

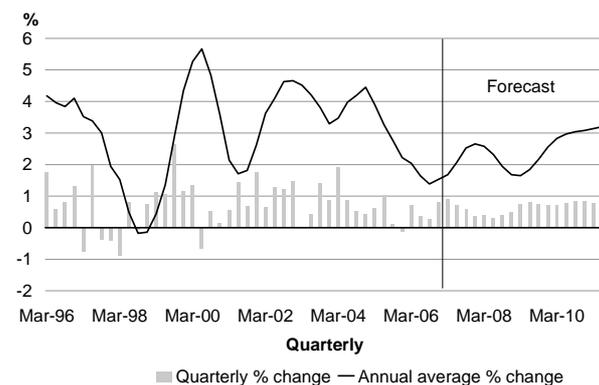
## Economic and Tax Outlook

### Summary

**Real Gross Domestic Product (GDP) growth has re-accelerated after a short period of below-trend growth**

- The economy expanded by 0.8% in the last quarter of 2006, a pace estimated to have been matched in the first quarter of this year.
- Quarterly real GDP growth is expected to be maintained at or just below potential (around ¾%) before easing in late 2007. The pace and duration of the current rebound is the main uncertainty of these forecasts.
- The central forecasts see annual average real GDP growth of 2.6% over the year to March 2008, up from 1.7% in the March 2007 year. Key risks and two alternative scenarios are explored in the *Risks and Scenarios* chapter.

**Figure 1.1 – Growth in real production GDP**



Sources: Statistics New Zealand, The Treasury

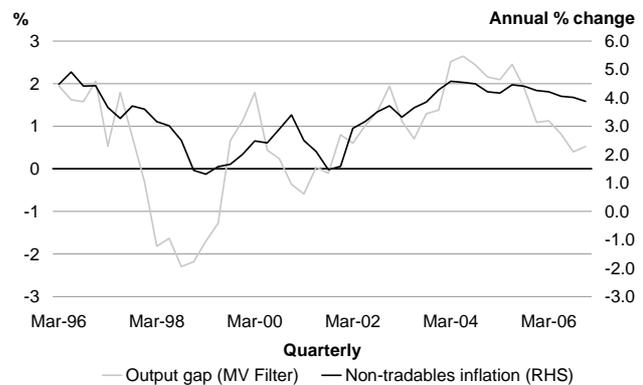
***The upswing is being driven by a rebound in domestic demand***

- Household consumption and investment spending have rebounded. The recent momentum is expected to be sustained for the next few quarters on the back of ongoing strong labour income growth. Additional support has come from somewhat lower oil prices, the recent pick-up in house price growth and immigration flows, the final stage of Working for Families and the high exchange rate keeping prices for imported goods and services low.
- Business investment has rebounded sharply, while government consumption and non-market investment are forecast to contribute around a total of 0.2 percentage points to quarterly growth.

***The brief period of slower growth was not enough to lower inflation pressures which remain elevated and the exchange rate is near post-float highs***

- Despite an expected temporary easing in annual Consumers Price Index (CPI) inflation to 1.7% in September 2007, associated with volatile petrol prices and the high exchange rate, the domestic, non-tradables bias of growth means strong medium-term inflation pressures are forecast to persist. CPI inflation is expected to return to near the top of the 1% to 3% target range by March 2008.

**Figure 1.2** – Output gap and annual non-tradables inflation



Sources: Statistics New Zealand

- Recent increases in the prices of some major export commodities have boosted the terms of trade, which is forecast to contribute to a fall in the current account deficit over 2007. Nevertheless the current account deficit is expected to remain above its long-run average.
- In response to more persistent inflation pressures, short-term interest rates are expected to be higher for longer than forecast in the *Half Year Update*.

***The upswing in growth is not expected to be sustained, allowing inflation to ease eventually***

- Effective mortgage interest rates are expected to increase to an even greater extent, reflecting the rise in swap rates and the recent increase in bank margins on fixed rate loans. This contributes to an eventual decline in household spending growth.
- Real GDP growth is expected to slow to 1.6% in the March 2009 year. The unemployment rate is forecast to rise to around 4½% in mid-2009 from 3.7% at the end of 2006.
- The slower period of growth during the March 2009 year is forecast to lead to an easing of non-tradables inflation. CPI inflation is forecast to decline to 2.4% in March 2009, despite solid tradables inflation owing to a forecast depreciation of the exchange rate.

