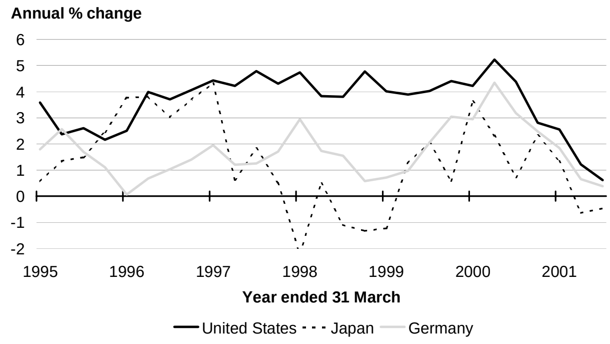
2

Economic Outlook

Since our Budget forecasts global growth has been weaker than expected…

At the time the 2001 Budget was finalised, global growth was projected to ease but then recover. In the event, world growth will be considerably weaker than expected over the second half of 2001. The US economy has decelerated further and contracted in the September quarter. Japan recorded consecutive falls in GDP in the June and September quarters. Growth also slowed markedly across the Euro area, with Germany recording two quarters of modest falls in GDP up to the September quarter.

Figure 2.1 – Synchronised downturn

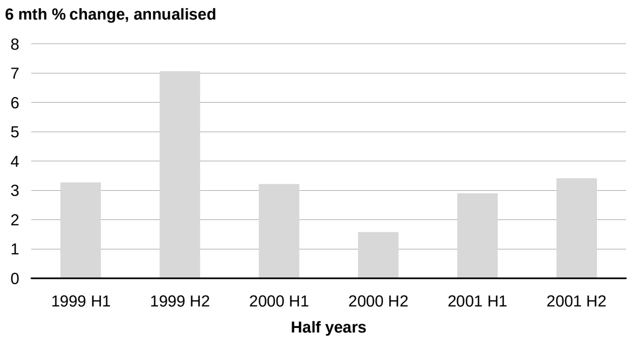


Source: Primark Datastream

…but New Zealand has outperformed

While the world has tracked more in line with the "weaker world growth" scenario contained in the 2001 Budget, the New Zealand economy has developed in line with, or turned out better than, our Central Forecast:

Figure 2.2 – New Zealand holding up so far



Source: Statistics New Zealand, The Treasury

*2001 H2 Treasury forecast

- GDP growth averaged just over 1% per quarter in the first half of 2001.
- Unemployment fell to a 13-year low of 5.2% in the June quarter and remained there in the September quarter.
- The annual current account deficit fell to 4% of GDP in the June 2001 quarter with a further fall expected in the September quarter.
- The nominal economy grew by 6.4% over the year to June 2001, indicating strong income growth.

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	0.3	1.9	1.9	3.1	2.9	3.0
Public consumption[2]	(3.0)	2.8	1.0	3.7	0.8	1.4
Total Consumption	**0.3**	**2.1**	**1.7**	**3.2**	**2.4**	**2.6**
Residential investment	(15.9)	(4.6)	6.2	11.6	6.2	4.9
Market investment	7.2	7.2	(3.7)	6.5	5.8	2.8
Non-market investment	(6.6)	(1.9)	3.3	2.8	2.8	2.8
Total Investment	**(0.4)**	**4.5**	**(1.1)**	**7.4**	**5.8**	**3.3**
Stock change[3]	(0.3)	(1.1)	0.7	0.1	0.0	0.0
Gross National Expenditure	**(0.2)**	**1.4**	**1.7**	**4.2**	**3.1**	**2.7**
Exports	6.8	2.9	2.3	7.3	5.4	4.5
Imports	0.4	0.2	1.4	9.8	7.3	4.7
GDP (Production Measure)	**2.6**	**3.1**	**1.9**	**3.7**	**2.6**	**2.8**
- annual % change	1.1	2.8	3.1	3.2	2.6	2.8
Nominal GDP (expenditure basis)	5.5	5.9	2.6	5.5	4.4	4.2
GDP deflator	3.6	3.6	0.6	1.9	1.8	1.5
Employment[4]	2.2	1.5	(0.1)	2.3	1.5	1.3
Unemployment[5]	5.4	5.6	5.7	5.2	5.2	5.2
Wages[6]	2.4	3.7	3.7	3.4	3.5	3.1
CPI inflation[7]	3.1	2.4	1.3	1.8	1.6	1.5
Export prices[8]	19.6	2.5	(8.2)	(3.6)	(1.4)	(0.1)
Import prices[8]	15.3	(0.1)	(2.9)	(3.5)	(2.6)	(0.4)
Current account balance						
- $ million	(5,338.0)	(3,725.0)	(4,612.0)	(5,174.0)	(5,304.0)	(5,297.0)
- % of GDP	(4.8)	(3.1)	(3.8)	(4.0)	(4.0)	(3.8)
TWI[9]	50.5	49.3	51.3	53.9	55.0	55.0
90-day bank bill rate[9]	6.4	4.8	5.8	6.0	6.0	6.0
10-year bond rate[9]	6.0	6.3	6.5	6.2	6.2	6.2

Sources: Statistics New Zealand, Primark Datastream, The Treasury

NOTES:
1 Finalised 21 November 2001.
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 This is the CPI-consistent series targeted by the Reserve Bank. Annual percentage change, March quarter.
8 Overseas Trade Index basis, annual average percentage change, March quarter.
9 Average for the March quarter.

