THE TREASURY

Kaitohutohu Kaupapa Rawa

# New Zealand’s Economic & Fiscal Outlook, Treasury’s Long-Term Fiscal Statement, and Treasury’s Living Standards Framework

# November 2013

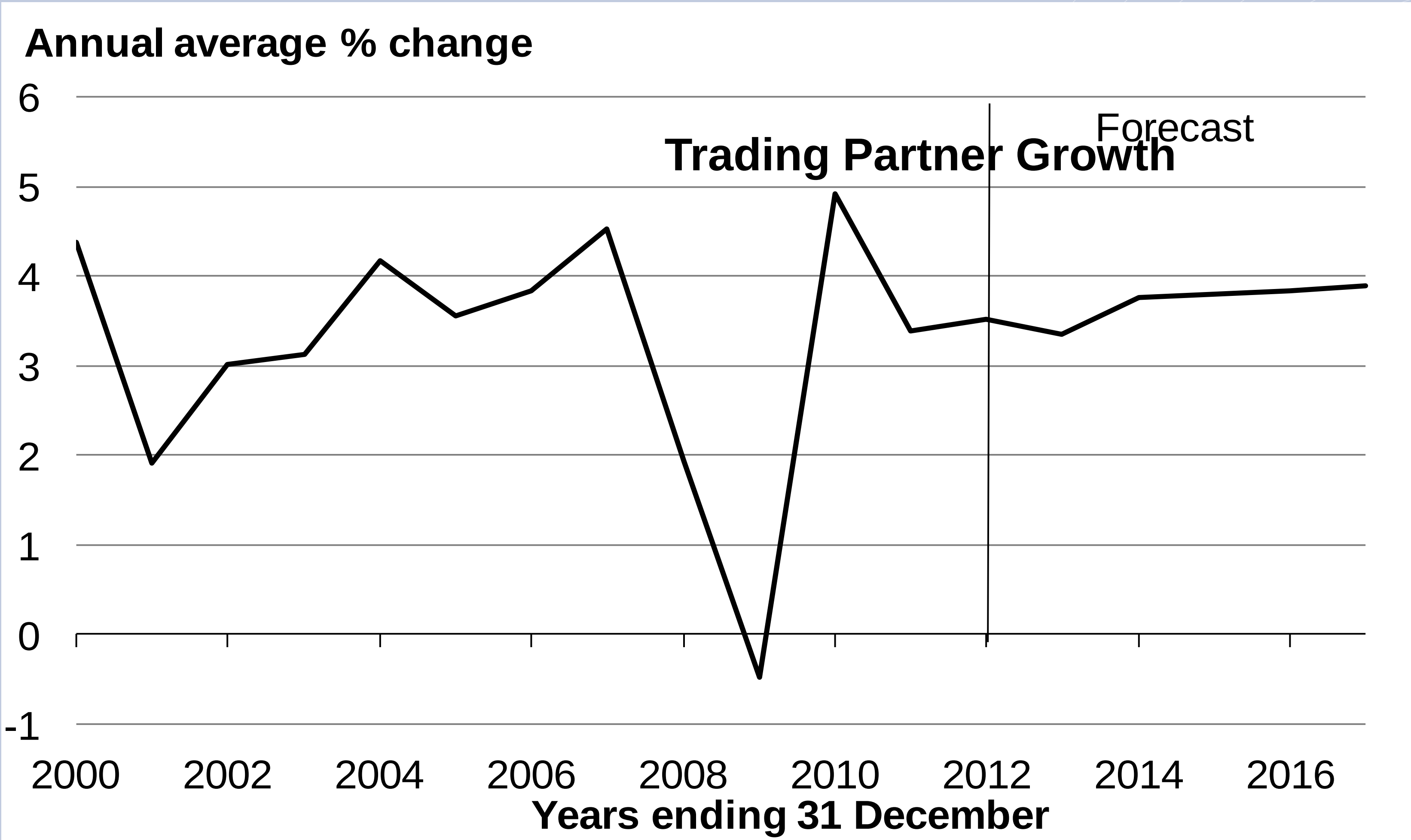
# Short-Term
# (next five years)
# Economic and Fiscal Outlook

# Five Key Judgements

- International Economic Situation
- Effects of the Drought
- Canterbury
- Terms of Trade
- Monetary Conditions

## ***Global Context***

# Global Outlook steady ...



# Global Economic Forecasts

| | 2013 weights | 2012 Actual | 2013 Forecast | 2014 Forecast | 2015 Forecast | 2016 Forecast | 2017 Forecast |
|---|---|---|---|---|---|---|---|
| Australia | *27%* | 3.6 | 2.7 | 2.9 | 3.0 | 3.0 | 3.0 |
| China | *17%* | 7.8 | 8.0 | 7.6 | 7.3 | 7.0 | 7.0 |
| United States | *11%* | 2.2 | 1.7 | 2.4 | 2.5 | 2.5 | 2.5 |
| Japan | *9%* | 2.0 | 1.0 | 1.4 | 1.1 | 1.0 | 1.0 |
| Euro area | *8%* | -0.5 | -0.4 | 1.0 | 1.2 | 1.3 | 1.4 |
| United Kingdom | *4%* | 0.3 | 0.7 | 1.4 | 1.8 | 2.0 | 2.0 |
| Canada | *2%* | 1.8 | 1.6 | 2.3 | 2.4 | 2.5 | 2.5 |
| Other Asia* | *23%* | 3.8 | 4.3 | 4.7 | 5.0 | 5.0 | 5.0 |
| **Trading Partner Growth (TPG)** | ***100%*** | **3.5** | **3.4** | **3.8** | **3.8** | **3.8** | **3.9** |
| TPG - Consensus (April 2013) | | 3.5 | 3.5 | 3.9 | 4.1 | 4.1 | 4.0 |
| TPG - IMF WEO (April 2013) | | 3.5 | 3.5 | 4.1 | 4.2 | 4.3 | 4.4 |

* South Korea, Taiwan, Hong Kong, Singapore, Malaysia, Indonesia, Thailand, Philippines, India

# Risks

- Risks more balanced than a year ago
- Global uncertainties remain
  - – Fiscal adjustments
  - – Monetary policy
  - – Slower growth in trading partners
- Domestic risks
  - – Mother nature - earthquakes and drought
  - – Saving behaviour and exchange rate

# ***Domestic Outlook***

# Growth outlook influenced by supportive and constraining factors...

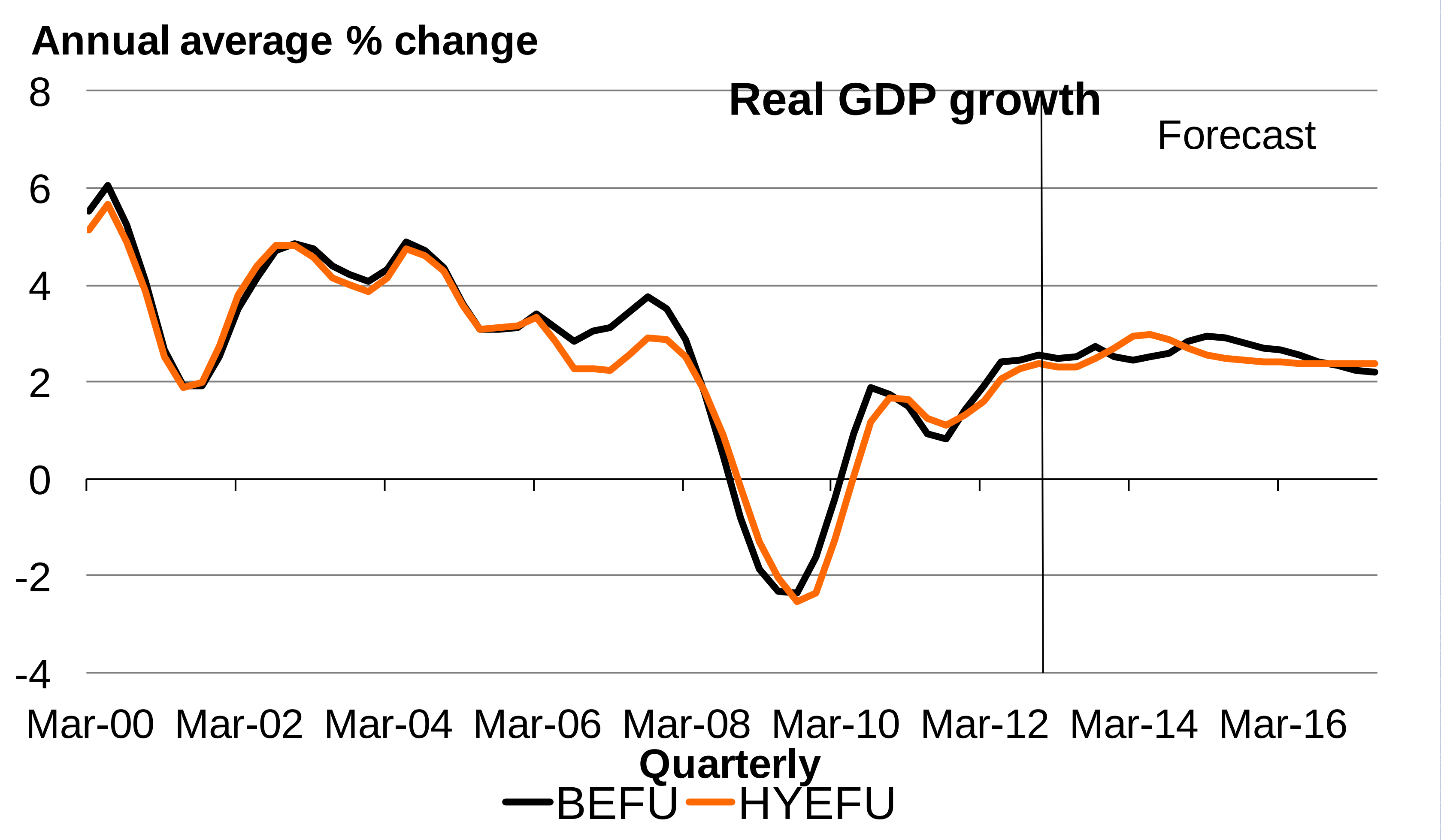
On the supportive side:

- The Canterbury rebuild
- A high terms of trade
- Low interest rates
- Less risk-averse households and firms

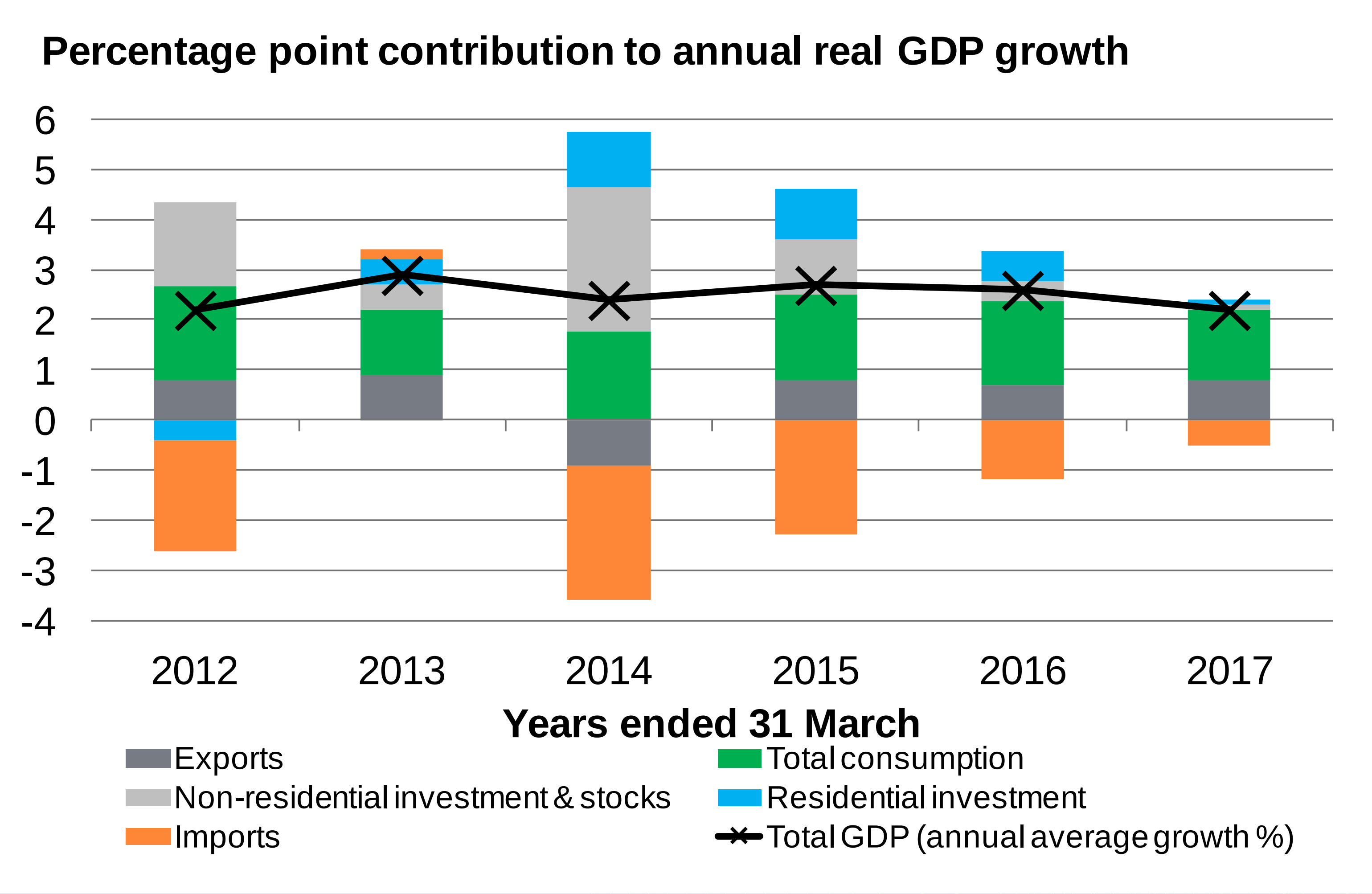
Factors constraining growth include:

- An elevated exchange rate
- Fiscal restraint
- The drought in the near term

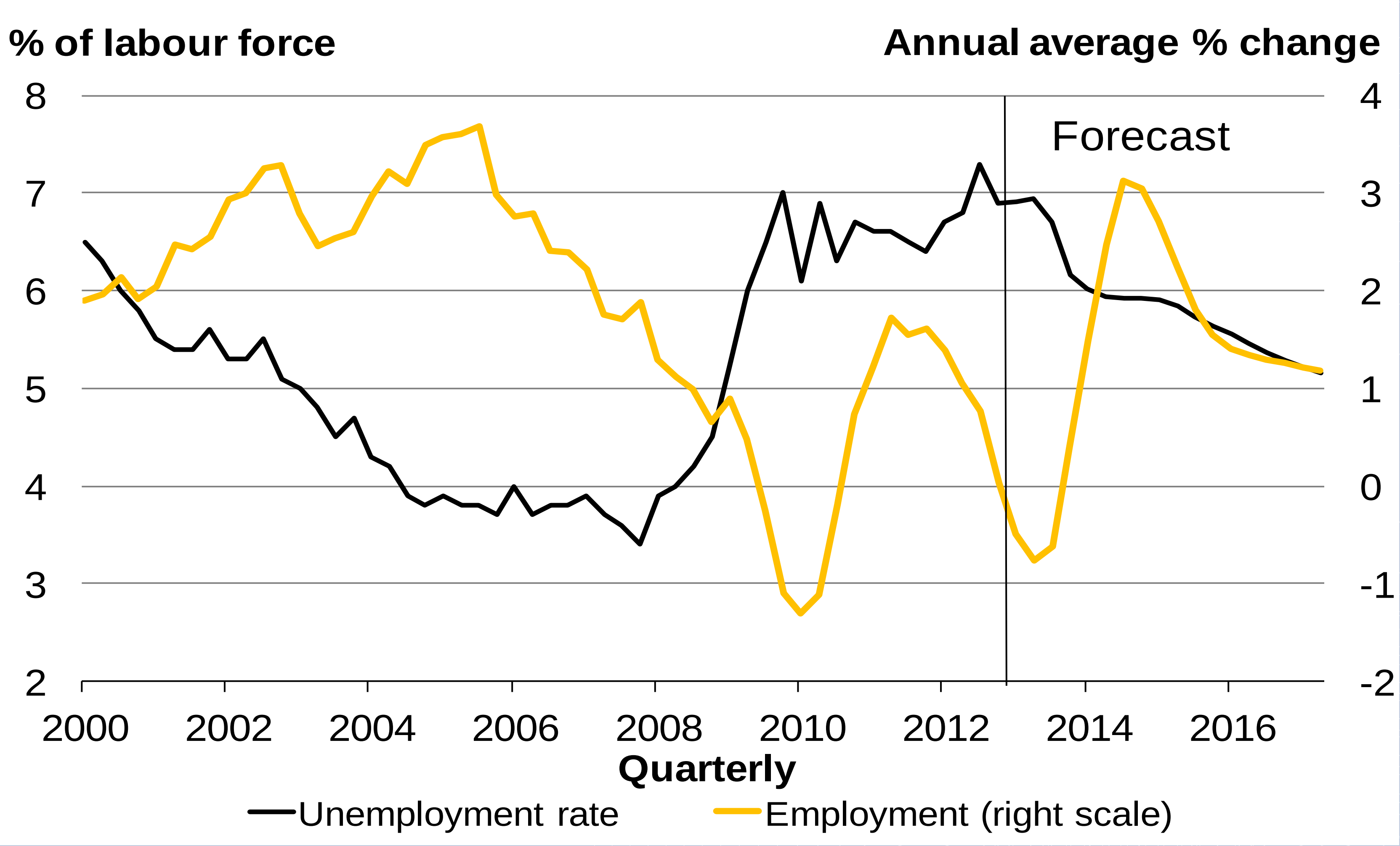
# ...but the overall economic outlook is similar to the Half Year Update



