1

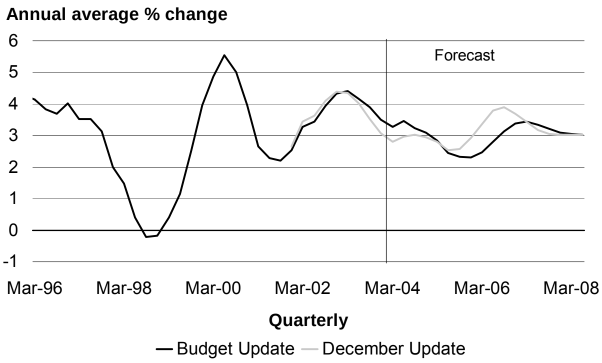
Economic Outlook

Summary

- The New Zealand economy is continuing its strong growth performance of the past couple of years. Real GDP growth is solid, with growth of 3.3% expected for the year to March 2004 (compared with the 2.8% expected in the *December Update*) and the unemployment rate is at a 16 year low.

- Growth has been dominated by domestic demand, which expanded by 6.6% in the 2003 calendar year. Contributing to this strength has been the strong performance of the labour market and increasing household wealth due to rapidly increasing house prices.

Figure 1.1 – Real GDP growth



Sources: Statistics New Zealand, The Treasury

- Over the short term, the momentum in growth is expected to continue, owing to continued strong household and business spending. Factors supporting this include high house prices, solid labour income growth and favourable terms of trade.

- This near-term strength is forecast to give way to a period of slower GDP growth over the second half of 2004 and much of 2005. Slowing net migration, slower employment growth, and the lagged effect of the high exchange rate are the main drivers of the forecast easing in growth. Both export volumes and export income growth are forecast to be lower than in the *December Update* over this period. Exporters are expected to spend less, with flow-on effects to those who provide goods and services to exporters. On top of this, the housing investment cycle is forecast to run its course and households are forecast to ease back their growth in spending.

- Around the start of 2006, GDP growth is forecast to pick up. This is due to both the exchange rate acting as less of a drag, given its assumed decline, and continuing global growth providing a greater stimulus to exports. Import growth is forecast to remain subdued leading to net exports making a positive contribution to growth for the first time since late 2001.

- The recovery in the export sector is expected to flow through to business investment and household spending, but by recent standards growth is expected to be more modest.

- Throughout the forecast period the government sector, either directly or via transfer payments to households, is forecast to add to growth.

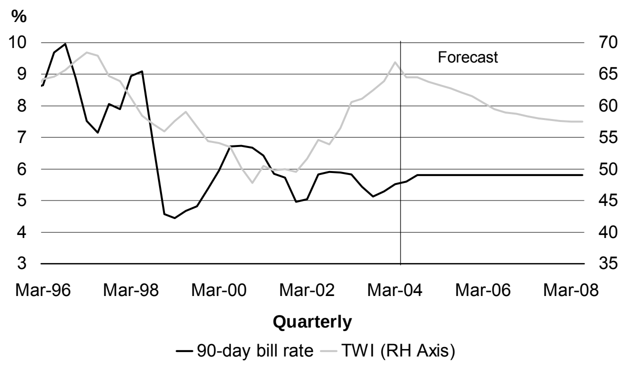
- The past few years of strong growth has seen the economy steadily absorb previously under utilised labour and capital equipment. This is most readily apparent in the labour market, where the unemployment rate is at a 16 year low, and in industries like construction where prices are rising strongly.

- With the economy expected to continue to operate close to or above capacity for some time to come, annual CPI inflation is forecast to increase to 2.6% in early 2005. Annual CPI inflation is expected to be above current levels throughout the forecast period, in part due to tradable inflation increasing as the exchange rate depreciates.

- Consistent with mounting inflation pressures the Reserve Bank has raised the Official Cash Rate (OCR) by 50 basis points since the beginning of 2004. We expect one further increase in the OCR around the middle of this year, bringing the OCR in to line with our current assessment of neutral.

- Growth in nominal GDP is initially forecast to continue to diverge from real GDP growth, peaking at 7.0% in the year ended June 2004. Nominal GDP growth is then forecast to slow, reaching a trough of 4.2% for the 2005 calendar year.

Figure 1.2 – Monetary conditions



Sources: Reserve Bank of New Zealand, The Treasury

Table 1.1 – Economic outlook: central forecast[1]

(Annual average % change, March years)	**2003 Actual**	**2004 Estimate**	**2005 Forecast**	**2006 Forecast**	**2007 Forecast**	**2008 Forecast**
Private consumption	4.4	5.4	3.3	2.3	2.6	2.7
Public consumption[2]	2.3	3.9	6.7	3.1	5.0	2.9
Total Consumption	**3.9**	**5.0**	**4.1**	**2.5**	**3.1**	**2.7**
Residential investment	23.4	15.7	7.4	-8.9	-6.9	0.5
Central Government investment	1.4	9.0	-0.2	6.3	3.1	2.8
Other investment	5.6	12.9	8.5	3.4	2.8	4.2
Total Investment	**9.6**	**13.3**	**7.5**	**0.4**	**0.5**	**3.3**
Stock change[3]	-0.3	0.3	-0.2	0.0	0.0	0.0
Gross National Expenditure	**4.6**	**7.0**	**4.7**	**2.0**	**2.5**	**2.8**
Exports	7.0	0.3	5.4	4.7	6.0	4.0
Imports	9.4	11.8	9.8	2.9	3.3	3.2
GDP (Production Measure)	**4.4**	**3.3**	**2.8**	**2.5**	**3.4**	**3.0**
- annual % change	*4.3*	*3.3*	*2.3*	*3.0*	*3.2*	*3.0*
Real GDP per capita	2.8	1.6	1.6	1.5	2.6	2.2
Nominal GDP (expenditure basis)	3.8	6.1	5.7	4.3	5.0	5.3
GDP deflator	-0.1	2.9	2.8	1.7	1.6	2.1
Employment[4]	2.6	2.8	1.4	0.7	1.6	1.4
Unemployment[5]	4.9	4.6	4.7	5.0	4.9	4.8
Wages[6]	2.9	3.6	4.2	3.9	3.6	3.6
CPI inflation	2.5	1.5	2.6	2.4	2.2	2.0
Export prices[7]	-13.3	-8.6	0.6	0.9	3.6	1.9
Import prices[7]	-8.2	-11.5	0.1	2.8	4.0	1.0
Current account balance						
- $ million	-5,035	-6,433	-8,415	-8,770	-8,405	-8,265
- % of GDP	-3.9	-4.8	-5.9	-5.9	-5.4	-5.0
TWI[8]	60.6	66.9	63.3	60.5	58.3	57.5
90-day bank bill rate[8]	5.8	5.5	5.8	5.8	5.8	5.8
10-year bond rate[8]	6.0	5.8	6.4	6.0	6.0	6.0