Assumptions Underlying the Central Forecast

Global economic activity is assumed to evolve in a politically benign 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 October and November *Consensus* forecasts, and *Asia-Pacific Consensus* forecasts.

Recent events leading to lower confidence and heightened uncertainty are assumed to result in temporary "wait and see" attitudes among both consumers and businesses.

The 2001/02 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 21 November 2001.

Figure 2.3 – ANZ commodity price indexes

Source: ANZ

One of the principal reasons why New Zealand growth has not followed the world down and tracked the weaker world growth scenario outlined in the 2001 Budget has been our robust terms of trade. Throughout much of the year New Zealand export prices have remained at high levels, rather than fallen in line with world growth. With export volumes also holding up, this has provided an important offset to weaker world growth as the income gains have fed through into the broader economy. This has supported investment, employment and consumption over the first half of calendar 2001, and led to a lower current account deficit.

Overall, in the year to June 2001, New Zealand GDP grew at 3.2%. This was better than expected in the 2001 Budget forecast, largely as a result of the very strong growth of 2% in the June quarter. Some of this may reflect volatility in the data, particularly in business investment, given that the March quarter figure was surprisingly weak and at odds with most qualitative assessments of the underlying strength of the economy.

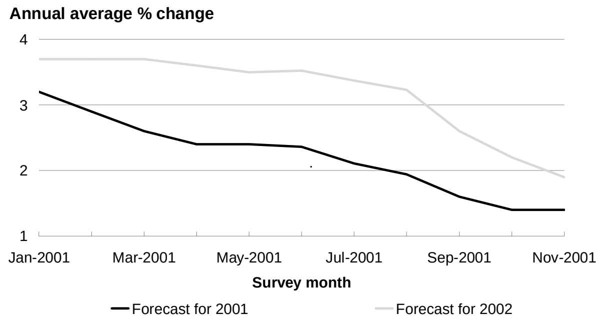
We estimate growth continued in the September quarter, although at a slower rate than in the June quarter. Private consumption and residential investment look to have made positive contributions to growth over the quarter, with market investment providing a negative offset while the contribution from net exports will likely be modest either way. Our estimate is for 0.6% growth for the September 2001 quarter, but an outturn slightly above or below this (perhaps reflecting some bringing forward of activity in the June quarter outturn) would not materially alter our underlying Central Forecast profile.

Looking forward, weak world growth also dominates the short-term outlook

Even before the events of 11 September, US and global growth prospects were being consistently revised down. Between the 2001 Budget in early May and September (compiled just prior to 11 September), forecast growth in our major trading partners was revised down 0.4 percentage points in calendar 2001 and 0.5 percentage points in calendar 2002.

While there were signs in some economies the slowdown could be reaching a turning point prior to 11 September, it was also becoming clear that the expected recovery of trading partner growth was not underway in the second half of 2001. Following the terrorist attacks, sentiment around short-term global growth prospects changed markedly for the worse.

Figure 2.4 – Changing trading partner growth forecasts



Sources: Consensus Economics, The Treasury

Altogether, since the 2001 Budget trading partner growth prospects have been revised down from 2.4% to 1.4% in 2001, and from 3.6% to 1.9% in 2002. Underlying this fall are the significant downward revisions to growth prospects in the US and Japan.

US economy a major driver

At the time the 2001 Budget was finalised in early May, *Consensus* forecasts were expecting economic recovery in the US in the second half of 2001, with a further pick-up in growth in 2002. Spending by US consumers was continuing to hold up, and marked reductions in interest rates together with impending tax cuts were expected to provide the basis for a recovery in growth.

A stream of weak economic data pointed to the end of the long-running US economic expansion prior to 11 September. At the same time, however, there were some signs of the economy nearing a turning point. The impact of the shock of 11 September on business and consumer confidence has led forecasters to significantly downgrade their outlook for the US economy, which is now expected to continue to contract in the final months of 2001. Little improvement is expected in the first quarter of 2002 before the economy begins to recover as the substantial monetary and fiscal stimulus put in place begins to take effect. The most recent *Consensus* forecasts have the US economy growing at 1.1% in calendar 2001 and 0.7% in calendar 2002. Growth in calendar 2003 is expected to return to over 3%.

The outlook for other countries has also weakened…

C*onsensus* forecasts for Japan have been revised down sharply and are for annual contractions of -0.5% in calendar 2001 and -0.6% in calendar 2002. There is little sign of the world's second largest economy emerging from recession in the short term.

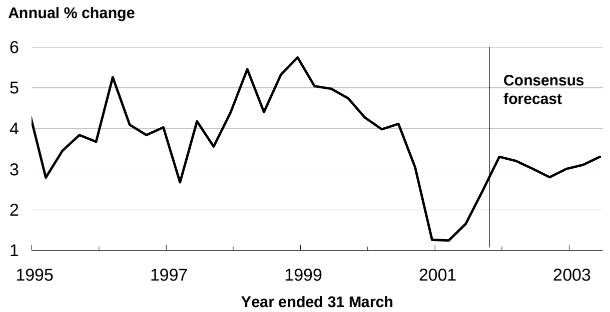
Elsewhere in the Asia-Pacific region, forecasts for most economies have been scaled back sharply, with the notable exception of China. Those countries with large electronic export sectors have been hit particularly hard by the global slowdown and the shake-out in the technology sector worldwide. Downward revisions have been particularly marked for Hong Kong, Singapore, South Korea and Taiwan, with an outright contraction in 2001 expected for all of these economies with the exception of South Korea.