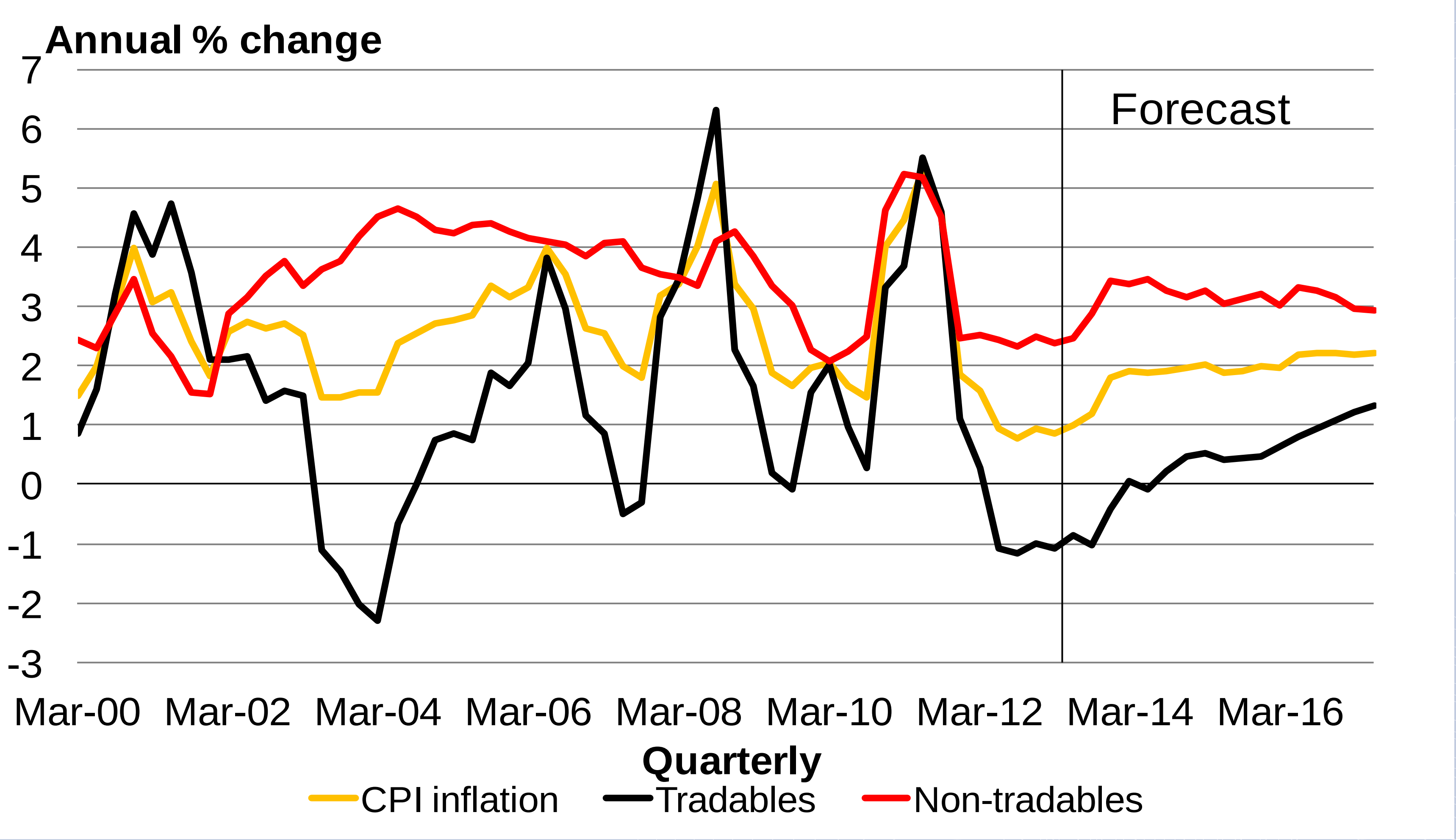
# Growth to be driven primarily through Investment and Consumption...



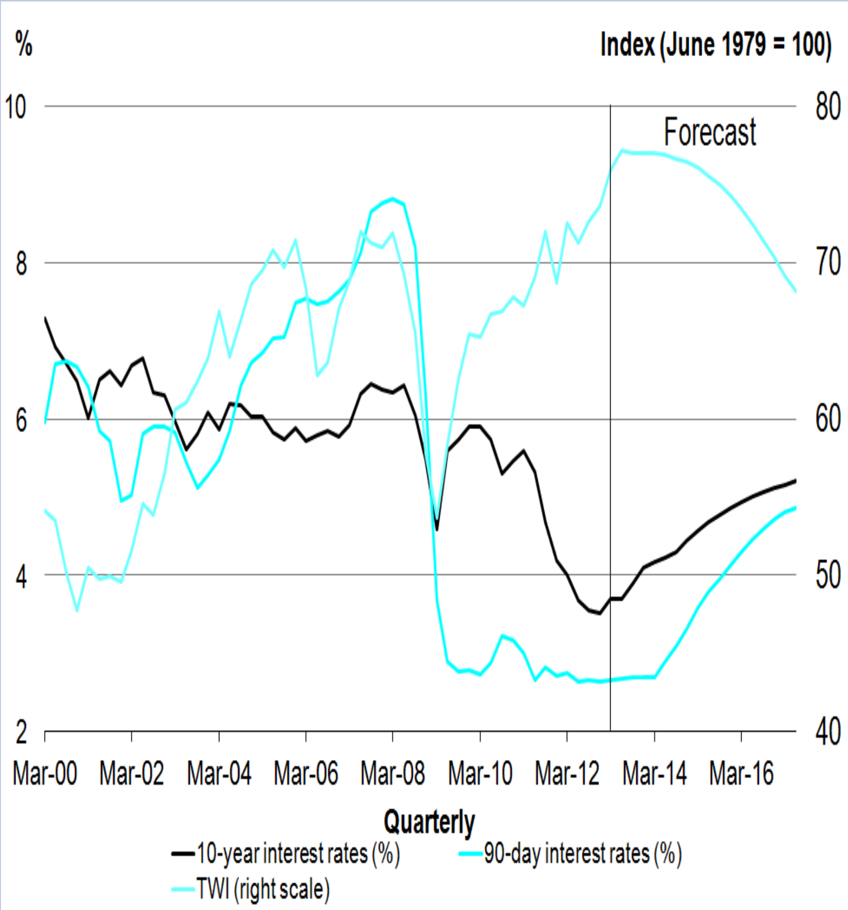
# Labour market is expected to strengthen over forecast period...

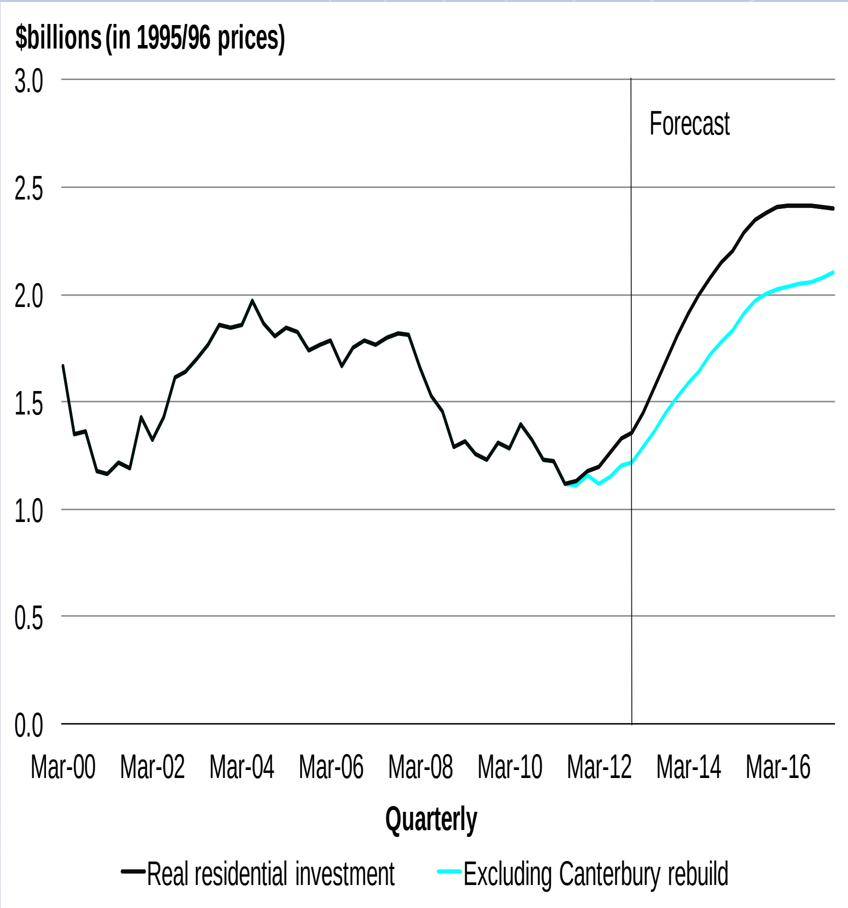


# ... while inflationary pressures pick up

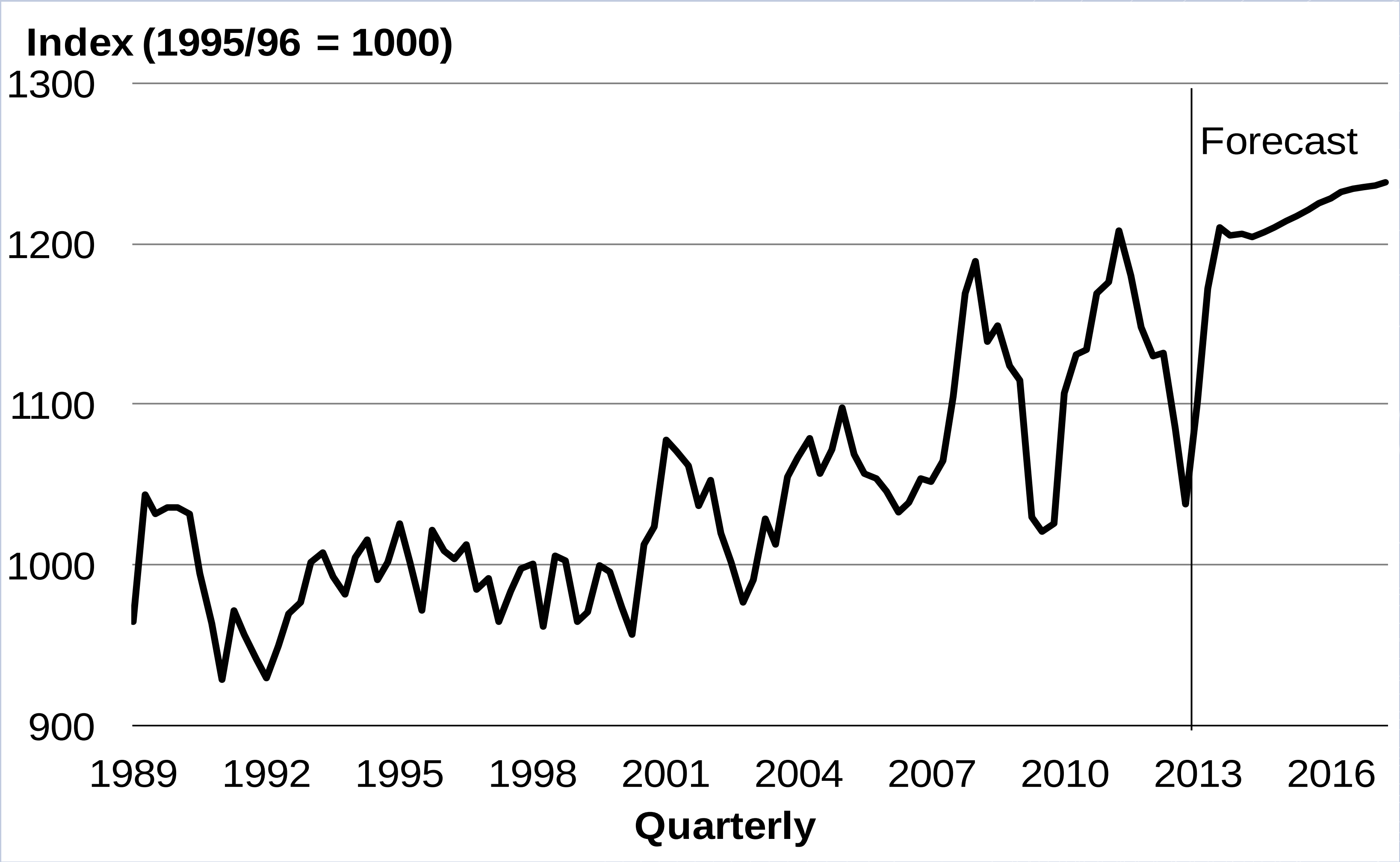


# Low interest rates and the Canterbury rebuild



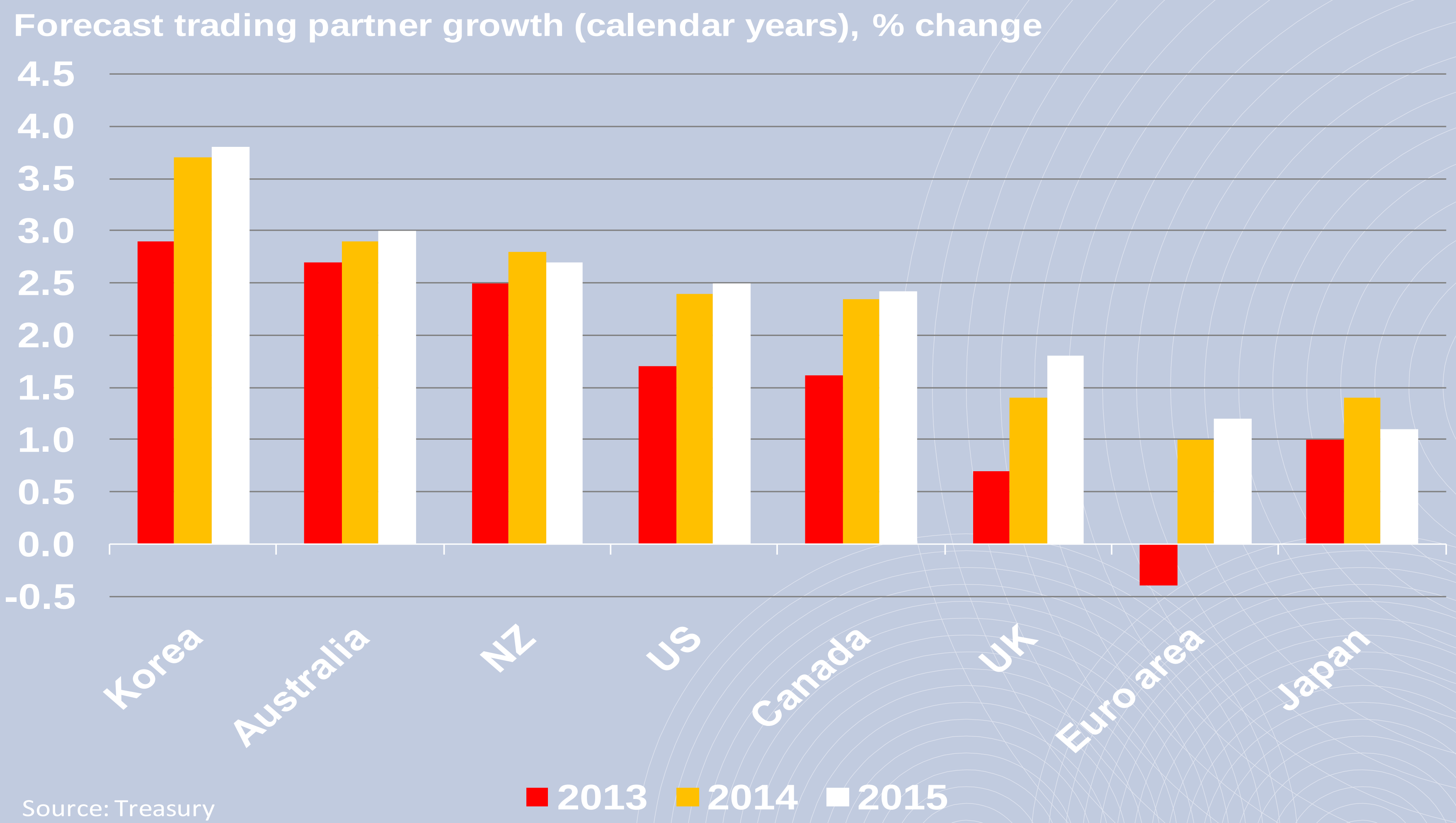
# ...but higher dairy prices will support a turnaround in the goods terms of trade