Sources: Statistics New Zealand, Datastream, The Treasury

NOTES:
1 Forecasts finalised 27 April 2004. Text finalised 20 May 2004.
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 – global economic growth, inflation and interest rate forecasts are assumed to conform to those presented in the April *Consensus Forecasts* and *Asia Pacific Consensus Forecasts*. For a more detailed discussion of the global outlook, see the “Global Economic Growth” box.

Oil prices – oil prices are assumed to remain at around US$32 per barrel (the average price for the preceding quarter at the time the forecasts were finalised) over the short term and then gradually decline, consistent with the April *Consensus* forecasts for the medium term. Thereafter, oil prices are assumed to converge to a long term average of around US$19 per barrel.

Net migration – the net number of migrants has started to decline from a peak early in 2003 and is assumed to continue to decline to approximately 10,000 per year by June 2006. The migration assumption for the year to June 2004 at 23,000 is 7,000 lower than that used in the *December Update.*

Monetary conditions – during the middle of 2004, the exchange rate (TWI) is assumed to be around 64.5 prior to declining steadily to its estimated equilibrium of around 57. This is a technical assumption. The forecasts assume a neutral short-term interest rate of 5.8%.

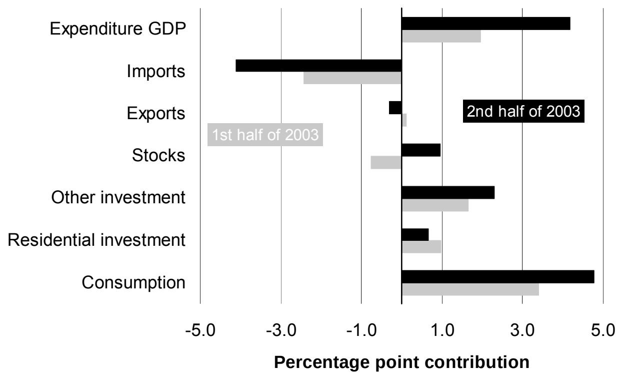
Climate – agricultural growing conditions and the level of hydro electricity storage lakes are assumed to be normal over the forecast period.

Developments over 2003

The economy continued to grow strongly

The economy grew strongly over the second half of the 2003 calendar year, with production-based GDP up 4.1% on an annualised basis. This was considerably faster than the 2.7% annualised growth recorded in the first half of the year, a period in which the economy was affected by several short-lived shocks – the Iraq conflict, the Severe Acute Respiratory Syndrome (SARS) outbreak, drought and its effect on hydro electricity generation. The strong growth performance over the second half of the year exceeded our *December Update* forecast and contributed to the economy growing in annual average terms by 3.5% for the 2003 calendar year.

Figure 1.3 – Six-month annualised contributions to 2003 GDP growth



Sources: Statistics New Zealand, The Treasury

Domestic demand growth was particularly strong…

Spending by households was very buoyant, both on consumption items and on investment in new and existing houses and apartments. Private consumption increased 5.2% in the December 2003 year. Within this increase, growth in expenditure on durables was particularly strong at 8.5%, partly reflecting the increase in new house construction. Growth in residential investment was just under 20% for the December 2003 year, with growth particularly strong in the first half of the year.

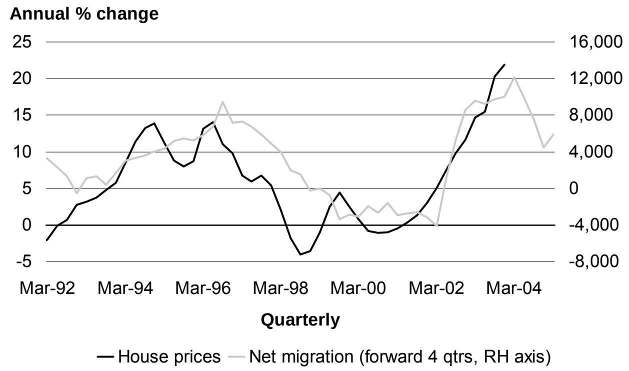
… buoyed by a mix of supportive drivers…

A number of factors supported the strong growth in household spending. Increased employment and steady wage growth were both positive for household spending over the past year. The unemployment rate at 4.6% in the December quarter was low by historical standards and, since finalising our forecasts, has fallen to 4.3% in the March quarter of 2004. Consumer confidence at the end of 2003, as measured by the Westpac McDermott Miller consumer confidence index, was at its highest level since early 1996.

… including rising house prices

Over 2003, average house prices increased by nearly 22%. This not only provided a positive stimulus to house building, but because houses are the most widely held type of household asset also increased household wealth. Increased household wealth contributed to households being more willing to take on debt to fund expenditure.

Figure 1.4 – House prices and net migration



Sources: Quotable Value New Zealand, The Treasury

Strong positive net migration has been an important influence on the demand for housing over the past couple of years and also contributed to household consumption spending growth. Annual net migration has been positive since October 2001 and rapidly increased to a peak of 42,500 in the May 2003 year. Since then migration numbers have fallen so that by March 2004 annual net migration was 28,000.

