Budget Economic & Fiscal Update 2000

HON DR MICHAEL CULLEN
TREASURER
MINISTER OF FINANCE

15 JUNE 2000

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Statement of Responsibility

On the basis of the economic and fiscal information available to it, the Treasury has used its best professional judgement in supplying the Minister of Finance with this Economic and Fiscal Update. The Update incorporates the fiscal and economic implications both of Government decisions and circumstances as at 29 May 2000 that were communicated to me, and of other economic and fiscal information available to the Treasury in accordance with the provisions of the Fiscal Responsibility Act 1994.

Dr Alan Bollard
Secretary to the Treasury

8 June 2000

This Economic and Fiscal Update has been prepared in accordance with the Fiscal Responsibility Act 1994. I accept overall responsibility for the integrity of the disclosures contained in this Update, and the consistency and completeness of the Update information in accordance with the requirements of the Fiscal Responsibility Act 1994.

To enable the Treasury to prepare this Update, I have ensured that the Secretary to the Treasury has been advised of all Government decisions and other circumstances as at 29 May 2000 of which I was aware and that had material economic or fiscal implications.

Hon Dr Michael Cullen
Treasurer and Minister of Finance

8 June 2000

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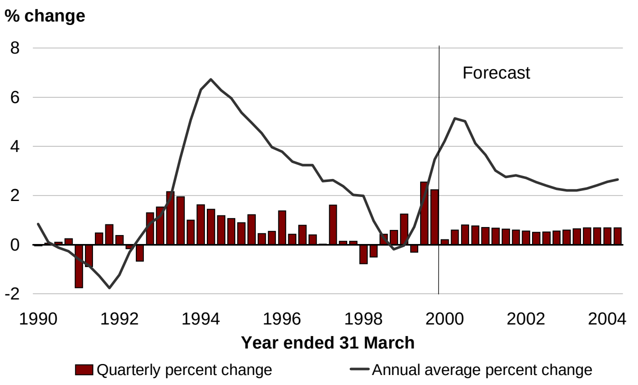
Economic Outlook

Overview

- After growing well above trend in 1999 the economy is expected to continue to expand at a solid and more sustainable pace through the forecast period. Annual average growth is expected to be 3.7% in the year to March 2001 before easing to around 2.5% further out.

Figure 1.1 – GDP growth



Sources: Statistics New Zealand, The Treasury

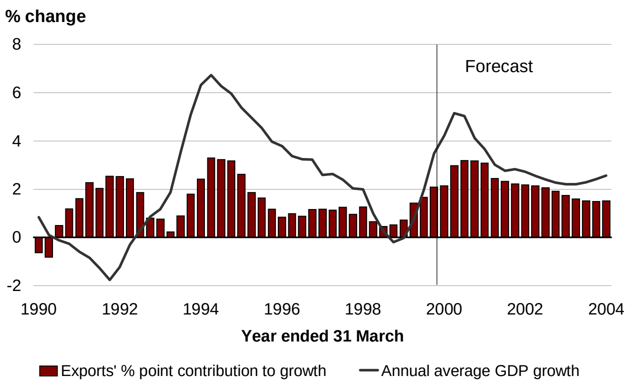
- The combination of strong world growth and supportive monetary conditions, in particular the stimulus from a low exchange rate, is expected to provide a solid foundation for ongoing growth. New Zealand's main trading partners are expected to grow by around 4% in calendar 2000 after growing 3.7% in 1999 and only around 2% in 1998.

- In the forecast period the proportion of overall growth due to exports is higher than in the recovery to date and higher than sustained in the previous cycle.

- Both non-commodity manufactured exports and tourism are expected to perform well, supported by a low exchange rate and strong world growth. Higher commodity prices, more favourable weather conditions after droughts and robust international demand conditions are expected to assist commodity exporters.

- Strong growth, particularly for exports, and limited spare capacity lift underlying investment growth.

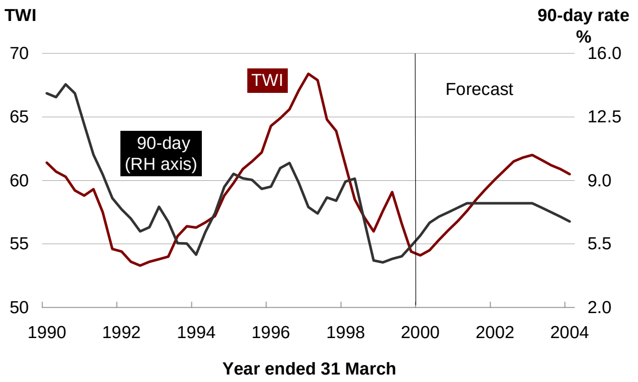
Figure 1.2 – Exports' contribution to GDP growth



Sources: Statistics New Zealand, The Treasury

- The labour market is set to tighten further with unemployment falling to below 6%.
- Household income grows solidly as employment and wages increase but higher household debt levels and debt servicing costs induce more restrained spending over the medium term. This results in the household savings rate improving somewhat.
- The strong growth during 1999 has significantly reduced spare capacity in the economy. A modest tightening in monetary conditions keeps the economy on a sustainable growth path.
- Monetary conditions tighten through both an increase in interest rates to a peak of 7.8% and a moderate increase in the TWI. Both interest rates and the TWI peak at levels well below those reached in the last cycle.

