THE TREASURY
Kaitohutohu Kaupapa Rawa

New Zealand Economic Outlook

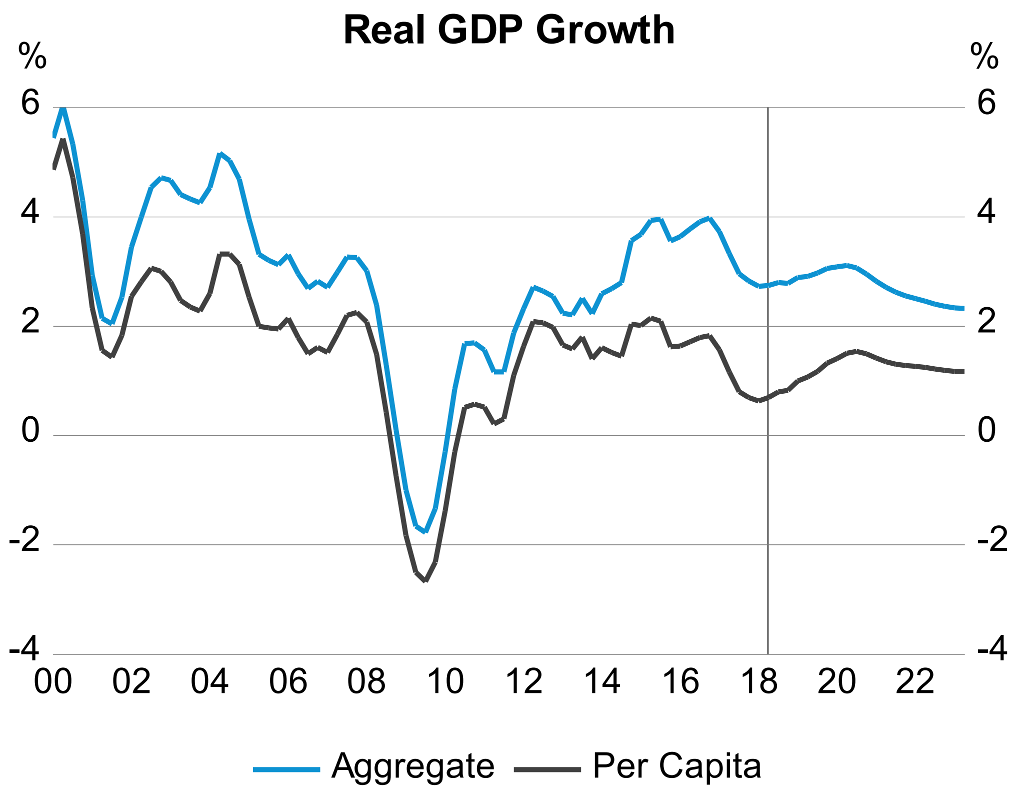
2019 Audit New Zealand Conferences

Key messages

- The economy is expected to expand at a pace that is close to trend, supported by **migration-led population growth**, **government spending**, **accommodative monetary policy**.
- OBEGAL **surpluses expected to rise** over the forecast period
- There are risks to the outlook:
  - The international outlook is softening
  - And the domestic demand looks to be cooling

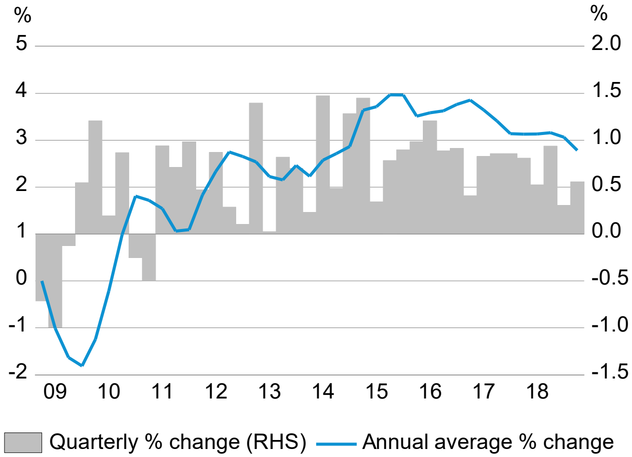
Economic outlook – overview (HYEFU)