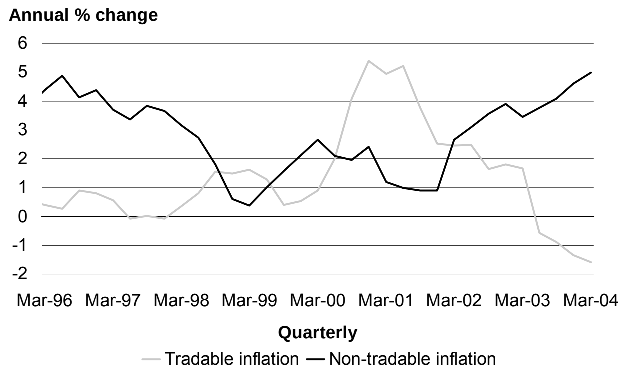
Domestic strength resulted in limited spare capacity within the economy…

Businesses appear to have been operating at levels close to capacity. The level of overall capacity utilisation in March 2004 at 92.1% was its highest since December 1973. Capacity utilisation was particularly high in the building sector. Businesses are also finding it increasingly hard to find skilled and unskilled labour and the proportion of firms reporting labour as the single factor that is most limiting their ability to increase production was the highest since 1974.

... and put upward pressure on inflation…

Overall headline CPI inflation at 1.5% for the March 2004 year was comfortably within the Reserve Bank's target band. The headline number, however, masks the very different profiles of tradable and non-tradable inflation. Non-tradable inflation for the year to March 2004 was very strong at 5.0%, consistent with very strong domestic demand and capacity pressures. Increasing costs associated with the purchase and construction of new dwellings contributed to this strong non-tradables result. Offsetting this trend, tradable prices fell 1.6% over the same period, due in large part to the appreciating New Zealand dollar.

Figure 1.5 – Tradable and non-tradable inflation



Source: Reserve Bank of New Zealand

… but also increased the incentive for businesses to invest

Consistent with a lack of spare capacity, coupled with a tight labour market and expectations of continued demand, businesses significantly increased investment. The annual rate of business investment growth for the December 2003 year was 12.1%, the highest rate since 1996. The fastest growth was in plant and machinery investment and transport equipment investment. In contrast, growth in building and infrastructure investment has so far been relatively slow, although the monthly value of consents issued for such projects is rising.

The exchange rate rose rapidly…

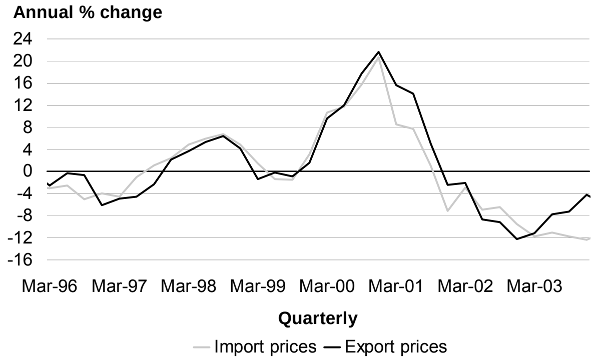
Between August 2002 and February 2004 the Trade Weighted Index (TWI) increased from around 53 to 68. The appreciation in the TWI was largely a result of an appreciation against the US dollar, rising from around US$0.46 to US$0.69 over the same period. Movements against other currencies were not as extreme. Since February the New Zealand dollar has fallen back quite rapidly. In mid May the New Zealand dollar was trading at around US$0.60 against the US dollar and 62 on a TWI basis. The assumed movement of the TWI throughout the forecast period is outlined in the assumptions box. However, movements in the exchange rate are notoriously difficult to predict as are their impact on the economy. Given this uncertainty, further discussion about the TWI is contained in Chapter 3 where an alternative scenario is presented in which the TWI is assumed to fall more rapidly than in the central forecast contained in this chapter.

… leading to lower import prices…

With the appreciation of the New Zealand dollar, the price of imported goods has fallen. This has provided a boost to both real private consumption and real business investment as consumers have taken advantage of low-priced consumption goods while businesses have benefited from lower-priced capital equipment. Computer prices, in particular, have fallen dramatically in real terms.

Increased demand for imported goods by both households and businesses has resulted in strong growth in import volumes, which grew 10.2% over the 2003 calendar year.

Figure 1.6 – Export and import prices



Sources: Statistics New Zealand, The Treasury

… but has negatively affected export receipts

While the appreciation of the exchange rate has enabled the purchase of cheaper imported goods, it has also reduced export earnings. Total export earnings fell 6.5% in the year to December 2003. This fall was driven by lower New Zealand dollar prices received by exporters, rather than export volumes, which grew by 1.3% in the year to December 2003. Increases in international commodity prices have provided exporters some relief from the high exchange rate. Higher world prices for New Zealand exports have contributed to export prices declining at a slower rate than import prices, resulting in an improvement in the terms of trade.

Export volumes were also quite volatile over 2003, with volumes recovering strongly after two quarters of decline, rising by 5.2% in the December quarter. Dairy exports contributed significantly to the December result, increasing by nearly 25% in the quarter. However, dairy production increased by a far smaller extent, indicating that some of this recent export growth has come from a rundown of inventories.

Overall, the strength of the domestic economy, the associated demand for imports and relatively weak export growth have resulted in a widening wedge between the contribution of domestic demand and net exports to growth.

Growth in the nominal economy has diverged from growth in the real economy

Although the annual rate of real GDP growth is slowing, the growth rate for nominal GDP has been accelerating, reaching 5.3% for the year to December 2003. The implicit GDP price deflator, the broadest measure of overall price changes for final goods and services produced in New Zealand, increased 2.0% for the December 2003 year.

The acceleration in the GDP price deflator has largely occurred in two areas. Strong house price growth has partially fed through into the rising price of residential investment. Further contributing to the GDP deflator increase has been the rise in the terms of trade.

