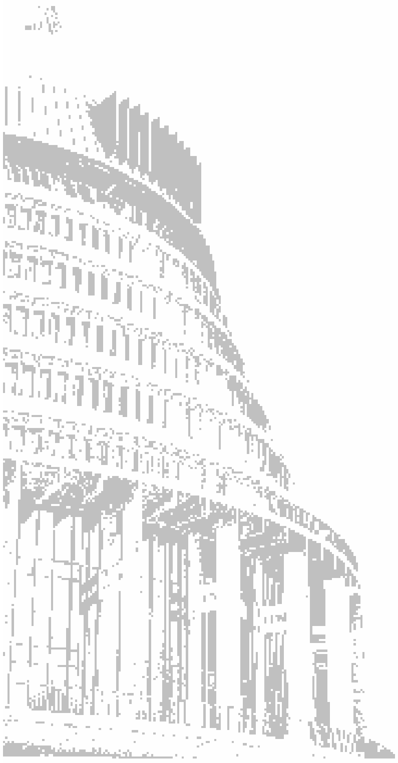
B.6

Hon Dr Michael Cullen
MINISTER OF FINANCE



December Economic & Fiscal UPDATE 2004

14 December 2004

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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 2 December 2004 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.

John Whitehead
Secretary to the Treasury

6 December 2004

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 2 December 2004 of which I was aware and that had material economic or fiscal implications.

Hon Dr Michael Cullen
Minister of Finance

6 December 2004

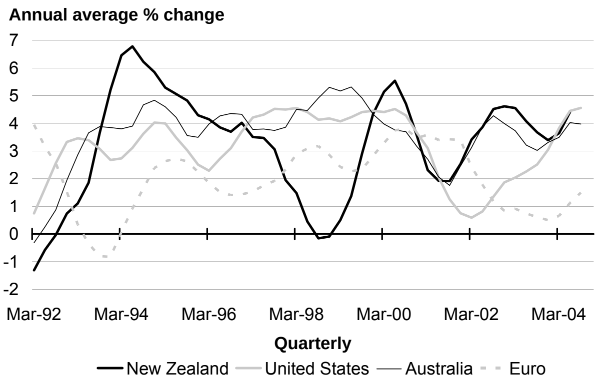
1

Economic Outlook

Summary

- New Zealand's economic growth has outperformed the OECD average over the past five years, with annual growth averaging 3.7% per annum compared to the OECD's 2.4% per annum. This outperformance has occurred despite some challenging international and domestic events (figure 1.1).

Figure 1.1 – Real GDP growth



Sources: Statistics New Zealand, Datastream

- In the near term, economic activity is expected to remain strong, taking real GDP growth to 4.7% for the year to March 2005. Stretched resources will lead to more inflationary pressures, taking annual CPI inflation towards the top of the Reserve Bank's target band. The current account deficit is expected to continue its recent deterioration.

- A slowdown in growth is still expected over the coming year as declining net migration, a forecast fall in the terms of trade, and the lagged effects of higher interest rates and a high exchange rate impact on growth. Real GDP growth is forecast to slow to 2.4% in the year to March 2006, rising slightly to 2.6% in the following year. Tight resource constraints mean that annual CPI inflation remains near the top of the Reserve Bank's target band through to mid-2006 despite the slowdown in growth.

- Activity in the housing market has started to show signs of slowing partly as a result of falling net migration. Further declines in housing activity are expected over the coming year, and this is expected to translate into a contraction in residential investment in the year to March 2006 and the following year.

- Although private consumption growth has yet to show signs of weakening, lower net migration and slowing income growth are major drivers for an expected slowdown in consumer spending over the next two years. Gains in recent labour income growth will be offset by the rise in debt burden faced by households from the large increases in mortgage lending of the past few years. Private consumption growth is forecast to slow from 5.5% in the year to March 2005 towards 2.3% in the year to March 2007. A key judgement in the forecasts involves the extent to which households will aim to improve their net asset position and saving rate.

- Exports largely appear to be holding up despite the rise in the exchange rate, possibly due to better currency risk management by exporters and strong global growth resulting in strong export demand. The lagged impact of the high exchange rate is still expected to affect export growth next year as hedging arrangements eventually unwind. An easing in global growth towards trend from next year will also result in lower demand for exports.

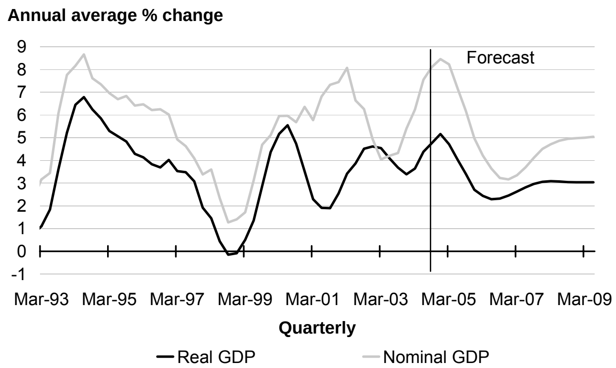
- The rise in world prices for New Zealand's major export commodities over the past year has provided an important offset to the rising exchange rate. Export prices are forecast to stay at their current levels in the short term, before declining as global growth slows towards trend and international agricultural supply constraints ease. This will lead to slower rural income growth and consequent flow-on effects on spending.

- The slowdown in growth over the coming two years will see the pace of employment growth slow from the current annual rate of 3% to less than 1% towards the end of 2005. The unemployment rate is forecast to fall towards 3.6% by the March 2005 quarter before rising towards 4.4% by mid-2007.

- Short-term interest rates are expected to remain at around current levels until the end of next year, reflecting a balance between current persistent inflationary pressures and a slowing economy over the coming year. Interest rates are expected to gradually revert towards neutral rates of 5.8% by the end of 2006.

- The economic cycle is more pronounced on the nominal economy compared to the real economy due to the stronger terms of trade cycle (figure 1.2). Growth in nominal GDP is forecast to be 8.2% in the year to March 2005, slowing to 3.3% in the year to March 2007 as the real economy slows and the terms of trade decline towards trend levels.

Figure 1.2 – Real and nominal GDP growth



Sources: Statistics New Zealand, The Treasury

Table 1.1 – Economic outlook: central forecast[1]

