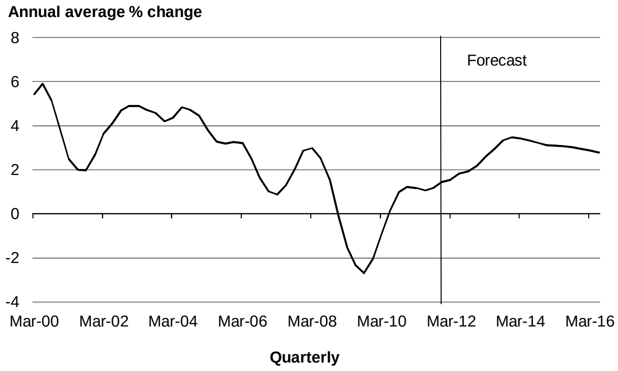
1

Economic Outlook

Overview

Over the past year, the New Zealand economy continued its recovery from the 2008/09 recession, registering 1.1% growth in the 12 months ending December 2011.[1]

Figure 1.1 – Real GDP growth



Sources: Statistics New Zealand, the Treasury

Factors facilitating this growth include strong merchandise terms of trade, good farming conditions, the Rugby World Cup (RWC) and an accommodating fiscal stance by the Government designed to underpin demand in the wake of the global financial crisis and devastating natural disasters. Monetary policy has also been supporting activity through low interest rates.

This below-trend growth rate is reflected in elevated unemployment and weaker inflation. In the current June quarter, the consumers price index (CPI) is estimated to have risen at its lowest annual rate in over a decade.

The Treasury expects the pace of overall growth in gross domestic product (GDP) to continue strengthening. This process will be aided by a substantial employment and income impulse arising out of the Christchurch rebuild, the maintenance of historically low borrowing costs and – in the case of primary industry exporters – ongoing solid demand for New Zealand produce from key trading partners.

Not all sectors of the economy will benefit equally from the factors expected to underpin overall activity levels.

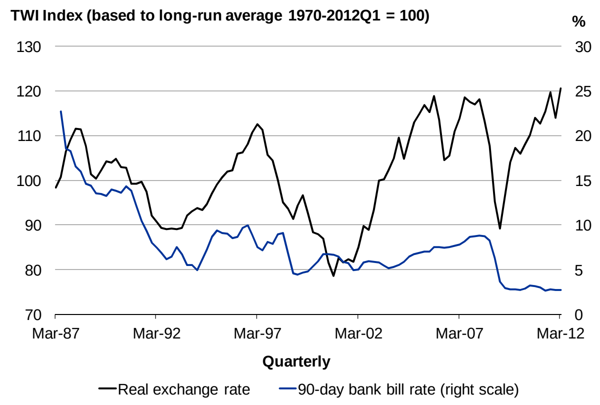
In the first part of the forecast period, non-commodity exporters are expected to continue to experience eroded competitiveness in the face of the strong exchange rate which will reduce their New Zealand dollar earnings. The tourism sector, in particular, is expected to

1 Revised from 1.4% in the 15 May 2012 GDP release.

face additional headwinds from weak income growth in a number of countries which are traditionally key sources of inbound tourists, the loss of infrastructure in Christchurch, and the effects of more New Zealanders taking advantage of the high value of the currency to holiday abroad instead of at home. In the broader retail sector, spending levels are expected to continue to be moderated by New Zealand households' rising rate of saving in the face of high average debt levels.

Despite the increase in saving, the current account deficit is forecast to widen to 6.7% of GDP in the year ending March 2016, with a significant contribution from the Canterbury rebuild. An assumed weakening of the exchange rate towards the end of the forecast period returns the goods balance to surplus and helps the current account deficit narrow. Further adjustment is required beyond the forecast period for the deficit to return to a sustainable level.

Figure 1.2 – Real exchange rate and 90-day interest rates



Source: Reserve Bank of New Zealand

International economy is more stable...

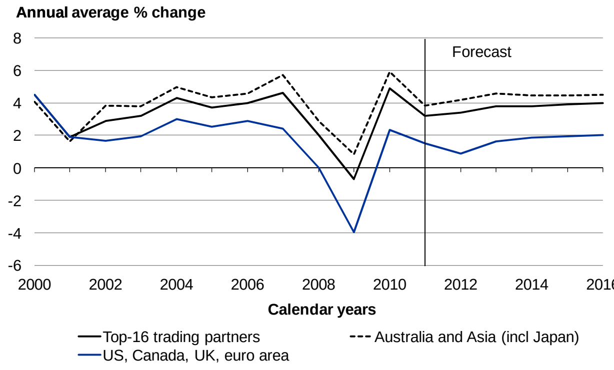
The economic outlook stabilised in the months following the publication of the *Budget Policy Statement* (BPS) earlier this year, but recent developments in Europe highlight the fragility of the outlook. Despite this uncertainty, on current readings of international and domestic indicators, New Zealand's economic outlook is relatively favourable.

...but risks remain

Ongoing financial concerns in some European countries continue to be a potential source of adverse shocks to the world economy.

In the United States (US), the economic recovery could yet be undermined by political delays in reaching a credible medium-term path to fiscal sustainability.

Figure 1.3 – Trading partner growth



Sources: IMF, the Treasury

The main threats to growth in China arise from the housing market, which became overheated following the rapid credit growth in 2009 and 2010 in response to the global financial crisis. In addition, China is Australia's largest export market so events in China have significant direct implications for the economic prospects of Australia. Together, China and Australia account for around 35% of New Zealand's merchandise exports.

Risks to the outlook from unanticipated developments internationally and domestically are explored in more detail in the *Risks and Scenarios* chapter.

Table 1.1 – Economic forecasts[1]

(Annual average % change, March years)	**2011 Actual**	**2012 Forecast**	**2013 Forecast**	**2014 Forecast**	**2015 Forecast**	**2016 Forecast**
Private consumption	2.0	2.7	2.2	2.9	2.8	2.6
Public consumption	3.7	1.1	-0.8	0.1	0.7	0.6
Total consumption	**2.4**	**2.3**	**1.5**	**2.2**	**2.4**	**2.2**
Residential investment	4.4	-11.2	29.5	40.7	14.7	5.2
Market investment	9.6	6.0	7.4	14.1	6.3	2.2
Non-market investment	-16.5	-7.4	5.4	3.3	5.6	3.4
Total investment	**6.8**	**1.0**	**12.6**	**18.4**	**8.1**	**3.0**
Stock change[2]	1.4	0.7	-0.7	-0.3	0.0	0.2
Gross national expenditure	**4.6**	**2.4**	**3.7**	**5.8**	**3.9**	**2.6**
Exports	1.9	3.0	2.1	1.0	2.1	2.1
Imports	10.5	5.2	2.8	8.5	4.9	1.7
GDP (expenditure measure)	**2.0**	**1.5**	**2.9**	**3.4**	**3.0**	**2.8**
GDP (production measure)	**1.2**	**1.6**	**2.6**	**3.4**	**3.1**	**2.9**
Real GDP per capita	0.0	0.8	1.8	2.4	2.1	2.0
Nominal GDP (expenditure measure)	5.9	4.2	4.1	6.5	5.4	4.9
GDP deflator	3.7	2.6	1.1	3.0	2.4	2.0
Output gap (% deviation, March quarter)[3]	-0.2	-1.0	-0.2	-0.6	-0.5	-0.1
Employment	1.2	1.3	1.3	1.6	1.6	1.4
Unemployment[4]	6.6	6.3	5.7	5.2	5.0	4.7
Participation rate[5]	68.6	68.3	68.2	68.2	68.2	68.4
Nominal wages[6]	2.6	3.2	3.8	3.9	3.7	3.5
CPI inflation[7]	4.5	1.6	2.6	2.5	2.4	2.4
Merchandise terms of trade[8]	9.9	1.3	-4.0	3.9	2.9	1.5
Current account balance						
$billion	-7.2	-8.7	-9.8	-13.5	-15.1	-16.8
% of GDP	-3.6	-4.2	-4.6	-5.9	-6.3	-6.7
Net international investment position						
% of GDP	-67.5	-72.1	-73.9	-75.3	-77.7	-80.8
TWI[9]	67.2	72.5	72.0	70.8	67.5	63.0
90-day bank bill rate[9]	3.0	2.7	2.9	3.6	4.1	4.4
10-year bond rate[9]	5.6	4.0	4.2	4.6	5.0	5.2