# Summary
## (March Years, %)

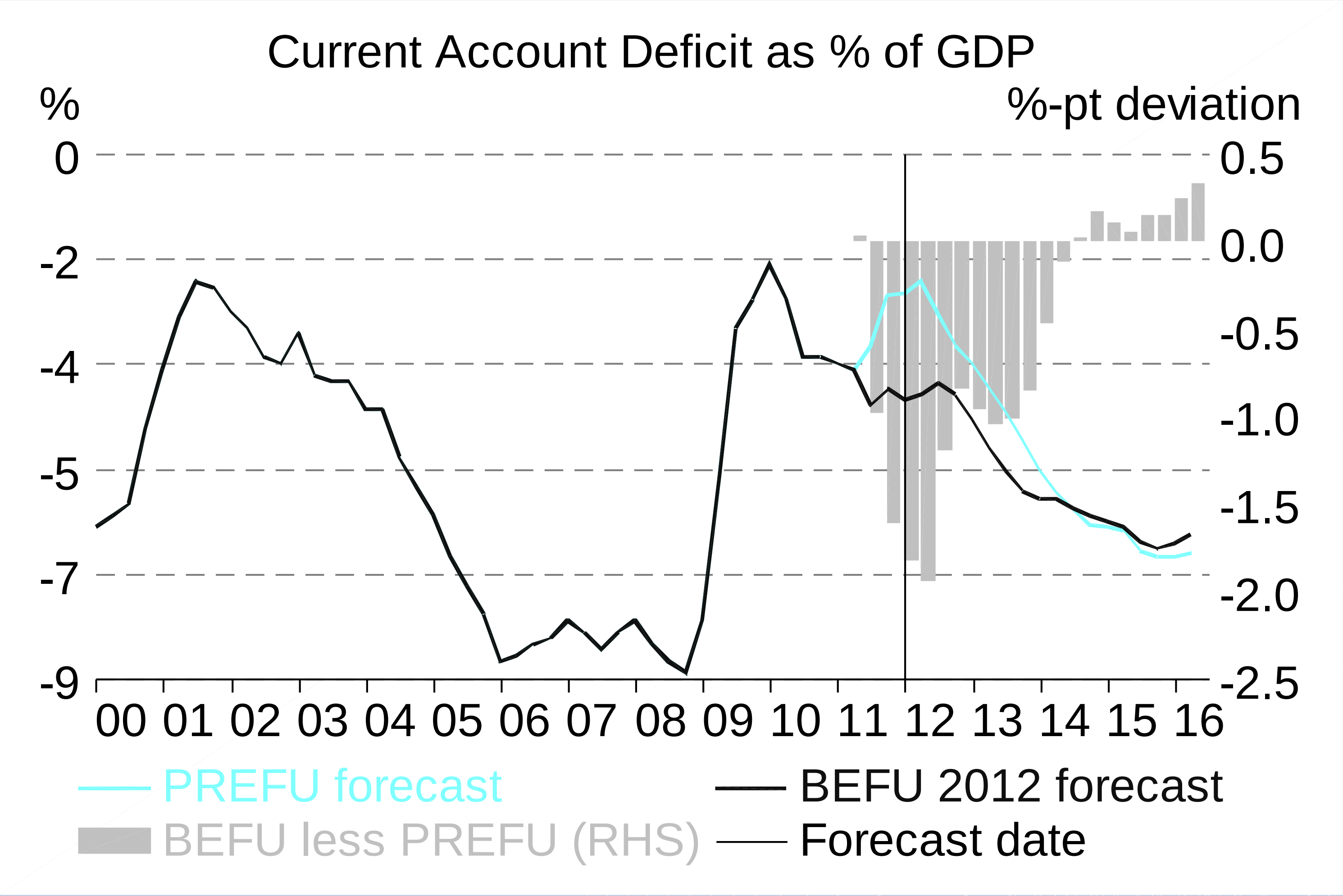
| | 2012 Actual | 2013 Estimate | 2014 Forecast | 2015 Forecast | 2016 Forecast | 2017 Forecast |
|---|---|---|---|---|---|---|
| Economic (March years, %) | | | | | | |
| Economic growth | 1.9 | 2.5 | 2.4 | 3.0 | 2.6 | 2.2 |
| Unemployment rate | 6.7 | 6.9 | 6.0 | 5.9 | 5.5 | 5.2 |
| CPI inflation | 1.6 | 0.9 | 1.9 | 2.0 | 2.0 | 2.2 |
| CA balance | -4.4 | -4.8 | -4.8 | -5.2 | -5.8 | -6.5 |
| Fiscal (June years, % of GDP) | | | | | | |
| Total Crown OBEGAL | -4.4 | -2.9 | -0.9 | 0.0 | 0.3 | 1.0 |
| Net debt | 24.3 | 27.1 | 28.4 | 28.7 | 28.1 | 27.3 |

# ...and in an international context, growth looks good

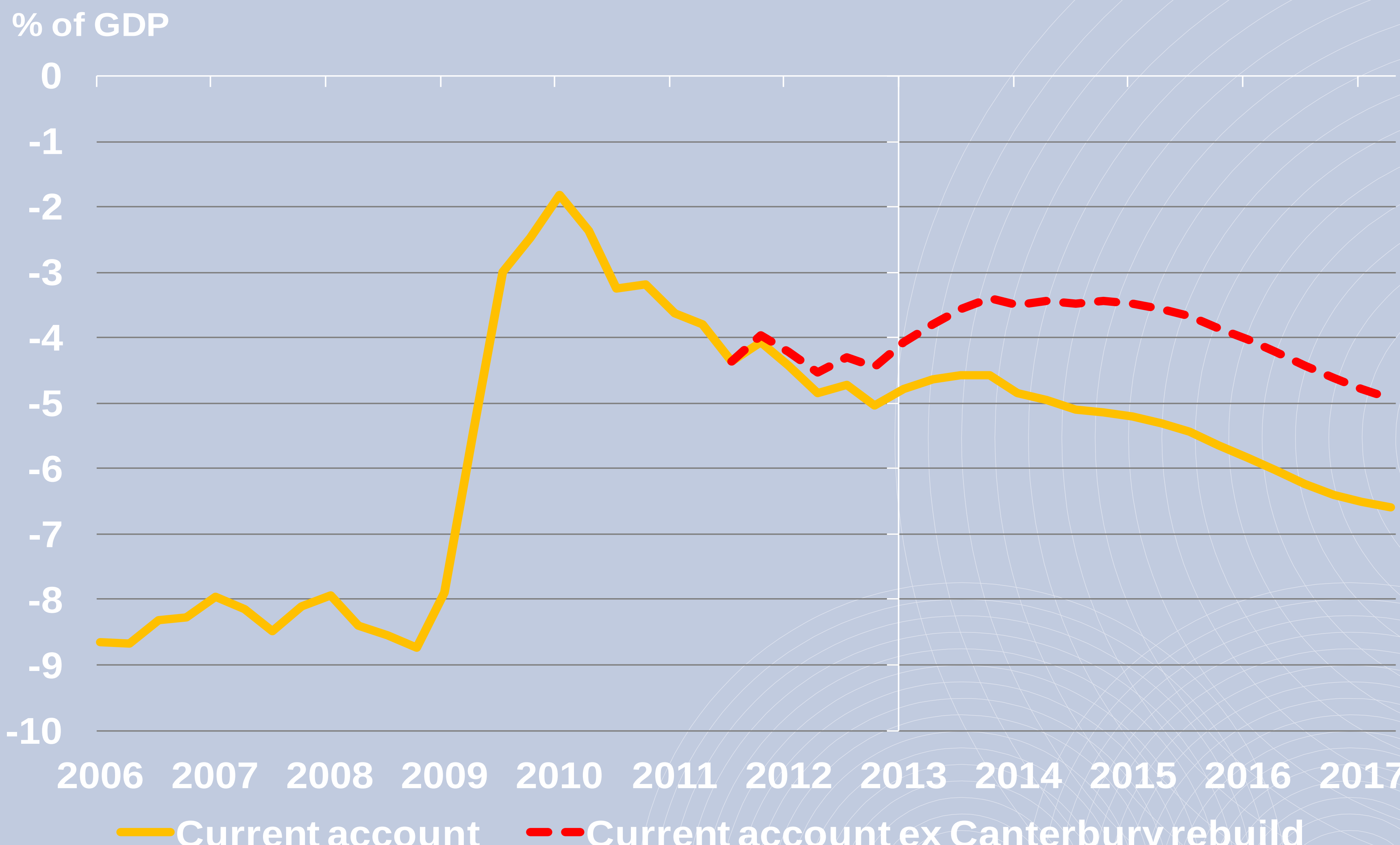



Source: Treasury

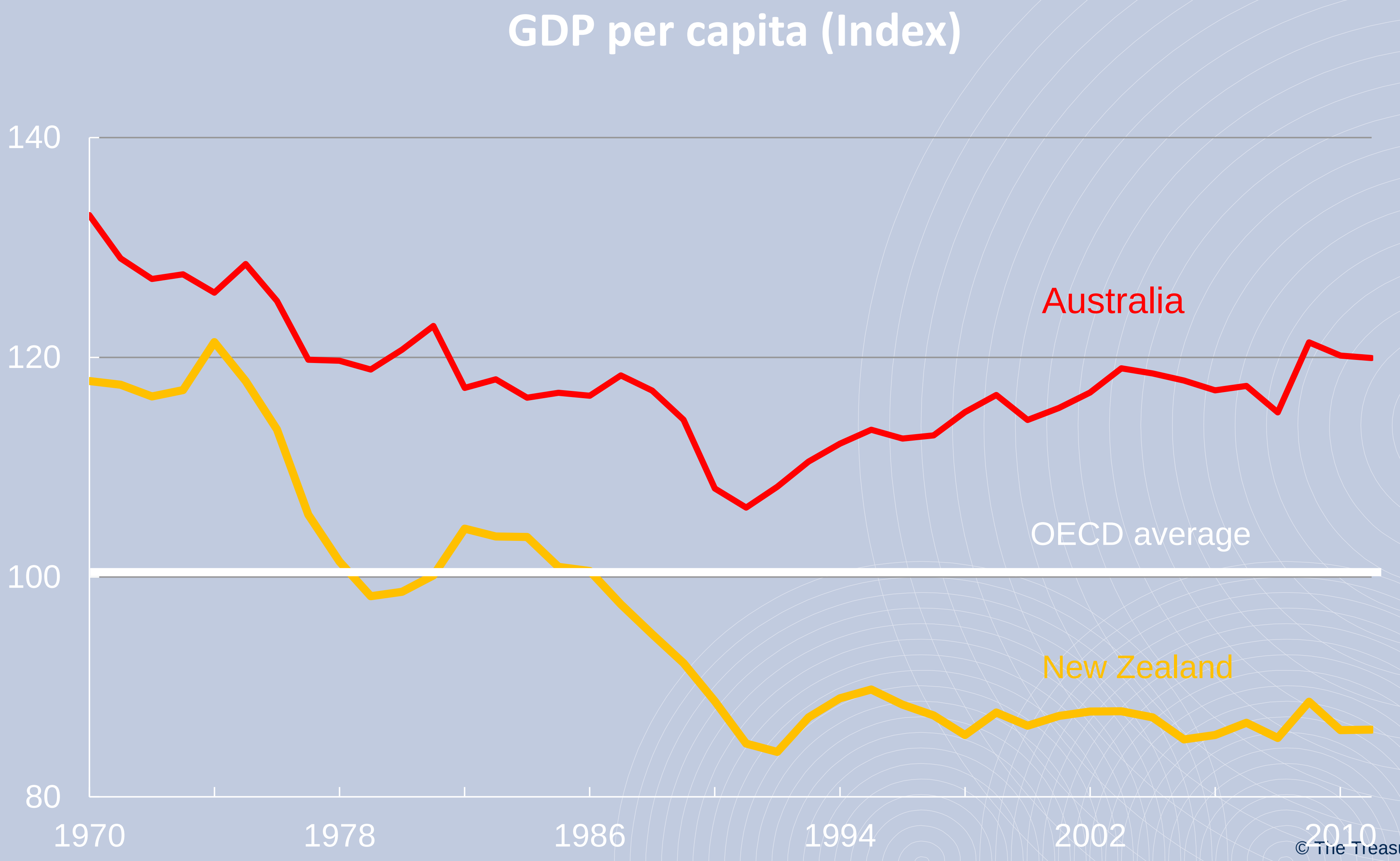
# Current Account



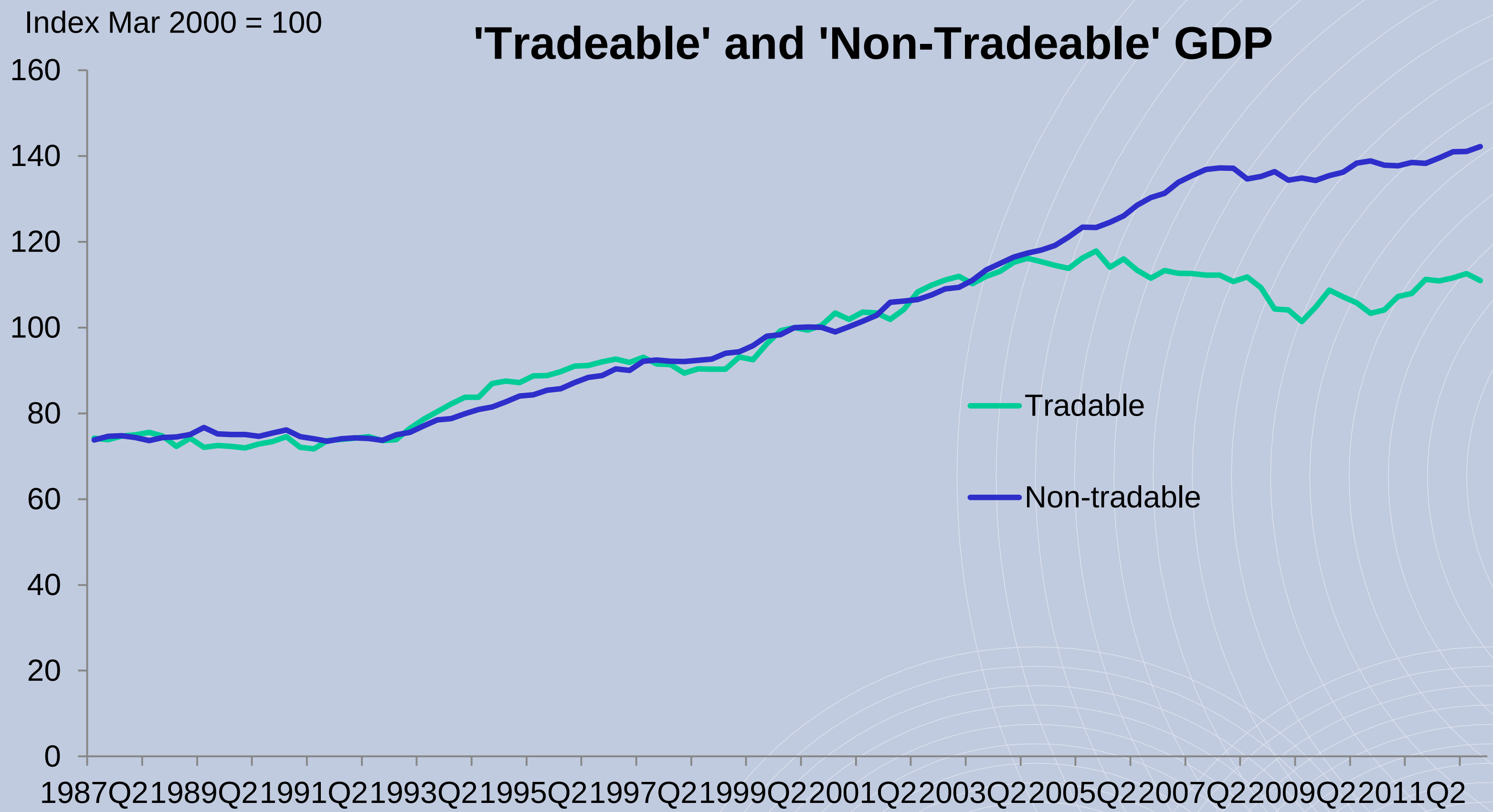
# ... higher investment drives current account deficit