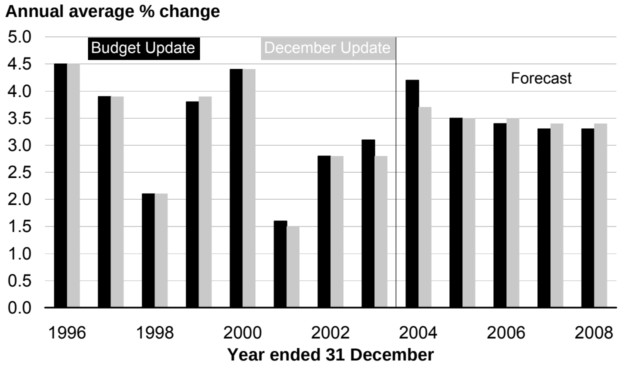
Global Economic Growth

Forecasts revised up

The growth rate of New Zealand's trading partners is forecast to be 4.2% over 2004, compared with a forecast of 3.6% in the *December Update*. The higher forecast reflects, in part, a strong end to 2003 and ongoing momentum over the first few months of 2004.

Over the period 2005-2008, the growth rate is forecast to return quite quickly to its long-term trend level.

Figure 1.7 – Trading partner growth



Sources: Consensus Economics, The Treasury

Recent developments

At the time of the *December Update*, the global economy was just beginning to recover from a period of slower growth. Since that time, the recovery has proved unexpectedly rapid, particularly in the US and Asia.

The American recovery has been underpinned by a substantial improvement in corporate profitability and a restructuring of debt, which have so far boosted share prices and led to more business investment. Employment growth has been sporadic to date, but there have been (in April) encouraging signs that the rate of job creation is finally increasing. In Asia, the influence of a booming manufacturing sector in China has led to higher growth rates throughout the region, even in struggling Japan.

Worldwide, accommodative monetary and fiscal policies have also aided growth.

Prospects

The US economy is expected to continue to lead global economic growth over 2004 and into 2005. The *Consensus* has GDP growth in the US slowing from 2005, as short-term interest rates rise to contain consumer and asset price inflation, but it is projected to remain above 3.0% until at least 2008.

Asian economies are also expected to continue growing steadily. China's rate of expansion is expected to slow from its current rate, which has been approaching 10% per annum, to around 8%, but this will still be sufficient to support other economies in the region and put upward pressure on commodity prices over the next year or more.

Australia is a beneficiary of Chinese demand for metals and energy, and Australia's growth rate is expected to reach 3.9% this year, despite signs that the long-lived housing market boom may finally be coming to an end. A "smooth landing" scenario is envisaged as building activity and house price inflation slow, and GDP growth is predicted to slow to no less than 3% to 3½% per year over the period 2005-2008.

Economic growth in Europe has been more gradual. Persistent structural problems have prevented a quick recovery from last year's recession, and growth has been slow, on average, since the turn of the decade. The growth rate is expected to hover around 2.0% per year over the forecast period.

Calendar Years	2002[a]	2003[a]	2004[f]	2005[f]	2006[f]	2007[f]	2008[f]
Australia	3.8	3.0	3.9	3.3	3.3	3.3	3.2
Japan	-0.3	2.7	3.0	1.7	1.5	1.4	1.9
US	2.2	3.1	4.6	3.7	3.6	3.4	3.1
Europe*	1.0	1.1	2.2	2.2	2.0	1.9	1.8
Non-Japan Asia**	5.5	5.0	6.4	5.9	5.9	5.7	5.6
Trading partner growth	2.8	3.1	4.2	3.5	3.4	3.3	3.3

* UK, Germany, Italy, France (weighted by export share).
** Korea, Taiwan, China, Malaysia, Hong Kong, Singapore (weighted by export share).
[a] Actual. [f] Forecast.

Risks faced by the global economy

Over the short term, it seems likely that the *Consensus Forecasts* are on track, with some risk that growth will be even faster. However, the medium-term prediction depends on the sustainability of the global recovery, which is less certain.

In most countries, fiscal and monetary policy settings are very expansionary. With the recovery in growth firmly in place, those settings will need to be returned to normal to prevent another boom-bust economic cycle. The consequent rise in interest rates and reining in of government spending are likely to constrain economic growth. To some extent, these constraints are already incorporated in the forecasts, but there is a possibility that policy tightening could occur sooner and by more than currently expected. If so, *Consensus* GDP growth forecasts for 2005 could come under downward pressure.

GDP growth has been strong in the US, Oceania and Asia, and weak in Europe. Consumer demand has boomed in the US and been weaker elsewhere. As a result, the US has built up a large current account deficit while Europe has accumulated a large surplus. This has put upward pressure on the value of the Euro (though less so recently) and threatens to undermine a fragile economic recovery on the Continent.

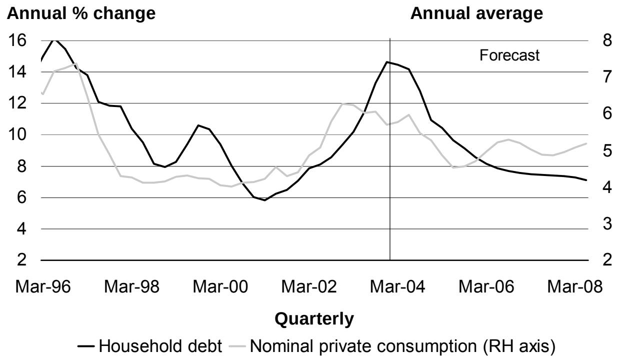
Asian economies have built up massive stocks of foreign reserves as they have pegged their exchange rates to the value of the depreciating US dollar at the same time as their exports have increased. This is causing inflation pressures to increase in those economies, and promoting potentially unstable economic booms. In China, the low exchange rate has contributed to large increases in lending for investment, with an element of speculative behaviour.

