TE TAI ŌHANGA
THE TREASURY

HYEFU Basics 2019

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)

11 December 2019

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.

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.

HYEFU Basics 2019 provides an overview split into two parts. 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. 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.

Economic indicators

Here are some of the key indicators we use to tell us what's happening in the economy:

- **Gross Domestic Product (GDP)** 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. There are two ways we look at GDP – nominal and 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.

- **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.

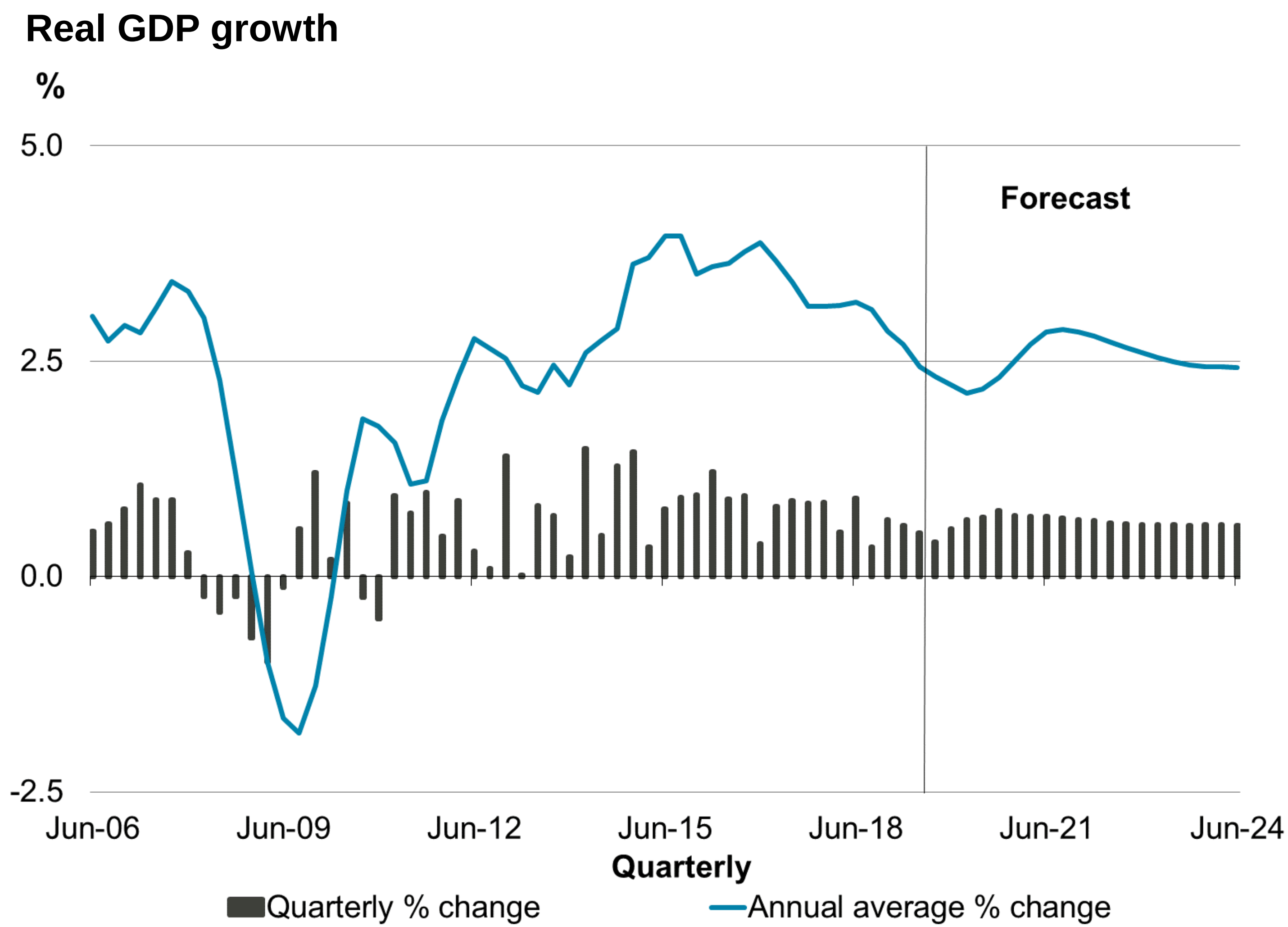
- **Household Spending**: Households choose to spend most of their income on goods and services (including housing). Households also save. When demand in the economy is greater than businesses' ability to provide the goods and services, prices can increase (inflation).