# ...but there is still a large gap to close



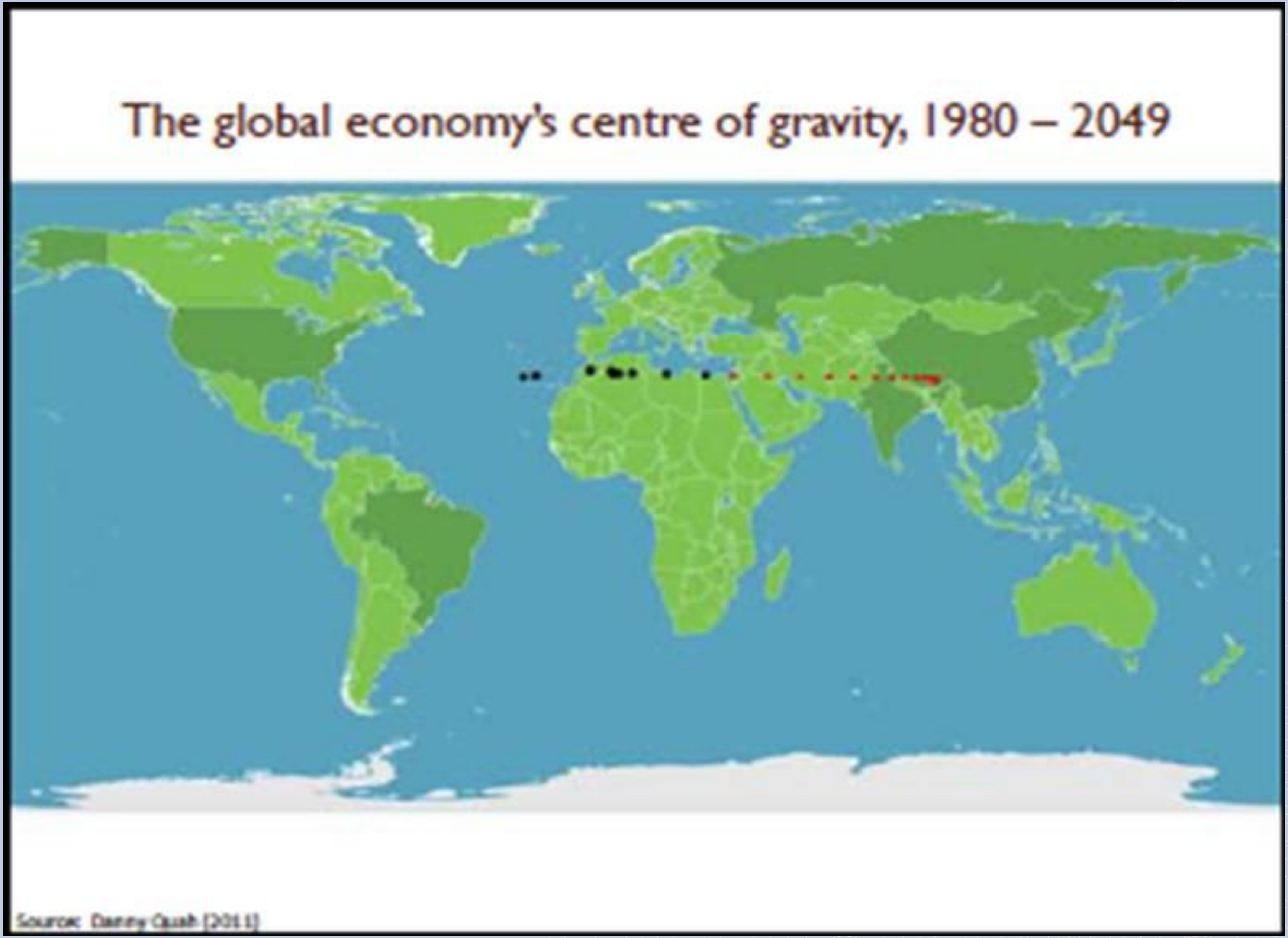
# Tradeables and Non-tradeables



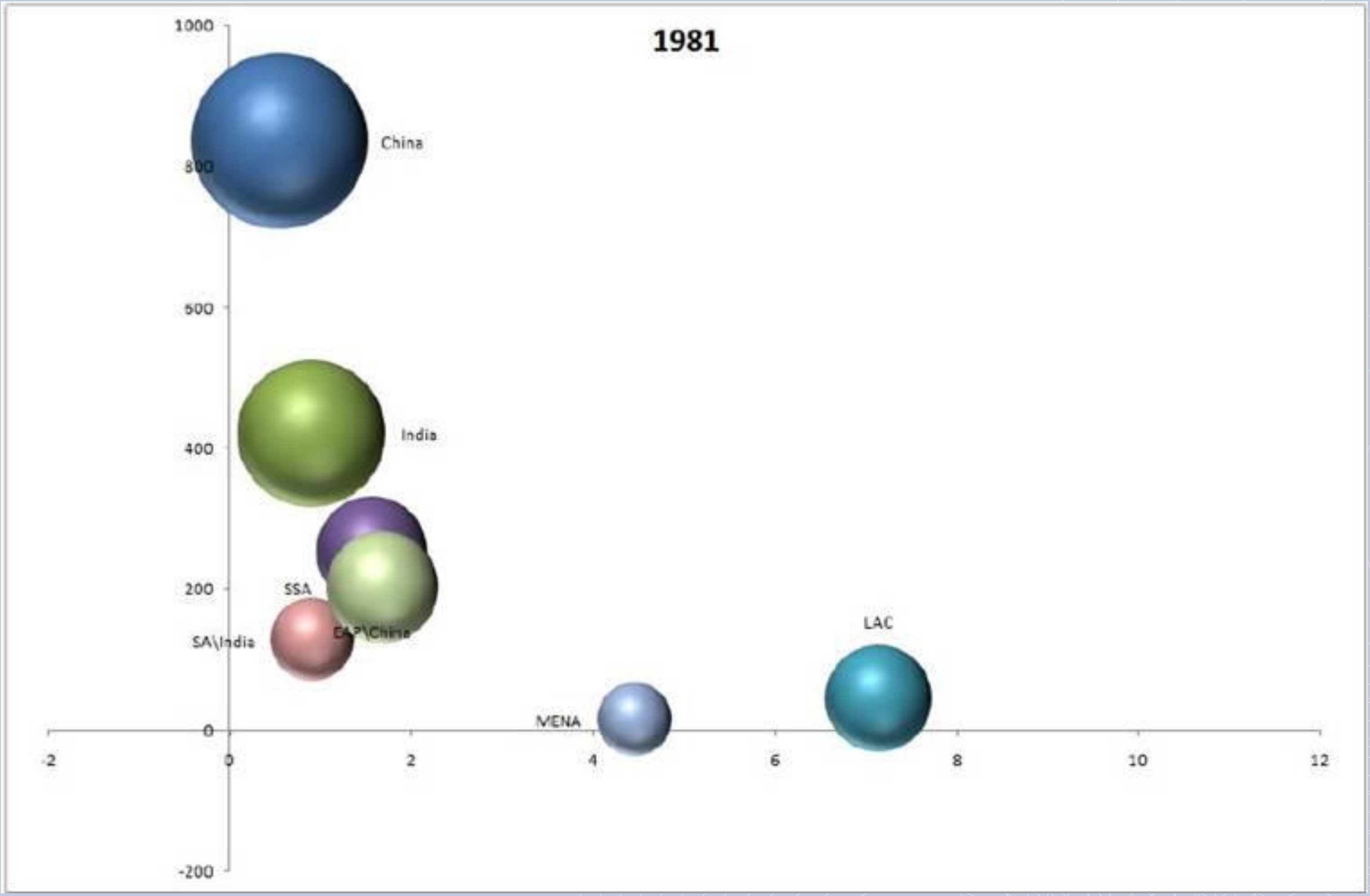
# Long Term Economic Outlook

Why am I an optimist?

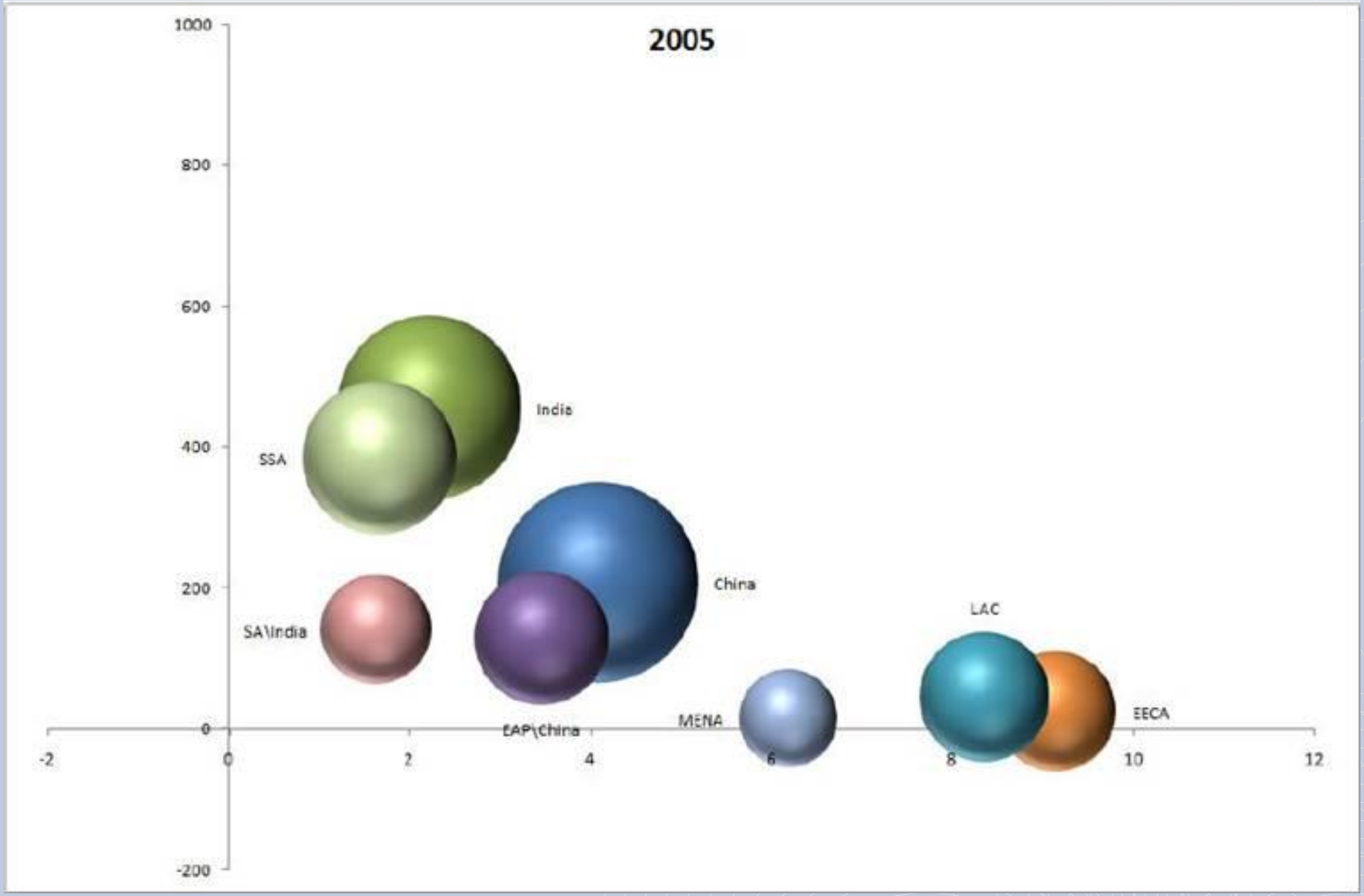
- Food
- Education
- Tourism
- Health


The global economy's centre of gravity, 1980 – 2049
Source: Danny Quah (2011)

# Falling Poverty in Asia



# Falling Poverty in Asia

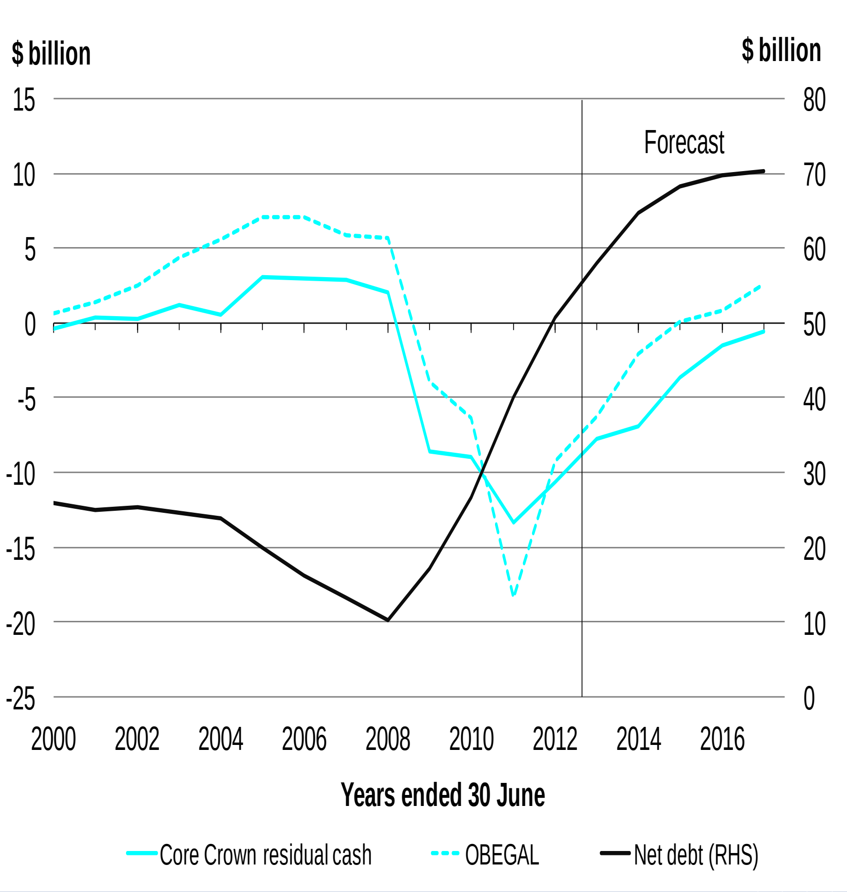


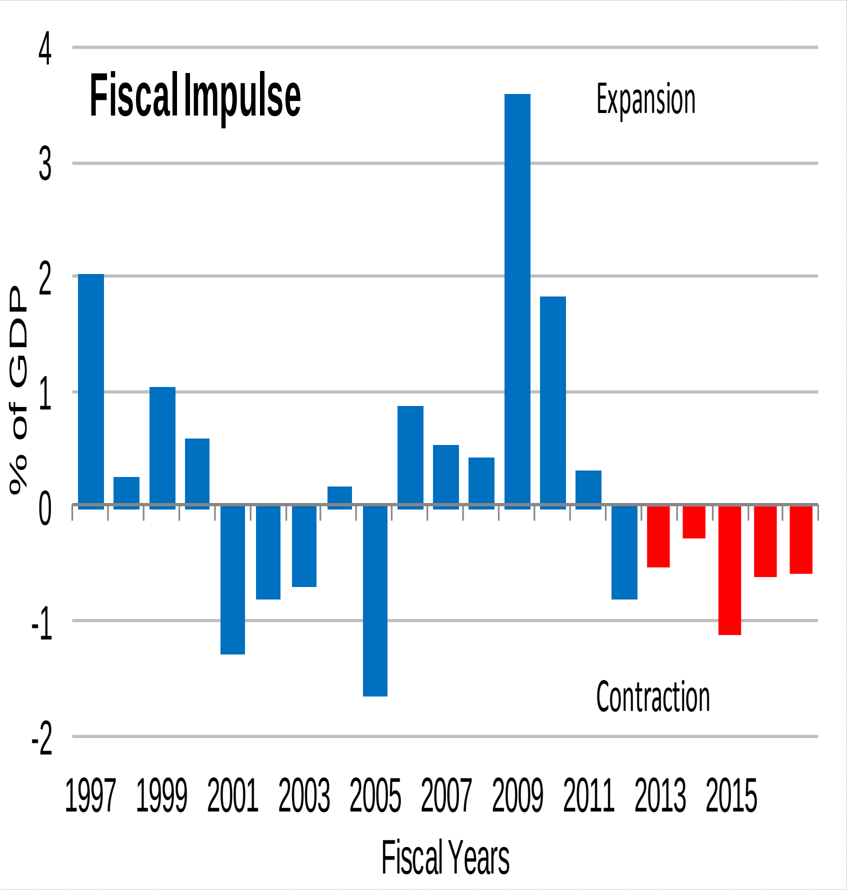
# Fiscal Strategy

# Overview of fiscal strategy

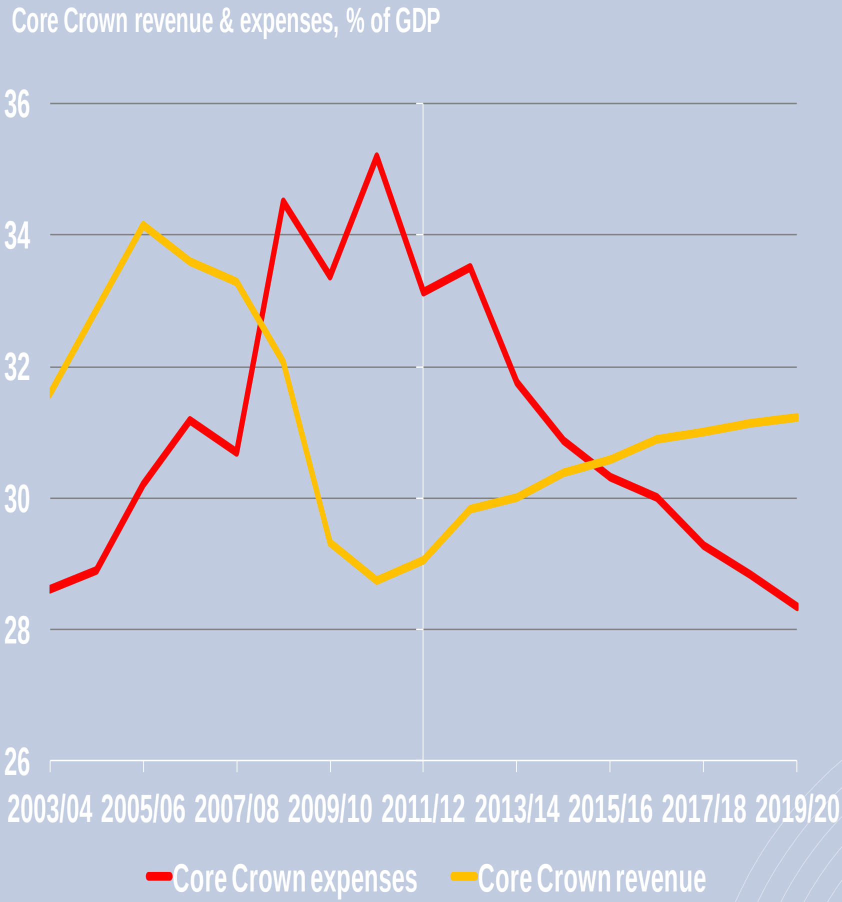
- Restore Government’s financial strength, reduce vulnerabilities
- Restrain expenditure growth
- On track for 2014/15 OBEGAL surplus
- Target net debt below 20% of GDP by 2020

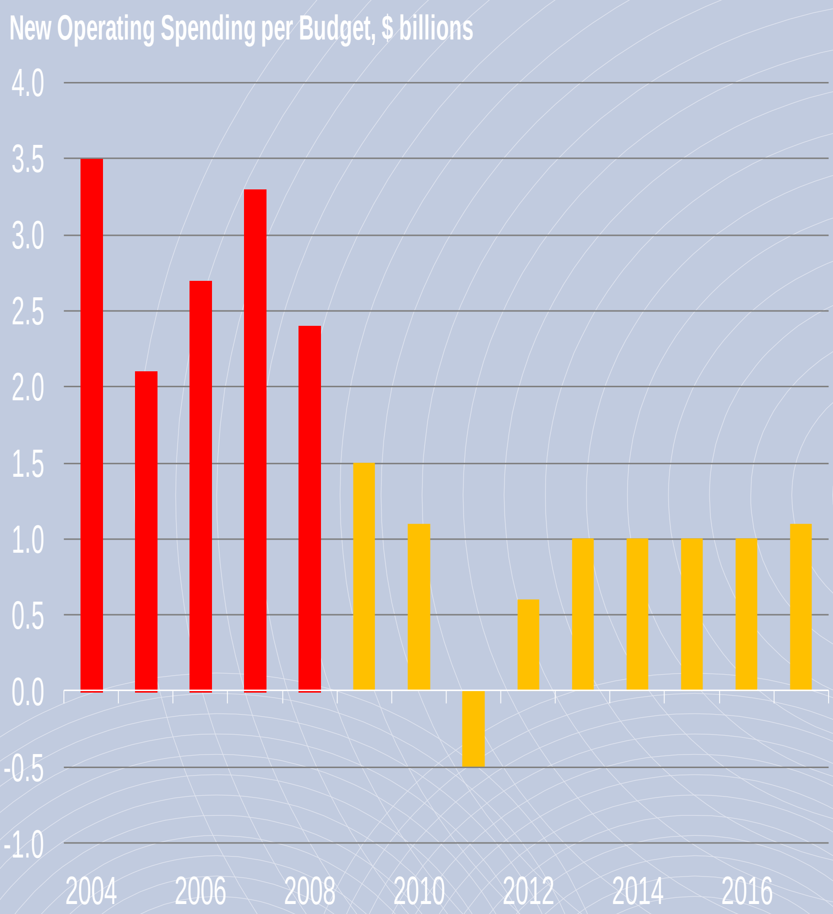
# From record deficit to surplus...