Growth forecasts have also fallen across the Euro-zone amidst rising concern the region may not avoid recession as business confidence wanes, industrial production weakens and unemployment rises. Like many other central banks, the European Central Bank has cut interest rates by 150 basis points.

…although Australia continues to hold up in the short term

Importantly for New Zealand, revisions to Australian growth prospects have been more moderate in the wake of recent global events. Relatively robust growth is forecast to continue at 2.1% in 2001 and 3.2% in 2002, down from September mean growth forecasts of 2.5% in 2001 and 4.0% in 2002. The weaker world economy is expected to have an impact on growth, particularly through the external sector. Domestic demand, however, is expected to hold up in the short term on the back of buoyancy in the housing sector, despite a deterioration in confidence and weakening labour markets. Steady growth in our largest trading partner is likely to provide some offset to the downturn elsewhere.

Figure 2.5 – Australia

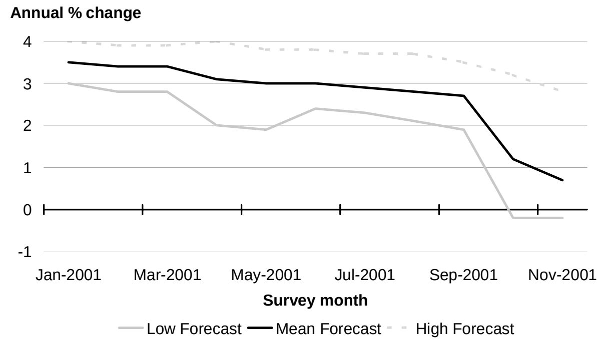


Sources: Primark Datastream, Consensus Economics

World Growth

The world growth assumptions underpinning the Central Forecast are based on an average of private sector forecasts from *Consensus Economics*. As we noted in the body of the chapter, *Consensus* forecasts have declined significantly over the past year. Forecasts of global activity from the Organisation for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF), have similarly declined.

Figure 2.6 – Forecasts of US growth in 2002



Source: Consensus Economics

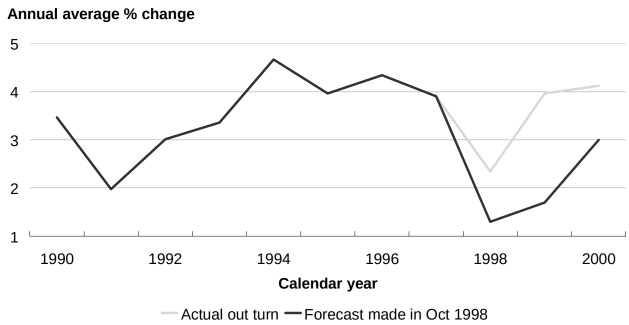
Despite this our reading of the current international data suggests that further falls in forecasts for 2002, albeit more modest than seen this year, cannot be ruled out. One illustration of this is the wide range of views on the outlook for growth in the US in 2002. Figure 2.6 tracks the low and high forecasts, as well as the average from *Consensus*. As can be seen, recent events have seen a greater range of views develop around the short-term outlook despite 2002 being upon us.

There are also downside risks to trading partner growth beyond 2002. The Consensus view implies a recovery in global growth to more satisfactory levels in the second half of 2002 and continuing into 2003. Even a short delay of a few quarters in US growth returning to around trend would likely see trading partner growth turn out materially lower. This possibility underpins the weaker world growth scenario in the Risks and Scenarios chapter.

The risks around global growth are not one way, however, particularly once the contraction in activity comes to a halt. Our current *Consensus* forecast assumptions of growth in calendar 2003 are essentially analysts' views of trend growth in trading partners – as such they do not build in any significant period of above-trend cyclical growth despite the current period of weakness.

Moreover just as the *Consensus* has lagged the slowdown in global growth over the past year, *Consensus* forecasts may also lag any upturn in global growth. Figure 2.7 shows *Consensus* forecasts from October 1998 at the bottom of the Asian financial crisis for the period 1998-2000 against the eventual outturns.

Figure 2.7 – Trading partner growth forecasts

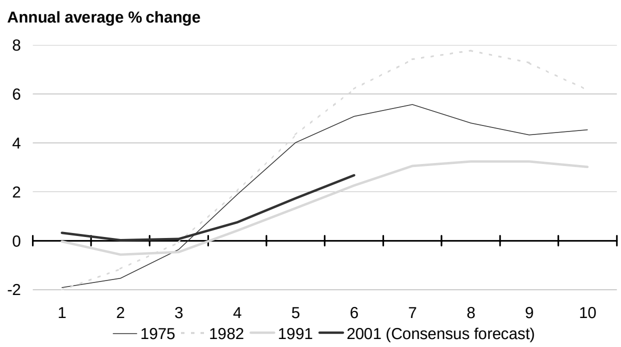


Sources: Consensus Economics, The Treasury

Given the substantial fiscal and monetary stimulus injected into the US and other economies, we do expect to see economic recovery next year. The key uncertainty is the pace of the upturn. For the US, the 6 November 0.5% cut in the Federal Funds Rate by the Federal Reserve takes the benchmark US interest rate to its lowest level in 40 years, with further reductions possible. In terms of fiscal policy, the additional stimulus in 2002 could be in the order of 1.5%-2% of GDP.