The First Half of 2004 – A Period of Continued Momentum

Business and household spending continue to provide the short-term impetus

Business and household spending is expected to drive solid growth over the first half of calendar 2004. Past strength in quarterly private consumption growth, coupled with solid growth in the first half of 2004, as indicated by recent retail sales figures, results in private consumption growth being forecast to peak at 5.4% for the June 2004 year. The lagged effect of increases in household wealth contributes to this strong near-term consumption growth. This wealth effect is supported by growth in incomes. Strong labour market outturns for the March quarter, released after the forecasts were finalised, should provide further support to household spending in the short term.

Figure 1.8 – Consumption and household debt



Sources: Westpac, Statistics New Zealand, The Treasury

Construction activity was surprisingly weak in the December 2003 quarter, given the strength of building consents data. This is possibly due to capacity constraints in the building industry or timing issues with regard to lumpier apartment projects. However, building consents continue to run at high levels, suggestive of further building activity in the pipeline. Given this, a bounce-back in the March 2004 quarter would be expected, however wet weather conditions over late February and early March may push the bounce-back into the June quarter.

Capacity constraints remain and coupled with a tight labour market encourage businesses to invest…

Strong economic growth has improved business profitability and corporate balance sheets over the past two years. High capacity utilisation, the tight labour market and favourable relative prices for investment goods should continue to encourage businesses to invest strongly, especially in plant and equipment. The current strength in business investment growth is estimated to continue in the near term, with annual average growth remaining at around 13% over the first half of 2004.

… but also result in rising inflation

With strong demand pressures and an economy operating above capacity, CPI inflation is expected to rise from its current rate of 1.5% to about 2.4% over the 2004 year. Prices for housing and household operation are expected to be significant contributors to this increase. We expect the Reserve Bank to respond to increased inflationary pressures with one further increase in the OCR around the middle of this year, bringing the OCR in to line with our current assessment of neutral.

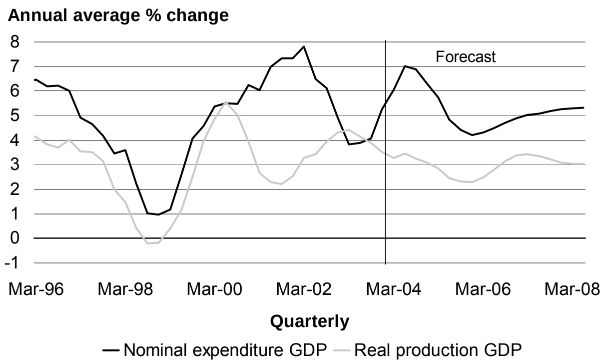
The net external sector subtracts from growth

Growth in export volumes is likely to remain volatile over the first half of 2004, with volume growth being solid but not spectacular. Agricultural exports will contribute to this volatility, with production being affected by weather conditions. Dairy production was strong in the second half of last year, reflecting good growing conditions up until December at which point dry weather impacted negatively on milkfat production. Meat production was also affected by the dry conditions in December, with slaughtering being brought forward. This volatility in production is likely to translate into volatility in export volume growth over the first few quarters of 2004.

Import volume growth continues to be strong and is forecast to peak at 13% in September 2004. The strong growth in volumes reflects the healthy state of domestic demand, combined with relatively low import prices.

The recent increase in oil prices may play a role in a deterioration in the terms of trade looking forward. Oil prices have moved significantly higher in recent weeks. A fuller discussion on the impact of oil prices on the economy is provided in the "Oil Prices" box.

Figure 1.9 – Nominal and real GDP growth



Sources: Statistics New Zealand, The Treasury

Nominal GDP continues to diverge from real GDP

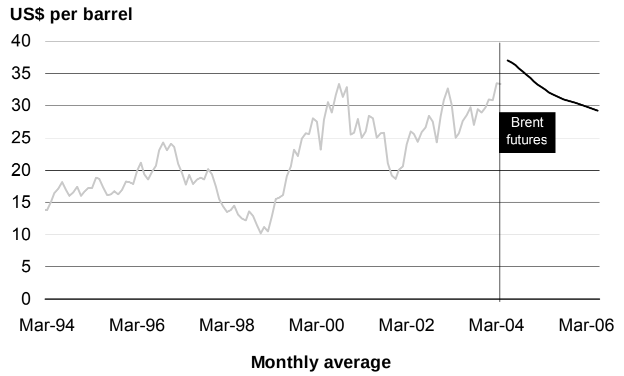
Growth in nominal GDP is expected to continue its recent divergence from real GDP, with nominal GDP growth forecast to peak at 7.0% for the year ended June 2004. Price movements for residential investment and increases in the terms of trade contribute to the stronger growth in nominal GDP relative to real GDP.

The strong growth in nominal GDP over the past year helps explain why the fiscal position has continued to improve at the same time as real GDP growth has eased back.

Oil Prices

The oil price assumption underpinning the central forecast is for Brent spot prices to remain around US$32 a barrel over the middle of this year, before easing back towards our assumed "equilibrium" level of crude prices of US$19. We attempt to capture information from *Consensus Forecasts*, Brent crude futures prices, and our perceived long-run equilibrium price of oil. Since the central forecast was finalised, Brent spot oil prices have increased to US$37 a barrel, some 16% above our assumption. The current spot price is the highest level oil prices have been since October 1990, when Iraq invaded Kuwait in a crisis that culminated in the Gulf War. The recent increase has been driven by heightened supply concerns in the Middle East and relatively low inventory levels ahead of peak summer demand in the US. The outlook for international oil prices is a key uncertainty in our forecasts.

Figure 1.10 – Brent spot oil price



Source: Datastream

Rising international oil prices have a direct impact on domestic inflation via petrol prices, which in turn has an effect on private consumption. There is also a less direct impact on consumption through the confidence channel, although this is more difficult to quantify. Higher oil prices impact directly on headline CPI through the increase in the retail price of petrol, which has a 3% weighting in the CPI index. Our current estimate is that for every US$1 increase in international oil prices, all else constant, retail petrol prices increase by around 1.1 cents per litre (this calculation is based on a constant margin assumption). Recent weakness in the New Zealand dollar may accentuate the recent rises in international oil prices. If international oil prices were to spike up to US$40 a barrel – the levels reached briefly in 1990 – retail petrol prices may increase by 6 to 7 cents per litre, adding 0.2% to headline inflation.