(Annual average % change, year to 31 March)	**2004 Actual**	**2005 Estimate**	**2006 Forecast**	**2007 Forecast**	**2008 Forecast**	**2009 Forecast**
Private consumption	5.3	5.5	2.5	2.3	2.6	3.0
Public consumption[2]	3.1	6.9	5.0	4.3	2.8	3.4
Total Consumption	**4.8**	**5.8**	**3.0**	**2.8**	**2.7**	**3.1**
Residential investment	15.8	14.3	-6.4	-6.4	0.5	1.5
Central Government Investment	6.0	4.7	2.9	3.1	2.8	2.8
Other Investment	12.5	15.2	5.1	0.2	2.0	3.7
Total Investment	**12.8**	**13.9**	**2.0**	**-1.2**	**1.7**	**3.2**
Stock change[3]	0.2	0.1	-0.1	0.0	0.0	0.0
Gross National Expenditure	**6.7**	**7.4**	**2.6**	**1.8**	**2.4**	**3.1**
Exports	0.8	5.5	4.0	5.4	4.4	3.2
Imports	11.0	13.7	4.5	3.1	2.4	3.3
GDP (Production Measure)	**3.6**	**4.7**	**2.4**	**2.6**	**3.1**	**3.0**
- annual % change	*5.1*	*3.3*	*2.2*	*2.9*	*3.0*	*3.0*
Real GDP per capita	1.9	3.5	1.5	1.7	2.1	2.1
Nominal GDP (expenditure basis)	6.2	8.2	4.2	3.3	4.7	5.0
GDP deflator	2.8	3.3	1.7	0.8	1.6	1.8
Employment[4]	2.9	3.3	1.0	0.6	1.1	1.2
Unemployment Rate[5]	4.2	3.6	4.0	4.3	4.4	4.4
Wages[6]	3.4	4.2	4.5	3.5	3.4	3.5
CPI inflation	1.5	2.9	2.8	2.4	2.2	2.0
Export prices[7]	-8.2	3.5	0.1	3.4	1.9	1.1
Import prices[7]	-11.6	-2.8	2.1	6.2	2.4	0.7
Current account balance						
- $ million	-6,023	-8,133	-9,139	-9,877	-9,755	-10,045
- % of GDP	-4.4	-5.5	-5.9	-6.2	-5.8	-5.7
TWI[8]	66.9	68.2	64.2	61.2	59.7	58.8
90-day bank bill rate[8]	5.5	6.8	6.5	5.8	5.8	5.8
10-year bond rate[8]	5.8	6.5	6.5	6.0	6.0	6.0

Sources: Statistics New Zealand, Reserve Bank of New Zealand, The Treasury

NOTES:
1 Forecasts finalised on 19 November 2004. Text finalised on 8 December 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 October and November editions of *Consensus Forecasts* and *Asia Pacific Consensus Forecasts*. Economic growth for New Zealand's top 14 trading partners is forecast at 4.4% for calendar 2004, the fastest growth rate since 1996. Growth then returns to trend of 3.5% from 2005 onwards. Despite a relatively optimistic outlook for trading partner growth as a whole, there are downside risks to the outlook:

- Oil prices have increased sharply over 2004. At the time of writing, the price of West Texas Intermediate crude oil was US$41.45 per barrel, up from US$32.55 per barrel in January. Strong demand, as well as supply disruptions, have been the main factors pushing prices up.
- Rising debt in the United States, including a large Federal Budget deficit, has fuelled an expansion in the current account deficit to 5.0% of GDP. This poses a risk of further downward adjustment in the United States dollar and may mean that consumer spending strength could become increasingly unsustainable.

Table 1.2 – Trading partner growth forecast

Year to 31 December	**2003[a]**	**2004[e]**	**2005[f]**	**2006[f]**	**2007[f]**	**2008[f]**	**2009[f]**
Australia	3.0	3.5	3.4	3.4	3.5	3.4	3.3
Japan	2.5	4.3	1.8	1.8	1.2	2.1	2.1
United States	3.0	4.4	3.4	3.4	3.2	3.1	3.1
Europe*	1.1	2.5	2.1	1.9	1.9	2.0	2.0
Non-Japan Asia**	5.1	7.2	5.6	5.9	5.9	6.0	5.9
Trading partner growth	3.1	4.4	3.5	3.5	3.4	3.5	3.4

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

Oil prices – Brent crude oil prices are assumed to remain at around US$46 per barrel over the short term and then gradually decline, consistent with futures pricing at the time the forecasts were finalised. Oil prices are assumed to reach around US$35 per barrel by the end of the forecast period, consistent with long-dated futures pricing. For a more detailed discussion of recent oil price developments, see the "Oil Prices" box.

Net migration – the net number of migrants has started to decline from its mid-2003 peak and is assumed to continue to decline to approximately 10,000 per year by June 2005. The migration assumption for the year to June 2005 is 5,000 lower than that used in the *Budget Update.*

Monetary conditions – the New Zealand dollar exchange rate as measured by the trade weighted index (TWI) is assumed to remain at around 68 until mid-2005, before proceeding to decline steadily to its estimated equilibrium level of around 59. This is a technical assumption. A neutral short-term interest rate of 5.8% is assumed.

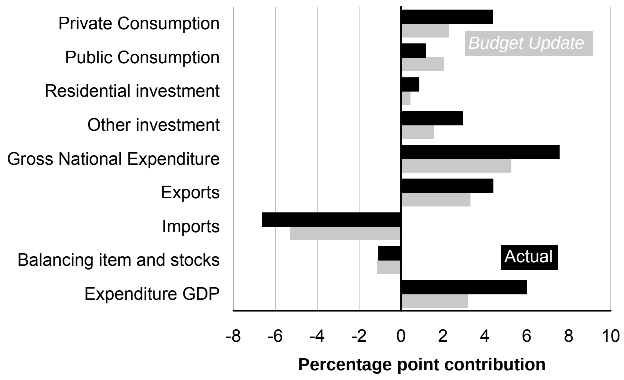
Climate – agricultural growing conditions and the level of hydro electricity storage lakes are assumed to be normal over the forecast period.

Recent Economic Environment

Growth surprised strongly on the upside in the first half of 2004

The economy expanded strongly over the past year, with production-based GDP increasing by 4.4% in the year to June 2004. Growth in the first half of calendar 2004 was particularly strong, expanding at an annualised rate of 6.1% compared with the *Budget Update* forecast of 2.9% (figure 1.3). This recent growth has been broad based, with strong contributions from domestic and external demand. The strong growth in private consumption, which grew at its fastest annual rate since 1995, drew in more imports which more than offset the positive contribution made from exports.

Figure 1.3 – Contributions to GDP growth (annualised growth, first half of 2004)



Sources: Statistics New Zealand, The Treasury

Recent growth a continuation of strong growth recorded in the last five years…

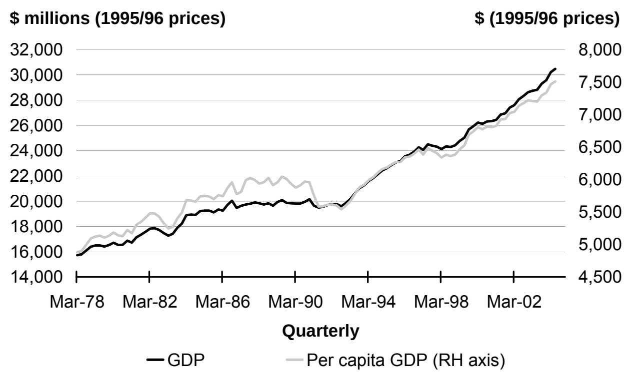
The recent growth performance is a continuation of the strong growth recorded since the economy rebounded from the 1997/98 recession, which was primarily caused by the Asian Financial Crisis and two consecutive summer droughts. Over the past five calendar years from 1999 to 2003, New Zealand's annual GDP growth rate averaged 3.7% per annum compared to the OECD's 2.4% per annum. New Zealand's growth performance over the past five years was achieved despite:

- the bursting of the technology bubble in 2000 which led to a recession in the United States
- heightened geopolitical uncertainties following the events of 11 September 2001, and the period leading up to the conflict in Iraq in 2003
- dry weather conditions in New Zealand in early 2003 which resulted in lower farm output and electricity production
- an outbreak of Severe Acute Respiratory Syndrome (SARS) in early 2003 which caused travel disruptions, and
- more recently, rising oil prices surpassing the levels (in nominal terms) seen during the second oil shock of 1979/80.