Figure 1.3 – Monetary conditions



Sources: Primark Datastream, The Treasury

- CPI inflation is strongest in the near term, boosted by recent increases in tobacco excise and petrol prices. Over the forecast period increasing inflation pressures from higher unit labour costs and widening margins are tempered by the tightening in monetary conditions.
- The current account deficit is forecast to decrease steadily from a peak of 8% in December 1999 to 4.7% by March 2004. The decrease in the deficit is entirely due to a turnaround in the goods and services balance from deficit to surplus.

Developments since the forecasts were finalised

These forecasts were finalised on 16 May 2000. There have been a number of events since then that could have a material impact on the economic outlook.

One of the most significant events is the sharp drop in the exchange rate. In the Central Forecast we assume that the TWI will average 54.5 in the June 2000 quarter, rising to 55.3 for the September 2000 quarter. At the time of publication the TWI sits around 52. If the exchange rate were to stay around this level, there is likely to be some additional impetus to the inflation outlook. In addition, stronger increases in short-term interest rates may also be warranted, resulting in a different mix of monetary conditions than the Central Forecast embodies. This could, in turn, suggest a different profile and composition of growth than that currently forecast.

Also significant is the recent firming in oil prices. The Central Forecast assumes that oil prices (Brent blend) will average US$23 per barrel in the June 2000 quarter, with further declines expected over the remainder of the forecast horizon. However, the past few weeks have seen international oil prices steadily rise to around US$29 per barrel.

These two events have primarily been responsible for further rounds of petrol price increases. Since the forecasts were finalised petrol prices have risen by a total of 7c/litre. All other things equal, this would add around 0.25 percentage points to CPI inflation over the next couple of quarters and may see annual CPI inflation move temporarily to 3% by the end of the year.

The real value of residential Work Put In Place rose sharply in the March 2000 quarter, recording a 20% quarterly increase. This was significantly stronger than expected and indicates that residential investment will be substantially higher in the March 2000 quarter than is contained in the Central Forecast. Indeed, residential investment could now add up to 1 percentage point to GDP growth in the March 2000 quarter. However, this surprising strength suggests there could be additional downside risk to residential investment further down the track. This would also be consistent with the picture of the residential market currently being painted by building consents.

Business confidence, as measured by the National Bank, fell sharply in May 2000. A net 21% of firms expected general business conditions to deteriorate over the next year, down from a net 15% that expected an improvement in April. There is a risk of this low business confidence translating into lower activity levels than in the Central Forecast (see Chapter 3 Risks and Scenarios).

Table 1.1 – Economic outlook: Central Forecast[1]

(Annual average % change, March years)	1999 Actual	2000 Forecast/ Actual	2001 Forecast	2002 Forecast	2003 Forecast	2004 Forecast
Private consumption	1.4	3.2	2.5	1.8	1.9	2.3
Public consumption	0.0	7.3	(1.8)	1.7	1.5	2.0
Total Consumption	**1.1**	**4.0**	**1.6**	**1.8**	**1.8**	**2.3**
Residential investment	(14.9)	17.5	(2.0)	4.3	4.6	3.2
Business investment	5.5	6.6	13.9	10.7	9.3	10.6
Total private investment	0.0	9.1	10.0	9.3	8.3	9.1
Public investment	(7.6)	11.5	1.4	5.4	10.8	13.2
Total investment	**(1.3)**	**9.5**	**8.5**	**8.7**	**8.7**	**9.8**
- excluding computers[2]	**(5.0)**	**4.9**	**5.8**	**3.1**	**2.1**	**1.9**
Stock change[3]	(1.0)	1.4	(0.9)	0.3	0.1	0.1
Gross national expenditure	(0.4)	6.5	2.3	3.7	3.6	4.3
Exports	2.2	6.4	9.1	6.1	4.7	4.0
Imports	3.3	11.5	4.5	8.4	8.0	8.2
- excluding computers[2]	3.3	7.2	4.2	5.2	4.2	3.4
GDP (Production Measure)	**0.0**	**4.2**	**3.7**	**2.7**	**2.2**	**2.6**
Employment[4]	(0.3)	2.2	1.7	1.8	0.9	1.2
Unemployment[5]	7.2	6.4	5.7	5.3	5.7	5.6
Wages[6]	3.0	1.3	3.4	4.0	3.7	3.6
CPI inflation[7]	1.3	1.7	2.6	2.3	2.1	1.8
Nominal GDP (expenditure)	0.7	4.9	5.5	5.1	4.5	4.4
Current account balance						
- $ million	(5,698)	(8,094)	(6,405)	(5,830)	(5,816)	(5,957)
- % of GDP	(5.8)	(7.8)	(5.8)	(5.1)	(4.8)	(4.7)
TWI[8]	57.6	54.1	56.8	60.1	62.0	60.5
90-day bank bill rate[8]	4.5	6.0	7.5	7.8	7.8	6.8
10-year bond rate[8]	5.7	7.3	7.5	7.5	7.4	7.3

