THE TREASURY
Kaitohutohu Kaupapa Rawa

New Zealand Economic Outlook

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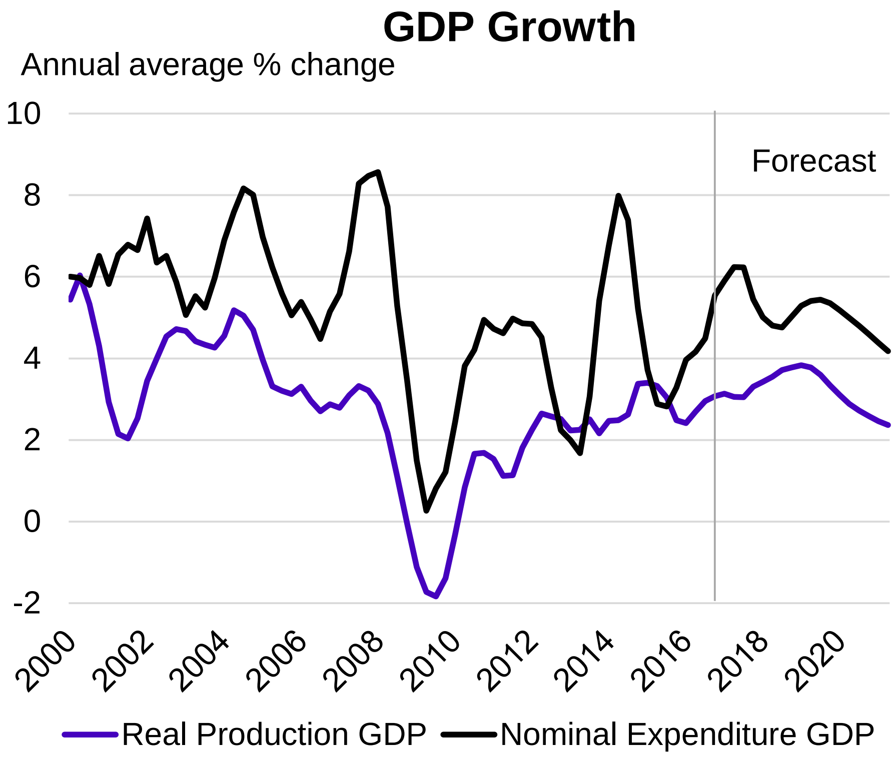
June 2017

Economic Outlook – Overview

The New Zealand economy is forecast to expand at a solid pace over the next five years…

- With real GDP growth around 3% in 2017:
  - underpinned by ***high net migration inflows*** and ***low interest rates,*** which support private consumption and investment
  - ***elevated tourist numbers*** support services exports. Goods exports recover alongside the dairy sector
- Growth accelerates to a peak of 3.8% in 2019 as:
  - the above drivers of growth persist
  - ***strong demand for housing*** continues as temporary factors restraining growth in residential investment subside
  - the ***Family Incomes Package*** supports private consumption
- Growth eases to a more sustainable pace (around 2.5%) by 2021



As spare capacity in the economy is absorbed, inflationary pressures build, interest rates rise and the unemployment rate approaches its long run rate of 4.25%

Solid real growth, along with rising inflation and the terms of trade remaining elevated, support nominal GDP, tax revenues and a steadily improving fiscal position