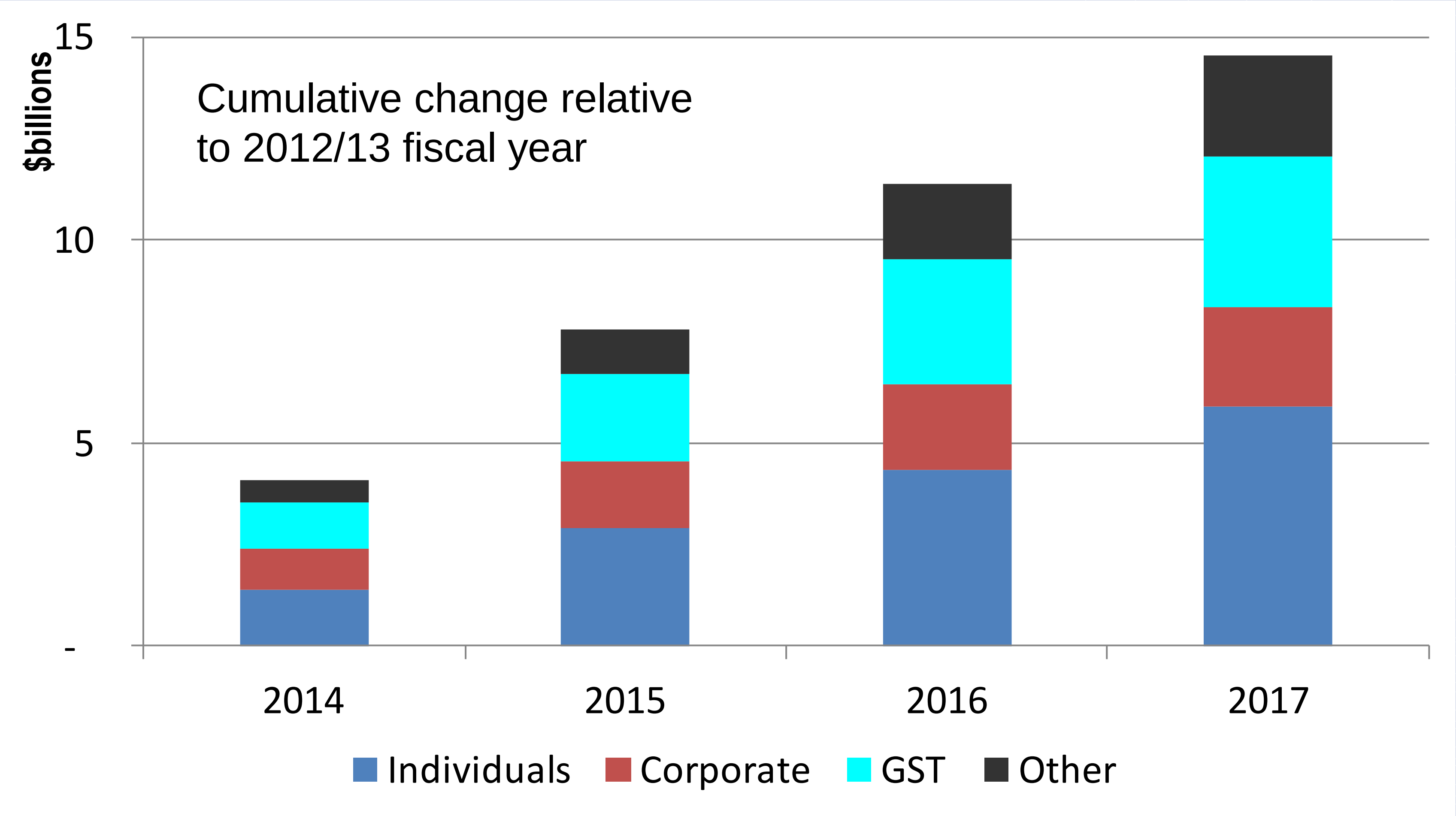



# ...via slower spending growth

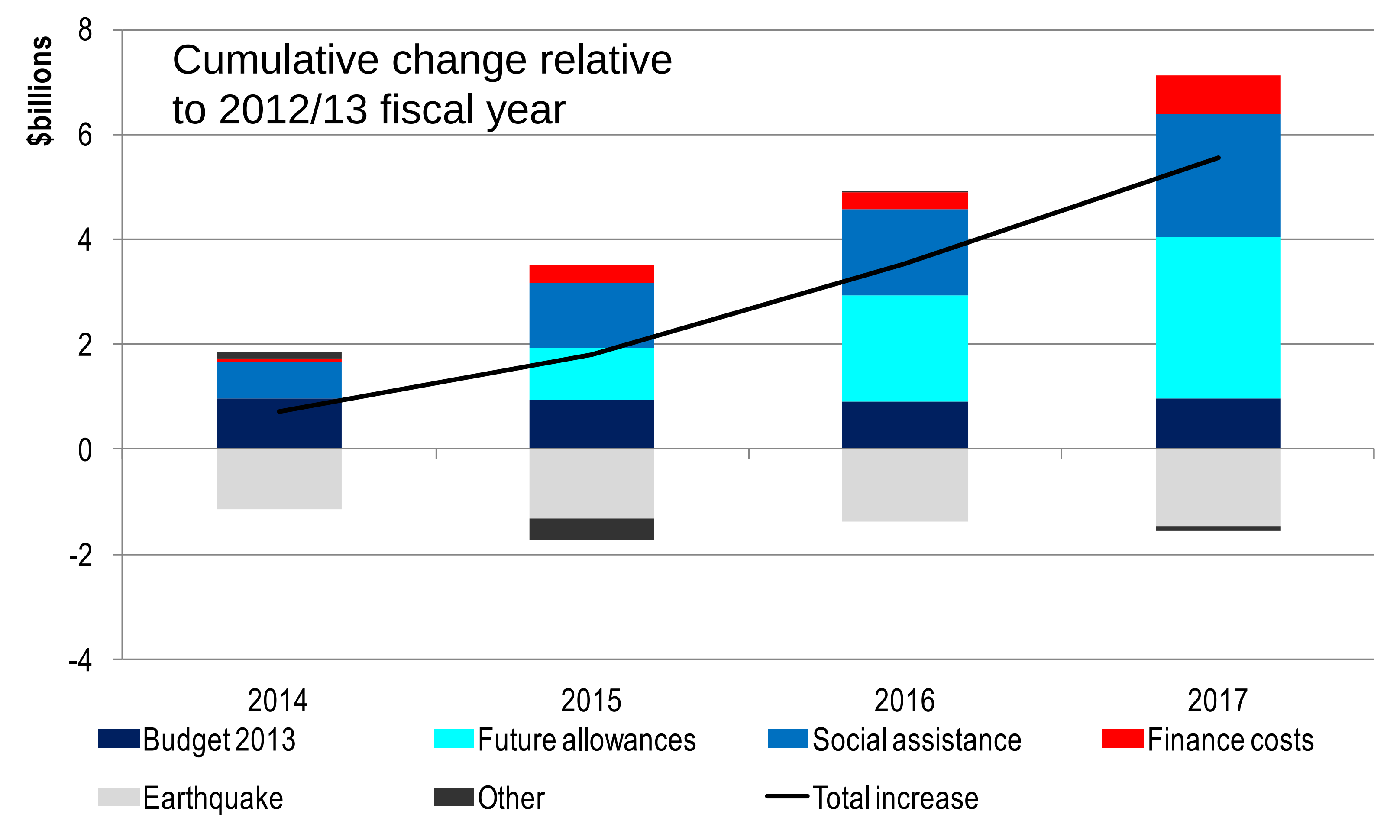


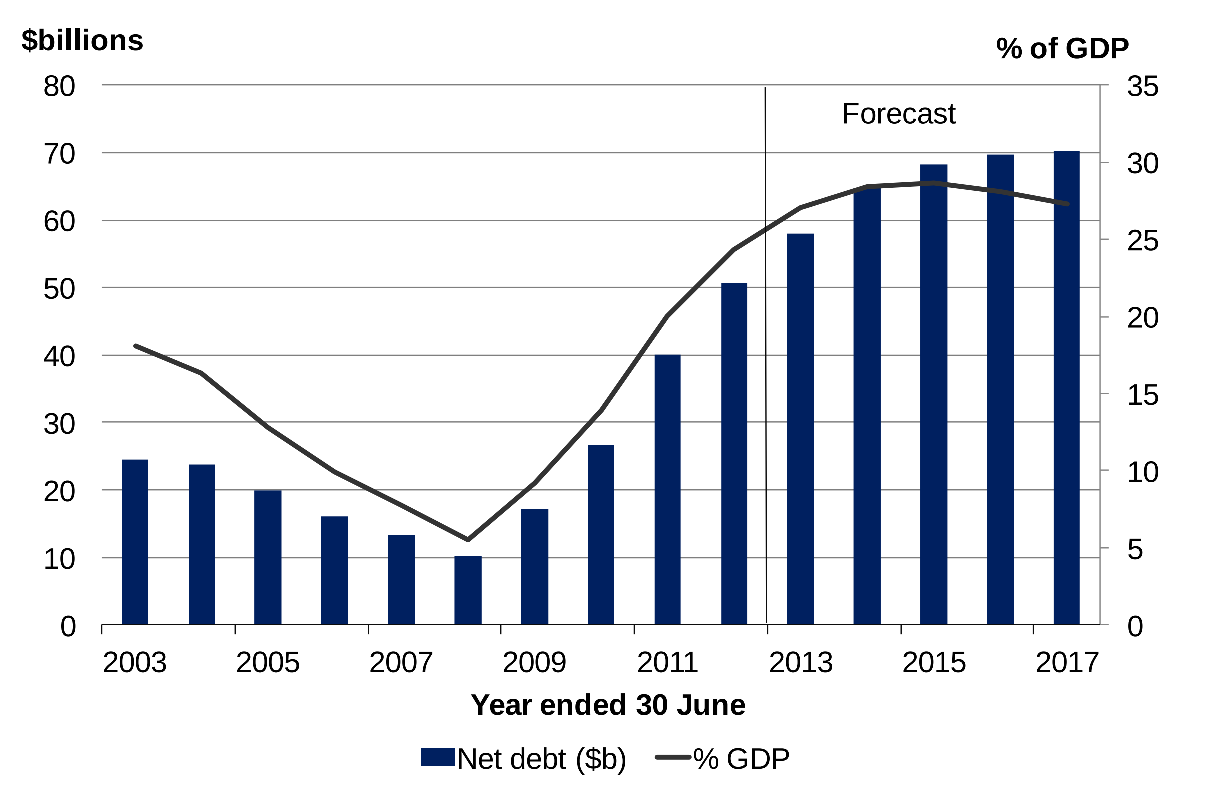
# Tax revenue increases by $14.5b



# Core Crown expenses grow $5.5b
## *(but grow slower than tax revenue)*



# Net debt peaks: 28.7% of GDP in 14/15




## Borrowing

$ **32b** over next four years

## Borrowing costs

$ **3.5b per year** roughly the same as total annual spending on law & order

THE TREASURY

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*Affording Our Future*

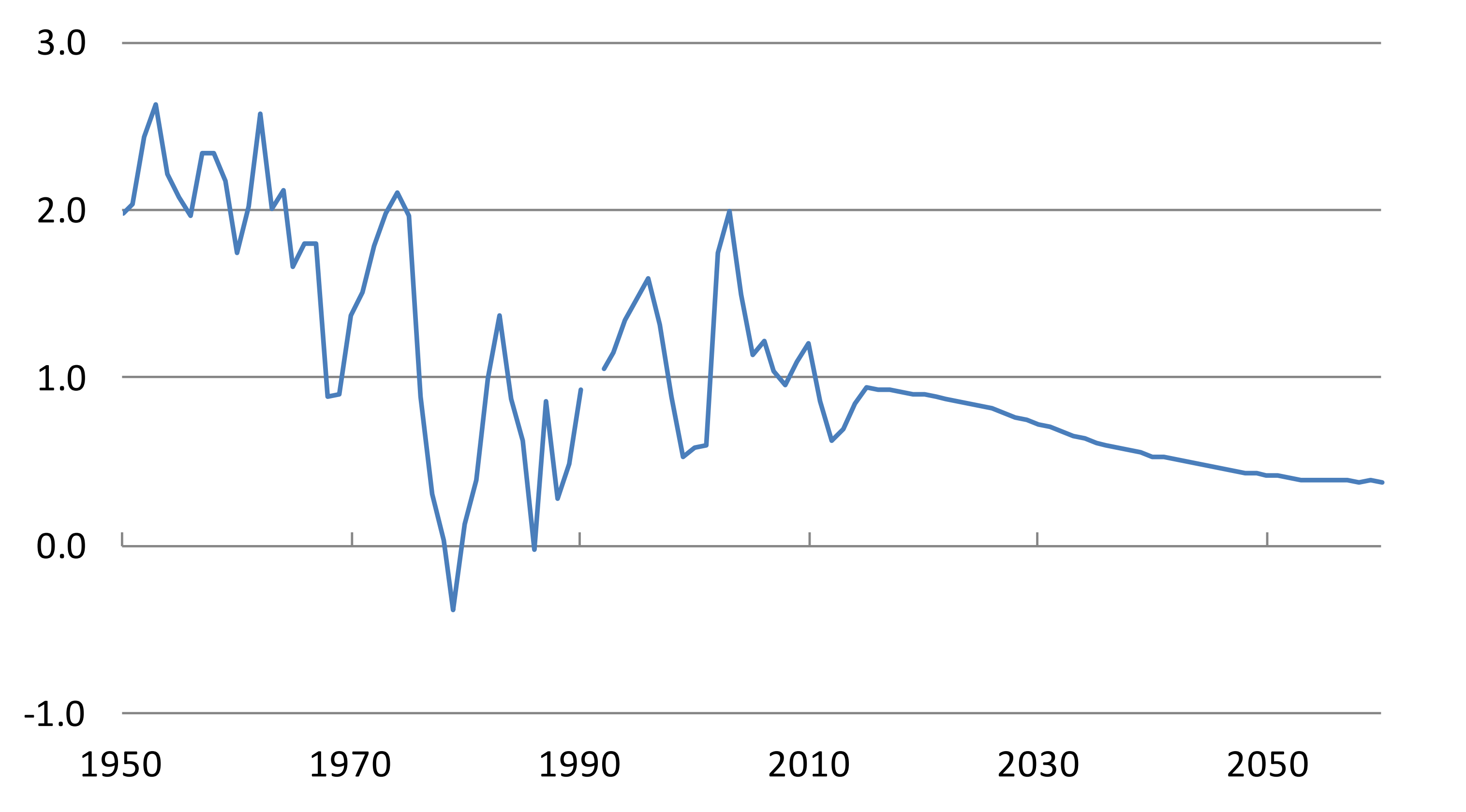
The Treasury's *2013 Statement on the Long-Term Fiscal Position*