… some of which is structural…

New Zealand's recent growth performance can be attributed to past structural reforms that began in the mid-1980s; which have resulted in a trend increase in New Zealand's growth rate since the early 1990s (figure 1.4), a more flexible economy better able to absorb adverse shocks and take advantage of favourable shocks, and sound macroeconomic policy settings.

Figure 1.4 – New Zealand's GDP Level



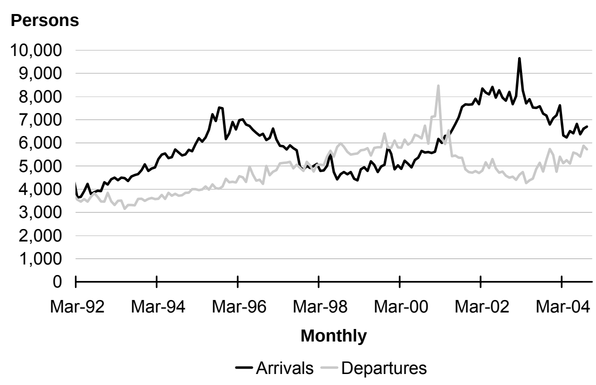
Sources: Statistics New Zealand, The Treasury

Between early 1993, at about the time when a structural change in New Zealand's trend growth started, to now, growth averaged 3.7% per annum and per capita growth averaged 2.5% per annum. Per capita growth since the early 1990s has been sourced from both labour productivity growth and increases in labour utilisation. The strong growth in labour utilisation has seen the unemployment rate fall from close to 10% in early 1993 to 3.8% in the September 2004 quarter, and the labour force participation rate rise from 63.3% to 67% over the same period. Since the later half of the 1990s labour productivity appears to have been providing greater impetus to growth in per capita GDP.[2]

… and some due to other factors at work…

The low New Zealand dollar exchange rate which prevailed over the 1999 to 2001 period coincided with a sharp increase in prices for New Zealand's main export commodities. The latter was driven by strong demand from major export markets, and a reduction in supply from certain key markets (see the "Terms of Trade" box). The combination of a low exchange rate and high commodity prices saw a large boost to export income, which stimulated spending in the rural sector that filtered out into the urban areas.

Figure 1.5 – Long-term arrivals and departures (monthly, seasonally adjusted)



Source: Statistics New Zealand

During this period when rural incomes were increasing, the country was losing around 10,000 people a year through net migration. Net migration started to turn around in 2001 when long-term departures fell sharply with a weak global economy and changes governing access of New Zealand citizens to social security in Australia. Departures continued to fall in the aftermath of the 11 September 2001 terrorist attacks in the United States. At the same time, long-term arrivals to New Zealand

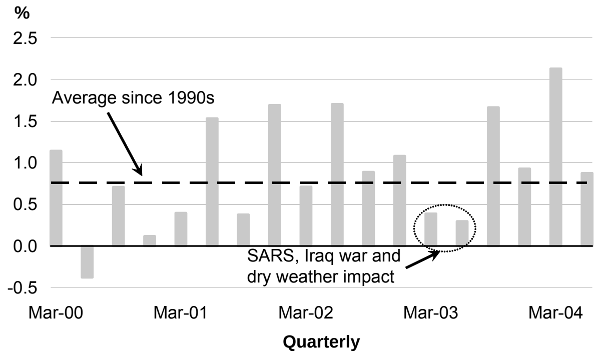
2 For more information on New Zealand's growth performance, refer to "New Zealand Economic Growth: An Analysis of Performance and Policy", The Treasury, April 2004.

increased, driven partly by returning New Zealanders but also new immigrants and a large increase in foreign students (figure 1.5). Net migration increased from a trough of -13,200 for the 12 months to February 2001 to a peak of 42,500 for the 12 months to May 2003. This large turnaround in net migration created a large stimulus to domestic demand, fuelling consumption growth and increasing investment in residential activity.

A global slowdown led by the United States was already in train when the 11 September attacks occurred. Central banks around the developed world eased monetary policy in an attempt to stabilise financial markets and inject liquidity into the system. In New Zealand, the Official Cash Rate was reduced from 5.75% to a historically low 4.75% within almost two months of the attacks. Low interest rates, together with strong net migration and the lagged effects of strong rural incomes, provided further stimulus to domestic demand.

New Zealand's run of strong quarterly growth rates starting from the December 2001 quarter was temporarily interrupted in the first half of calendar 2003 by several short-lived shocks – the Iraq conflict, the SARS outbreak, and drought conditions affecting farm output and electricity production. Growth slowed to an annualised rate of 2.2% during that period, but strong underlying fundamentals at that time saw growth rebound strongly in the second half of 2003 once the temporary effects of the shocks dissipated (figure 1.6).

Figure 1.6 – New Zealand quarterly GDP growth rates

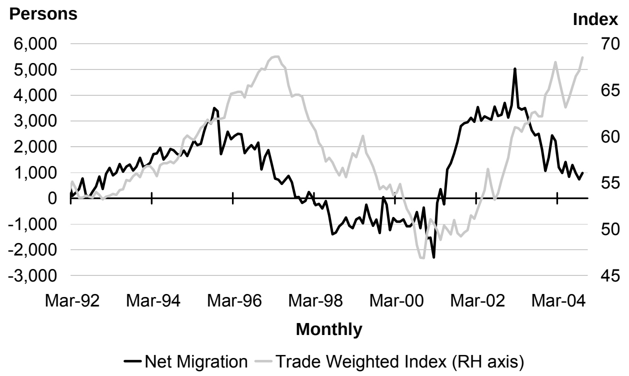


Source: Statistics New Zealand

… some unwinding…

The exchange rate and net migration are no longer at the stimulatory levels they once were a few years ago (figure 1.7). Since hitting a low of 46.2 on a trade weighted index basis in November 2000, the New Zealand dollar exchange rate has appreciated by close to 50% to around 69. At this level, the exchange rate is impacting on export returns and is expected to impact on competitiveness.

Figure 1.7 – Net migration and exchange rate



Sources: Statistics New Zealand, Reserve Bank of New Zealand

Net migration has trended downwards after reaching its peak in mid-2003. Long-term arrivals have started to fall due to changes in the immigration programme and a downturn in the foreign student market. The lower number of arrivals is compounded by a rise in long-term departures, resulting in net migration declining to an annualised rate of 10,000 per month. The increase in long-term departures can be attributed to a more benign geo-political environment, improved employment prospects overseas, and foreign students completing their studies and returning to their home countries.