Figure 2.8 tracks the pace of recovery in US growth coming out of past recessions and compares this with the track implied by *Consensus* forecasts. Whether or not the US does recover more quickly will likely hinge on the extent of turnaround in investment and inventories.

Figure 2.8 – Recovery out of past US recessions



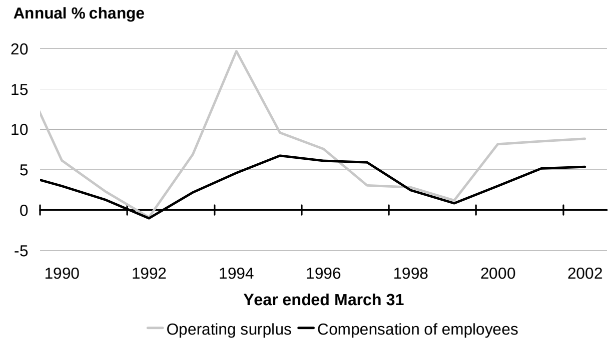
Sources: Primark Datastream, Consensus Economics

New Zealand is well positioned to cope with weaker world growth…

While the size of the external shock is significant, the actual impact on New Zealand of developments offshore is still uncertain. While New Zealand is unlikely to be immune to these external forces, a number of factors suggest the economy is somewhat better positioned to cope than it has been in similar instances in the past:

- Many parts of the economy have recorded a second year of good income growth, while employment and wage growth has increased household incomes.
- Firm's balance sheets appear healthy.
- Unlike in some economies, there are few signs of any investment overhang, with residential investment at a cyclical low and capacity utilisation high.
- New Zealand manufacturing exports have not been heavily exposed to the technology sector, which has driven the downturn in global industrial production.
- The fall in oil prices is providing support to real income growth compared with a year ago.
- The real exchange rate is at levels which provide stimulus to the export sector.

Figure 2.9 – Firm and household income growth



Sources: Statistics New Zealand, The Treasury

*2001/02 Treasury forecast

…and policy has also adjusted

Faced with a large external shock to demand, macroeconomic policy has also moved to a more accommodative stance since the beginning of the year. The current monetary policy cycle peaked over the second half of 2000 when the Official Cash Rate (OCR) stood at 6.5%. Since March this year the Reserve Bank has cut the OCR five times and 1.75% in total, initially in a series of 0.25% cuts before 11 September, followed by an unscheduled cut of 0.5% on 19 September, and another 0.5% cut in mid-November. At 4.75% the level of the OCR is significantly lower than projected in the 2001 Budget and is close to levels when it was first introduced in early 1999. Reflecting this, mortgage rates are close to 30-year lows.

With respect to fiscal policy, the progress made in fiscal consolidation over the past decade means automatic stabilisers are being allowed to operate fully.

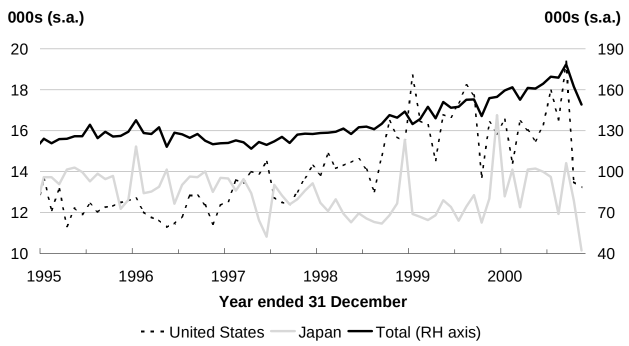
Nevertheless, New Zealand is beginning to feel the effect of the global slowdown

The impact of the global slowdown is starting to affect New Zealand through recent falls in tourism numbers, export prices, and business and consumer confidence.

Monthly visitor arrivals have fallen in both September and October, with the fall in arrivals greatest among the high-spending US and Japanese visitors.

World prices for some of New Zealand's commodities are showing the effects of slowing demand. Nevertheless, while New Zealand export commodity prices have fallen from historic high levels, given that the global economy has been slowing since the start of the year these prices have surprised with their resilience. Furthermore, falls in world prices have been somewhat offset by the weakness of the New Zealand dollar. Import prices, notably for oil, have also weakened.

Figure 2.10 – Visitor arrivals

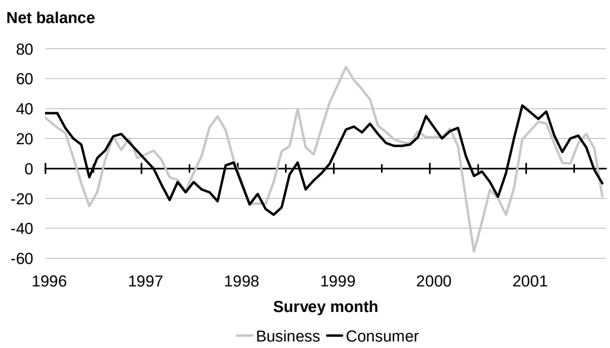


Sources: Statistics New Zealand, The Treasury

The picture around confidence has been a little more mixed. This is perhaps understandable given the difficulty of forming judgements about how shocks like 11 September will affect people's actions. The initial impact is of a strong negative shock to confidence and security, reinforced by the possibility of further terrorist attacks.