***Eventually growth returns to trend and the pattern of growth becomes more balanced as interest rates and the exchange rate fall***

- Export volume growth is expected to increase in the later forecast years as growth in services and manufactured exports accelerates following the forecast exchange rate depreciation from 2008. A lower exchange rate also acts to reduce import growth. The current account deficit is forecast to fall to around 6% of GDP.
- Despite lower interest rates, weak household spending growth is forecast to continue for a sustained period as people respond to higher debt servicing costs, falling house prices and net wealth, and slower income growth. Somewhat higher unemployment will also make households less sure about job security.

- Real GDP growth of around 3% is forecast for the March 2010 and 2011 years – around potential.

***The more cyclical outlook for growth and inflation will be mirrored in tax revenue growth***

- A higher level of inflation, a lift in the terms of trade and near term strength in domestic demand all contribute to a higher level of nominal GDP than forecast in the *Half Year Update* until the middle of 2009.
- Forecasts of tax revenue growth have been revised up for the 2007 and 2008 fiscal years, mainly on the back of higher growth in source deductions (PAYE), GST and Resident Withholding Tax (RWT).
- In the 2009 June year, the Business Tax Reform (BTR) announced in the Budget sees corporate tax revenue decline and overall tax grow at a pace below nominal GDP growth.
- Notwithstanding the tax policy changes which reduce the tax take, the ratio of tax revenue is forecast to end the forecast period little changed from what it was in the year to June 2006, and higher than forecast in the *Half Year Update*. This reflects the removal of the judgement concerning corporate tax losses built into recent forecasts, and labour receiving a greater share of nominal GDP.

**The discussion of the forecasts that follows is separated into four parts:**

- **the slowdown during the 2005 and 2006 calendar years**
- **the current re-acceleration in growth**
- **a forecast slowdown in the March 2009 year, and**
- **a return to trend growth in the years to March 2010 and 2011.**

**Table 1.1** – Economic outlook: central forecast<sup>1</sup>

<b>Economic outlook: central forecast<sup>1</sup></b>						
<b>(Annual average % change, year to 31 March)</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
	<b>Actual</b>	<b>Estimate</b>	<b>Forecast</b>	<b>Forecast</b>	<b>Forecast</b>	<b>Forecast</b>
Private consumption	4.3	1.7	3.2	1.6	1.6	1.6
Public consumption <sup>2</sup>	4.7	4.4	4.1	3.9	4.0	3.5
<b>Total consumption</b>	<b>4.4</b>	<b>2.3</b>	<b>3.4</b>	<b>2.1</b>	<b>2.1</b>	<b>2.1</b>
Residential investment	-4.7	-2.3	3.4	-1.9	-0.5	0.9
Central government investment	6.4	-3.4	4.1	-0.5	-1.7	-0.3
Other investment	7.5	-4.6	5.8	0.2	1.4	4.2
<b>Total investment</b>	<b>4.1</b>	<b>-4.0</b>	<b>4.9</b>	<b>-0.3</b>	<b>0.8</b>	<b>3.3</b>
Stock change <sup>3</sup>	-0.5	-0.4	0.8	-0.1	-0.2	-0.1
<b>Gross national expenditure</b>	<b>3.9</b>	<b>0.6</b>	<b>4.4</b>	<b>1.4</b>	<b>1.6</b>	<b>2.3</b>
Exports	-0.3	3.1	0.4	3.5	4.1	4.1
Imports	4.1	-1.2	4.8	2.2	0.4	1.6
<b>GDP (production measure)</b>	<b>2.0</b>	<b>1.7</b>	<b>2.6</b>	<b>1.6</b>	<b>2.8</b>	<b>3.1</b>
- annual % change	1.8	2.3	2.1	1.9	3.0	3.3
Real GDP per capita	1.1	0.6	1.5	0.7	1.9	2.3
Nominal GDP (expenditure basis)	4.6	4.4	5.6	3.5	4.2	4.8
GDP deflator	2.1	2.3	2.6	1.9	1.4	1.7
Employment <sup>4</sup>	2.7	1.8	0.8	1.0	0.5	1.3
Unemployment <sup>5</sup>	3.9	3.8	3.9	4.5	4.4	4.3
Wages <sup>6</sup>	4.7	4.8	4.1	4.0	4.0	3.6
CPI inflation <sup>7</sup>	3.3	2.6	2.7	2.4	2.4	2.2
Export prices <sup>8</sup>	1.0	8.8	-2.6	4.2	9.1	5.5
Import prices <sup>8</sup>	1.8	7.3	-6.0	4.1	9.8	5.7
Current account balance						
- \$ million	-14922.0	-13933.2	-12676.9	-12593.1	-12844.5	-12100.9
- % of GDP	-9.6	-8.6	-7.4	-7.1	-6.9	-6.2
TWI <sup>9</sup>	68.3	68.8	69.0	62.3	56.9	54.5
90-day bank bill rate <sup>9</sup>	7.6	7.8	8.0	6.7	6.3	6.2
10-year bond rate <sup>9</sup>	5.7	5.8	6.1	6.1	6.1	6.0

