2

Economic Outlook

Our* December Update *was set against the global backdrop of weak growth and a high degree of uncertainty

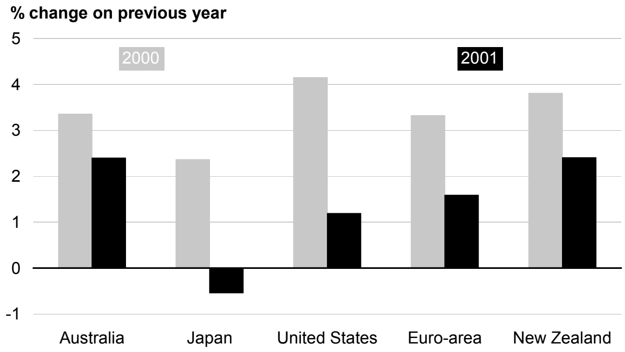
The economic forecasts for the *December Update*, which were finalised in mid-November, were prepared against the backdrop of slowing trading partner growth and a high degree of uncertainty surrounding the global outlook. Reflecting the perceived weakness of the global economy, New Zealand's trading partner growth was forecast at 1.9% for calendar 2002, although, importantly for New Zealand, Australian growth was expected to remain resilient at 3.2% for calendar 2002.

However, we also pointed out that the New Zealand economy was in a relatively good position to weather the slowdown in trading partner growth. A number of sectors in the New Zealand economy had experienced two years of strong income growth, the real exchange rate was at historically stimulatory levels, and firms' balance sheets were reasonably healthy. Moreover, largely in response to developments in the external environment, the Reserve Bank had cut the Official Cash Rate (OCR) by 175 basis points over 2001, including an unscheduled 50 basis point cut about a week after the events of 11 September. These factors were expected to help buffer the New Zealand economy from slowing global growth.

Nonetheless, we still expected weaker global growth to transmit through to the New Zealand economy, via the following three key channels:

- lower demand for New Zealand exports (including tourism)
- lower export prices, only partially offset by lower import prices
- heightened uncertainty and weak business and consumer confidence, resulting in a weak short-term domestic expenditure profile, particularly over the first half of 2002.

Figure 2.1 – Real GDP growth



Sources: Datastream, Statistics New Zealand

Table 2.1 – Economic Outlook: Central Forecast[1]

(Annual average % change, March years)	2001 Actual	2002 Forecast	2003 Forecast	2004 Forecast	2005 Forecast	2006 Forecast
Private consumption	1.6	2.8	2.9	2.3	3.0	3.0
Public consumption[2]	(2.2)	2.1	2.4	4.1	1.1	1.3
Total Consumption	**0.7**	**2.7**	**2.8**	**2.7**	**2.6**	**2.7**
Residential investment	(15.9)	6.2	16.1	(4.1)	3.8	3.6
Market investment	7.4	9.0	2.0	6.8	4.3	2.9
Non-market investment	(5.0)	(2.8)	(1.7)	5.9	5.0	1.9
Total Investment	**(0.1)**	**7.8**	**5.5**	**4.1**	**4.2**	**3.0**
Stock change[3]	(0.4)	(0.3)	(0.1)	0.2	0.0	0.0
Gross National Expenditure	**0.2**	**3.3**	**3.3**	**3.2**	**2.9**	**2.7**
Exports	6.8	1.8	6.6	6.1	4.7	3.8
Imports	0.4	3.5	5.9	6.7	5.2	3.9
GDP (Production Measure)	**2.7**	**3.1**	**3.1**	**3.0**	**2.9**	**2.8**
- annual % change	1.0	3.7	2.9	3.2	2.7	2.8
Nominal GDP (expenditure basis)	5.8	6.6	3.7	5.0	4.6	4.3
GDP deflator	3.6	3.7	0.3	1.9	1.8	1.6
Employment[4]	2.2	2.5	2.0	1.0	1.5	1.3
Unemployment[5]	5.4	5.3	5.4	5.1	5.2	5.3
Wages[6]	2.4	3.5	3.8	3.5	3.6	3.0
CPI inflation	3.1	2.6	2.5	1.8	1.6	1.5
Export prices[7]	19.6	3.0	(10.4)	(0.4)	0.0	0.2
Import prices[7]	15.3	(0.9)	(5.1)	0.0	(0.5)	(0.5)
Current account balance						
- $ million	(5,412)	(3,867)	(5,467)	(6,370)	(6,257)	(5,875)
- % of GDP	(4.8)	(3.2)	(4.4)	(4.9)	(4.6)	(4.1)
TWI[8]	50.5	51.6	54.0	54.6	55.0	55.0
90-day bank bill rate[8]	6.4	5.0	6.1	6.0	6.0	6.0
10-year bond rate[8]	6.0	6.7	6.6	6.2	6.2	6.2

Sources: Statistics New Zealand, Datastream, The Treasury

NOTES:
1. Forecasts finalised 10 May 2002.
2. The forecast profile for public consumption is influenced by government defence spending.
3. Contribution to GDP growth.
4. Household Labour Force Survey, full-time equivalent employment.
5. Household Labour Force Survey, percentage of the labour force, March quarter, seasonally adjusted.
6. Quarterly Employment Survey, average hourly ordinary time earnings.
7. Overseas Trade Index basis, annual average percentage change, March quarter.
8. Average for the March quarter.

Assumptions Underlying the Central Forecast

Global economic activity is assumed to evolve in an environment where any future political or military actions do not have significant negative effects on the overall economic climate.

The international outlook conforms to that presented in the March and April *Consensus Forecasts,* and *Asia-Pacific Consensus Forecasts*.

The 2002/03 agricultural season is assumed to be an average or "normal" growing season.

Our forecasts assume an equilibrium exchange rate of 55 on a Trade Weighted Index (TWI) basis, and an equilibrium short-term interest rate of 6.0%.

We have assumed no change in announced Government policy as of 10 May 2002.

The world economy has been weak…

Since the *December Update* economic forecasts were finalised, the world economy has turned out to be stronger than embodied in our *Consensus Forecasts*-based assumptions of trading partner growth. Nevertheless, global growth was still weak at the end of 2001. The US economy grew by a modest 0.3% in the December quarter, while a number of Euro-area countries – notably Germany, France and Italy – all posted declines in GDP. While growth in non-Japan Asia recovered somewhat in the December quarter, Japan posted its third consecutive quarterly decline in GDP. In contrast, the Australian economy posted growth of 1.3% in the December quarter, on the back of robust domestic demand.