Sources: Statistics New Zealand, Reserve Bank of New Zealand, the Treasury

Notes:
1 Forecasts finalised 27 April
2 Contribution to GDP growth
3 Estimated as the percentage difference between actual real GDP and potential real GDP
4 Percent of the labour force, March quarter, seasonally adjusted
5 Percent of the working-age population, March quarter, seasonally adjusted
6 Quarterly Employment Survey, average ordinary-time hourly earnings, annual percentage change
7 Annual percentage change, 2012 actual
8 System of National Accounts (SNA) basis, annual average percentage change
9 Average for the March quarter, 2012 actual

A longer time series for these variables is provided on page 132.

International Outlook

Trading partner growth outlook is more stable...

The trading partner growth outlook is similar to the forecasts underpinning the BPS, which were a significant downward revision from last year's *Pre-election Update*. The economic outlook became more stable in the months following the publication of the BPS as policy responses increased financial market liquidity and eased funding pressures in Europe and elsewhere. More recent developments, particularly those in Europe, highlight the fragility of the outlook.

Trading partner growth of 3.4% is expected over the year ending December 2012, just below the 30-year average growth rate of 3.6%. Natural disasters in Australia and Japan reduced their growth rates in 2011, but the recovery from these disasters adds to growth over 2012 and offsets weaker growth in the euro zone, the United Kingdom (UK), China and other Asian economies. The modest pace of economic recovery in the US is expected to continue over 2012. Trading partner growth is expected to be just above trend in 2013 as the recovery from 2011's dip becomes more broad based, strengthening to around 4% in the longer term, supported by New Zealand's increasing dependence on China and Australia. This outlook is very similar to those from other forecasters, including the International Monetary Fund (IMF).

Table 1.2 – Trading partner growth (years ending December)

	2012 weights	**2011** *actual*	**2012** *forecast*	**2013** *forecast*	**2014** *forecast*	**2015** *forecast*	**2016** *forecast*
Australia	*28%*	2.0	3.0	3.2	3.0	3.0	3.0
China	*15%*	9.3	8.1	8.3	8.0	8.0	8.0
United States	*11%*	1.7	2.1	2.2	2.3	2.4	2.5
Euro area	*9%*	1.5	-0.6	1.0	1.4	1.4	1.4
Japan	*9%*	-0.7	1.8	1.5	1.2	1.1	1.0
United Kingdom	*4%*	0.7	0.5	1.4	1.6	1.8	2.2
Canada	*2%*	2.5	2.0	2.1	2.4	2.4	2.5
Other Asia*	*23%*	4.5	4.1	5.0	5.1	5.2	5.2
Trading Partners	***100%***	**3.2**	**3.4**	**3.8**	**3.8**	**3.9**	**4.0**
Consensus (April 2012)		3.2	3.6	4.0	4.0	4.0	4.0
IMF (April WEO)		3.2	3.5	4.1	4.2	4.3	4.4

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

Sources: IMF, Consensus Economics, the Treasury

...but risks of slower growth continue to dominate

Most of the risks to the international outlook are oriented to weaker growth than forecast. Further policy measures are required to return sovereign debt to a sustainable path in Europe, the US and Japan. Failure to address these issues could lead to disruption in financial markets. At the same time, addressing the issues through tighter fiscal policy could reduce economic activity. A slowing in emerging market economies – for example, from a sharp fall in property prices – would lead to lower trading partner growth. There is also the risk of political tensions in the Middle East escalating and disrupting oil supplies. A sharp increase in oil prices could undermine the already fragile recovery in world growth.

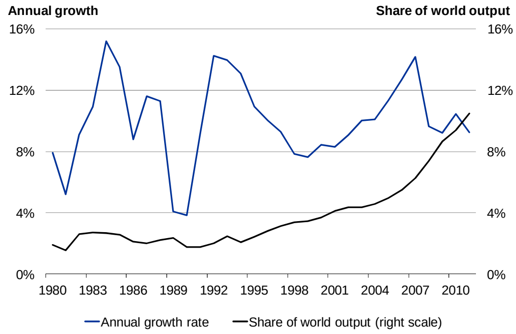
On the positive side, there is potential for a sharp improvement in sentiment in the US and a subsequent lift in investment and activity more generally, financed from the large amounts of liquidity that have been injected in bank and corporate balance sheets, which would support faster trading partner growth.

China's Economic Growth: Past, Present and Future

Since the start of the liberalisation of China's economy in 1978 it has experienced average annual growth in real GDP of 10%, doubling the size of its economy every seven years (Figure 1.4). Its share of world output has increased from 2% in 1980 to 10% in 2011 (14% if allowance is made for its lower cost of living), becoming the second largest economy in the world after the US in 2010. China has become increasingly important to New Zealand in these past three decades, especially since its accession to the World Trade Organisation in 2001 and the conclusion of a Free Trade Agreement between the two countries in 2008.

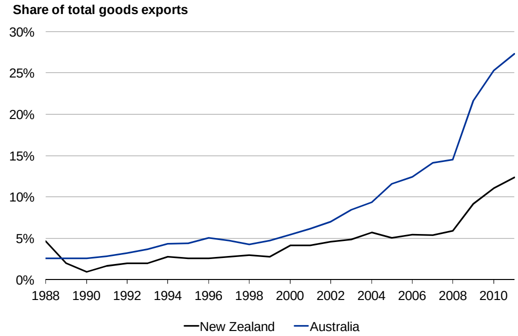
China's share of New Zealand's merchandise exports increased from 2% in the earl 1980s to 12% in 2011, surpassing the US to become our second largest trading partner after Australia (Figure 1.5). China is also an important market for services exports (eg, tourism and education) and a source of consumer goods imports and foreign investment. China is even more important to Australia as its major trading partner, accounting for more than a quarter of merchandise exports, chiefly mineral resources (Figure 1.5). The close integration between New Zealand and Australia is an additional channel for China's economic influence on New Zealand.