- The economy continues to expand at a pace that is close to trend, supported by migration-led population growth, government spending, accommodative monetary policy and solid growth abroad.
- Nominal GDP growth is supported by a rising terms of trade, inflation around 2%, and government labour market policies.
- Wage growth is forecast to accelerate owing to a tight labour market, higher inflation compared with recent years and a range of labour market policies.
- Inflation is close to the mid-point of the Reserve Bank’s target but interest rates are expected to remain on hold for some time.
- Economic data and developments since finalisation of the *Half Year Economic and Fiscal Update* point to higher growth in recent history but weaker short term momentum in the economy.
- International risks remain skewed to the downside but domestic risks are more balanced.

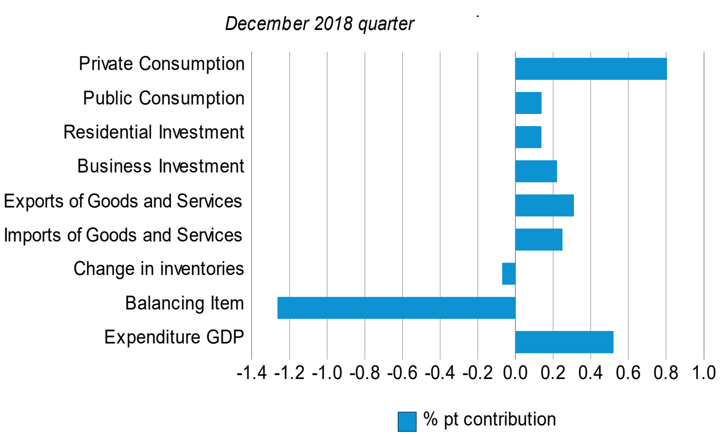


Domestic developments

Production GDP



Q4 real expenditure growth



Solid but not spectacular…

December 2018 quarter real production GDP growth of 0.6% was slightly weaker than forecast (0.7%) but in line with broader mkt expectations.

December quarter followed a weak September quarter (+0.3%).

- Production in ten of the sixteen industries increased. Retail trade and accommodation made the largest contribution
- Activity in the primary industries eased
- On the expenditure measure, growth was broad-based (up 0.5%), consumption (+1.3%) and construction activity (+2.1%) underpinned growth
- Annual (average) growth has been easing since 2017 and is now 2.8%

Weaker TOT hit nominal expenditure GDP…

TOT declined 2.7% in the quarter, with the overall (both goods and services) terms of trade declining 2.2%,

Overall this decline was slightly greater than we had been anticipating, with growth in nominal GDP, at 0.3%, a little weaker than incorporated in the preliminary BEFU forecasts.

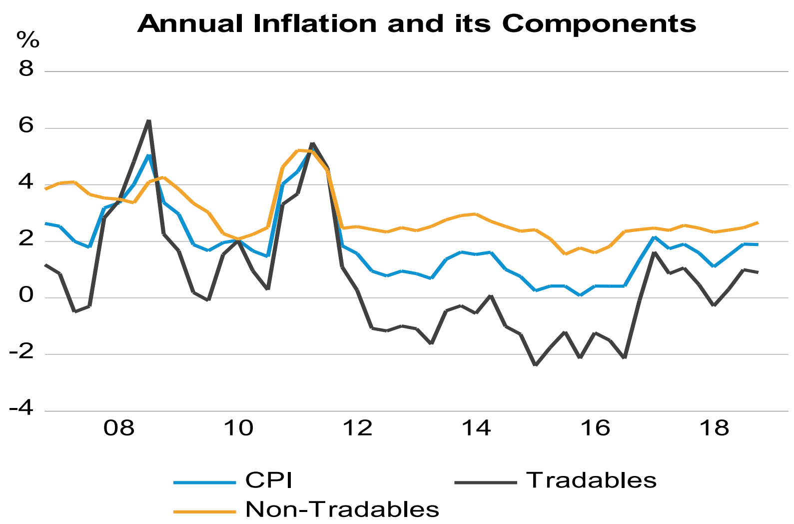
Domestic developments cont'd

Labour Market

- Unemployment rate rose to 4.3% in the December 2018 quarter.
- QSBO reports that firms are facing difficulty finding both skilled and unskilled workers – the most difficult since 2005.
- Lower migration possibly a contributing factor.