# What's the story and why does it matter for you?

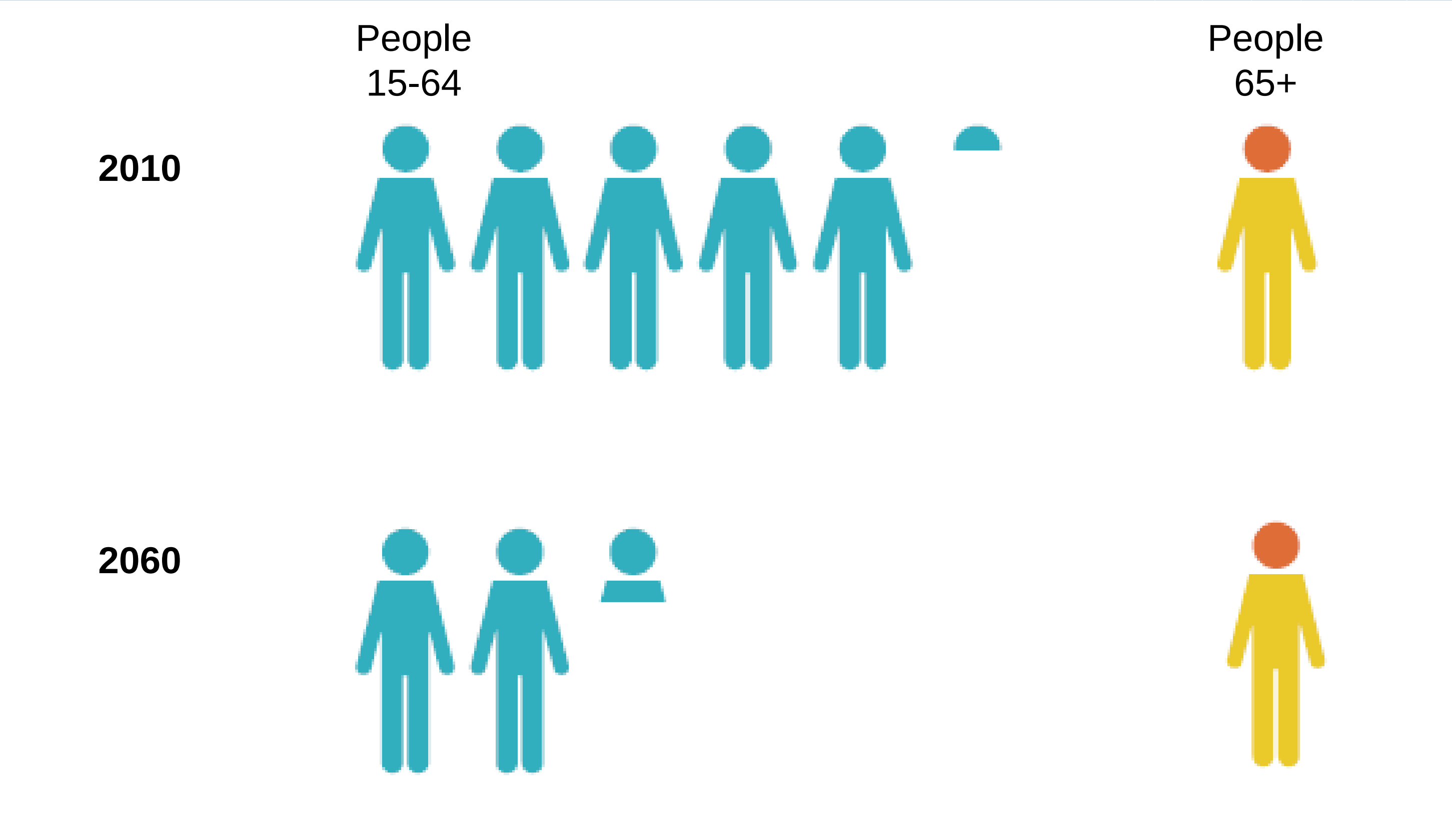
# Background

- The Public Finance Act requires Treasury to publish a Statement on the Long-Term Fiscal Position at least every 4 years
- Must relate to a period of at least 40 years
- The *2013 Statement* was presented to Parliament on 11 July
- Together with about 40 background papers, *Affording Our Future* is available on Treasury's website

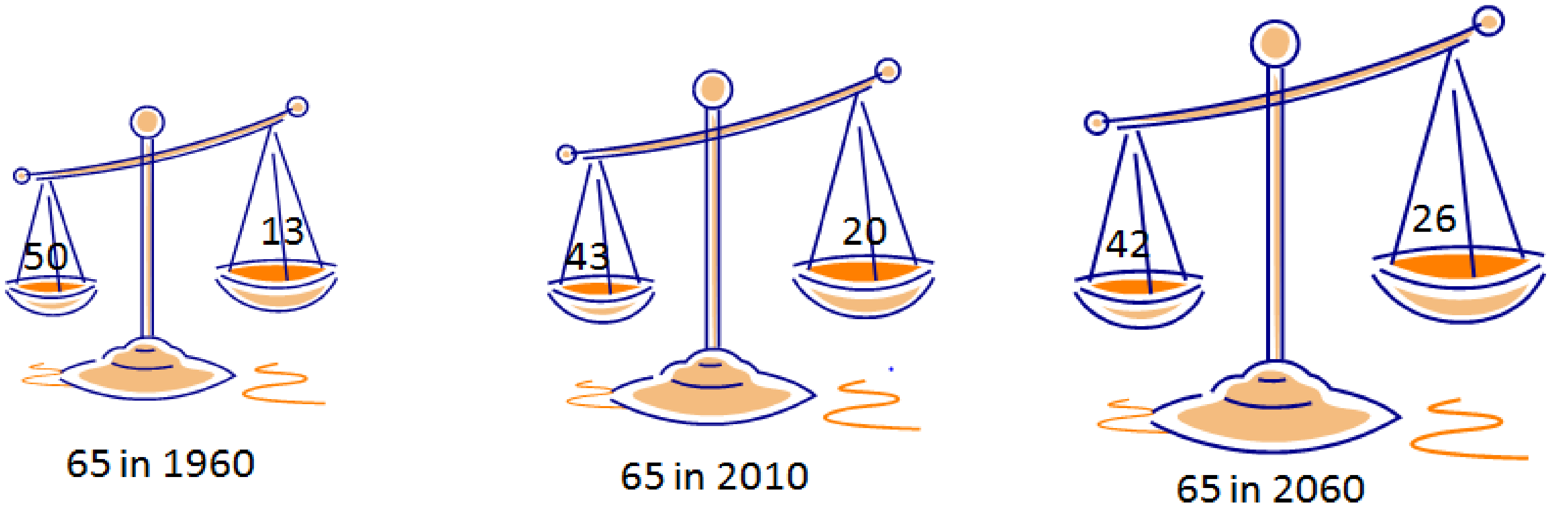
# Population growth (%)



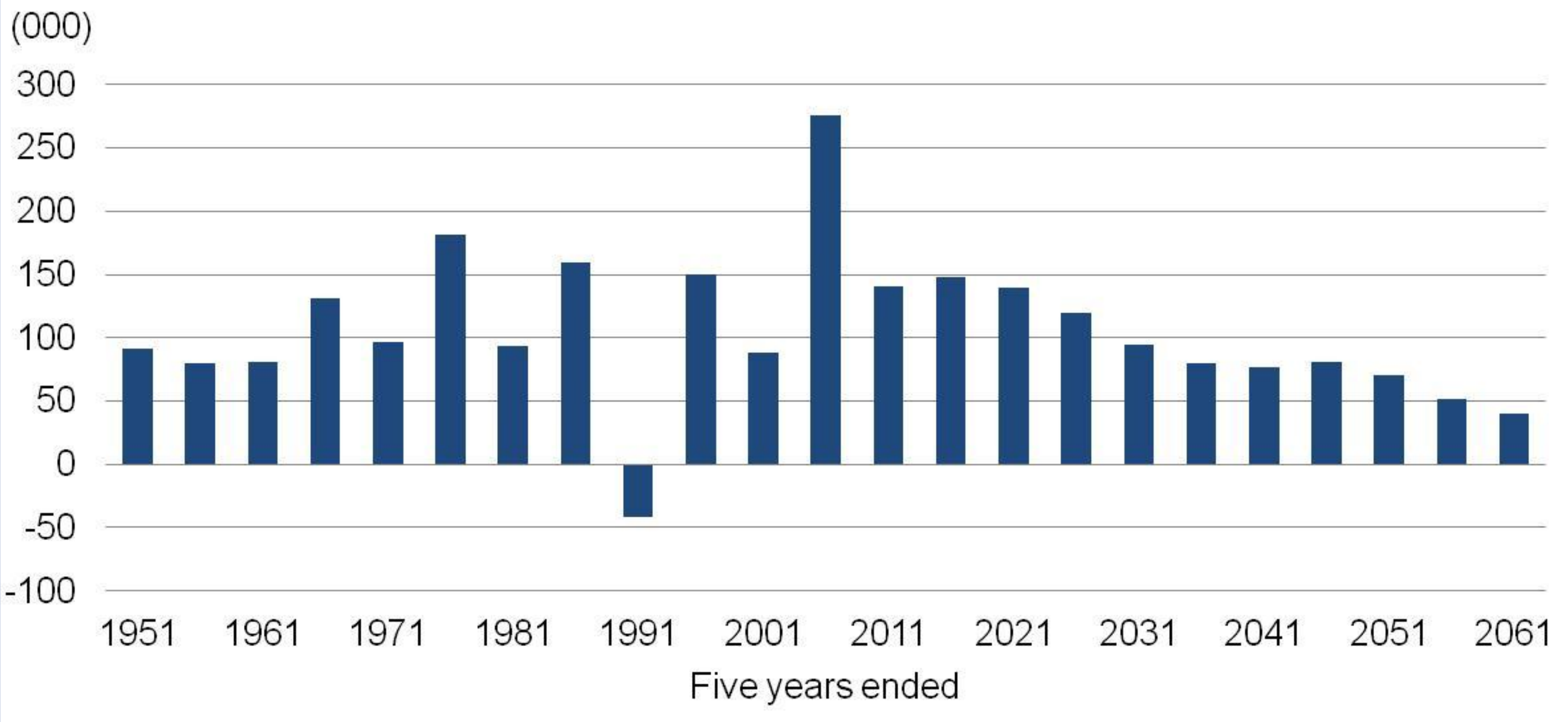
# Dependency ratio 65+ to 15-64



# Changing balance between work/ remaining life for males turning 65



# Slowing growth of the labour force



# Key economic assumptions

- Trend productivity assumption of 1.5% growth in output per hour worked per annum from 2020 (versus 1.1% for the last 40 years)
- Average weekly hours worked assumed at 33.2 hours (compared with 34.6 hours over the last 35 years)
- Assumes an average annual consumer price inflation rate of 2% (the midpoint of the current inflation range target)

# Treasury's long-term projections are a *"what if"* scenario

- Treasury's projections do not include the long-term consequences of the Government's fiscal strategy (the May 2013 FSR)
- Rather, they use a *"Resume Historic Cost Growth"* scenario from the 2015/16 fiscal year (first full fiscal year of new Parliamentary term)
- Point is to show how expense categories might grow in the future, using the past as a guide

# What exactly is the “Resume Historic Cost Growth” scenario?

- Historic growth rates per recipient in different expense categories; plus
- Current legislative settings (e.g. for welfare benefits and NZ Super); plus
- Assumptions about future demographics; plus
- Assumptions about future economic factors

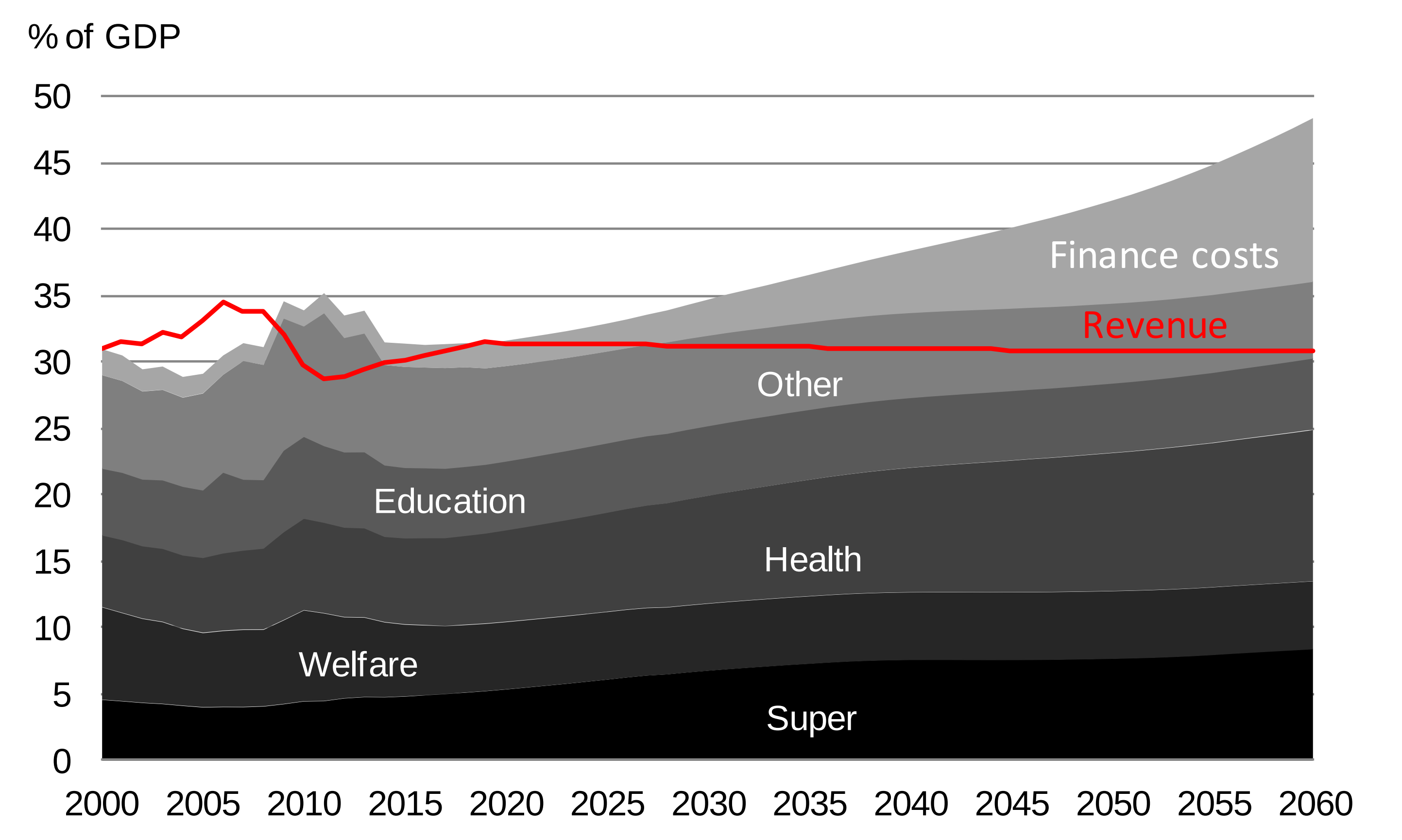
# The “Resume Historic Cost Growth” scenario shows:

- If we allow expenses to grow in accordance with the “Resume Historic Cost Growth” scenario from 2015/16
- And collect the same amount of tax as in recent history (29% of GDP)
- We’ll face a growing gap between revenue and expenses, which we’ll need to borrow to fill

# Key Conclusions from "Resume Historic Cost Growth" projections

| % of nominal GDP | 2010 | 2020 | 2030 | 2040 | 2050 | 2060 |
|---|---|---|---|---|---|---|
| Healthcare | 6.8 | 6.8 | 7.7 | 8.9 | 9.9 | 10.8 |
| NZ Super | 4.3 | 5.1 | 6.4 | 7.1 | 7.2 | 7.9 |
| Education | 6.1 | 5.3 | 5.2 | 5.2 | 5.1 | 5.2 |
| Law and order | 1.7 | 1.4 | 1.4 | 1.4 | 1.4 | 1.4 |
| Welfare (excluding NZ Super) | 6.7 | 4.8 | 4.4 | 4.2 | 4.0 | 3.8 |
| Other | 6.5 | 5.6 | 5.7 | 5.8 | 5.9 | 6.1 |
| Debt-financing costs | 1.2 | 1.8 | 2.5 | 4.2 | 7.1 | 11.7 |
| Total government expenses | 33.4 | 30.8 | 33.4 | 36.9 | 40.6 | 46.8 |
| | | | | | | |
| Tax revenue | 26.5 | 28.9 | 29.0 | 29.0 | 29.0 | 29.0 |
| Other revenue | 3.2 | 3.0 | 3.2 | 3.2 | 3.3 | 3.6 |
| Total government revenue | 29.7 | 31.9 | 32.2 | 32.2 | 32.3 | 32.6 |
| | | | | | | |
| Expenses less revenue | 3.6 | -1.1 | 1.2 | 4.6 | 8.3 | 14.3 |
| | | | | | | |
| Net government debt | 13.9 | 27.4 | 37.1 | 67.2 | 118.9 | 198.3 |

# Major spending areas and aggregate revenue



# FSR versus LTFS

- You may have noticed net Crown debt is projected to be higher in 2020 in *Affording Our Future* compared with the Government's commitment of *no higher than 20% of GDP* in its May 2013 *Fiscal Strategy Report*
- That is because Treasury projections capture scale of potential expense pressures, based on historic rates of expenses growth re-asserting themselves from 2015/16, versus this Government's commitments should it be responsible for the annual budgets through to 2020
- The Government's approach is more fiscally prudent and more fiscally constrained than recent governments