- **Terms of Trade** represent the ratio between a country's export prices and its import prices. Terms of Trade above 100% means the country is earning more from its exports than it spends on imports, and vice-versa if the figure is less than 100%.

GDP growth

- New Zealand's long run of solid economic growth is going to continue throughout the forecast period. However, we are experiencing a period of slower growth, as global uncertainty weighs on business investment and household spending growth slows.
- Recent data suggest growth has continued at this slower pace over the second half of 2019. As a result, the forecast for GDP growth in 2019/20 has been revised down.
- Moving to 2020/21, growth is forecast to pick up, largely supported by monetary and fiscal stimulus. A $12 billion increase in public investment being announced in the Government's *Budget Policy Statement 2020* complements other spending measures announced in Budget 2019 and underpins increased economic activity from 2020/21 onwards.
- Economic momentum eases towards the end of the forecast period, as the fiscal stimulus fades, net migration growth eases and interest rates increase.

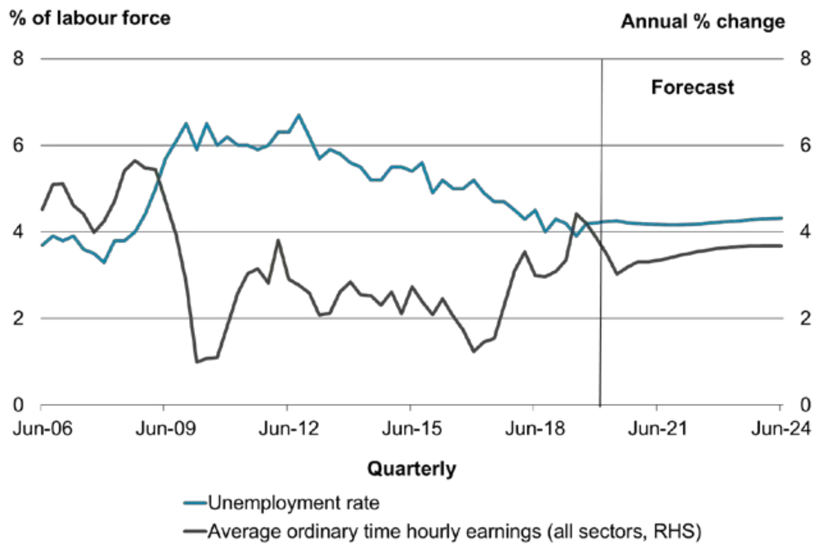
GDP growth continued



Labour market

Although growth has slowed, conditions in the labour market remain tight, and this has caused wages to rise. The unemployment rate is projected to be steady at 4.2 percent, while wage growth remains solid and reaches 3.7 percent at the end of the forecast period.