Sources: Statistics New Zealand, Datastream, The Treasury

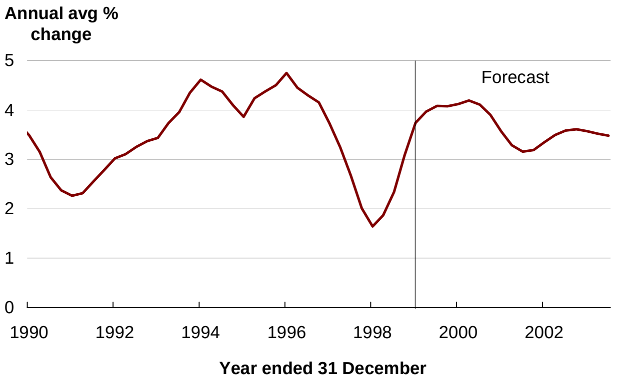
Notes:
1 Finalised 16 May 2000.
2 Excludes computers to give a better underlying picture. See Revisions-to-GDP box.
3 Contribution to GDP growth.
4 Household Labour Force Survey full-time equivalent employment, annual percentage change.
5 Percentage of the labour force, March quarter, seasonally adjusted.
6 Quarterly Employment Survey average hourly ordinary time earnings, annual percentage change.
7 This is the CPI-consistent series targeted by the Reserve Bank. Annual percentage change, March quarter.
8 Average for the March quarter.

The Forecast Story

The global economy expanded strongly in 1999 and momentum has continued to build in 2000.

Global growth was stronger than expected in 1999 and a further strengthening is forecast in 2000.

Figure 1.4 – Trading partner growth



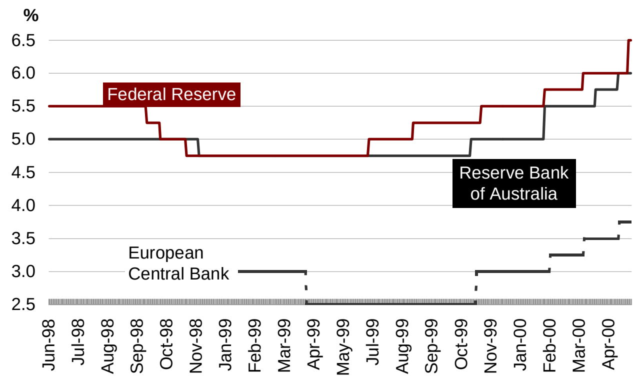
Sources: Consensus Forecasts, Primark Datastream, The Treasury

The United States and Australia, boosted by strong productivity growth, continued their robust expansions during 1999, both growing at around 4%. More remarkable was the performance of the non-Japan Asian economies, which posted a much stronger-than-expected V-shaped recovery. Activity in the Euro zone and the UK also picked up. However, the Japanese economy continued to languish with flat growth after a sharp contraction in 1998.

Building on a solid recovery in 1999 the world economy is expected to strengthen further in 2000 and the outlook remains favourable over the entire forecast horizon. Major trading partner growth is expected to rise to around 4% in 2000 and then to run at around 3.5% over the remainder of the forecast horizon.

Over the next two years the United States and Australian economies are expected to slow gradually. There have been some signs of cooling activity in the US but generally domestic demand has remained strong. In Australia, a run of soft data through early 2000 has led to some speculation that the slowdown is materialising somewhat earlier than expected although solid export performance and fiscal stimulus should work to underpin Australian growth this year. Robust activity is expected to continue in the Euro area and Japan is forecast to stage a gradual pick-up in growth over the next two years. Uncertainty surrounding Japanese consumer behaviour and the unsustainable fiscal position, however, make for both short- and medium-term risks around Japan's outlook. The non-Japan Asian region is forecast to continue growing strongly in 2000 and 2001.

Figure 1.5 – Official short-term interest rates



Source: Primark Datastream

Continued excess capacity in industrial sectors around the world suggests relatively strong world growth can be sustained without triggering excessive inflationary pressures. Global inflation has, however, edged up through 2000 largely reflecting the increase in international oil prices. After falling back somewhat over March and April of this year global oil prices are currently running at treble their early 1999 value. Strong growth is also adding to underlying inflationary pressures with recent US data, for example, showing some signs of a pick-up in core inflation and labour costs.

