December Economic & Fiscal Update 2000

HON DR MICHAEL CULLEN
TREASURER
MINISTER OF FINANCE

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Statement of Responsibility

On the basis of the economic and fiscal information available to it, the Treasury has used its best professional judgement in supplying the Minister of Finance with this Economic and Fiscal Update. The Update incorporates the fiscal and economic implications both of Government decisions and circumstances as at 27 November 2000 that were communicated to me, and of other economic and fiscal information available to the Treasury in accordance with the provisions of the Fiscal Responsibility Act 1994.

Dr Alan Bollard
Secretary to the Treasury

8 December 2000

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

To enable the Treasury to prepare this Update, I have ensured that the Secretary to the Treasury has been advised of all Government decisions and other circumstances as at 27 November 2000 of which I was aware and that had material economic or fiscal implications.

Hon Dr Michael Cullen
Treasurer and Minister of Finance

8 December 2000

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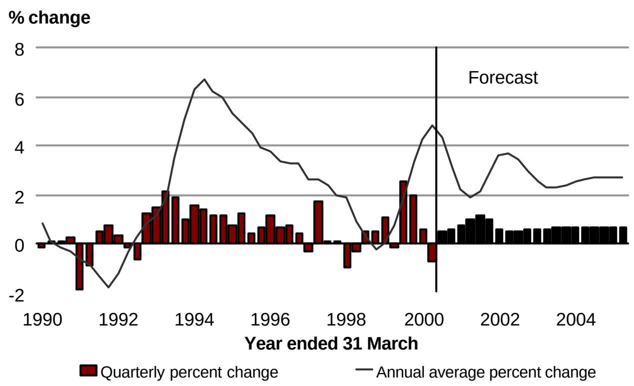
Economic Outlook

Overview

- The observed softening in business and consumer confidence, together with the generally weaker-than-expected domestic activity over the first half of this year, mean that annual average GDP growth is now expected to be 2.2% in the year to March 2001.

Figure 1.1 – GDP growth

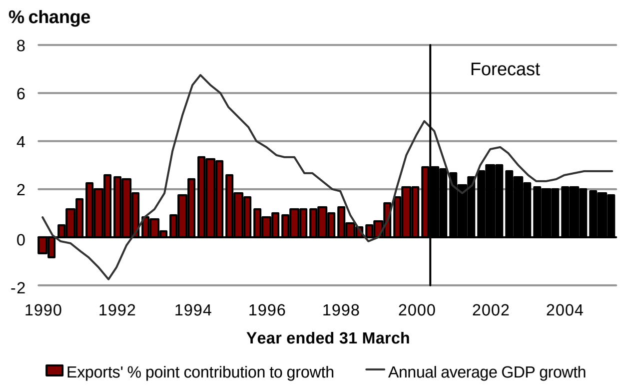


Sources: Statistics New Zealand, The Treasury

- Growth is expected to peak at 3.7% by March 2002, largely reflecting a greater projected external sector contribution on the back of strong world growth and supportive monetary conditions. Thereafter, a gradual slowing in global growth, together with a modest tightening in monetary conditions, is expected to slow activity back to a rate of growth of around 2.8%.

- Both non-commodity manufactured goods and services exports are expected to continue to perform well over the forecast horizon, boosted by the recent decline in the exchange rate. Higher commodity prices, together with robust international conditions, are expected to further assist commodity exporters.

Figure 1.2 – Exports' contribution to GDP growth



Sources: Statistics New Zealand, The Treasury

- New Zealand's main trading partners are expected to grow by 4.5% in calendar 2000, following an increase of 3.7% in 1999, before easing back to 3.5% growth in 2001.

- This boost to the tradeables sector is expected to lead to a substantial improvement in the current account over the forecast horizon, with the deficit as a percentage of GDP falling from 7.2% in the June 2000 quarter to a forecast 3.1% by March 2005. The decline in the current account deficit largely reflects both the goods and services balances moving from deficits to surpluses.

- We expect growth in household expenditure over the year ahead to be dampened by high consumer debt levels, restrained wealth effects from subdued housing market activity, relatively modest employment growth and rising retail prices. Over the latter part of the forecast horizon, consumption spending is expected to gain some momentum on the back of a general recovery in activity, a decline in interest rates and a modest pick-up in housing market activity.

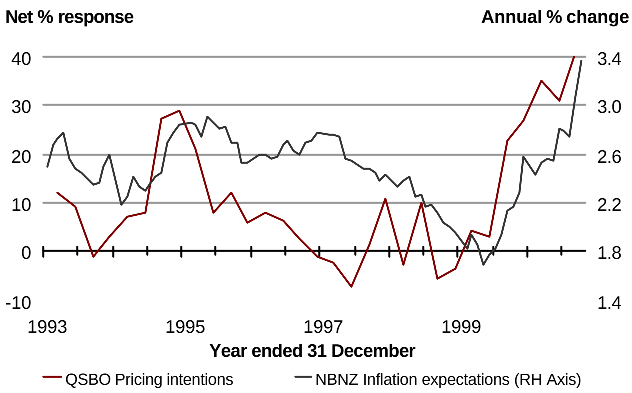
- Despite a projected slowing in investment growth over the short term, we expect reasonably strong investment expenditure over the calendar 2001 year as deferred investment spending is implemented, and as firms become more confident on the back of the upturn in activity. A large part of this investment is expected to take place in the export and import-competing sectors.

