Reference: 20220016

28 March 2022

TE TAI ŌHANGA
THE TREASURY

Dear

Thank you for your Official Information Act request, received on 14 January 2022. You requested:

> *Any assessments, advice, reports, forecasts or any other similar documents/information you have produced or received since 1 June 2021 regarding New Zealand's productivity or labour productivity that are not publicly available. This includes potential policies, initiatives or changes that could be implemented to improve productivity or labour productivity.*
>
> *Please note this is not just a request for briefings you have provided Government Minister's, but for all such information you hold within the scope of the request.*

On 11 February 2022 I wrote to you that your request was extended by 30 days.

As you may be aware, the Treasury has a wide-ranging programme of work on New Zealand's economic performance. This includes work on productivity and labour productivity, as well as analysis on the wider drivers of good economic performance (including resilience, sustainability, and distribution), as set out in the Treasury's refreshed Living Standards Framework.

In acknowledgement of this, we have taken a broad interpretation of the scope of your request and have included documents that relate primarily to topics of wider economic performance, but may also have impacts on New Zealand's productivity.

You may be aware that in 2021 the Treasury established an Economic Strategy Directorate, which includes our Economic Strategy Team, Economic Policy Team and Regulatory Strategy Team. This Directorate works closely with the wider Treasury, as well as the Productivity Commission and the Ministry of Business, Innovation and Employment, on matters relating to productivity and economic performance.

Information being released

The following documents are to be released:

Item	Date	Document Description	Decision
1.	9 August 2021	T2021/2022: Economic Strategy Ministerial meeting – annotated agenda	Release in part

1 The Terrace
PO Box 3724
Wellington 6140
New Zealand
tel. +64-4-472-2733

https://treasury.govt.nz

2.	11 August 2021	Attachment T2021/2022: Economic Strategy Ministerial meeting – annotated agenda	Release in part
3.	23 September 2021	T2021/2328: Progressing medium-term work on accelerating the economic recovery and rebuild	Release in part
4.	11 October 2021	T2021/2533: Preliminary economic forecasts for HYEFU 2021	Release in part
5.	14 October 2021	T2021/2584: Productivity Commission Inquiry into Economic Inclusion and Social Mobility	Release in part
6.	15 October 2021	T2021/2525: HYEFU 2021 Preliminary Economic and Tax Forecasts	Release in part
7.	19 November 2021	T2021/2831: HYEFU 2021 Final Economic and Tax Forecasts	Release in part
8.	23 November 2021	Executive Leadership Team paper: Discussion of New Zealand's medium – to longer-term economic strategy	Release in part
9.	2 December 2021	T2021/3046: Updating Assumptions and Other Information About the 2021 Half Year Update Fiscal Strategy Model	Released in part

I have decided to release the above documents to you subject to information being withheld under one or more of the following sections of the Official Information Act:

- section 9(2)(a) – to protect the privacy of natural persons, including that of deceased people,
- section 9(2)(g)(i) – to maintain the effective conduct of public affairs through the free and frank expression of opinions,
- section 9(2)(g)(ii) – to maintain the effective conduct of public affairs through protecting Ministers, members of government organisations, officers and employees from improper pressure or harassment,
- section 9(2)(f)(iv) – to maintain the current constitutional conventions protecting the confidentiality of advice tendered by Ministers and officials, and
- section 9(2)(k) – to prevent the disclosure of information for improper gain or improper advantage.

We are putting together the binder of the documents to be released and will send this to you in the next five working days.

Regarding your request for documents that the Treasury has received, please see the list of titles below.

Item	Date	Document Description	Received from
10.	July 2021	Draft working paper: Circular economy - MBIE levers and opportunity areas	Ministry of Business, Innovation and Employment
11.	July 2021	Literature review: How a circular economy could support a more productive, sustainable, inclusive and resilient economy	Ministry of Business, Innovation and Employment
12.	September 2021	Slide pack: Resetting our future - Making the most of our post-COVID recovery opportunity	Ministry of Business, Innovation and Employment
13.	November 2021	Slide pack: Industry Transformation Plans: Purpose, Potential and Progress	Ministry of Business, Innovation and Employment
14.	November 2021	Slide pack: Industry Transformation Plans: Supplementary Slides: ITP Progress Updates	Ministry of Business, Innovation and Employment
15.	December 2021	Slide pack: Exploring emerging economic frameworks	Ministry of Business, Innovation and Employment
16.	December 2021	Slide pack: New Zealand's economic context	Ministry of Business, Innovation and Employment
17.	December 2021	Agenda: Framework Exploration Workshop	Ministry of Business, Innovation and Employment
18.	December 2021	The Future Economy: Framework Exploration Workshop Capture	Ministry of Business, Innovation and Employment
19.	December 2021	Cabinet paper: Government Response to the Productivity Commission's Frontier Firms Inquiry	Ministry of Business, Innovation and Employment

Information Publicly Available

The information listed in the table below is also covered by your request and will soon be available on the Treasury website. Accordingly, your request for this information is refused under section 18(d) of the Official Information Act: the information requested is or will soon be publicly available.

Item	Date	Document Description	Website Address
20.	14 October 2021	Cabinet Paper: Potential Productivity Commission inquiry into economic inclusion and social mobility	https://www.treasury.govt.nz/publications/information-release/finance-portfolio-cabinet-material
21.	10 November 2021	Cabinet Paper: Progressing the economic recovery and rebuild: Opportunities for industry policy	

I can also advise that there are a range of documents which the Treasury has both produced and received relating to productivity and labour productivity which are already publicly available.

Treasury's information releases can be found on our website: https://www.treasury.govt.nz/publications/other-official-information/information-releases

Information to be withheld

We have identified one additional document covered by your request in the table below which I have decided to withhold, under the following section of the Official Information Act:

- Section 9(2)(g)(i) – to maintain the effective conduct of public affairs through the free and frank expression of opinions by or between or to Ministers of the Crown or members of an organisation or officers and employees of any public service agency or organisation in the course of their duty

Item	Date	Document Description
22.	1 December 2021	Slide pack: Initial discussion on EST work on the performance of New Zealand's economy

In making my decision, I have considered the public interest considerations in section 9(1) of the Official Information Act.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This reply addresses the information you requested. You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Natalie Labuschagne
Manager, Economic Strategy

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Economic Strategy Ministerial meeting – annotated agenda

Date:	9 August 2021	**Report No:**	T2021/2022
		File Number:	TY-2-0

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	Circulate the attached annotated agenda ahead of your meeting with Hon Woods, Hon Nash and Hon Parker.	10 August 2021

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Tim Maddock	Senior Analyst, Economic Policy	s9(2)(k)	N/A (mob)	✓
Alastair Cameron	Manager, Economic Policy	N/A (wk)	s9(2)(g)(ii)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: Yes (attached)

Treasury Report: Economic Strategy Ministerial meeting – annotated agenda

Recommended Action

We recommend that you:

a **note** the attached annotated agenda for your meeting with Hon Woods, Hon Nash and Hon Parker on Wednesday 11 August

b **agree** to share the attached annotated agenda

Agree/disagree.

c **note** that we worked with MBIE to develop the agenda material

d **note** that we will provide further advice in the next two weeks on opportunities to better enable:

a. industries to innovate, lift value and diversify, and

b. industries, regions and communities most vulnerable to the climate transition to adapt.

Alastair Cameron
Manager, Economic Policy

Hon Grant Robertson
Minister of Finance

Treasury Report: Economic Strategy Ministerial meeting – annotated agenda

Purpose of Report

1. On Wednesday 11 August, you are meeting with Ministers Woods, Nash and Parker.
2. We understand that key outcomes you are seeking are:
   - a to get buy-in from your colleagues to prioritise further work in the following areas:
     - i better enabling industries to innovate, lift value and diversify, and
     - ii supporting industries, regions and communities most vulnerable to the climate transition to adapt.
   - b to test their views on what the ambition and focus areas for this work should be.
3. This report provides you with an annotated agenda and supporting material for the meeting (refer to attachment).

Next Steps

4. We recommend you share the attached agenda with Ministers Woods, Nash and Parker ahead of the meeting on Wednesday (tomorrow).
5. Depending on the outcome of the meeting, we can also provide you with further advice in the next two weeks on opportunities to better enable:
   - a industries to innovate, lift value and diversify, and
   - b industries, regions and communities most vulnerable to the climate transition to adapt.
6. If you still wish to prepare a Cabinet Paper following the meeting, we will prepare to reflect any feedback from the meeting and on the further advice.

Annotated agenda: Meeting of Economic Ministers
Wednesday 11 August

Attendees: Hon Robertson, Hon Nash, Hon Woods, Hon Parker, Ministerial advisors

Supporting material prepared by officials

- Annex 1: Note to support Ministers' discussion of future strategic focus areas
- Annex 2: Indicative summary of the current landscape for broader industrial policy
- Annex 3: Illustrative process for progressing industry policy focussed work.

Topic	Specific actions
1. Priority areas to further progress the Government's economic agenda (20 mins)	**Discuss** what Ministers see as the key opportunities and challenges for progressing Government's economic goals. **Agree** to prioritise industrial policy (including innovation, regional economic development and just transitions) as a focus area for further advice. Agree/Disagree **Discuss** how this work could best complement existing work programmes such as the Emissions Reduction Plan and Future Pathways.
2. Progressing industrial policy-focussed work (15 mins)	**Discuss** the Government's level of ambition for a future medium-term work programme. **Indicate** which of the following areas Ministers wish to progress: • How to better align existing measures across the industrial policy landscape, including how to leverage existing climate targets (and establish a set of concrete objectives) as a focal point for coalescing action across government and driving future priorities. • Where Government could push harder and scale up existing measures (and where not to) to achieve greater critical mass. • Principles for when to intervene (and when not to) in particular firms, sectors and communities, and strategies for exiting existing measures. • Identifying and addressing areas where different approaches to regulation or new regulatory systems could unlock industry innovation and investment **Identify** potential vehicles could Government use to signal any change in policy direction (e.g. Response to Frontier Firms report, public communication).
3. Next steps (5 mins)	**Agree** on a process for progressing this work – including developing a Cabinet Paper and progressing work towards potential decisions in Budget 22.

Annex 1: Note to support Ministers' discussion of future strategic focus areas

This note was prepared by Treasury officials with input from MBIE officials to support an initial discussion among Ministers about progressing Government's economic goals, with a focus on how to better enable:

a industries to innovate, lift value and diversify, and

b industries, regions and communities most vulnerable to the climate transition to adapt.

The current economic landscape

1. The economy continues to recover stronger than expected with a low and falling unemployment rate, though labour and skills shortages persist.
2. However, economic challenges that existed pre-COVID remain such as low wages, capital intensity and rates of innovation compared to other advanced economies, a stubborn GHG emissions trajectory, concerning water quality and biodiversity trends, housing unaffordability and poor economic outcomes for Māori and Pasifika.

Significant progress must be made to achieve Government's long-term economic goals

3. We understand that you wish to build a productive, sustainable and inclusive economy. In particular, this means transitioning to a low-emissions and high-wage economy. The Government has also set various ambitious targets (eg, emissions reduction, lifting R&D and primary sector value). As you further develop your economic strategy, clarifying and forming a shared view about what outcomes Government wants to prioritise will help to focus action across government.
4. Significant progress must be made to have a chance of achieving current targets, particularly climate-related targets. Success will require, among other things:
    - enabling significant capital investment and innovation from the private sector, and
    - our economic structure diversifying toward more sustainable and export-oriented firms.

There is a good case for rethinking the role of industrial policy alongside innovation and regional policy in achieving Government's goals and managing the transition

5. Industrial policy can be thought of as interventions that stimulate specific economic activities in order to direct structural change. They are hence an important lever for achieving desired economic transitions and supporting transitioning firms and communities, alongside broad-based policies that benefit a wider range of firms.
6. The Government delivers many kinds of industrial policies. Industry Transformation Plans (ITPs) are a specific example, where Government actively partners with firms, industries and workers. Others include grants and innovation support, free allocation of emission credits, exporter support, and regulatory and procurement policy. Notably, even more broad-based policy systems, like skills and immigration, are skewed, to varying degrees, toward particular activities.
7. The Government's agreed refreshed Industry Strategy post-COVID-19 took useful steps toward taking a more structured approach to industrial policy. However, there is scope to build on this work, for example by:
    - *Improving coherence across the wider policy landscape* – the current landscape is cluttered, multiple sectors receive focus, and some policy systems are working at cross-purposes – e.g. while the Industry Strategy[1]outlines a set of core sector priorities, these are not fully reflected in the priorities of innovation policy or sector targeted investment in practice. There is scope for greater prioritisation to help grow and develop frontier firms. You may also wish to use the Government's

[1] The narrow priorities in the refreshed Industry Strategy are Digital technologies, Advanced manufacturing, and Food and beverage manufacturing, Forestry and wood processing, and Agritech

aspirations around the climate transition as a focus for future investments in industry policy.

- *Scaling up existing measures to achieve critical mass*– the current scale of investment combined with the wide range of sectors in focus means that resources are spread thinly. The Productivity Commission noted that "Government will need to make significant investments in infrastructure, research and people, in a small number of focus areas, to complement the efforts and investments of the business sector". Prioritising your investments around climate change could help to achieve greater critical mass.
- *Developing an agreed framework for intervening and exiting* – Government will face difficult choices about when to intervene and when to withdraw existing measures, particularly in the context of assisting firms and population groups most vulnerable to the climate transition. Having an agreed framework and principles for intervening and exiting could support Government in making decisions that are more consistent and aligned with their overarching objectives.

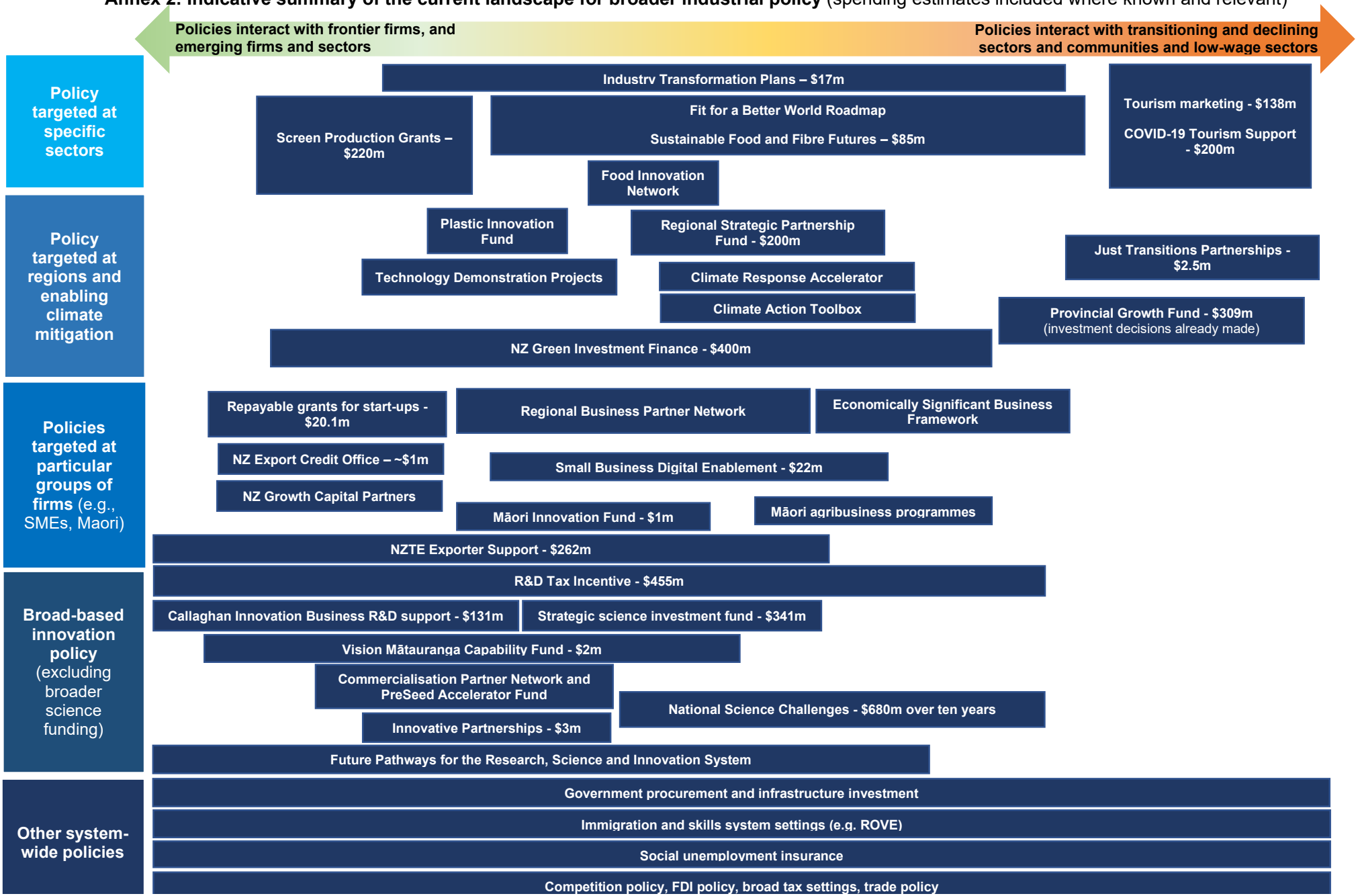
You have choices about what a potential medium-term work programme could address

8. s9(2)(f)(iv)

9.

10. Annex 3 illustrates a possible process for progressing this work.

Annex 2: Indicative summary of the current landscape for broader industrial policy (spending estimates included where known and relevant)



Annex 3: Illustrative process for progressing economic strategy work programme

Month	Milestone	Notes
August 2021	Ministers receive initial policy advice (led by TSY with MBIE, MPI, MfE and NZTE input).	Focused on objectives and the opportunities
September 2021	Officials prepare draft Cabinet Paper that indicates focus areas for Government's economic agenda Ministers meet to discuss Cabinet Paper Publish Cabinet Paper	Separate Cabinet Paper led by MBIE focussed on ITPs due to go up in September
October 2021	Officials provide advice on initial opportunities for Budget 2022 Ministers meet to discuss advice	
November 2021	Officials provide more detailed options for Budget 2022 Ministers meet to discuss advice	
December 2021	Development of high-level what further work programme could cover	
s9(2)(f)(iv)		

TE TAI ŌHANGA
THE TREASURY

Treasury Report: Progressing medium-term work on accelerating the economic recovery and rebuild

Date:	23 September	**Report No:**	T2021/2328
		File Number:	TY-2-0

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Confirm** the key points from your recent Ministers meeting. **Agree** to the scope and timing of the upcoming Cabinet Paper. **Forward** this report to key relevant Ministers.	27 September 2021

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Tim Maddock	Senior Analyst, Economic Policy	s9(2)(k)	N/A (mob)	✓
Rose Austen	Senior Analyst, Regions, Enterprise and Economic Development		N/A (mob)	
Alastair Cameron	Manager, Economic Policy	N/A (wk)	s9(2)(g)(ii)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Forward to the Minister for Economic and Regional Development, Minister of Research, Science and Innovation, and Minister for the Environment.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Progressing medium-term work on accelerating the economic recovery and rebuild

Executive Summary

This report identifies next steps for progressing medium-term work on accelerating the economic recovery and rebuild. It follows your recent meeting with the Minister for Economic and Regional Development, Minister of Research, Science and Innovation, and Minister for the Environment, where we understand you agreed to:

- prioritise work on identifying opportunities to strengthen the existing industry policy landscape (e.g. by improving alignment and coherence) to progress Government's goals, and
- develop a Cabinet paper as a next step.

We seek your agreement on the scope for the agreed Cabinet paper

Following your Ministers meeting, both Treasury and MBIE have had to divert resources to support policy and operational work to respond to the current COVID-19 outbreak. As a result, limited progress has been made on the broad work programme agreed by Ministers. MBIE has indicated they will have limited capacity to engage meaningfully with the development of the Cabinet paper due to competing pressures.

To help mitigate resourcing pressures, we are seeking further guidance from you on the scope and content of the Cabinet paper. We have identified three potential areas that could be covered in the Cabinet paper

1. **Identifying industry policy as a key vehicle for delivering on the Government's economic goals and reinforcing the need for policy alignment** – You could signal the role industry policy can play in addressing supply-side barriers to growth and progressing Government's goals, highlight the connections between work programmes from an industry perspective, and discuss how industry policy fits within the Government's broader economic agenda and its response to climate change.
2. **Seeking agreement on specific opportunities where existing industry policies could be better aligned or simplified, and direct officials to undertake further analysis on these** – Opportunities include drawing closer links between Future Pathways and Industry Transformation Plans (ITPs), investigating the consolidation of funds, and providing greater direction on how mission-led approaches could be applied in a New Zealand context across portfolios to address climate change.
3. **Signalling linkages to upcoming Budget decisions and other potential levers where industry policy could help progress the Government's goals** – You could highlight that bids enabling industry investment and innovation that help achieve emissions reductions will be prioritised. You could also seek to manage expectations about the limited spend available for non-climate bids and encourage your colleagues to identify regulatory opportunities where industry policy could progress goals.

You may also wish to consider using the Cabinet paper to reinforce and/or further clarify the Government's key economic goals to guide policy work and achieve consistent messaging.

We also seek your preferences on timing for lodging the Cabinet paper

We see value in lodging the Cabinet paper in late October, as this aligns with the timing of relevant Cabinet papers on ITPs and Regional Economic Development. s9(2)(g)(i)

s9(2)(g)(i)

Recommended Action

We recommend that you:

1) **confirm** whether the bullets in paragraph 6 accurately capture the key points of agreement at your meeting with the Minister for Economic and Regional Development, Minister of Research, Science and Innovation, and Minister for the Environment on 11 August

   Yes / No

2) **agree** the scope of the Cabinet paper:

   a) Identify industry policy as a key vehicle for delivering on the Government's economic goals and reinforce the need for policy alignment

      Yes / No

   b) Seek agreement on specific opportunities where existing policies could be better aligned or simplified and direct officials to undertake further analysis on these

      Yes / No

   c) Signal linkages to upcoming Budget decisions and other potential levers where industry policy could help progress the Government's economic goals

      Yes / No

3) **agree** whether you would also like the Cabinet paper to reinforce and clarify messaging on the Government's economic goals for the recovery and rebuild

   Yes / No

4) **note** that lodging the paper in late October (as opposed to late November)

   a) has the advantage of being aligned with the timing of other Cabinet papers addressing ITPs and Regional Economic Development and provides greater opportunity to influence other key work programmes such as the Climate Emergency Response Fund.

   b) s9(2)(g)(i)

5) **agree** whether to lodge the Cabinet paper in

   a) late October

      OR

   b) late November

6) **forward** this report to the Minister for Economic and Regional Development, Minister of Research, Science and Innovation, and Minister for the Environment.

Alastair Cameron
Manager, Economic Policy

Hon Grant Robertson
Minister of Finance

Treasury Report: Progressing medium-term work on accelerating the economic recovery and rebuild

Purpose of Report

1. The purpose of this report is to identify next steps for progressing medium-term work on accelerating the economic recovery and rebuild, with a focus on ways to improve alignment across programmes with an industry policy component.
2. The report seeks your agreement to the scope and timing of a Cabinet paper to progress these next steps. This follows your recent Ministerial meeting on 11 August with the Minister for Economic and Regional Development, Minister of Research, Science and Innovation, and Minister for the Environment, where you agreed to develop a Cabinet paper as a next step.