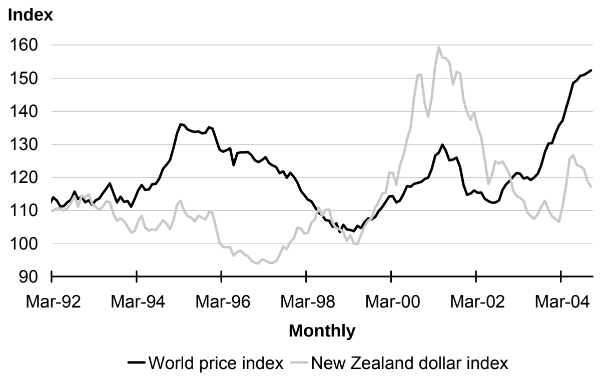
The *Budget Update* forecast had incorporated a slowdown in growth over the latter part of this year and into next, in part because of slowing domestic spending due to the decline in net migration. The effect of the higher exchange rate was also expected to bite at about this time as companies' hedging arrangements may have unwound.

… others still present

While the decline in net migration and its effects on the housing cycle look to be playing out as foreseen, the expected slowdown in domestic demand is yet to occur. Consumer spending remains strong, even as house sales and building consents trend downwards.

Trend export receipts fell from mid-2001 to mid-2003 as the rising exchange rate started to impact on export returns. However, from mid-2003 onwards there has been a resurgence in the prices for New Zealand's major export commodities (figure 1.8). The rise in commodity prices helped offset the impact of the rising exchange rate, resulting in a rise in export receipts and providing ongoing growth in income for the rural sector. While the high exchange rate did reduce the returns on non-agricultural exports, which did not benefit directly from higher commodity prices, it also reduced the cost of imported raw materials and other commodities, including oil. This saw an increase in New Zealand's terms of trade to its highest level since 1988.

Figure 1.8 – Commodity price index



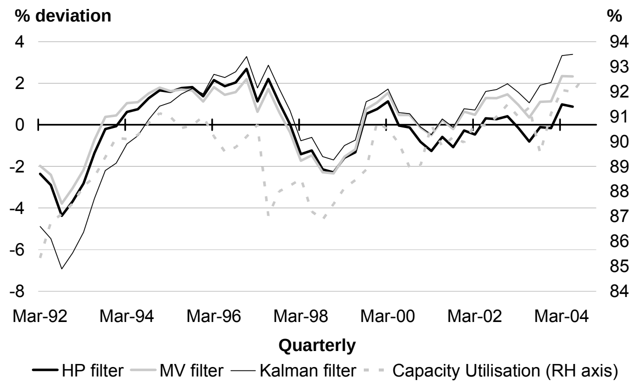
Source: ANZ

Another key driver of the current growth cycle is the buoyant state of the labour market, which will continue to support the current growth momentum in the short term. The commodity price boom and turn around in net migration early this decade saw employment growth accelerate and maintained at a strong pace. This saw strong growth in labour income, which supported consumption and residential investment growth.

Strong growth has led to pressure on resources…

Strong growth over the past few years has seen spare labour and capital increasingly used. This led to pressure on resources, stretching the available spare productive capacity of the economy. The extent to which the economy is running above capacity (ie. a positive output gap) is not directly observable, but is an important consideration in our thinking of the extent and the evolution of the current business cycle.

Figure 1.9 – Output gap measures and capacity utilisation



Sources: Statistics New Zealand, NZIER, The Treasury

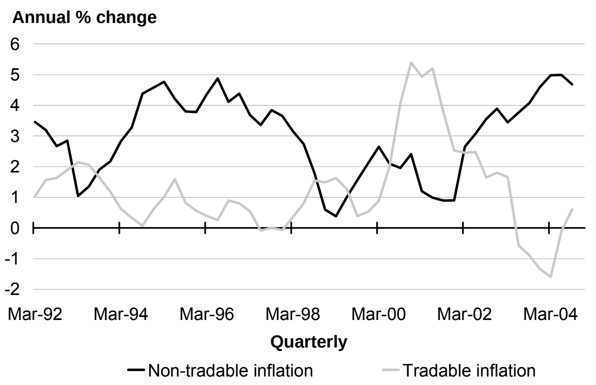
We use a range of statistical indicators and data, including surveys, to gauge the size of the output gap.[3]

The various statistical measures of the output gap are unanimous in pointing to above trend growth (figure 1.9). The New Zealand Institute of Economic Research's survey measure of capacity utilisation is at its highest level since the survey began in 1961, also suggestive of limited spare capacity. Strong labour demand has driven the unemployment rate down to 3.8% in the September 2004 quarter, the lowest rate in almost two decades. Despite more people entering the workforce and pushing the labour force participation rate to its highest level since 1986 at 67%, firms continually report difficulty in finding both skilled and unskilled labour.

… leading to greater inflationary pressures

Tight resource constraints have led to greater inflationary pressures in the economy, pushing CPI inflation towards the upper half of the Reserve Bank's target band. Annual headline CPI inflation, at 2.5% for the September 2004 quarter, masks a dichotomy between inflation in the tradable and non-tradable sectors (figure 1.10).

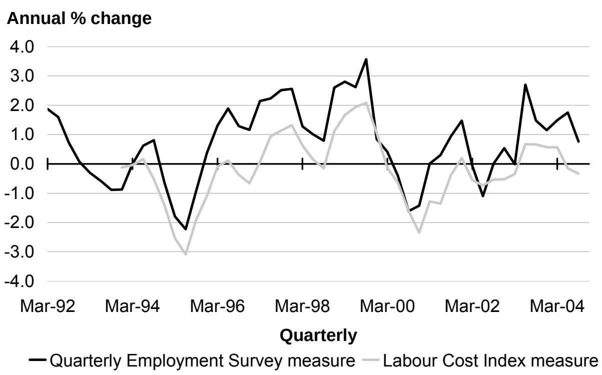
Figure 1.10 – Tradables and non-tradables Inflation



Sources: Reserve Bank of New Zealand

Non-tradable inflation has accelerated since early 2002 and has been running at a rate close to 5% since late last year, consistent with an economy running at above trend growth. The construction sector has contributed significantly to non-tradable inflation, due to very strong demand in this sector. Tradable inflation has been moving in the opposite direction, driven lower by the rising New Zealand dollar exchange rate. The gap between annual tradable and non-tradable inflation has narrowed in the September 2004 quarter, but overall inflationary pressure is expected to persist in the near term.

Figure 1.11 – Inflation adjusted private sector wage growth



Sources: Statistics New Zealand, The Treasury

Wage inflation has been rising, in line with a tight labour market environment. Wage growth in inflation adjusted terms is lower than the previous peak in the economic cycle of the mid-1990s (figure 1.11). We have been surprised, however, that it has not been stronger given the low unemployment rate and reported generalised labour shortages. Compositional changes within the labour market and greater use of non-wage benefits, including better working

3 Refer to "Trend Growth Developments" box in the *2002 December Update* economic chapter.

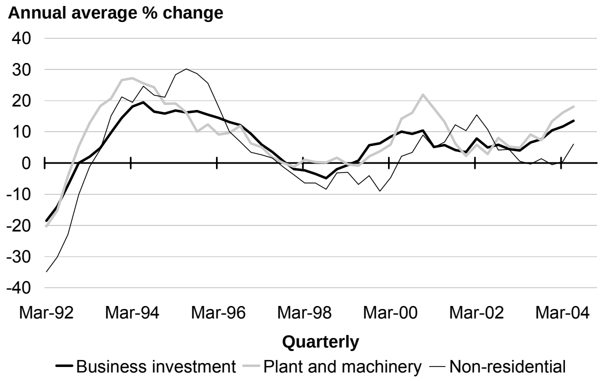
conditions, may partly explain why wage growth has not been as strong as we were expecting. Our business contacts inform us that there is greater wage demand from employees, with higher wage settlements likely over coming wage negotiation rounds. This is likely to translate into higher wage inflation in the official published data over the coming year.