Higher inflation from the second round impacts of high oil prices could also occur as businesses attempt to pass their higher input costs onto consumers. Some airlines have already placed a levy on airfares. The extent of this second-round impact on inflation depends on the ability of businesses to either absorb the higher cost in their margins or push the cost further down the supply chain.

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 4% of their total expenditure on petrol. In the event that international oil prices increase to US$40 a barrel, we estimate that household discretionary income would be reduced by around 0.2%.

Economic Outlook

Mid-2004 Through 2005 – the Slowdown Arrives

As the near-term momentum diminishes the economy enters a period of slower growth

While near-term momentum is likely to support economic growth in the first half of 2004, we expect an unwinding, with growth forecast to slow from the second half of 2004. At the trough of the cycle, GDP growth of 2.3% over the year ended December 2005 is forecast.

There are a number of fundamental factors that will contribute to this slowing in growth. Net migration has been tracking weaker than the *December Update* and is expected to slow further. The exchange rate has tracked higher than that expected in the *December Update* and peaked at historically high levels. Oil prices have also risen substantially.

The exact timing and magnitude of the slowdown in growth are sources of uncertainty in this forecast, as they have been over the past year. Alternative scenarios are examined in Chapter 3 where growth is either sustained at current rates or slows more substantially.

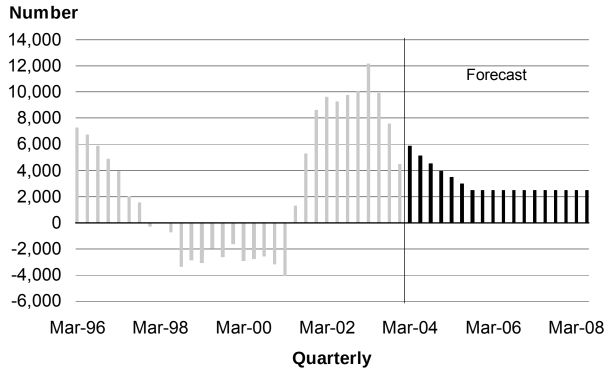
House price and construction growth slows…

Slowing domestic demand makes a significant contribution to the growth slowdown, with household spending playing a key role. The rapid house price growth that has occurred over the past year comes to an end during the second half of 2004. Housing construction slows significantly, prior to a two year period beginning in December 2004 in which quarterly growth is either flat or negative.

… in part due to slowing migration…

Slowing population growth due to lower migration levels is an important determinant of firstly slower and then modestly negative house price growth and is also a key influence on the slowing housing construction. Net migration for the year to June 2004 is assumed to be 23,000, which is 7,000 lower than the assumption used in the *December Update*. Net migration then slows to 15,000 for the year to June 2005 and 10,000 in the year to June 2006. The assumed slowdown in net migration is quite moderate compared with recent historical slowdowns where net migration has rapidly turned negative. However, there do not appear to be any current signs that would indicate net migration falling more rapidly.

Figure 1.11 – Net migration



Sources: Statistics New Zealand, The Treasury

… which also contributes to lower private consumption…

Slower population growth also affects private consumption spending, with growth slowing to 2.2% in the December 2005 year. Household wealth and house prices are closely related due to the dominance of housing within the assets held by households. With house price growth slowing and becoming negative, the wealth effects present in the near term are extinguished, contributing to slower private consumption growth. With smaller capital gains arising from holding housing assets, the potential and willingness to fund consumption purchases via debt are reduced.

The extent to which households are able to accumulate and remain comfortable with accumulating more debt is an important judgement. An important consideration for households will be the effect that rising debt levels are having on debt servicing costs. Debt servicing as a proportion of disposable income is forecast to rise throughout the forecast period. Chapter 3 presents a scenario of weaker domestic growth in which household concerns about their debt levels and debt servicing costs, as well as the future level of house prices, result in a larger reduction in consumer spending.

… as does slower employment growth…

Facing higher wage costs and slowing demand, firms become more reluctant to take on new staff. Employment growth provides less of a stimulus to household spending, with annual employment growth at the end of 2004 falling below 2% for the first time since the start of 2000, prior to becoming even softer throughout 2005. The unemployment rate is forecast to rise to 5.0% in the second half of 2005.

… although government spending provides some offset

Government consumption and investment are expected to increase throughout the whole forecast period. This steady growth in Government spending and the boost to household incomes from the *Working for Families* package provide a buffer to growth over this period of slowdown. Non-market investment is likely to be boosted by infrastructure investment, including spending on roads, although the precise timing and magnitude are uncertain.

The effect of the higher exchange rate on export income begins to bite

Despite recent declines in the New Zealand dollar exchange rate, the lagged effect of the exchange rate appreciation of the past few years is expected to impact on growth at the end of calendar 2004 and early 2005. The unwinding of hedging arrangements that companies may have in place contributes to the impact.

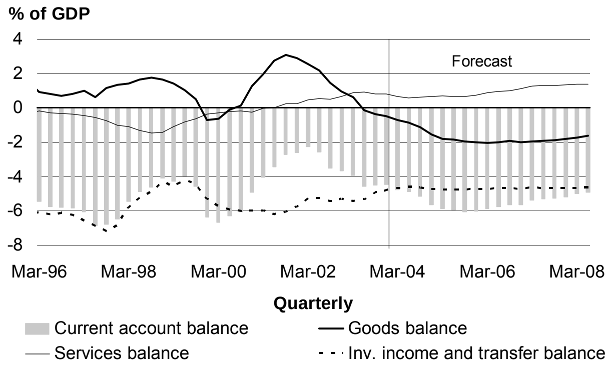
Over this period both export volumes and export income growth are forecast to be lower than at the *December Update*. In particular, services and manufacturing export volumes are expected to be negatively affected by the higher exchange rate, while primary export volume growth remains robust due to a lower sensitivity to exchange rate movements. Quarterly growth in export income is forecast to be lower than the *December Update* forecast throughout the 2005 calendar year and the start of 2006. Lower export incomes negatively impact on the spending patterns of exporters, with flow-on effects to those who provide goods and services to exporters.