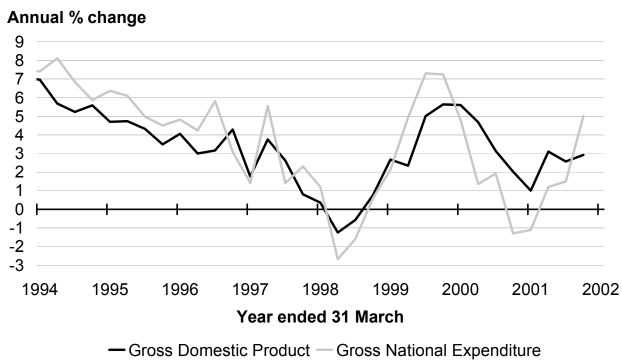
Perhaps even more significant than the actual GDP outturns for New Zealand's trading partners is that the downside risks surrounding the global outlook appear to have reduced substantially since late last year, although undoubtedly downside risks remain. Reflecting this change in sentiment, the global monetary policy easing cycle is generally perceived to have ended, with central banks in the US and the Euro-area expected to begin raising interest rates in the second half of 2002.

*…**but the New Zealand economy continued to outperform***

In the event, overall economic activity has also been somewhat better than embodied in the Central Forecast at the *December Update*, although the composition of growth has been different from the composition we were expecting in November:

- Quarterly GDP growth averaged around 0.4% over the second half of 2001, with the economy growing 2.4% in the year to December 2001. Growth in the September and December quarters was characterised by strong domestic demand, partially offset by a weaker external sector.

Figure 2.2 – Strong domestic demand



Source: Statistics New Zealand

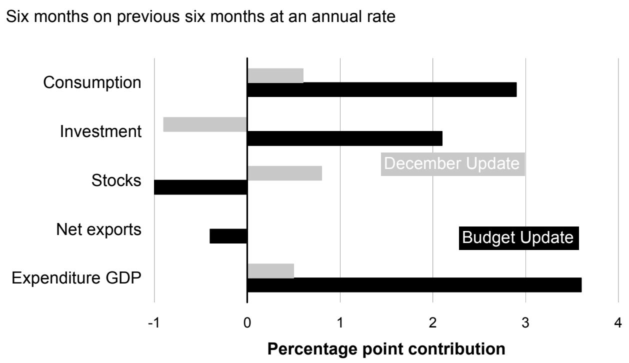
- Employment grew by 1.3% in the March quarter, continuing the strong growth displayed in the second half of 2001. The unemployment rate fell to 5.3%, with strong employment growth largely offset by a further large increase in the participation rate.

- The annual current account deficit fell to 3.2% of GDP in the December 2001 quarter and looks to have remained at this in the March 2002 quarter.

Of the three key channels through which slowing global growth was expected to impact on the New Zealand economy, the first two channels of weaker demand for New Zealand's exports and declining commodity prices have largely operated as expected, albeit with greater volatility on the volume side. The fall in export volumes in the December 2001 quarter provided a clear indication that slowing global growth was having an impact on New Zealand's external sector. The decline in crude material exports was reportedly due to a lower wool clip with wet weather resulting in shearing delays. The fall in dairy exports – and the corresponding build-up in primary stocks – likely reflected dairy producers holding back product owing to unfavourable world prices and weaker world demand. Moreover, the large decline in tourist arrivals in late 2001 resulted in a significant contraction in services exports in the December 2001 quarter. Furthermore, export incomes have also suffered from falling prices owing to declining world prices for New Zealand's key commodities and, to a lesser extent, a modest appreciation in the New Zealand dollar over the second half of 2001.

In contrast, the third transmission channel of heightened uncertainty resulting in a lower profile for domestic expenditure does not appear to have worked as expected. Initial falls in both consumer and business confidence towards the end of 2001 proved to be short lived, and rather than recording weaker growth, some components of domestic demand accelerated. Indeed, in some respects data outturns for the components of domestic demand have been closer to the "More Resilient Terms of Trade and Confidence" scenario outlined at the *December Update*.

Figure 2.3 – Contributions to GDP growth – First half of 2002



Sources: Statistics New Zealand, The Treasury

Some key assumptions have evolved differently

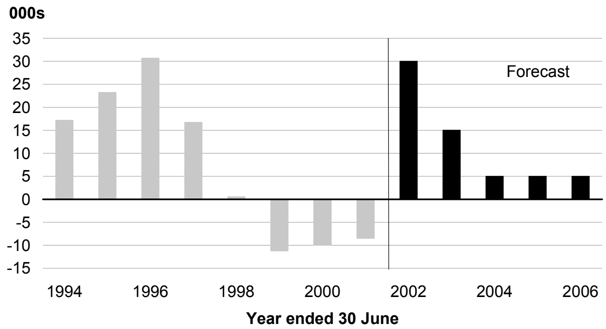
There are a number of possible reasons why domestic expenditure has outperformed our expectations. One of the key reasons is likely to be that the "non-economic" factors we saw depressing sentiment look to have unwound relatively quickly. As a result, the robust "fundamentals" we saw limiting the downside to growth reasserted themselves, and in some instances turned out to be stronger than expected. In the latter camp must be put the surprising strength of the labour market over the second half of 2001. This, coupled with lower oil prices, strengthening house prices and a historically low level of interest rates have served to boost consumption and residential investment spending over the last nine months. In addition, our assessment is that the turnaround in net migration has already begun to have an impact on household expenditure, and will continue to do so over the year ahead.

The substantial turnaround in net migration over the second half of 2001 has caused us to revise up our net migration assumption to 30,000 in the year to June 2002 – 20,000 more than we assumed at the *December Update.* This is one of the key changes to our forecast assumptions. The turnaround in net migration to date is due to both an increase in arrivals, particularly from China and other Asian countries, and to a sharp drop in departures. Given that a significant number of arrivals to date have been in the 15-19 age group, it would appear that a large proportion of arrivals have been students. Forming a view on the likely impact of the increase in net migration on the New Zealand economy is one of the key judgements underlying our *Budget Update* economic forecasts. Our view is that over the year ahead, the turnaround in net migration is likely to add more to demand than it does to supply, putting some degree of pressure on the economy's capacity. Over the medium term, the demand and supply effects of the increase in net migration will become more balanced, as migrants integrate into the labour force.