International Outlook

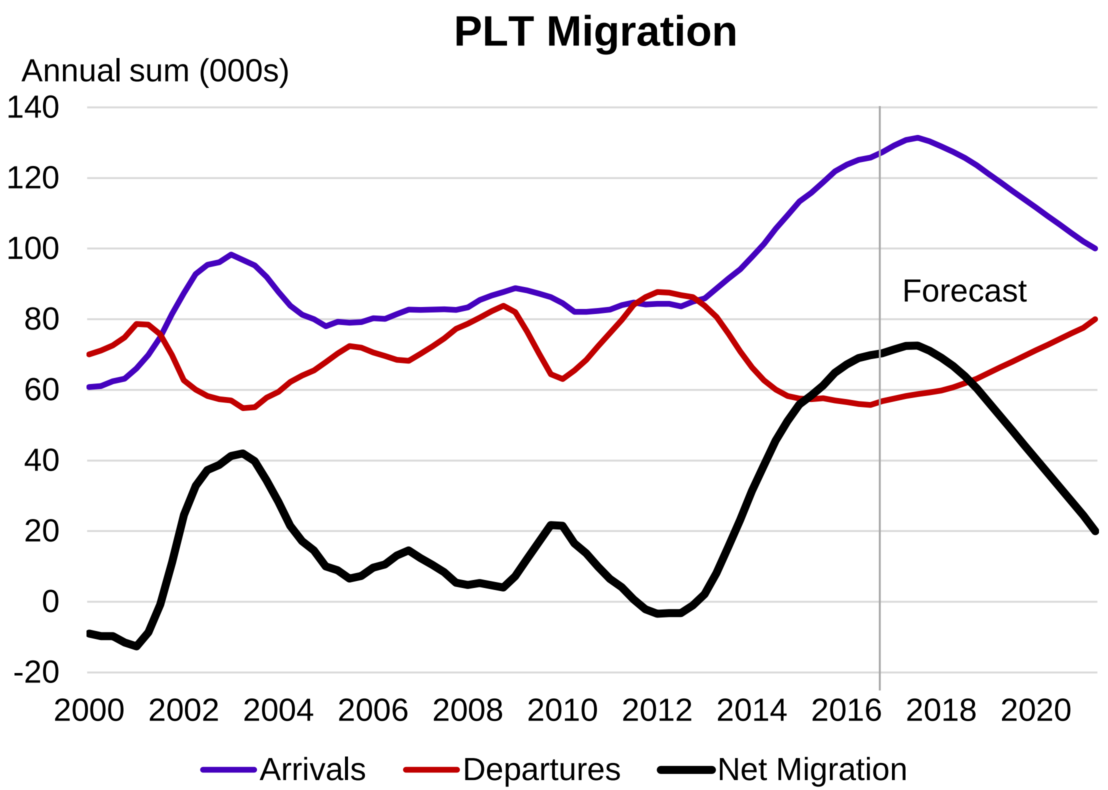
- Stable outlook for trading partner growth, but many risks
- The Australian economy continues to transit from mining investment towards other drivers of growth
- Growth in China continues to slow as the economy shifts from investment-led growth towards consumption
- Momentum in the US persists into the near term, but there is heightened uncertainty around the medium-term outlook
- Growth in the UK expected to weaken on Brexit
  - uncertainty constrains investor appetite
  - higher inflation (from the weaker pound) erodes purchasing power, dragging on consumption
- Growth in the euro area and Japan remains moderate with monetary policy remaining highly stimulatory

Net migration inflows support domestic demand…

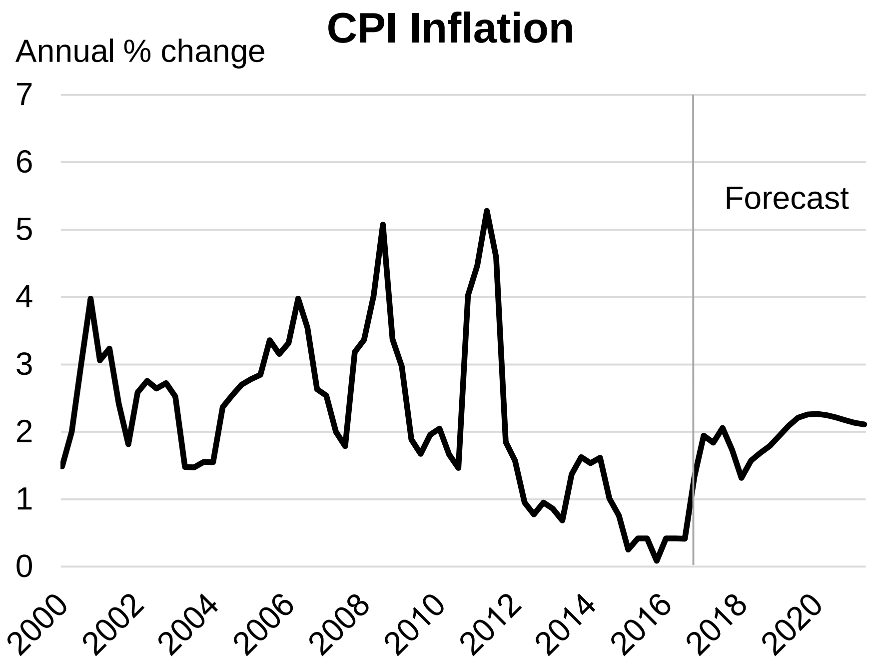
- Reflecting relatively favourable economic conditions in New Zealand, net inward migration is currently at record levels of around 72,000 per annum