Trade developments

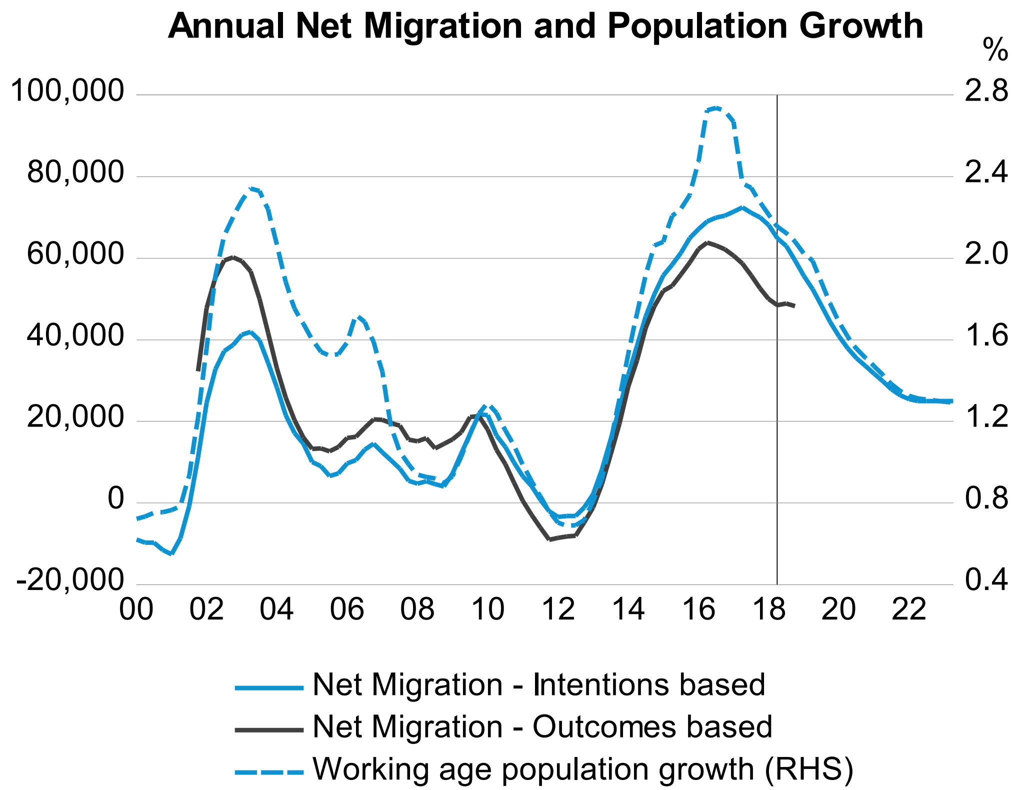
- Continued growth in capital goods imports (an indicator of domestic investment).
- Dairy exports volumes growth reflects strong production, but prices softer.
- Increased exports to China accounted for almost half the increase in exports over the past year.



- Higher petrol prices in 2018Q3 have contributed to a pick up in inflation to 1.9% (will drop out) but early signs of slightly stronger non-tradables inflation.
- Market pricing has shifted from approximately a 50% chance of a rate rise by the end of 2019, to a 50% chance of a rate cut by the end of 2019.