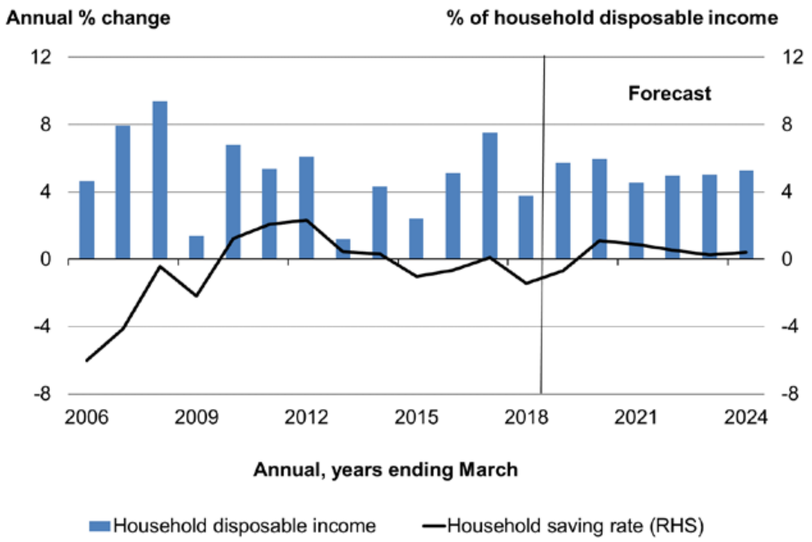
Unemployment and wage growth



Household income and saving

Growth in disposable income is forecast to remain solid over 2020/21 and beyond, as the expected pickup in wage growth offsets slower growth in employment and government transfers. Household consumption rises a little more quickly than disposable income, reflecting stronger house price growth, and household saving trends down.

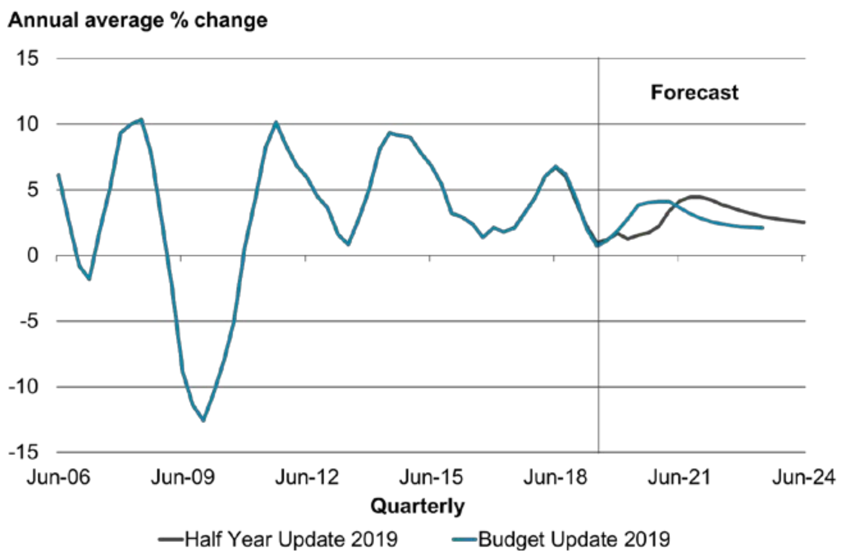
Growth in disposable income and the household saving ratio



Business investment

Business investment, which includes both public and private investment, is expected to increase at a moderate pace over 2019/20 and to gather momentum in 2020/21 as public investment spending increases. Private business investment also increases, as businesses look to alleviate constraints in the labour market and as overall economic activity picks up.