- For much of the forecast horizon, the unemployment rate is expected to fluctuate around current levels before easing to around 5.7% at the end of the period. Higher participation rates as growth picks up are expected to offset much of the steady employment growth.

- Largely reflecting the flow-on effects of higher oil prices and rising import costs as a result of the weaker currency, short-term inflationary pressures continue to build. CPI inflation is expected to peak at around 3.8% in the June 2001 quarter, before edging back into the Reserve Bank's 0-3% inflation target range by the December 2001 quarter. Over the medium term, we expect inflationary pressures emerging from a forecast rise in wages and firms' margins to be tempered by a decline in oil prices and a slowing in import price growth on the back of the projected currency appreciation.

- To keep inflation in check over the medium term, a modest tightening in monetary conditions is expected. We expect the RBNZ to raise the official cash rate by 75 basis points next year to a peak of 7.25%, while an appreciation in the level of the TWI is also forecast. Nevertheless, both interest rates and the TWI are expected to peak at levels substantially below those reached in the last cycle.

Figure 1.3 – Inflation and price expectations



Sources: NZIER, NBNZ

Table 1.1 – Economic outlook: Central Forecast[1]

(Annual average % change, March years)	2000 Actual	2001 Forecast	2002 Forecast	2003 Forecast	2004 Forecast	2005 Forecast
Private consumption	2.6	1.3	1.8	2.1	3.1	3.2
Public consumption[2]	7.3	(4.4)	3.0	1.9	4.5	(0.7)
Total Consumption	**3.5**	**0.2**	**2.0**	**2.1**	**3.4**	**2.5**
Residential investment	21.3	(12.5)	0.4	7.2	4.1	4.0
Business investment	6.5	13.3	10.8	11.2	10.4	12.0
Total private investment	10.1	6.8	8.6	10.5	9.2	10.6
Public investment	9.9	0.2	4.5	10.9	13.1	13.2
Total Investment	**10.1**	**5.7**	**7.9**	**10.6**	**9.8**	**11.0**
- excluding computers[3]	**6.4**	**2.6**	**2.0**	**4.1**	**2.0**	**2.1**
Stock change[4]	1.4	(0.6)	0.3	(0.1)	(0.1)	0.2
Gross national expenditure	6.3	0.8	3.7	4.1	5.0	4.9
Exports	6.3	7.9	8.4	5.9	5.4	4.6
Imports	11.2	2.7	8.7	9.3	10.8	9.5
- excluding computers[3]	9.3	0.5	5.4	5.5	6.6	4.3
GDP (Production Measure)	**4.2**	**2.2**	**3.7**	**2.6**	**2.6**	**2.8**
Employment[5]	1.9	1.4	1.3	1.5	1.2	1.5
Unemployment[6]	6.4	6.1	5.8	6.0	5.9	5.7
Wages[7]	2.3	2.2	3.4	4.1	3.5	3.4
CPI inflation[8]	1.5	3.6	2.8	2.1	1.8	1.6
Nominal GDP (expenditure)	4.7	4.0	7.2	4.9	4.4	5.0
Current account balance						
- $ million	(7,325)	(5,970)	(4,355)	(3,981)	(4,703)	(4,115)
- % of GDP	(7.1)	(5.5)	(3.8)	(3.3)	(3.7)	(3.1)
TWI[9]	54.1	48.2	55.6	58.5	57.0	56.2
90-day bank bill rate[9]	6.0	7.0	7.5	7.5	6.8	6.5
10-year bond rate[9]	7.3	6.9	7.1	6.9	6.8	6.7

Sources: Statistics New Zealand, Datastream, The Treasury

NOTES:
1 Finalised 14 November 2000.
2 The forecast profile for public consumption is influenced by government defence spending (see box on military equipment).
3 Excludes computers to give a better assessment of underlying trends.
4 Contribution to GDP growth.
5 Household Labour Force Survey full-time equivalent employment.
6 Percentage of the labour force, March quarter, seasonally adjusted.
7 Quarterly Employment Survey average hourly ordinary time earnings.
8 This is the CPI-consistent series targeted by the Reserve Bank. Annual percentage change, March quarter.
9 Average for the March quarter.

Oil price assumption

Oil prices have risen sharply from a 22-year low of less than US$10 a barrel in 1998 to be recently trading around US$32 per barrel, with the future profile remaining a major uncertainty in our forecasts. The recent upward cycle began in February 1999 and has reflected a number of internal and external factors. The recovery in Asian economies has played a major role, but the dominant feature appears to have been the production restraint achieved by OPEC and a few non-OPEC countries in early 1999. Looking ahead, the major immediate influence on oil prices continues to remain the production capacity to serve strong demand. This alone is expected to provide underlying support to oil prices over the short term.

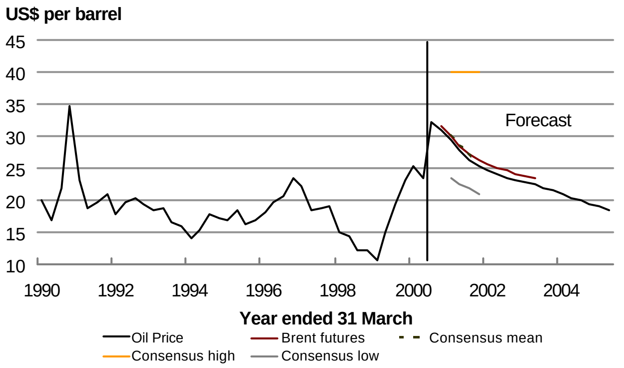
The methodology underlying the Treasury's oil price assumption attempts to capture information from three sources including: Brent crude futures prices, *Consensus* forecasts and the perceived long-run equilibrium price. Over the quarter ahead, we use the Brent crude futures price, which is then integrated with short-term *Consensus* forecasts.