Population growth is high but declining

- High net inwards migration has boosted population growth and supported aggregate demand
- Migration is expected to continue to fall, which will weigh on aggregate growth
- A new method for estimating migration suggests there have been fewer migrants than previously thought

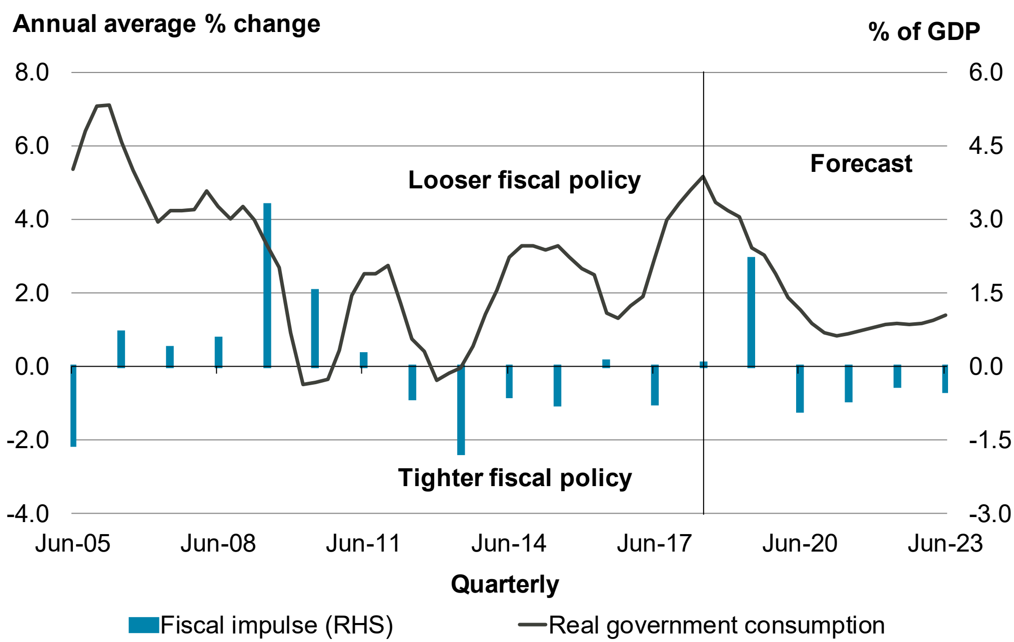


Rising incomes support consumption

- The economy has absorbed a large increase in the labour force
- The labour market is expected to remain tight, with unemployment hovering around 4%
- The tight labour market, together with government labour market policies, underpins an acceleration in wage inflation
- Solid household income growth underpins consumption growth
- Over the longer term slowing population growth and rising interest rates weigh on growth

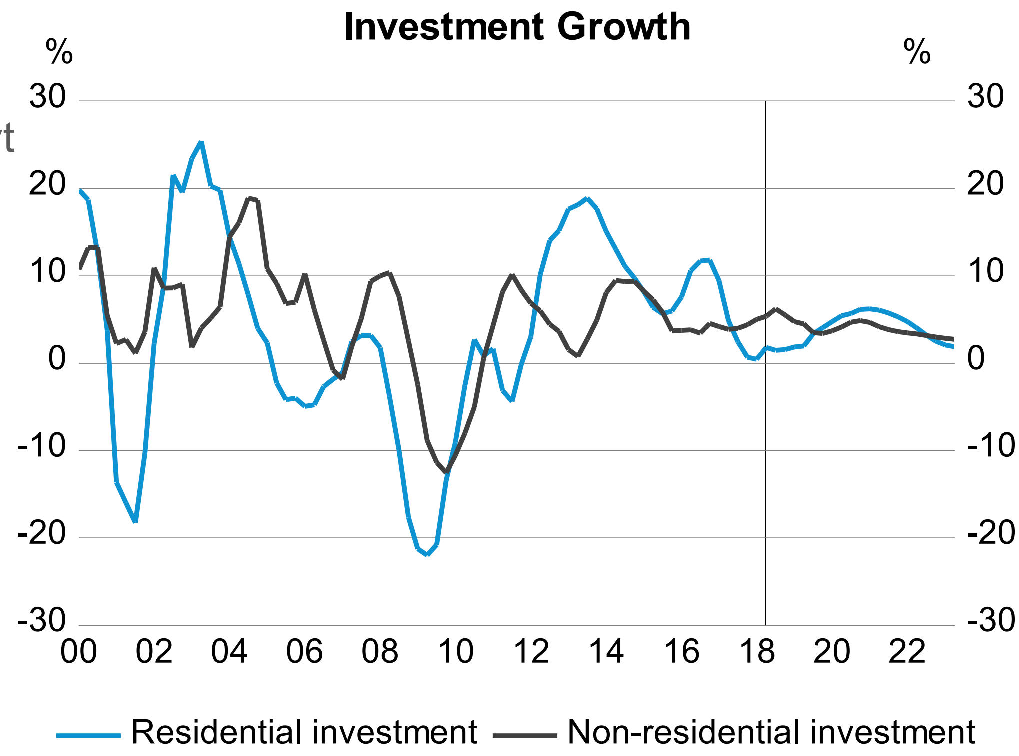
Government spending supports demand (HYEFU)