Background and context

Your goals for the economic recovery and rebuild

3. You have indicated that your overarching goal for accelerating the recovery and building back better from COVID-19 is 'creating a high-wage, low-emissions, job-rich economy' and that you see the following as important for achieving this goal:
   - a Crowding-in and reducing barriers to innovation and investment to help reduce emissions and lift value;
   - b Reducing business reliance on low-skilled labour – e.g., by diversifying away from low-value sectors, shifting to more capital-intensive models and increasing upskilling of workers;
   - c Diversifying what we produce, and who we trade with;
   - d Realising the economic potential of our Māori and Pacific communities and businesses, and small and medium enterprises and entrepreneurs; and
   - e Reforming, and investing in, areas that are critical underpinnings of productivity such as resource management, skills and infrastructure.

Ministers recently agreed to prioritise medium-term work on industry policy, with a focus on improving alignment of existing programmes and decarbonisation

4. On 11 August, you met with the Minister for Economic and Regional Development, Minister of Research, Science and Innovation, and Minister for the Environment to discuss medium-term opportunities for progressing the Government's economic goals.
5. The meeting focussed on the role of industry policy – defined broadly as policies that stimulate specific economic activities to direct structural change. Examples are targeted innovation policy, ITPs, transitions and regional economic development.
6. We understand that Ministers agreed the following points at the meeting.
   - a. Officials should prioritise further work on opportunities for industry policy to accelerate progress toward the Government's economic goals.
   - b. This work should focus on ways to strengthen the current policy landscape rather than adding new programmes. For instance,
     - i. opportunities to improve coherence and alignment so that policies are joined up and pushing in the same direction, and

ii. where different approaches to regulation could unlock industry innovation and investment.

c. The Government's emissions reduction commitments are paramount and should be a key cross-cutting focus across this work.

d. Ministers agreed that officials should prepare a Cabinet paper, without confirming the specific purpose or scope.

We seek your guidance on the scope of a Cabinet paper to progress this work

7. Following the meeting, both Treasury and MBIE have had to divert resources to support policy and operational work to respond to the current COVID-19 outbreak. As a result, limited progress has been made on the broad work programme agreed by Ministers. MBIE has indicated they will have limited capacity to engage meaningfully with the development of the Cabinet paper due to competing pressures.

8. To help mitigate resourcing pressures, we are seeking further guidance from you on the scope and content of the Cabinet paper. To facilitate this discussion, we have identified three potential areas that could be covered in the Cabinet paper (discussed further below):

   a Identifying industry policy as a key vehicle for delivering on the Government's economic goals and reinforcing the need for policy alignment;

   b Seeking agreement on specific opportunities where existing industry policies could be better aligned or simplified and directing officials to undertake further analysis on these; and

   c Signalling linkages to upcoming Budget decisions and other potential levers where industry policy could help progress the Government's goals.

9. You may also wish to consider whether to use the Cabinet paper to reinforce and/or further clarify the Government's key economic goals to guide policy work and achieve consistent messaging.

This work will need to be well aligned with the Reconnecting New Zealanders strategy

10. The progress of the Reconnecting New Zealanders strategy will be integral to the delivery of the Government's economic strategy over the near term [T2021/2338 refers]. Labour and skills shortages, supply chain issues and the disproportionate impact of COVID-19 on already vulnerable communities and some sectors (e.g., tourism, hospitality and major events) pose new challenges for making progress towards the Government's goals. A gradual re-opening of the border when it is safe to do so will help ease these constraints.

Industry policy could help to address some structural barriers to growth

11. Evidence to date suggests that demand has held up better than expected in this lockdown compared to previous ones. Due to strong pre-lockdown demand, we expect capacity pressures, skills shortages and inflationary pressures to remain after Alert Level restrictions ease [T2021/2338 refers].

12. With the biggest challenges to growth on the supply-side, industry policy could play an important role in lifting economic performance by addressing structural barriers to growth such as access to capital and labour shortages. Addressing these barriers is also important for enabling the significant capital investment and innovation needed from the private sector to meet our climate targets in priority sectors.

13. Industry policy may also have a role to play in supporting individuals and businesses to transition to a more COVID-19 resilient economy. In doing so, the Government will need to take account of the potential longer-term impacts on different sectors and risks of entrenching existing path dependencies (e.g. over reliance on low-skilled migrant labour) when making decisions. This includes decisions about responding to supply-

chain issues, support for firms in Auckland facing prolonged high Alert Levels, and new approaches to economic support as we achieve high vaccination rates. Work to advise you on these areas is underway.

Potential focus areas for the Cabinet paper

Identifying industry policy as a key vehicle for delivering on the Government's economic goals and reinforcing the need for policy alignment

14. Industry policy covers a range of portfolios and is prominent across several key and interconnected programmes in train. Examples include:

    a Climate Emergency Response Fund – in development and to be allocated through the Budget 22 process. s9(2)(f)(iv) .

    b Future Pathways – a draft discussion document on the Research, Science and Innovation (RSI) system is due to be considered by the Cabinet Economic Development Committee (DEV) on 29 September and then released in October. Policy decisions are due in mid-2022.

    c s9(2)(f)(iv)

    d National Adaptation Plan – public consultation on the National Adaptation Plan is due early 2022.

    e ITPs – Seven ITPs[1] in progress ranging from scoping to implementation. MBIE will be updating the Cabinet Priorities Committee (CPC) on ITPs in October.

    f Regional Economic Development – MBIE to report back to Cabinet on the Kānoa-Regional Economic Development Unit's ongoing operating model, reprioritisation and recycling of funds in late October.

    g Energy Strategy – to be developed in 2022 once the Emissions Reduction Plan is in place.

    h Immigration Rebalance – Cabinet has agreed to rebalance the immigration system by pursuing a lower overall volume of migrants and improved composition of temporary and skilled migrants. Two Cabinet papers in October and November will report back on options for international education, lower-skilled migrant workers, partnership settings, and skilled residence pathways.

15. The Cabinet paper could signal industry policy as a focus area for delivering the Government's longer-term goals, highlighting the connections between work programmes from an industry perspective and discuss how industry policy fits within the Government's broader economic agenda and its response to climate change. It should also reinforce the need for:

    a portfolios and strategies across the Government's agenda being aligned and working together, and

    b focussing on implementing and strengthening existing policies and avoiding unduly adding programmes to Government's economic agenda.

[1] Construction, Agritech, Advanced Manufacturing, Digital Technologies, Food and Beverage, Forestry and Wood Processing, Tourism

Seeking agreement on where specific opportunities exist for better aligning or simplifying existing industry policies

16. Programmes with an industry policy component include a range of reforms, funds and other policies. There are some overlaps between different portfolios and the purpose of the policy instruments (see Annex 1).

17. There are some opportunities for improving alignment and coherence. Options include:

    a Drawing closer links between Future Pathways and ITPs, especially in the development of research priorities;

    b Investigating the consolidation of funds (especially across Vote Business, Science and Innovation) to make it simpler for applicants and avoid duplication;

    c Providing greater direction on how mission-led approaches could be applied in a New Zealand context across portfolios to address climate change;

    d Undertaking reviews and evaluation of programmes[2]; and

    e Considering non-fiscal regulatory changes, especially where funds have shown to have a limited impact.

18. The Cabinet paper could direct officials to further examine these areas.

s9(2)(f)(iv)

Reinforcing messaging on the Government's key economic goals

21. The Government has communicated that it is working to achieve a range of economic goals via various strategic documents. See Annex 2 for a summary of these.

22. We think there is scope to achieve greater clarity across government about the Government's goals that should be guiding policy work on accelerating the recovery and rebuild. For instance, we have observed in some cases that departments have differing understandings or develop different frameworks for articulating Government's goals and priorities. These risk policy programmes in train being misaligned and resources being diverted away from key priorities.

23. Achieving greater clarity would also be timely, given that several additional strategies important for industry policy are in the pipeline, such as a Digital Strategy, Energy Strategy, Circular Economy and Bioeconomy Strategy, and Equitable Transitions Strategy.

[2] For example, MBIE and MPI have contracted Martin Jenkins to review the R&D, innovation and business support mechanisms in the food and beverage, forestry and wood processing, and manufacturing sectors ITPs to understand if the current mix of direct to support R&D, innovation and business development in the targeted sectors are fit-for-purpose, or if there may be a case for change.

24. You could use the Cabinet paper to signal your key goals for the recovery and rebuild (for instance, those in paragraph 3 of this report) that could be shared with agencies to inform their policy work. Let us know if you wish to go further than this.

25. We understand that during the 11 August meeting Ministers discussed the need to achieve consistency when communicating Government's economic programme. If you wish, we could work with your office to attach a one-page narrative to the Cabinet paper placing the goals within a set of key messages for Ministers to communicate when discussing the Government's economic programme.

Timing for the Cabinet paper

26. We see value in aiming to submit the Cabinet paper in late October, as this would align with the timing of other directly relevant Cabinet papers.

    a ITPs (due at CPC on **19 October**) – this paper will provide an overview of the ITPs and their potential, position the ITPs alongside other priorities, and provide an update on their progress, and

    b Regional Economic Development (due at DEV on **27 October**) – this paper will report back on matters related to further reprioritisation, recycling of returns and Kānoa-Regional Economic Development & Investment Unit's ongoing operating model.

27. s9(2)(g)(i)

28.

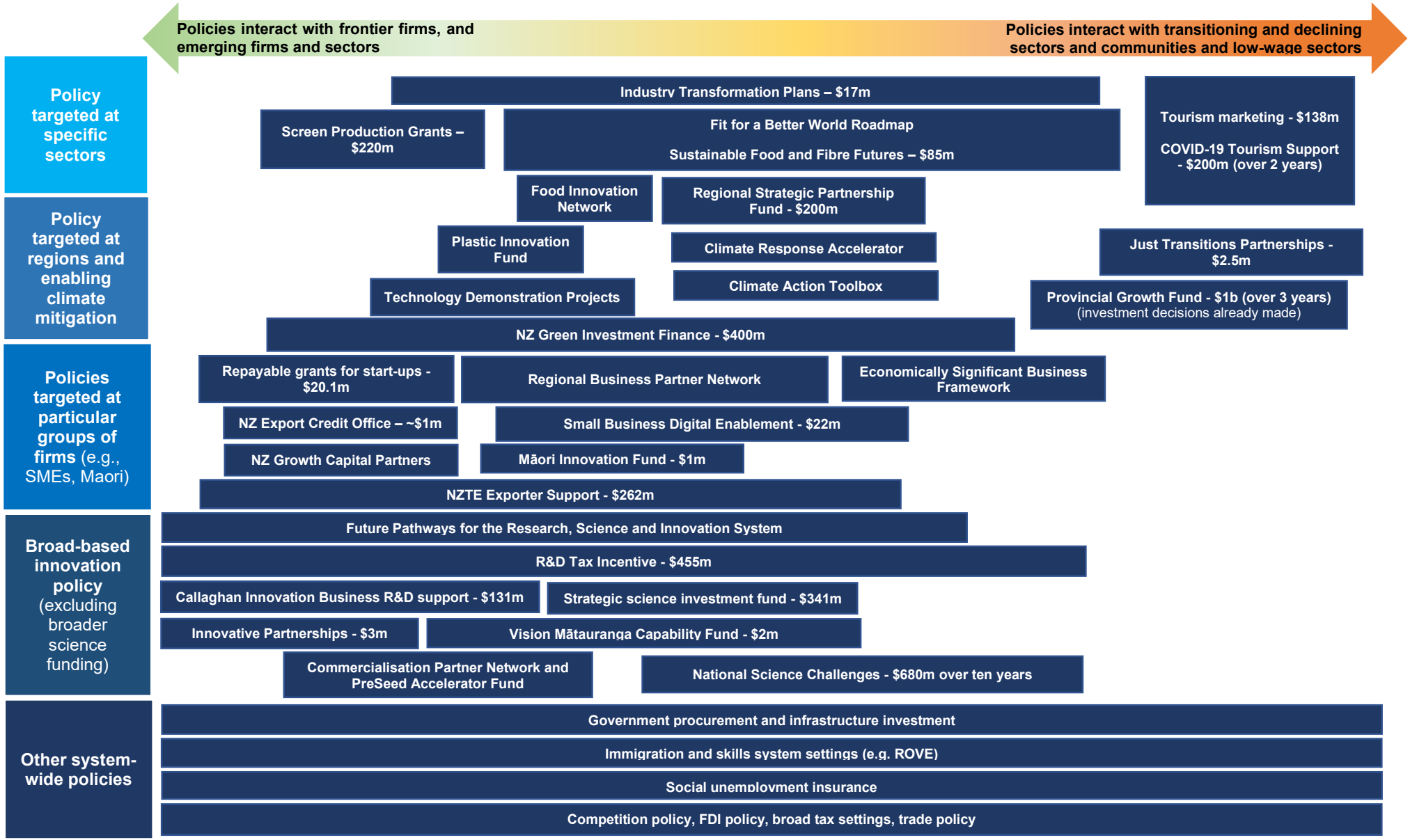
29. An alternative is delaying the Cabinet paper until late November. This increases the likelihood that agencies will be able to meaningfully input. However, this option also risks missing immediate opportunities for this work to influence Budget decisions and align key work programmes in train such as the Climate Emergency Response Fund.

Next Steps

30. We would welcome a discussion with you on the proposed scope and timing of the Cabinet paper at the Weekly Agency Meeting scheduled for 27th September.

31. Subject to your approval, and within the resourcing constraints outlined above, we will continue to work with MBIE, MfE, Ministry for Primary Industries and Te Puni Kōkiri on the development of a draft Cabinet paper.

Annex One: Indicative summary of the current landscape for broader industrial policy



Annex Two: Summary of the Government's goals active or in development

Description	*Goals*
Overarching goals for this term, signalled in the Speech from the Throne and Budget 2021	• Keeping New Zealanders safe from COVID-19 • Accelerating the recovery and rebuild from the impacts of COVID-19 • Laying the foundations for the future, with key priorities being climate change, housing affordability and child poverty.
Long-term economic goals from the Economic Plan developed in 2019 (i.e., pre-COVID)	• Overarching goal – transitioning to a more productive, sustainable and inclusive economy • Sitting under this goal is eight long-term economic shifts that cover shifting from 'volume to value', capital markets, housing, regions, land and resource use, Māori and Pacific economies, skills, energy.
Priorities for the economic recovery and rebuild articulated in the 5-point Recovery Plan (announced via the Speech from the Throne)	• The delivery of $42 billion of infrastructure investment to future proof the economy • Job retention and creation, and training opportunities to support workers and businesses • Supporting small business to grow and thrive • Delivering an export-led recovery, and • Preparing for the future by making the most of our competitive advantage in, for example, renewable energy and waste reduction.
Wellbeing Objectives directly linked to economic strategy (i.e., we have not included 'Physical and Mental Wellbeing' and 'Child Wellbeing') for Budget 2022	• Just Transition – Supporting the transition to a climate-resilient, sustainable and low-emissions economy. • Future of Work – Enabling all New Zealanders and New Zealand businesses to benefit from new technologies and lift productivity and wages through innovation. • Māori and Pacific – Lifting Māori and Pacific incomes, skills and opportunities, including through access to affordable, safe, and stable housing.
Key examples of **visions and goals set out in additional strategies** that address specific policy areas	• Modern regenerative production systems – Fit for a Better World • Boost primary sector earnings by $44 billion over 2020-2030 – Fit for a Better World • Lift R&D spending to 2% of GDP by 2027 – Draft RSI Strategy • Secure employment, rewarding careers and ongoing skills development – Employment Strategy • A circular economy reducing waste – draft Emissions Reduction Plan • Ethical, innovative, inclusive and sustainable digital technologies – the draft Digital Technologies Industry Transformation Plan.
You recently signalled **four specific areas of strategic focus** at your speech to the Trans-Tasman Business Circle (on July 12)	• Increase productivity through large scale investment in skills, research and innovation, infrastructure, building international connections and reforms of critical underpinnings of productivity such as our planning, water and immigration systems. • Lift the value and increase the diversity of what we produce and do, and who we trade with. • Transition to a low carbon economy and seize the potential of new technology and innovation to lead this transition. • Realise the economic potential of our Māori and Pacific communities and businesses, small and medium enterprises and entrepreneurs.

TE TAI ŌHANGA
THE TREASURY

Reference: T2021/2533 BM-3-6-1

Date: 7 October 2021

To: Minister of Finance (Hon Grant Robertson)

Deadline: 11 October 2021

Preliminary economic forecasts for HYEFU 2021

Summary

Table 1: Economic forecasts

Year to June		2021	2022	2023	2024	2025	2026
Real GDP (AAPC)	prelim HYEFU21	5.1	0.7	4.7	2.8	2.5	2.2
	BEFU21	2.9	3.2	4.4	3.3	2.9	
CPI (APC)	prelim HYEFU21	3.3	3.2	2.3	2.4	2.3	2.1
	BEFU21	2.4	1.7	1.8	2.0	2.1	
Unemployment rate	prelim HYEFU21	4.0	3.7	3.5	3.4	3.6	4.0
(June qtr)	BEFU21	5.2	5.0	4.4	4.2	4.2	
Nominal GDP ($billion)	prelim HYEFU21	339.7	359.7	384.2	406.1	427.5	447.3
	BEFU21	334.4	349.7	371.7	392.9	414.4	

- The economy was strong over the first half of 2021 but the outbreak of the Delta-variant will create a deep dip in activity. However, a rapid rebound is expected.
- Capacity constraints and rising interest rates will limit growth, but activity levels are expected to remain above BEFU over most of the forecast period.
- Labour market to remain tight with further falls in unemployment likely.
- Higher and persistent inflation is a key driver of higher nominal GDP. This will drive sizable upward revisions to tax forecasts, while also adding to public sector cost pressures.

Preliminary economic forecasts for the Half Year Economic and Fiscal Update have been prepared. A brief overview of the forecasts is provided in this note. Tax forecasts consistent with this outlook are currently being developed. We will provide a comprehensive report on both the economic and tax forecasts late next week.

An attached A3 provides additional forecast detail.

Economic activity in first half of the year significantly stronger than forecast

The New Zealand economy performed significantly ahead of forecast over the first half of 2021 across most metrics including GDP, the labour market, and tax revenue. Strong demand and disrupted supply of both goods and labour have contributed to elevated capacity constraints and rising prices. Consequently, the outlook for interest rates has shifted considerably with the Reserve Bank increasing the Official Cash Rate to 0.5% this week, with further increases expected to see 90-day interest rates progressively rise to around 3% by the end of 2024 (Figure 1).

Figure 1: 90-day interest rates

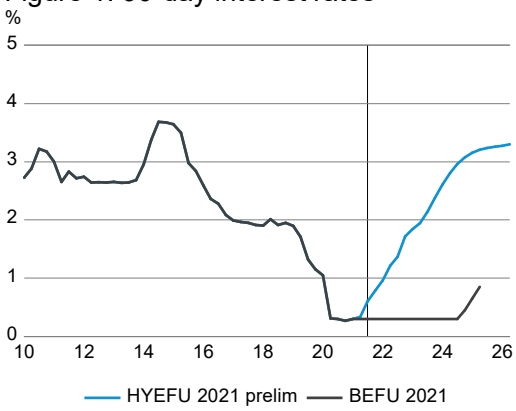
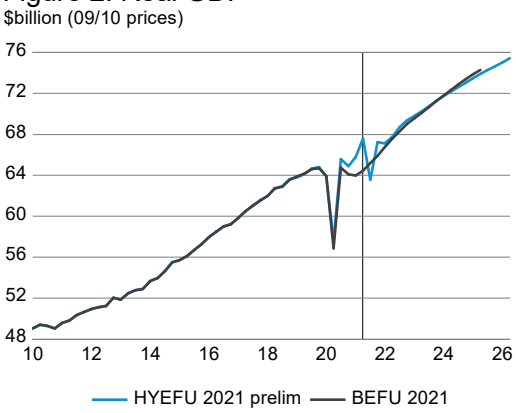


Figure 2: Real GDP



Delta developments and response measures are key in second half of 2021

The emergence in New Zealand of the Delta-variant of COVID-19 in August, and the associated increase in alert levels, is anticipated to drive a 6% fall in real GDP in the September quarter (Figure 2). This is followed by a forecast 5.8% rebound in activity in the December quarter, conditional on restrictions in Auckland reducing further and no sustained move up alert levels in the rest of the country.

COVID-19 assumptions

The forecasts include several COVID-19-related assumptions that we will continue to monitor and reassess ahead of the final forecasts:

- A gradual, phased, risk-based approach to reopening the border beginning 2022. In practice this is implies a slower increase to international tourism than was included in the 'significant reopening' from 1 January 2022 incorporated in Budget.

- A small negative impact to activity in the rest of the country when Auckland is at higher Alert Levels and the rest of the country is at Alert Level 2 (approximately $50 million per week).

- An average Alert Level through to the middle of 2022 that is a little higher than Alert Level 1 to account for possible ongoing impacts from the Delta-variant.

- COVID-19 causes a mix of relatively temporary and more persistent supply-side impacts. During higher alert levels, production is reduced or prevented. Over the medium term we have assumed that the continued presence of more transmissible strains of COVID-19 will have an ongoing negative impact on potential GDP of around 0.5%. This is to capture the impact of COVID-19 management measures on firm productivity and risk of higher rates of sickness.

- A $10 billion increase in Covid-19 Response and Recovery Fund spending over the forecast period ($3 billion of which has been transferred from earlier underspends).

Rapid rebound expected, and tourism recovers, …

It is anticipated that the economy will experience a rapid rebound following the September quarter decline in real GDP. The pace of recovery has been informed by the experience over 2020, supplemented by the assumptions above to account for the more transmissible nature of the Delta-variant. This is particularly apparent in the labour market where we expect recent tightness to persist and are not forecasting increases in the unemployment rate associated with the shift to Alert Level 4 in August.

… but capacity constraints and rising interest rates will likely limit growth…

Beyond this initial rebound the growth outlook is influenced by the re-emergence of international tourism, which boosts growth, and continued capacity and inflation pressures which drive interest rates higher, which constrain growth. In Table 1, the current outbreak shows up in the year to June 2022 with annual average growth in real GDP slowing from 5.1% in 2021 to 0.7% in 2022. Growth then rebounds to 4.7% in 2023 reflecting both the recovery from recent restrictions combined with the continued gradual recovery of international tourism.

Labour demand is forecast to remain strong and the labour market tight (Figure 3).

Figure 3: Unemployment

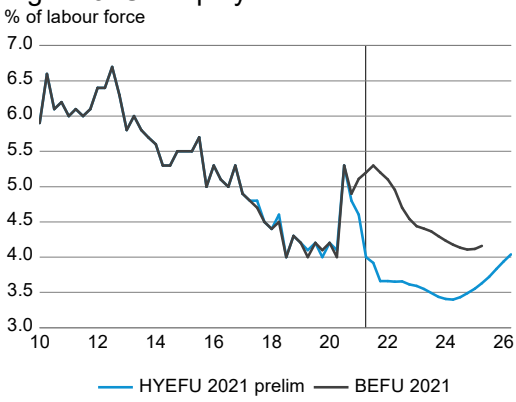
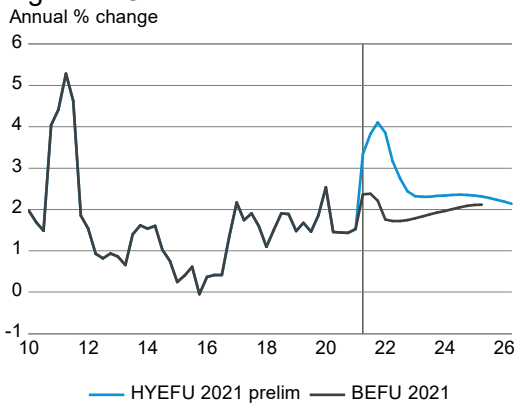


Figure 4: CPI inflation



…which will reduce inflation, but inflation is expected to remain elevated relative to the experience of recent years

Inflation is expected to peak at around 4% at the end of calendar 2021 (Figure 4). Rising interest rates and some easing in supply constraints should see inflation ease. COVID-19 is likely to continue to influence the supply side of the economy for some time, contributing to a degree of persistence in inflation. Interest rates are expected to gradually rise over most of the forecast period, reaching just above 3% by the beginning of 2025, and contribute to the slowing in overall GDP growth to around 2.2% by the end of the forecast.