Figure 1.4 – China's economic growth and share of the world economy



Source: IMF

Figure 1.5 – New Zealand and Australian goods exports to China



Sources: Australian Bureau of Statistics, Statistics New Zealand

New Zealand's and Australia's exports to China are dominated by agricultural and industrial commodities. China's increasing demand for these goods arises from the related processes of urbanisation and industrialisation, combined with rising living standards and changing diets and tastes. Demand for these commodities has increased rapidly since 2008 as a result of the Chinese Government's fiscal and monetary stimulus in response to the global financial crisis. Demand for minerals and energy from Australia, and dairy, meat and forestry products from New Zealand, increased sharply in that period, driving up the terms of trade for both countries.

However, growth in China is slowing and there are risks to its sustainability. Annual growth in real GDP eased to 8.1% in the March quarter 2012, down from its post-global financial crisis peak of 11.9% two years ago. The slowdown is largely the result of monetary and fiscal tightening to reduce inflation which reached 6.5% mid-last year, as well as weaker demand from Europe, China's largest export market. Authorities have signalled slower growth and are also aiming to cool the housing market which became overheated following the rapid credit growth in 2009 and 2010 in response to the global financial crisis.

So far, China appears to be achieving a managed slowdown in economic growth and we expect growth to average just over 8% in 2012 with some additional strength in the second half of the year carrying through to 2013. There are risks to this outlook, chiefly centred on a sharper-than-expected correction in the property market, possibly combined with an increase in bad debts in the banking sector arising from the rapid expansion of credit in 2009 and 2010. This possibility is explored in the *Risks and Scenarios* chapter. While the European sovereign debt crisis does not pose a direct threat to China through financial channels (given the generally closed nature of its financial markets), weaker export demand could lead to a further slowing in the economy. The Government has room to loosen both monetary and fiscal policy if growth slows more than expected.

We expect China's growth to slow in the longer term as a number of factors come into play. Rebalancing growth from investment and exports to private consumption (a stated aim of the Government) will result in lower overall growth as households are unlikely to fully replace high investment rates as a driver of growth. In addition, growth in the working-age population is expected to peak in the next few years, limiting the sources of economic growth to gains in labour participation and productivity. We also consider that China will not be able to sustain its average 10% growth rate of the past three decades as the most rapid gains in output have already been made and growth is likely to slow as per capita incomes catch up with the developed world. However, China's per capita GDP is still only 11% of the US's. We expect that even if there are short-term fluctuations in China's growth, it will continue to be an important market for New Zealand exports.

Domestic Outlook

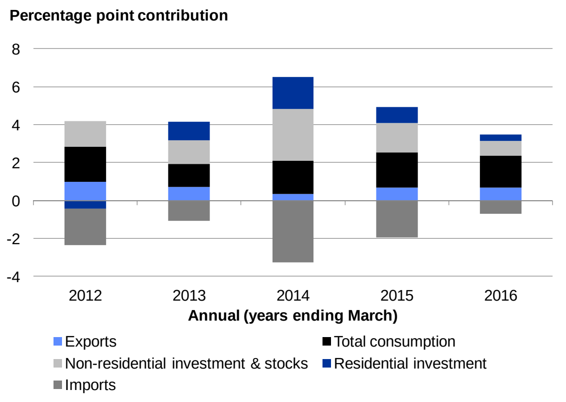
New Zealand's economic recovery continues...

Economic activity over 2011 was disrupted by the Canterbury earthquake of 22 February and subsequent aftershocks. The immediate disruption to overall economic activity proved to be less than the Treasury initially forecast, although the negative effects on tourism and on construction activity have been more pronounced. In the second half of 2011, the economy was buoyed by the effect of the RWC on consumption and a strong start to the dairy season. Offsetting these positive influences, the international environment deteriorated and domestic business confidence weakened. As a consequence, forecast real GDP growth for the year ending March 2012 has been downgraded from 1.9% in the BPS to 1.6%.

The weaker international outlook, combined with a stronger New Zealand dollar assumption, has also reduced forecast real GDP growth in the years ending March 2013 and March 2014 to 2.6% and 3.4% respectively. Growth across the remaining two years of the forecast period averages 3% per year.

GDP growth is led by investment, underpinned by the Canterbury rebuild. This is partly offset by the negative impact from the import

Figure 1.6 – Composition of GDP growth



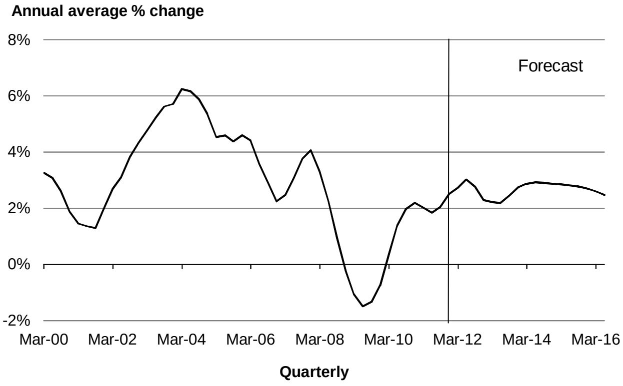
Sources: Statistics New Zealand, the Treasury

content of investment. Consumption spending also makes a significant contribution to forecast growth as private consumption spending rises and more than offsets slower growth in public consumption. Export volume growth is expected to be subdued as farming conditions return to normal, international prices weaken and the high New Zealand dollar constrains returns, although the latter factors become more favourable towards the end of the forecast period.

...consumers remain cautious...

Private consumption growth, which has moderated since the 2008/09 recession, received a boost from the RWC. While some of the rise in consumer spending, such as that on hospitality and supermarket sales, appears to be closely linked to the RWC, spending on consumer durables, such as televisions and furniture, is indicative of a more generalised improvement in consumer sentiment.

Figure 1.7 – Real private consumption growth



Sources: Statistics New Zealand, the Treasury

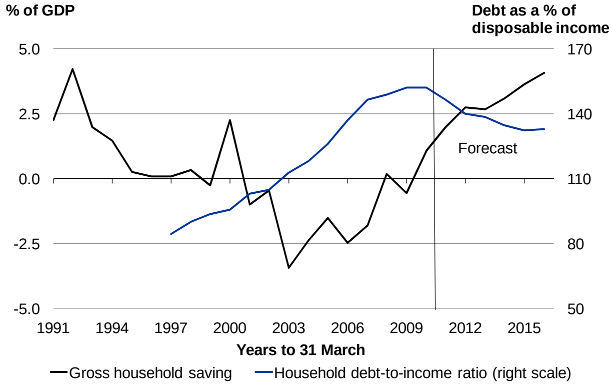
Over the past year the labour market has strengthened, although unemployment remains elevated, household incomes have risen and consumer confidence has returned to average levels. Nonetheless, consumers continue to be cautious in their spending following an extended period when household consumption exceeded income, leading to an accumulation of debt. The excess of household consumption over income closed around the time the 2008/09 recession started and gross household income is now significantly greater than consumption.