Rising inflationary and wage pressures are also reflected in pricing intentions and inflation expectations surveys, which have been edging up over the past year. In response, the Reserve Bank has raised the Official Cash Rate by a total of 150 basis points since early this year to 6.5%.

Strong business investment could help alleviate resource pressures in future

Over the past two years, business investment growth has been strong, particularly in plant, machinery and equipment. Annual growth in business investment in the June 2004 quarter was 13.5%, the highest since the mid-1990s. Plant, machinery and equipment investment is the largest component of business investment, and has generated most of the recent growth in the total (figure 1.12). Around two-thirds of the increase in total business investment since early 1999 has been in this component. Non-residential investment has shown a pick-up after a period of stagnation, expanding at an annualised rate of 17.5% in the first half of this year. Construction activity has started to shift away from residential housing towards non-residential and other construction types.

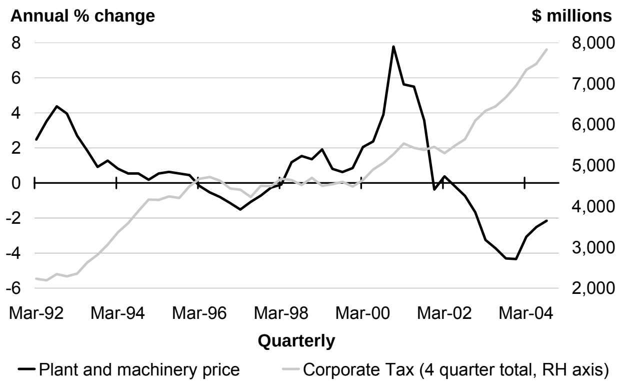
Figure 1.12 – Business investment growth



Sources: Statistics New Zealand, The Treasury

The climate for businesses to invest has been favourable. Strong demand conditions, high capacity utilisation rates, a scarcity of labour and rising labour costs have encouraged firms to utilise more capital in order to expand output. Solid growth in corporate profits resulting in rising corporate tax revenue and sound balance sheets, and the high level of the exchange rate leading to a lower cost for capital equipment, have provided the additional impetus for businesses to invest (figure 1.13). Capacity utilisation still remains high despite the strong investment growth, indicating that the additional capacity has been soaked up by strong demand. This suggests that business investment growth will remain strong in the near term. After a period of labour deepening throughout the 1990s, where growth was sourced from labour utilisation, we are now seeing a switch towards capital deepening as labour becomes scarcer. The additional investment will increase capital available for workers, potentially enhancing labour productivity growth in future.

Figure 1.13 – Capital investment prices and corporate tax



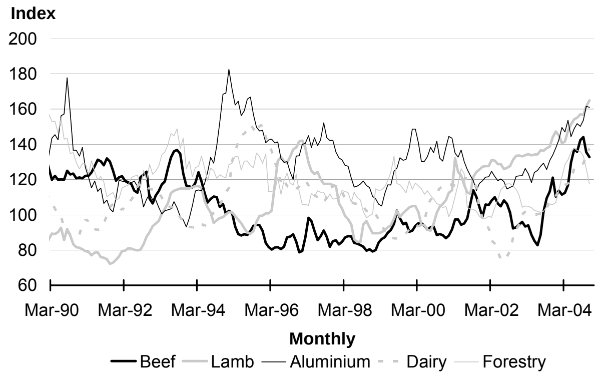
Sources: Statistics New Zealand, The Treasury

Terms of Trade

The terms of trade is the ratio of export prices to import prices and tells us how many imports New Zealanders can buy for a set amount of exports. An increase in the terms of trade means New Zealand can buy more imports for the same volume of exports and amounts to an increase in national income. Changes in the terms of trade are an important driver of real economic activity and directly impact on nominal GDP.

The terms of trade increased 5.6% in the year ended June 2004, providing a boost to incomes in the economy. In New Zealand Dollar terms export prices fell 4.6% in the year, a smaller fall than the 9.6% decline in import prices, with the appreciation of the dollar putting downward pressure on prices of exports and imports.

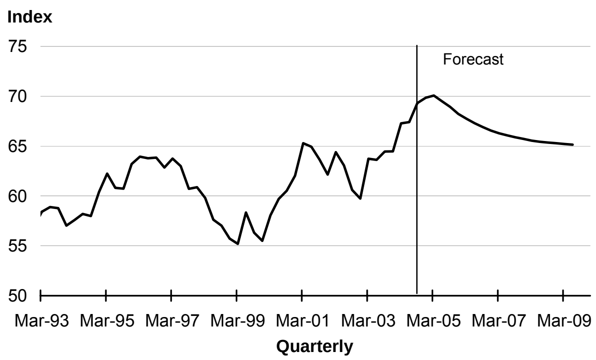
Figure 1.14 – ANZ Commodity Price Indexes



Source: ANZ

In world price terms, export prices have increased sharply over the last 12 months, as shown in the graph of the ANZ Commodity Price Index, and have been the main driver of the lift in the terms of trade (figure 1.14). The future path of export prices and therefore the terms of trade is an important component of the Central Forecast. Strong world economic growth has contributed to the lift in prices. Dairy, beef and lamb prices have all increased and are at or near record levels. Supply conditions have contributed to the lift in prices of these commodities. Drought in Australia has limited dairy production and the supply of beef and lamb. Climatic conditions in the United States have also affected beef production, with several years of drought in some parts of the country lengthening the stock liquidation phase and reducing current production. The outbreak of foot and mouth disease and the subsequent destruction of many flocks mean that lamb production in the UK is currently at a low level, pushing up lamb prices. In addition, an isolated case of BSE in Canada led to a restriction on Canadian beef exports in the United States, driving up beef prices there.

Figure 1.15 – World export prices



Sources: Statistics New Zealand, The Treasury

Export prices are forecast to stay at a high level in the short term, with further increases forecast until the first half of 2005 when prices are forecast to begin to fall (figure 1.15). The fall reflects an easing in demand as the pace of world growth slows and a gradual easing in some of the supply constraints in agricultural markets as international production increases. Supply conditions in the lamb and beef markets that support prices are expected to prevail for longer, with the UK lamb flock and therefore production expected to remain at a low level for some time.

As a result, the level of meat export prices in world terms is expected to remain high over the forecast period, despite some falls over 2005 and 2006. Dairy prices are forecast to decline more sharply over 2005 as production increases in other parts of the world.

Crude materials prices, particularly aluminium, have increased recently, and our measure of manufactured exports prices after removing the impact of the exchange rate suggests these prices have also increased in world terms over the last year reflecting strong world demand. The prices of these exports are forecast to fall over the forecast period.

There is considerable uncertainty around the outlook for export prices. Our assessment is that the recent increases in prices will not be sustained over the forecast period. The pace and the extent to which prices fall will be an important driver of economic activity. If recent price rises are sustained such that there is a structural lift in export prices and the terms of trade, national income will be higher and real GDP growth is likely to be stronger than forecast.