The Impact of Net Migration on the Economy

Permanent and long-term migration flows in New Zealand have turned from an outflow of 12,600 in the year to March 2001 to an inflow of 25,600 in the March 2002 year. The turnaround is made up as much by a reduction in departures (21% decline or 16,300 fewer departures) as an increase in arrivals (33% increase or 21,900 more arrivals). The increase in arrivals of young people, many of whom are students, has been especially pronounced, as shown in the table below.

Figure 2.4 – Net migration



Sources: Statistics New Zealand, The Treasury

	0-14	15-19	20-24	25-39	40-59	60+
Contribution to net gain	5,263	7,829	849	8,086	2,270	1,338
Percentage of net gain	20.5%	30.5%	3.3%	31.5%	8.9%	5.2%

At the time of the *December Update* we had anticipated a net migration gain of 10,000 in the year to June 2002, followed by gains of 5,000 in future years. The Central Forecast in this *Budget Update* incorporates a net flow into New Zealand of 30,000 in the year to June 2002, before a slowing to a net gain of 15,000 in 2003 and 5,000 thereafter. While there is substantial uncertainty around the migration flows in future years, the change in migration forecasts between the *December Update* and the *Budget Update* is large. The turnaround in net migration could have substantial demand and supply impacts over the next couple of years.

Demand impacts are likely to hit the economy relatively quickly, as migrants buy consumption goods and seek housing. Our estimates suggest that additional demand growth of around 0.5% to 1% in the 2002/03 year could eventuate from the additional population gains relative to that anticipated at the time of the *December Update*.[10]

In the Central Forecast, demand is not expected to increase at the rate seen during the migration inflows of the 1990s. The smaller impact is due to the duration of the gains being substantially shorter than during the 1990s and the demographic make-up of the migration gains. The number of young people in the migration numbers, including students, means that the demand impacts are likely to be somewhat less than during the 1990s. Young people are likely to bring with them less accumulated wealth and have less earning power once in New Zealand than the relatively older cohort in the 1990s. To date, the level of migrant transfers is only half the peak recorded in 1995/96, although this figure does not capture money brought into the country by international students.

We also expect the flow of people into New Zealand to add to labour supply. The Central Forecast sees the working age population growing at between 1.6% to 1.8% over 2002/03, compared with growth of 1.1% in the *December Update*, equivalent to approximately an extra 16,000 people. While the high number of arrivals of 15-19 year olds should depress the participation rate of the people making up the gain in net migration, we estimate that the combined impact of the fall in departures and the low number of older migrants relative to the rest of the population, should result in a labour market participation rate for the net migration gain that is similar to the rest of the population. However, there is the likelihood of an initial period of lower participation as migrants adapt to the labour market and establish themselves in New Zealand. We estimate net migration to add at most 0.4% to 0.5% to labour force growth in the 2002 calendar year compared with our *December Update* forecasts. Lower labour force participation rates of immigrants pose the most substantial risk to this estimate.

Once in the labour market, migrants may face a further adjustment period before obtaining work and/or adjusting to a new working environment. In addition, a number of studies suggest new immigrants have a sustained period of average earnings below the rest of the population, pointing to lower marginal productivity. Such lags may lessen the initial contribution of immigration to the productive capacity of the economy. However, it is difficult to believe that the current cohort of people that are being added to the labour force have consistently lower productivity than those already in the labour force.

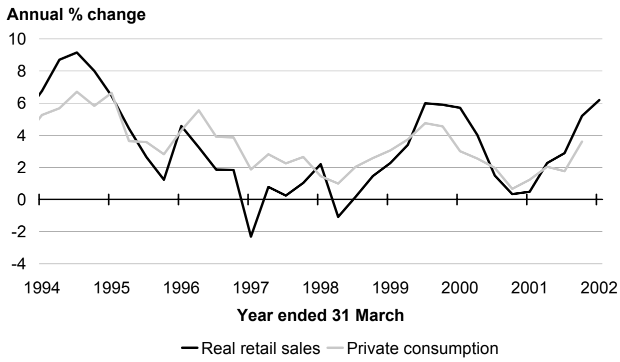
The lag in adapting to the labour market means that the demand impact from migration is likely to be more immediate than the supply impact.

10 This impact excludes the spending of international students whose expenditure under the System of National Accounts (SNA) is treated as services exports in the same way as that of international tourists if education is the main purpose of their stay in New Zealand.

Growth has picked up in the March quarter

Our assessment is that quarterly economic growth has accelerated going into 2002, with GDP growing at around 1% in the March quarter. We see some upside risk to this forecast, particularly given the strong employment growth recorded in the March quarter. We estimate that private consumption and residential investment left off where they did in the December 2001 quarter, making positive contributions to growth in March. Moreover, exports also appear to have added to growth in the March quarter, on the back of a partial unwind of primary stocks, continuing growth in manufactured exports, and a significant rebound in services exports, the latter reflecting the large increase in tourist arrivals seen in the March quarter. In contrast, market investment and stocks are expected to detract from growth. Reflecting the relative strength of domestic demand, imports are also expected to record ongoing growth in the March quarter and, therefore, subtract from growth.

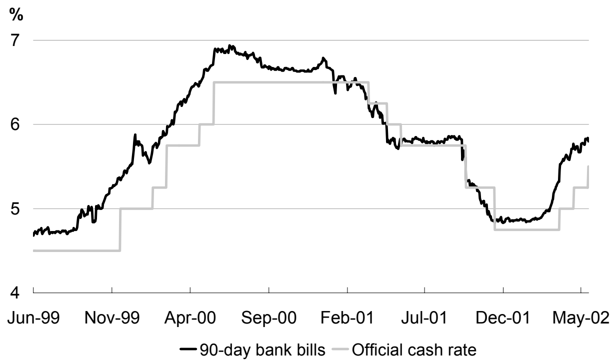
Figure 2.5 – Retail sales and consumption



Sources: Statistics New Zealand, The Treasury

The strength of domestic demand, and the resultant impact on capacity and the outlook for inflation, coupled with the general improvement in the global outlook, have seen the Reserve Bank begin to remove the interest rate stimulus. There have been three consecutive 25 basis point increases in the OCR in March, April and May of this year taking the OCR to 5.5%. At the time of finalisation, 90-day bank bill rates are trading between 25 to 50 basis points higher than the OCR, reflecting the market's expectation of further OCR increases.