- Government spending is expected to support demand, particularly in the shorter term
- Budget operating allowances are set at $2.4 billion per annum



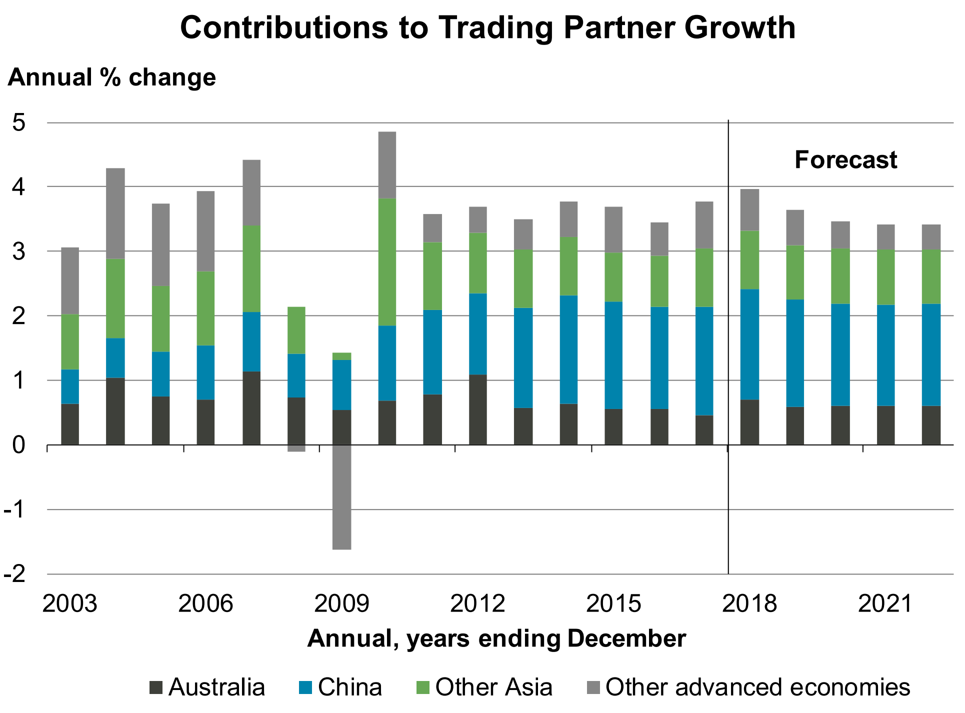
Investment grows steadily

- Growth in residential investment is expected to be subdued in the short term owing to capacity constraints
- Over time, KiwiBuild, and broader Govt investment in housing is expected to support faster growth, supported by policies that alleviate capacity pressures
- Non-residential investment grows steadily, underpinned by the high terms of trade, low interest rates and rates of capacity utilisation
- Non-residential investment includes the Governments $13.1 billion multi-year capital envelope