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

NOTES: 1 Forecasts finalised on 16 April 2007.

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 Annual percentage change.

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* – global economic growth, inflation and interest rate forecasts are taken from the March 2007 *Consensus Forecasts* and *Asia Pacific Consensus Forecasts*. The general outlook remains positive and for steady growth of around 3.6% for our top 14 trading partners over the period. The outlook for the United States economy in 2007 has weakened recently, with growth expected to be only 2.4% in 2007, but stronger growth is now expected in Japan and the Euro Zone in the near term. Growth in Australia is expected to be 3.0% in 2007; and 2.6% in the UK.

*Oil prices* – prices for West Texas Intermediate (WTI) in the December quarter of 2006 matched the assumption in the *Half Year Update*, but lower prices in early January contributed to March quarter prices averaging US\$58/barrel – around US\$4 below the *Half Year Update* assumption. Futures pricing at the time these forecasts were finalised suggested that prices will increase to US\$68/barrel in June 2008 and not fall below this point until the start of 2010. Prices end the forecast period at around US\$67/barrel, about US\$2/barrel higher than in the *Half Year Update*.

*Net migration* – net migrant inflows of around 13,000 are expected in the year to March 2007. Net migration levels are then assumed to fall by around 1,000 a year over the next three years so that net migration totals 12,000 in the year to March 2008, 11,000 in the year to March 2009 and 10,000 in the years to March 2010 and 2011.

*Monetary conditions* – the NZ dollar exchange rate as measured by the Trade Weighted Index (TWI) is assumed to average 70.0 over the June quarter of 2007 and 69.0 during the next three quarters through to March 2008, before easing to 62.3 in March 2009, 56.9 in March 2010 and 54.5 in March 2011.

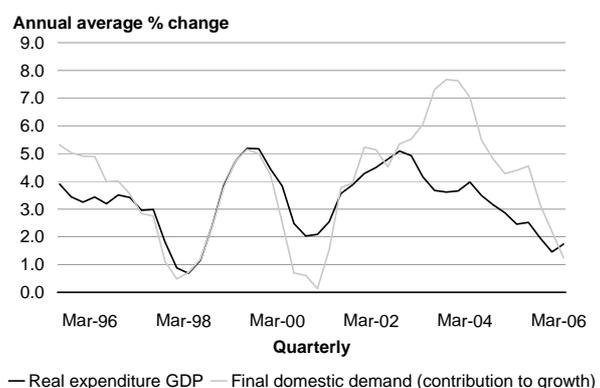
*Climate* – agricultural growing conditions and the level of hydro electricity storage lakes are assumed to be normal over the forecast period.

## Growth Eased in 2005 and 2006

### *New Zealand's rate of economic growth slowed in 2005 and 2006 ...*

During 2005 and most of 2006 New Zealand's annual average rate of growth slowed, with real expenditure GDP growth falling from 4.0% at the end of 2004 to 1.5% in September 2006. This followed a period of strong growth between 2002 and 2004, in which real expenditure GDP growth peaked at 5.1% in June 2003. The slowing in domestic demand growth was particularly marked – the contribution to GDP growth from final domestic demand has declined sharply from over seven percentage points during 2004 to just over one percentage point in the year to December 2006.