Figure 2.6 – OCR and 90-day bank bill rates

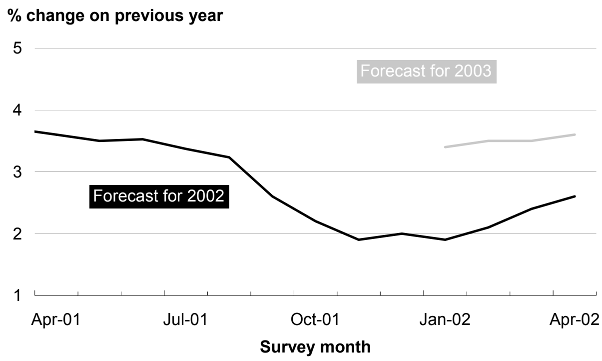


Sources: Reserve Bank, Datastream

Trading partner growth is forecast to pick up but will remain weak

Since our *December Update* forecasts were finalised, forecast trading partner growth for calendar 2002 has been revised up from 1.9% to 2.6%. To a large extent, the upward revision to trading partner growth in calendar 2002 is because of a higher starting point rather than stronger growth going forward. While up on calendar 2001, trading partner growth in 2002 is forecast to remain modest and only in 2003 is growth expected to approach trend.

Figure 2.7 – Forecast trading partner growth



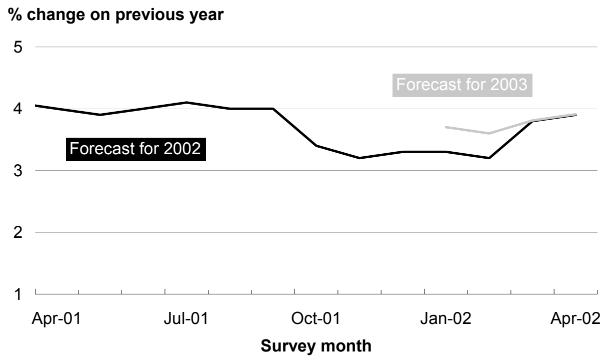
Sources: Consensus Economics, The Treasury

At the time of our *December Update, Consensus Forecasts* had the US economy growing at 1.1% for calendar 2001. In the event, GDP growth was 1.2% following stronger than expected growth in December. *Consensus Forecasts* for 2002 have been revised up from 0.7% in November to 2.6% in April. Analysts expect private consumption, aided by low interest rates and tax cuts, and a more rapid corporate adjustment than previously expected, to drive growth in the year ahead. Growth in the US for calendar 2003 is expected to reach 3.5%. Growth for a number of Euro-area economies is expected to be weaker in 2002 than in 2001, however this masks what is generally expected to be a pick-up in quarterly growth in the second half of 2002.

Despite current signs of stabilisation, the economic outlook for Japan continues to look fragile. While the Japanese economy is expected to resume growth on a quarterly basis, growth for the year as a whole is expected to be negative again in 2002. Since the November edition of *Consensus Forecasts*, the mean GDP forecast has been revised down from -0.6% to -1.1%. Private consumption growth is expected to remain weak in the face of what is an historically weak labour market, with the unemployment rate forecast to reach 5.8% by the end of 2002.

Growth in non-Japan Asia is projected to pick up reasonably rapidly during the next year as exports benefit from the rebound in global growth and as the recovery spreads to the less tech-oriented economies.

Figure 2.8 – Australia Growth Forecasts



Source: Consensus Economics

Importantly for New Zealand, the Australian economy is expected to continue to grow strongly, with GDP growth of around 4% forecast for both calendar 2002 and 2003. While Australian residential investment is expected to moderate this year, this is expected to be offset by robust consumption growth, a pick-up in business investment and a recovery in export growth. Robust growth in our largest trading partner will help to support growth in the New Zealand economy over the forecast period.

Along with the increase in trading partner growth forecasts, the nature of risks around the outlook also appears to have altered. In particular, the "non-economic" factors that were impacting on sentiment have dissipated considerably. Many of the risks around the outlook for trading partner growth now appear to relate to more traditional economic factors that impact on the pace and durability of growth. While these could lead to growth proceeding at either a slower or faster pace than currently expected, overall we see the risks around the external environment being more balanced and less extreme than at the time of the *December Update*.

Table 2.2 – Trading partner growth forecasts

	2001	2002	2003	2004-2006
Australia	2.4	3.9	3.9	3.8
Japan	-0.5	-1.1	1.1	1.6
US	1.2	2.6	3.5	3.3
Europe*	1.8	1.6	2.7	2.5
Non-Japan Asia**	1.9	4.5	5.6	5.5

* UK, Germany, Italy, France (weighted by NZ export share)

** Korea, Taiwan, China, Malaysia, Hong Kong, Singapore (weighted by NZ export share)

Source: Consensus Economics

In the US, should household expenditure – which has shown a high degree of resilience to date – weaken and/or business investment recover more slowly, perhaps in response to concerns about corporate earnings and equity returns, the recovery in economic growth could be more sluggish than embodied in *Consensus Forecasts.* On the other hand, after what will be two years of sub-trend growth over 2001 and 2002, current projections do not have the US recording growth above trend. Closer to home, and perhaps of equal importance to the New Zealand outlook, the timing of the projected pick-up in business investment and rebound in exports is also important for the Australian outlook. A delayed pick-up in these areas could see activity falter in the second half of the year as residential investment slows. Conversely, an earlier acceleration would see them reinforcing what is already strong household spending, leading to even stronger growth over the short term.