World prices for New Zealand's commodity exports have reached record levels. This growth in world prices has been more than offset by the rising exchange rate. Commodity prices are expected to soften in the second half of 2004 as world demand stabilises. This contributes to a falling terms of trade over 2004 and 2005.

While net exports subtract from growth throughout the slowdown period, the negative contribution diminishes over time. Contributing to this is a fall in the rate of growth in imports, as slowing domestic demand and increasing import prices reduce the demand for imported goods and services. Annual growth in import volumes falls from a peak of 13% for the September 2004 year to around 3% by the end of 2005. Growth in import values also slows but to a lesser extent due to the depreciating exchange rate. After growing at approximately the same rate as import volumes over the March 2005 year, annual growth in import values at the end of 2005, at around 7%, is much faster than the growth in volumes.

The overall effect of these movements in export and import values is an increase in the annual current account deficit from its current level of 4.5% of GDP to a peak of 6.1% in September 2005.

Figure 1.12 – Current account balance (four quarter rolling total)



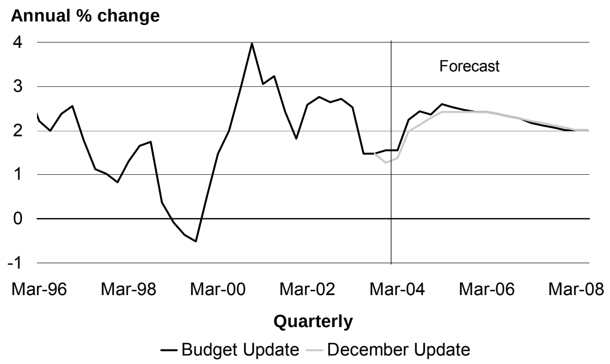
Sources: Statistics New Zealand, The Treasury

With the slowdown in growth, non-tradable inflation eases

Annual CPI inflation is forecast to peak at 2.6% in the first quarter of 2005, prior to declining to 2.4% at the end of 2005. Tradables prices have made a negative contribution to the CPI in recent times, but with a depreciating exchange rate the price of imported goods is likely to increase. Non-tradables inflation, while declining, is also likely to persist into the future.

Growth in nominal GDP is expected to begin to converge towards real GDP, with nominal GDP growth slowing, associated with a downward movement in the terms of trade. With less demand for residential investment, the current price pressure in this area is also expected to diminish, which also contributes to slower nominal GDP growth.

Figure 1.13 – CPI inflation

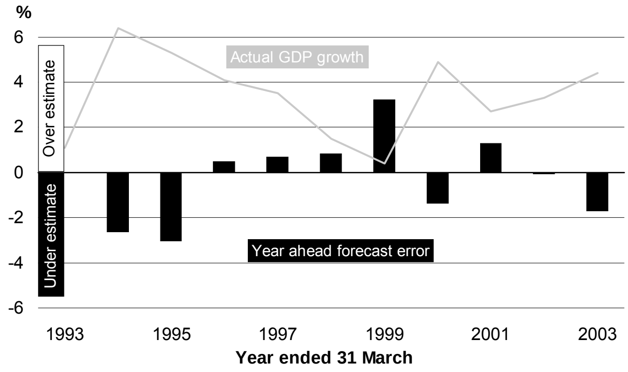


Sources: Statistics New Zealand, The Treasury

Forecast Uncertainty

Economic forecasts, as with other forecasting activities, have a degree of uncertainty attached to them. These uncertainties relate to the data we have available, our understanding of economic relationships both now and through time and to the judgements we apply. They can also relate to "shocks" that inevitably hit economies. In recognition of the uncertainties forecasters face we regularly produce economic scenarios presented in Chapter 3 which incorporate differences in judgements from the central forecast.

Figure 1.14 – Forecast errors of real GDP growth from *Consensus Forecasts*



Sources: Statistics New Zealand, NZIER, The Treasury

The magnitude of the uncertainty forecasters face is highlighted by the chart on the right, which shows the average forecast errors for real GDP growth one year ahead. The forecast errors are based on the *NZIER Consensus Forecasts*, which is published quarterly. One observation apparent from the chart is the tendency to initially under estimate growth during periods of economic expansion or growth rebounds, and a tendency to over estimate growth during periods of growth slowdowns. For example, at the peak of the growth cycle in 1995, the *Consensus* under-estimated growth by up to three percentage points. The *Consensus* also failed to predict the recession of 1999 a year out, forecasting growth rates which were over 3 percentage points higher than what eventuated. The forecast errors capture a host of information, including unexpected shocks, and errors in judgement around the cycle and trend. It is difficult to disentangle the effects that each had in contributing to the forecast error.

In our central forecast we do not attempt to predict and incorporate new shocks, and any existing shocks that we identify are assumed to unwind. For example, the dry weather conditions and outbreak of SARS, which were important considerations in last year's *Budget Update* forecasts, were assumed to dissipate over time.

However, the high level of the exchange rate prevailing over the start of this year has prompted some concerns that the economy will slow markedly. Analysis of past shocks, and particularly their contributions to previous periods of recession, can provide insights for thinking about the forecasts.

One way to analyse past shocks is to use a structural Vector Autoregressive (VAR) model of the New Zealand economy.[6] The dates of the recessions have been specified as 1991-1993 and 1998-1999. These dates correspond to periods during which New Zealand's GDP was substantially below trend.[7]

Highlights from this analysis suggest that the major causes of the 1998 growth recession were very different to that of the early 1990s and that it is the culmination of several simultaneous shocks to the economy which are operating in the same direction that cause recessions, or a severe supply shock in the form of adverse climatic conditions.