In times of greater uncertainty and insecurity, households and firms become more cautious and postpone spending decisions. During our business talks firms indicated that while they were still relatively optimistic, they had become more cautious since the events of 11 September. More formal surveys of consumer and business confidence show sharp falls since the events of 11 September. Businesses' own activity expectations and investment and employment intentions, are falling but remain in positive territory.

Figure 2.11 – Business and consumer confidence



Sources: National Bank, Colmar Brunton

Short-term outlook

New Zealand is not immune from weaker world growth…

We expect the New Zealand economy to slow over the short term before picking up later in 2002 with the rebound in the global economy.

There are a number of direct and indirect "transmission channels" through which we expect weaker world growth to impact on New Zealand. Amongst the key ones are:

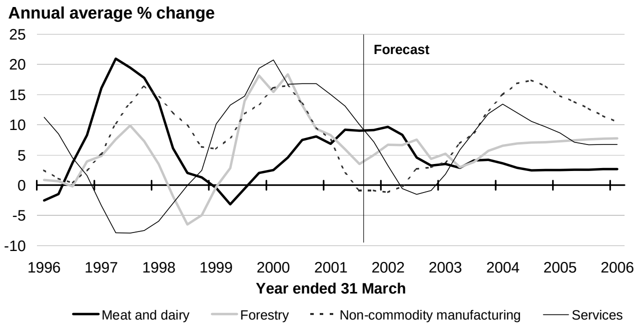
- lower demand for New Zealand exports (including tourism)
- lower export prices, only partially offset by lower import prices
- heightened uncertainty and weaker sentiment over the short term leading to a lower domestic spending profile.

The key judgements in this set of forecasts concern the mechanisms through which the shock is transmitted to New Zealand, and the size and timing of the impact.

…as the global downturn hits export growth…

We expect the immediate impact of weak global growth to show up in weaker demand for exports, most notably for services as a result of declining tourist numbers. The negative effect of weaker global growth on incomes together with an aversion to international travel, particularly among American and Japanese tourists, is assumed to have a significant negative impact on total arrivals in New Zealand, relative to previous expectations, until mid-to-late 2002. This is in spite of a competitive exchange rate.

Figure 2.12 – Export volumes



Sources: Statistics New Zealand, The Treasury

Visitor arrivals fell sharply in September and October, with US and Japanese arrivals clearly showing an impact from 11 September. Going forward into 2002, we expect this weakness to continue despite some potential offset from greater numbers of Australian and Asian tourists, which is helped by the perception of New Zealand as a safe travel destination. Service exports are expected to fall in both the December and March quarters. From the second half of 2002 we expect tourism numbers to pick up as incomes recover on the back of a rebound in global growth, and as people feel more comfortable about international air travel.

Merchandise export volumes are also expected to contract mildly in late 2001 and early 2002, with the global slowdown particularly impacting on the more demand-sensitive non-commodity manufacturing, crude materials and forestry export sectors. Nevertheless, robust growth in the Australian economy - our largest export destination - provides a significant offset to weak activity elsewhere. In particular, very strong growth in Australian residential investment is expected to provide support for New Zealand manufactured and forestry exports.

New Zealand’s agricultural export volumes are largely driven by supply-side factors and hence tend to be less sensitive to fluctuations in international demand. Dairy exports are projected to ease in the near term as climatic conditions are assumed to return to “normal” this year following the rapid growth of the past two seasons. Meat exports also decline in the near term, partially reflecting the recent increase in slaughtering earlier in 2001 as a result of last season’s dry conditions, before returning to steady growth.

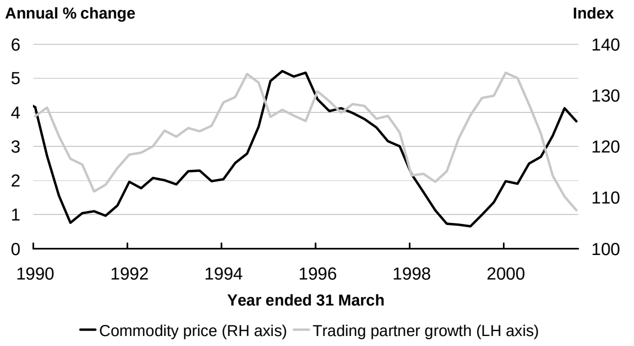
Overall, we expect total export volumes to fall marginally over the short term, largely as a result of falling services and flat non-commodity manufactured exports. As trading partner growth recovers mid-2002, exports are expected to pick up from the end of 2002. Recovery in global growth will reinforce the competitive effect of the exchange rate for non-commodity manufactured exports. The lack of international demand over the past year is likely to be one of the reasons why manufacturing export growth has not performed as strongly over the past year, as might have been expected given the New Zealand exchange rate. Bilateral exchange rate movements are another.

Should weaker world growth continue throughout most of 2002, then there is downside risk to our Central Forecast, which is explored in one of our scenarios in the Risks and Scenarios chapter.

…and prices

Weaker world demand is also expected to have a significant negative impact on world prices for New Zealand exports towards the end of 2001 and throughout most of calendar 2002, before gradually recovering further out. However, we assumed that export prices would decline in the 2001 Budget, and so far they have held up surprisingly well.