According to the October edition of *Consensus* forecasts, respondents expect oil prices to ease back to around US$30 per barrel by the end of January 2001. Looking further ahead, analysts anticipate an ongoing easing in crude prices as supply and demand conditions rebalance, with oil projected to be trading around the US$26 level by the end of October 2001. However, the lack of spare capacity in most countries, together with supply disruptions and the potential for adverse weather conditions over the Northern winter, suggests that OPEC could, struggle to move prices down into its target range of US$22-28 per barrel over the short term.

Over the long term, the end point for our oil price forecast continues to be anchored by our view of the "equilibrium" level for crude prices. This estimate is based on the historical average for oil prices, which is calculated to be US$18.50.

While oil remains an important world commodity, any price shock is likely to have a more modest impact than in the 1970s, reflecting the diminished role of oil in the economy. For instance, the IMF's October *World Economic Outlook* forecasts are based on the assumption that oil prices average US$27 a barrel over 2000 and US$23 in 2001. However, on the basis that oil prices persist at around $US30 a barrel, the IMF estimates that such a 30% rise in oil prices above base forecasts would lower global GDP growth rates by around 0.5 percentage points, while inflation would be raised by around 1 percentage point next year. These estimates suggest that, even on the assumption that oil prices persist at reasonably high levels, the net effect on global growth and inflation is not anticipated to be a major source of concern. However, a significant degree of uncertainty surrounds these estimates, particularly attempting to assess the impact of central bank's response to higher oil prices and the potential effect on financial markets.

Figure 1.4 – Oil price forecasts



Sources: Consensus Forecasts, Primark Datastream, The Treasury

The Forecast Story

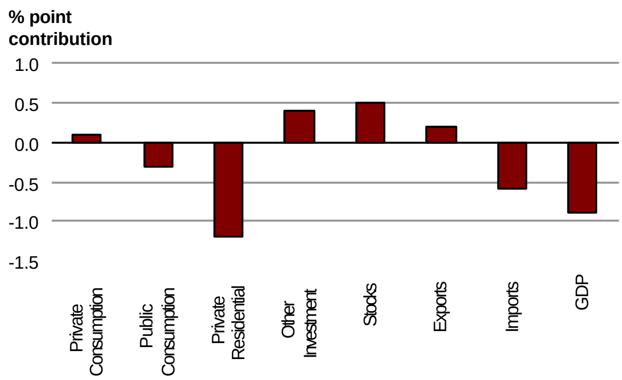
The short-term growth profile is expected to be lower ...

Since the finalisation of the Budget forecasts in mid-May a number of developments have occurred that could significantly impact on the economy's growth profile going forward. These events have included:

- a substantial softening in both business and consumer confidence
- a significant rise in crude oil prices
- a considerable depreciation in the value of the NZD, resulting in overall monetary conditions being significantly more stimulatory than projected in June.

In addition to these developments, activity outturns have confirmed that aggregate demand over the first half of this year has been weaker than we had anticipated. In particular, the release of the June quarter GDP data showing a 0.7% decline, together with downward revisions to back data, confirmed a weaker short-term growth profile relative to our Budget projections. On an expenditure basis, the latest components showed the decline in domestic demand being dominated by a sharp fall in residential investment.

Figure 1.5 – Contributions to GDP growth (June 2000 quarter)



Source: Statistics New Zealand

However, in making an assessment of the underlying state of activity, the June quarter outturn should be placed in context. In particular, some of the drivers of this result, such as the early close of the dairy season, together with the sharp reversal of the March quarter spike in residential investment, have not been repeated in the September quarter. Nevertheless, business surveys showing generally low levels of confidence and own activity expectations highlight the risk of reasonably subdued GDP growth over the second half of this year. Our latest business visits provide further evidence to support this picture of relatively soft domestic demand over the remainder of this year. While those industries with some export exposure – particularly in the agricultural and tourism sectors – were reaping significant benefits from the weakness of the currency, the near-term activity profile of those firms trading in the domestic market appeared to be generally flat.

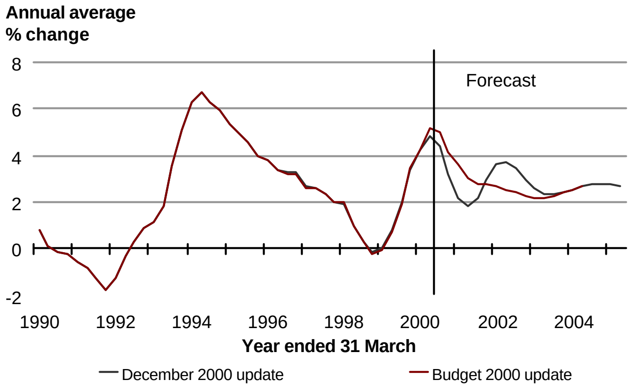
… however, fundamentals remain sound

On the other hand, factors supporting a modest rebound in activity over the second half of this year include: the underlying strength of recent employment data, a trend increase in job advertisements, strong tourism growth, reasonably robust retail sales, some consolidation in the construction sector, and a good start to the agricultural export season – particularly the dairy industry. Since the finalisation of our forecasts, we have also observed some signs of a recovery in both business and consumer confidence.