Global growth outlook remains solid but risks of weaker growth have increased

- The forecasts assume a fairly stable outlook for world growth, with growth in our top 16 trading partners in the 3.4% to 3.6% range.
- Risks to the international outlook remain prevalent and are skewed to the downside. Key risks include
  - Trade tensions
  - Brexit
  - China debt levels
  - Australia housing market

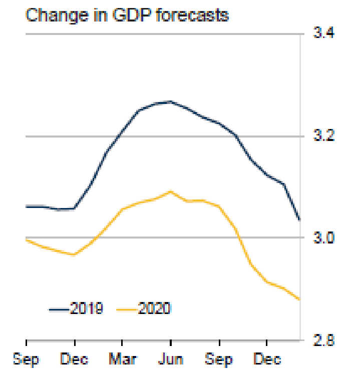


Global environment

Global growth is slowing with softer trading partner growth expected

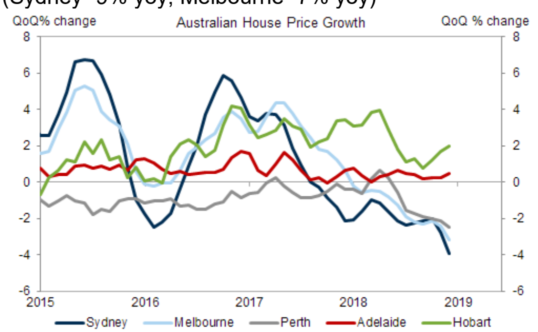
- 2018Q3 growth slowed more than expected with softer momentum expected to carry over into Q4 and 2019.
- Weakening market sentiment and trade policy uncertainty appear to be affecting world activity.
- IMF and consensus forecasts have been reduced (Fig 1).
- Australian business confidence sharply lower and house price falls continue (towards -20%) as supply adjusts to lower demand (Fig 2).
- China growth transition continues but trade has slowed markedly, impacting other Asian trading partners including Japan.
- US Federal government shutdown and tighter financial conditions point to slower US growth.
- Euro area challenges continue as “yellow vests” slow French services and German manufacturing confronts slower global demand.
- Brexit uncertainty continues to hinder UK growth.
- Positives include ongoing US-China trade talks, increased policy stimulus in China, ongoing talks to avoid “no-deal” Brexit, and recovery in equities over January.
- In sum, growth is slowing more quickly than anticipated and risks of slower growth have increased.
- BEFU19 trading partner growth 0.2%-points lower in 2018 and 0.1%-points lower in 2019 and 2020 at 3.8%, 3.5% and 3.4% respectively.
- Weaker growth may reduce/delay monetary policy tightening, influencing exchange rates.

Figure 1: Global GDP consensus forecasts are falling…



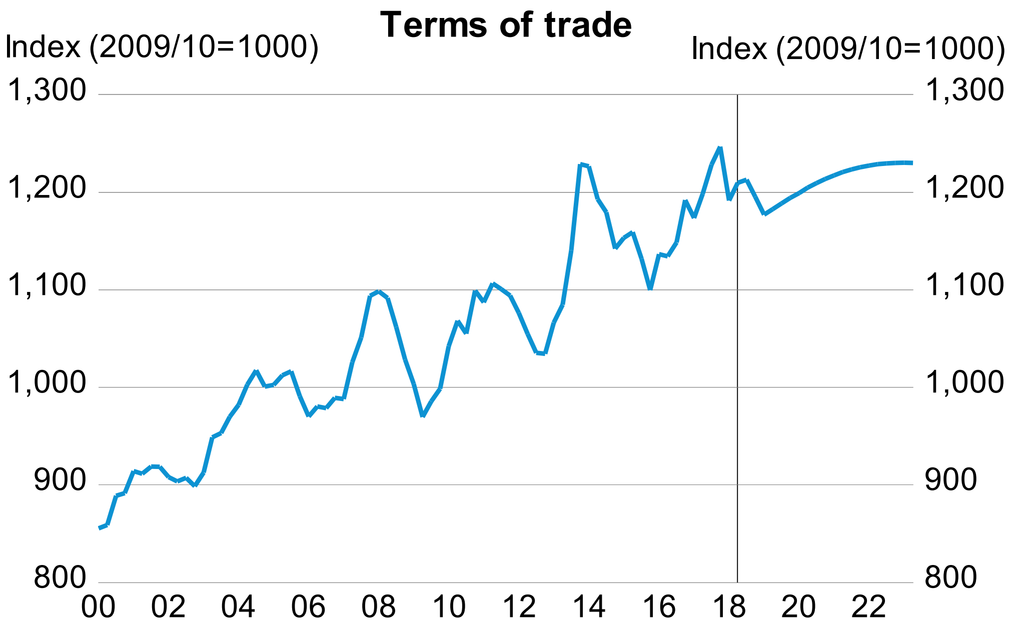
Note: GDP, evolution of 2019 and 2020 forecasts during the last 18 months.