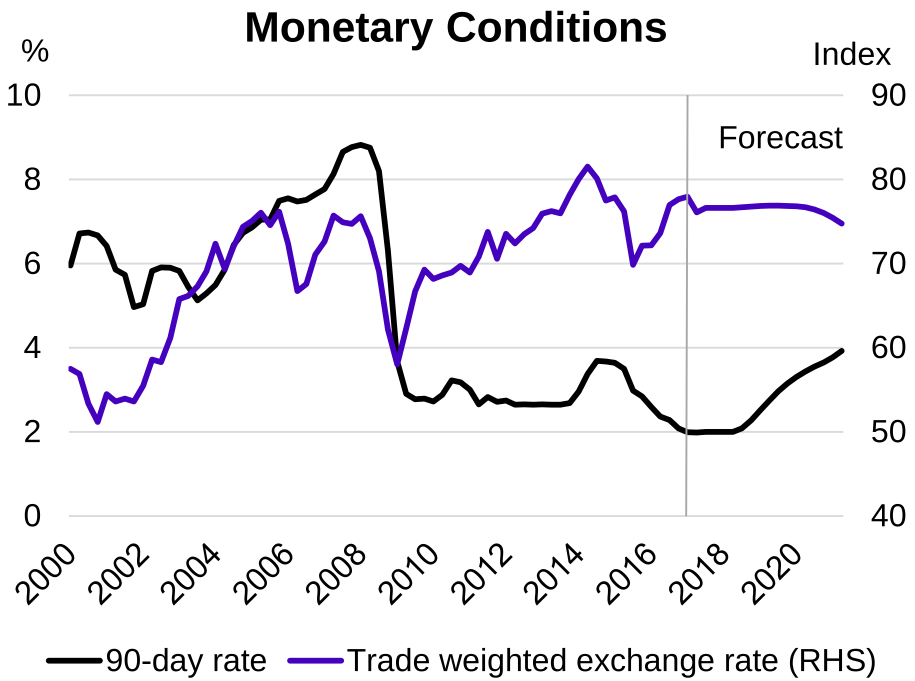
- Net migration is assumed to decline gradually over the forecast period as the real wage differential between New Zealand and Australia returns trans-Tasman flows to a net outflow and as non citizen arrivals ease

- Net migration adds 212,000 people to the population over the forecast period
    - increasing the productive capacity in the economy through increased labour supply
    - supporting investment
    - boosting demand for goods and services