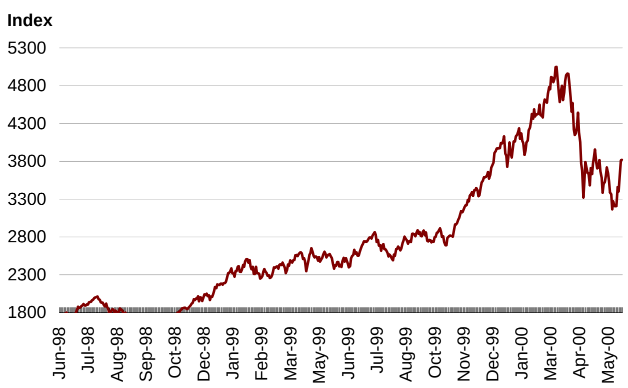
Against this background, world central bankers have continued to raise policy rates over 2000, largely in a gradualist fashion. The persistent strength in US demand, however, prompted the Federal Reserve to deliver a 50 basis point rate increase in May 2000 marking a more aggressive move than the typical, (at least since early 1995) 25 basis point move.

This year has seen a mixed performance on commodity markets. In contrast to surging oil prices, the rise in base metal prices seen over 1999 seems to have stalled and foodstuff commodities have generally remained weak. On the other hand, New Zealand's specific basket of export commodities have performed well over 2000 with world prices currently up around 11% on a year ago.

While the global environment is currently very favourable, uncertainty about the cycle, and in particular the path for the US economy, remains. Financial market volatility over 2000 has been a symptom of this uncertainty. The most visible volatility has been that to hit US equity prices.

While an orderly US equity market correction is in keeping with the soft landing expected for the US by most forecasters, a key risk to the global outlook is a sharper than expected slowing in the US. This could be associated with the emergence of stronger inflationary pressures than expected and, as a consequence, more aggressive monetary tightening. Current imbalances in the US economy such as high equity prices and a large current account deficit make for vulnerability in an environment of rising interest rates. Alternatively a significant correction in equity prices could occur independently of interest rate changes, with investors reassessing valuations.

Figure 1.6 – Nasdaq



Source: Primark Datastream

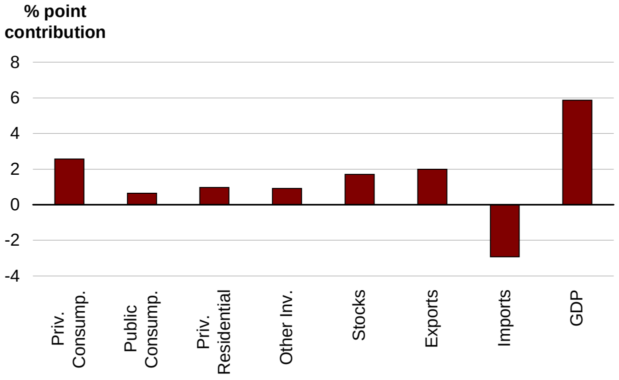
The economy grew strongly over 1999, particularly in the second half of the year...

Boosted by the recovery in the world economy, New Zealand's quarterly growth was well above trend during 1999, averaging 1.4%, and was particularly robust in the second half of the year. Overall growth during 1999 left the economy 6% larger than at the end of 1998.

Private consumption was strong in 1999 on the back of lower interest rates and an improving labour market. Lower interest rates also sparked a boom in residential investment through 1999: it was growing at an annual rate of over 20% by the end of the year. Export growth was solid with services exports, which grew 16% in the year to December 1999, providing particular strength. Underlying investment staged a slight lift after holding up during the 1998 slowdown. Stock-building, which was given a lift by precautions taken for Y2K, accounted for nearly one third of growth over the year.

Growth was widespread across the economy. Agricultural production grew strongly in the current season with dairy production reaching record levels. The bounce back from drought combined with very favourable weather conditions ensured good pasture growth and production. Aside from the agricultural sector there were particularly strong contributions to growth from the machinery and equipment manufacturing, wholesale trade and the transport and communications sectors.

Figure 1.7 – Contributions to GDP growth (March 1999-December 1999 inclusive)



Source: Statistics New Zealand

Note: The investment and import data excludes computers and large transport items in order to better depict underlying trends

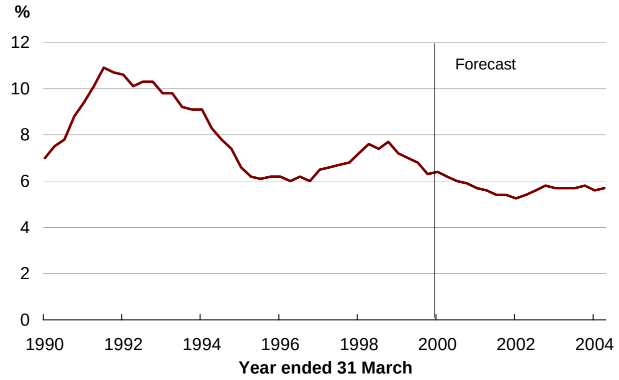
…and monetary conditions need to tighten moderately to keep the economy on a sustainable growth path.

The strong growth experienced last year quickly reduced spare capacity in the economy. The *Quarterly Survey of Business Opinion* capacity utilisation index showed a sharp reduction in spare capacity at the end of 1999 and the unemployment rate of 6.4% in the March 2000 quarter is close to the 6% trough it reached in the last cycle.