Moreover, the theme of a shift in the composition of growth away from the non-tradeables sector in favour of the tradeables sector, on the back of the weaker exchange rate, has generally been confirmed by recent activity outturns. Historically, the level of monetary conditions that we are presently experiencing has been followed by a reasonably sharp recovery in growth. Indeed, one of the major uncertainties in attempting to determine the likely activity profile going forward is assessing the degree of monetary stimulus emanating from the low exchange rate.

In weighing these positive and negative factors together, we conclude that the balance of risks suggests reasonably modest growth over the second half of this year. While some uncertainty surrounds the precise short-term quarterly profile for GDP, we project only modest growth of around 1% over the second half of this year. Despite this generally subdued growth profile, we expect activity to strengthen considerably going into next year, largely reflecting stronger export growth on the back of a favourable exchange rate and strong world growth.

Figure 1.6 – GDP growth



Sources: Statistics New Zealand, The Treasury

The short-term growth profile is dominated by export growth

In terms of the likely composition of growth, we continue to expect net exports to make a growing contribution, while domestic demand, at least over the short term, is expected to remain reasonably soft. This profile is driven by the present weakness in the TWI, which is very stimulatory for the export sector, but imposes some costs on the domestic sector in terms of higher import costs.

The recovery in domestic demand will therefore be largely dependent upon the flow-on effects emanating from the buoyant export sector filtering through to the rest of the economy. The timing and extent of this anticipated positive stimulus is another of the major uncertainties in this forecast. Relative to the economic recovery of the early nineties, we could perhaps expect to see a shorter lag before sustained and substantial quarterly GDP growth rates are recorded. The faster pick-up may reflect a less pronounced slowing in activity, a higher starting level for capacity utilisation, stronger corporate balance sheets, a more modest projected fiscal tightening, more stimulatory monetary conditions and a robust international outlook.

Comparing the latest forecast growth profile with that presented in June, the anticipated slowing in domestic demand is clearly visible in considerably lower annual average GDP growth over the 2001 year. However, largely reflecting the greater projected external sector contribution over the following year, activity is now expected to peak at 3.7% around the middle of 2002. Thereafter, a gradual slowing in global growth, together with a modest tightening in monetary conditions, is expected to slow activity back to a rate of growth of around 2.8%.

Upgraded National Accounts

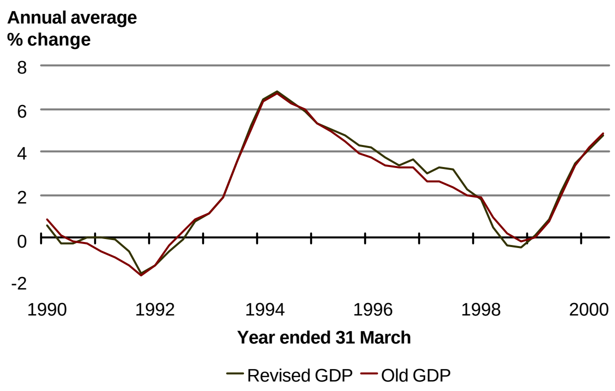
The economic forecasts presented here were finalised on 14 November 2000. On 24 November, Statistics New Zealand released upgraded National Accounts and Provisional National Accounts to the year ended March 2000. This new data has not been incorporated into the forecasts.

The new series represent a major upgrade to the New Zealand System of National Accounts, improving the relevance of the accounts for analysing economic developments. This includes development of new series measuring capital stock. Not all the announced revisions have been published to date, with the revised real expenditure GDP series still to be released. The revisions currently only go back to 1987, a relatively short period for economic analysis. The series will be backdated to 1971/72 over the coming year.

Real GDP and Nominal GDP

The National Accounts data show that real GDP increased 30.6% between June 1987 and June 2000 compared with 27.9% under the old series. This corresponds to around 0.1% higher growth per year on average over the period. Two periods account for most of this increase. The 1991/92 recession is now shorter than previously, and growth was stronger in 1995/96 and 1996/97 at the end of the last expansion. Year-on-year changes for other years were little different.

Figure 1.7 – GDP comparisons

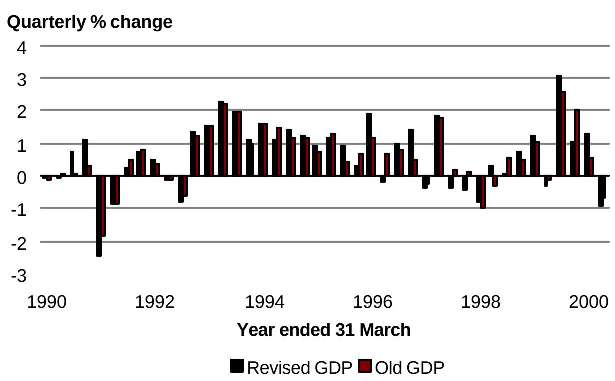


Source: Statistics New Zealand

While year-on-year changes have not been significantly altered, there is more variation between the quarterly patterns of growth. There appears to be more quarterly variation in the new real production-based chain linked series, some of which looks to have come from increased volatility in the primary industries sector. The new series shows eight quarters of negative growth since June 1996 against five in the old series, and there are now three consecutive quarters of negative growth beginning September 1997 compared with two beginning March 1998. This latter change may imply some rethink to the relative impacts of drought, the Asian Crisis and macroeconomic policy over this period. The pattern of growth since mid-1999 has also changed, with the September 1999 quarter now showing growth of 3% (2.6% previously) and growth in the first half of 2000 being slightly higher.