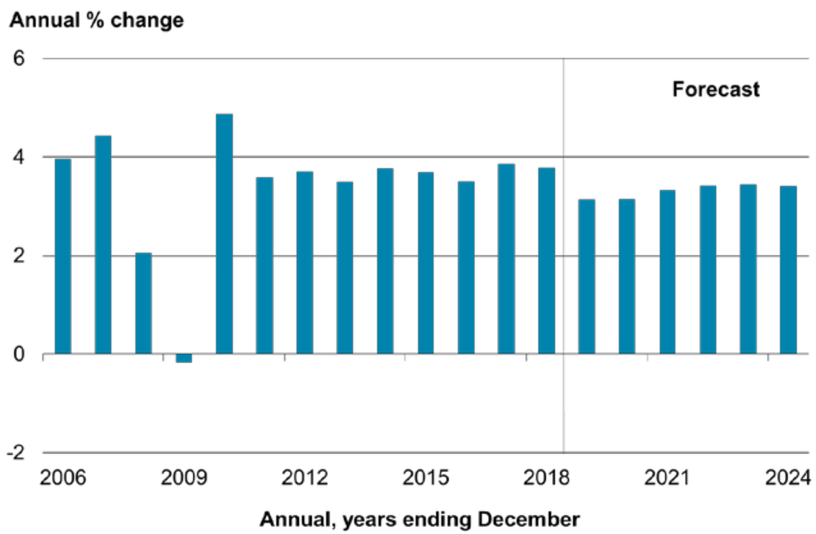
Business investment



Trading partner growth

Major trading partner growth is slower but still reasonable. It is expected to be around 3.1 percent in the years ending December 2019 and 2020 before increasing a little in 2021 and thereafter. However, the outlook is contingent on a resolution of the sources of global uncertainty that are weighing on investment, such as the US-China trade dispute and Brexit.

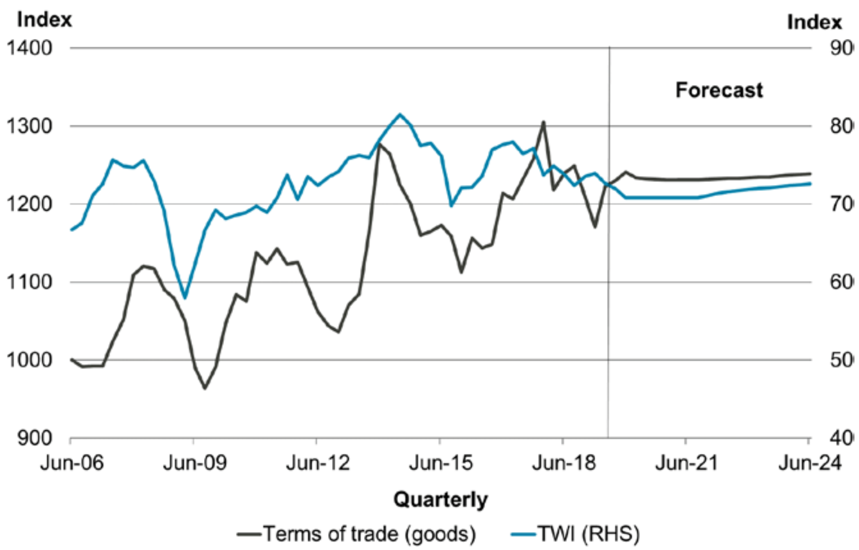
Trading partner growth



Terms of trade

New Zealand's terms of trade have remained resilient to the global slowdown. Demand for our major export commodities has stayed firm and prices have increased, although growth in tourism has eased. The lower kiwi dollar is providing additional support for export incomes. Terms of trade are projected to remain around current levels, underpinned by ongoing income growth in China and other Asian trading partners.

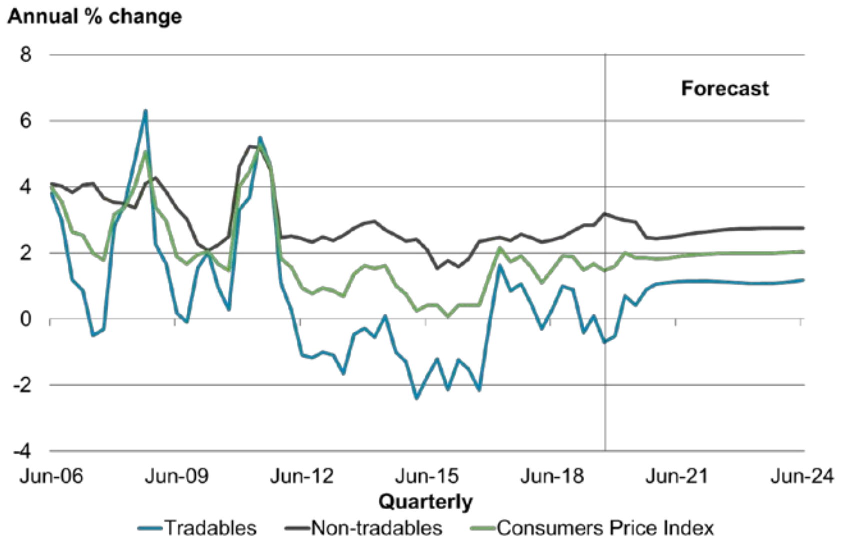
Terms of trade (goods) and the exchange rate