Figure 5: House prices

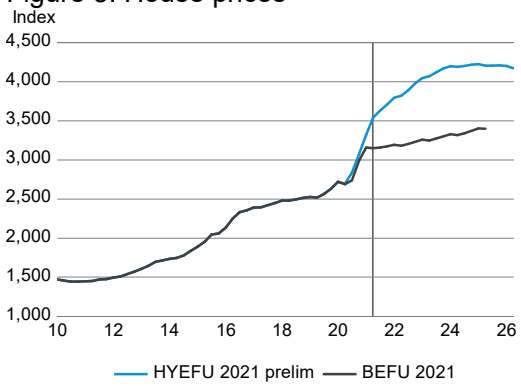
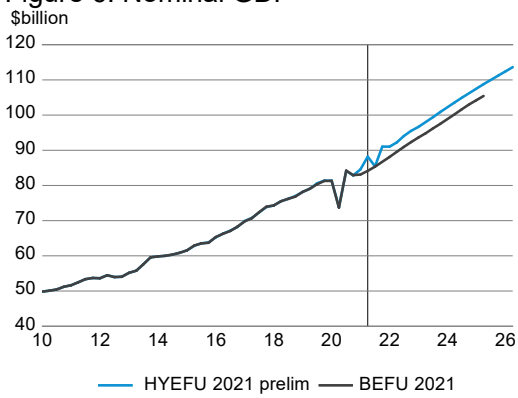


Figure 6: Nominal GDP



Rising interest rates contribute to slowing house price growth over the forecast period. House price growth has exceeded expectations since BEFU. In addition, the announced interest deductibility rules (with a longer period of deductibility for new builds) is expected to exert less downward pressure on prices, resulting in a higher house price forecast than in BEFU (Figure 5).

By the 2025, the level of real GDP is broadly similar to that in BEFU. The slightly lower endpoint largely reflects a slightly smaller population owing to both historical data revisions and a slightly slower pickup of migration over the forecast period.

In the near term higher real activity and higher prices boosts nominal GDP. Nominal GDP in the year to June 2021 was $5 billion higher than forecast. This rises to $10 billion to $13 billion above BEFU in each of the 2022 to 2025 June years. By the year to June 2025 higher nominal GDP is solely the result of higher prices in the economy.

Higher nominal GDP will result in significantly higher forecasts of tax revenue, which will be reported to you at the end of next week.

COVID-19 developments in New Zealand and abroad remain key risks to the outlook. We will comment on these and the international outlook underpinning these forecasts in next week's report.

Peter Mawson, Principal Advisor, Forecasting, s9(2)(k)
Nairn MacGibbon, Team Leader, Forecasting,

TE TAI ŌHANGA
THE TREASURY

Treasury Report: Productivity Commission Inquiry into Economic Inclusion and Social Mobility

Date:	14 October 2021	**Report No:**	T2021/2584
		File Number:	SH-11-1-3-1-2-2-3

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Provide** feedback on the draft Cabinet paper and Terms of Reference for the inquiry. **Agree** to send the attached letter to the referring Ministers. **Agree** to conduct Ministerial consultation on the attached Cabinet paper for 10 days from 26 October to 8 November 2021, so it can be lodged on 11 November 2021 for consideration by the Cabinet Economic Development Committee on 17 November 2021.	21 October 2021

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Diego Cardona	Graduate Analyst, Economic Strategy	s9(2)(k)	N/A (mob)	✓
Natalie Labuschagne	Manager, Economic Strategy, Economic Strategy		N/A (mob)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Refer the draft Cabinet paper and Terms of Reference to the fellow referring Ministers for the inquiry.

Note any feedback on the quality of the report	

Enclosure: Yes (draft Cabinet paper, terms of reference, and letter to referring Ministers)

Treasury Report: Productivity Commission Inquiry into Economic Inclusion and Social Mobility

Recommended Action

We recommend that you:

a **note** a draft Cabinet paper is attached seeking Cabinet's approval for the attached Terms of Reference for a Productivity Commission inquiry into economic inclusion and social mobility.

b **agree** to send the attached Letter to Referring Ministers to the Minister for Child Poverty Reduction, the Minister for Children, the Minister for Education, the Minister for Māori Development, the Minister for Pacific Peoples and the Minister for Social Development and Employment to advise them of your intent for them to act as referring Ministers for this inquiry.

Agree / disagree.

c **note** the Productivity Commission has consulted with agencies on the terms of reference and has briefed the Treasury on the outcomes of this consultation.

d **note** you have agreed to an inquiry delivery date of November 2022 provided Cabinet agrees to the Terms of Reference by November 2021.

e **note** if Cabinet approval of the Terms of Reference takes longer than anticipated, you may wish to consider a delivery date of February 2023 to avoid the release of the inquiry during the Christmas wind-down period.

f **agree** to conduct Ministerial consultation on the attached Cabinet paper for 10 days from 26 October to 8 November 2021, so we can revise it as required and provide you with a final copy in time for lodging on 11 November 2021, for consideration by the Cabinet Economic Development Committee on 17 November 2021.

Agree / disagree.

Natalie Labuschagne
Manager, Economic Strategy

Hon Grant Robertson
Minister of Finance

Treasury Report: Productivity Commission Inquiry into Economic Inclusion and Social Mobility

Purpose of Report

1. This report seeks:
   i. your feedback on the attached draft Cabinet paper and Terms of Reference for a Productivity Commission inquiry into economic inclusion and social mobility.
   ii. your agreement to begin Ministerial consultation on the attached Cabinet paper and terms of reference.

Background

2. In May 2021, you agreed that the Productivity Commission should scope a potential inquiry on social mobility and economic inclusion with a focus on the dynamics and drivers of persistent disadvantage.
3. Following your conversations with the Productivity Commission, and consistent with your Letter of Expectations to them, the Productivity Commission has led public engagement on the scoping of the inquiry and has developed Terms of Reference for it.
4. The Productivity Commission's engagement included a public consultation paper and two media partnerships to help raise awareness and interest in the inquiry and to encourage the public to provide feedback via the Commission's website. The Commission received 81 formal submissions and 875 responses to its online survey. The Productivity Commission also engaged directly with a range of agencies, organisations and interested parties. They held meetings with over 180 people, representing more than 60 organisations. In addition, 20 iwi and whānau members participated in deep-dive online hui run by Haemata. *Annex 1* lists the people and organisations engaged with in developing the Terms of Reference.
5. The Productivity Commission and the Treasury suggest that the inquiry be called "A Fair Chance for All". This embraces social mobility and economic inclusion as the main topics of the inquiry, allowing a focus on persistent disadvantage and its dynamics across lifetimes (e.g., people may become stuck in disadvantage at some point during their life) and generations (e.g., people born into disadvantaged circumstances).
6. Subject to your approval, the draft Cabinet paper and Terms of Reference are ready for Ministerial consultation. We will conduct formal agency consultation in parallel with the Ministerial consultation, noting that the Productivity Commission has already engaged with agencies on the Terms of Reference.
7. In May 2021, you agreed to November 2022 as the proposed inquiry delivery date, subject to Cabinet approving the Terms of Reference in November 2021. We support a 12-months timeframe for the inquiry to ensure analytical depth and high-quality public engagement. If the approval of the Terms of Reference by Cabinet takes longer than anticipated, you may wish to extend the inquiry delivery date to February 2023. This extension will give the Productivity Commission at least 12 months to complete the inquiry and, at the same time, will avoid the delivery of the final report being affected by the Christmas wind-down period.

Referring Ministers

8. The Productivity Commission Act 2020 states that, to initiate an inquiry, the Minister of Finance and other referring Ministers must refer Terms of Reference to the Productivity Commission.

9. You have previously signalled your intention to nominate the following Ministers as fellow referring Ministers for the inquiry. We have attached a letter for you to send to Ministers to advise them of your intent to nominate them as referring Ministers.

Minister	Portfolio
Rt Hon Jacinda Ardern	Child Poverty Reduction
Hon Kelvin Davis	Children
Hon Chris Hipkins	Education
Hon Willie Jackson	Māori Development
Hon Aupito William Sio	Pacific Peoples
Hon Carmel Sepuloni	Social Development and Employment

Preliminary feedback from agencies

10. The Productivity Commission has undertaken preliminary consultation with relevant agencies on the draft Terms of Reference. The draft Terms of Reference reflects substantive early feedback from the following agencies: the Ministry of Social Development (MSD), Ministry of Housing and Urban Development (HUD), Te Puni Kōkiri (TPK), Ministry for Pacific Peoples (MPP), Office of the Children's Commissioner (OCC), Ministry for Women, Ministry of Justice, and the Treasury.

11. The Productivity Commission also shared the draft Terms of Reference with the Department of Prime Minister and Cabinet (DPMC) and engaged with them during pre-Terms of Reference work. However, further conversations were hampered by the Alert Level shifts. The Treasury and the Productivity Commission will ensure they offer avenues to receive feedback from DPMC during the formal agency consultation period.

12. out of scope

13.

14. Inequality and systemic advantage, as well as further analysis of the tax and welfare system, were raised consistently as second-tier themes for the inquiry during both agency and public consultation.

15. To avoid duplication of parts of other major inquiries, such as the Welfare Expert Advisory Group and the Tax Working Group, the Productivity Commission proposed the inquiry focus on non-income policies. Nonetheless, the Terms of Reference note the inquiry should build on the existing evidence and the work undertaken for these and other major reviews and inquiries, as well as investigate the way public services are designed, funded and delivered, and aspects of New Zealand's labour market and the future of work that could affect economic inclusion.

16. Investigating systemic advantage directly would be a significant increase in the scope of the inquiry – i.e. expanding the scope from persistent disadvantage (e.g. focusing on the bottom income decile) to people benefiting from systemic advantage (e.g. the top income decile). The Terms of Reference is sufficiently broad to allow for the consideration of persistent advantage to the extent that it contributes to persistent disadvantage, but would not look at the dynamics of persistent advantage directly.
17. While broadening the scope can provide important insight, it would present trade-offs, including:
    i. Extending the timeframes of the inquiry (e.g. by around 6 months), or
    ii. Reducing the scope of other parts of the inquiry.
18. We suggest leaving systemic advantage out of scope to keep the focus on the drivers and underlying dynamics of persistent disadvantage. You may wish to consider the topic of systemic advantage as a future (or follow up) inquiry topic alongside other potential inquiry topics.

out of scope

Annex One: Engagement to develop the Terms of Reference

In seeking input to the Terms of Reference, the Productivity Commission spoke with over 180 people, including representatives from more than 60 organisations. Participants included experts and researchers, service providers and practitioners, stakeholder groups, non-government and philanthropic organisations, and government agencies, which are listed below. In addition, 20 iwi and whānau members participated in deep-dive online hui run by Haemata. The Commission also spoke with a number of private individuals who engaged in the public consultation.

Experts, researchers and academics

s9(2)(a)

Stakeholders, service providers and philanthropic organisations

Auckland City Mission

BusinessNZ

Child Poverty Action Group

Council of Trade Unions

NZ Council of Christian Social Services

Disabled Persons Assembly

E Tū

E Tu Whānau

FinCap

First Union

Hikoikoi Kaumatua Rōpū

Howard League

I Have a Dream

Inspiring Communities

Intersex Awareness NZ

JR McKenzie Trust (incl, Vodafone Foundation, Action Station, Community Housing Aotearoa, Shift)

Le Va

Manaaki Tairawhiti

Methodist Mission Southern

NEXT Foundation

North Island Housing Association CEs

NZEI Te Riu Roa

NZ Nurses Organisation

Public Service Association

Salvation Army

South Auckland Social Wellbeing Board

Tairawhiti Community Voice

Te Waipounamu Housing Association CEs

The Cause Collective

The Family Centre

The Southern Initiative

The Wise Group

Unite Union

Villa Education Trust

Waikato Wellbeing Project

Wellington City Mission

Whānau Ora Commissioning Agencies

Government agencies

Department of Prime Minister and Cabinet

Human Rights Commission

Mental Health and Wellbeing Commission

Ministry for Pacific Peoples

Ministry for Women

Ministry of Business, Innovation and Employment

Ministry of Education

Ministry of Health
Ministry of Justice
Ministry of Social Development
Office of the Children's Commissioner
Oranga Tamariki
Public Service Commission
Social Wellbeing Agency
Stats NZ
Te Arawhiti
Te Puni Kōkiri
Treasury

TE TAI ŌHANGA
THE TREASURY

Treasury Report: HYEFU 2021 Preliminary Economic and Tax Forecasts

Date:	15 October 2021	**Report No:**	T2021/2525
		File Number:	BM-3-6-1

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Note** preliminary economic forecasts for HYEFU 2021 show an economic outlook that is stronger than BEFU 2021, resulting in an upward revision in core Crown tax revenue of $36.4 billion over the four years to June 2025.	Weekly Agency Meeting of week beginning 25 October.

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Andrew Kennedy	Analyst, Forecasting	s9(2)(k)	N/A (mob)	✓
Nairn MacGibbon	Acting Team Leader, Forecasting		N/A (mob)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: HYEFU 2021 Preliminary Economic and Tax Forecasts

Executive Summary

New Zealand's economic performance has been strong since the publication of the Budget Economic and Fiscal Update (BEFU) 2021, reflecting that the economy has been more adaptable and resilient to the COVID-19 pandemic than previously thought. Robust demand throughout the first half of 2021 has catalysed broad-based growth, with stronger-than-expected real production GDP, tax revenues exceeding forecasts, and the unemployment rate dropping to pre-Global-Financial-Crisis (pre-GFC) levels.

The Delta outbreak beginning August 2021 is expected to weaken this position in the September quarter, though we anticipate a relatively swift recovery in activity with only a small degree of scarring as restrictions ease. Accordingly, annual real GDP growth is forecast to peak in 2023, underpinned by positive growth in consumption and investment that is supported by low unemployment, buoyant house prices, and the gradual re-emergence of international tourism.

This increase in real activity, in combination with higher inflation, translates to nominal GDP being $13.1 billion higher by the year to June 2025 and a cumulative $54.2 billion over the forecast period. This is the main driver of the additional $36.4 billion in core Crown tax revenue across the four years to June 2025.

COVID-19 has equally impacted the supply side, offsetting the disinflationary pressures from activity disruptions. Compounded by persistent domestic demand, supply-side pressures relating to labour/skills shortages, capacity constraints, and supply-chain disruptions will increase inflationary pressures, resulting in consumer price inflation peaking at 4.1% in the December 2021 quarter. In response, the Reserve Bank of New Zealand is expected to continue to gradually tighten monetary policy to bring inflation within the 1-3% target band which will also moderate house price growth over the medium term.

The labour market has been remarkedly resilient and is expected to persist in a state of tightness, with firms reporting record-high difficulty finding skilled labour and near record-high difficulty finding unskilled labour in the September 2021 quarter. Unemployment is consequently expected to continue to fall to 3.4% in the December 2023 quarter before rising towards 4.0% by the end of the forecast period, and employment is expected to continue to exhibit quarter-on-quarter growth; both of which will exert upward pressure on wage inflation and labour costs.

The global economic recovery has lost some momentum due to the emergence of Delta and ongoing supply-chain disruptions but remains more positive than in BEFU 2021 due to vaccination, policy support, savings drawdown, and the reopening of economic activity. A rise in export prices is forecast to boost the terms of trade in the short term, but declining export prices alongside persistently higher import prices will lead to a lower terms of trade in the medium term compared to BEFU 2021.

The economic forecasts are dependent on some key assumptions. For example, public health restrictions and behavioural responses to COVID-19 are assumed to impact activity to an extent similar to Alert Level 2 until 1 July 2022; the international border is assumed to have a gradual and phased reopening from 1 July 2022; and potential output has been revised lower to account for ongoing disruptions and behavioural shifts related to the pandemic. Significant deviation from these assumptions – either on the upside or downside – would change the underlying fundamentals of the forecast, as would the realisation of key risks such as the advent of a more communicable or lethal coronavirus.

Table 1: Forecast summary, preliminary HYEFU 2021 compared to BEFU 2021

Year to June		2021 Actual	2022 Forecast	2023 Forecast	2024 Forecast	2025 Forecast	2026 Forecast
Real GDP (AAPC)	Preliminary HYEFU 2021	5.1	0.7	4.7	2.8	2.5	2.2
	BEFU 2021	2.9	3.2	4.4	3.3	2.9	
Unemployment Rate	Preliminary HYEFU 2021	4.0	3.7	3.5	3.4	3.6	4.0
	BEFU 2021	5.2	5.0	4.4	4.2	4.2	
CPI Inflation (APC)	Preliminary HYEFU 2021	3.3	3.2	2.3	2.4	2.3	2.1
	BEFU 2021	2.4	1.7	1.8	2.0	2.1	
Nominal GDP ($billion)	Preliminary HYEFU 2021	339.7	359.7	384.2	406.1	427.5	447.3
	BEFU 2021	334.4	349.7	371.7	392.9	414.4	
	Change	5.3	9.9	12.6	13.2	13.1	
Core Crown tax revenue ($billion)	Preliminary HYEFU 2021	97.9	101.0	109.7	116.9	124.0	131.1
	BEFU 2021	91.5	93.2	101.7	107.1	113.2	
	Change	6.4	7.8	8.0	9.8	10.8	

Recommended Action

We recommend that you:

a **note** the Treasury's preliminary Half-Year Economic and Fiscal Update (HYEFU) 2021 economic forecasts show an economic outlook that is stronger than the BEFU 2021 forecasts. This represents the stronger-than-expected demand in early 2021 and the speed and magnitude of the expected rebound from the Delta outbreak;

b **note** that, in line with the economic forecasts, tax revenues are higher than in BEFU 2021. In total across the four years to June 2025, core Crown tax revenues forecasts are $36.4 billion higher than in BEFU 2021; and

c **note** that the uncertainty around the economic outlook remains higher than usual and that we expect to see larger-than-normal revisions to the fiscal outlook over the coming years as Treasury updates it's forecasts.

Nairn MacGibbon
Acting Team Leader, Forecasting

Hon Grant Robertson
Minister of Finance

Treasury Report: HYEFU 2021 Preliminary Economic and Tax Forecasts

Purpose and context of report

1. This report provides an overview of the Treasury's preliminary economic and tax forecasts for HYEFU 2021. These economic and tax forecasts underpin the preliminary fiscal forecasts currently being compiled.

2. Based on these preliminary forecasts, you will receive advice on your fiscal strategy for the Budget Policy Statement 2022 (BPS) on 22 October (T2021/2424). Following discussion with you at Budget Matters on 28 October, we will provide further advice alongside preliminary fiscal forecasts to seek confirmation of budget allowances for communicating at the BPS. As noted in relation to the HYEFU 2021 and BPS timelines (T2021/2156 refers), we require your decisions on allowances by 8 November so that these can be incorporated into a consistent set of final HYEFU 2021 economic and fiscal forecasts.

3. Annex 1 provides tables with additional details on the economic forecasts, including changes since BEFU 2021.

Key assumptions underpinning the economic forecasts

4. **COVID-19 continues to materially influence the economic outlook and uncertainty remains high.** A number of assumptions about the impact and likely timing of public health and border restrictions remain necessary.

5. **Public health restrictions and behavioural responses to COVID-19 are assumed to impact activity to a similar extent as Alert Level 2 until 1 July 2022.** Imbedded in this is the assumption that the vaccine rollout has been completed by 1 July 2022.

6. **Potential output has been revised lower** in the forecast period by 0.5% (Figure 1). This change from BEFU 2021 accounts for ongoing disruptions related to the pandemic, elevated public health restrictions over the medium term, the risk of further episodes, and relatively fewer hours worked and lower productivity levels owing to sickness.

Figure 1: Potential Output

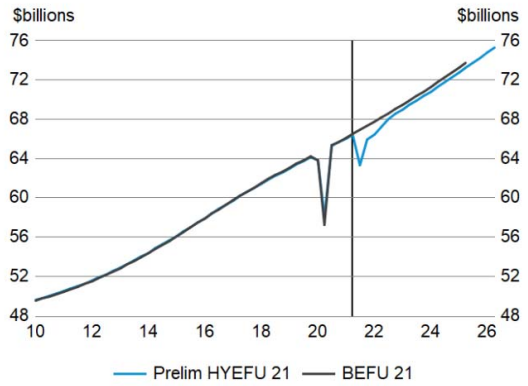
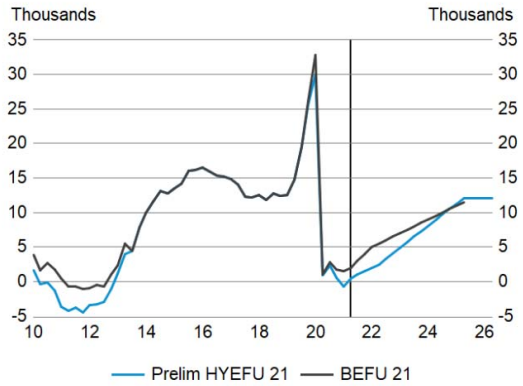


Figure 2: Net Migration



7. **The international border is assumed to have a gradual and phased reopening from 1 July 2022 until the end of the forecast period.** This differs from the working assumption in BEFU 2021 where border restrictions were assumed to ease from 1 July 2021 and to be removed from 1 January 2022.

8. Annual net migration is assumed to gradually rise from approximately 1,300 in the September 2021 quarter to be above 30,000 in the June 2024 quarter and to subsequently reach 48,400 by the end of the forecast period (Figure 2). This puts the net **migration pathway lower than assumed at BEFU 2021** and, at the end of the forecast period, is still more than 10,000 people shy of the approximate 60,000 average annual net migration between 2016 and 2020.

9. **Fiscal support has increased by a net $10 billion** relative to BEFU 2021, comprising an additional $7 billion in the COVID Response and Recovery Fund and a $3 billion underspend being pulled into the forecast period. This fiscal support is anticipated to fund the public health response, vaccine rollout, Reconnecting New Zealand programme, and future business/income supports. In this regard, the addition fiscal stimulus partially offsets the impact of higher average Alert Levels over the medium term and the increased likelihood of added disruption due to the Delta strain or emerging variants.

Economic outlook

Following strong demand in early 2021, a rapid rebound from Delta is expected …

10. Since the publication of BEFU 2021, data outturns have repeatedly demonstrated that **the New Zealand economy has been more adaptable and resilient to the COVID-19 pandemic than forecast.** This performance has been broad-based, with the unemployment rate dropping below pre-pandemic levels in the 2021 June quarter, robust demand leading to stronger-than-expected real production GDP growth, and tax revenue exceeding forecasts.