Household consumption growth is expected to slow from 2.7% over the year ending March 2012, to 2.2% in the year ending March 2013 as the one-off impact of the RWC fades. The pace of growth rises to 2.9% in the year ending March 2014, supported by increasingly favourable economic conditions and by demand for durable goods, such as furniture and furnishings, associated with newly constructed dwellings. A gradual easing, to 2.8% and 2.6%, is forecast in the following years.

...and household saving increases

Household income growth is also forecast to slow over the year to March 2013, reflecting the lower terms of trade, and the household saving ratio remains around its current rate. From March 2013 onwards, the faster pace of GDP growth feeds through to a stronger labour market and the terms of trade improve, increasing household incomes. The household debt to income ratio has declined from its peak but remains elevated. Continued restraint in consumption spending is expected to generate higher saving and further falls in the debt-to-income ratio.

Figure 1.8 – Household saving and leverage



Sources: Statistics New Zealand, Reserve Bank of New Zealand, the Treasury

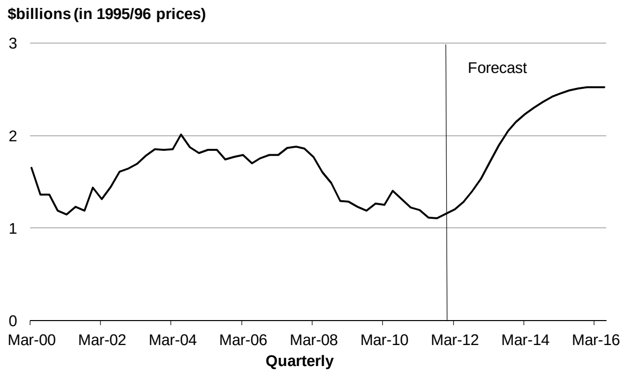
Ongoing household caution is reflected in the subdued outlook for house price inflation. The forecast for rapid growth in the supply of houses also helps to temper gains in house prices. House price growth of around 1.5% per year is forecast, less than the rate of consumer price inflation.

Residential investment rises rapidly...

Households have also been cautious in their residential investment decisions, which have contributed to weakness in the residential construction industry. This generalised weakness has been compounded by the earthquake disasters in Canterbury. Indicators of residential building activity show activity is likely to remain at a low level in the short term. Household credit growth is weak and building consents are rising but the level remains low.

In Canterbury there is a significant amount of repair work underway, but the number of new dwelling consents and rebuilds is small. Repair and rebuilding work is expected to accelerate over coming months and to continue rising for most of the forecast period. Much uncertainty surrounds the expected pace of new building work, although potential cost inflation is also a significant uncertainty. The Treasury forecasts assume a large increase in residential investment from the middle of 2012. The pace of activity is forecast to continue to rise, reaching a peak growth rate of over 40% in the year ending March 2014. The level of activity continues to rise for the remainder of the forecast period, but the growth rates slow to 15% in the year ending March 2015 and 5.2% in the year ending March 2016.

Figure 1.9 – Real residential investment



Sources: Statistics New Zealand, the Treasury

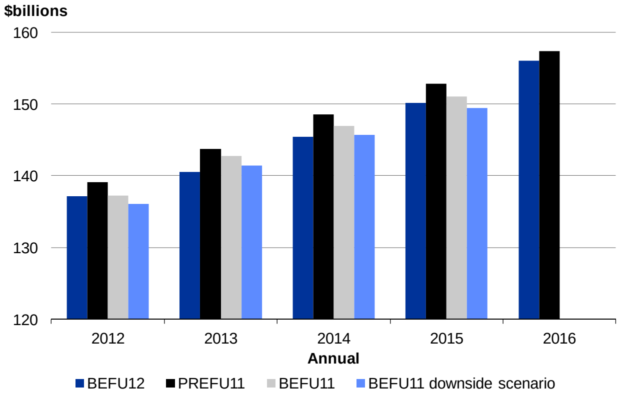
Economic Forecast Changes Since *Budget Update 2011*

The forecast level of real GDP in this *Budget Update* is lower than in recent forecasts, but is similar to that presented in the downside scenario in the *2011 Budget Update*.

In that scenario, world economic growth slowed, the terms of trade fell and business and consumer confidence weakened. This resulted in weaker real and nominal GDP growth.

The world economic outlook did deteriorate over the second half of 2011, but to a lesser extent than in the downside scenario. Other factors contributing to the weaker growth outlook since Budget 2011 include a delay in the Canterbury rebuild, a stronger currency and revisions to GDP outturns.

Figure 1.10 – Real GDP forecasts in recent *Updates*

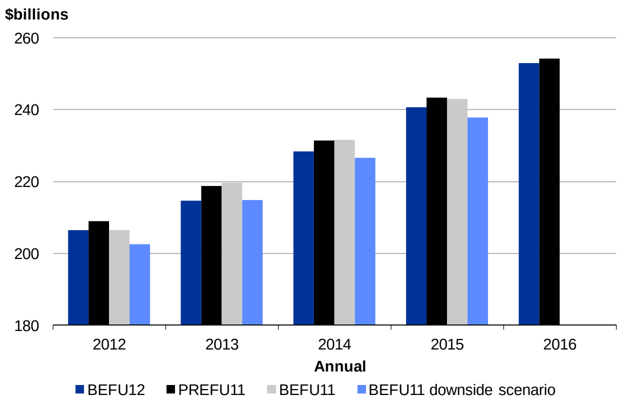


Sources: Statistics New Zealand, the Treasury

Compared to the main forecast in the *2011 Budget Update*, aggregate price pressures in the economy have been weaker than expected, reflecting the strength of the exchange rate, lower commodity prices and a greater degree of spare capacity in the economy. As a result, the level of GDP in current prices in the *2012 Budget Update* has been revised down towards the levels in the downside scenario.

GDP in current prices provides the base for tax revenue forecasts. In the downside scenario, lower nominal GDP led to tax revenue being $5 billion lower over the four year period ending June 2015 than in the main forecast. In the *2012 Budget Update*, nominal GDP is higher than in the downside scenario but forecast tax revenue over the four-year period ending June 2015 is similar. In other words, the ratio of tax to GDP in the current forecasts is lower than in previous forecasts.

Figure 1.11 – Nominal GDP forecasts in recent *Updates*



Sources: Statistics New Zealand, the Treasury

One of the main contributors to the lower tax-to-GDP ratio is the current high level of goods and services tax (GST) refunds, which are being boosted by insurance settlements following the Canterbury earthquakes. Insurance settlements include GST, which entitles insurance companies to a refund from Inland Revenue (IRD). This reduces net tax revenue until the claimants incur GST on their purchases. While temporary, the impact remains significant until the bulk of the insurance settlement are spent.