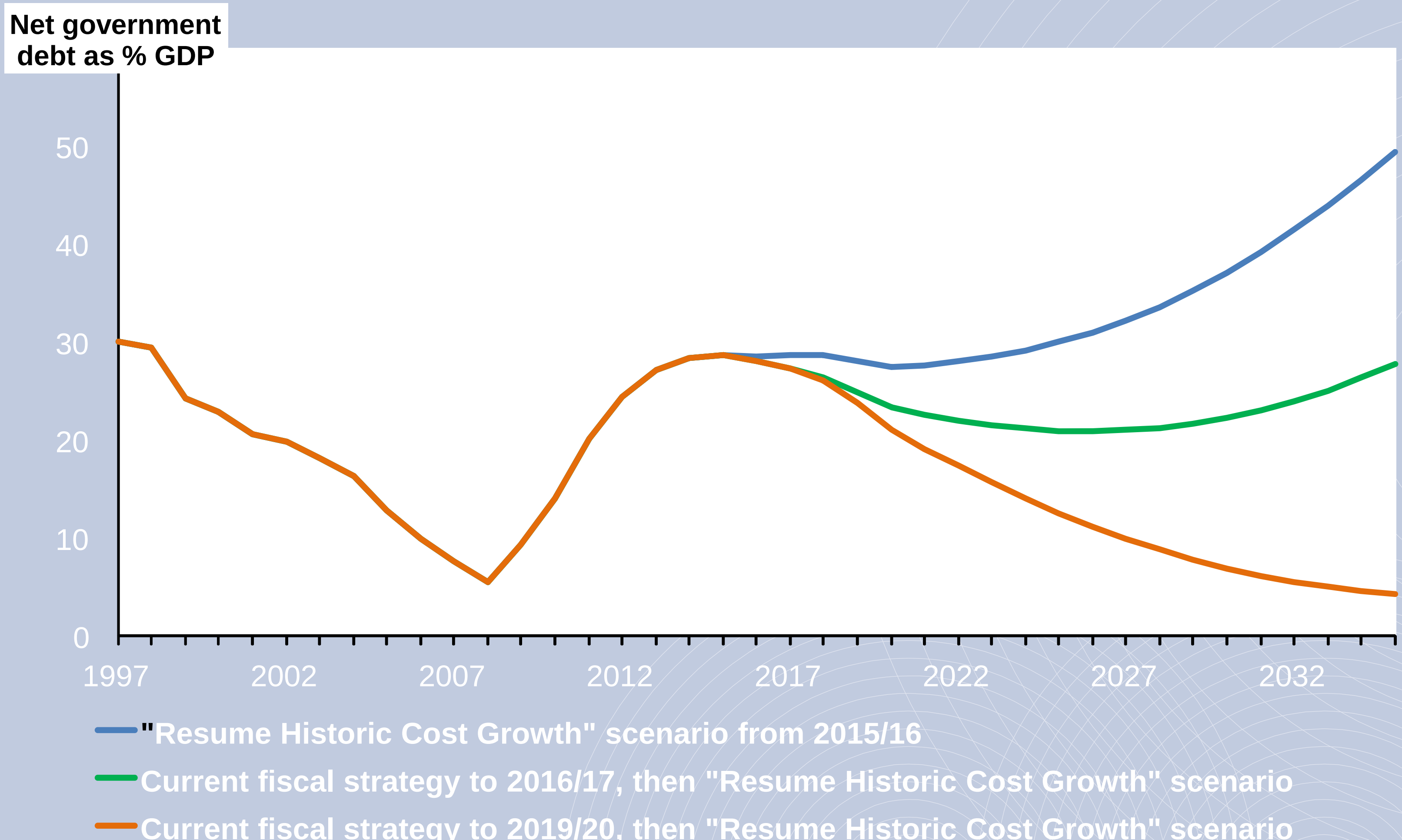
# Adjusting early, pays big dividends over time

- Stick with the current fiscal strategy (or a different equally prudent alternative) until 2020, before letting historic rates of Crown expenses growth per recipient to re-assert themselves thereafter : Net Crown Debt would be around 39% in 2059/60 **and rising**

- Maintain fiscal strategy until 2016/17 before you let historic expense patterns progressively re-assert themselves: Net Crown Debt would be around 124% of GDP in 2059/60 **and rising**

- Maintain fiscal strategy until we return to surplus in 2014/15, but then turn on history (from 2015/16) : Net debt would be around 198% of GDP by June 2060 **and rising)**

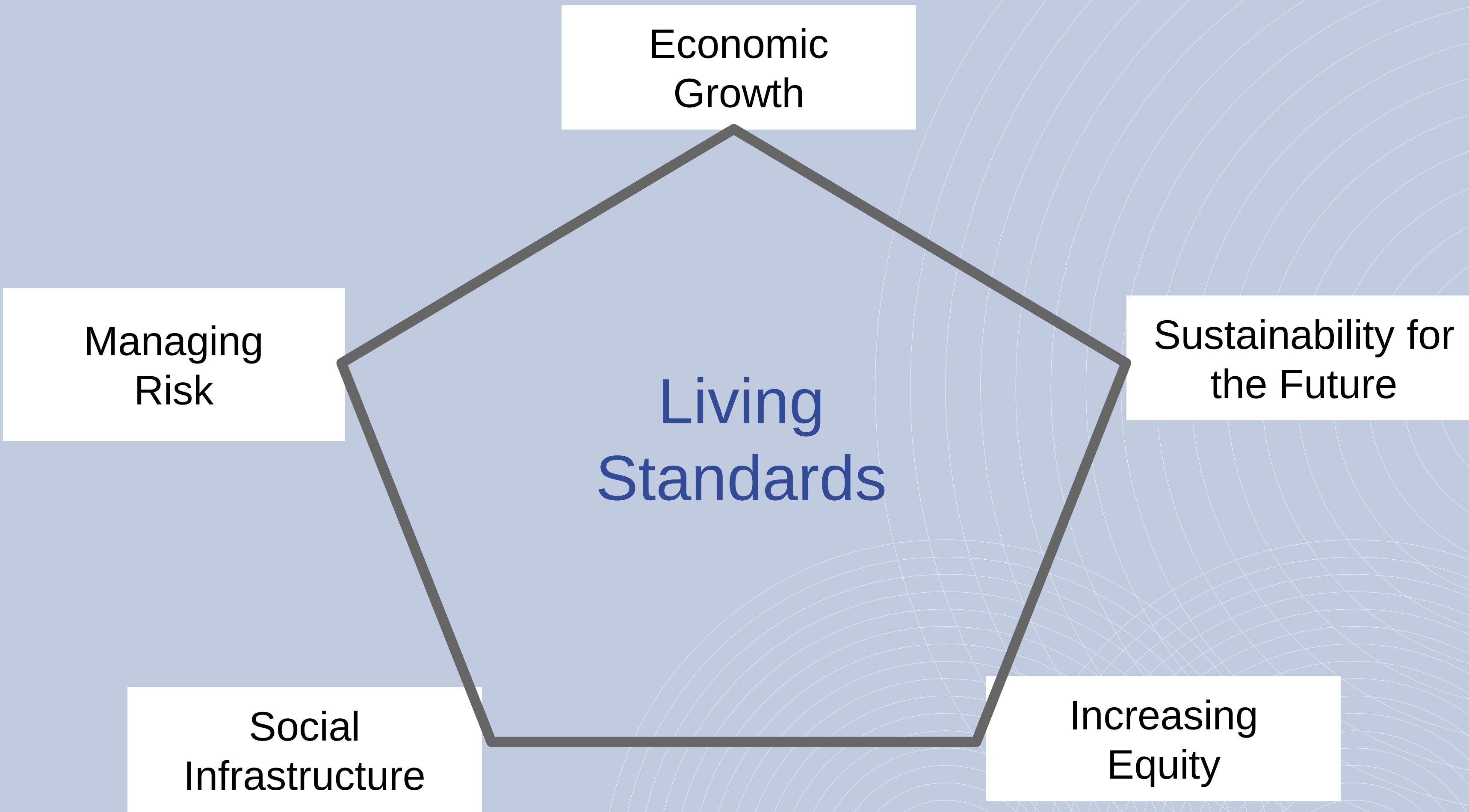
# Putting that into a graph ....



# The Illustrative Options

- Different governments might make different choices to meet the long-term fiscal challenge – that's why the *Statement* analyses some illustrative examples of policy changes that future governments could consider to address long-term fiscal issues, including:
  - Options to increase taxes
  - Options to constrain growth in health spending
  - Options to constrain growth in spending on NZ Super
- There are many, many more in the *Background Papers Supporting the Statement*
- ... And an *on-line long-term fiscal calculator at* http://nzpublicfinance.com/ltf-calculator-introduction/

# It isn't just about money ...



***Treasury's***
***Living Standards Work Programme***

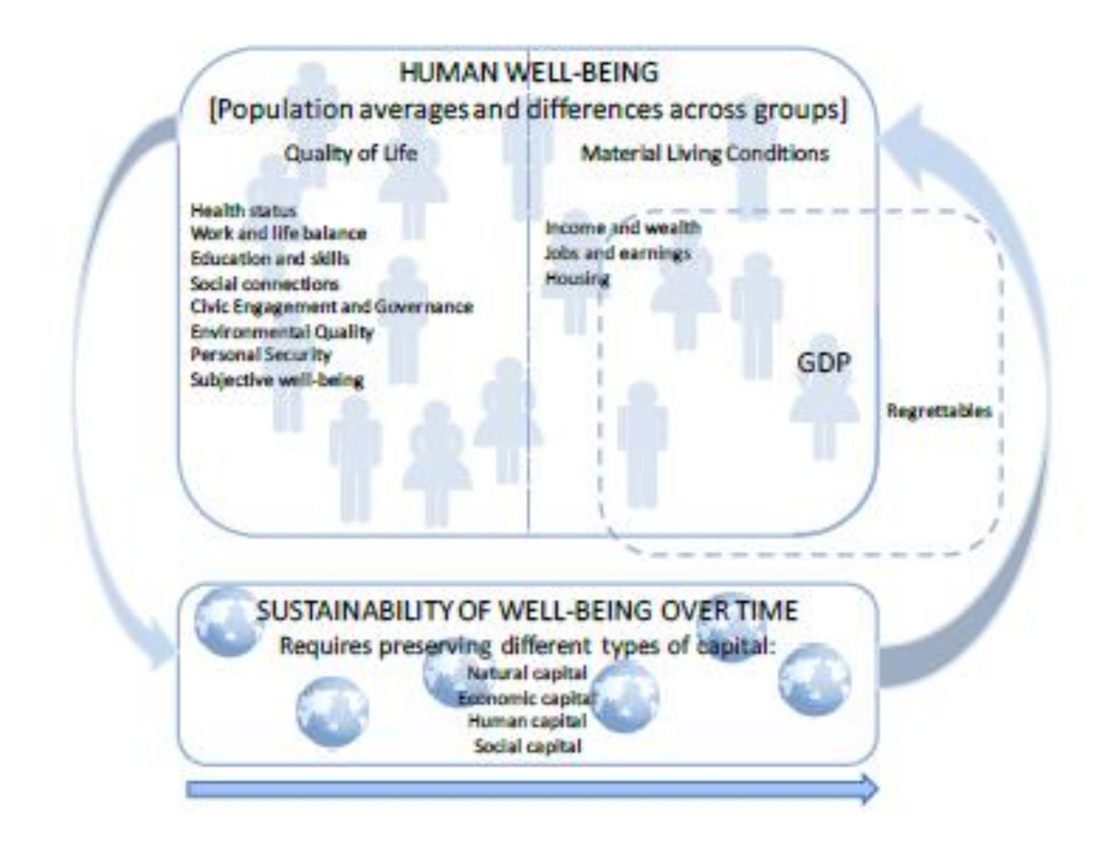
# Treasury's Vision

To be a world class Treasury

**working for higher living standards**

**for New Zealanders**.

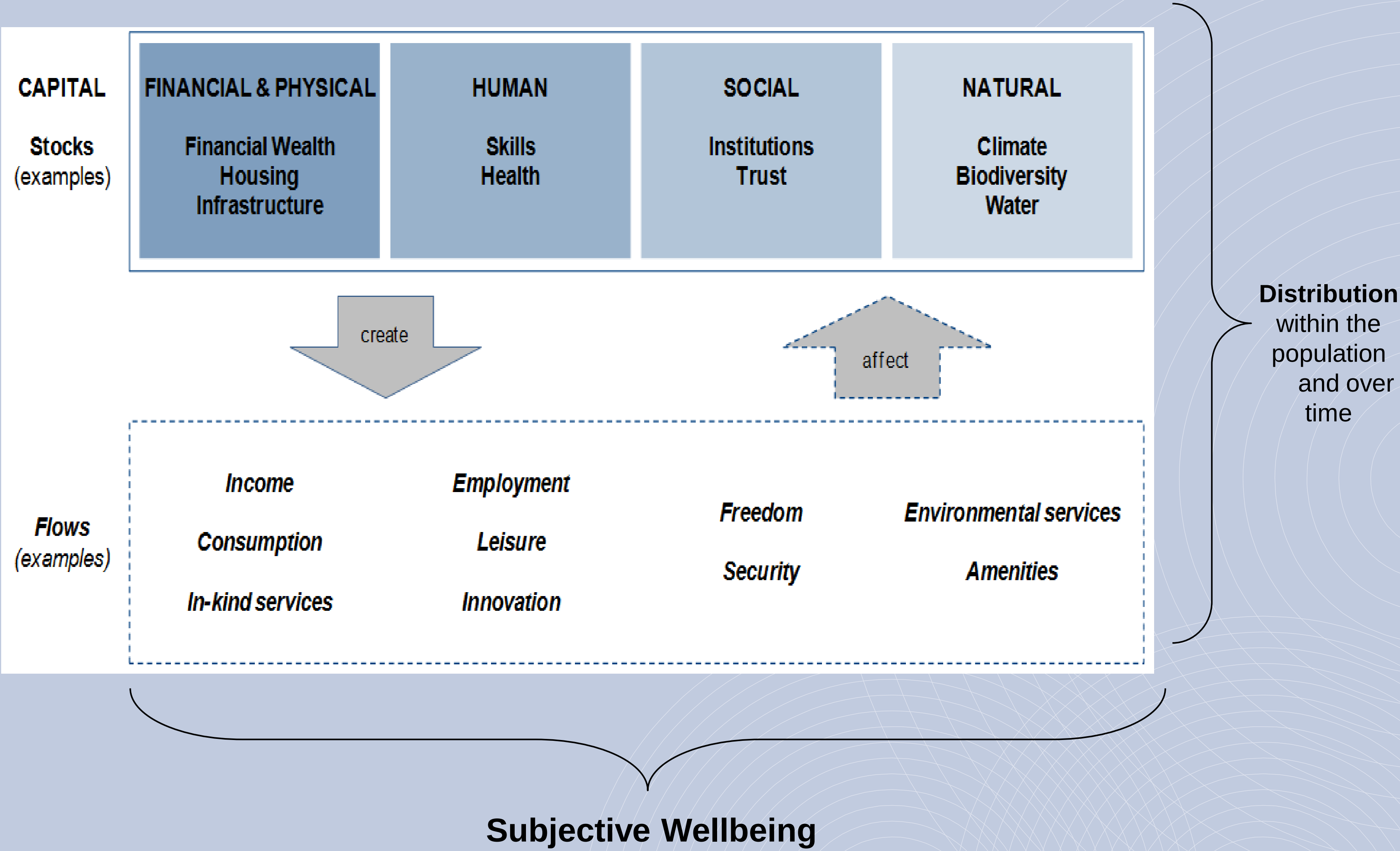
# The OECD



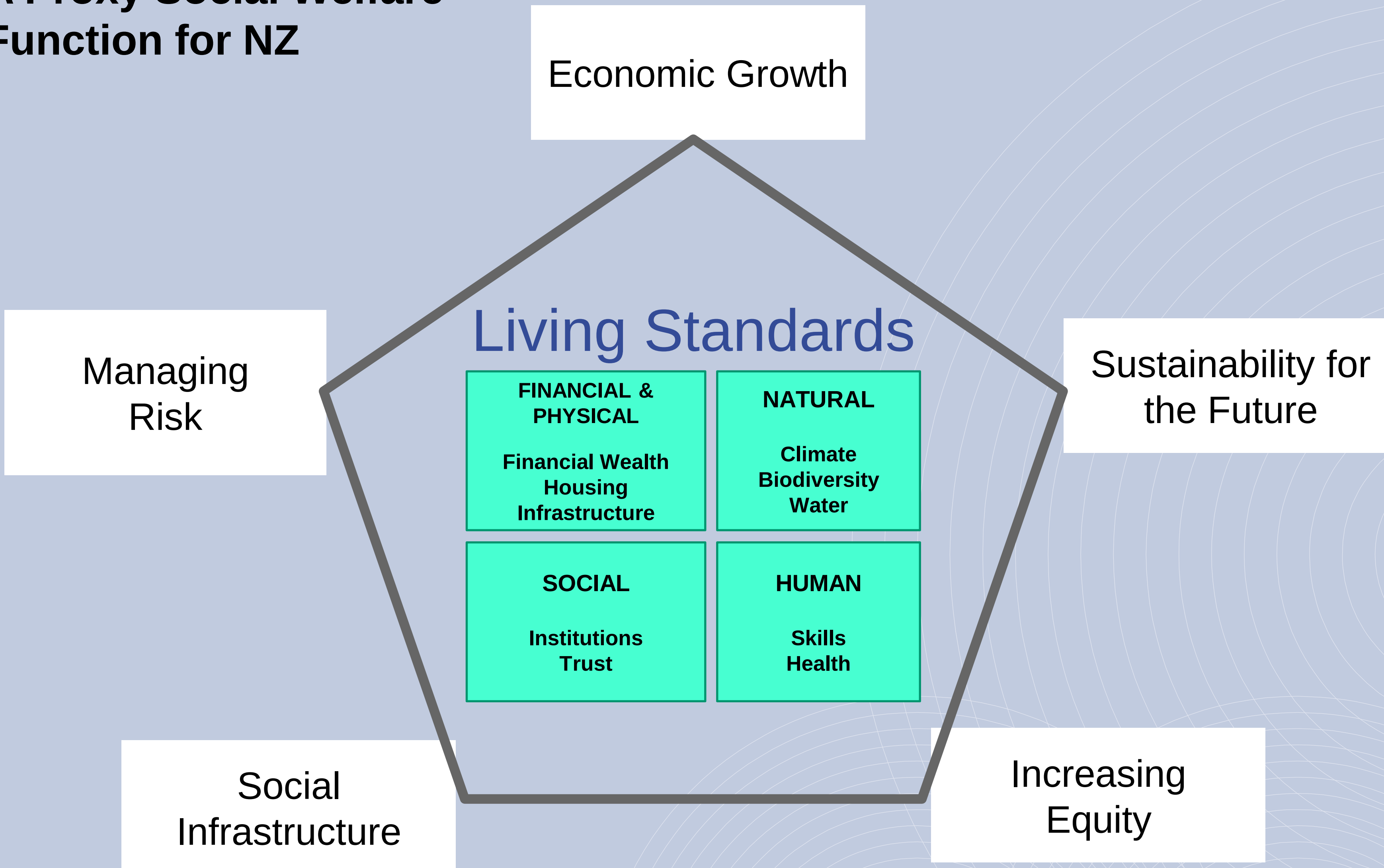
HUMAN WELL-BEING
[Population averages and differences across groups]
Quality of Life
Material Living Conditions
Health status
Work and life balance
Education and skills
Social connections
Civic Engagement and Governance
Environmental Quality
Personal Security
Subjective well-being
Income and wealth
Jobs and earnings
Housing
GDP
Regrettables
SUSTAINABILITY OF WELL-BEING OVER TIME
Requires preserving different types of capital:
Natural capital
Economic capital
Human capital
Social capital

# Better Life vs. GDP

# The Living Standards Framework



# A Proxy Social Welfare Function for NZ



# Key Policy Question

Instead of thinking of trade-offs between the five corners of the living standards cobweb, can we come up with policies that make these corners mutually reinforcing – so that we can create an expanding dynamic cobweb?