To maintain sustainable growth and keep the lid on inflationary pressures, monetary conditions will need to tighten moderately.

The tightening in overall monetary conditions is owing to both an increase in interest rates and an appreciation of the TWI, but both series peak well below the levels they reached in the mid-1990s. From historically low levels the TWI is expected to appreciate modestly over the medium term. Higher interest rates in New Zealand than in the rest of the world and ongoing growth in the economy will provide support for the exchange rate.

Figure 1.8 – Unemployment rate



Sources: Statistics New Zealand, The Treasury

The mix of monetary conditions is difficult to pick. While a different mix may not affect overall growth it would be likely to affect the relative performance of the tradeables and non-tradeables sectors of the economy. For example, if the exchange rate were not to appreciate as much as forecast then interest rates would be higher and this would be likely to flow through into a stronger export sector and weaker domestic demand than currently forecast.

While growth in the first half of 2000 is expected to slow from the very strong rates experienced in the second half of 1999…

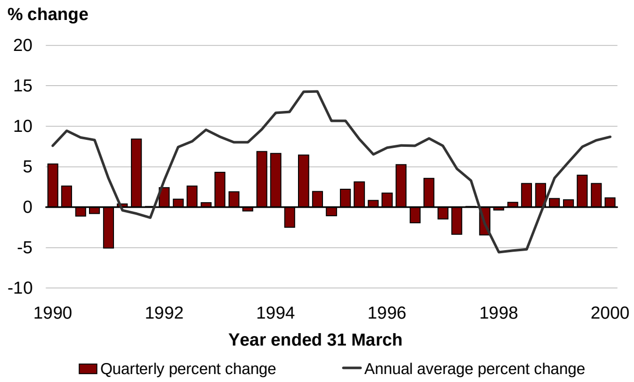
Available indicators of GDP growth in the first half of 2000 suggest that economic growth is likely to slow from the very strong growth seen in the second half of last year. Business and consumer confidence has weakened, growth in job ads and trend retail sales has softened and trend building consents have continued to fall. However visitor arrivals and trade data suggest that export volumes have continued to grow solidly so far in 2000.

The expected softening in activity also partly reflects the reversal of one-off events. The economy was temporarily lifted by factors such as a stock build running up to Y2K and millennium celebrations. The reversal of these factors will have a dampening effect on growth in the near-term. Growth is also likely to be softer due to a fall away in the strong growth rates seen in agriculture last year owing to a better-than-normal season as a result of favourable weather conditions.

…a low exchange rate and a strong world economy support an export driven expansion in the economy over the forecast horizon.

The lagged effects of a low exchange rate and strong growth in our trading partners support strong export growth over the next 18 months. A greater proportion of GDP growth is due to export growth in the forecast horizon than in the recovery to date and than sustained in the previous cycle. Total annual export growth is forecast to reach just over 9% in the March 2001 year and 6% in the March 2002 year before moderating further out as the exchange rate appreciates.

Figure 1.9 – Short-term visitor arrivals



Source: Statistics New Zealand

Non-commodity manufactured export volumes have posted above average growth since June 1998 growing at annual rates between 10 and 14% over 1999. The depreciation of the exchange rate has increased export receipts significantly and this is expected to continue to induce further growth in manufactured exports.

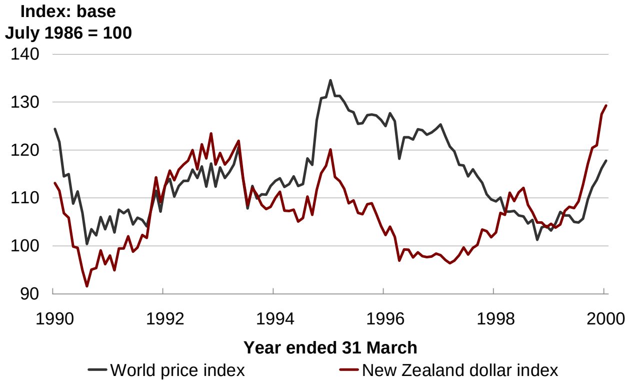
The strong momentum in services exports during 1999 has carried on into 2000 with ongoing strength in tourist arrivals. These grew 3.8% in the three months to April 2000 to leave annual growth running at 10%. One-off events such as the America's Cup and the millennium have given extra impetus to tourism. Tourism is also well supported by solid fundamentals including a low exchange rate, strong income growth in visitor markets (except Japan), and particularly the recovery in Asian markets. Going forward, the strong tourism performance is expected to continue into the first part of the forecast period as the effects of these fundamental factors persist. The Sydney Olympics is also expected to provide a boost in the medium term by raising the profile of the Australasian region.