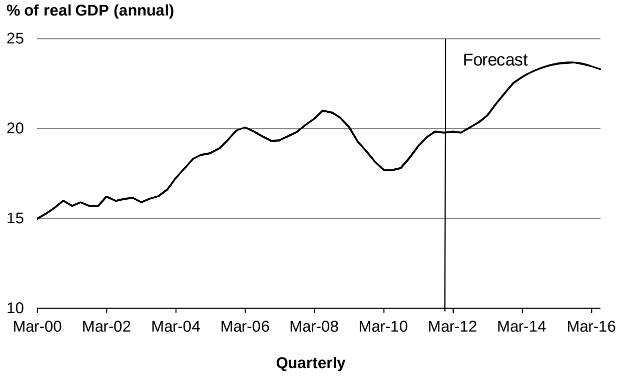
While the initial phases of the rise in residential investment are driven by the Canterbury rebuild, activity in the rest of the country is forecast to become increasingly significant over 2013. The national demand for housing is supported by past population growth, expected future population growth, rising household incomes, falling unemployment and repair of leaky homes.

...and business investment strengthens

Business investment is forecast to continue rising, picking up pace over the second half of 2012 as the rise in business confidence over the first half of 2012 and the imminent Canterbury rebuild impact on firms' decisions.

The Treasury's estimate for the damage to commercial and infrastructure assets remains $7 billion (in 2011 prices), but is subject to a large degree of uncertainty. The Canterbury rebuild is expected to provide increasing support for non-residential investment particularly in the period beyond March 2013, while other construction related to the Canterbury rebuild is assumed to be spread more evenly over the forecast period. With the Canterbury rebuild underway, and continuing support from low interest rates and the high exchange rate, business investment growth is forecast to rise to 14% in the year ending March 2014 and to reach an historically high share of 24% of real GDP. The pace of business investment slows over the remainder of the forecast period, reflecting the lower exchange rate and rises in interest rates.

Figure 1.12 – Real business investment



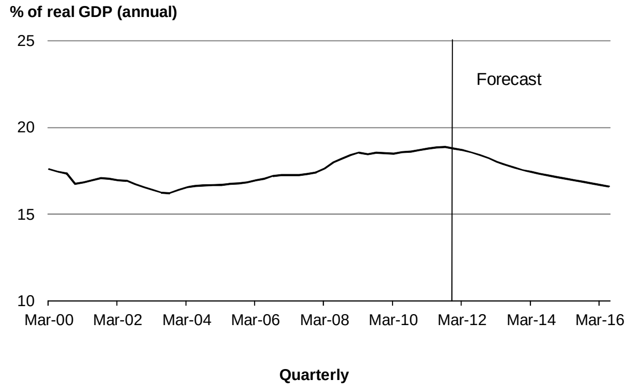
Sources: Statistics New Zealand, the Treasury

Government spending growth slows...

Real government consumption is forecast to fall in the year ending March 2013, as some of the temporary spending related to the Canterbury earthquakes is withdrawn and growth in other government spending slows. Government spending restraint in Budget 2012, and in earlier Budgets, is reflected in a reduction of government spending on goods and services as a share of real GDP (government transfer payments, such as Working for Families, are captured in private consumption). Estimates of the cyclically-adjusted operating balance show fiscal policy is withdrawing demand from the economy in each of the forecast years, with a peak contraction of almost 2% of GDP in the fiscal year ending June 2014.[2]

[2] For more details, see the *Additional Information* on the Treasury website www.treasury.govt.nz

Figure 1.13 – Real government consumption



Sources: Statistics New Zealand, the Treasury

Although government consumption expenditure continues to increase in current prices, and increases in inflation-adjusted (or constant) prices after the year ending March 2013, it grows more slowly than the rest of the economy. As a share of real GDP, government consumption declines from 18.7% in the year ending March 2012 to 16.6% by March 2016.

Partly offsetting the reduction in consumption demand, real government investment is forecast to grow at an average rate of 4% over the forecast period, reflecting the Government's ongoing social infrastructure investment programme. More generally, the reduction in demand from fiscal policy is more than offset by the increase in private sector demand from the Canterbury rebuild and other parts of the economy.

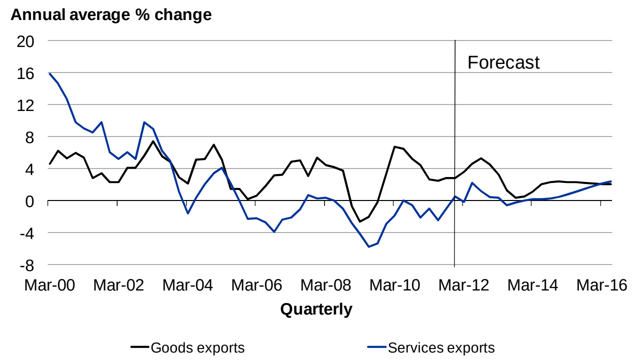
Good farming conditions lift commodity exports volumes...

Exports of goods increased 2.9% in the year ending December 2011, led by strong growth in dairy volumes. The RWC contributed to a 0.6% rise in services exports, with much of the positive impact offset by weakness in other tourist arrivals owing to the natural disasters in Canterbury and Japan, and generally weak demand in many of the traditional tourism markets. Together, goods and services exports rose 2.4% in the year ending December 2011.

Export growth is expected to slow to around 2% in the year ending March 2013 and 1% in the following year, as farming conditions return to normal and the elevated exchange rate constrains profitability. The assumed weakening of the exchange rate over 2015 and 2016 is forecast to lift volume growth to 2% per year over the final two years of the forecasts.

...but growth slows as conditions return to normal...

Figure 1.14 – Export volume growth



Sources: Statistics New Zealand, the Treasury

The assumption of a return to normal farming conditions is reflected in lower commodity export growth. Dairy export volumes, up 9.9% in the year ending December 2011, are expected to rise further before falling back when the current season ends and conditions revert to normal.

Thereafter, ongoing productivity gains and investment in the dairy industry result in a rising profile for dairy export volumes. The meat industry is also benefiting from good farming conditions, but the trend decline in the sheep flock is expected to continue, with an offset from a larger dairy herd resulting in stable meat export volumes. Forestry export volumes are also forecast to remain stable, reflecting steady demand in an industry that is operating close to its maximum sustainable harvest rate. Some other commodity exporters, such as kiwifruit and pip fruit growers, are finding conditions challenging.

...and international demand remains subdued

Growth in non-commodity goods exports, including manufactured goods, is forecast to slow from around 4% in the year ending December 2011 to 2% in the year ending March 2013 as the elevated exchange rate and subdued trading partner conditions slow demand growth. The forecast recovery in world demand and the easing in the exchange rate contribute to growth rising to 2.9% and 3.9% in the years ending March 2014 and 2015 respectively, slowing to 3% in the year ending March 2016.