Inflation

As growth in the economy picks up, and wage pressures rise, we expect consumer price inflation to gradually move higher, reaching 2.0 percent in late 2021. Thereafter, we expect monetary and fiscal stimulus to ease, which will help keep inflation stable and help prolong the run of the current economic expansion.

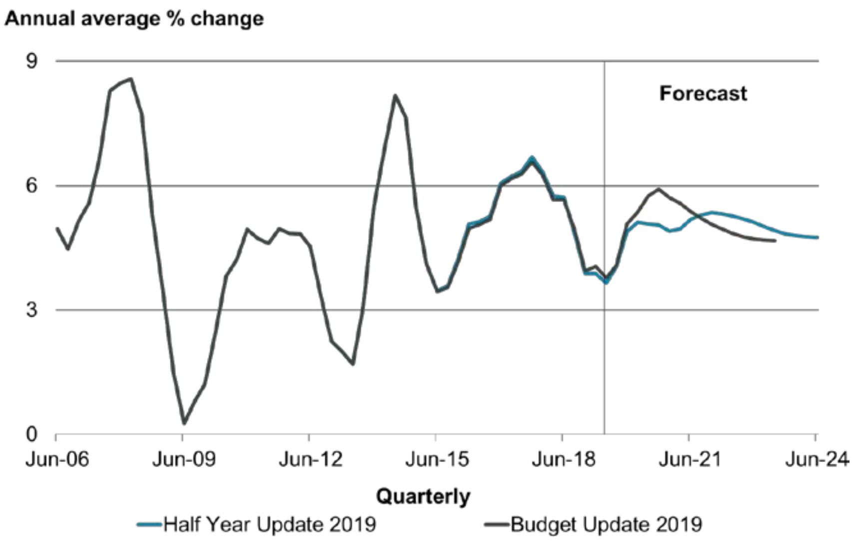
Inflation and its components



Nominal GDP growth

Nominal GDP, the main driver of tax revenue, is forecast to increase 5.1 percent in the year ahead, supported by improved terms of trade. Growth averages 5.0 percent over the forecast period, slightly lower than expected in Budget 2019. Nominal GDP is lower in each forecast year and, in total, is $5.1 billion lower than in the Budget.

Nominal GDP growth



Fiscal indicators

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

- **Core Crown 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.

Fiscal outlook

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.

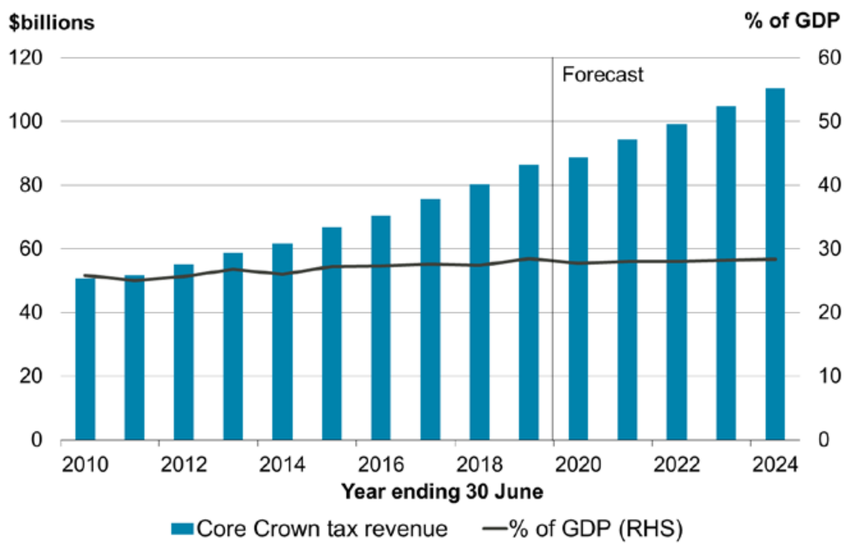
The fiscal outlook has weakened since Budget 2019. This is due to a number of factors, including the slower but solid economic outlook, higher social assistance spending, lower interest rates and the Government's new capital investment. Therefore, we are forecasting most fiscal indicators to be weaker than thought in Budget 2019. Core Crown expenses will outpace tax revenue as Budget 2019 spending decisions come into effect, economic activity slows and capital spending increases.