The strong world growth that has lifted New Zealand's export prices has also lifted the price of many other raw materials which New Zealand imports. However, these are forecast to fall as the growth in world demand slows. Together these export and import price movements will determine the path of the merchandise terms of trade.

Economic Outlook

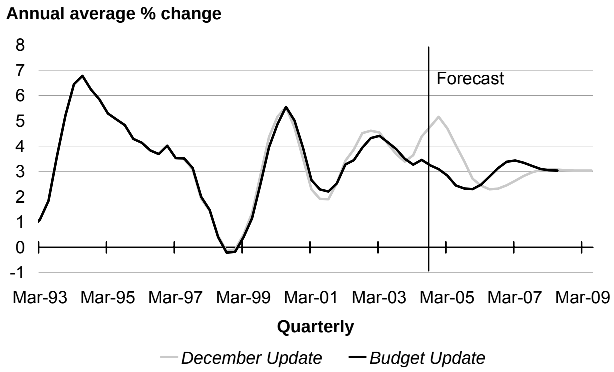
Near term strength persists…

In the near term, economic activity is expected to remain buoyant, as the recent lift in the terms of trade and strong growth in labour income continue to lend support to consumer spending. Growth in business investment is expected to remain strong throughout the rest of this year as firms seek to reduce capacity constraints or get around labour shortages. The near term strength in domestic demand will be offset by the net external sector. Export volume growth is expected to remain weak for the second half of this year due to supply factors limiting dairy and forestry exports, and demand for imports will remain firm due to strong domestic demand and a high exchange rate.

… but slowdown still expected

We estimate that this near term strength in the economy will take GDP growth to 4.7% for the year to March 2005, much higher than the 2.8% forecast in the *Budget Update*. But as in the *Budget Update*, we continue to expect a slowdown over 2005, driven by a combination of an expected fall in the terms of trade, declining net migration, and the lagged effect of much tighter monetary conditions. This slowdown results in almost a halving of the growth rate to 2.4% for the year to March 2006.

Figure 1.16 – GDP Growth



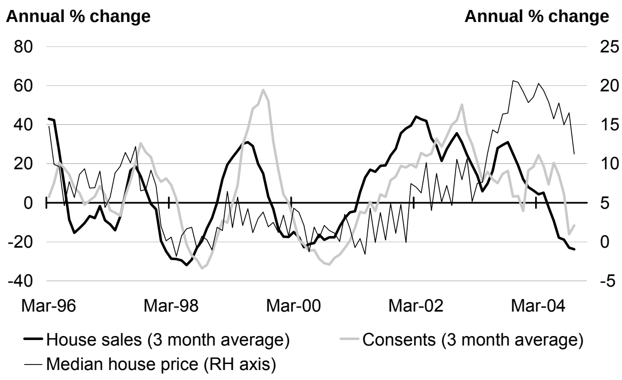
Sources: Statistics New Zealand, The Treasury

Compared to the *Budget Update*, the slowdown in growth is sharper, and growth stays at below trend for longer (figure 1.16). The economic cycle is also more pronounced on the nominal economy due to a combination of higher real GDP and a stronger terms of trade.

Nominal GDP growth is forecast to be 8.2% in the year to March 2005 compared to the *Budget Update* forecast of 5.7%. Nominal GDP growth then slows to 3.3% in the year to March 2007 as the real economy slows and the terms of trade decline towards its trend level.

Some of the drivers in place

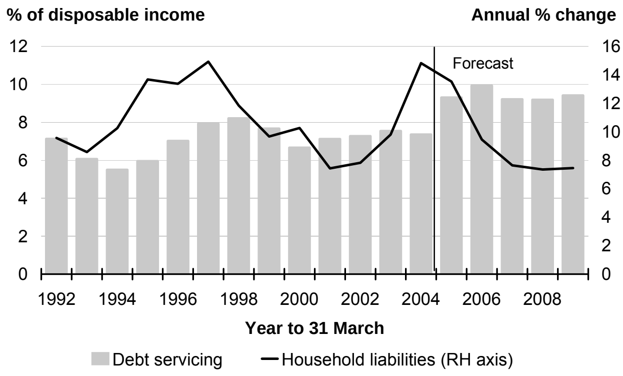
Figure 1.17 – Housing activity



Sources: Statistics New Zealand, REINZ, The Treasury

Slowing population growth due to lower migration levels are starting to affect activity in the housing market (figure 1.17). Building consents and house sales have started to decline, and house price growth, while still positive, is coming off its peak. The existing backlog of residential construction activity should help hold residential investment at current high levels for the rest of the year. But the drop-off in house sales and consents will translate into a decline in residential investment throughout next year and the year after. We forecast that residential investment will fall by 6.4% in the year to March 2006, and show a similar fall in the year to March 2007 before gradually recovering towards the end of the forecast period. The recent discounting of fixed term mortgage rates by the large retail banks poses a risk that housing activity may hold up for longer than expected. Our assessment is that this discounting will not last, and the retail banks will quickly move to restore their interest rate margins. We have assumed that the discounting will have minimal impact on the forecasts. However, the level of fixed term mortgage rates may stay at current low levels if global long-dated bond rates decline.

Figure 1.18 – Household debt servicing and liabilities



Sources: Statistics New Zealand, Reserve Bank of New Zealand, The Treasury

A sharp slowdown in private consumption growth is expected to accentuate the slowdown in GDP growth. Lower net migration and slowing income growth further in the forecast period are the major drivers of the slowdown. In addition, the wealth effect from rising house prices will no longer be a factor supporting consumption as residential activity is forecast to contract over the coming year.

Although growth in labour income will remain firm throughout most of next year, the debt burden that households are carrying from the recent run-up in mortgage lending may lower spending growth (figure 1.18). A key judgement in the forecast of a slowdown in consumption growth remains the extent to which households will consolidate their balance sheets and look to improve their savings position, which has been deteriorating for over a decade. The exact timing and the extent that households will begin this adjustment is uncertain. The longer that households continue to spend more than they earn and accumulate debt, the greater the likelihood of a more severe adjustment in the future.

Drivers of Slower Growth

For some time now we, like many other economic forecasters, have been expecting a slowdown in the economy, only to be surprised by further strength. As discussed in the Economic Chapter, some of the drivers we expect to slow growth in the year to March 2006 are already in train (e.g. net migration). There are others that are currently still supportive of growth but that we expect will reverse shortly (e.g. terms of trade) and therefore also have a slowing impact on growth in the March 2006 year. Some of the drivers impact on growth coincidentally, and others with a lag. The differences in the timing of these impacts show up in the divergence of indicators we monitor, and typically reflect the nature of a turning point in the economic cycle. On balance, our assessment is that these indicators are pointing to slower growth next year. Table 1.3 shows the development of a number of drivers over the past year, and how we see them impacting on growth in the year to March 2006.