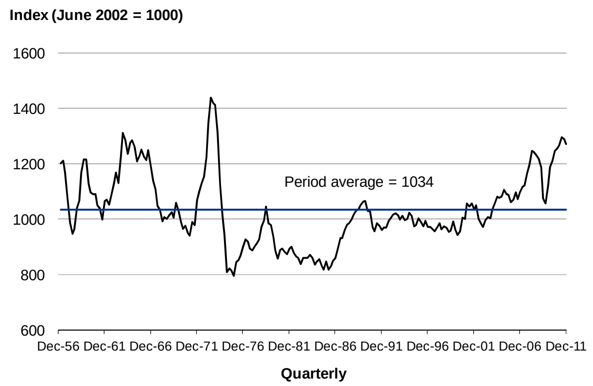
Services export growth is forecast to be weak over much of the forecast horizon – rising world incomes and a weaker exchange rate permit some recovery in the final year of the forecasts. Exports of services are dominated by travel and transport services; conditions in this industry are expected to remain subdued, reflecting weak income growth in many developed countries and the relatively high cost of New Zealand as a tourism destination. In contrast to the weakness in these industries, exports of commercial services are trending up, and have increased almost 30% since early 2007. Growth in this latter sector is expected to continue to partly offset the weakness in tourism.

Import growth is forecast to slow to 2.8% in the year ending March 2013, from 5.2% in the year ending March 2012. The expected slowing in consumption demand reduces consumption goods import growth, and imports of services, which have risen strongly in the last two years, are expected to consolidate at a high level. The Canterbury rebuild, combined with firmer domestic demand, drives the strong rise in imports in the following two years. In the final year of the forecasts, the weaker exchange rate and more restrained demand growth result in slower import growth.

Goods export prices fall in the short-term...

Over 2011 the overseas trade index (OTI) measure of the merchandise terms of trade rose to their highest level since 1974 as solid demand and short supply of dairy and meat products lifted export prices. However, good farming conditions have led to increased dairy production around the world and prices have fallen. At the same time, trading partner demand has weakened. Further falls in export prices are expected and the System of National Accounts (SNA) measure of the merchandise terms of trade is expected to fall around 8% from its peak in September 2011 to its trough in late 2012. From the end of 2012, commodity supply growth is expected to slow and demand growth to strengthen leading to a recovery in the terms of trade over 2014 and 2015. However, recent commodity price falls point to the risk of a greater decline in the terms of trade than forecast.

Figure 1.15 – Merchandise terms of trade (OTI basis)



Source: Statistics New Zealand

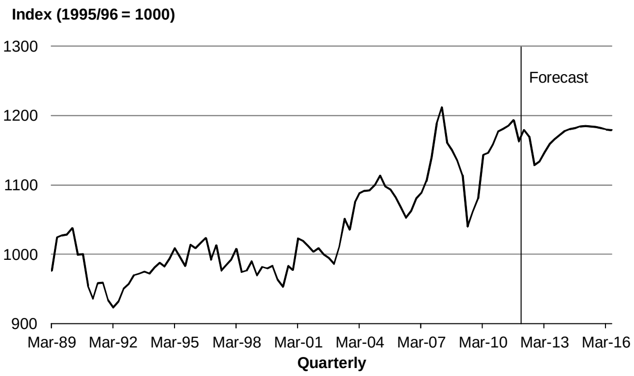
...but recover in the medium term...

World dairy prices were around 20% below their April 2011 peak and close to their average over the past 7 years when these forecasts were finalised. Dairy prices have been supported by rapid growth in China's dairy consumption and per capita consumption remains well below that of countries such as Korea and Japan. The growth outlook for China remains solid, and is expected to generate rising demand for dairy products. Global dairy supply is expected to increase, although production costs are also expected to rise due to increased land-use competition from food, fibre and bio-fuel industries. Tighter environmental standards are also likely to contribute to higher production costs. World supply of beef and lamb is generally short following several seasons of poor farming conditions. Biological constraints on the speed of the supply response are expected to sustain prices at a relatively high level over the forecast period. Prices for forestry exports have been supported by developments in China, but the weak housing market in North America has moderated the extent of price increases. The recovery in the US is expected to gather pace over the forecast period, increasing demand for forestry products and helping to maintain forestry prices at historically high levels.

World oil prices rose over the first quarter of 2012 as the prospect of supply disruptions increased, but prices have eased in recent weeks. Oil market futures prices, which form the basis for our oil price assumption, show that oil prices in 2016 are expected to be at a similar level to current prices (US$94.4 per barrel).

...offsetting weakness in the services terms of trade

Figure 1.16 – Goods and services terms of trade (SNA basis)



Sources: Statistics New Zealand, the Treasury

In contrast to the expected recovery in the merchandise terms of trade, the services terms of trade are forecast to continue weakening, ending the forecast period around 20% below their current level. The price of overseas travel by New Zealanders, which is treated as imports of services in the SNA, is currently low, and is reflected in the growing number of overseas trips. On the other hand, the high exchange rate means the cost of travel to New Zealand is relatively high and the value of tourism spending has fallen in real terms. The expected decline in the New Zealand dollar increases the relative price of travel and other services imports for New Zealanders, resulting in a falling services terms of trade. Overall, the combined goods and services terms of trade deteriorate over 2012, but recover over 2013 and 2014, and stabilise at a level similar to that prevailing over 2011.

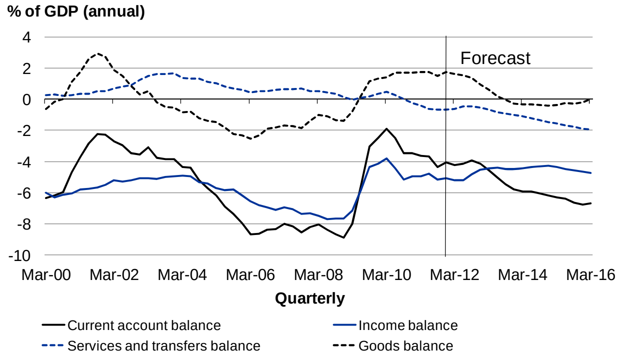
Wider current account deficit...

The current account of the balance of payments measures economic transactions between New Zealand residents and the rest of the world. It is a composite of balances on imports and exports of goods and services, income flows, and transfers. The current account deficit is expected to widen to 6.7% of GDP in the year ending March 2016, from

4.0% in the year ending December 2011, driven by a falling surplus on the trade balance and a widening of the deficit on services.

The income deficit rose over 2011 as profit outflows recovered and was a little over 5% of GDP in the year ended December 2011. Income outflows are expected to stabilise over 2012 and to decline to 4.5% of GDP in the year ending March 2013. The goods surplus is forecast to narrow from 1.7% of GDP in the year ending December 2012 to 0.6% of GDP in the year ending March 2013. As a consequence, the current account deficit widens to 4.6% of GDP.