Year ending 30 June	2019 Actual	2020 Forecast	2021 Forecast	2022 Forecast	2023 Forecast	2024 Forecast
$billions						
Core Crown tax revenue	86.5	88.7	94.3	99.2	104.8	110.5
Core Crown expenses	87.0	93.8	98.8	102.0	106.3	109.2
Total Crown OBEGAL	7.3	(0.9)	0.1	1.8	4.1	5.9
Total Crown operating balance	0.3	0.4	3.6	5.8	8.5	10.9
Core Crown residual cash	(0.7)	(5.2)	(8.0)	(5.6)	(2.2)	0.9
Net core Crown debt	57.7	62.5	70.6	76.1	77.7	76.3

Core Crown tax revenue

Core Crown tax revenue is forecast to reach $110.5 billion or 28.4 percent of GDP by 2023/24, $24 billion higher than in 2018/19. The increase reflects the forecast slower but solid economic activity. A little over half of the forecast growth in source deduction revenue, which is mainly PAYE on wages and salaries, is largely because of tighter labour market conditions and a range of labour market policies like fair pay agreements, pay equity settlements, and the minimum wage policy.

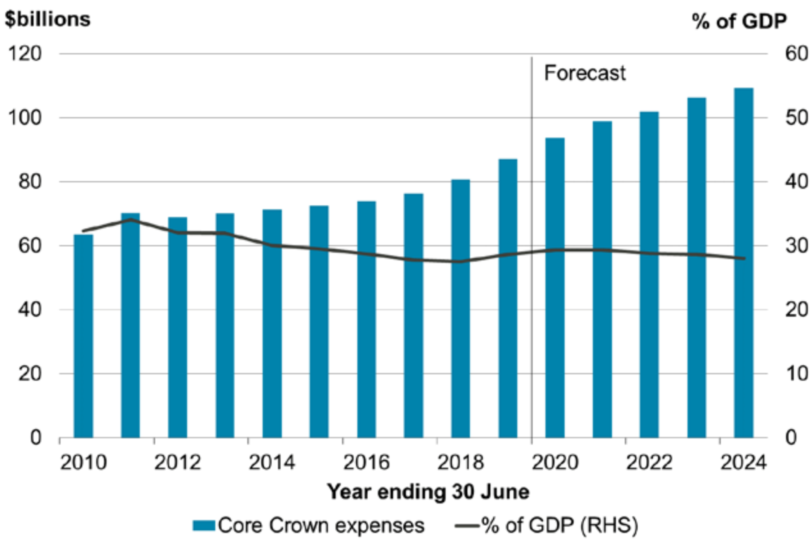
Core Crown tax revenue



Core Crown expenditure

Core Crown expenditure reaches $109.2 billion or 28.1 percent of GDP in 2023/24, an increase of $22.2 billion from 2018/19. This increase is largely due to previous Budget decisions and future Budget allowances combined with higher benefit expenses, especially NZ Superannuation expenses as our population ages and wages grow (because NZ Superannuation is indexed to the average wage).