…along with low interest rates

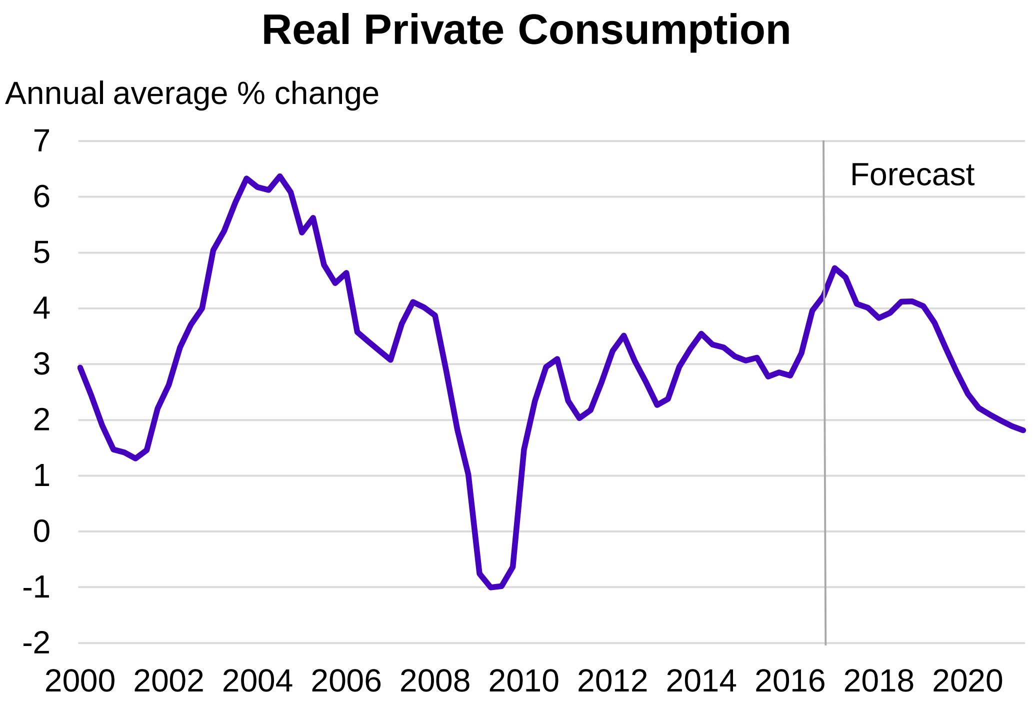




- Annual inflation was above 2% in the 2017 March quarter, boosted by previous oil price declines dropping out of the annual calculation and unseasonally-high food prices (on bad weather)
- These *transitory* impacts drop out in a year, but underlying inflationary pressures continue to build

- Interest rates are assumed to remain low for some time, increasing from late 2018 in response to increasing inflationary pressures
- The exchange rate is assumed to remain broadly stable

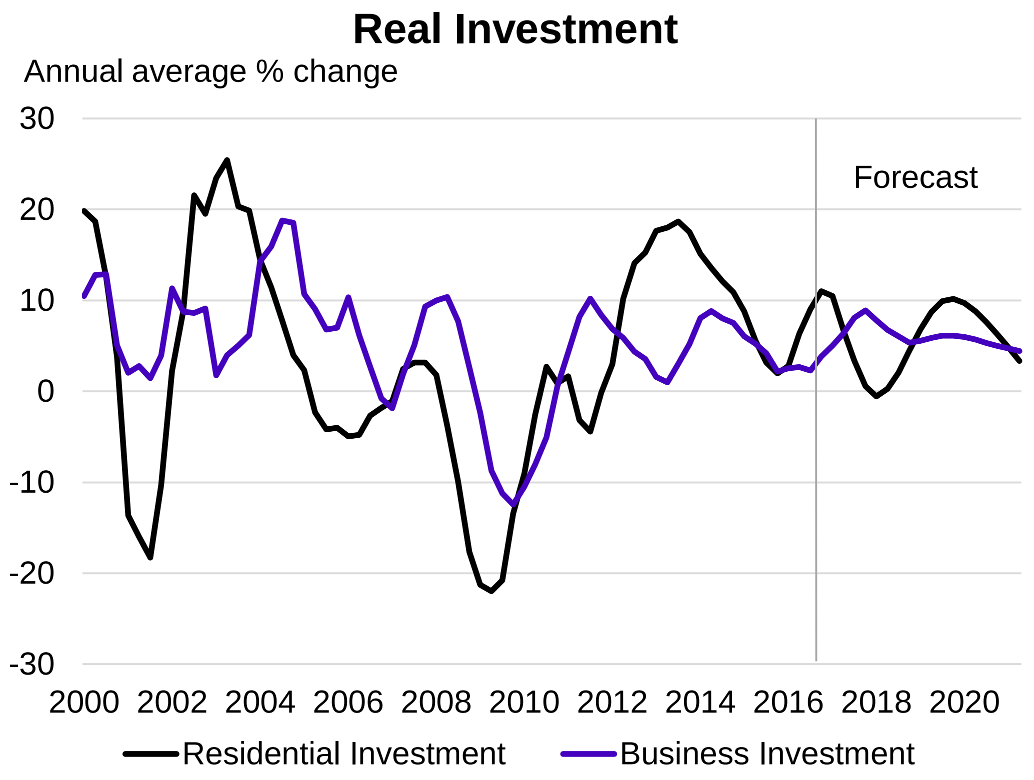
Household consumption continues to grow at a solid pace