Short-term Outlook

Economic growth is set to remain robust…

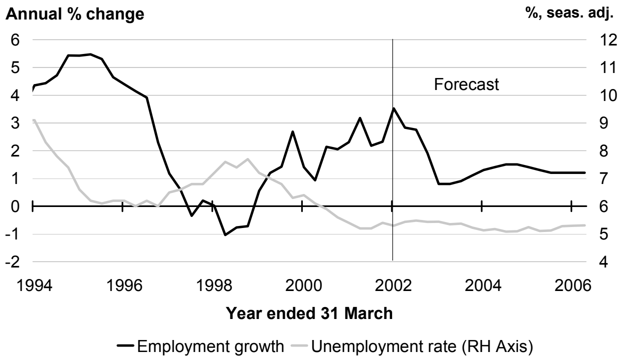
Despite the majority of New Zealand's trading partners growing below trend over calendar 2002, the New Zealand economy is expected to post solid growth of 3.1% in the year to March 2003. This is a significant change from our *December Update* forecast for GDP growth of 1.9% in the year to March 2003, and is largely due to the change in the profile for domestic demand. Quarterly growth is forecast to be relatively robust in the March and June quarters, reflecting some of the momentum already evident in the domestic components of GDP, averaging around 0.9% before slowing moderately over the second half of 2002 and early 2003. While growth in domestic demand remains robust over the year to March 2003, strong quarterly growth in exports owing to reversals in dairy and meat stocks and a strengthening world environment, means the composition of growth becomes more balanced than at the end of 2001.

… but employment growth is expected to slow…

After displaying strong growth in the year to March 2002, employment growth is forecast to slow from mid-2002. In part this reflects a view that a significant amount of the employment growth that took place in the education, health and community services sectors is unlikely to continue over the next year. More generally, firms are expected to seek productivity gains, following the significant growth in employment over the last year, to help offset pressure on profitability elsewhere.

Owing to both a rising participation rate and the turnaround in net migration, labour force growth is currently around 2.4%, providing a temporary boost to the economy's potential growth rate and helping to offset some of the demand pressure. Because employment growth is expected to slow over 2002, the participation rate is also expected to ease back slightly. Nonetheless, we still expect the participation rate to remain at high levels. Given our forecasts for both employment and labour force growth, the unemployment rate is forecast to remain relatively static at around 5½% over the year to March 2003. Reflecting a historically tight labour market, wage growth is forecast to hold up in the year ahead.

Figure 2.9 – Labour market

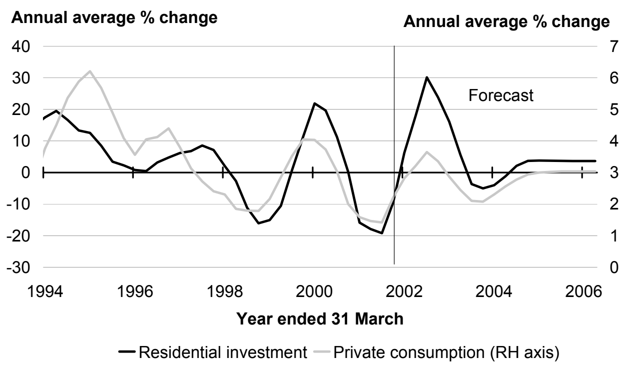


Sources: Statistics New Zealand, The Treasury

… as is household spending, after a strong start to the year

After accelerating over the year to March 2002, quarterly consumption growth is expected to moderate over the year ahead, as disposable income growth slows markedly owing to slowing employment growth. A significant slowdown in labour income growth in conjunction with a decline in farm incomes, leads to a modest slowing in consumption growth over the second half of 2002 and the first half of 2003. Rising interest rates and the current level of oil prices are also expected to operate in the same direction.

Figure 2.10 – Consumption and residential investment



Sources: Statistics New Zealand, The Treasury

Providing some support to household spending in the year ahead, however, is the substantial turnaround in net migration. As discussed in the box on net migration, all else held constant, we estimate that the extra 10,000 to 12,000 people added to New Zealand's population since our *December Update* forecasts were finalised will probably add between 0.5% to 1% to demand growth over the next year. The profile for both housing activity and residential investment will also support consumption growth over the near term, with rising house prices increasing household wealth and new house building boosting durables consumption.

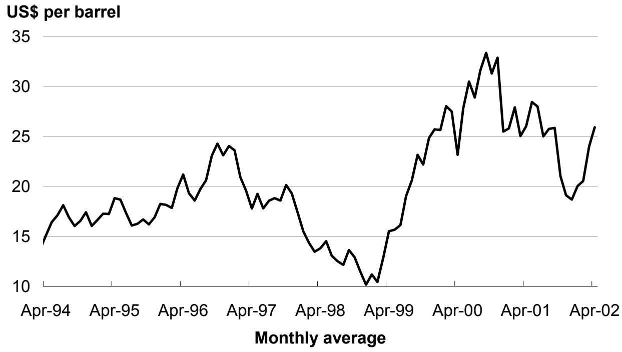
Reflecting both the recent and the expected growth in house sales and consents, residential investment is expected to display ongoing growth over the first three quarters of 2002, before contracting over late 2002 and early 2003, as income growth slows and activity feels the impact of rising interest rates. The turnaround in net migration is also expected to reinforce the residential investment profile.

One of the key judgements underlying our forecast for the household sector is the willingness of households to take on more debt, especially over the year ahead. Although the forecast accumulation of debt is significantly slower than was the case during the 1990s, our Central Forecast implies that households will take on more debt than they did over the 2000-2002 period – a period where the household dis-saving reduced markedly on the back of strong income growth and subdued growth in residential investment. Should households display greater or less willingness to take on debt than we have assumed, the profile for household expenditure may evolve somewhat differently from that portrayed in our Central Forecast. This could be accentuated by changes in key determinants of household expenditure, such as oil prices (which we explore in the Oil Prices box below). Two alternative paths for consumption and residential investment are developed in more detail in the Risks and Scenarios chapter.

Oil Prices

After fluctuating around the US$20 mark in the wake of the events of 11 September, Brent spot prices have trended upwards since the beginning of March 2002 to around $26 a barrel recently – significantly higher than our *December Update* forecast for an increase to around $22.50. The recent surge in international oil prices has primarily been driven by three factors: (i) the OPEC commitment to maintaining current production targets until June, (ii) the market factoring in the increasing tensions in the Middle East, and (iii) improved prospects of global recovery.

Figure 2.11 – Oil price



Source: Datastream

Our assumption for this forecast round is for Brent spot prices to remain around $25 a barrel over 2002, before easing back towards our assumed "equilibrium" level of crude prices of US$18.50 (based on historical average). We attempt to capture information from *Consensus Forecasts*, Brent crude futures prices, and our perceived long-run equilibrium price of oil. However, both the Brent futures curve and the *Consensus* view fluctuate considerably, reflecting volatile spot price movements, and hence the outlook for international oil prices is a key uncertainty of our forecasts.