Figure 2.13 – Global growth and commodity prices



Sources: ANZ, Primark Datastream, The Treasury

Compared with previous downturns, New Zealand's world export prices have remained relatively strong in the face of slow world economic growth. This is primarily due to meat and dairy prices holding up at historically high levels owing to market specific factors like: constraints on lamb supply in the UK following the BSE and foot-and-mouth disease outbreaks; stronger beef prices in the US reflecting recent supply-driven US beef price rises; and higher dairy prices owing to cuts in European export subsidy rates. While our Central Forecast is based on a fall in export prices, one of the scenarios maps out the possibility of a more modest fall in export prices.

Consistent with previous global downturns, our Central Forecast therefore assumes that world export prices will fall, although not to the same extent due in part to the market specific factors discussed above. Overall, world prices for New Zealand exports are expected to fall by about 8% in the year to March 2003.

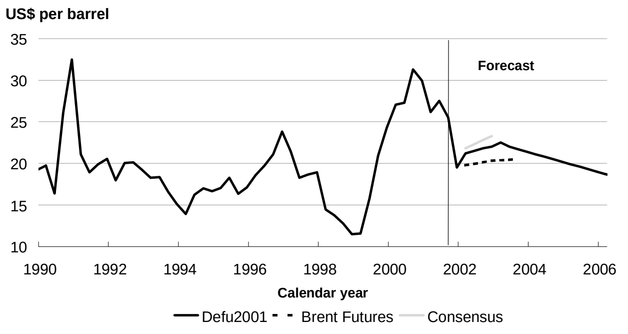
As global demand weakens import prices are also expected to moderate across the board. The fall in import prices reflects the historical relationship between weaker global growth and softer import prices. However, import prices are not expected to fall to the same extent as export prices. A larger import price fall would provide an important offset to export price falls.

Oil Prices

Oil prices have fallen dramatically since the 11 September attacks, from around US$27 a barrel in early September to US$19 a barrel more recently. The future oil price profile is a major uncertainty in our forecasts.

The methodology underlying the Treasury's oil price attempts to capture information from *Consensus* forecasts, Brent crude futures prices, and the perceived long-run equilibrium price of oil. Reflecting the trends shown by both the *Consensus* view and Brent Futures prices, our profile is for prices to steadily recover to around US$22.50 over the next 18 months before easing back towards our assumed "equilibrium" level for crude prices of US$18.50 (based on an historical average).

Figure 2.14 – Oil price forecasts



Sources: Primark Datastream, The Treasury, Consensus Economics

There are clear risks to this profile both on the upside and downside. Should OPEC prove successful in moving oil prices to the middle of its target range of US$22-28 per barrel, oil prices could rise considerably higher than our forecasts. Conversely, further deterioration in the world economic outlook, and consequently weaker demand for oil, could lead to prices remaining at or below current levels for some quarters to come.

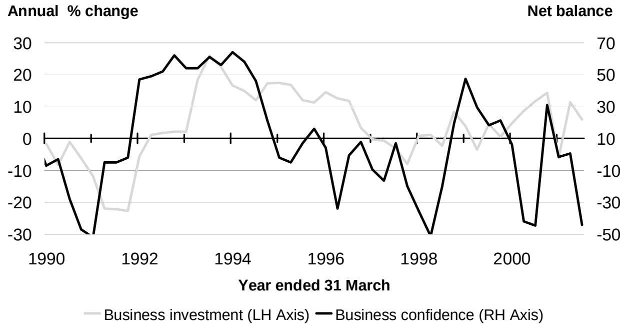
In our Central Forecast we expect the terms of trade to deteriorate sharply going into the first half of 2002 as our prices for exports fall away quicker than import prices. Despite these falls, the terms of trade remain slightly above the lows reached in 1990/91 and 1997/98, supported by structural factors impacting New Zealand's key agricultural prices, as well as oil prices remaining below recent highs. The terms of trade subsequently recover over 2002/03 as global growth picks up and commodity prices recover.

Greater uncertainty negatively affects business confidence and feeds into investment…

The third principal channel we see operating over the short-term is from domestic confidence to spending. We see weaker confidence having an impact on the willingness of both firms and households to employ, spend and invest. However, it is very hard to quantify this impact. Assuming that further political or military actions do not have any significant effects on the international economic climate, we expect to see some of the uncertainty, insecurity and risk aversion associated with 11 September dissipate over time as firms and households become clearer about its lasting impacts, even if these are negative for a period of time.

In light of greater uncertainty around the outlook, firms will be more cautious about undertaking new investment. This will be reinforced by expectations of slower income growth over the short term as export growth falls away and domestic demand moderates. However, good balance sheets, lower interest rates, recent high levels of capacity utilisation, and the expectation of a recovery means that we do not expect to see large declines in investment. Overall, we expect market investment to fall around 4% in the year to March 2003 with a couple of negative quarters of investment spending in the December 2001 and the March 2002 quarters.

Figure 2.15 – Business confidence and investment



Sources: Statistics New Zealand, NZIER

Going into 2003 investment growth begins to pick up as profit growth, and the need to undertake investment as the economy nears capacity, plus a relatively tight labour market going forward all provide support to business investment as deferred projects are brought back on line.