Figure 2: Australian house prices continue to fall (Sydney -9% yoy, Melbourne -7% yoy)



Solid demand supports exports and the terms of trade

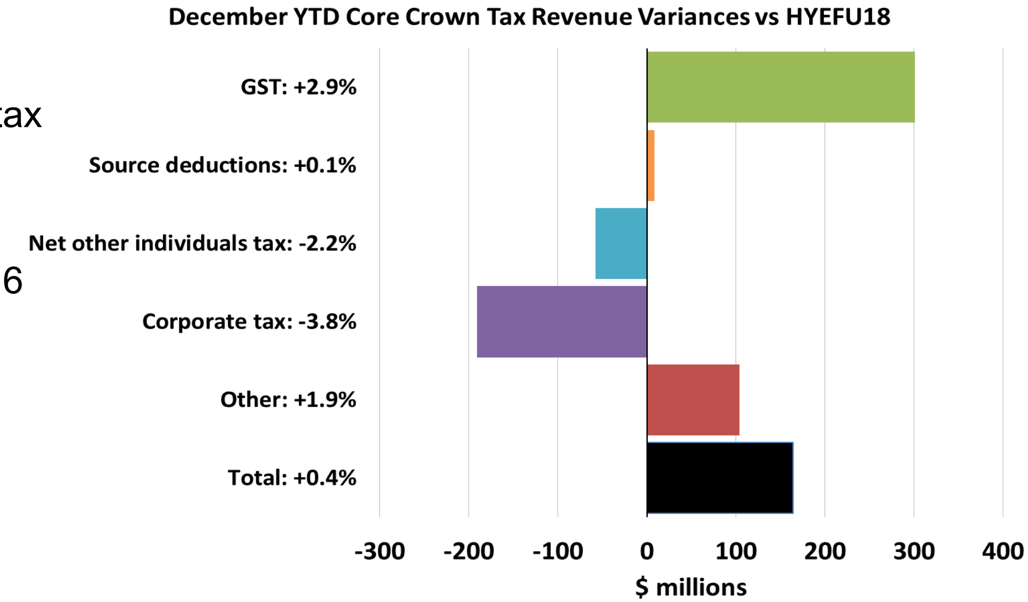
- Growing conditions have been generally favourable, supporting agricultural exports, and tourism continues to grow strongly
- Import growth is also high, consistent with solid domestic demand
- Shorter term factors weigh on the terms of trade in the near term but overall the terms of trade remain at relatively high levels
- The current account deficit is expected to remain broadly stable at about 3.6% of GDP