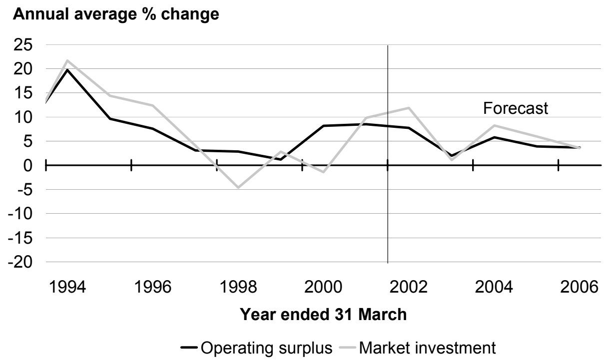
Rising international oil prices have a direct impact on domestic inflation via petrol prices, which in turn has an effect on domestic consumption. There is also a less direct impact on consumption through the confidence channel, although this is more difficult to quantify. The petrol price component accounts for 3% of the CPI index. Higher oil prices impact directly on headline CPI through the increase in the retail price of petrol. Our estimate is that for every US$1 increase in international oil prices, all else constant, retail petrol prices increase around 1.6 c/litre. (This calculation is based on a constant margin assumption.) Recent strength in the New Zealand dollar has ameliorated some of the recent rises in international oil prices. If the New Zealand dollar had stayed where it was relative to the US dollar since early March, we estimate that petrol prices could have been around 3 c/litre higher than the current pump price. If international oil prices were to spike up to US$30 a barrel – approximately the average price in 2000 – retail petrol prices may increase by 6 to 7 c/litre, adding 0.2% to headline inflation.

Since the demand for petrol is largely inelastic in the short term, large spikes in oil prices can be viewed as a tax on consumers as they reduce household discretionary income and result in lower expenditure on other goods and services. The effect is compounded if consumer confidence is affected as well. New Zealand households spend approximately $2 billion per annum or almost 4% of their total expenditure on petrol. In the event that international oil prices increase to US$30 a barrel, we estimate that household discretionary income would be reduced by around 0.25%.

Investment spending is looking robust…

Quarterly growth in market investment is forecast to accelerate over 2002 and early 2003, growing at around 2% in the year to March 2003. This contrasts with our *December Update* forecast where we expected market investment growth to fall around 4% in the March 2003 year.

Figure 2.12 – Market investment and operating surplus



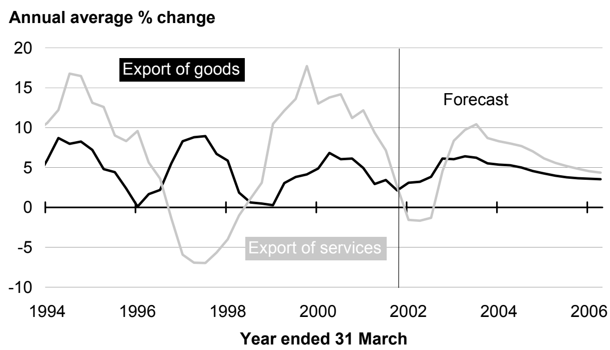
Sources: Statistics New Zealand, The Treasury

Two years of good growth in economy-wide profits and strong growth in domestic demand, exhausting some of the spare capacity in the economy, are two key factors behind the investment profile in the next year. The delayed impact of falling interest rates through 2001 is also forecast to support investment growth in the next year. Although we have largely removed the negative shock to market investment emanating from weak sentiment, the profile for investment still builds in a degree of delayed investment given that the lead times between investment decisions and when investment actually takes place can be reasonably long for some investment projects. Owing to slowing profit growth in the year to March 2003, quarterly market investment growth is expected to lose some of its momentum in the second half of 2003, but still remain at relatively robust rates.

…and solid export volume growth will rebalance growth in the year ahead

The short-term profile for merchandise export volumes is largely dominated by developments in dairy and meat exports. Following a large build-up in dairy stocks over the latter part of 2001, quarterly growth in dairy exports is forecast to be strongest over 2002, as some of the build-up in stocks of dairy products is unwound. Further out, dairy export growth is expected to ease as stock levels fall back into line with production. An upward revision in cow numbers and consequently milk fat production also reinforces the profile for dairy exports in the year to March 2003. Like dairy exports, growth in meat exports is forecast to be strongest during the first three quarters of 2002. This is due to delayed slaughtering during the recent wet summer. Non-commodity manufactured exports are projected to display robust quarterly growth, as this export category benefits from the lagged impact of the depreciation in the TWI and stronger – but still below-trend – trading partner growth.

Figure 2.13 – Export volumes



Sources: Statistics New Zealand, The Treasury

The projected strength in services exports in the year ahead reflects a reversal of the significant fall in travel exports at the end of 2001, together with a judgement that "normal" travel patterns will resume more quickly than was the case at the *December Update*. More generally, services exports are expected to benefit from the lagged impact of the depreciation in the currency and a pick up in trading partner growth.

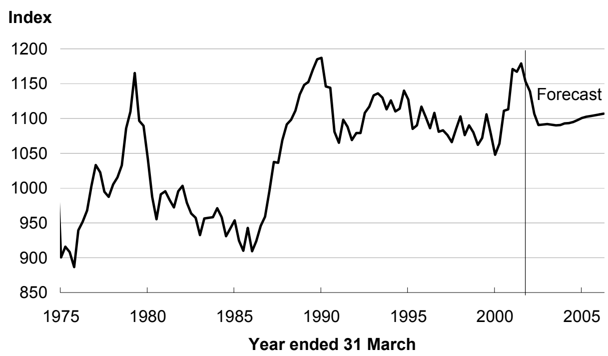
The overall profile for exports is for growth of 6.6% in the year ahead, following growth of around 1.8% in the year to March 2002.