**Figure 1.3** – Real GDP and final domestic demand



Source: Statistics New Zealand

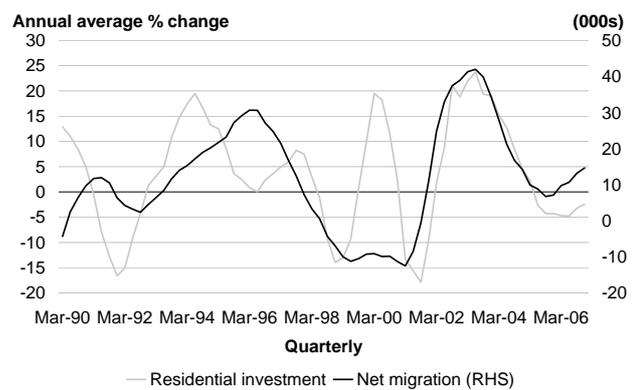
**... as a range of negative forces came together**

Reversals in some of the same factors which contributed to the period of strong growth from 2002 to 2004 were behind the slowdown in the 2005 and 2006 calendar years. Declining migration, slowing house price growth and tighter monetary conditions in the latter period led to slower household and business spending, overcoming the effects of the generally high terms of trade, strong labour market and an increase in government consumption and investment spending, which all acted to support growth.

**Net migration gains have eased from their peak, contributing to slower growth**

Annual net migration inflows eased from their peak of 42,500 in mid-2003 to a trough of 6,000 in late 2005 as a result of lower student arrivals, a strengthening NZ dollar and slowing economic growth. An easing in net migration meant less additional demand for housing, with both slower growth in prices for existing houses and a decline in new housing construction. The latter directly reduced domestic demand growth, while slower house price growth acted to slow the rise in households' wealth and hence their willingness to consume at the same pace as previously.

**Figure 1.4** – Net migration and residential investment



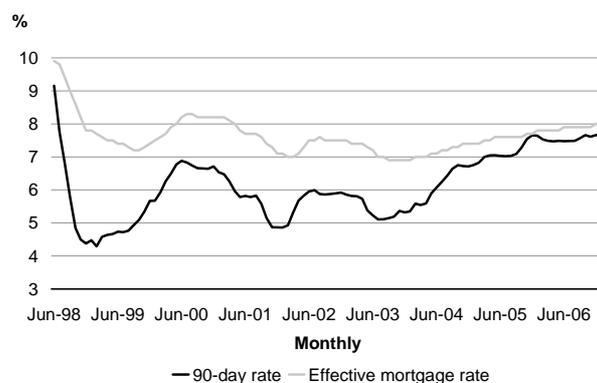
Source: Statistics New Zealand

Annual average growth in private consumption slowed from 6.0% in 2004 to 2.0% in 2006, while growth in residential investment declined – from a peak of nearly 25% in mid-2003 to falls during most of the past two years.

**Higher interest rates have slowed growth in domestic demand, but with a lag ...**

Ninety-day interest rates increased from around 5% in mid-2003 to around 7.5% at the end of 2005. However, the full effect of higher short-term rates was not reflected in effective mortgage rates which increased by less than one percentage point over the same period as a result of access to lower-cost funding from offshore and competition amongst lenders that encouraged borrowers to shift to lower longer-term fixed rates. Despite this, debt servicing costs increased steadily, acting as a drag on household disposable income.

**Figure 1.5** – Short-term interest rates and the effective mortgage rate



Source: Reserve Bank of New Zealand

Higher interest rates also increased firms' financing costs and reduced the attractiveness of additional capital investment. Combined with slower growth in sales, this contributed to growth in business investment declining from a peak of over 15% in mid 2004 to an absolute decline at the end of 2006. Overall, annual average growth in gross national expenditure slowed from 4.0% in 2005 to 0.4% in 2006.

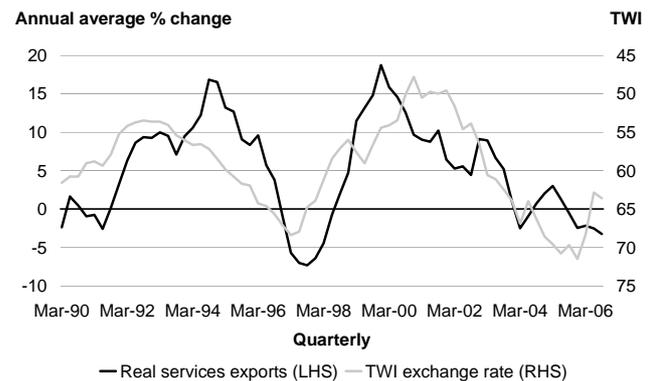
**... and the high exchange rate has slowed growth in exports**

Increasing terms of trade and large positive interest rate differentials saw the NZ dollar appreciate from below 50 on the TWI in late 2000 to an average of 70.4 in 2005. This has contributed to slower growth in export volumes, particularly for services. Annual export growth declined from an average of 4.4% in the period from 2002 to 2004 to negative in late 2005 to early 2006.