Table 1.3 – Selected drivers

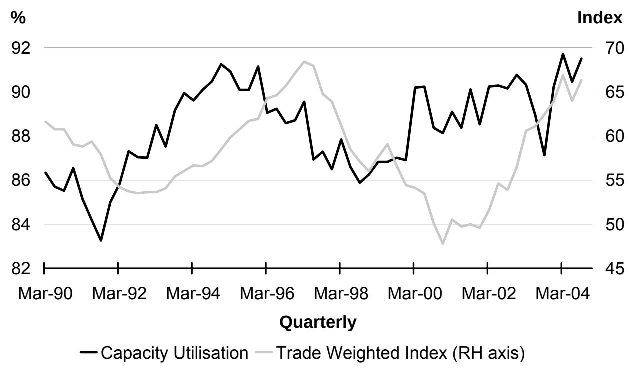
	12 months ago	Current	Change	Growth stimulus
Net migration (12 month total)	39,314	16,955	-56.9%	Less
Exchange rate (TWI monthly average)	64.5	68.3	5.9%	Less
Interest rates (OCR, %)	5.00	6.50	150 bps	Less
Trading partner growth (%)	3.1	4.4	1.3 ppt	More
Terms of trade (index)	1007	1080	7.2%	More
Fiscal policy (fiscal impulse as % of GDP) *	0.6	-0.3	-0.9 ppt	More

* A positive fiscal impulse represents a tightening of fiscal policy relative to the previous year. For more information on the fiscal impulse, refer to the "Fiscal Impulse and Structural Fiscal Balances" box in the *2003 December Update* economic chapter.

High exchange rate effect to be felt eventually…

Manufactured exports, which tend to be more sensitive to exchange rate movements, appear to be holding up despite the rising New Zealand dollar in the past two years. Unlike the last peak in the exchange rate cycle in the mid-1990s when manufactured export activity fell, current surveys of manufactured exporters report very high usage of capacity in their plant and machinery (figure 1.19). This could be due to stronger than expected global growth this year resulting in strong export demand, and exporters becoming more adept at managing exchange rate fluctuations. The lagged impact of the high exchange rate is still expected to affect export growth next year as hedging arrangements eventually unwind. An easing in global growth towards trend from next year will also result in lower demand for manufactured exports.

Figure 1.19 – Manufactured exporters' capacity utilisation and exchange rate



Sources: NZIER, Reserve Bank of New Zealand

The high exchange rate is expected to impact most on the international education sector, as New Zealand's price competitiveness has been eroded over the past two years. Anecdotal evidence points to a sharp fall in short-term foreign students, particularly from

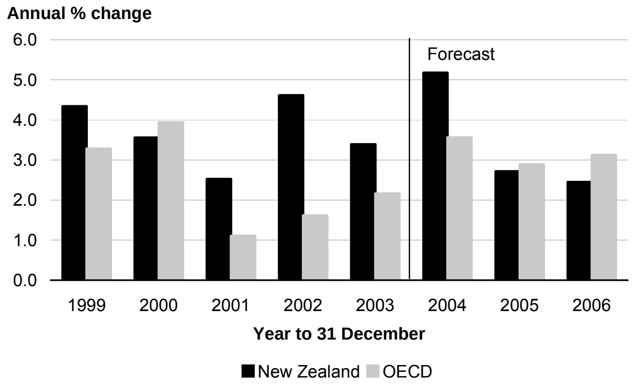
China. Student permit data from the New Zealand Immigration Service show that offshore approvals for the 12 months to October 2004 were almost 45% lower compared to the peak achieved in the 12 months to August 2002. While some recovery can be expected as the exchange rate starts to depreciate, the international education sector is unlikely to repeat the growth rates achieved over 2000-2002. Tourism growth is expected to remain resilient due to reductions in the cost of air travel, and the strength of New Zealand as a brand travel destination. However, the high exchange rate is expected to affect the average amount that tourists spend while in New Zealand.

In the near term, there is a risk that the New Zealand dollar could appreciate further against the United States dollar, particularly if there are growing concerns over the current imbalances in the United States economy. Further appreciation of the New Zealand dollar would have a more marked effect on the economy than forecast. In the Risks and Scenarios chapter 3, we provide an alternative path of the economy based on a stronger exchange rate.

New Zealand Growth Prospects Compared to OECD

The New Zealand economy is expected to outperform the OECD in calendar 2004 for the fourth consecutive year. In its latest *Economic Outlook*, the OECD projected aggregate growth of 3.6% for all its member countries, compared to our estimate of 5.2% growth for New Zealand. Over the following two calendar years, New Zealand is expected to grow at rates slightly below the OECD (figure 1.20).

Figure 1.20 – New Zealand vs OECD growth



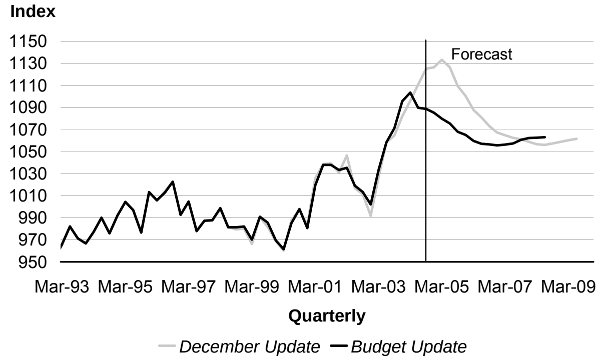
Sources: Statistics New Zealand, OECD, The Treasury

The relative growth performance of the New Zealand economy versus the OECD over the coming few years mainly reflects differences in the economic cycles. The OECD has rebounded from its cyclical lows of 2001 and is moving towards trend rates while the New Zealand economy is slowing from its cyclical high of 2004. Over the last decade New Zealand has averaged faster growth than the OECD, and abstracting from the economic cycle, is expected to at least match if not exceed the OECD's trend growth rates in the future.

… but export prices could continue to provide an offset

World export prices for New Zealand's major commodities are forecast to ease from their current high levels from next year as some of the temporary supply factors dissipate and global growth eases. A declining export price translating to a declining terms of trade is a key judgement in the forecast, resulting in lower rural incomes and eventually flowing through into lower consumption growth. The *Budget Update* incorporated a decline in the terms of trade which has not yet eventuated (figure 1.21). There is a risk in the near term that export prices continue to hold at high levels for longer, or even increase. If that were to occur, then economic activity could remain stronger for longer than forecast.

Figure 1.21 – SNA terms of trade (goods and services)



Sources: Statistics New Zealand, The Treasury

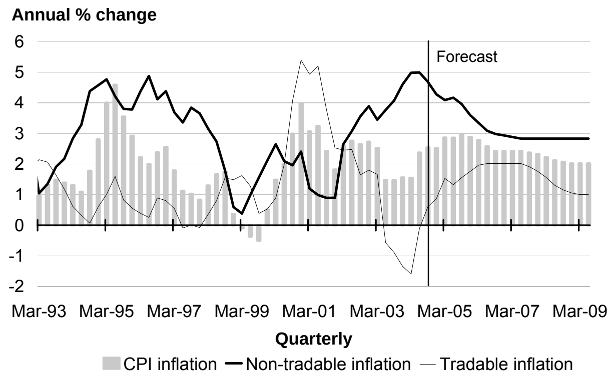
Labour market less of a source for future growth

Since the late-1990s, New Zealand's strong growth performance has been increasingly sourced from labour utilisation. This saw the unemployment rate drop to historic lows and the labour force participation rate rise to near historic highs. With the current tight labour market, the scope for further increases in labour utilisation to meet demand is somewhat limited, particularly with falling net migration providing less of a contribution to labour supply. The slowdown in growth over the coming two years will see the pace of employment growth slow from the current annual rate of 3% to less than 1% towards the end of 2005. The unemployment rate is forecast to fall towards 3.6% by the March 2005 quarter before rising towards 4.4% by mid-2007.

