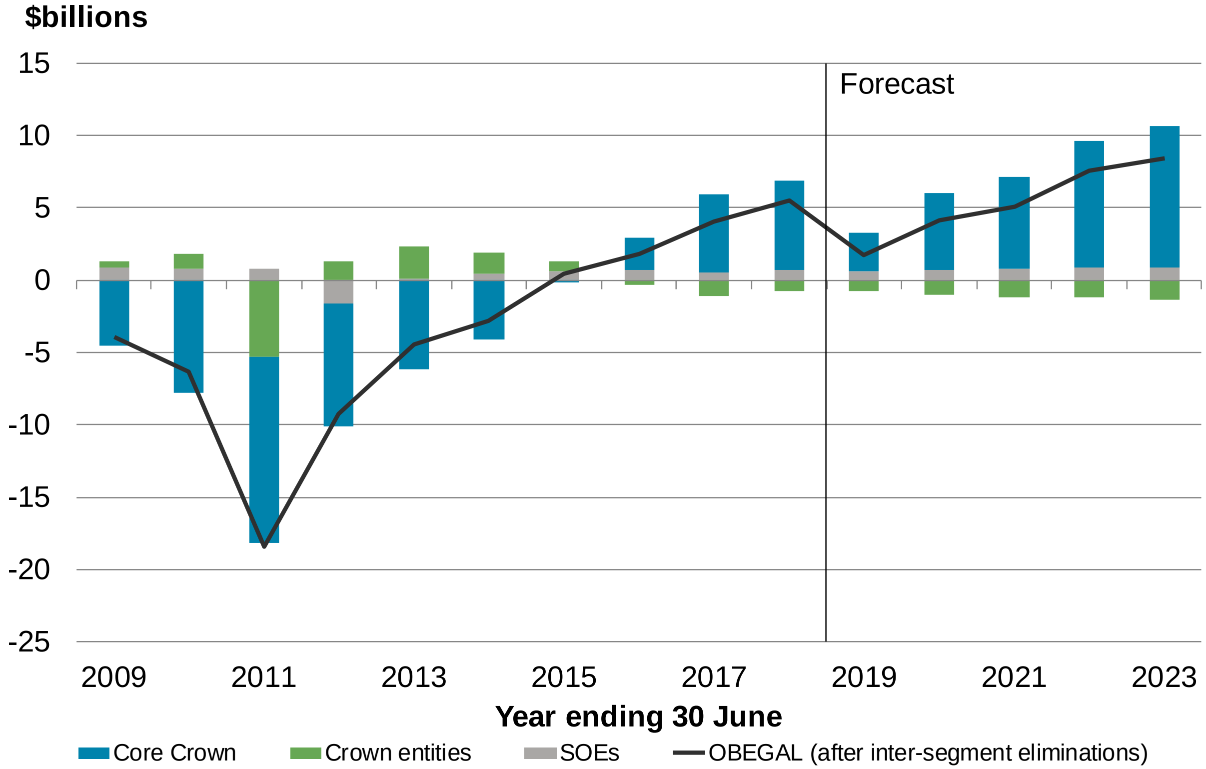
OBEGAL includes operating expenses of the Government but doesn't include spending on capital items such as building state highways or prisons.

What the Treasury says

The OBEGAL surplus of $5.5 billion in 2017/18 is expected to decrease to $1.7 billion in the current year, followed by steady growth over the next four years. By 2023, OBEGAL is forecast to reach a surplus of $8.4 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).

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 core Crown 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.