Another important aspect of the upgraded national accounts has been the changes to both the level and composition of nominal GDP. The level of current price expenditure on GDP is now 1.6% higher than previously for the year ended March 2000. This means that measures often expressed as a ratio of GDP will now be slightly lower.

Figure 1.8 – GDP comparisons



Source: Statistics New Zealand

For instance, the current account deficit for the year ended March 2000 is now 7.0% of GDP compared with 7.1% previously.

The changes to the accounts are more noticeable at lower levels of aggregation. For example, the level of final consumption expenditure by households is lower in the new accounts, while government consumption is higher.

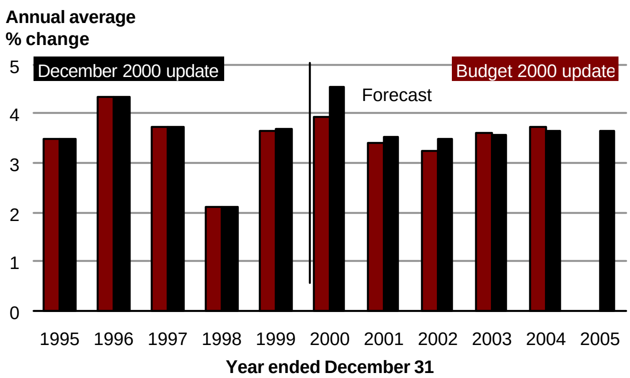
The move to chain linking will reduce the upward bias that pronounced falls in quality-adjusted computer prices relative to other goods have on fixed-based volume indices for imports and investment. For both series, real growth is significantly lower in the new accounts. With respect to investment, this is slightly offset by the capitalisation of computer software under SNA93. As a result, the new accounts show a much larger contribution to growth coming from net exports and less from domestic demand than previously recorded.

The global economy remains robust, although risks appear on the downside for the year ahead

The prospects for the global economy remain favourable. Projections of trading partner growth for 2000 have continued to strengthen since the Budget projections, and remain solid for 2001 and beyond. Underlying this forecast profile is a projected "soft landing" for the US economy, steady growth in Europe, and a consolidation of growth in Japan. Major trading partner growth is expected to be 4.5% in 2000 and then to ease back to 3.5% next year.

In the United States, a gradual slowdown appears to be underway, with a soft landing over the coming 12-18 months the most likely outcome. Consumer price inflation forecasts for the US have eased slightly, supporting a view that the Federal Reserve may have completed its current tightening cycle. The ongoing expansion and tight labour market is supporting larger fiscal surpluses over the short term. On the other hand, the current account deficit remains large at over US$450 billion.

Figure 1.9 – Trading partner growth rates



Sources: Consensus Forecasts, Primark Datastream, The Treasury

In Japan, confidence in the recovery has been improving and projections for this year's growth in private consumption, industrial production and GDP have all been revised up over recent months. Nevertheless, risks continue to surround the durability of any recovery, given ongoing uncertainty surrounding Japanese consumer behaviour, particularly in light of the unsustainable fiscal position.

Australian economic growth is expected to moderate from 4.5% this year, to around 3.5% in 2001 and 2002. Net exports are expected to contribute significantly to growth on the back of competitiveness gains arising from the low dollar. At the same time, domestic demand is projected to ease but nevertheless remain solid over the forecast horizon, with business investment likely to rebound in 2001, as capital goods expenditure benefits from the GST-related removal of wholesale sales taxes. Given the likely boost to growth from exports, the extent of the easing in domestic demand will be a key determinant of the pressure on the monetary authority to raise interest rates.

While the current global environment remains favourable, a number of uncertainties remain. These have been reflected in recent months in slightly lower growth forecasts for 2001, some widening in interest rates for riskier investments and volatility in equity markets. Two risks in particular are worth mentioning:

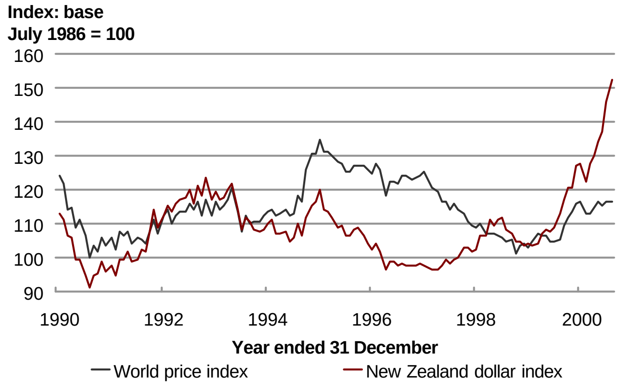
- Considerable uncertainty remains around the likely path of oil prices. If these do not ease back, they will act to dampen world growth, while at same time increasing the risk of feeding into price expectations, thereby complicating the job of monetary authorities.
- After many years of rapid expansion in the US, even a moderation in growth to around 3% could exhibit many of the characteristics of a more marked slowdown in terms of lower investment, equity prices and confidence. A more rapid slowing in the US economy than expected could exacerbate these trends and spill over into other parts of the world, adversely affecting the recoveries taking place in East Asian and other emerging markets.

A low exchange rate and a strong world economy support export growth

Exports are expected to continue to perform well throughout the forecast horizon, reflecting the impact of the low exchange rate and the solid growth in trading partner activity. The strongest growth in exports occurs over the first two years, with total annual average export growth forecast to reach around 8% over both the March 2001 and March 2002 years, before moderating further out.