11. **The Delta outbreak from August 2021 and return to Alert Level 4 restrictions is expected to weaken this economic position, but not anywhere near to the extent of the 2020 lockdown.** Consumer and business confidence have only fallen mildly during the Delta outbreak; the labour market has remained very tight with firms continuing to report extreme difficulty finding skilled and unskilled labour; and economic activity, as measured by the New Zealand Activity Index, fell only a fraction of the 2020 Alert Four Period.

12. To this extent, the Delta outbreak from August 2021 is forecast to decrease real production GDP by 6.0% in the September quarter. This decline in activity reflects the amount of time within the quarter spent at Alert Levels 4,3, and 2, as well as the spillover effect on regions outside Auckland when Auckland was at relatively higher Alert Levels. The timing of the Delta outbreak from August 2021 means that the impact on real GDP growth is not discernible on an annual basis until the year to June 2022 where growth slows to 0.7%, down from 5.1% in 2021.

… with the bounce back in demand followed by strong but moderating growth …

13. Based on the experience from 2020 and the strength of the economy preceding the Delta outbreak**, we expect economic activity to bounce back quickly from the forecast contraction in the September 2021 quarter.** High-frequency data suggests that economic activity has already rebounded at Alert Level 2. Outside of Auckland, for instance, electronic card spending is already higher than 2019 levels and heavy traffic volumes are slightly above their pre-Delta outbreak levels.

14. Owing to this rebound, **annual real GDP growth is forecast to peak again at 4.7% in the June 2023 quarter** – reflecting both the recovery from the recent lockdown period combined with the gradual re-emergence of international tourism – before steadily declining to 2.2% in 2026 following the gradual tightening of monetary policy. This results in real production GDP being slightly higher than forecast in BEFU 2021 until the March 2024 quarter, after which real production GDP is lower than the BEFU 2021 forecast (Figure 3).

15. Following a substantial 5.6% rise in the March quarter and offsetting 1.4% fall in the June quarter, **private consumption is expected to fall 5.7% in the September quarter due to the effects of lockdown, followed by a 6.8% rebound** in the December quarter (Figure 4). Household spending is expected to bounce back as restrictions on activity ease, supported by resilient consumer confidence, fiscal support, and pent-up demand coming out of lockdown. We expect rising house prices together with strong household incomes and low unemployment to support consumption over the medium term.

Figure 3: Real GDP

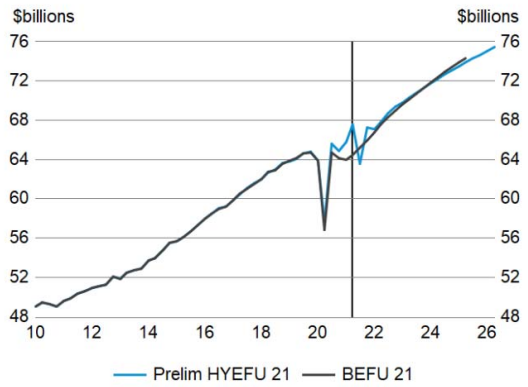
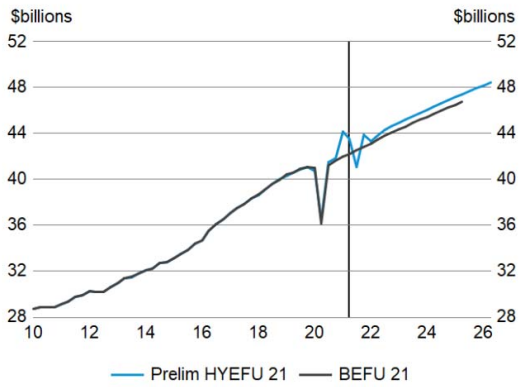


Figure 4: Real Private Consumption



16. **Quarterly business investment growth is forecast to peak in 2022,** following a 5.5% fall in the September quarter and return to 2019 levels in the December quarter with an 8.0% rebound. Business confidence waned during August and September on account of the Delta outbreak, but businesses are significantly less pessimistic than they were during last year's lockdown, evidenced by firms' own activity indicators continuing to improve in the September quarter. Elevated cost pressures and expectations that demand will remain resilient are leading to inflationary pressures, although cost and price pressures appear to be initially easing in most sectors, apart from construction. Heightened uncertainty together with a lack of specialised skills and travel restrictions owing to the closed border are holding back investment for some firms; however, a strong pipeline of Government infrastructure projects is expected to support investment.

… increasing inflationary pressures due to capacity constraints …

17. The strength in demand so far across 2021, expected recovery from the Delta outbreak, and continued supply-chain disruption has resulted in an **upward shift in the consumers price index (CPI) inflation profile across the forecast period** compared to BEFU 2021. Annual CPI inflation exceeded market expectations in the June 2021 quarter, jumping to a ten-year high of 3.3%. This increase was broad-based across most classes of expenditure, with housing construction cost increases contributing to almost a third of the quarterly movement.

18. **The impacts of the COVID-19 pandemic have equally been supply side as they have been demand side.** In virtue of this, the reduction in aggregate demand related to higher Alert Level restrictions has not been associated with as much downward pressure on inflation as it would in a traditional downturn. It has instead been offset by upward inflationary pressures stemming from more persistent supply constraints. Increases in fiscal stimulus outside of higher Alert Levels, however, have exerted inflationary pressures as usual by increasing aggregate demand.

19. **Annual CPI inflation is forecast to peak at 4.1%** in the December 2021 quarter before declining toward the 2.0% mid-point of the Reserve Bank's target range over the remainder of the forecast period (Figure 5). Outside of the inflationary pressure from resilient demand over the forecast period, this elevation in inflation is being driven by cost pressures relating to labour/skills shortages, capacity constraints, and supply-chain disruptions which will likely persist over the coming quarters; the latter of which we expect to ease next year resulting in slightly lower tradables inflation. Other pressures are anticipated to be transitory, such as petrol and food prices.

… resulting in gradual interest rate hikes …

20. In response to the strength in demand and inflation exceeding the target band, the **Reserve Bank of New Zealand (RBNZ) has tightened monetary policy** since BEFU 2021 **and we expect this trend to continue** over the forecast period. In July 2021, the RBNZ halted the Large-Scale Asset Purchases programme and, having delayed raising the Official Cash Rate (OCR) due to the Delta outbreak, increased the OCR from 0.25% to 0.50% in October. We expect interest rates will continue to rise to bring inflation back towards the RBNZ's 2.0% target midpoint – in line with financial market expectations foreseeing the OCR to reach around 1.5% by the end of 2022 – with the 90-day rate rising to 3.3% by June 2026, roughly equivalent to an OCR of 3.0% (Figure 6).

Figure 5: CPI inflation

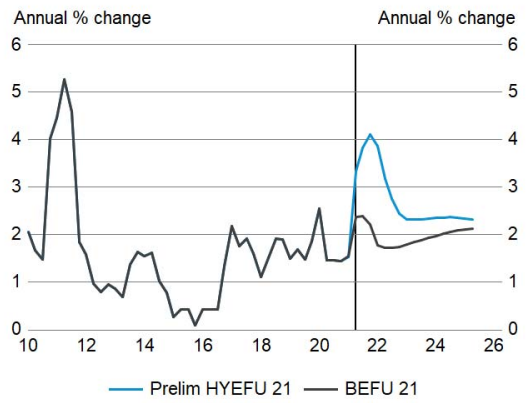
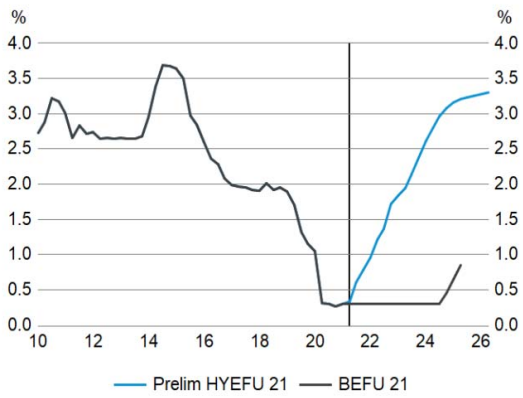


Figure 6: 90-day interest rates



… which are anticipated to cool the housing market over the medium term …

21. **House prices have continued to rise rapidly** since the finalisation of the BEFU 2021 forecasts. Monthly growth in the Real Estate Institute of New Zealand House Price Index peaked at 3.6% in February – the highest monthly growth since 1996 – and has since remained elevated averaging 1.9% per month through to September. This historically strong growth over the last year can be attributed mainly to persistently low interest rates. While restrictions on activity in August has led to fewer house sales, housing market activity is expected to rebound as restrictions ease, with industry

representatives indicating that some buyers have chosen to delay market activity until they are able to view properties in person again.

22. **Compared to BEFU 2021, house prices are forecast to rise at a faster, albeit diminishing, rate,** with peak annual growth in the June 2021 quarter abating to a very slight fall at the end of the forecast period (Figure 7). These dynamics are primarily governed by changes to monetary policy settings. Low interest rates, resilient consumer confidence, and continued robustness in the labour market are expected to initially sustain house price growth; however, with interest rates rising and tighter loan-to-value ratio restrictions for owner occupiers in effect from 1 November 2021, house price growth is expected to ease over the forecast period.

Figure 7: House prices

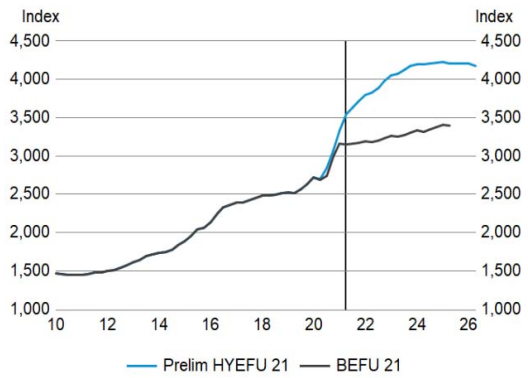
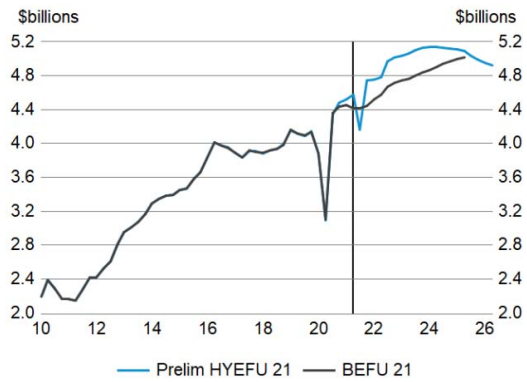


Figure 8: Residential investment



23. The denial of interest deductibility for leveraged rental property owners is also expected to have a mild dampening effect on house price growth. With the exemption period for new builds confirmed at twenty years, however, this impact is expected to be much lower than assumed at BEFU 2021 which was based on a ten-year exemption period.

24. Residential investment grew 1.3% in the June 2021 quarter but is expected to fall 9.1% in the September quarter as a result of the Delta outbreak (Figure 8). Record-high building consents issuance over the past year is expected to support construction activity over the year ahead, although capacity constraints will hinder growth. **Continued high house prices will contribute to a sustained high level of residential investment activity,** but rising interest rates and relatively low population growth will dampen investment over time. The effects of the lockdown will also be leading to a further increase to the backlog of activity. As borders reopen and global shipping disruptions ease, a degree of pent-up demand relating to capacity constraints over the year ahead could lead to an increase in investment activity before the effects of lower housing demand stabilise activity.

… but labour market tightness will persist on account of labour supply constraints

25. **The labour market has been remarkably resilient over the last 18 months and, despite the Delta outbreak, is currently characterised by a state of tightness.** The unemployment rate has continued to fall from its peak in the September 2020 quarter, dropping to pre-GFC levels in the June quarter at 4.0%. This relatively low peak and subsequent prompt decline can, at least in part, be credited to the COVID-19 policy response which buttressed demand and preserved attachment to the labour market, which in turn created the conditions for people who initially became displaced to quickly find another job.

26. Likewise, employment continues to increase and, due to constrained labour supply from closed borders, the **Quarterly Survey of Business Opinion (QSBO) reported record-high difficulty finding skilled labour and near-record difficulty finding unskilled labour** in the September quarter (Figure 9). This is particularly pronounced in sectors experiencing substantive demand pressures, such as construction. There is little sign of these pressures easing in the short term: in the September quarter QSBO, a net 42% of businesses planned to increase headcount in the next quarter.

27. Given this tightness in the labour market and absence of short-term opportunities to increase labour supply, **the unemployment rate profile has been revised downward across the forecast period,** dropping to 3.4% in the December 2023 quarter before rising to 4.0% at the end of the forecast period (Figure 10). Similarly, **employment is expected to continue to grow quarter-on-quarter,** with the rate of annual average growth moderating to around 1.5% from the June 2023 quarter. In turn, this persistent tightness in the labour market is expected to catalyse wage growth and increase labour force participation. Annual wage growth is forecast to reach an apex of 4.5% in the December 2022 quarter and remain elevated above 4.0% for the majority of the forecast period, while labour force participation increases to around 70.9% from the March 2024 quarter.

Figure 9: QSBO difficulty finding labour

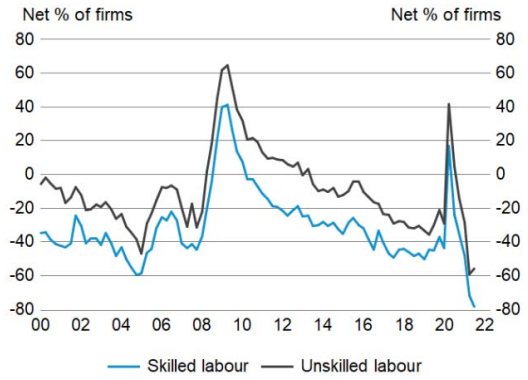
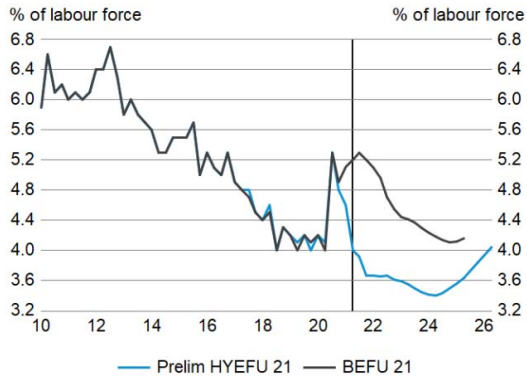


Figure 10: Unemployment rate



The global economic recovery has lost some momentum but remains positive …

28. **The international COVID-19 outlook has continued to improve since BEFU 2021,** supporting the economic performance of New Zealand's key trading partners. This is primarily due to the global vaccine rollout and subsequent relaxing of public health restrictions, such as in the United Kingdom, leading to a shift towards living with the virus. The emergence of the Delta variant, however, has weakened the global health position and resulted in differing approaches to manage the severe outbreaks experienced across various parts of the world. In China, for instance, ongoing lockdowns are being used to control Delta, whereas the United States has continued to gradually reopen and ease restrictions.

29. **There is growing concern that international vaccination rates are plateauing at levels well below required for herd immunity,** leading to weaker growth of New Zealand's key trading partners (Figure 11). As of 13 October 2021, Our World in Data show that the total percentage of the population fully vaccinated against COVID-19 was 53.0% in Australia, 55.9% in the United States, and 66.3% in the United Kingdom. While developed regions have generally been successful in the procurement of vaccines, the rollout in some of New Zealand's trading partners in emerging Asia is still fairly nascent, negatively impacting global manufacturing. The emergence of new

coronavirus variants, particularly those resistant to existing vaccines, remains a key risk internationally.

Figure 11: People fully vaccinated

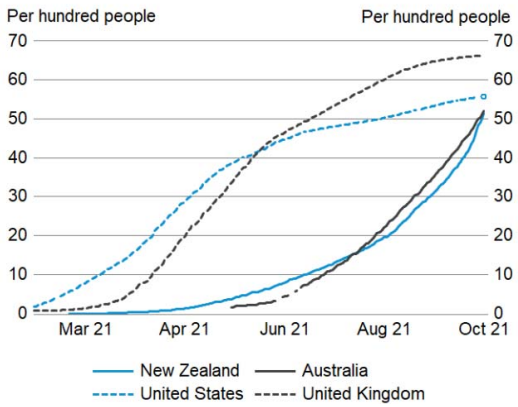
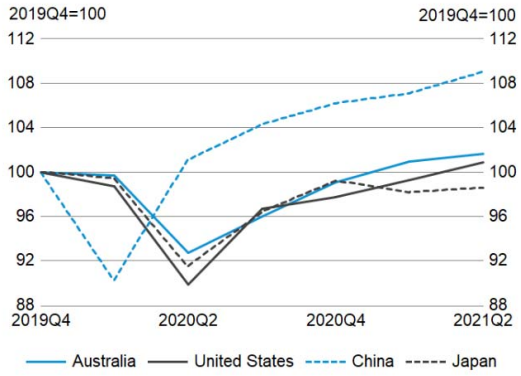


Figure 12: Real GDP in selected countries



30. **The global economic recovery has lost some momentum due to the emergence of Delta and ongoing supply-chain disruptions but remains more positive than in BEFU 2021** due to vaccination, policy support, savings drawdown, and the reopening of economic activity (Figure 12). Growth in real GDP in the United States and China has slowed due to Delta outbreaks, and Australia is expected to contract in the September 2021 quarter but bounce back relatively quickly in 2022.

31. **Inflation has resurfaced as a key international risk; specifically there are concerns of stagflation.** Global inflation pressures have risen, driven by temporary factors such as oil prices and once-off pandemic impacts, more persistent factors such as supply-chain issues and energy costs, and factors whose persistence is yet to be determined such as inflation expectations. Accordingly, inflation has surprised on the upside in a number of regions which could lead to monetary policy normalising earlier. To date, central banks have generally remained relatively dovish; however, the Korean and Norwegian central banks have hiked interest rates and the Bank of England and United States Federal Reserve communicated an earlier start to tapering their quantitative easing programmes.

… supporting higher commodity export prices and the terms of trade in the short term

32. Despite the slowdown in global growth, **demand for New Zealand's goods exports is expected to remain strong. Global supply-chain disruption is causing challenges for exporters and is expected to have lingering impacts,** with real goods exports now forecast to be 1.1% lower in 2025 compared to BEFU 2021. Services exports are forecast to begin to recover from the second half of 2022 in line with the Reconnecting New Zealand plan. The return of international visitors, however, is likely to be more gradual compared to BEFU 2021 as a result of the worldwide spread of the Delta variant.

33. **Goods import volumes are expected to be subdued over the next few quarters as global supply-chain disruption continues** and ongoing public health restrictions weaken the New Zealand economy. In the medium term, widespread vaccination allows for a steady recovery in private consumption and business investment, resulting in a similar outlook to BEFU 2021.

34. **Commodity export prices have risen to record highs,** driven by the global economic recovery as well as stockpiling behaviour from buyers motivated by supply-chain

concerns. Prices are expected to ease over 2022 as global agricultural supply recovers and global demand normalises.

35. **The rise in export prices is forecast to boost the terms of trade,** though higher import prices driven by supply-chain disruption will hold back the increase to some extent. The terms of trade are expected to fall next year as export prices ease, with persistently higher import prices causing the terms of trade to be lower in the medium term compared to BEFU 2021 (Figure 13).

36. **The current account deficit is forecast to be wider compared to BEFU 2021,** reaching 4.8% of annual GDP in 2023 before beginning to narrow. This is driven by the slower recovery in services exports and the weaker income balance resulting from higher interest rates increasing debt-servicing costs.

Figure 13: Terms of Trade

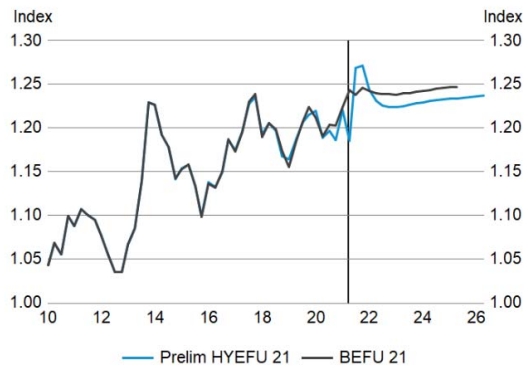
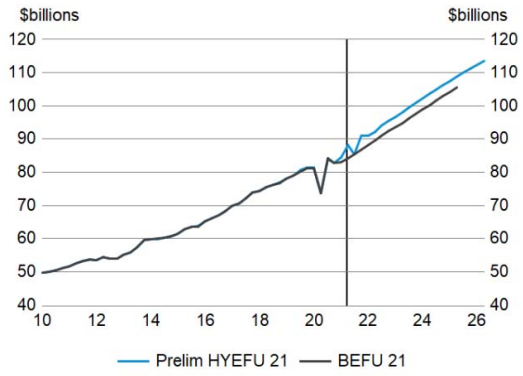


Figure 14: Nominal GDP



Higher inflation over the forecast period translates to higher nominal GDP

37. In the near term, higher real activity and higher prices are expected to provide a boost to nominal GDP. **In the year to June 2021, nominal GDP was $5.3 billion higher than forecast in BEFU 2021. This is forecast to rise to $9.9 billion and $13.1 billion above BEFU 2021 in the 2022 to 2025 June years, respectively, culminating in an additional $54.2 billion over the forecast period (Figure 14).** By the year to June 2025, higher nominal GDP is solely the result of higher prices in the economy.

Tax outlook

38. Higher forecasts of nominal GDP and stronger-than-anticipated tax outturns in recent months are the main drivers of increased tax revenue over the forecast period**. Core Crown tax revenue forecasts have increased by $36.4 billion across the four years to June 2025 compared to BEFU 2021 (Table 2).**

39. Much of the forecast increase in tax has come from the upward revision to nominal GDP forecasts. Moreover, to align the tax forecasts with recent tax outturns, the forecast contains some of the positive tax adjustments from previous forecasts.

Table 2: Estimated change in core Crown tax revenue since 2021 BEFU[1]

June years, $ billions	2022	2023	2024	2025	2026	Totals
2021 Budget Update	93.2	101.7	107.1	113.2		
% of GDP	26.6	27.4	27.3	27.3		
Forecasting changes by tax type:						
Source deductions	+1.9	+2.5	+3.4	+4.2		+12.0
Net other persons tax	+2.3	+1.7	+1.9	+2.0		+7.9
Corporate tax	+2.8	+1.7	+1.6	+1.6		+7.7
GST	+0.6	+1.6	+1.8	+1.9		+5.9
Resident withholding taxes	-	+0.1	+0.3	+0.3		+0.7
All other taxes	+0.1	+0.2	+0.4	+0.3		+1.0
Total forecasting change	**+7.7**	**+7.8**	**+9.4**	**+10.3**		**+35.2**
Policy changes	+0.1	+0.2	+0.4	+0.5		+1.3
Total change	**+7.8**	**+8.0**	**+9.8**	**+10.8**		**+36.4**
2021 Half-year Update (prelim)	**101.0**	**109.7**	**116.9**	**124.0**	**131.1**	
% of GDP	28.1	28.6	28.8	29.0	29.3	

40. **Increases in the forecasts of nominal GDP and its components add $27.3 billion to tax revenue over the forecast period.** In addition to this, tax revenue outturns for the two months up to August 2021 are close to $1.9 billion above the BEFU 2021 forecasts, further suggesting that the economy was stronger than anticipated prior to the Delta outbreak.