Table 1.2 – Export volumes annual average growth

(March years %)	**1998/99**	**1999/00**	**2000/01**	**2001/02**	**2002/03**	**2003/04**
Meat and Dairy	-3.6	0.3	4.6	6.1	3.9	2.4
Forestry	-1.3	14.2	10.6	8.1	6.8	5.9
Manufacturing[1]	5	12	12.9	10.1	8.6	8.3
Services	12.2	12.2	9.6	5.2	3.6	3.2
Total	**2.2**	**6.4**	**9.1**	**6.1**	**4.7**	**4.0**

Sources: Statistics New Zealand, The Treasury

Figure 1.10 – ANZ commodity price indexes



Source: ANZ

Commodity exports are expected to lift further. Initially dairy export growth is expected to be more muted than production growth in the 2000 season, as stocks complete a rebuilding phase. Further out, productivity increases and land conversion to dairy farming are expected to drive ongoing growth. Meat exports are expected to perform reasonably well in the first half of the forecast horizon supported in part by higher slaughter weights. Forestry exports also are expected to grow strongly in the first part of the forecast horizon before slowing. Total forestry export growth is being driven by strong growth in logs and sawn lumber and wood panels, which is supported by very good international demand conditions and a large supply of harvestable timber.

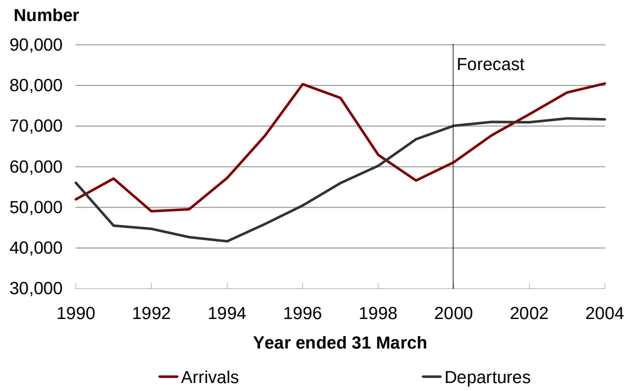
World prices for New Zealand's commodities began to rise noticeably towards the end of 1999. By April 2000 the ANZ world price index was up 11% on a year ago. The depreciating exchange rate has boosted New Zealand dollar prices, which were up 21% on a year ago in April and very close to their highest level since 1986. Strong world growth is expected to provide support for further increases in world commodity prices in the forecast period.

1 Machinery and Transport Equipment plus Other Manufactured Goods Exports as defined in the System of National Accounts.

The labour market is expected to tighten further and provide solid income growth to households…

The labour market starts from a position of reasonable tightness. The unemployment rate is near the low it reached in the previous cycle and skill shortages appear to be emerging. In comparison to the mid-1990s, labour supply growth is not expected to get a large boost from migration. Net immigration is forecast to reach only a moderately positive level.

Figure 1.11 – Long-term arrivals and departures



Sources: Statistics New Zealand, The Treasury

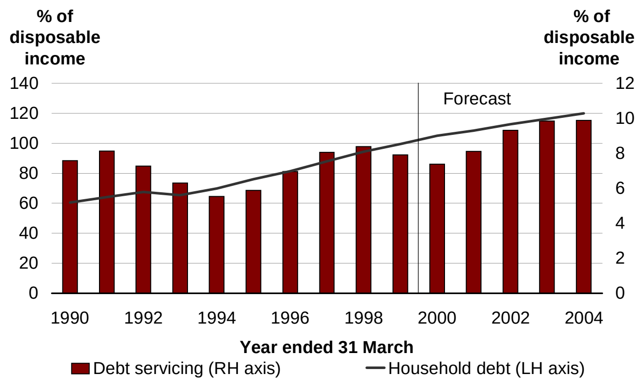
In line with ongoing GDP growth, employment is expected to continue expanding. Unemployment is expected to trough at 5.3% in the March 2002 quarter before picking up slightly over the year to March 2003 as employment growth slows below labour force growth.

A tightening labour market is expected to flow through to a pick-up in wage growth, which is forecast to peak at around 4% in 2002. On the back of increases in wages and employment, households are expected to receive solid annual income growth averaging around 5% per annum.

…but consumption growth is expected to moderate over the medium term.

In the short term a strong boost to farm incomes, increased transfer payments, primarily superannuation, and the lagged effects of the boom in residential investment are still supportive of some strength in consumption growth. However, the household sector has to deal with a number of recent events including tax increases, petrol price rises and higher interest rates that are likely to have some dampening effect on consumption further out.

Figure 1.12 – Household debt and debt servicing



Sources: Statistics New Zealand, The Treasury

In the medium term household incomes are higher due to higher employment and wages, but wealth effects are mild with only moderate house price increases expected in comparison to the previous cycle.

Furthermore, household debt has risen significantly during the 1990s and rising interest rates will see debt servicing as a proportion of total income rise to historic highs in the forecast period.

High levels of debt and debt servicing prevailing currently are expected to reduce households' desire to take on more debt compared to the past. We therefore expect that consumption growth will moderate over the medium term resulting in a small increase in the savings rate.