Note: Goods and services, SNA basis

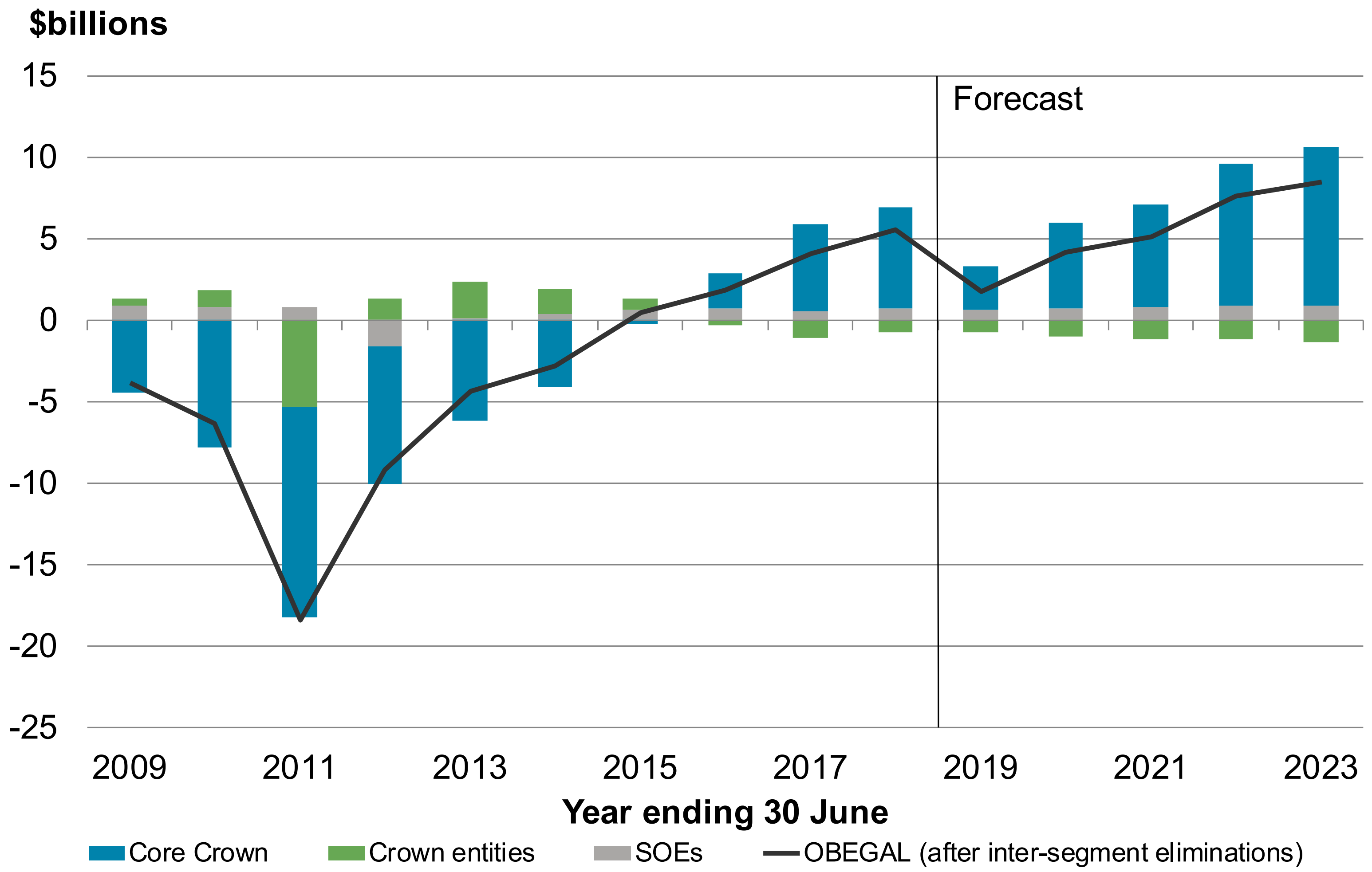
Tax developments

Stronger than forecast tax revenue may provide a partial offset to weaker growth



- There have been two months of actual tax data subsequent to the 2018 HYEFU forecast.
- In total, core Crown tax revenue for the 6 months to December was close to forecast (0.4% above).
- GST revenue was $300 million above forecast. Inland Revenue advises that December GST returns lodged up to 23 Jan were very strong.
- Corporate tax was $200 million below forecast. Most of this came from lower-than-forecast provisional tax. However, the two peak provisional tax months of the year, January and May, are yet to come.

The fiscal outlook continues to improve



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Questions?