Boosted by the recent decline in the exchange rate, both non-commodity manufactured goods and services exports are expected to perform well over the forecast horizon. The strong momentum in services exports during 1999 has carried on into 2000, with ongoing strength in tourist arrivals. Tourism is well supported by solid fundamentals, including a low exchange rate and strong income growth in visitor markets (except Japan). Looking ahead, we expect a strong performance from the tourism sector as the impact of these positive fundamentals persists.

Figure 1.10 – ANZ commodity price indexes



Source: ANZ

Commodity exports are expected to lift further. In particular, we anticipate that dairy exports will show solid growth throughout the forecast period, reflecting increases in both herd numbers and productivity. Meat export growth is strongest over the first part of the forecast horizon, principally reflecting an increase in beef exports, before moderating. Forestry exports are expected to show solid export growth throughout the forecast horizon. Growth is driven by increases in log exports, sawn timber and wood panels. Paper and pulp production is more muted on the back of production capacity constraints. Following some growth in the March 2001 and 2002 years, reflecting good growing conditions, wool exports are expected to decline with falling sheep numbers.

World prices for New Zealand's commodities began to rise noticeably towards the end of 1999. In October 2000, the ANZ world price index was up 11% on a year ago. The depreciating exchange rate has boosted New Zealand dollar prices, which in October this year were up 35% on October 1999, the fastest rate of growth since the series' inception. Continuing world growth is expected to provide underlying support for world commodity prices in the forecast period.

Imports, driven by exports and domestic demand, continue to increase

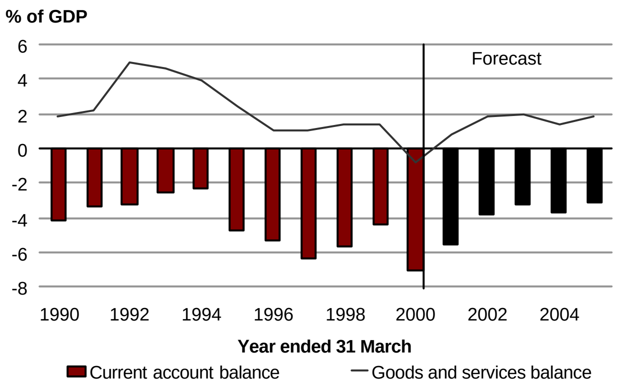
Over the short term, we expect a slowing in import growth, largely reflecting some substitution away from imports as a result of the recent depreciation of the currency. However, as the TWI begins to appreciate, we would expect to observe a further increase in the ratio of imports to GDP. Nevertheless, the rate of growth in the penetration ratio is expected to fall below the trend experienced over the 1990s, as the effects of past trade liberalisation begin to fade.

The current account deficit is expected to show a significant improvement

Reflecting these export and import developments, and aided by the short-term improvement in the terms of trade, the current account deficit is expected to show a significant improvement. Over the short-term, the current account balance is expected to move from a deficit level of 7.1% of GDP at March 2000 to around 5.5% by March 2001. While this short-term improvement is boosted by the frigate Te Mana – equal to 0.6% of GDP – falling out of the annual total, we also expect underlying export growth to continue exceeding trend import growth. The decline in the current account deficit is brought about by an improvement in the goods and services balances. Both these balances (ex military equipment) improve to surpluses of around 2.0% of GDP by the end of the forecast horizon.

The current account balance is forecast to continue to fall in both the March 2002 and 2003 years, with the deficit as percentage of GDP expected to edge back from 3.8% to 3.3%. Over the following year, the deficit profile is somewhat distorted by the importation of military equipment (see box on military equipment spending). This leads to the headline current account deficit widening to 3.7% of GDP in the March 2004 year, before edging back to 3.1% at the end of the forecast horizon.

Figure 1.11 – Current account



Sources: Statistics New Zealand, The Treasury

The investment income balance is expected to remain steady at around 7% of GDP throughout the forecast horizon, reflecting New Zealand's substantial net liability position with the rest of the world.

Consumption growth is projected to remain subdued over the short term before gaining momentum further out

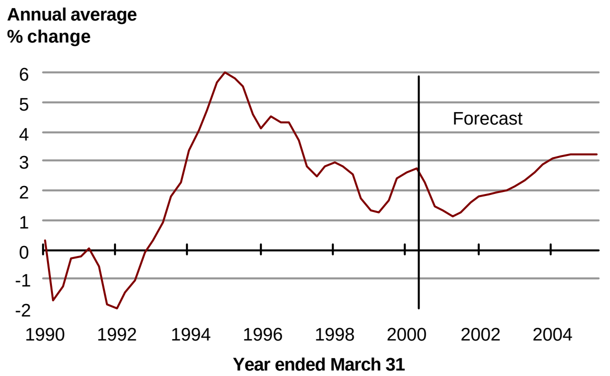
Reflecting the impact of weak consumer confidence, higher petrol prices, rising interest rates, and the increase in tax rates, consumer spending has been subdued over the first half of this year.

Over the year ahead, factors expected to soften consumption growth include high consumer debt levels, minimal wealth effects from subdued housing market activity and rising retail prices. Nevertheless, we assess that past declines in consumer confidence are somewhat overstated and are unlikely to be fully reflected in an ongoing decline in consumer spending.

Over the latter part of the forecast horizon, consumption expenditure is expected to gain some momentum on the back of a general recovery in economic activity, a decline in interest rates and a modest pick-up in residential investment expenditure.