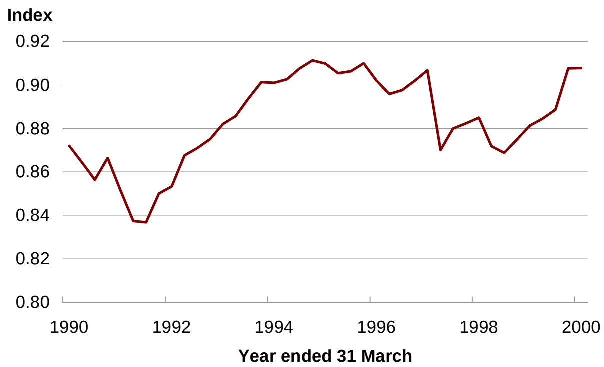
Even with an improving savings rate we still expect the household sector will need to borrow a large proportion of the funds required for residential investment over the forecast horizon.

Following a boom in residential investment during 1999, we are forecasting a contraction throughout most of 2000 based on recent declines in the number of building consents and the weak state of the housing market. Further out, residential investment is expected to recover as households' incomes grow.

Limited spare capacity and solid export growth encourage a lift in investment.

Partially boosted by Y2K computer spending, investment staged a reasonable expansion through 1999. Despite the recent fall in business confidence, investment intentions improved slightly in the March 2000 quarter but remain at modest levels compared to the early 1990s. There was a sharp reduction in spare capacity at the end of 1999, as indicated by the rise in the *Quarterly Survey of Business Opinion* capacity utilisation index.

Figure 1.13 – Capacity utilisation index



Source: NZIER

The lack of spare capacity and the outlook for continued growth, particularly in exports, is expected to drive investment in calendar 2000 and into 2001. Improved corporate profitability will also support an increase in investment in general. A commitment to IT investment will help to underpin plant and machinery investment. Interest rate increases are expected to moderate investment growth further out in the forecast horizon.

Headline investment numbers are biased upwards as they include items that have large relative price declines, primarily computers, and therefore mask the underlying picture for investment. While headline investment numbers peak at 14% in the March 2001 year and remain at around 10% thereafter, investment growth ex-computers is much lower, peaking at 12.5% in the March 2001 year before falling away to 5.2% in the March 2002 year and 2.8% by the end of the forecast horizon (see Revisions-to-GDP box).

Imports, driven by domestic demand and export growth, continue to increase.

In line with growth in both exports and domestic demand, imports continue to increase. The penetration ratio (imports as a share of domestic and export activity) continues to rise but at a slower rate than in the past. The boost to import penetration from trade liberalisation through the 1980s and 1990s is expected to moderate over time and the exchange rate only appreciates modestly by comparison to the last cycle. These factors are expected to dampen growth in the penetration ratio.

Revisions to GDP– re-writing history

In late August, Statistics New Zealand is scheduled to release a thoroughly revised set of historical GDP data as part of moves toward the System of National Accounts guidelines of 1993.

The revisions, reaching back as far as 1971/72, include a move to chain-linked volume indices, as well as a new input-output benchmark, a full shift to ANZSIC industrial classifications, counting computer software and mineral exploration as investment, and allocating the implicit costs of the finance industry directly to users.

While it is difficult to anticipate what the revised data will look like in detail, Statistics New Zealand has indicated that the changes are likely to increase the level of nominal GDP by around 3 percent (at the 1995/96 benchmark). This will obviously have implications for ratios that use nominal GDP, such as the current account deficit, and government expenses and debt.

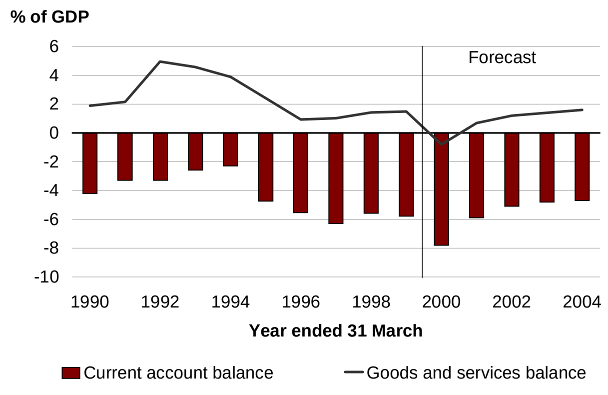
The move to chain-linking volume indices will, in essence, "re-base" at every year, meaning relative prices and expenditures between various goods and services will keep more up-to-date. The extent to which chain-linking itself will re-write history is uncertain, although experimental series already released by Statistics NZ, and the experience of Australia and the US, suggest that some revisions might be significant.

It seems reasonably clear that chain-linking will overcome the upward bias that pronounced falls in quality-adjusted computer prices, relative to other goods, have on fixed-based volume indices for imports and investment (as are currently used). This was certainly the experience of Australia and the US when they moved to chain-linking some years ago. Therefore, we are likely to see downward adjustments to volume measures of imports and investment – each of which contains a proportion of computers.

We have published "ex-computers" tracks for imports and investment to give a better indication of underlying growth of these components and to approximate what the new "chain-linked" tracks might look like, in history and the forecast period.