…the labour market…

We also expect firms to be more cautious about taking on additional employees. As a result, employment growth stops over the short term and for much of 2002 as firms delay hiring, and seasonal employment is more muted in selected industries, notably tourism. However, the extent of the slowing in employment growth is expected to be more modest than in previous downturns as firms look to maintain the bulk of their workforce given the relatively tight labour market. Demand for skilled labour is likely to hold up as firms seek to fill skilled vacancies as the opportunity arises.

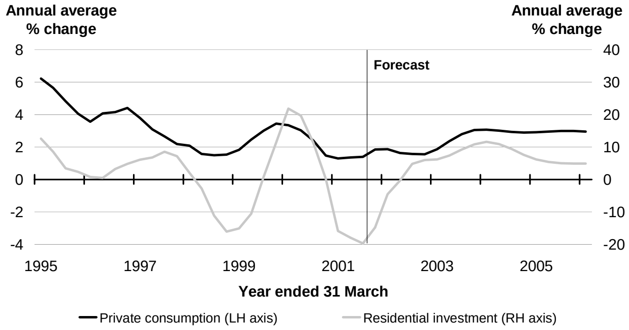
As a consequence we therefore expect the unemployment rate to rise moderately until mid-2002, although continuing to remain under 6% as a softening in the labour participation rate offsets some of the impact of weaker employment growth.

As the economy regains momentum over 2002/03, firms resume hiring, employment growth resumes from mid-2002 leading to a pick-up in the labour market and a rise in the participation rate. Unemployment begins to fall towards 5.5% by the end of 2003.

…and households.

The "wait and see" attitude of firms is expected to be mirrored by households. Greater uncertainty leads households to be more cautious about their expenditure patterns over the short term as a weaker labour market, and slower global growth and

Figure 2.16 – Consumption and residential investment



Sources: Statistics New Zealand, The Treasury aggregate demand lead to more modest farm and entrepreneurial income growth. With household net wealth also remaining flat, consumption growth is expected to moderate and remain subdued over the first half of 2002.

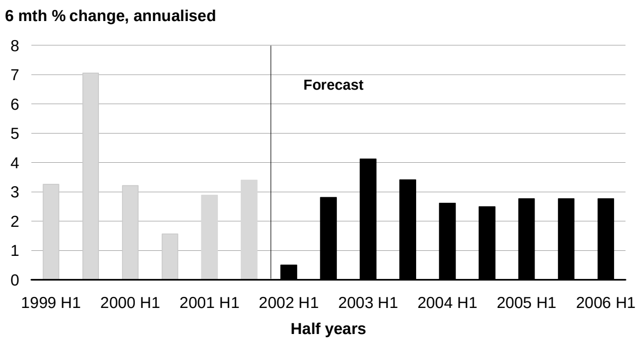
However, the turnaround in migration and the moderate pick-up in residential investment are expected to provide some support to consumption.

Activity in the housing sector and residential construction is expected to continue to increase modestly over the short term, as lower consumer confidence provides some offset to lower interest rates. Once consumer confidence turns around, lower interest rates and net inward migration should all provide support to a pick-up in residential investment in 2002/03, although not to the levels of the Auckland housing boom of the mid-1990s. The pick-up in the housing market also provides support for house prices, which in turn, bolsters household wealth.

GDP growth profile is more cyclical than expected in the 2001 Budget

Overall, the short-term profile for real GDP growth is considerably more cyclical than forecast in the 2001 Budget. On an annual percent change basis growth falls to around 1.0% in the first half of calendar 2002 before rebounding to 3% in early 2003 and rising to 4% towards the end of 2003. Growth is expected to be weakest over the period December quarter 2001 to June quarter 2002 – on average only slightly positive. Thereafter, growth recovers to above trend rates on a quarterly basis by the end of 2002 and in early 2003. In annual average terms, this sees real GDP growth of 3.1% in the year to March 2002 and 1.9% in the year to March 2003.

Figure 2.17 – GDP growth profile



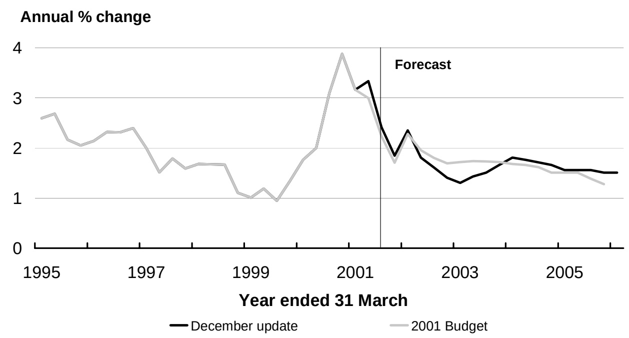
Sources: Statistics New Zealand, The Treasury

*2001 H2 Treasury forecast

Such outturns would see New Zealand GDP growth matching or outperforming the OECD average over the period 1999-2003.

The profile for nominal GDP growth is also more cyclical, which has implications for our fiscal forecasts in the next chapter. Nominal growth in the year to March 2002 is forecast to be 5.9%, partly as a result of the strong June quarter outturn. In the year to March 2003, lower real growth and lower inflation leads nominal growth to fall to 2.6%, before picking up further out as growth rebounds.