Comparison to bank forecasts

41. The **Treasury's preliminary HYEFU forecasts are generally concordant with the latest forecasts of the major domestic banks.** Bank forecasters, on average, are slightly more optimistic about GDP growth over the near term, but this is offset by weaker growth expectations in the medium term. In contrast, Treasury's forecasts of the unemployment rate are lower than consensus over the forecast period, reflecting that the Treasury expects greater persistence of labour market tightness in the absence of reforms that proportionately increase labour supply. Likewise, Treasury forecast higher house price growth than the bank consensus over the short term given the expected resilience in demand. Inflation forecasts are comparable to the bank consensus forecasts, with high inflation in 2022 easing to just over 2% in the medium term.

Risks to the central forecasts

42. **There are several upside and downside risks to our central forecasts that could lead to different outcomes for the economy and, in turn, tax revenue.**

43. **The central forecasts assume public health restrictions to broadly average Alert Level 2** until 1 July 2022. Future community outbreaks of COVID-19 that necessitate

[1] The unconsolidated tax revenue forecasts were completed on 14 October. Since the Crown eliminations forecasts (used for calculating core Crown and total Crown measures of tax) are not yet available, all numbers in Table 2 should be regarded as approximate.

the reinstatement of higher Alert Levels will likely lead to further declines in economic activity and, depending on frequency and length, have long-term scarring effects.

44. Parallel to the Alert Level assumptions, the vaccine programme is assumed to be complete by 1 July 2022. **If the vaccine rollout takes longer to inoculate a sufficient proportion of the population, border restrictions and Alert Level restrictions may be lifted later than in the central forecasts. Further, if vaccines are less effective against the spread of COVID-19, then there will likely be additional long-term behavioural shifts** – such as persistent decreases in consumption as people forego activity to prevent contracting COVID-19 – and declines in labour productivity associated with illness that will depress economic activity. Such weakening in the growth of New Zealand's trading partners would hinder services exports and put downward pressure on the exchange rate and terms of trade.

45. **Expectations about the impact of the Delta outbreak on economic activity are anchored to the experience of the 2020 lockdown period and recovery.** If this analogy is not appropriate – for instance, due to lesser pent-up demand – the economic recovery from the Delta lockdown period will likely be spread over multiple quarters and therefore increase the likelihood of firm failures, increase unemployment, and lower business investment. On the other hand, firms have greater certainty of the potential impact on their balance sheet so may be less likely to employ redundancy, thereby supporting a relatively faster recovery, all other things being equal.

46. **Disruptions related to supply chains are expected to subside by the end of 2023.** If supply-chain disruption subsides sooner, then there will be upside risk with a reduction in cost pressures, stronger trading partner growth, and an increase to the terms of trade, vice versa.

47. Annual net migration is assumed to gradually rise from approximately 1,300 in the September 2021 quarter to be above 30,000 in the June 2024 quarter and to subsequently reach 48,400 by the end of the forecast period. **As part of the Immigration Rebalance work programme, limits imposed on net migration below this profile would reduce New Zealand's labour force,** placing downward pressure on consumption and real GDP growth. Future Economic and Fiscal updates will incorporate any indicated shifts in migration policy.

Annex 1: Forecast summary tables

Table A1: Summary of economic forecasts, June years

(Annual average percent change, unless specified otherwise)

June Years	2018	2019	2020	2021	2022 Forecast	2023 Forecast	2024 Forecast	2025 Forecast	2026 Forecast
Private consumption	4.6	4.2	-0.8	7.5	1.2	3.4	1.1	2.0	2.2
Public consumption	3.8	3.6	6.8	6.8	4.8	1.8	0.6	0.8	1.1
TOTAL CONSUMPTION	**4.4**	**4.1**	**0.9**	**7.3**	**2.1**	**3.0**	**1.0**	**1.7**	**2.0**
Residential investment	-0.1	3.7	-6.1	17.8	8.9	3.4	-2.1	-0.5	-1.1
Business investment*	12.0	3.9	-4.5	4.5	2.9	9.8	4.0	2.6	2.1
TOTAL INVESTMENT	**8.7**	**3.9**	**-4.9**	**7.8**	**4.5**	**8.0**	**2.4**	**1.8**	**1.3**
Stocks (contribution to GDP growth)	0.2	-0.5	-0.4	0.5	0.3	-0.3	0.0	-0.0	0.0
GROSS NATIONAL EXPENDITURE	**5.7**	**3.4**	**-1.0**	**7.9**	**3.1**	**4.2**	**1.3**	**1.7**	**1.8**
Exports	3.9	3.4	-5.0	-11.4	2.1	7.1	6.3	5.0	4.2
Imports	8.4	2.3	-5.9	-4.2	12.2	4.9	3.0	2.7	2.5
EXPENDITURE ON GDP	**4.6**	**3.7**	**-0.8**	**5.9**	**0.3**	**4.3**	**2.0**	**2.2**	**2.2**
GDP (PRODUCTION MEASURE)	**3.7**	**2.9**	**-1.4**	**5.1**	**0.8**	**4.9**	**2.2**	**2.3**	**2.3**
- annual % change, June quarter	3.7	2.2	-10.2	17.4	1.6	2.4	2.2	2.3	2.3
Other Output Measures									
Real Gross National Disposable Income	3.9	2.7	0.5	4.9	0.2	4.5	2.1	2.4	2.3
Nominal GDP (Expenditure Basis)	7.3	4.8	2.2	7.1	6.8	8.6	5.3	5.1	4.8
Potential GDP	2.9	2.6	-0.6	5.5	-0.3	4.6	2.6	2.7	2.7
Output gap (June qtr,% of potential)	1.3	1.0	-0.9	1.5	1.5	1.3	0.9	0.5	0.2
Total Population (thousands, mean quarter ended)	4,893	4,972	5,087	5,118	5,155	5,200	5,253	5,313	5,379
Real GDP per capita (Production basis)	1.7	1.2	-3.3	3.8	0.1	4.1	1.2	1.2	1.1
Labour Market									
Employment	3.6	2.0	1.6	0.7	3.7	0.9	0.9	1.1	1.2
Unemployment Rate (June quarter)	4.6	4.0	4.1	4.0	3.2	3.3	3.6	3.8	4.1
Labour Productivity (Hours worked basis)	-0.6	0.4	-0.2	1.6	1.6	0.4	1.4	1.2	1.1
Wages (QES average hourly ord time earnings, APC)	2.8	4.0	3.0	4.0	4.1	4.5	4.6	4.4	4.2
Monetary Conditions									
90-day Bank Bill Rate (June quarter ave)	2.0	1.7	0.3	0.3	2.0	3.2	3.1	3.1	3.1
10-year Bond Rate (June quarter ave)	2.8	1.8	0.8	1.7	2.6	2.9	3.2	3.4	3.4
TWI (June quarter ave)	73.8	72.7	69.7	74.7	77.2	78.3	78.7	78.9	78.9
- annual % change (June quarter)	-3.5	-1.5	-4.1	7.3	3.3	1.4	0.6	0.2	0.1
Price Measures									
CPI Inflation (ann % change, June quarter)	1.5	1.7	1.5	3.3	5.1	3.1	2.7	2.4	2.2
Consumption Deflator	1.3	1.6	1.9	1.4	4.5	3.5	3.2	2.8	2.6
GDP Deflator	2.6	1.1	3.0	1.1	6.5	4.1	3.2	2.8	2.5
House Price Inflation (ann % change, June qtr)	3.6	1.5	7.1	29.0	10.4	-0.2	-0.4	0.5	0.6
Key Balances									
Current account balance ($ million)	-10,219	-10,806	-4,695	-11,243	-20,879	-21,439	-20,084	-19,082	-18,470
Current account balance (% of GDP)	-3.5	-3.5	-1.5	-3.3	-5.8	-5.4	-4.8	-4.4	-4.0
Terms of Trade (goods) - SNA Basis	4.6	-3.4	4.4	-0.2	0.5	0.4	-0.4	-0.4	-0.4
Net International Investment Position (%GDP)	-52.2	-54.2	-57.2	-45.8	-48.6	-50.2	-52.5	-54.4	-55.9

* Total investment excluding residential

Table A2: Change in economic forecasts from BEFU 2021, June years

(Annual average percent change, unless specified otherwise)

June Years	2018	2019	2020	2021	2022	2023	2024	2025	2026
					Forecast	Forecast	Forecast	Forecast	Forecast
Private consumption	0.0	-0.1	0.1	2.5	-1.8	0.5	-1.4	-0.4	NA
Public consumption	-0.0	0.0	0.1	2.7	1.8	0.4	-0.8	-1.2	NA
TOTAL CONSUMPTION	**0.0**	-0.0	0.1	2.5	-0.9	0.5	-1.3	-0.6	NA
Residential investment	0.0	0.0	-0.1	1.8	7.2	-1.8	-4.8	-3.1	NA
Business investment*	-0.2	-0.2	0.2	3.9	-2.2	0.4	-1.1	-1.0	NA
TOTAL INVESTMENT	**-0.2**	-0.1	0.1	3.4	0.3	-0.3	-2.1	-1.6	NA
Stocks (contribution to GDP growth)	-0.0	-0.0	0.0	0.2	0.0	-0.3	0.0	-0.0	NA
GROSS NATIONAL EXPENDITURE	**-0.0**	-0.1	0.1	2.8	-0.5	0.3	-1.5	-0.8	NA
Exports	-0.1	0.2	0.6	-1.1	-4.0	0.3	0.9	0.3	NA
Imports	-0.0	-0.1	0.1	0.8	1.5	-1.1	-1.0	-0.7	NA
EXPENDITURE ON GDP	**-0.1**	0.0	0.2	1.6	-1.6	0.5	-1.1	-0.6	NA
GDP (PRODUCTION MEASURE)	**0.0**	-0.0	0.4	2.2	-2.4	0.6	-1.1	-0.6	NA
- annual % change, June quarter	*-0.0*	-0.0	1.2	4.0	-3.2	-1.3	-1.0	-0.4	NA
Other Output Measures									
Real Gross National Disposable Income	-0.0	0.0	0.3	2.0	-3.4	0.3	-1.0	-0.6	NA
Nominal GDP (Expenditure Basis)	-0.1	0.0	0.2	1.5	2.2	2.3	-0.4	-0.4	NA
Potential GDP	-0.0	-0.0	0.4	-0.3	-2.8	2.1	-0.0	-0.0	NA
Output gap (June qtr,% of potential)	-0.1	-0.1	-0.2	4.6	2.3	1.0	0.1	-0.2	NA
Total Population (thousands, mean quarter ended)	**0**	**0**	**-3**	**-8**	**-13**	**-19**	**-26**	**-34**	**NA**
Real GDP per capita (Production basis)	**0.0**	**-0.0**	**0.4**	**2.3**	**-2.3**	**0.7**	**-0.9**	**-0.4**	**NA**
Labour Market									
Employment	-0.0	0.0	-0.1	0.5	2.3	-1.5	-1.0	-0.7	NA
Unemployment Rate (June quarter)	0.1	0.0	0.1	-1.2	-1.8	-1.1	-0.5	-0.3	NA
Labour Productivity (Hours worked basis)	-0.0	-0.0	0.4	1.8	-1.0	-1.6	-0.1	0.0	NA
Wages (QES average hourly ord time earnings, APC)	-0.2	-0.4	-0.0	0.5	1.1	2.1	1.8	1.2	NA
Unit Labour Costs (Hours worked basis)	-0.2	-0.1	-0.7	-1.5	1.7	3.7	2.0	1.4	NA
Monetary Conditions									
90-day Bank Bill Rate (June quarter ave)	0.0	0.0	0.0	0.0	1.7	2.9	2.8	2.3	NA
10-year Bond Rate (June quarter ave)	0.0	0.0	0.0	-0.0	0.4	0.5	0.5	0.5	NA
TWI (June quarter ave)	0.0	0.0	0.0	0.2	2.7	3.8	4.0	3.8	NA
- annual % change, June quarter	0.0	0.0	0.0	0.3	3.3	1.4	0.3	-0.3	NA
Price Measures									
CPI Inflation (ann % change, June quarter)	0.0	0.0	0.0	1.0	3.4	1.3	0.7	0.3	NA
Consumption Deflator	-0.0	0.0	-0.0	0.2	3.0	1.4	0.7	0.3	NA
GDP Deflator	-0.0	0.0	-0.0	-0.1	3.8	1.7	0.6	0.2	NA
House Price Inflation (ann % change, June quarter)	0.0	0.0	0.3	11.8	9.4	-2.3	-2.5	-2.0	NA
Key Balances									
Current account balance ($ million)	458	830	982	-2247	-9054	-8476	-6981	-6196	NA
Current account balance (% of GDP)	0.2	0.3	0.3	-0.6	-2.4	-2.0	-1.5	-1.3	NA
Terms of Trade - SNA Basis	-0.0	0.1	-0.2	-0.5	-0.5	1.3	-0.0	-0.1	NA

* Total investment excluding residential

TE TAI ŌHANGA
THE TREASURY

Treasury Report: HYEFU 2021 Final Economic and Tax Forecasts

Date:	19 November 2021	**Report No:**	T2021/2831
		File Number:	BM-3-6-1

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Note** final economic forecasts for HYEFU 2021 show an outlook for activity similar to the preliminary forecasts, with the dampening impact of rising interest rates and a more gradual recovery from Delta restrictions partially offset by the move to the more permissive COVID-19 Protection Framework. More persistent inflation boosts nominal GDP resulting in an upward revision in core Crown tax revenue of $9.3 billion over the five years to June 2026.	Weekly Agency Meeting, 22 November 2021

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Andrew Kennedy	Analyst, Forecasting	s9(2)(k)	N/A (mob)	✓
Peter Gardiner	Manager, Forecasting		s9(2)(g)(ii)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: HYEFU 2021 Final Economic and Tax Forecasts

Executive Summary

The New Zealand economy has continued to perform relatively strongly since the preliminary Half-Year Economic and Fiscal Update (HYEFU) 2021 forecasts, **despite the ongoing impacts of the Delta outbreak** and higher Alert Levels in part of the country. The unemployment rate dropped to a record-equalling 3.4% in the September 2021 quarter; consumer and business confidence have both been resilient compared to the previous period of prolonged restrictions; and the female labour force participation rate jumped to its highest point on record.

The major development since the preliminary forecasts is that inflation had risen well outside the Reserve Bank of New Zealand's (RBNZ's) target range of 1-3%. While some elevated pressures in tradables inflation are expected to be more transitory in nature, overall consumer price inflation will be elevated by persistently higher non-tradables inflation over the forecast period associated with labour shortages and robust domestic demand. As a result, **interest rates are anticipated to rise more rapidly and to a higher level than in the preliminary forecasts**, placing downward pressure on aggregate demand and returning inflation within the target range from late 2023.

In combination with a lower net migration track, this more rapid tightening of monetary policy is forecast to dampen real GDP growth over the medium term and check house price growth from the middle of 2022. **In the short term, the extension of public health restrictions into the December 2021 quarter results in a more gradual recovery from the Delta outbreak**. We anticipate growth in 2022 to be supported by pent-up demand, higher employment, and continued strength in residential investment. **The more permissive COVID-19 Protection Framework is forecast to have a positive effect on economic activity from the start of 2022.**

Higher inflation translates to **nominal GDP being a cumulative $38.9 billion higher over the forecast period** relative to the preliminary forecasts. This is the major driver of the **additional $9.3 billion in core Crown tax revenue** over the five years to June 2026. **Higher wages and costs, however, will constrain growth in real government consumption.**

The labour market remains tight, with increasingly less room for future expansions in employment from the resident population. Unemployment is consequently expected to drop to 3.1% in the March 2022 quarter and remain below 4.0% for the majority of the forecast period, and employment is expected to exhibit quarter-on-quarter growth**. In light of the slightly weaker migration, such demand puts more pressure on wage inflation, with labour force participation remaining elevated throughout the forecast period.**

The global economy has lost some momentum due to the emergence of Delta and ongoing supply-chain disruptions, but still remains positive amid concerns of rising inflation. Recent strength in goods import volumes has led to an upward revision over the near term, and tepid increases to export prices alongside stronger import prices are expected to result in a much smaller near-term rise in the terms of trade compared to the preliminary forecasts, though the medium term is slightly higher owing to more persistent strength in export prices.

The economic forecasts are dependent on some key assumptions. For example, public health restrictions are assumed to average an Amber setting over the first half of 2022; the international border is assumed to have a phased reopening from the start of 2022; and potential output has been revised lower than the Budget Economic and Fiscal Update (BEFU) 2021 to account for ongoing disruptions and behavioural shifts related to the pandemic. Significant deviation from these assumptions – either to the upside or downside –

would change the underlying fundamentals of the forecast, as would the realisation of key risk such as the advent of a more communicable or lethal coronavirus.

Table 1: Forecast summary, final HYEFU 2021 compared to preliminary HYEFU 2021

Year to June		2021 Actual	2022 Forecast	2023 Forecast	2024 Forecast	2025 Forecast	2026 Forecast
Real GDP (AAPC)	Final HYEFU 2021	5.1	0.8	4.9	2.2	2.3	2.3
	Preliminary HYEFU 2021	5.1	0.7	4.7	2.8	2.5	2.2
Unemployment Rate	Final HYEFU 2021	4.0	3.2	3.3	3.6	3.8	4.1
	Preliminary HYEFU 2021	4.0	3.7	3.5	3.4	3.6	4.0
CPI Inflation (APC)	Final HYEFU 2021	3.3	5.1	3.1	2.7	2.4	2.2
	Preliminary HYEFU 2021	3.3	3.2	2.3	2.4	2.3	2.1
Nominal GDP ($billion)	Final HYEFU 2021	339.7	362.8	393.9	414.7	435.8	456.5
	Preliminary HYEFU 2021	339.7	359.7	384.2	406.1	427.5	447.3
	Change	0.0	3.1	9.7	8.6	8.2	9.3
Core Crown tax revenue ($billion)	Final HYEFU 2021	98.0	102.7	113.0	119.2	126.2	133.2
	Preliminary HYEFU 2021	98.0	101.2	110.2	117.4	124.8	131.4
	Change	0.0	1.5	2.8	1.8	1.4	1.8

Recommended Action

We recommend that you:

a **note** the Treasury's HYEFU 2021 economic forecasts show a more gradual recovery from the Delta outbreak than the preliminary forecasts, partially offset by the move to the more permissive COVID-19 Protection Framework;

b **note** that inflation is expected to be higher and more enduring over the forecast period relative to the preliminary forecasts. This reflects greater persistence of inflationary pressures associated with capacity constraints and COVID-19 related disruption;

c **note** that, in line with the economic forecasts, tax revenues are higher than in the preliminary HYEFU 2021 forecasts. In total across the five years to June 2026, core Crown tax revenues forecasts are $9.3 billion higher than in the preliminary forecasts;

d **note** that the uncertainty around the economic outlook remains higher than usual and that we expect to see larger-than-normal revisions to the fiscal outlook over the coming years as Treasury updates its forecasts; and

e **refer** this report to:

- Hon Megan Woods, Associate Minister of Finance

Refer/not referred.

- Hon David Parker, Associate Minister of Finance

Refer/not referred.

Peter Gardiner
Manager, Forecasting & Modelling

Hon Grant Robertson
Minister of Finance

Treasury Report: HYEFU 2021 Final Economic and Tax Forecasts

Purpose and context of Report

1. This report provides an overview of the Treasury's final HYEFU 2021 economic and tax forecasts. These economic and tax forecasts underpin the fiscal forecasts due to be completed on Thursday 25 November. You will receive a Treasury Report on the final fiscal forecasts by 2 December 2021.

2. You have also received separate advice on the communication of Budget operating allowances (T2021/2875 refers). Your decisions on this advice, along with our final economic and fiscal forecasts, will be included in a Cabinet paper on Budget allowances and the Climate Emergency Response Fund (CERF) for discussion at Cabinet on 6 December. We will provide a draft paper to you on 26 November ahead of lodgement the following week.

3. Annex 1 provides tables with additional details on the economic forecasts, including changes since the preliminary HYEFU 2021 forecasts and BEFU 2021 forecasts.

Developments since preliminary forecasts

4. Since the preliminary forecasts, New Zealand's COVID-19 situation and response has continued to evolve. There is increasing evidence of labour market tightness and a combination of factors driving higher inflation.

5. The **net impact of these developments is that we expect interest rates to rise more rapidly and to a higher level** than forecast in the preliminary HYEFU forecasts. In the short term, a more uniform recovery supported by pent-up demand, building consents, and higher employment and wage growth more than offsets the negative effect of rising interest rates on real GDP growth, but over the medium term higher interest rates have a constraining impact on growth.

6. **Annual Consumers Price Index (CPI) inflation in the September quarter exceeded expectations at 4.9%,** the highest growth in over ten years and 1.1 percentage points higher than the preliminary forecast of 3.8%. This increase was underpinned by most classes of expenditure, led by housing, recreation, transport, and food. We anticipate some of these price pressures to be transitory, particularly tradables inflation related to rising petrol prices and supply-chain disruptions. To a greater extent than the preliminary forecasts, however, we expect more persistent non-tradables inflation arising from robust domestic demand and labour shortages.

7. **September quarter labour market statistics came in stronger than forecast in the preliminaries, reflecting an even tighter labour market than expected.** Driven by a 55,000-person increase to employment over the quarter, annual employment growth increased to 4.2% and the unemployment rate dropped to a record-equalling 3.4%, compared to the preliminary forecasts of 2.4% and 3.9%, respectively. Reflecting ongoing skills shortages and excess demand pressures, annual wage growth of 3.4% matched the preliminary forecast, while hours worked fell 6.6% owing to the impact of lockdown and elevated public health restrictions.

8. **Monthly house price growth rose to 2.3% in October, in line with house price growth over the past six months.** A degree of pent-up demand likely contributed to part of this increase, with Auckland house prices increasing 3.7% in October as buyers returned to the market compared to an average 1.3% increase in areas outside of Auckland. Overall sales activity rose 8.5% in October driven by some lockdown-induced volatility in Auckland where sales rose almost 70% but remain below pre-Delta-outbreak levels. The latter is also true for other parts of the country, although this could be indicative of parts of Waikato and Northland entering Alert Level 3 in October.

9. **The October ANZ Business Outlook (ANZBO) shows that business confidence is easing but remains robust.** Investment intentions and profitability expectations were both higher than in the September ANZBO, with a net 21.7% of firms expecting an increase in their own activity in the near future. Employment intentions diminished but are still positive, while a net 87.2% of firms are expecting increasing costs.

10. **Consumer confidence fell sharply in October,** reflecting the impact of rising prices, mortgage rate rises, uncertainty around the impact of the Delta variant, and supply shortages. Despite the latest fall, consumer confidence is still exhibiting resilience compared to the 2020 lockdown period.

11. **There is growing concern of stagflation in the global economy.** Annual inflation in the United States reached 6.2% in October – the highest rate since mid-1982 – while both the United States and China experienced a slowdown in growth in the September 2021 quarter. There is non-trivial risk that rising inflation will prompt central banks to consider reducing stimulus earlier than previously expected, which will weigh further on the international economic recovery and consequently New Zealand's economic position.

Key assumptions

12. **COVID-19 continues to materially influence the economic outlook and uncertainty remains high.** A number of assumptions about the impact and likely nature and timing of public health and border restrictions remain necessary.

13. **The vaccination programme is expected to enable a full shift to the COVID-19 Protection Framework from early 2022. We assume an average of the Amber setting over the first half of 2022,** which is slightly more permissive than the corresponding assumption in the preliminary forecasts that public health restrictions and behavioural responses to COVID-19 would impact activity to a similar extent as Alert Level 2.