The current account deficit is expected to steadily fall through the forecast horizon.

Figure 1.14 – Current account



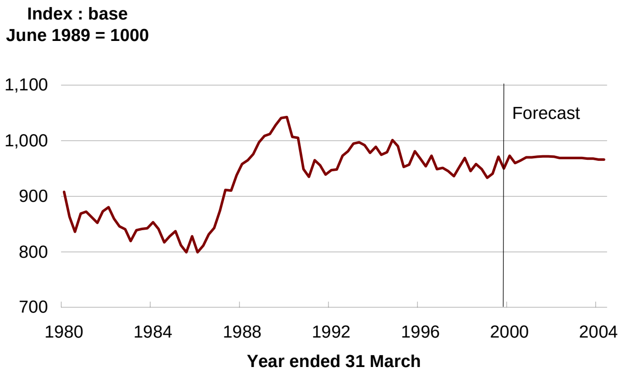
Sources: Statistics New Zealand, The Treasury

Boosted by the import of the frigate Te Mana, worth 0.6% of GDP, the annual current account deficit increased to 8.0% in December 1999, significantly up from 5.1% a year earlier. The increase in the deficit was owing to the annual merchandise trade balance moving from surplus to deficit and an increase in the investment income deficit. Returns to foreign investment in New Zealand increased in line with the economic recovery and returns on New Zealand investment abroad decreased.

Over the forecast horizon we expect a steady decrease in the current account deficit. This is entirely due to a turnaround in the goods and services balance from a forecast annual deficit of 1.1% in March 2000 to a forecast surplus of 2.5% in March 2004.

This turnaround is due to the increase in export volumes exceeding import volumes in the short run, as well as some improvement in the terms of trade. The goods terms of trade level increases in the first part of the forecast horizon before remaining reasonably flat further out. The services terms of trade improves over most of the forecast period owing to the exchange rate appreciation, which reduces the New Zealand dollar price of services imports.

Figure 1.15 – Goods terms of trade



Sources: Statistics New Zealand, The Treasury

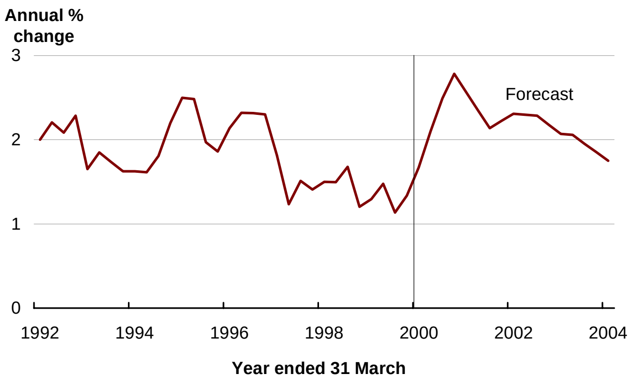
The investment income deficit is expected to remain around 7-8% of GDP reflecting New Zealand's substantial net liability position with the rest of the world.

The monetary tightening keeps inflation within the Reserve Bank's target band.

Annual CPI inflation is strongest in the near term. This near term increase largely reflects the effect of higher international oil prices[2] and the increase in tobacco excise.

Further into the forecast horizon, inflationary pressure is expected to come from increased unit labour costs as wages rise in response to a tightening labour market. We also expect firms to widen margins, as demand conditions remain buoyant. House prices are expected to increase moderately receiving medium- term support from rising household incomes. A supply overhang from strong growth in residential investment and net outwards migration are expected to be moderating influences on house price movements. Import prices, boosted by oil price lifts, have increased recently. However, the exchange rate appreciation is expected to keep imported inflation pressure minimal over most of the forecast horizon.

Figure 1.16 – Consumers price index[3]



Sources: Statistics New Zealand, The Treasury

Over the medium term, inflationary pressures gradually moderate in response to the forecasted tightening in monetary conditions. Inflation eases back to below 2% by the end of the forecast period.

2 Petrol price increases totalling 7 cents per litre that occurred after the forecasts were finalised are not included.

3 This is the CPI-consistent series targeted by the Reserve Bank.

Nominal GDP grows around 5% per annum over the forecast period.

Nominal GDP growth drives the Government's tax revenue forecast and is a combination of real GDP growth and price changes. The inflation forecast also feeds into the Government's expenditure forecast as welfare benefits are inflation indexed.

Nominal GDP growth is 5.5% in the March 2001 year and around 4.5 to 5% further out. This is very similar to the forecast in the 2000 *Budget Policy Statement*.

On the income GDP side, total labour income is lifted by both employment and wage rate increases and peaks at 5.8% in the March 2002 year. Profits are also expected to see solid growth peaking at 7.9% in the March 2001 year before falling away to 3.9% by March 2004.

In the early part of the forecast period profits grow by more than labour income. Near-term profits are boosted by strong export growth and widening margins on the back of generally buoyant demand conditions. Further out, labour income growth is higher than profit growth as a tight labour market and sustained economic growth deliver ongoing wage and employment increases to households.