Figure 2.18 – CPI inflation



Sources: Statistics New Zealand, The Treasury

The inflation outlook looks benign over the short term

With reduced growth and weaker global price pressures (including for oil) the outlook for inflation in the short term is more moderate than we had assumed in the 2001 Budget. In the labour market, short-term wage pressure is diluted by concerns about the world economy and a rise in the unemployment rate. Our projections have CPI inflation falling back to the middle of the Reserve Bank's target range by the December 2002 quarter as pricing pressures ease on the back of weaker unit labour costs and weaker world export and import prices. Weaker demand also makes it more difficult for firms to pass on price rises.

As growth picks up over 2002/03, the Reserve Bank is assumed to steadily return the Official Cash Rate to around 6.0%, our current estimate of neutral short-term interest rates, to lean against any emerging inflationary pressures. This is also helped by a modest appreciation in the exchange rate.

The current account will continue to improve in the short run, but weaker world demand will see it decline moderately in 2002/03

The current account has improved more than expected throughout the year, although slower export growth in the year ahead, together with the forecast fall in the terms of trade slows down the extent of further improvement. However, declines in business investment and consumption expenditure lead to a fall in imports. As global growth slows, profits from New Zealand subsidiaries offshore are expected to fall. In the year to March 2002, the current account is expected to fall to around 3% of GDP, before deteriorating in 2002/03 as the goods and services surplus retraces some of the recent gains. Government defence spending adds to imports over most of the forecast period.

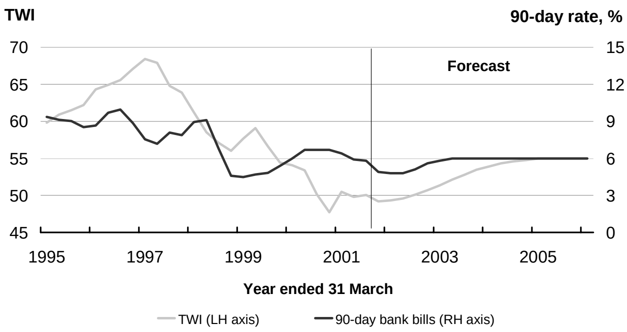
Longer term outlook – 2003/04 and beyond

Over the medium term the economy continues to post good growth

In the year to March 2004, the economy is forecast to enjoy growth of 3.7% as export growth accelerates markedly, and as the domestic economy recovers strongly. The forecast resumption of business investment growth, and the improvement in the labour market see a strong pickup in domestic demand. However, as economic growth and business investment recovers, imports also increase so that net exports make a negative contribution to growth towards the end of the forecast horizon.

The outer years of the forecast period see some slowing of the economy, with average annual growth falling back to around trend growth of around 2.75%. Rising interest rates from late 2002 slow some components of domestic demand and help close an emerging positive output gap, while a gradual appreciation of the TWI to its expected long term equilibrium level moderates export growth.

Figure 2.19 – TWI, 90 day bills



Sources: RBNZ, The Treasury

Exports continue to recover…

Over the medium term, exports continue to recover. In volume terms, agricultural exports are expected to steadily increase over the forecast horizon due to increased stock numbers as well as productivity improvements. Non-commodity exports continue to do well on the back of continuing world growth and the exchange rate converging to its assumed equilibrium level.

…as does domestic demand

Business investment remains fairly strong further out in the forecast period given a continued tight labour market. To overcome capacity and labour market constraints firms are expected to meet more of their output growth from capital rather than labour. This will also serve to underpin average labour productivity of around 1.5% over the forecast period.

Consistent with rising economic growth over the medium term, labour demand also picks up. Employment growth is expected to gain momentum going into 2003/04 with the unemployment rate returning to around current levels of just over 5% as the higher participation rate and continued moderate net migration inflows offset further employment growth.

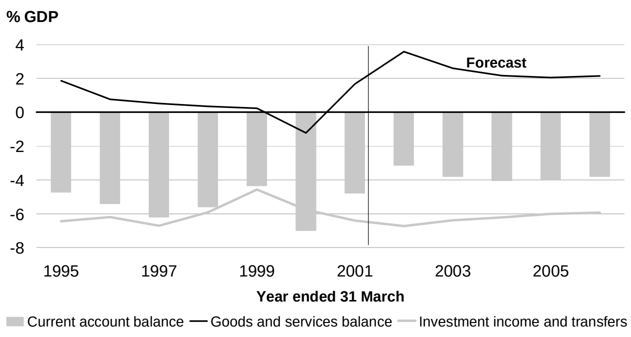
Monetary conditions

In late 2003 and early 2004, inflation tracks marginally above the mid-point of the target band as unit labour costs pickup somewhat and a slightly positive output gap emerges. However, the impact of rising interest rates leans against any emerging inflation pressures and inflation tracks down toward the mid-point of the Reserve Bank's target inflation band.

Current account improves further out

Following the deterioration in the current account deficit to 3.8% of GDP in 2003, the deficit falls further to 4.0% of GDP as imports increase on the back of the pick-up in investment spending and domestic consumption. Further out, continued steady improvement in service exports underpins an improvement in the current account balance at the end of the forecast horizon.

Figure 2.20 – Current account



Sources: Statistics New Zealand, The Treasury

Growth in the nominal economy rebounds

Over the last three years of the forecast horizon the nominal economy is forecast to record solid growth of 4% to 5%, owing to the combined contribution of relatively steady GDP growth and stable inflation around the middle of the Reserve Bank's target band. This growth in nominal GDP underpins solid revenue growth in our fiscal forecasts.