Core Crown expenses



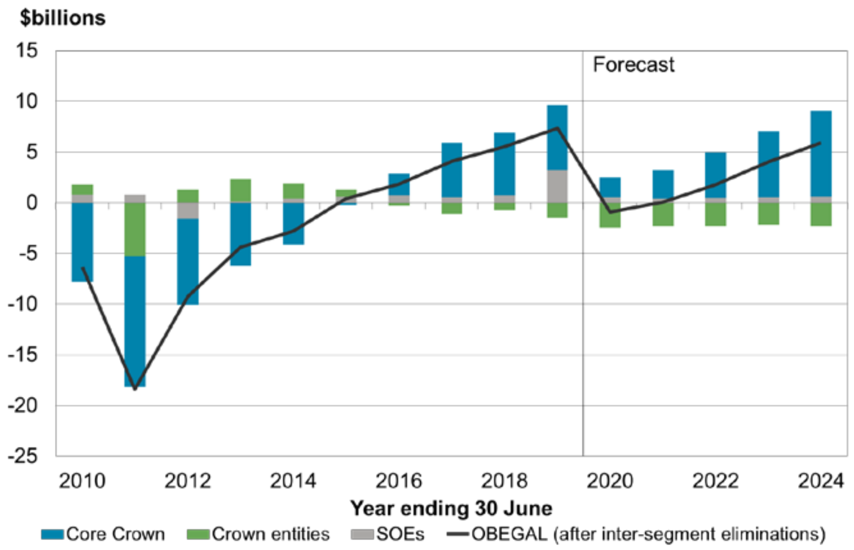
OBEGAL

We are forecasting OBEGAL to be lower than expected at Budget 2019 across all years, with a deficit in 2019/20.

This is mainly driven by a slowing but solid economic outlook affecting tax revenue and an increase in social assistance spending. At the same time, falling interest rates have adversely affected ACC's forecast results with ACC insurance claims costs increasing. In addition, DHB and KiwiRail forecasts are weaker.

We anticipate OBEGAL returning to a small surplus in 2020/21 and growing to reach $5.9 billion or 1.5 percent of GDP in 2023/24.

Components of OBEGAL by segment



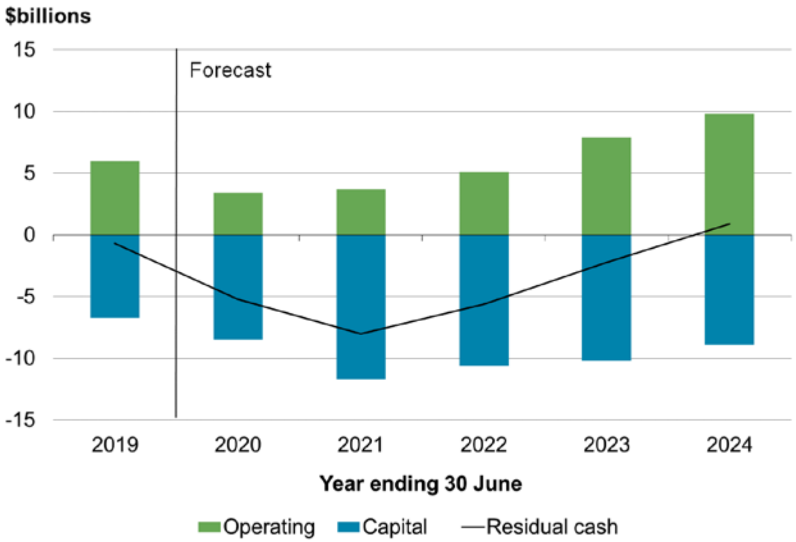
Core Crown residual cash

Core Crown residual cash deficits are forecast for the next four years as capital expenditure is more than the cash generated from operating activities.

Overall, $49.9 billion of net capital expenditure is expected across the forecast period. This includes the Government's new capital investment of $12billion, with $8.1 billion of that sum included in this forecast and the remaining $3.9 billion forecast to be spent after 2023/24.