- Consumption growth eases later in the forecast period as population growth slows and interest rates rise

- Strong consumption growth in the near term reflects recent momentum and population growth
- Low interest rates support consumption, particularly for durable goods
- The Family Incomes Package is forecast to commence on 1 April 2018
  - households expected to spend the majority of the tax cut on consumption
  - impact on labour supply broadly neutral
  - stronger demand supports employment growth
  - modest contribution to inflationary pressures

Investment underpinned by strong fundamentals



- Business investment picks up in response to solid demand for goods and services (driven by population growth) and to accommodate expansion in the workforce

- Strong fundamentals continue to underpin demand in the housing and construction sectors, including:
  - population growth
  - high tourist numbers
  - low interest rates

- However, capacity constraints push construction costs higher, limiting the supply response

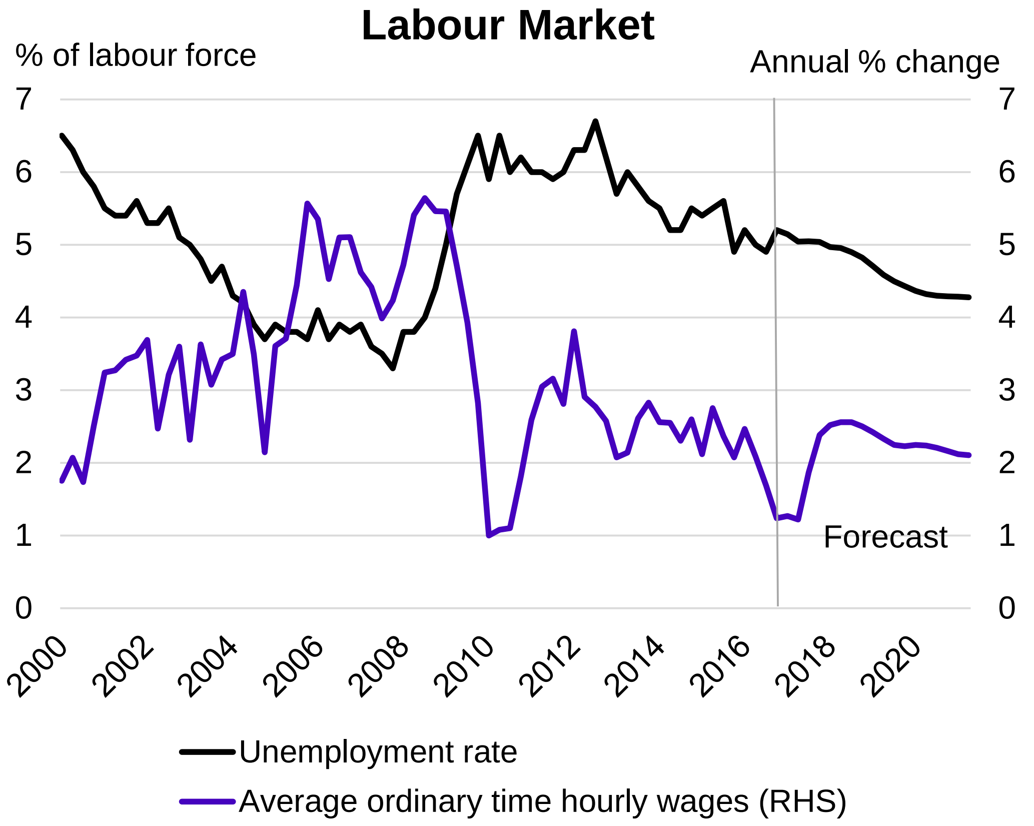
- Residential investment is expected to slow in the near term reflecting the impact of tighter LVR restrictions and uncertainty around the Auckland Unitary Plan