However, export prices will continue to fall throughout 2002

The full impact of the sharp drop in global growth on export prices has still to be felt, with world export prices forecast to decline through until the second half of 2002, with New Zealand dollar export prices to fall by 12% in the March 2003 year. Behind the falls in the aggregate world export price are sharp declines in world dairy prices, reflecting both weaker world demand and increases in EU and US subsidies, together with ongoing weakness in crude material and manufactured goods prices. Although world export prices are expected to begin to pick up from late 2002, on the back of increases in forestry, manufactured and crude material goods prices, our assumption of an appreciating exchange rate essentially offsets world price gains. Hence, New Zealand dollar prices do not start increasing until mid-2003. As has been the case since late last year, meat exporters are expected to continue to benefit from market-specific factors in the beef and lamb markets, with meat prices remaining at current levels for approximately the next two years.

Largely on the back of higher international oil prices, world import prices are expected to post modest quarterly growth over the year ahead. However, given the assumed appreciation in the TWI, New Zealand dollar import prices are expected to decline around 7%.

Figure 2.14 – Terms of trade



Sources: Statistics New Zealand, The Treasury

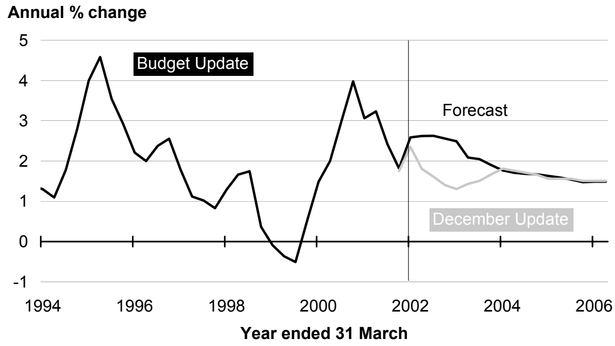
Consistent with most previous episodes of slowing trading partner growth, New Zealand's terms of trade is forecast to post a significant fall. Our *Budget Update* forecast embodies an estimated 7% decline in the terms of trade from its peak in March 2001 to our forecast trough in mid-2002. What is perhaps unique is that compared with previous downturns in global growth, the terms of trade is expected to bottom at a considerably higher level, highlighting how several market-specific factors have helped to support New Zealand's terms of trade. In turn, this has helped to support the New Zealand economy in the face of a large external demand shock.

Inflation will remain near the top end of the Reserve Bank's target band

Reflecting high unit labour cost growth, where wage inflation is expected to significantly outstrip productivity growth, and strong GDP growth over the year ahead, annual CPI inflation is forecast to remain persistently at or above 2.5% over the remainder of 2002, before ameliorating somewhat going into 2003. While we expect an appreciating exchange rate to place some downward pressure on inflation, we also expect firms to take the opportunity of robust demand to seek to rebuild margins, particularly over the first part of 2002.

Even though we see inflationary pressures subsiding somewhat from the second half of 2002, there is a degree of upside risk to this inflation profile, particularly around the near term. Although our *Budget Update* forecast embodies a strong 0.9% increase in the Consumers Price Index (CPI) in the June 2002 quarter, there is a risk that the outturn may be stronger than this forecast, taking inflation to the upper end of the Reserve Bank's 0% to 3% target band. This may occur because of substantial one-off price increases in the non-tradeable sector of the economy. Looking further ahead, there is also a risk that with inflation staying near the top end of the target band for an extended period of time, inflation expectations will increase, making the Reserve Bank's job of bringing back inflation to the mid-point of the target band somewhat more difficult. However, our view is that inflation expectations are reasonably well anchored, with the 2000 to 2001 period being a case in point, where higher CPI inflation did not appear to feed substantially into wage-setting behaviour.

Figure 2.15 – CPI inflation

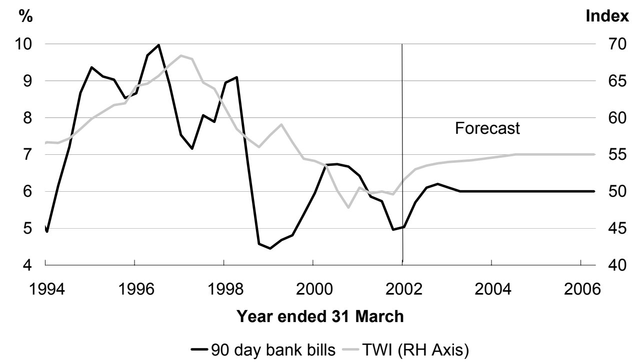


Sources: Statistics New Zealand, The Treasury

The Reserve Bank removes the interest rate stimulus

With growth set to remain strong in the year to March 2003, the Reserve Bank is assumed to remove the stimulus emanating from 90-day rates by taking the OCR to 6% by the end of 2002, with 90-day rates peaking just above our assumed neutral level of 6%. Past monetary tightening cycles would suggest there is upside risk to our 90-day profile and that rates could go above the level currently forecast, particularly in the event that domestic demand proves to be stronger than embodied in our Central Forecast. However, our view is that 90-day rates peaking at just over 6% should be enough to curtail inflationary pressures, given that other factors are at work to slow growth and check inflationary pressures over the next year. More specifically, the fall in disposable income growth over the year ahead should help to dampen domestic demand. Moreover, because household debt levels are now higher than during previous tightening cycles, interest rates will not need to rise to the same extent before having a comparable impact on household spending.

Figure 2.16 – 90-day rate and TWI



Sources: Reserve Bank, The Treasury

The current account will increase in the year ahead

Despite export volume growth gaining some momentum in the year ahead, the current account deficit is expected to increase to around 4.5% of GDP in the second half of 2002. This largely reflects our stronger consumption and investment profiles resulting in strong import growth over the March 2003 year. Government defence spending also adds to the import profile over the forecast horizon. Reflecting a strengthening world economy and, importantly for New Zealand, robust economic growth in Australia, income flows from offshore are expected to be stronger compared with what we were projecting late last year, albeit partly offset by slightly stronger income flows from New Zealand to the rest of the world. Our flow of funds analysis suggests that a significant amount of the deterioration in the current account in the near-term is due to activity in the household sector.

The profile for nominal GDP remains cyclical

While the near term profile for GDP growth is relatively flat, nominal GDP growth is considerably more cyclical, owing to movements in the GDP deflator accentuating the movements in real GDP. After growing 6.6% in the year to March 2002, nominal GDP growth is forecast to slow to 3.7% in the year to March 2003, before rising to 5% in the year after. Compared with the *December Update* forecast, the level of nominal GDP is around $2 billion higher in the year to June 2006. The higher level of nominal GDP throughout the entire forecast period underpins the solid growth in tax revenue feeding through to an improved fiscal position.