# Example: Education Reforms


Note: This is intended to demonstrate how the diagram could be used, rather than a Treasury view of the recommendations

# How might we measure progress for New Zealand?

Economic Growth

- NNI / capita

Living Standards

**FINANCIAL & PHYSICAL**

**Financial Wealth**
**Housing**
**Infrastructure**

**NATURAL**

**Climate**
**Biodiversity**
**Water**

**SOCIAL**

**Institutions**
**Trust**

**HUMAN**

**Skills**
**Health**

Managing Risk

- NII position of NZ
- Reducing crime rate
- Reduction in social welfare dependency

Sustainability for the Future

- gross capital formation
- GHG emissions tonnes/capita
- % aged between 35-34 with tertiary qualifications

Social Infrastructure

- World Bank government effectiveness indicator
- World Values Survey: social trust indicator

Increasing Equity

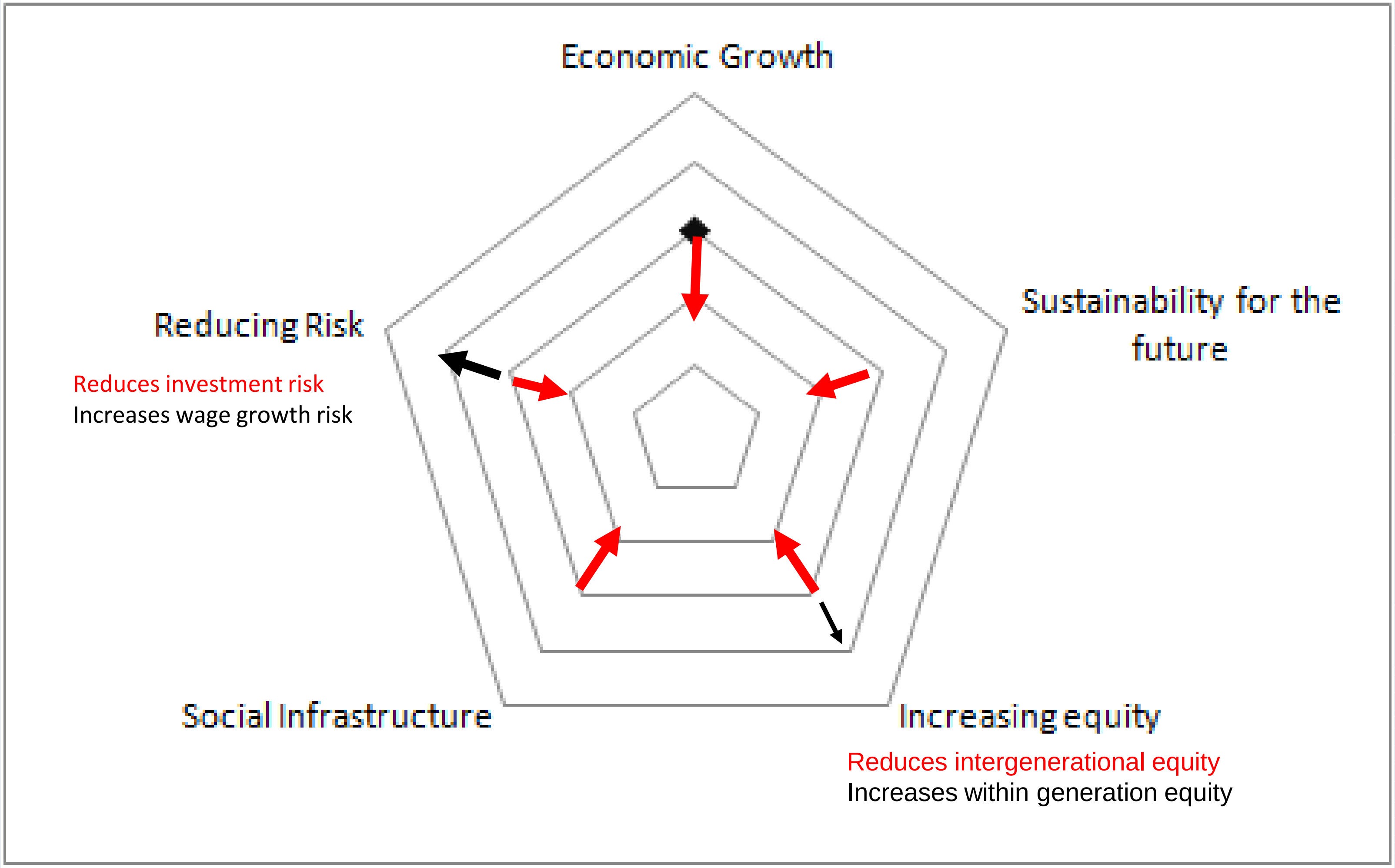
- % of population below 50% of median income
- Difference in the PISA score between the top and bottom 10% of students

**Example:** **Living Standards Assessment: Risk Management**

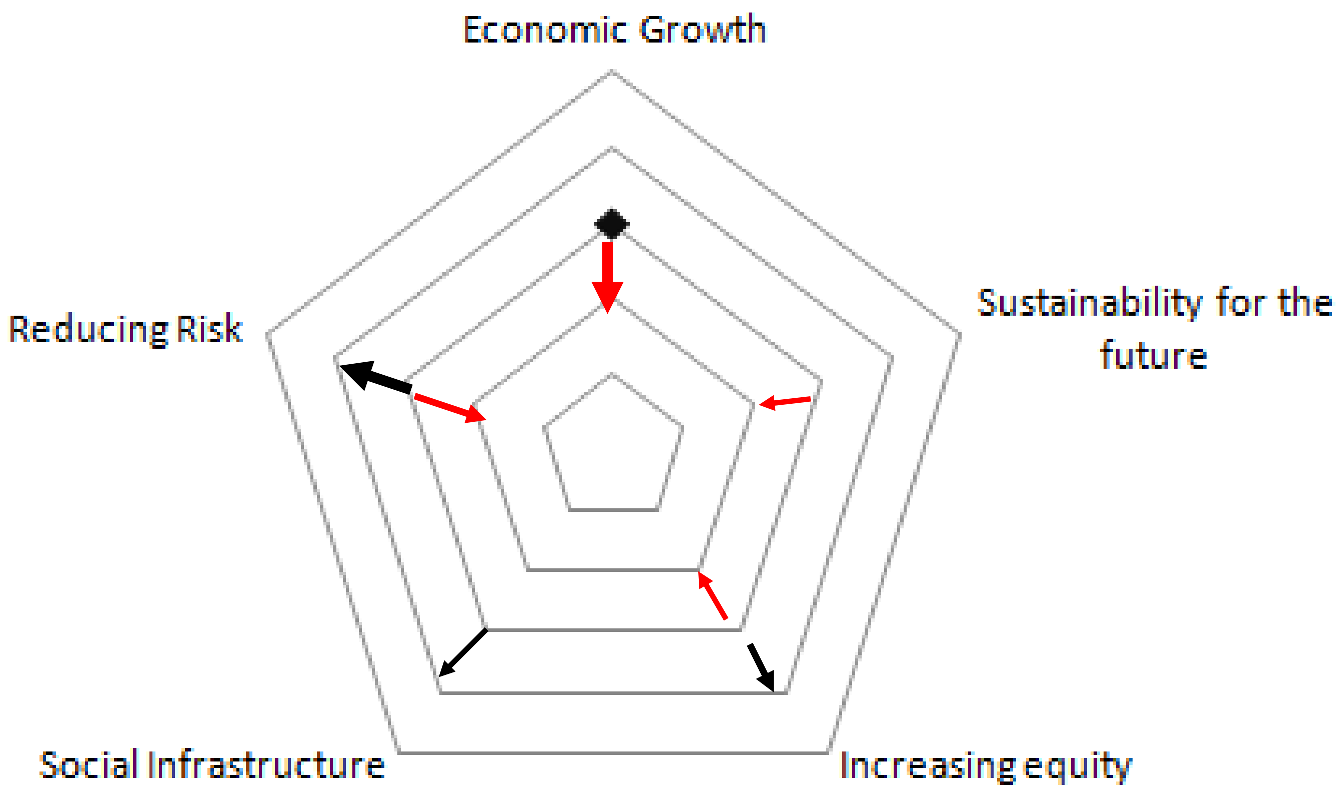
Method: Increasing the freedoms of individuals to enjoy desired lifestyles

| Elements: | Physical Capital | Human Capital | Social Capital | Natural Capital |
|---|---|---|---|---|
| Risks e.g. | Earthquakes<br>Floods<br>Eruptions<br>Infrastructure disrepair<br>White elephants | Crime<br>Ill health<br>Skill Deficiency | Welfare dependency<br>Economic crises<br>Education failure<br>Civic society failure | Climate Change<br>Biodiversity risks<br>Erosion |
| Mitigations | Insurance | Education Policy | Welfare Reform | Emissions Trading |

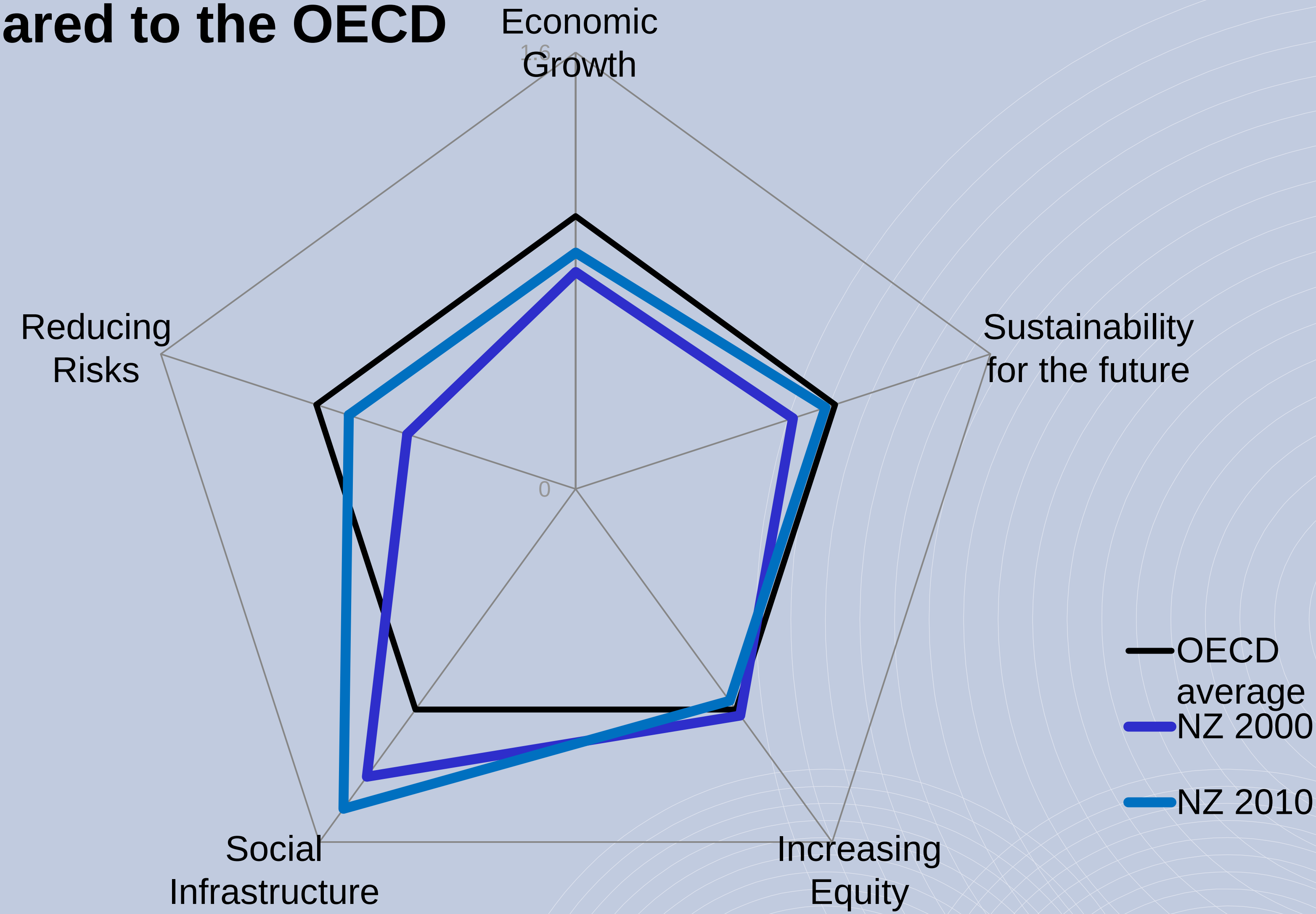
# Example: Effect of a PAYGO-funded expansion of New Zealand Superannuation



## Example: Effect of a SAYGO-funded expansion of New Zealand Superannuation



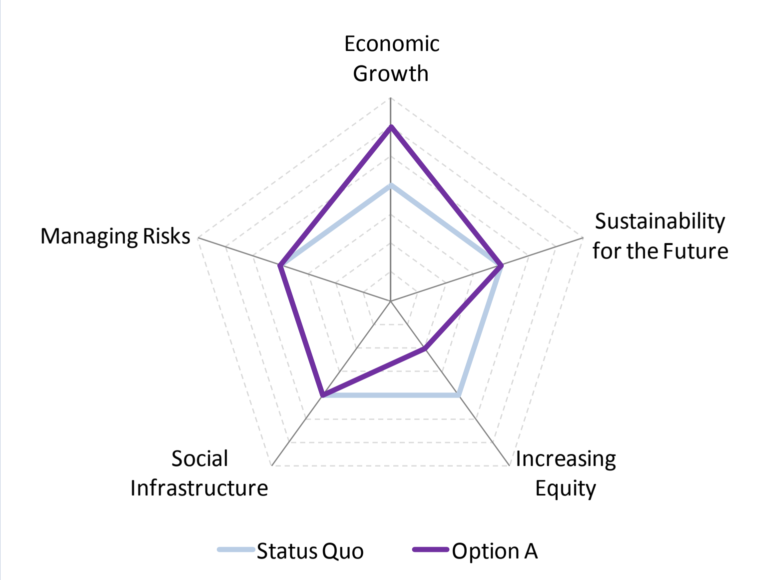
# Example: NZ's performance compared to the OECD




Note: This is only intended to indicate how the diagram may be used. The data involved and the methodology for constructing the indices needs significant further work. It does not therefore represent Treasury's view of what has happened over the ten years concerned.

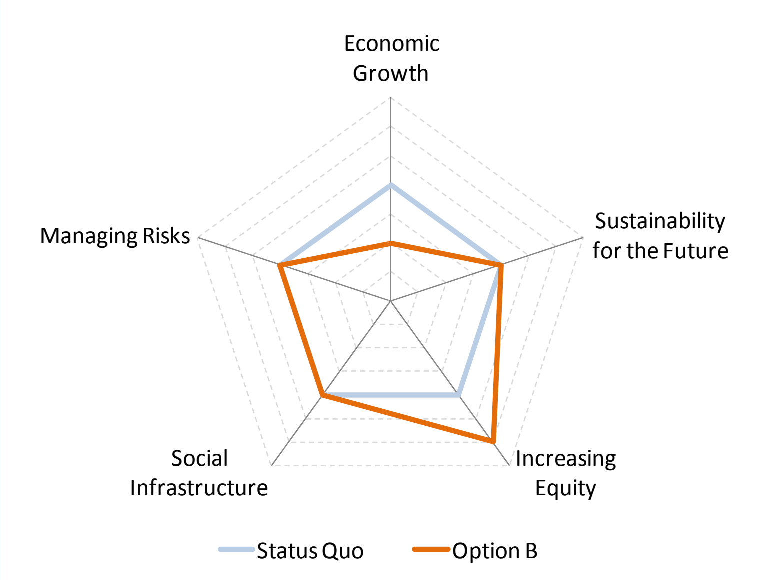
# 4. WEIGHT THE 5 DIMENSIONS OF THE FRAMEWORK

**Option A**




**this one**

**Option B**




**this one**

**they are equal**

Joey Au, Andrew Coleman (Treasury) and Trudy Sullivan (University of Otago)
HUGE thanks to Paul Hansen (University of Otago) and Franz Ombler (1000Minds)

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when good decisions matter

THE TREASURY
Kaitohutohu Kaupapa Rawa