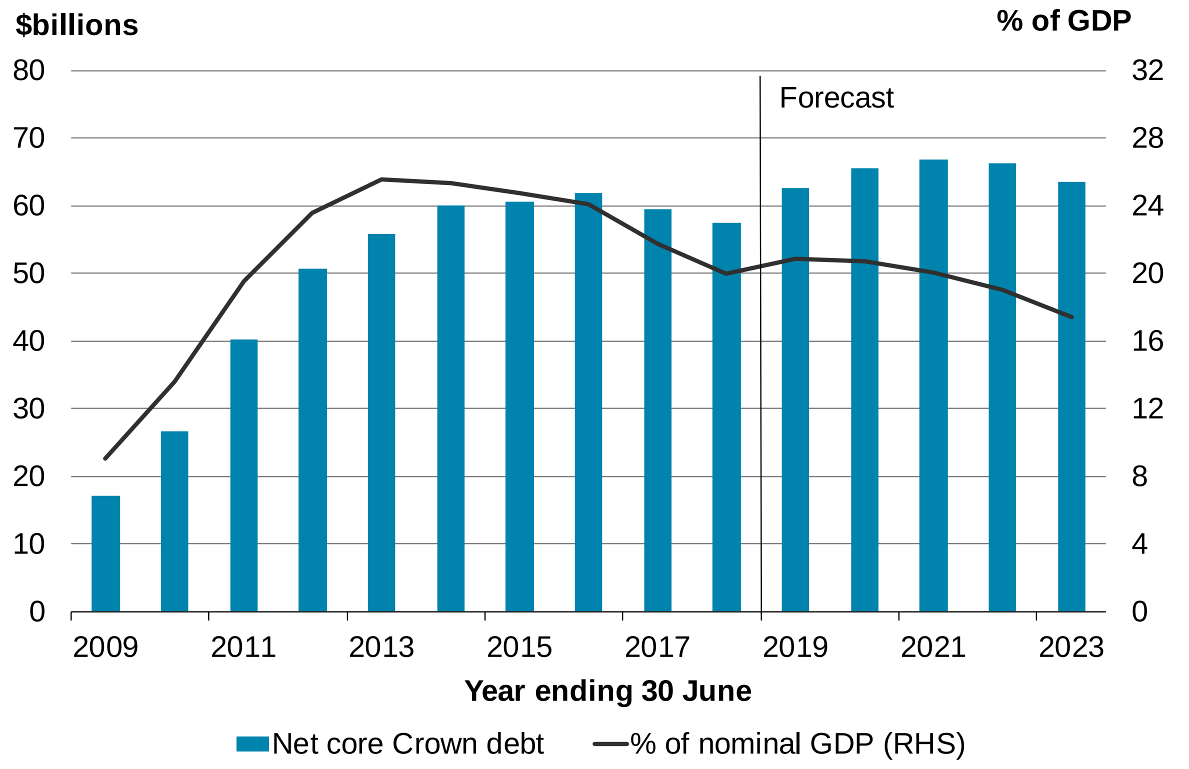
Net debt is the amount borrowed less cash and investments the core Crown holds.

What the Treasury says

Over the first three years of the forecast, spending is expected to be more than receipts and the Government is expected to have a cash deficit. In 2022, 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.

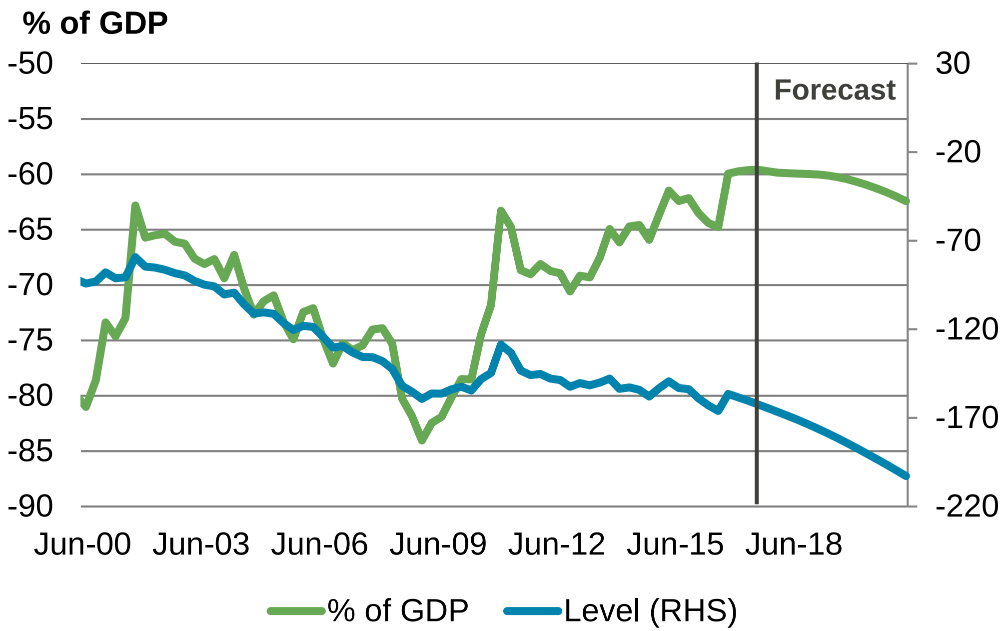
We expect net debt to decline as a percentage of GDP from 20.0% in 2018 to 17.4% in 2023. Overall, we see net debt rising in the short term and peaking in dollar terms at $66.9 billion in 2021 before reducing to $63.5 billion in 2023.



Resources

About forecasting

Forecasting is a combination of understanding trends, applying our forecasting model and using assumptions. Forecasting models are simplified representations of what ultimately are complex human behaviours. You can understand more about how we forecast here.



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Need to access our glossary?

Need to dive deeper?

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