14. **Potential output remains lower than in BEFU 2021** in the forecast period by 0.5%, as in the preliminary forecasts. This allows for ongoing disruptions related to the pandemic, the likelihood of ongoing public health restrictions over the medium term, the risk of further episodes, and relatively fewer hours worked and lower productivity levels owing to sickness.

15. **The international border is assumed to have a gradual and phased reopening from the start of 2022 and to ease more broadly in the September 2022 quarter.** This is in line with advice provided to Cabinet on the Reconnecting New Zealand plan allowing New Zealand citizens and residents to return as a first priority – which will most likely boost services imports to a greater extent than services exports as New Zealanders travel overseas – with the wider easing of restrictions from the September 2022 quarter then expected to allow for a recovery in services exports (Figure 1). This differs slightly from the assumption in the preliminary HYEFU 2021 forecasts of a gradual reopening from the start of the September 2022 quarter.

Figure 1: Net service exports

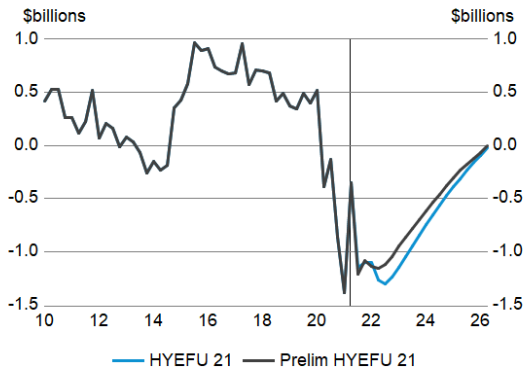
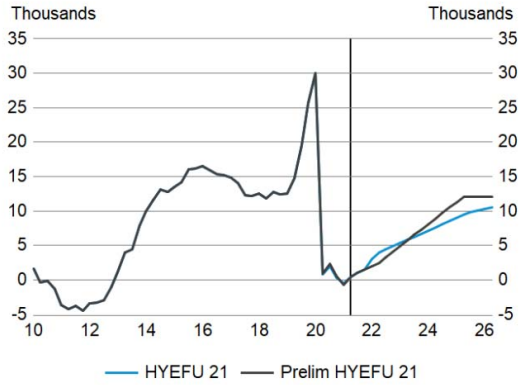


Figure 2: Quarterly net migration



16. Annual net migration is assumed to gradually rise from approximately 2,600 in the December 2021 quarter to be 27,700 in the June 2024 quarter and subsequently reach 40,800 by the end of the forecast period (Figure 2). This puts the **net migration pathway slightly higher in the near term than the preliminary forecasts but notably lower over the medium term.** At the end of the forecast period, annual net migration is just under 20,000 people shy of the approximate 60,000 average annual net migration between 2016 and 2020, reflecting the sentiment of the Immigration Rebalance work programme.

17. **Fiscal support has increased by a net $20.2 billion relative to BEFU 2021**. This comprises an additional $7 billion in the COVID Response and Recovery Fund and a $3 billion underspend that were included in the preliminary HYEFU forecasts (totalling $10 billion), anticipated to fund the public health response, vaccine rollout, Reconnecting New Zealand programme, and future business/income supports. The extra $10.2 billion since the preliminary forecasts stems from the decisions made at Budget Ministers on 9 November to provide new operating spending of $6.0 billion for Budget 2022, $4.0 billion for Budget 2023 and $3.0 billion for Budgets 2024 and 2025. Over the forecast period, this translates to increases on our preliminary forecasts of $7.2 billion and $3.0 billion in new operating spending across Budget 2022 and Budget 2023, respectively. To this extent, additional fiscal stimulus partially offsets the impact of restrictions on activity over the medium term and the increased likelihood of added disruption due to the Delta strain or emerging variants.

Economic outlook

Strong inflationary pressures related to demand and capacity constraints expected to persist …

18. Reflecting the intense costs pressures reported in business surveys, **annual CPI inflation in the September 2021 quarter significantly exceeded market expectations at 4.9%,** the highest growth in over ten years and 1.1 percentage points higher than the preliminary HYEFU forecast of 3.8%.

19. **Domestically-driven demand-side inflationary pressures are expected to remain elevated over much of the forecast period,** reflecting tighter labour market conditions and ongoing capacity constraints, raising non-tradables inflation. On the other hand, some elevated pressures in tradables inflation, such as petrol prices and supply-chain disruptions, are expected to be transitory.

20. **CPI inflation has been revised upward across the forecast period** relative to the preliminary forecasts (Figure 3). Annual CPI inflation is forecast to peak at 5.6% in the March 2022 quarter compared to the preliminary forecast peak of 4.1% in the December 2021 quarter. Inflation then falls across 2022 and continues to decline towards the RBNZ's 2.0% target midpoint over the remainder of the forecast period.

21. **This dynamic is governed by supply-side and, to a greater extent, demand-side pressures.** Tradables inflation is expected to ease in the near term as elevated world energy prices and price effects of supply-chain disruptions unwind, whereas rising interest rates over 2022 attenuate domestic demand and continue to gradually dampen non-tradables inflation over the forecast period.

Figure 3: CPI inflation

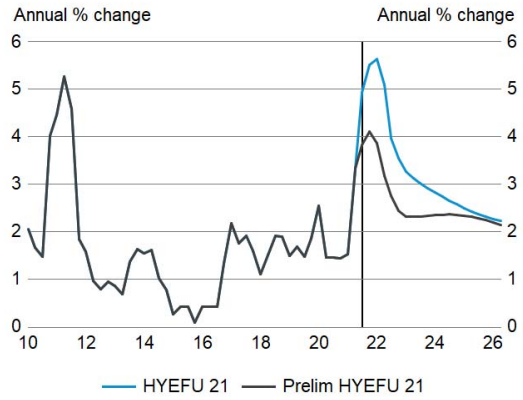
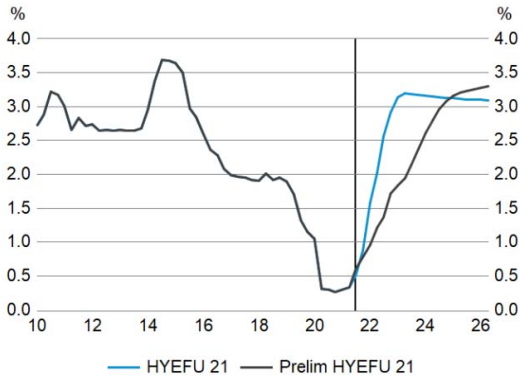


Figure 4: 90-Day interest rates



… prompting a more rapid tightening of monetary policy …

22. Having increased the Official Cash Rate (OCR) from 0.25% to 0.5% in October, the **RBNZ is expected to respond to the stronger-than-expected inflationary pressures by tightening monetary policy more rapidly than in the preliminary forecasts.**

23. **The 90-day interest rate is forecast to rise to 0.9% in the December 2021 quarter before rapidly rising to 3.1% by the March 2023 quarter where it plateaus** for the remainder of the forecast period (Figure 4). This constitutes a notable deviation from the preliminary HYEFU 2021 and BEFU 2021 forecasts and is slightly above financial market expectations of around a 200-basis point increase to the OCR by the start of 2023. This slight difference potentially reflects an information asymmetry related to fiscal spending.

24. There is considerable uncertainty among stakeholders surrounding the marginal impact of rising interest rates on households with elevated debt levels. Through Monetary Policy Statements, the RBNZ will have regular opportunities to reassess the impact it is having on wider economic activity and therefore be able to change path as appropriate.

… which moderates a slower recovery from Delta over the medium term …

25. **The persistence of COVID-19 restrictions into the December 2021 quarter results in a slower recovery than in the preliminary forecasts.** Since the finalisation of the preliminary forecasts, the public health response has shifted towards a suppression strategy. We continue to forecast an approximate 6% fall in real GDP in the September 2021 quarter due to the Delta outbreak; however, as opposed to a 5.8% bounce back in the December quarter, we now are expecting more uniform growth over the December 2021 and March 2022 quarters of 3.7% and 3.8%, respectively. This is supported by pent-up demand, higher employment, continued strength in building

consents, and the more permissive COVID-19 Protection Framework boosting activity at the start of 2022.

26. This results in **higher annual average real GDP growth from the June 2022 quarter through to the June 2023 quarter** – peaking at 5.0% in December 2022 quarter – and a higher level of real GDP until the June 2023 quarter (Figure 5). **Real GDP is thereafter marginally lower for the rest of the forecast period** than in the preliminary forecasts, stemming from a more rapid tightening of monetary policy and approximately 8,000 fewer net migrants entering New Zealand by the middle of 2026.

Figure 5: Real GDP

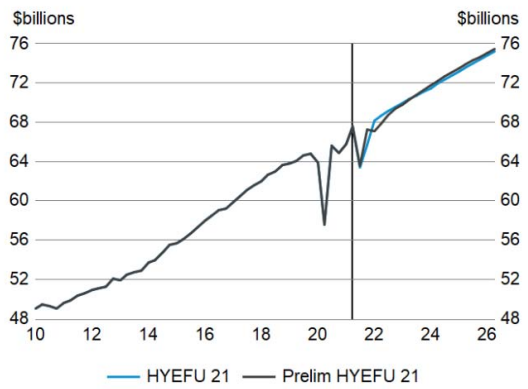
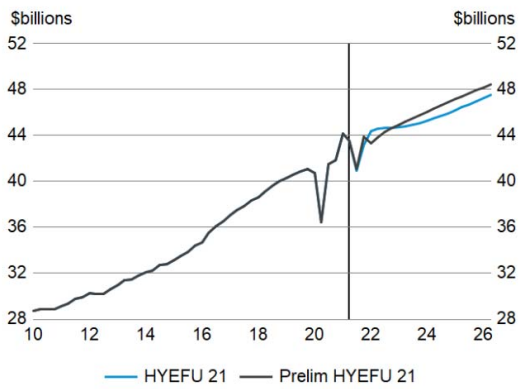


Figure 6: Real Private Consumption



27. Akin to the real GDP forecast, **we expect private consumption to be stronger throughout 2022 than the preliminary forecasts, but to be subsequently weaker from 2023 (Figure 6).** In the short term, we continue to anticipate a recovery in private consumption as restrictions on activity ease, with the impact of greater persistence of higher public health restrictions offset by higher house price growth and elevated employment. In the medium term, higher household incomes and employment levels will support consumption, but lower real wages owing to high inflation and higher interest rates depress consumption growth relative to the preliminary forecasts, with annual average private consumption growth declining to 0.8% in the December 2023 quarter before gradually increasing to 2.2% by the end of the forecast period.

Figure 7: Real government consumption

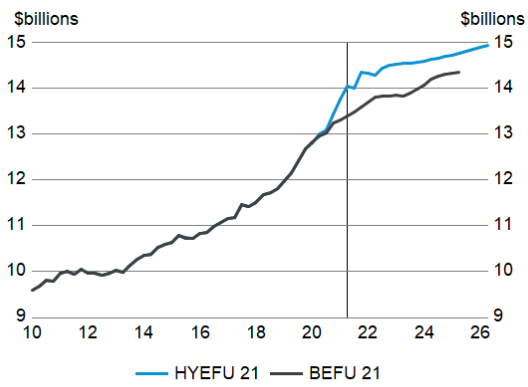
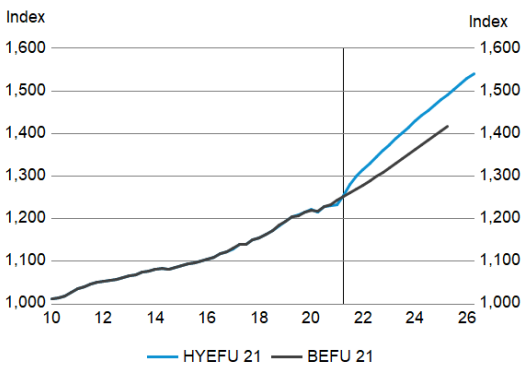


Figure 8: Government consumption deflator



28. **Annual average growth in real government consumption is forecast to be lower than in the BEFU 2021 forecasts for most of the forecast period.** This is because, although the level of real and nominal government consumption is greater due to additional fiscal spending (Figure 7), higher inflation and wage costs flow through to higher costs for government, thereby limiting the rate of growth in real government

consumption relative to nominal consumption expenditure. This is equally reflected in a significantly higher government consumption deflator (Figure 8), the price measure for government services used in the national accounts.

… and cools the housing market over the forecast period …

29. **House prices are forecast to plateau from the middle of 2022** following continued growth in late 2021 and early 2022, in contrast to the more persistent growth outlined in the preliminary forecasts (Figure 9). This stalling of growth is primarily the result of higher mortgage interest rates in the near term, but is also related to ongoing affordability challenges and tighter loan-to-value ratio restrictions for owner occupiers in effect from 1 November 2021. The denial of interest deductibility for leveraged rental property owners is also expected to have a mild dampening effect on house price growth. With the exemption period for new builds confirmed at twenty years, however, this impact is expected to be much lower than assumed at BEFU 2021 which was based on a ten-year exemption period.

30. **Record-high building consents issuance over the past year is expected to support construction activity over the year ahead, although investment is expected to ease** from an elevated level over much of the forecast period with rising interest rates and declining house price growth reducing incentives to construct new dwellings (Figure 10). The effects of the recent lockdown will also be leading to a further increase to the backlog of activity. As borders reopen and global shipping disruptions ease, a degree of pent-up demand relating to capacity constraints could lead to an increase in investment activity over the year ahead before the effects of lower housing demand stabilise activity. Given capacity constraints related to materials, labour and civil infrastructure, we expect only a modest impact on residential investment over the forecast period relating to the Medium Density Residential Standards.

Figure 9: House prices

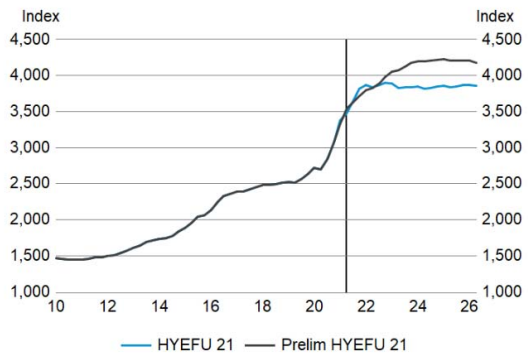
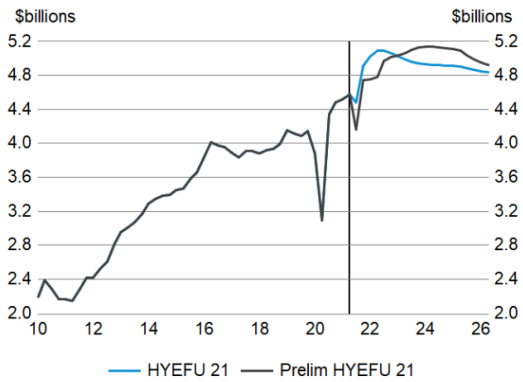


Figure 10: Residential investment



… but labour market tightness will persist on account of labour supply constraints

31. **The labour market continues to be remarkably resilient despite the Delta outbreak and remains characterised by a state of tightness.** Reflecting strong demand for labour, employment continues to increase with 55,000 more people entering employment in the September 2021 quarter, including around 50,000 more people in full-time employment. Combined with lower underemployment, this has resulted in a marked reduction in what little slack there was in the labour market.

32. There is little sign of these pressures easing in the short term. The September quarter Quarterly Survey of Business Opinion (QSBO) reported record-high difficulty finding skilled labour and near-record difficulty finding unskilled labour in the September quarter, and a net 42% of businesses planned to increase headcount in the next quarter. Although the recent surge in employment was able to be sourced from an

increase in labour force participation – with the labour force participation rate increasing 0.7 percentage points to 71.2% – **there is increasingly less room for future increases in employment to be derived from the domestic population.**

33. **The unemployment rate profile has been revised downward over the near term compared to the preliminary forecasts**. Given the tightness in the labour market and absence of short-term opportunities to increase labour supply, the unemployment rate drops to 3.1% in the March 2022 quarter before rising at a faster rate than the preliminary forecasts towards 4.1% at the end of the forecast period due to weaker demand (Figure 11). Likewise, **employment is expected to grow quarter-on-quarter** but at a slower rate than the preliminary forecasts, with annual average employment growth tempering over 2022/2023 before rising to 1.2% at the end of the forecast period.

Figure 11: Unemployment rate

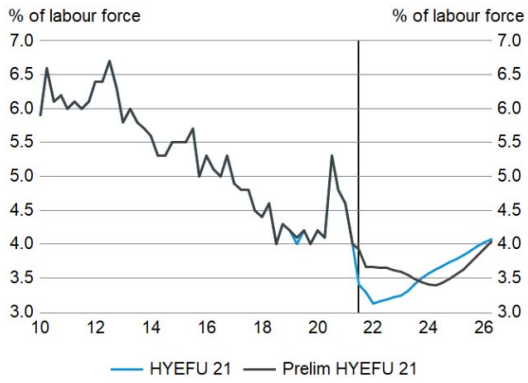
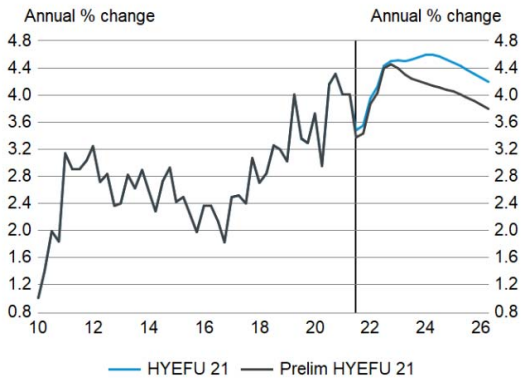


Figure 12: Annual wage growth



34. In turn, **this persistent tightness in the labour market is expected to catalyse wage growth and maintain an elevated rate of labour force participation.** Annual wage growth is forecast to reach an apex of 4.6% starting in the December 2023 quarter and then marginally decline to 4.2% by the end of the forecast period (Figure 12), while labour force participation slowly declines from 71.2% in the September 2021 quarter to 70.9% at the end of the forecast period.

The global economy has lost some momentum but remains positive …

35. **The global economic recovery has lost some momentum due to the emergence of Delta and ongoing supply-chain disruptions, but the growth outlook remains positive** due to vaccination, policy support, savings drawdown, and the reopening of economic activity (Figure 13). Growth in real GDP in the United States and China has slowed due to Delta outbreaks, and Australia's GDP is expected to contract in the September 2021 quarter but bounce back relatively quickly in 2022. While growth in the United States is expected to pick up in the December quarter, China faces a number of headwinds including energy shortages, COVID-19 lockdowns, and a precarious property market.

36. **Inflation has resurfaced as a key international risk; specifically, there are concerns of stagflation.** Global inflation pressures have risen, driven by temporary factors such as oil prices and once-off pandemic impacts, more persistent factors such as supply-chain issues and energy costs, and factors whose persistence is yet to be determined such as inflation expectations. Accordingly, inflation has surprised on the upside in a number of regions – reaching 6.2% in October in the United States – which could lead to monetary policy normalising earlier. To date, central banks have generally remained relatively dovish; however, the Korean and Norwegian central banks have

hiked interest rates and the Bank of England and United States Federal Reserve have communicated an earlier start to tightening monetary policy settings.

Figure 13: Real GDP in selected countries

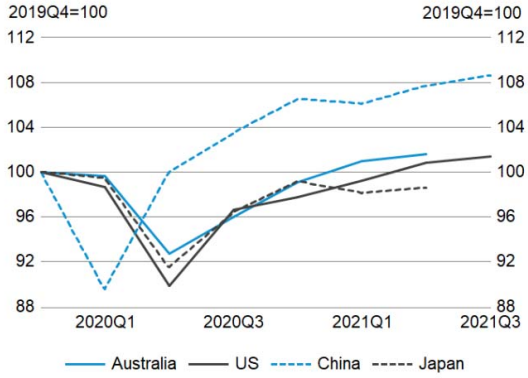
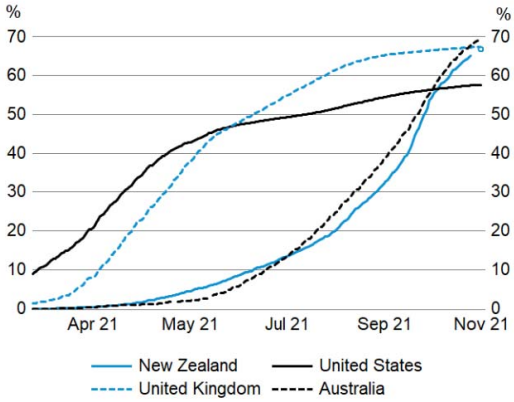


Figure 14: People fully vaccinated



37. **There is growing unease that international vaccination rates are levelling off at levels well below that required for herd immunity,** leading to weaker growth of New Zealand's key trading partners (Figure 14). Our World in Data shows that, on 8 November 2021, Australia surpassed the United Kingdom with respect to the total percentage of the population fully vaccinated and that New Zealand is set to follow suit. As of 15 November 2021, the total percentage of the population fully vaccinated against COVID-19 was 66.9% in New Zealand, 69.6% in Australia, 57.7% in the United States, and 67.5% in the United Kingdom. While developed regions have generally been successful in the procurement of vaccines, the rollout in some of New Zealand's trading partners in emerging Asia is still fairly nascent, negatively impacting global manufacturing. The emergence of new coronavirus variants, particularly those resistant to existing vaccines, remains a key risk internationally.

… leading to stronger imports and weaker terms of trade in the near term

38. The **outlook for goods exports remains similar to the preliminary forecasts**, with annual average growth forecast to peak at 5.4% in the March 2022 quarter. Global supply-chain disruption continues to bring challenges for importers and exporters, though data suggest that trade volumes have held up. **Goods import volumes appear particularly strong, with the near-term weakness in the preliminary forecasts no longer expected to occur.**

39. Trade data indicate that export prices have not risen to the extent suggested by global commodity price indexes, and import prices are set to rise more strongly as global inflation rises. This results in a **much smaller near-term rise in the terms of trade compared to the preliminary forecasts, although the medium term is slightly higher** due to more persistent strength in export prices (Figure 15).

40. The services exports assumption remains largely unchanged from the preliminary forecasts, with visitor numbers expected to recover from the September 2022 quarter in line with the Reconnecting New Zealand Plan. Services imports are now forecast to recover faster owing to the expected focus on allowing New Zealand citizens and residents to travel freely.

41. **The current account balance is expected to widen in the near term,** with stronger imports and weaker terms of trade leading to an annual current account deficit of 5.8% of GDP in the June 2022 quarter. By the end of the forecast period, the recovery in services exports and rising terms of trade narrow the deficit to 4.0% of GDP.