Figure 1.17 – Current account balance



Sources: Statistics New Zealand, the Treasury

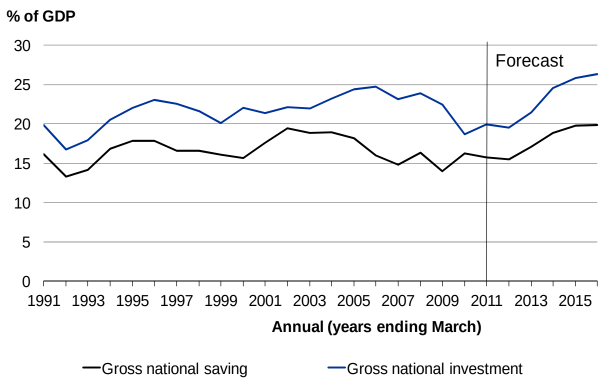
The goods surplus is forecast to continue to narrow and a goods deficit is expected to develop in late 2013. Small goods deficits, of around 0.4% of GDP, are expected to persist until the end of the forecast period, when the weaker exchange rate helps return the balance into surplus. The income deficit is forecast to remain around 4.5% of GDP over the years ending March 2013 to March 2015 as business profitability and interest payments keep pace with nominal GDP growth. The transfers balance is forecast to remain in deficit throughout the forecast horizon reflecting the impact of higher insurance premiums in the wake of the Canterbury earthquakes.

The current account deficit is forecast to widen to 6.7% of GDP in the year ending March 2016, but the assumption of a significant weakening in the exchange rate and the gradual unwind of activity in Canterbury mean that the deficit is narrowing. This narrowing trend is expected to continue beyond the end of the forecast period.

...but national saving also rises

From a saving and investment perspective, the widening of the current account reflects the expected increase in investment driven by the Canterbury rebuild and part-financed from overseas reinsurance inflows. The inflows are recorded in the capital account of the balance of payments. Statistics New Zealand estimates over $15 billion of reinsurance inflows for the earthquakes have been paid to New Zealand insurers to date, reflecting the high level of insurance coverage by Canterbury businesses and households. The large proportion of home and business equity protected by insurance policies means that households and businesses can continue saving, contributing to a rise in national saving. The Government's programme of fiscal consolidation further supports national saving.

Figure 1.18 – Saving and investment

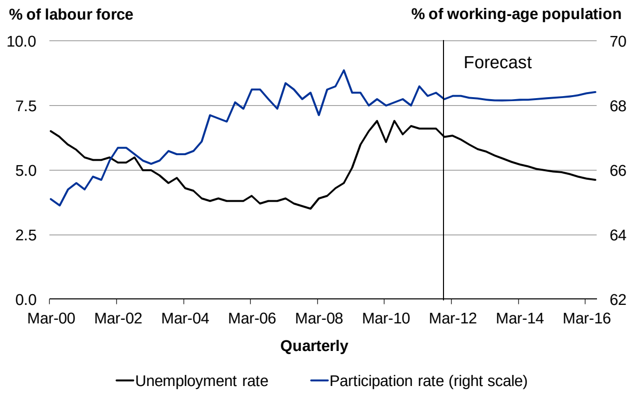


Sources: Statistics New Zealand, the Treasury

The net international liability position is forecast to rise from 72% of GDP at the end of 2011 to 81% of GDP at the end of March 2016, driven by a fall in international assets as insurance claims are settled. At the end of the forecast period, a small proportion of the insurance claims remain to be settled and the current account deficit remains above its sustainable level, suggesting that the net liability position will deteriorate further. The Treasury estimates that a current account deficit of 4% of GDP would stabilise net international liabilities at 85% of GDP.

Firmer labour market...

Figure 1.19 – Labour market



Sources: Statistics New Zealand, the Treasury

The labour market has firmed over the past year and this is expected to continue over the forecast period. In the year ending December 2011, the number of people employed increased 1.6% and the unemployment rate eased to 6.4% (revised up from 6.3%). Data released after the forecasts were finalised show employment increased 1.4% in the year ending March 2012, compared to a forecast rise of 1.3%, and the unemployment rate increased to 6.7% in the March 2012 quarter, higher than the 6.3% forecast. A higher labour force participation rate, which rose to 68.8% compared to a forecast of 68.3%, accounts for most of the difference between the actual unemployment rate and the forecast rate. The participation rate can be volatile but, if sustained, the increase in the size of the labour force points to greater spare capacity in the labour market, which may moderate inflation pressures as a result of weaker wage growth and the assumed rise in labour productivity.

Employment growth is expected to remain modest over 2012, but to begin rising more quickly in 2013 as the Canterbury rebuild increases labour demand. Employment growth of 1.6% is expected in the years ending March 2014 and 2015, up from 1.3% in the year ending March 2013, easing to 1.4% in the final year of the forecasts.

Labour force participation has averaged a little over 68% of the working-age population in recent years. Participation in older age groups has been increasing, but that has been offset by falling participation in younger age groups, where unemployment is highest. These trends are expected to continue, and the participation rate is forecast to remain close to 68% over the forecast period.[3] The unemployment rate is expected to decline to 4.7% in the March 2016 quarter, reflecting ongoing employment growth.

...leads to ongoing wage growth

Annual wage and salary growth accelerated to 3.8% in the March 2012 quarter, up from 2.6% in the previous March quarter. The wage and salary data for the March quarter was released after the forecasts were finalised, and shows that wages and salaries grew more

3 Some components of welfare reform (work tests and associated provisions for sole parents and partners) are within the scope of these forecasts (see *Specific Fiscal Risks* page 66) and their impact has been considered during the development of these forecasts.

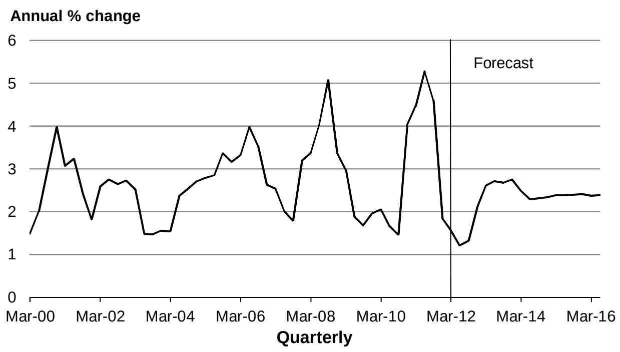
strongly than expected. If sustained, the most recent data point to higher wage growth than contained in our forecasts. However, when considered alongside the moderating influence of the higher unemployment rate on wage growth, the forecast for wages to continue growing at around the current rate remains appropriate.

The Canterbury rebuild will likely see construction sector wages rise more rapidly than those in other industries. There is a risk that this exerts more upward pressure on wages in other industries than is currently factored in, either because of greater labour shortages for the types of labour skills required or because labour productivity in the rebuild is lower than expected. On the other hand, the localised and intensive nature of the rebuild may lift labour productivity.

Inflation is restrained...

Inflation is restrained but is forecast to rise as downward price pressure from the recent appreciation of the exchange rate fades, excises on tobacco and transport increase, and spare capacity in the economy is reduced.

Figure 1.20 – CPI inflation



Sources: Statistics New Zealand, the Treasury

The Treasury estimates the output gap, a measure of spare capacity, to be around 1% of GDP currently. This is contributing to relatively low domestically generated, or non-tradable, inflation. The acceleration in business investment over the next two years increases productive capacity, partly through an increase in imports, but output increases more rapidly and the output gap narrows, closing at the end of the forecast period. With resources less than fully employed across the forecast period, non-tradables inflation is expected to remain restrained. However, in the year ahead, rising insurance premiums, higher excises on tobacco and transport, and higher rental accommodation prices, are expected to increase non-tradable inflation. With tradable inflation also increasing, headline inflation is forecast to rise to 2.6% in the March quarter of 2013. Further tobacco excise increases, ongoing but diminishing spare capacity, and a depreciating exchange rate, contribute to inflation remaining around 2.4% over the remainder of the forecast period.