6 Buckle, R A, Kim, K, Kirkham, H, McLellan, N, and Sharma J, "A Structural VAR model of the New Zealand business cycle", Treasury Working Paper 02/26.

7 This is known as a growth recession, as opposed to the classical recession which is defined as two consecutive quarterly declines in GDP growth.

Beyond 2005 – A Growth Recovery

A rebound in growth begins in late 2005…

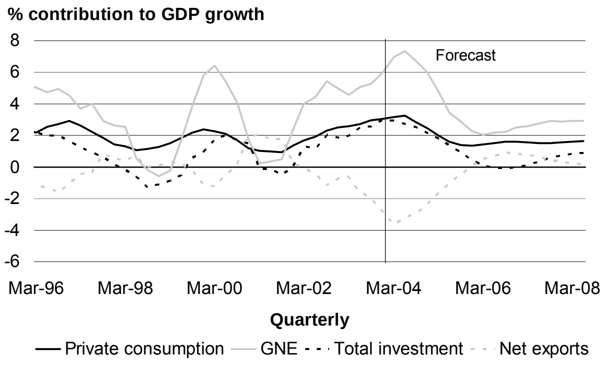
Economic growth begins to rebound in late 2005 and early 2006. Annual real GDP growth steadily picks up, increasing to around 3.4% at the end of 2006 and beginning of 2007.

… as net exports begin to make a positive contribution to growth due to stronger global growth

From late 2005, net exports are forecast to start making a positive contribution to growth for the first time since late 2001. The turnaround is driven by ongoing growth in the world economy and the delayed effects of the depreciation of the exchange rate. Export volume growth accelerates significantly, while growth in import volumes remains relatively subdued relative to the rapid growth experienced recently.

The increase in export volumes contributes to strong growth in export earnings. Nominal export earnings are forecast to grow by 9.4% in the 2007 March year.

Figure 1.15 – Contributions to GDP growth



Sources: Statistics New Zealand, The Treasury

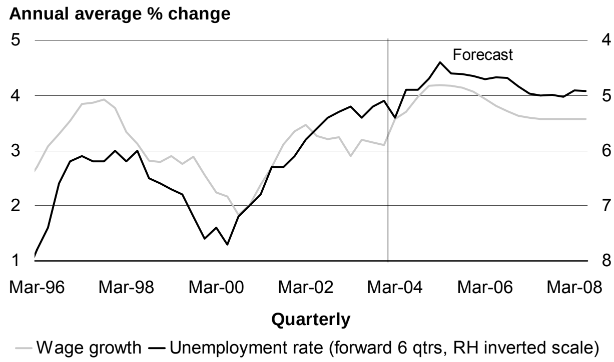
Domestic demand picks up, but in a more modest manner…

Domestic demand growth also begins a more modest pick-up, with gross national expenditure (GNE) growth increasing from a low of 2% at the start of 2006 to around just under 3% at the end of the forecast period. Increased social assistance spending via the *Working for Families* policy announced in the 2004 Budget increases household disposable income and provides support to private consumption spending, largely from mid-2005. While this contributes to private consumption growth, the rebound in growth is forecast to be modest, with growth around 2½%, as households are faced with higher debt servicing costs due to their accumulation of increasing levels of debt.

… and the labour market also strengthens, putting a floor under wage growth

Annual wage growth drops below 4% in early 2006 but is forecast to persist above 3½%. This encourages businesses to continue to seek improvements in labour productivity rather than rapidly increasing employment. As a consequence, employment growth remains relatively modest, with employment increasing by about 1½% per annum from the end of 2006. This rate of increase combined with lower population growth contributes to the unemployment rate falling to 4.8% by 2007/08.

Figure 1.16 – Unemployment and wage growth



Sources: Statistics New Zealand, The Treasury

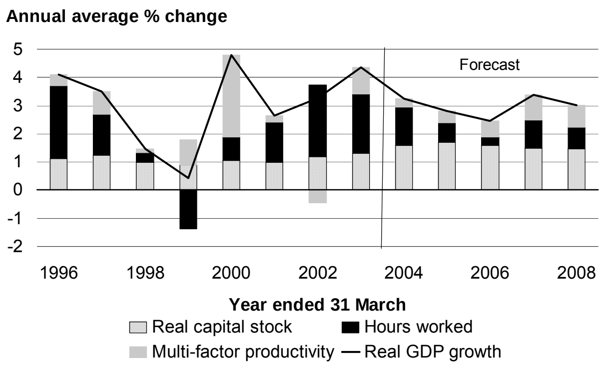
At the end of the forecast period economic growth returns to trend rates

By the final year of the forecast horizon, the rate of economic growth is seen as returning to our best estimate of trend. The estimated impacts of past shocks in history, or earlier in the forecast horizon, will have worked their way through the economy.

By 2007/08, real GDP growth of 3.0% is forecast. Domestic demand is forecast to be growing at approximately the same rate as total GDP, and the real contribution of net exports is predicted to be close to zero. Nominal GDP will be rising at a rate of approximately 5% per annum.

Decomposing GDP growth into its factor contributions highlights the increasing contribution that the capital stock makes to GDP growth and the decreasing contribution that growth in hours worked makes. This is in contrast to the past few years where GDP growth has been largely sourced from increased labour utilisation. Multi-factor productivity is expected to make a more sustained contribution to growth than in recent history.

Figure 1.17 – Factor inputs to GDP growth



Sources: Statistics New Zealand, The Treasury

Employment and labour force growth is assumed to be relatively stable and the prevailing unemployment rate, at a little under 5%, is around the level at which wage growth is expected to be relatively stable. CPI inflation is forecast to decline gradually to about 2% per year.

The balance of payments deficit, at about 5% of GDP, is expected to be sustainable in the longer term without increasing New Zealand's debt-to-GDP ratio.