Figure 15: Terms of Trade

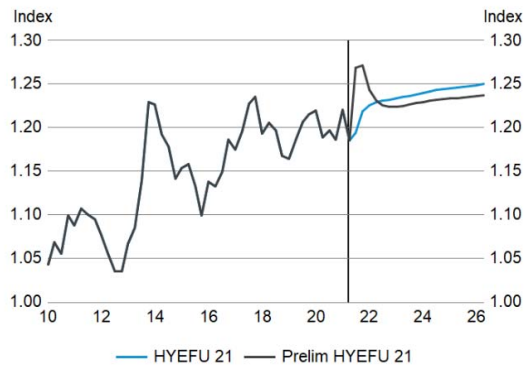
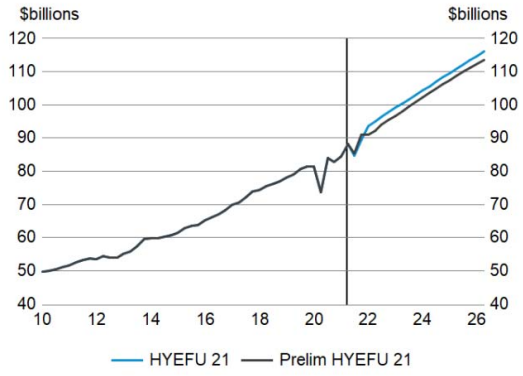


Figure 16: Nominal GDP



Higher inflation over the forecast period translates to higher nominal GDP

42. Higher inflation is the dominant driver of higher nominal GDP. **Nominal GDP is $3.1 billion above the preliminary forecasts in the year to June 2022, rising to $8-10 billion higher per annum over the 2023 to 2026 period (Figure 16). For the five-year period as a whole, nominal GDP is $38.9 billion higher than in the preliminary forecasts.** By the year to June 2024, higher nominal GDP is solely the result of higher prices in the economy.

Tax outlook

43. Higher forecasts of nominal GDP and stronger-than-anticipated tax outturns in recent months are the main drivers of increased tax revenue. **Core Crown tax revenue forecasts have increased by $9.3 billion across the five years to June 2026 compared to the preliminary tax forecasts (Table 2).**

Table 2: Estimated change in core Crown tax revenue since preliminary forecasts[1]

June years, $ billions	2022	2023	2024	2025	2026	Totals
2021 Half-year Update (prelim)	101.2	110.2	117.4	124.8	131.4	
% of GDP	28.1	28.7	28.9	29.2	29.4	
Forecasting changes by tax type:						
Corporate tax	+0.4	+1.8	+1.6	+1.5	+1.6	+6.9
Net other persons tax	-	+0.4	+0.5	+0.4	+0.4	+1.7
Source deductions	-	+0.2	+0.1	+0.3	+0.6	+1.2
Resident withholding taxes	-	+0.3	+0.3	+0.2	+0.2	+1.0
GST	+1.1	-	-0.6	-1.0	-1.1	-1.6
All other taxes	-	+0.1	-0.1	-	+0.1	+0.1
Total change	***+1.5***	***+2.8***	***+1.8***	***+1.4***	***+1.8***	***+9.3***
2021 Half-year Update Final	**102.7**	**113.0**	**119.2**	**126.2**	**133.2**	
% of GDP	28.3	28.7	28.8	29.0	29.2	

44. Most of the increase to the nominal GDP forecasts fell into operating surplus – broadly, a measure of profits in the economy – which led to increases in the forecasts of corporate tax and other persons tax.

[1] Unconsolidated tax forecasts were completed on 16 November. Core Crown tax forecasts will be finalised on 25 November.

45. The compensation of employees (COE) forecast also increased which pushed up the forecasts of source deductions. As most of the upward revision to the COE forecast was in wages rather than employment, there is also a stronger contribution from fiscal drag in the final forecast than in the preliminary forecast. A higher outlook for interest rates has increased the RWT-on-interest forecast through the forecast period.

46. **The unconsolidated forecast for GST is higher than the preliminary forecasts throughout the forecast period,** with increases to both public and private consumption forecasts outweighing a small reduction in the residential investment forecast. Aligning the forecast Crown GST eliminations with the GST on government consumption forecasts to ensure that both include the GST effects of the revised Budget allowances, however, is estimated to leave the net core Crown GST revenue forecast around $1.6 billion lower than the preliminary forecast across the forecast period.

47. **The Treasury and Inland Revenue's tax forecasts are broadly similar,** with the Treasury forecast $0.8 billion (0.1%) higher than Inland Revenue's set of forecasts over the forecast period. The main difference in the source deductions forecasts, where Treasury's forecast carries more of the current PAYE strength through the later years of the forecast period. The remaining variances in the tax forecasts are a result of differences in the modelling approaches and assumptions.

Comparison to bank forecast

48. The **Treasury's final HYEFU forecasts are generally concordant with the latest forecasts of the major domestic banks.** In line with the HYEFU 2021 forecasts, bank forecasters expect high levels of CPI inflation in the short term but believe that inflationary pressures will attenuate faster than the Treasury anticipates. The real GDP forecasts are generally situated around the upper range of the bank forecasts, with slightly higher growth over the second half of 2021 and early 2022 offset by lower growth onward to 2024. Treasury's forecasts of the unemployment rate are lower than consensus over the forecast period, reflecting both that banks are yet to incorporate the September 2021 quarter outturn and that the Treasury expects greater persistence of labour market tightness in the absence of reforms that proportionately increase labour supply.

Risks to the central forecasts

49. **There are several upside and downside risks to our central forecasts that could lead to different outcomes for the economy and, in turn, tax revenue.** We will once again communicate some of these risks with scenarios in the publication of the HYEFU 2021 document.

50. **The central forecasts assume public health restrictions to average an Amber setting in the COVID-19 Protection Framework** until 1 July 2022. Future community outbreaks of COVID-19 that necessitate the reinstatement of elevated public health restrictions will likely lead to weaker economic activity and, depending on frequency and length, could have long-term scarring effects.

51. The vaccination programme is expected to enable a full shift to the COVID-19 Protection Framework from early 2022. **If the vaccine rollout takes longer to inoculate a sufficient proportion of the population, border restrictions and public health restrictions may be lifted later than in the central forecasts. Further, if vaccines are less effective against the spread of COVID-19, then there will likely be additional long-term behavioural shifts** – such as persistent decreases in

consumption as people forego activity to prevent contracting COVID-19 – and declines in labour productivity associated with illness that will depress economic activity. Such weakening in the growth of New Zealand's trading partners would hinder services exports and put downward pressure on the exchange rate and terms of trade.

52. **Expectations about the impact of the Delta outbreak on economic activity are anchored to the experience of the 2020 lockdown period and recovery.** If this analogy is not appropriate – for instance, due to lesser pent-up demand – the economic recovery from the Delta lockdown period will likely be spread over an extended period and therefore increase the likelihood of firm failures, increase unemployment, and lower business investment. On the other hand, firms have greater certainty of the potential impact on their balance sheet so may be less likely to employ redundancy, thereby supporting a relatively faster recovery, all other things being equal.

53. **Disruptions related to supply chains are expected to continue until at least 2023.** If supply-chain disruption subsides sooner, then there will be upside risk with a reduction in cost pressures, stronger trading partner growth, and an increase to the terms of trade, vice versa.

54. Annual net migration is assumed to gradually rise from approximately 2,600 in the December 2021 quarter to be 27,700 in the June 2024 quarter and subsequently reach 40,800 by the end of the forecast period. **As part of the Immigration Rebalance work programme, limits imposed on net migration below this profile would reduce New Zealand's available labour force,** placing downward pressure on consumption and real GDP growth. Future Economic and Fiscal updates will incorporate any indicated shifts in migration policy.

Annex 1: Forecast summary tables

Table A1: Summary of economic forecasts, June years

June Years	2018	2019	2020	2021	2022 Forecast	2023 Forecast	2024 Forecast	2025 Forecast	2026 Forecast
Private consumption	4.6	4.2	-0.8	7.5	1.2	3.4	1.1	2.0	2.2
Public consumption	3.8	3.6	6.8	6.8	4.8	1.8	0.6	0.8	1.1
TOTAL CONSUMPTION	**4.4**	**4.1**	**0.9**	**7.3**	**2.1**	**3.0**	**1.0**	**1.7**	**2.0**
Residential investment	-0.1	3.7	-6.1	17.8	8.9	3.4	-2.1	-0.5	-1.1
Business investment*	12.0	3.9	-4.5	4.5	2.9	9.8	4.0	2.6	2.1
TOTAL INVESTMENT	**8.7**	**3.9**	**-4.9**	**7.8**	**4.5**	**8.0**	**2.4**	**1.8**	**1.3**
Stocks (contribution to GDP growth)	0.2	-0.5	-0.4	0.5	0.3	-0.3	0.0	-0.0	0.0
GROSS NATIONAL EXPENDITURE	**5.7**	**3.4**	**-1.0**	**7.9**	**3.1**	**4.2**	**1.3**	**1.7**	**1.8**
Exports	3.9	3.4	-5.0	-11.4	2.1	7.1	6.3	5.0	4.2
Imports	8.4	2.3	-5.9	-4.2	12.2	4.9	3.0	2.7	2.5
EXPENDITURE ON GDP	**4.6**	**3.7**	**-0.8**	**5.9**	**0.3**	**4.3**	**2.0**	**2.2**	**2.2**
GDP (PRODUCTION MEASURE)	**3.7**	**2.9**	**-1.4**	**5.1**	**0.8**	**4.9**	**2.2**	**2.3**	**2.3**
- annual % change, June quarter	3.7	2.2	-10.2	17.4	1.6	2.4	2.2	2.3	2.3
Other Output Measures									
Real Gross National Disposable Income	3.9	2.7	0.5	4.9	0.2	4.5	2.1	2.4	2.3
Nominal GDP (Expenditure Basis)	7.3	4.8	2.2	7.1	6.8	8.6	5.3	5.1	4.8
Potential GDP	2.9	2.6	-0.6	5.5	-0.3	4.6	2.6	2.7	2.7
Output gap (June qtr,% of potential)	1.3	1.0	-0.9	1.5	1.5	1.3	0.9	0.5	0.2
Total Population (thousands, mean quarter ended)	4,893	4,972	5,087	5,118	5,155	5,200	5,253	5,313	5,379
Real GDP per capita (Production basis)	1.7	1.2	-3.3	3.8	0.1	4.1	1.2	1.2	1.1
Labour Market									
Employment	3.6	2.0	1.6	0.7	3.7	0.9	0.9	1.1	1.2
Unemployment Rate (June quarter)	4.6	4.0	4.1	4.0	3.2	3.3	3.6	3.8	4.1
Labour Productivity (Hours worked basis)	-0.6	0.4	-0.2	1.6	1.6	0.4	1.4	1.2	1.1
Wages (QES average hourly ord time earnings, APC)	2.8	4.0	3.0	4.0	4.1	4.5	4.6	4.4	4.2
Monetary Conditions									
90-day Bank Bill Rate (June quarter ave)	2.0	1.7	0.3	0.3	2.0	3.2	3.1	3.1	3.1
10-year Bond Rate (June quarter ave)	2.8	1.8	0.8	1.7	2.6	2.9	3.2	3.4	3.4
TWI (June quarter ave)	73.8	72.7	69.7	74.7	77.2	78.3	78.7	78.9	78.9
- annual % change (June quarter)	-3.5	-1.5	-4.1	7.3	3.3	1.4	0.6	0.2	0.1
Price Measures									
CPI Inflation (ann % change, June quarter)	1.5	1.7	1.5	3.3	5.1	3.1	2.7	2.4	2.2
Consumption Deflator	1.3	1.6	1.9	1.4	4.5	3.5	3.2	2.8	2.6
GDP Deflator	2.6	1.1	3.0	1.1	6.5	4.1	3.2	2.8	2.5
House Price Inflation (ann % change, June qtr)	3.6	1.5	7.1	29.0	10.4	-0.2	-0.4	0.5	0.6
Key Balances									
Current account balance ($ million)	-10,219	-10,806	-4,695	-11,243	-20,879	-21,439	-20,084	-19,082	-18,470
Current account balance (% of GDP)	-3.5	-3.5	-1.5	-3.3	-5.8	-5.4	-4.8	-4.4	-4.0
Terms of Trade (goods) - SNA Basis	4.6	-3.4	4.4	-0.2	0.5	0.4	-0.4	-0.4	-0.4
Net International Investment Position (%GDP)	-52.2	-54.2	-57.2	-45.8	-48.6	-50.2	-52.5	-54.4	-55.9

* Total investment excluding residential

Table A2: Change in economic forecasts from preliminary forecasts, June years

June Years	2018	2019	2020	2021	2022 Forecast	2023 Forecast	2024 Forecast	2025 Forecast	2026 Forecast
Private consumption	0.0	0.0	0.0	0.0	0.5	-0.7	-1.5	-0.4	0.0
Public consumption	0.0	0.0	0.0	0.0	-1.4	3.0	1.5	-0.2	-0.2
TOTAL CONSUMPTION	**0.0**	0.0	0.0	0.0	0.1	0.3	-0.8	-0.4	-0.0
Residential investment	0.0	0.0	0.0	0.0	6.0	-5.5	-4.2	-0.2	1.6
Business investment*	0.0	0.0	0.0	0.0	0.3	0.3	-0.5	-0.1	0.5
TOTAL INVESTMENT	**0.0**	0.0	0.0	0.0	1.8	-1.3	-1.5	-0.1	0.8
Stocks (contribution to GDP growth)	0.0	0.0	0.0	0.0	0.7	-0.5	-0.2	-0.0	0.0
GROSS NATIONAL EXPENDITURE	**0.0**	0.0	0.0	0.0	0.5	-0.1	-1.0	-0.3	0.2
Exports	0.0	0.0	0.0	0.0	-0.6	0.5	0.3	-0.0	0.1
Imports	0.0	0.0	0.0	0.0	4.0	-1.8	-1.7	-0.5	0.3
EXPENDITURE ON GDP	**0.0**	0.0	0.0	0.0	-0.1	0.1	-0.7	-0.2	0.1
GDP (PRODUCTION MEASURE)	**0.0**	0.0	0.0	0.0	0.1	0.2	-0.6	-0.2	0.1
- annual % change, June quarter	*0.0*	0.0	0.0	0.0	1.3	-1.3	-0.5	-0.0	0.2
Other Output Measures									
Real Gross National Disposable Income	0.0	0.0	0.0	0.0	-0.9	0.9	-0.4	0.1	0.3
Nominal GDP (Expenditure Basis)	0.0	0.0	0.0	0.0	0.9	1.8	-0.4	-0.2	0.2
Potential GDP	0.0	0.0	-0.0	0.1	-0.1	-0.0	-0.0	-0.1	-0.1
Output gap (June qtr,% of potential)	-0.1	-0.1	-0.1	-0.2	0.6	0.1	-0.4	-0.4	-0.0
Total Population (thousands, mean quarter ended)	**0**	**0**	**0**	**0**	**2**	**5**	**3**	**-5**	**-13**
Real GDP per capita (Production basis)	**0.0**	**0.0**	**0.0**	**0.0**	**0.1**	**0.2**	**-0.6**	**-0.0**	**0.3**
Labour Market									
Employment	0.0	0.0	-0.0	-0.1	1.6	-0.5	-0.7	-0.3	-0.0
Unemployment Rate (June quarter)	0.0	-0.1	0.0	0.0	-0.5	-0.2	0.2	0.2	0.0
Labour Productivity (Hours worked basis)	-0.0	-0.0	0.0	0.1	0.4	-0.6	-0.0	0.1	0.0
Wages (QES average hourly ord time earnings, APC)	0.0	0.0	0.0	0.0	0.1	0.2	0.5	0.4	0.4
Unit Labour Costs (Hours worked basis)	0.0	0.0	-0.0	-0.1	-0.3	0.7	0.4	0.3	0.4
Monetary Conditions									
90-day Bank Bill Rate (June quarter ave)	0.0	0.0	0.0	0.0	0.8	1.3	0.3	-0.1	-0.2
10-year Bond Rate (June quarter ave)	0.0	0.0	0.0	0.0	0.3	0.4	0.4	0.3	0.3
TWI (June quarter ave)	0.0	0.0	0.0	0.0	0.2	1.3	1.7	1.9	1.9
- annual % change, June quarter	0.0	0.0	0.0	0.0	0.2	1.4	0.6	0.2	0.1
Price Measures									
CPI Inflation (ann % change, June quarter)	0.0	0.0	0.0	0.0	1.9	0.8	0.4	0.1	0.1
Consumption Deflator	0.0	0.0	0.0	0.0	1.5	0.9	0.4	0.1	0.0
GDP Deflator	0.0	0.0	0.0	0.0	1.0	1.6	0.2	-0.0	0.0
House Price Inflation (ann % change, June quarter)	0.0	0.0	0.0	-2.4	2.4	-6.8	-3.3	0.1	1.4
Key Balances									
Current account balance ($ million)	0	0	0	0	-6631	-3036	-672	658	920
Current account balance (% of GDP)	0.0	0.0	0.0	0.0	-1.8	-0.7	-0.1	0.2	0.3
Terms of Trade - SNA Basis	0.0	0.0	0.0	0.0	-3.8	4.5	0.3	0.1	0.1

* Total investment excluding residential

Table A3: Change in economic forecasts from BEFU 2021, June years

June Years	2018	2019	2020	2021	2022 Forecast	2023 Forecast	2024 Forecast	2025 Forecast	2026 Forecast
Private consumption	0.0	-0.1	0.1	2.5	-1.8	0.5	-1.4	-0.4	NA
Public consumption	-0.0	0.0	0.1	2.7	1.8	0.4	-0.8	-1.2	NA
TOTAL CONSUMPTION	**0.0**	-0.0	0.1	2.5	-0.9	0.5	-1.3	-0.6	NA
Residential investment	0.0	0.0	-0.1	1.8	7.2	-1.8	-4.8	-3.1	NA
Business investment*	-0.2	-0.2	0.2	3.9	-2.2	0.4	-1.1	-1.0	NA
TOTAL INVESTMENT	**-0.2**	-0.1	0.1	3.4	0.3	-0.3	-2.1	-1.6	NA
Stocks (contribution to GDP growth)	-0.0	-0.0	0.0	0.2	0.0	-0.3	0.0	-0.0	NA
GROSS NATIONAL EXPENDITURE	**-0.0**	-0.1	0.1	2.8	-0.5	0.3	-1.5	-0.8	NA
Exports	-0.1	0.2	0.6	-1.1	-4.0	0.3	0.9	0.3	NA
Imports	-0.0	-0.1	0.1	0.8	1.5	-1.1	-1.0	-0.7	NA
EXPENDITURE ON GDP	**-0.1**	0.0	0.2	1.6	-1.6	0.5	-1.1	-0.6	NA
GDP (PRODUCTION MEASURE)	**0.0**	-0.0	0.4	2.2	-2.4	0.6	-1.1	-0.6	NA
- annual % change, June quarter	*-0.0*	-0.0	1.2	4.0	-3.2	-1.3	-1.0	-0.4	NA
Other Output Measures									
Real Gross National Disposable Income	-0.0	0.0	0.3	2.0	-3.4	0.3	-1.0	-0.6	NA
Nominal GDP (Expenditure Basis)	-0.1	0.0	0.2	1.5	2.2	2.3	-0.4	-0.4	NA
Potential GDP	-0.0	-0.0	0.4	-0.3	-2.8	2.1	-0.0	-0.0	NA
Output gap (June qtr,% of potential)	-0.1	-0.1	-0.2	4.6	2.3	1.0	0.1	-0.2	NA
Total Population (thousands, mean quarter ended)	**0**	**0**	**-3**	**-8**	**-13**	**-19**	**-26**	**-34**	**NA**
Real GDP per capita (Production basis)	**0.0**	**-0.0**	**0.4**	**2.3**	**-2.3**	**0.7**	**-0.9**	**-0.4**	**NA**
Labour Market									
Employment	-0.0	0.0	-0.1	0.5	2.3	-1.5	-1.0	-0.7	NA
Unemployment Rate (June quarter)	0.1	0.0	0.1	-1.2	-1.8	-1.1	-0.5	-0.3	NA
Labour Productivity (Hours worked basis)	-0.0	-0.0	0.4	1.8	-1.0	-1.6	-0.1	0.0	NA
Wages (QES average hourly ord time earnings, APC)	-0.2	-0.4	-0.0	0.5	1.1	2.1	1.8	1.2	NA
Unit Labour Costs (Hours worked basis)	-0.2	-0.1	-0.7	-1.5	1.7	3.7	2.0	1.4	NA
Monetary Conditions									
90-day Bank Bill Rate (June quarter ave)	0.0	0.0	0.0	0.0	1.7	2.9	2.8	2.3	NA
10-year Bond Rate (June quarter ave)	0.0	0.0	0.0	-0.0	0.4	0.5	0.5	0.5	NA
TWI (June quarter ave)	0.0	0.0	0.0	0.2	2.7	3.8	4.0	3.8	NA
- annual % change, June quarter	0.0	0.0	0.0	0.3	3.3	1.4	0.3	-0.3	NA
Price Measures									
CPI Inflation (ann % change, June quarter)	0.0	0.0	0.0	1.0	3.4	1.3	0.7	0.3	NA
Consumption Deflator	-0.0	0.0	-0.0	0.2	3.0	1.4	0.7	0.3	NA
GDP Deflator	-0.0	0.0	-0.0	-0.1	3.8	1.7	0.6	0.2	NA
House Price Inflation (ann % change, June quarter)	0.0	0.0	0.3	11.8	9.4	-2.3	-2.5	-2.0	NA
Key Balances									
Current account balance ($ million)	458	830	982	-2247	-9054	-8476	-6981	-6196	NA
Current account balance (% of GDP)	0.2	0.3	0.3	-0.6	-2.4	-2.0	-1.5	-1.3	NA
Terms of Trade - SNA Basis	-0.0	0.1	-0.2	-0.5	-0.5	1.3	-0.0	-0.1	NA

* Total investment excluding residential

Executive Leadership Team

Proposal Paper

Proposal Title: Discussion of New Zealand's medium- to longer-term economic strategy

Date: 23 November 2021

Prepared by: Chris Thompson (Economic Strategy Team)

ELT Sponsor: Bryan Chapple

Team Attending: Economic Strategy Team

Attachments: 10 November DEV paper: Progressing the economic recovery and rebuild: Opportunities for industry policy
10 November DEV minute
Aide Memoire – Talking points: DEV item on progressing the economic recovery and rebuild

Purpose

This memo provides background information to support an ELT discussion on New Zealand's medium- to longer-term economic strategy.

ELT is receiving this paper, because ELT is:

Responsible: ☐ **A**ccountable: **X** to be **C**onsulted: ☐ to be **I**nformed: ☐

Decisions

The decisions we are seeking from ELT are as follows:

1. **NOTE** the contents of this memo.

Background and context

The Treasury's prioritisation of work on the response to the COVID-19 resurgence has shifted analytic resources away from work on economic strategy.

On 10 November, DEV considered a paper on progressing the economic recovery and rebuild (attached, along with supporting memo). The commissioning for this paper came from the Minister of Finance. In sum, DEV:

- agreed a focus on advancing a **high wage, low emissions** economy;
- agreed that the government should play a more **active and strategic role in collaborating with the private sector**; and

- noted that there is scope to better **align and improve the coherence of policy levers** to drive further progress toward the government's goals.

DEV also agreed to the following principles for developing proposals to support industry innovation, transformation and transition for Budget 2022 and beyond:

- alignment with the emissions reduction goals;
- alignment with the goal of lifting value and wages;
- alignment with other strategies and government programmes;
- target a specific problem or issue;
- maximise the opportunity to enable Māori and Pasifika to lift the value of their businesses and sectors;
- maximise the opportunity for transformation;
- funding in support of specific investments should generally be time limited, unless there are compelling policy reasons to the contrary; and
- clear measures of success and evaluation.

The Office of the Minister of Finance indicated it would make use of the principles above in its feedback on DEV papers.

DEV also directed the Treasury and MBIE to identify further opportunities to improve the coherence of the government's approach and noted that the Minister of Finance intends to report back to DEV in early 2022 on this issue.