Longer-term Outlook – 2003/04 and Beyond

We expect GDP to grow 3% in the year to March 2004, with trading partner growth returning to around trend (3½%) in calendar 2003, as well as the economy benefiting from business investment and employment growth. Further out, growth converges back to around the economy's long-run trend in the outer years of the forecast period.

Household spending will pick up…

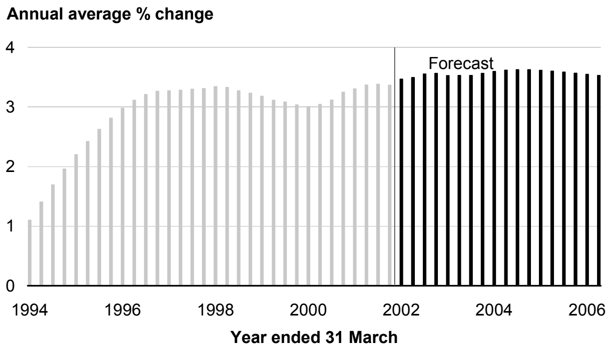
After slowing over the second half of 2002 and the first half of 2003, quarterly consumption growth is forecast to pick up in late 2003 as disposable income growth begins to gain some momentum over the year to March 2004. Ongoing household wealth increases, supported by modest growth in house prices, are also expected to reinforce the consumption profile during this period.

While residential investment contracts in the March 2004 year, growth returns to levels that are consistent with what is required to house New Zealand's population in the medium term.

Our household sector forecast embodies further increases in household debt (as a percentage of disposable income) over the forecast period. This projection is largely due to households taking on debt to finance residential investment. However, in contrast to the 1990s, the rate of accumulation in debt is significantly slower, although it is somewhat greater than was seen during the 2000-2002 period. Households' willingness to take on debt is a key judgement looking forward.

… and investment and employment will support growth

Figure 2.17 – Capital stock growth



Sources: Statistics New Zealand, The Treasury

Market investment remains reasonably strong over the out years of the forecast period. This reflects a reasonably tight labour market – with firms using capital to meet more of their output growth – and the need for firms to provide additional capital to newly employed workers. The capital stock is forecast to grow at around its recent pace of 3½% in the out years of the forecast period. This serves to underpin labour productivity growth over a period where employment growth is relatively strong. We expect a significant amount of investment to go into the manufacturing sector, in support of ongoing growth in non-commodity manufactured exports.

Non-market investment is also expected to add to growth in both the March 2004 and 2005 years, reflecting expected capital expenditure in the road and education sectors. In contrast, public consumption expenditure growth (excluding military equipment) is expected to slow in the out years of the forecast horizon as the Government seeks to build up structural surpluses.

Consistent with robust economic growth in the medium term, employment growth begins to pick up somewhat from the March 2004 year onwards. As employment growth increases, the unemployment rate is forecast to fall over 2003 and 2004, bottoming at around 5% in March 2005.

Export growth remains robust

Export growth is forecast to remain fairly robust over the medium term. Agricultural exports are expected to continue to grow owing to growth in livestock numbers and ongoing productivity gains. Non-commodity manufactured exports are expected to post ongoing robust growth, benefiting from solid external demand and an exchange rate that is assumed not to overshoot its equilibrium level.

Inflation falls to the mid-point of the target band

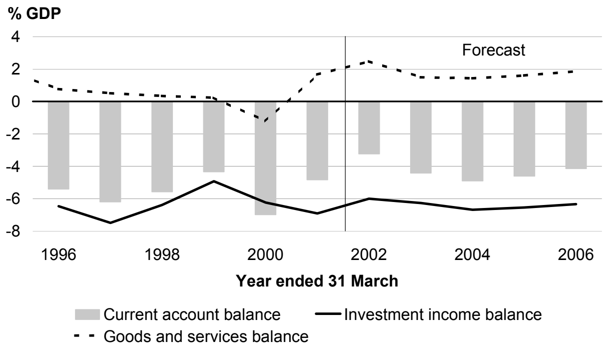
Going into 2003, inflation is expected to fall back quite quickly towards the mid-point of the Reserve Bank's 0% to 3% target band, as inflation pressures moderate on the back of interest rate increases and an appreciating currency keeping inflationary pressures in check over the medium term. Even though the economy grows at a higher rate than its recent trend of around 2¾% from March 2003 through to March 2005, in a cyclical sense potential growth is seen to benefit from both robust labour force and capital stock growth. This means that the capacity is in place to meet demand without leading to the emergence of substantial inflationary pressure. If the extra labour supply adds less to productive capacity then the pressure would likely be greater.

The current account deficit improves in the outer years of the forecast period

Following the deterioration in the current account deficit over the March 2003 and 2004 years, the current account deficit is expected to reduce in the out years of the forecast horizon, reaching 4.1% of GDP by March 2006. The initial improvement in the deficit is driven by a slowdown in import growth, as consumption and investment growth slow in the March 2004 year and into 2005. A continued steady improvement in services exports also helps to underpin the current account improvement.

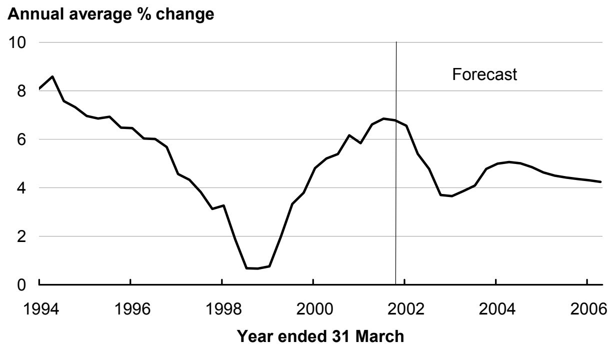
Over the last three years of the forecast horizon the nominal economy is expected to grow at around 4% to 5%, owing to the combination of steady GDP growth and inflation around the mid-point of the Reserve Bank's target band.

Figure 2.18 – Current account balance



Sources: Statistics New Zealand, The Treasury

Figure 2.19 – Nominal GDP



Sources: Statistics New Zealand, The Treasury