...and monetary policy stimulus is withdrawn...

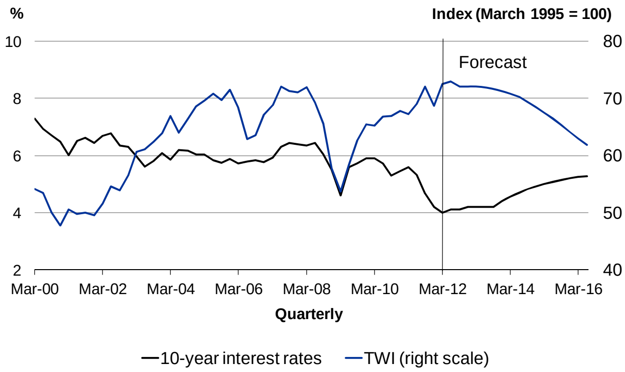
The forecasts assume that monetary policy does not tighten to offset the temporary effects of the higher excises on the CPI. However, strengthening demand in the economy and diminishing spare capacity are forecast to lead to a gradual withdrawal of monetary stimulus. The withdrawal of this support is forecast to begin in early 2013. Short-term 90-day interest rates are expected to rise from 2.7% in the March 2012 quarter to 4.4% in the March 2016 quarter.

...but the pace of tightening is uncertain

The pace and extent of interest rate rises are dependent on the strength of the exchange rate, the strength of domestic demand, and conditions in financial markets; a stronger exchange rate would also lead to tighter monetary conditions. Banks continue to find the cost of funds elevated relative to their pre-global financial crisis levels, which is increasing the margin between the Reserve Bank's Official Cash Rate (OCR) and retail interest rates. These higher costs are assumed to persist over the forecast horizon; international funding markets are expected to improve but to remain impaired; and upward pressure on domestic funding costs is expected as domestic deposit growth slows and credit demand rises. Further increases in the cost of funds would, if passed on to borrowers, reduce the extent of increases in the OCR required to meet the Reserve Bank's medium-term target of inflation between 1% and 3%.

The rate of productivity growth is also critical to the inflation outlook. The Treasury forecasts assume labour productivity growth of 1.4% per year over the forecast period, similar to that over the decade prior to the 2008/09 recession. A lower rate of productivity growth would lead to a faster reduction in spare capacity and require an earlier tightening of monetary policy.

Figure 1.21 – Exchange rate and 10-year interest rates



Sources: Reserve Bank of New Zealand, the Treasury

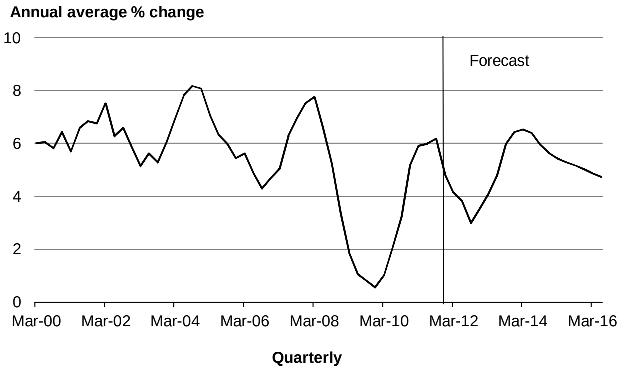
Ten-year interest rates fell to an historic low of 4.0% in the March 2012 quarter, reflecting lower yields internationally, but also some specific factors such as an improvement in investor sentiment as New Zealand's economic outlook has remained favourable relative to a number of other countries. Long-term interest rates are forecast to rise to a little over 5% by the end of the forecast period, reflecting the expected recovery in world economic growth and the gradual normalisation of global monetary conditions. The expected rise in 10-year interest rates flows through to higher business and government borrowing costs.

Stronger income growth expected

Nominal GDP growth is expected to slow to 4.1% over the year ending March 2013, reflecting the decline in the terms of trade. Nominal GDP is forecast to rise strongly in the following year as the terms of trade recover and the pace of growth in the real economy accelerates. Nominal GDP growth eases to around 5% per year in the last two years of the forecast period as real activity slows and the terms of trade level off.

Nominal GDP is comprised of compensation of employees, and business and agricultural operating surplus.

Figure 1.22 – Nominal GDP growth



Sources: Statistics New Zealand, the Treasury

Compensation of employees is forecast to grow 3.9% in the year ending March 2013, increasing to 5.2% the following year, underpinned by the firming labour market and the Canterbury rebuild. Compensation of employees continues to grow at around 5% per year through to the end of the forecasts. This means compensation of employees is stable as a share of GDP at around 44%.

Agricultural operating surplus is expected to fall in the year ending March 2013, reflecting lower commodity prices and the assumption that the exchange rate will provide only a limited offset. Operating surplus growth is expected to remain subdued in the year ending March 2014, but to recover strongly in the following years as the exchange rate falls and commodity demand firms.

Business operating surplus is expected to increase to 5.3% in the year ending March 2013, while the impetus from the Canterbury rebuild generates surplus growth of over 10% in the year ending March 2014. Operating surplus growth averages around 5% in the following years, in line with the moderation in activity across the economy.

Economic Forecast Assumptions

- From an outflow of 4,000 in the year ending March 2012, net permanent and long-term migration rises to an inflow of 19,000 in the year ending March 2014 and returns to a long-run assumption of 10,000 by mid-2015.
- The non-accelerating inflation rate of unemployment (NAIRU) is assumed to be around 4.5% by 2016 (it varies over time, starting out around 5.2% in 2011).
- Average hours worked per week are assumed to be 33 (near their current level).
- Economy-wide labour productivity growth is assumed to average around 1.4% per year between the years ending March 2012 and March 2016.
- Damage caused by the Canterbury earthquakes is assumed to be $20 billion (2011 dollars) spread across residential property and contents ($13 billion), commercial ($4 billion) and infrastructure ($3 billion). Rebuilding is expected to ramp up from the second half of 2012.
- West Texas Intermediate (WTI) oil prices are assumed to fall from above US$100 per barrel in the March quarter 2012 to US$94.4 in the June quarter 2016, although we also look at other oil price measures.
- 90-day interest rates are assumed to increase starting with OCR rises in early 2013 to around 4.5% at the end of the forecast period, while 10-year interest rates are assumed to move towards our anchor assumption of 5.5%, reaching 5.3% within the forecast period.
- The Trade Weighted Index (TWI) is assumed to remain around 72 for the next two years or so before falling to 62 by the June quarter 2016, which is the end of the forecast period.
- Tobacco excise increases add 0.2 percentage points to the CPI in each of the March quarters 2013, 2014, 2015 and 2016.