- But picks up again as these temporary factors subside

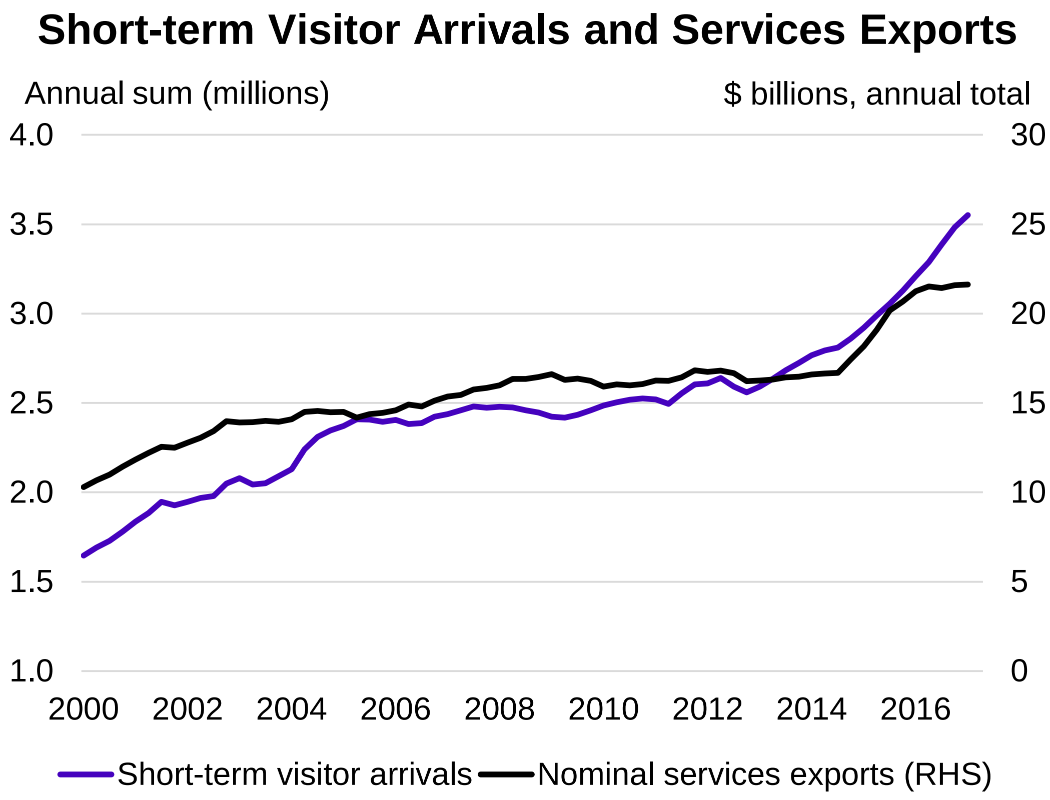
- Overall, house price growth moderates over the forecast period, but picks up for a brief period as residential investment growth slows

Labour market tightens, but wage growth modest

- Solid population growth adds to the size of the labour force (and to the degree of spare capacity in the economy)
- Strong employment growth outpaces growth in the labour force and the unemployment rate gradually declines
- Wage growth is expected to pick up in the near term, recovering from recent weakness and, in part, reflecting the impact of higher inflation on wage negotiations
- Overall, wage growth is relatively modest owing to strong labour supply and the fact that much of the jobs growth is in the services sector