Taking into consideration both the operating and capital activities of the Government, we expect a total cash shortfall of $20.1 billion over the forecast period, to be funded mainly from additional borrowing.

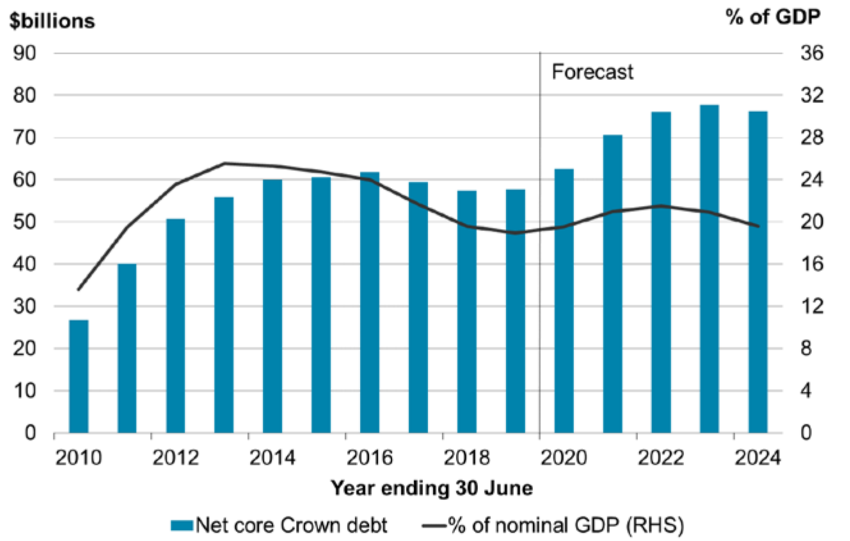
Core Crown residual cash



Net core Crown debt

Net core Crown debt is forecast to increase $18.6 billion by 2023/24, peaking at $77.7 billion in 2022/23 before declining the following year. As a percentage of GDP, net core Crown debt rises from 19.0 percent in 2018/19 to 21.5 percent in 2021/22, then dropping back to 19.6 percent at the end of the forecast period in 2023/24.

Net core Crown debt



Alternative scenarios and risks

There are always risks and uncertainties around any set of forecasts. We communicate these uncertainties through two alternative scenarios, which illustrate how the economy and fiscal position may deviate from the main forecast when key assumptions are changed.

- Scenario One explores the effects of weaker world demand owing to further disruption to global trade and increased financial market volatility.
- Scenario Two illustrates a stronger domestic economy driven by higher net migration that lifts demand, leading to business sentiment recovering sooner than expected.

You can find more detail in HYEFU’s Risks and Scenarios chapter and the Specific Fiscal Risks chapter.

2019 HYEFU forecast summary

June years	2019 Actual	2020 Forecast	2021 Forecast	2022 Forecast	2023 Forecast	2024 Forecast
Real production GDP (annual average % change)	2.4	2.2	2.8	2.7	2.5	2.4
Nominal expenditure GDP (annual average % change)	3.7	5.1	5.2	5.3	4.9	4.8
Unemployment rate	3.9	4.3	4.2	4.2	4.3	4.3
CPI inflation (annual % change, June quarter)	1.7	1.9	1.9	2.0	2.0	2.0
Current account balance (% of GDP)	-3.4	-3.2	-3.4	-3.6	-3.7	-3.8
Fiscal (% of GDP)						
Core Crown tax revenue	28.4	27.7	28.0	28.0	28.2	28.4
Core Crown expenses	28.6	29.3	29.4	28.8	28.6	28.1
Total Crown operating balance before gains and losses	2.4	-0.3	0.0	0.5	1.1	1.5
Core Crown residual cash	-0.2	-1.6	-2.4	-1.6	-0.6	0.2
Net core Crown debt	19.0	19.6	21.0	21.5	20.9	19.6
Net worth	48.0	45.6	44.4	43.8	44.1	44.9

Sources: Stats NZ, the Treasury