The current landscape of broader industry policy is cluttered, and a large number of significant and interconnected work programmes are in train. Other agencies have advocated for establishing a more well-defined longer-term (e.g. 2050) vision and overarching strategy for agencies and industries to coalesce around. s9(2)(f)(iv) [redacted]

While the Cabinet paper identifies productivity and emissions reduction as cross-government focus areas, our view is that how we build a more resilient post-COVID-19 economy should also be central to the economic strategy moving forward. Supply chain disruptions, geo-political tensions and the implications of the pandemic for how we think about international connections all have the potential to adversely impact New Zealand's wellbeing over the longer term.

Next steps

Cabinet paper report back

The Economic Strategy Team has reached out to MBIE to collaborate on work leading to the early 2022 report back to DEV. The scope of this work will need to be tested with the Minister. However, possible areas of focus could include:

s9(2)(f)(iv) [redacted]

s9(2)(f)(iv)

This work should be cognisant of the evolving COVID-19 context. This means integrating our work with shorter-term work related to the COVID-19 response, such as border strategy, economic supports and the public health response.

Progressing the Treasury's Stewardship role on Economic Strategy

In addition, the Economic Strategy Team is currently developing an internal issues paper that seeks to build consensus on the composition and nature of New Zealand's economy, as well as on how we should conceptualise and measure 'good economic performance'. Much of this work involves refining and updating analytical work undertaken in 2019 and 2020 (the 'narrative' work), and focuses on issues that are not being investigated elsewhere in the Treasury.

As above, this analysis will need to consider the long-term impact of COVID-19 on the nature of New Zealand's economy.

This analysis will be integrated into other priority work (e.g. on climate change and distribution), and will provide an updated foundation for the policy advice the Treasury provides to this and future Governments.

TE TAI ŌHANGA
THE TREASURY

Treasury Report: Updating Assumptions and Other Information About the 2021 Half Year Update Fiscal Strategy Model

Date:	2 December 2021	**Report No:**	T2021/3046
		File Number:	MC-1-5-2-2022

Action sought

	Action sought	Deadline
Minister of Finance Hon Grant Robertson	**Agree** to publish the Fiscal Strategy Model online alongside the 2022 Budget Policy Statement. **Agree** to the proposed allowance assumptions in the Fiscal Strategy Model. **Note** that the Treasury has updated some long-term tax and economic assumptions in the Fiscal Strategy Model.	7 December 2021

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Matthew Bell	Senior Analyst, Modelling and Research	s9(2)(k)	N/A (mob)	✓
Peter Gardiner	Manager, Modelling and Research		s9(2)(g)(ii)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Treasury Report: Updating Assumptions and Other Information About the 2021 Half Year Update Fiscal Strategy Model

Executive Summary

This report seeks your agreement to publish the 2021 Half Year Economic and Fiscal Update (HYEFU) version of the Fiscal Strategy Model (FSM) online alongside the 2022 Budget Policy Statement (BPS) and other material related to the 2021 HYEFU. It also seeks a decision on the operating and capital allowance assumptions to be applied in the model over the post-forecast projected years. These allowance assumptions should reflect your long-term fiscal strategy.

Operating and capital allowances, and their growth rates, are the principal policy assumptions in the FSM you can adjust to meet your desired long-term fiscal strategy. We recommend:

- assuming a **2% per annum growth rate of allowances** (as a proxy for inflation) in the projection period (this is unchanged from the 2021 Budget version of the FSM).
- assuming new **capital allowances of $6.0 billion** per year from 2026/27 (this is a $2.0 billion increase from the 2021 Budget version of the FSM).
- assuming new **operating allowances of $2.7 billion** per year from 2026/27 (this is a $0.7 billion increase from the 2021 Budget version of the FSM).

Given the improved fiscal and economic outlook, particularly in regard to significant increases in tax outturns and forecasts, there is space to make these increases to the allowances in the projection period while meeting your current long-term objectives for fiscal policy. We can work with your office to consider different allowance assumptions if you wish.

Under these recommended allowance settings and modified assumptions, net core Crown debt is projected to be 14.8% of GDP and total Crown OBEGAL is projected to be in a surplus of 0.5% of GDP by the end of the decade-long projection period (2035/36).[1] This is based on the HYEFU 2021 economic and fiscal forecasts as the base of the projections (with allowance settings in the forecast period as agreed by Budget Ministers in November 2021), and these updated economic and tax assumptions in the FSM.

This report also outlines changes made to two assumptions used in the projection logic of the FSM. These changes were made to reflect the influence of updated data outturns and analysis on the potential outlook for the government 10-year bond rate. For the 2021 HYEFU version of the FSM, we are:

- Revising down the transition path for tax revenue categories to reach their assumed long-run percentages of GDP in projected years from 0.5 percentage points (ppt) of GDP per year to 0.2 ppt per year, mainly because the end-of-forecast value for total Crown tax revenue of 29.3% of GDP is significantly higher than the long-run assumption of 27.4% of GDP. A slower transition to the long-run assumption produces what appears to be a more likely path for tax relative to GDP. If you would like to retain the tax transition rate of 0.5 ppt of GDP per year used in the 2021 Budget version of the FSM, it would mean running smaller projected operating allowances than those recommended above (that is, $2.7 billion growing at 2% per annum) to achieve OBEGAL surpluses in all projected years.
- Revising the long-term assumption for the 10-year government bond nominal annual rate down from 4.8%, as was applied in the 2021 Budget version of the FSM, to 4.3%, in line

[1] Throughout this report we have used the standard definition of net core Crown debt, rather than the measure that looks through the impact of Funding for Lending Programme advances in the forecast period.

with the recommendations in the background paper to the 2021 Long-Term Fiscal Statement, *Long-term projections of the New Zealand Government's interest rate*.

We seek your decisions on this report by Tuesday 7 December in order to finalise the HYEFU FSM, which will be published online on Wednesday 15 December.

Recommended Action

We recommend that you:

a **agree** to publish the Fiscal Strategy Model (FSM) online alongside the 2022 Budget Policy Statement and other material related to the 2021 Half Year Economic and Fiscal Update

Agree/disagree.

b **agree** to set the allowance assumptions in the FSM as follows:

i. operating allowance of $2.7 billion for Budget 2026 growing at 2% per year (relative to $2.0 billion assumption in the 2021 Budget version of the FSM)

Agree/disagree.

ii. capital allowance of $6 billion for Budget 2026 growing at 2% per year (relative to $4 billion assumption in the 2021 Budget version of the FSM)

Agree/disagree.

c **Indicate** if you or your advisors would like to discuss with the Treasury other potential combinations of projected operating and/or capital allowances

Agree/disagree.

d **note** that the Treasury has updated some long-term tax and economic assumptions in the Fiscal Strategy Model.

Peter Gardiner
Manager, Modelling and Research

Hon Grant Robertson
Minister of Finance

Treasury Report: Updating Assumptions and Other Information About the 2021 Half Year Update Fiscal Strategy Model

Purpose of Report

1. This report seeks your agreement to publish the 2021 Half Year Economic and Fiscal Update (HYEFU) version of the Fiscal Strategy Model (FSM) online alongside the 2022 Budget Policy Statement (BPS) and other material related to the 2021 HYEFU. It also seeks a decision on the operating and capital allowance assumptions used in the model. These allowance assumptions should reflect your long-term fiscal strategy.

2. This report also outlines changes made to two assumptions used in the projections of the FSM, namely the transition rate used in bringing tax revenue categories to their long-run stable percentages of GDP and the long-run stable assumption for the nominal annual return rate on the government 10-year bond. These changes were made to reflect the influence of updated data outturns and a research project on the potential outlook for the government 10-year bond rate.

Background

3. The Public Finance Act (PFA) requires the Government to publish medium-term projections as part of the Fiscal Strategy Report at each Budget. The Treasury uses the FSM to produce these decade-long projections of key fiscal variables, which show likely future progress against your long-term fiscal objectives. Although not a legal requirement, the established practice has been to publish the FSM alongside the BPS to illustrate the Government's long-term fiscal strategy.

4. Your long-term objectives for fiscal policy, as stated in the Fiscal Strategy section of the Wellbeing Budget 2021 are to[2]:

   i. Stabilise net core Crown debt as a percentage of GDP by the mid-2020s and then reduce it as conditions permit (subject to any significant shocks).

   ii. Run an operating balance consistent with meeting the long-term debt objective.

5. You are achieving these objectives within the forecast period of the 2021 HYEFU. Based on the allowance settings agreed by the Budget Ministers last month, net core Crown debt is forecast to peak at 40.1% of GDP in 2022/23 before falling to 30.2% of GDP by the end of the forecast period (2025/26). Total Crown operating balance before gains and losses (OBEGAL) is forecast to go into surplus in 2023/24 and reach $8.2 billion, or 1.8% of GDP, by the final forecast year.

6. Beyond the forecast period there are two principal policy assumptions in the Fiscal Strategy Model which you can adjust to meet your desired long-term fiscal strategy:

   - **Operating allowances**, reflecting yearly growth in ongoing operating expenditure. These have the largest impact on total Crown operating balance before gains and losses (OBEGAL) and net core Crown debt.
   - **Capital allowances**, reflecting one-off yearly expenditure on capital. These affect net core Crown debt but have minimal impact on total Crown OBEGAL.

[2] We will provide advice in the coming months on a new set of long-term objectives and short-term intentions to announce at the 2022 Budget. This will be signalled in the Budget Policy Statement 2022.

7. The next section presents options for projected operating and capital allowances. These options are based on operating allowances that are as close as possible to those used in the final two forecast years of $3 billion, and are therefore likely to be realistic, **while maintaining OBEGAL surpluses over the projected years**. Capital allowances are based on different rates of decline of net core Crown debt to GDP, while still ensuring the projected capital allowances are at levels that could realistically be spent annually in these future years.

Options for Projected Operating and Capital Allowances

8. In all scenarios we have assumed a 2% growth rate of allowances (indexed to inflation). This is unchanged from the assumption in the 2021 Budget version of the FSM. Table 1 presents four alternative options for the operating allowance that are consistent with your fiscal strategy.

Table 1 – Options on operating allowance and their fiscal impact

	Assumption		Fiscal impact		
	Initial operating allowance (in 2025/26)	Initial capital allowance (in 2025/26)	Net debt in 2035/36 (% GDP)	Total Crown OBEGAL in 2035/36 (% GDP)	Core Crown Expenses in 2035/36 (% GDP)
Option 1	$3.0bn	$6.0bn	17.8%	~0.1%	29.3%
Option 2	$3.0bn	$3.9bn	13.7%	0.1%	29.2%
Option 3	$2.8bn	$5.0bn	13.9%	0.4%	28.9%
Option 4 (recommended)	$2.7bn	$6.0bn	14.8%	0.5%	28.7%
Budget 2021 settings	$2.0bn	$4.0bn	27.8% in 2034/35	0.2% in 2034/35	28.0% in 2034/35

9. **We recommend Option 4 in Table 1, which has starting projected operating allowances of $2.7 billion per year, accompanied by capital allowances of $6.0 billion per year,** in both cases growing at 2% per year in later projected years. This remains consistent with your fiscal strategy, allows more funding to deal with future cost pressures, and ensures adequate and realistic capital funding to allow projects in the capital pipeline to proceed smoothly. Under these allowance settings total Crown OBEGAL is projected to be in a surplus of 0.5% of GDP by 2035/36 (the end of the projection period) as shown in Figure 1, while net core Crown debt is projected to be 14.8% of GDP in 2035/36, as shown in Figure 2.

10. However, if you wish to keep net core Crown debt to GDP at a level closer to 20% of GDP over the projections and are willing to have total Crown OBEGAL show a slight deficit in only the very final year of projections (of ~$0.7 billion or ~0.1% of GDP) then the better option would be Option 1. This applies starting projected operating and capital allowances of $3.0 billion and $6.0 billion per year respectively, both growing at 2% per year after that.

11. Options 2 and 3 present some alternative combinations of operating and capital allowances which continue to achieve an OBEGAL surplus over all projected years. Compared to our recommended Option 4, they use higher operating allowances and lower capital allowances.

12. We can work with you and your office to illustrate different operating and/or capital allowance assumptions for projected years if you wish. We do not recommend, given cost pressures, going substantially lower than the $2.7 billion starting projected operating allowance in our recommended option. This would likely leave limited space for any new spending other than cost pressures in future Budgets. We also do not recommend opting for a starting projected capital allowance significantly above the $6 billion in our recommended option, as this would risk being higher than what could realistically be spent within a given year.

Figure 1 – Total Crown operating balance before gains and losses (OBEGAL) as a percentage of GDP for different options of operating and capital allowances

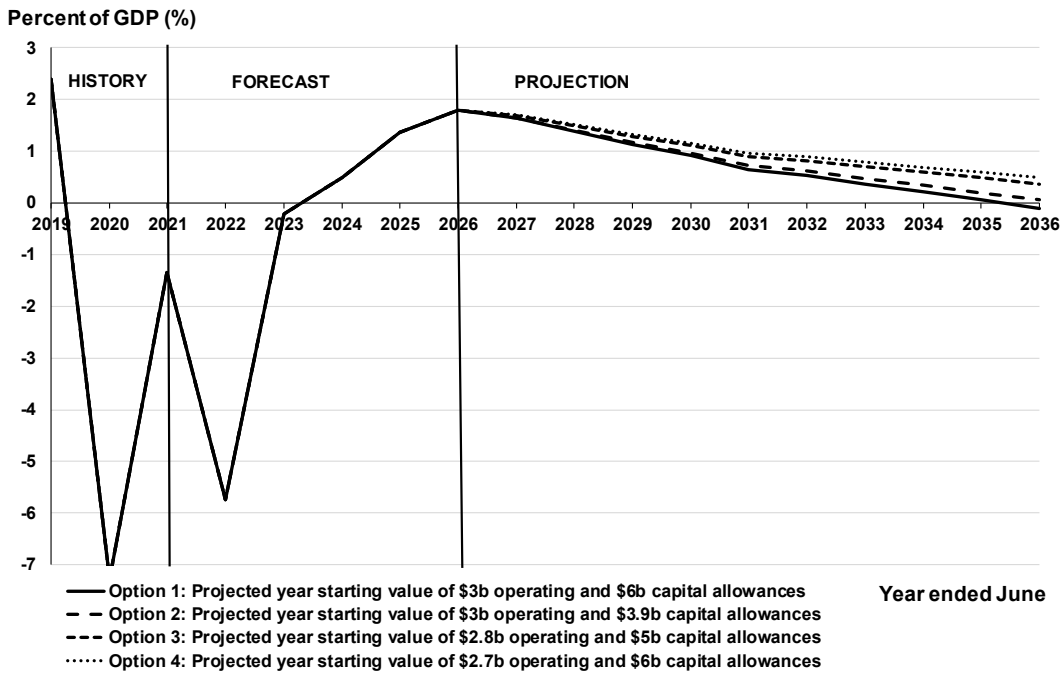
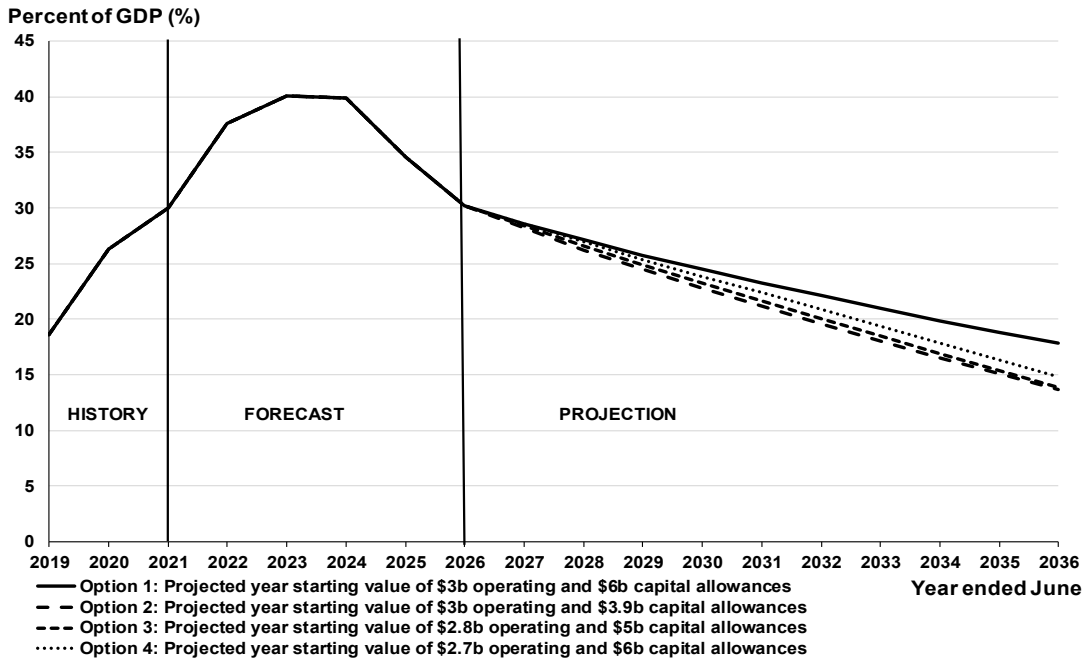


Figure 2 – Net core Crown debt as a percentage of GDP for different options of operating and capital allowances



13. Were you to stay with your 2021 Budget assumptions of starting projected operating and capital allowances of $2.0 billion and $4.0 billion respectively, both growing at 2% per year, by 2035/36 total Crown OBEGAL would be at 2.0% of GDP, while net core Crown debt would be reduced to 3.9% of GDP.

14. The policy options and the fiscal projections presented above are based on:

- The economic and fiscal forecast base published in the 2021 HYEFU.
- A reduced transition rate to long-term stable percentages of GDP for the tax revenue categories in the FSM..
- A reduced assumption for the long-run stable nominal annual rate of return for the government 10-year bond rate of 4.3%.
- These last two changes are discussed in the next section.

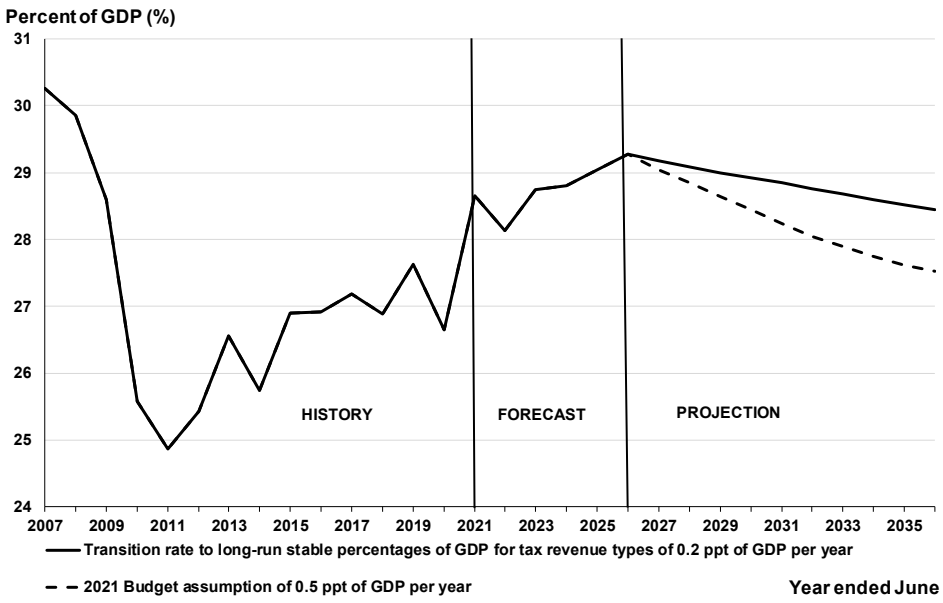
Changes to Long-Term Tax and Economic Assumptions

15. The FSM uses numerous assumptions about economic and fiscal variables to produce medium-term projections of key fiscal indicators. Two main changes have been made to key assumptions since the 2021 Budget version of the FSM was published.

16. The first assumption change relates to the rate at which the tax revenue categories in the FSM move from their end-of-forecast percentages of GDP towards the levels we have assumed for their long-run stable percentages of GDP. This transition rate has been reduced from 0.5 percentage points (ppt) of GDP per year to 0.2 ppt per year. The reason for lowering the transition rate is because, at an end-of-forecast value for total Crown tax revenue of 29.3% of GDP, a decline over the projection years to 27.5% of GDP by 2035/36 does not appear very likely.

17. As Figure 3 illustrates, with the exception of temporary dips in the tax-to-GDP percentage, the general pattern of this measure has been a rising trend between 2010/11 (when personal tax cuts reduced the percentage) and 2020/21, and this increasing trend carries on into the 2021 HYEFU forecast years.

Figure 3 – Total Crown tax revenue as percentage of GDP – the proposed new transition rate of 0.2 ppt per year compared to original 0.5 ppt per year



18. The long-run stable assumption for total Crown tax revenue to GDP is 27.4% of GDP, which was based on historical averages between 2006/07 and 2019/20. In 2020/21 alone the percentage lifted by 2 ppt of GDP. Even if the 2021 Budget version of the FSM's transition rate of 0.5 ppt of GDP per year were retained, the long-run stable assumption still would not be attained by the end of the decade-long projection period.

19. Given the strength of the 2021 HYEFU tax forecasts and recent historic trends, rapidly reducing tax-to-GDP does not appear particularly credible over the projection years.

20. To address this issue in the short amount of time before publication of the 2021 HYEFU, we advise that the best option is to not change any assumptions around the long-run stable percentages of GDP, but rather to simply reduce the transition rate to 0.2 ppt of GDP per year so that the reduction in tax revenue-to-GDP over the projected years is far more gradual.

21. Between now and the publication of the Treasury's 2022 Budget version of the FSM, more work will be done on refining the tax projection logic, including re-estimating historical averages of percentages of GDP for the five main tax categories used in the FSM, as well as for overall tax revenue-to-GDP. We will also consult with you on options about re-introducing fiscal drag modelling back into the FSM for source deductions tax revenue, as well as developing a tax projection logic that may better reflect your desired policies around the levels of future tax to GDP.

22. The other main modelling change is a reduction in the long-run stable assumption for the nominal annual return rate on the government 10-year bond. This has been reduced from the 4.8% value used in the 2021 Budget version of the FSM to 4.3%. One reason for lowering this assumption is to reflect the fact that long-term global trends, such as ageing population structures in the advanced economies and decreasing productivity growth, mean that interest rates are unlikely to rise to the levels seen before the global financial crisis significantly lowered them, although they will probably gradually lift from the current low rates (in fact this gradual increase has probably already begun). Another reason is to bring the assumption more into line with the projections of other international finance agencies, as well as those of New Zealand institutions like the New Zealand Superannuation Fund.

23. More detail about this change can be found in the background paper for the 2021 Statement on the Long-term Fiscal Position Long-term projections of the New Zealand Government's interest rate.[3]

Next Steps

24. The Treasury can work with you and your office to set alternative allowances, for either operating or capital or both, in the projections should you wish to investigate different options.

25. Your decision on the operating and capital allowances will be built in to the 2021 HYEFU version of the FSM, which will be published alongside the 2022 Budget Policy Statement (BPS) and other material related to the 2021 HYEFU on the Treasury website. Therefore, you should provide the Treasury with your decisions by **Tuesday 7 December 2021**.

[3] This paper can be sourced at: https://www.treasury.govt.nz/publications/background/ltfs21-bg-long-term-projections-nz-governments-interest-rate