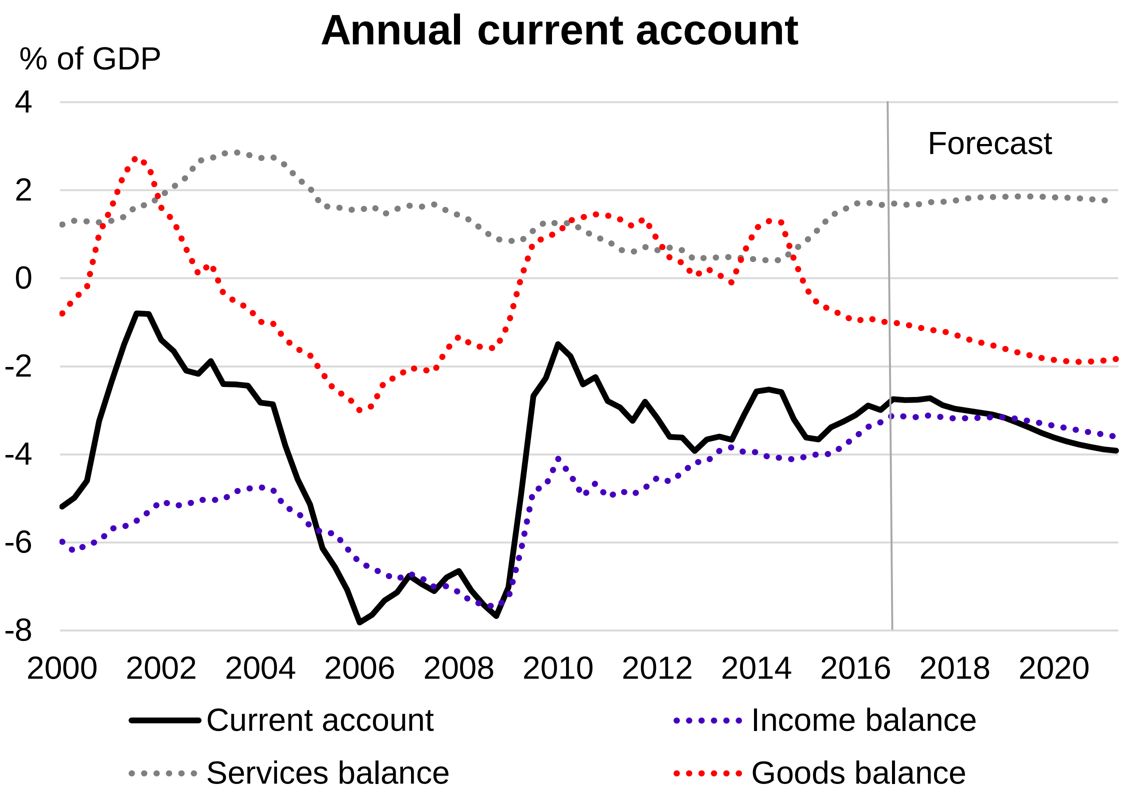
Tourism remains strong



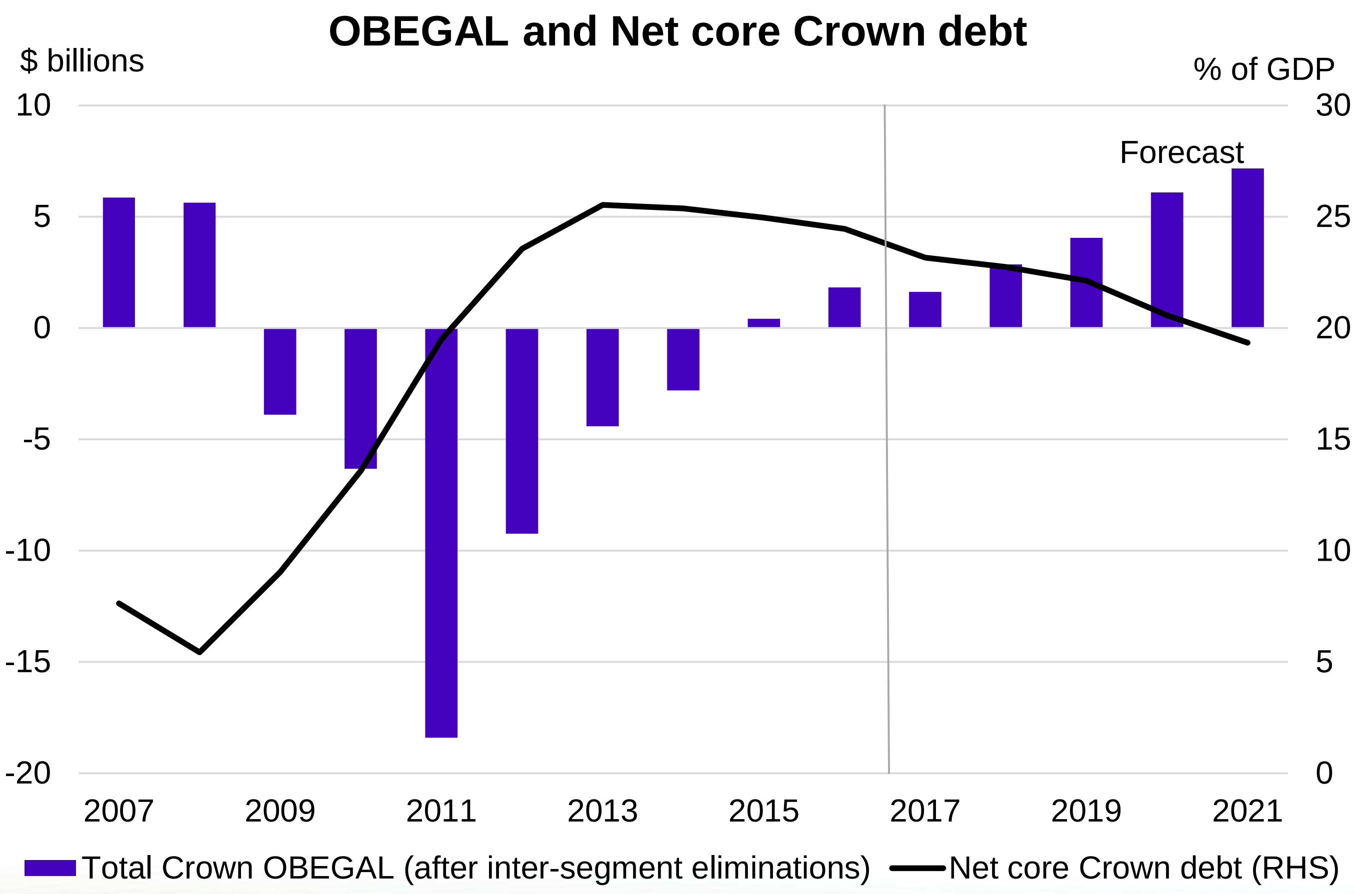
- Short-term visitor arrivals are at record levels – 3.6 million people in the year to April 2017
- Growth in arrivals has been strong from China, Australia and the US
- Tourism accounts for around 20% of total export earnings and 60% of services exports
- Over 7% of people employed in New Zealand work in the tourism industry
- Tourism is expected to remain strong over the forecast period, reflecting:
  - structural change in China
  - retiring baby boomers in the US
  - rising incomes, especially in emerging economies
  - relatively low travel costs (on oil prices)

Exports recover, but current account deficit widens

- The current account deficit is forecast to widen
- The income deficit widens owing to rising interest rates
- The services surplus holds up, reflecting buoyant tourism
- The goods deficit widens as strong domestic demand drives stronger growth in imports relative to exports
- However, goods exports pick up
  - Dairy is poised to grow strongly following two very hard seasons for farmers
  - Forestry exports supported by a strong housing market in China
  - Horticulture and viticulture continue to do well



The fiscal outlook continues to improve



Summary

- The New Zealand economy is forecast to expand at a solid pace, underpinned by:
  - high net migration inflows
  - strong visitor arrivals
  - low interest rates
  - higher disposable incomes owing to the Family Incomes Package
- The combination of solid real activity and rising prices support growth in nominal GDP…
- …supporting tax revenues and rising OBEGAL surpluses over the forecast period