The household savings rate is expected to show some improvement over the medium term, as households are expected to take the opportunity created by steady employment and wage growth to rebuild their savings.

Figure 1.12 – Private consumption



Sources: Statistics New Zealand, The Treasury

Following the sharp rise in residential spending over 1999, dwelling investment over the first half of this year has exhibited considerable volatility, with the surprisingly robust March quarterly outturn being largely reversed over the June quarter. Reflecting the generally soft state of sales and consents data, we expect residential investment spending to remain reasonably subdued over the year ahead. Thereafter, we anticipate that some recovery in household incomes, together with natural population growth, increasing migration and household formation trends, is likely to provide some support to residential investment over the remainder of the forecast period.

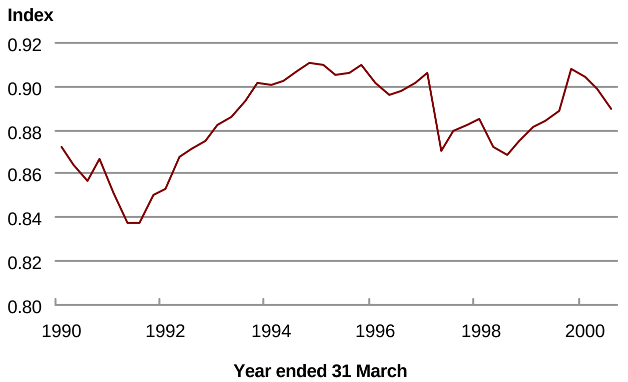
Government Expenditure on Military Equipment

Earlier this year the Government approved the purchase of $800 million of tactical radios and light armoured vehicles (LAVs) for the New Zealand Defence Force, to be acquired over the next four years. Under the present System of National Accounts, government expenditure on military equipment is classified as public consumption expenditure. As such, the $800 million of expenditure on radios and LAVs is incorporated into the DEFU forecast for public consumption. Because the radios and personnel carriers are to be imported, there is no impact on the bottom-line GDP forecast. However, because the majority of the military equipment is forecast to be acquired in the 2003 calendar year, the forecast profiles for public consumption, imports and the current account are quite lumpy during this period.

The recovery in general economic activity encourages a lift in investment

Despite the recent weakness in surveyed business confidence and investment intentions, business investment has held up surprisingly well over the first half of this year. Nevertheless, an easing in the economy's aggregate capacity constraint, uncertainty about the general business environment, together with the prospect of subdued domestic demand over the second half of this year, suggests a near-term slowing in quarterly investment growth. Further reinforcing this investment profile, anecdotal reports from our business visits suggests that firms may be delaying investment expenditure. However, over the 2001 calendar year, we expect reasonably strong investment spending as deferred investment is implemented, and as firms become more confident on the back of the cyclical upturn in economic activity. Improved corporate profitability is also expected to support a rise in investment expenditure. We expect much of this investment to take place in the export and import-competing sectors.

Figure 1.13 – Capacity utilisation index



Source: NZIER

Relative to our June projections, the growth profile for business investment is more cyclical and follows a similar profile to that projected for GDP. Largely reflecting the computer deflator problem – where headline investment numbers are biased upwards by the inclusion of items that have large relative price declines – the underlying picture for investment is somewhat distorted.[1]

Labour market outcomes are expected to be dominated by the more cyclical output profile and inflation persistence

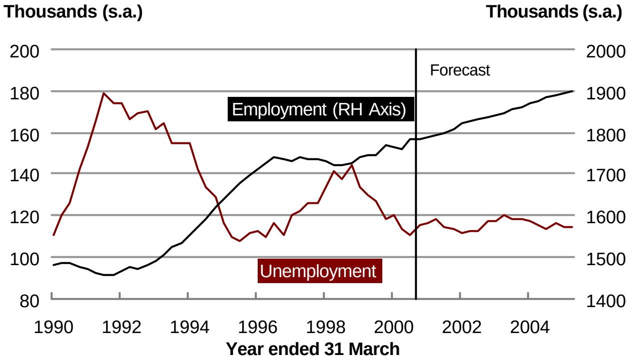
Given the reasonably soft short-term outlook for growth, we do not see the strength evident in the September quarter *Household Labour Force Survey* being continued over the next

1 While the headline investment numbers look to peak at 11% at the March 2005 year, investment growth ex-computers is substantially lower and peaks at 4.1% in the March 2003 year, before falling away to around 2% growth by the end of the forecast.

few quarters. Employment is expected to be flat in December, before rising moderately over the following few quarters as activity begins to pick up.

Looking further out, relative to our June projections, the major drivers underlying the labour market forecasts are the more cyclical real output path and the persistence of inflation. Employment growth is expected to fluctuate between 1% and 2% over the forecast period, with annual average growth peaking in late 2002. Given our real GDP forecasts, these employment growth rates imply higher average labour productivity over the forecast period than experienced during the 1990s.

Figure 1.14 – Labour market



Sources: Statistics New Zealand, The Treasury

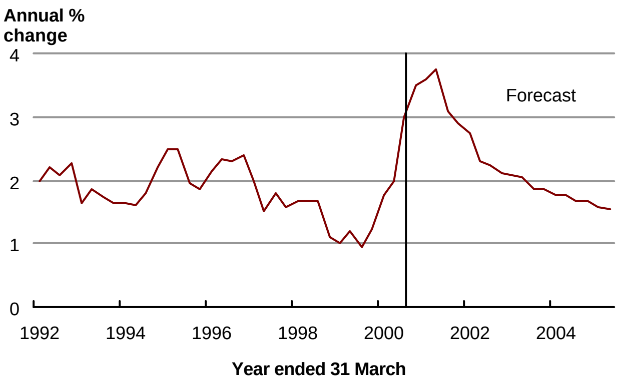
For much of the forecast period, the unemployment rate is expected to fluctuate around current levels before easing to around 5.7% at the end. Higher participation rates as growth picks up are expected to offset much of the steady employment growth.