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

As a result of the tight resource pressures in the economy, annual CPI inflation is forecast to increase towards the top of the Reserve Bank's target band, peaking at 3% in the latter half of 2005. Resource constraints and rising wage pressures from a tight labour market, with wage growth forecast to increase by 4.5% in the year to March 2006, result in non-tradable inflation remaining high in the near term. As the economy slows over the coming year, non-tradable inflation is forecast to ease. This is expected to be offset by rising tradable inflation due to a depreciating exchange rate (figure 1.22).

Figure 1.22 – Inflation forecast



Sources: Statistics New Zealand, The Treasury

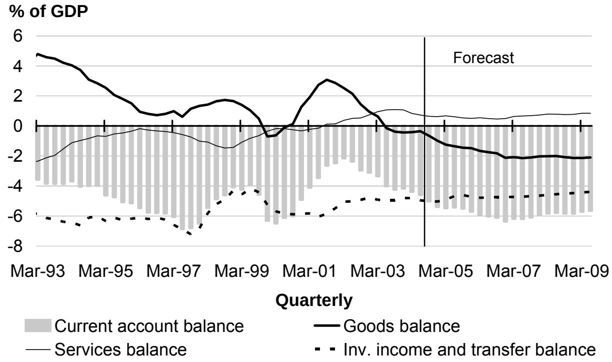
Annual CPI inflation should remain within the top half of the Reserve Bank's target band for over two years as resource pressures within the economy gradually unwind.

Short-term interest rates are expected to remain at around current levels until the end of next year, reflecting a balance between current persistent inflationary pressures and a slowing economy over the coming year. Interest rates are then forecast to gradually revert towards their neutral rates by the end of 2006.

Current account deficit to increase

The increase in the current account balance seen in 2001 on the back of strong terms of trade and high export volumes reversed in 2002 and has continued to decrease, despite the terms of trade being at high levels. The current account deficit is forecast to peak at 6.4% of GDP on an annual basis by the end of 2006 (figure 1.23). This increase in the deficit is driven initially by strong growth in import volumes to meet domestic demand; and further on by the falling terms of trade. With the Government's strong fiscal position over the forecast period and sound balance sheet position of businesses, the current account situation largely reflects the ongoing dis-saving by households. The improvement in the current account position further in the forecast period is due to households lowering their spending towards more sustainable levels. If households continue to consume at a faster rate than forecast, the current account deficit could increase more rapidly, risking a larger currency adjustment than we have factored in.

Figure 1.23 – Current account balance (four quarter rolling total)

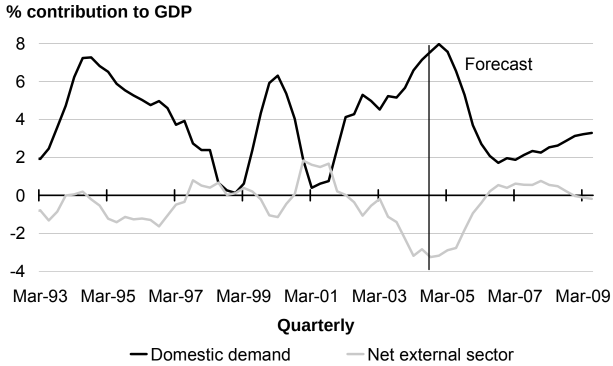


Sources: Statistics New Zealand, The Treasury

Growth to become more 'balanced' by 2008

The dichotomy in growth that has emerged over the past few years between the domestic and net external sectors of the economy is forecast to widen in the near term due to stronger near term strength in domestic demand (figure 1.24). The current divergence is not sustainable, and has contributed to more inflationary pressures and a widening current account deficit. The current imbalance in growth is forecast to unwind by 2008 as consumption and residential investment growth slows. The resulting lower import growth should mean the net external sector recovers.

Figure 1.24 – Contributions to GDP Growth



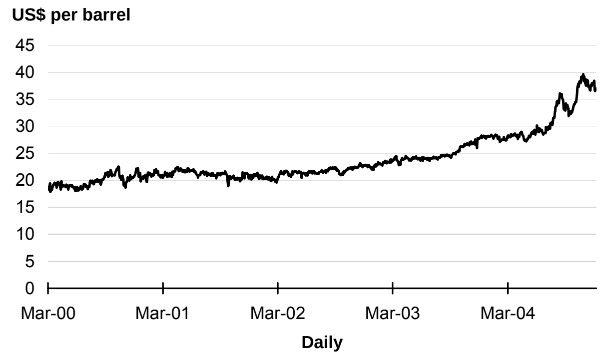
Sources: Statistics New Zealand, The Treasury

Oil Prices

Since the *Budget Update*, we have lifted our medium-term assumption for the price of oil. A combination of strong global demand for oil and continued supply concerns in Russia, Iraq, Nigeria and Venezuela has pushed oil prices to levels well above those assumed in the *Budget Update*. When the *December Update* forecasts were finalised, the West Texas Intermediate oil price was US$48.45 per barrel, the Brent crude oil price was US$43.21 per barrel, and the Dubai oil price was US$32.52 per barrel.

The International Energy Agency (IEA) estimate that demand for oil in China increased by 14.6% in 2004 or 0.81 million barrels a day after increasing 11.0% in 2003, and is forecast to increase by 5.6% in 2005. This increase in oil demand has been the result of fast economic growth. Demand in the rest of Asia increased 6.1% in 2004. Other regions to record strong growth were the countries formerly of the Soviet Union (4.1% or 0.15 million barrels a day) and the Middle East (6.1% or 0.34 million barrels a day). Elsewhere, demand has increased at a slower rate. For instance, in 2004 North American demand increased 2.0% (0.5 million barrels a day), and between 2% to 3% in each of Europe, Africa and Latin America.

Figure 1.25 – Long-dated futures price (NYMEX crude)



Source: Datastream

The lift in demand for oil looks to be a structural increase that is likely to be sustained and underpins our medium-term projections for the price of oil. Projection of short-term Brent oil prices in the *December Update* are based on futures prices at the time of finalising the forecasts. This sees a gradual decline in prices to US$43 per barrel in March 2005, and to US$40.50 per barrel by March 2006. By the end of the forecast period, the oil price is projected to reach US$35 per barrel, a large lift from the US$19.50 per barrel used in the *Budget Update*. This new price level is based on the long-dated futures price of Light Crude Oil, the longest futures contract available, of around US$38 per barrel with an adjustment for a margin that has existed in the past between this type of oil and Brent crude oil. The long-dated futures price has increased steeply in the last 12 months (figure 1.25). In December 2003 the price was US$30 per barrel, whereas when these forecasts were finalised on 19 November 2004 the price was US$43.21 per barrel. Since finalising the economic forecasts, however, the Brent crude oil price has declined by around 14% to US$37 per barrel.

The lift in oil prices will put downward pressure on the terms of trade, but has to date been offset by a lift in the prices of New Zealand exports.