On the wages front, we expect short-term wage pressures to remain reasonably modest, before beginning to pick up from around the middle of 2001. Based on the historical relationship between skill shortages and wage growth, the rise in the former through late 1999 and 2000 suggests an acceleration in wage growth in 2001, although the magnitude remains uncertain. Current and prospective inflation outturns may also feed through into wages, reinforcing the pressures arising from a relatively tight labour market. Forecast productivity developments offset these events somewhat, leading to growth in unit labour costs being more muted.

Inflation is a key risk

We continue to expect a building of inflationary pressures over the short-term. This view largely reflects the flow-on effect of higher oil prices and the weaker exchange rate. CPI inflation is expected to peak at around 3.8% in the June 2001 quarter, before edging back into the RBNZ's 0-3% inflation target range by the December 2001 quarter.

Figure 1.15 – Consumers Price Index



Sources: Statistics New Zealand, The Treasury

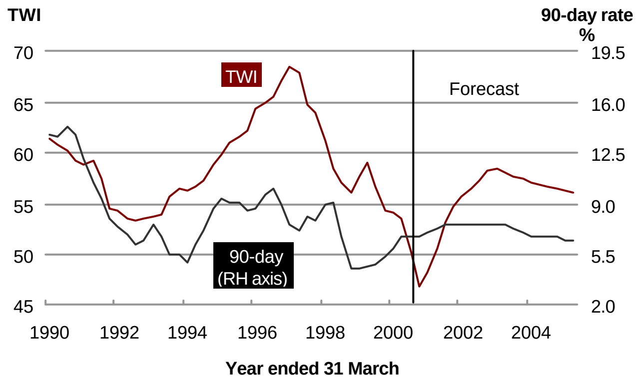
Reinforcing this picture of stronger pricing pressures, recent price and inflation expectations surveys have shown a sharp pick-up. Looking further ahead, inflationary pressures are expected to build in the labour market. In addition, we expect firms will attempt to restore margins as demand conditions improve. However, somewhat offsetting these inflationary effects, we expect oil prices to move lower over the forecast horizon. Moreover, the forecast exchange rate appreciation is expected to help dampen imported inflation pressure over most of the forecast horizon.

Monetary conditions tighten moderately to dampen inflationary pressures

To keep inflationary pressures in check, a modest tightening in monetary conditions is expected. In particular, we expect the Reserve Bank to raise the official cash rate by 75 basis points to a peak of 7.25% next year. Of particular concern for the monetary authority is attempting to ensure that the impact of higher import costs – particularly oil prices – does not feed through into "second-round" inflationary pressures.

In addition to the rise in short rates, we also project an appreciation in the currency over the medium term. Factors expected to support an upward move in the TWI include a sharp improvement in the current account and generally higher interest rates in New Zealand than the rest of the world, together with an expectation that some of the US dollar's strength is likely to be unwound over the medium term. Nevertheless, despite the forecast rise in interest rates and the TWI, both are expected to peak at levels substantially below those reached in the previous cycle.

Figure 1.16 – Monetary conditions



Sources: Primark Datastream, The Treasury

This leads to inflationary pressures moderating over the medium term, with annual CPI inflation settling down to the mid-point of the RBNZ's inflation target by the end of the forecast horizon.

The precise combination of monetary conditions that will emerge over the forecast horizon is difficult to predict. This uncertainty adds to the difficulty in forecasting the profile of activity going forward, as a differing mix of conditions has the potential to significantly impact on the composition of growth between the tradeables and non-tradeables sectors. For instance, a more rapid appreciation in the exchange rate than we have projected could lead to a lower interest rate profile. This would be likely to flow through to stronger domestic demand and a weaker export sector than currently forecast.

Nominal GDP growth peaks in the 2002 year before edging back to around 5% growth per annum

Nominal GDP growth – a combination of real GDP growth and price changes – drives the Government's tax revenue forecast. The inflation and labour market forecast also feeds into the Government's expenditure forecast, as some welfare benefits are linked to the inflation rate.

Reflecting the projected cycle of real activity, nominal GDP growth is expected to slow to around 4% in the March 2001 year. However, on the back of a forecast upturn in growth, together with a rise in inflationary pressures, nominal GDP growth over the March 2002 year is expected to accelerate to 7.2% – around half of this projected nominal growth reflects an increase in the size of the real economy, with the remainder a consequence of a rise in the GDP deflator. Thereafter, nominal growth ebbs back to 4-5% over the remainder of the forecast horizon.

On the income GDP side, profits are expected to see strong growth over the March 2002 year, peaking at 12.3%, before falling away to 5.5% by March 2005. Total labour income is lifted by both employment and wage rate increases, peaking at 6.0% in the March 2003 year.

In the early part of the forecast period, both profits and labour income are more restrained relative to our June projections. However, by the March 2002 year, profits are boosted by strong export growth and widening margins on the back of generally buoyant demand conditions. Somewhat offsetting this stronger profile for profits going forward, labour income growth is more restrained than previously forecast, largely reflecting slower employment growth over the forecast horizon.