**The terms of trade have generally boosted activity ...**

New Zealand's terms of trade have trended up since 2002 as strong growth in the world economy was accompanied by increased demand for New Zealand's export products and various disruptions affected competing agricultural producers. The continuing strength in the terms of trade supported export returns, providing a partial offset to the appreciation of the NZ dollar. The higher exchange rate also increased households' real incomes as it lifted their purchasing power relative to the rest of the world. This provided some support to private consumption growth. However, increases in oil prices since early 2004 detracted from household disposable income and growth in private consumption during the 2005 and 2006 calendar years.

**Figure 1.6 – Services exports and TWI**



Sources: Statistics New Zealand, Reserve Bank of New Zealand

**... and the labour market and government spending have also provided support**

The labour market remained buoyant, even with the slowdown in growth. Employment growth was robust, participation reached a record high in mid-2006 and the unemployment rate was below 4% from the second half of 2004. Labour income growth was strong, supporting private consumption and residential investment.

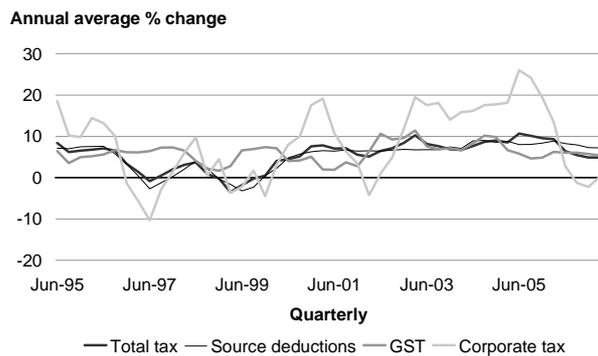
Government transfers, and public consumption (averaging 4.6% growth since the start of 2004) and investment spending also supported growth in domestic demand, both directly and via household spending. However, with receipts growing at an even faster pace, the government in aggregate was withdrawing resources from the economy.

### ***Growth in tax receipts has slowed in line with the easing in activity***

With the slowing in economic growth, growth in tax receipts has eased in the past two years. The largest contributor to this easing was corporate tax, the growth of which declined from a peak of 26% in 2005 to around zero in the year to March 2007, reflecting the trend in corporate profits through that period. The growth rates of the two largest tax types, source deductions and GST, have slowed only marginally since 2005, supported by the recent strength in labour incomes and private

consumption mentioned above. Overall, growth in total tax receipts was just under 5% in the year to March 2007, after being up around 10% in 2005.

**Figure 1.7 – Tax component growth**



Source: The Treasury

### ***Resource pressures remain intense and macroeconomic imbalances remain***

Despite the period of slower growth, the economy still appeared to be operating at or above capacity. Indicators of firm capacity utilisation remain at a high level, the unemployment rate is near its recent low and firms continue to record difficulty in finding labour at prevailing wages. Annual non-tradables inflation remained above 4% for the three years since December 2003.

The domestic demand-dominated nature of growth led to a widening of the current account deficit from 3.2% of GDP at the start of 2002 to a peak of 9.7% in June 2006. While the deficit reduced slightly in the second half of 2006 as growth in domestic demand – and imports – began to ease and profitability of local firms levelled off, at 9.0% of GDP the deficit remained high at the end of 2006.

## **Growth Rebounded in Late 2006 and Early 2007**

### ***A rebound in some drivers of growth ...***

Many of the forces which led to the slower growth in the economy in 2005 and 2006, particularly in domestic demand, rebounded towards the end of 2006. Net migration inflows increased, house price growth re-accelerated, petrol prices fell and world prices for some key export commodities increased further. In addition, the labour market and government expenditure have provided continuing support and in aggregate these are outweighing the impact of tighter monetary conditions.

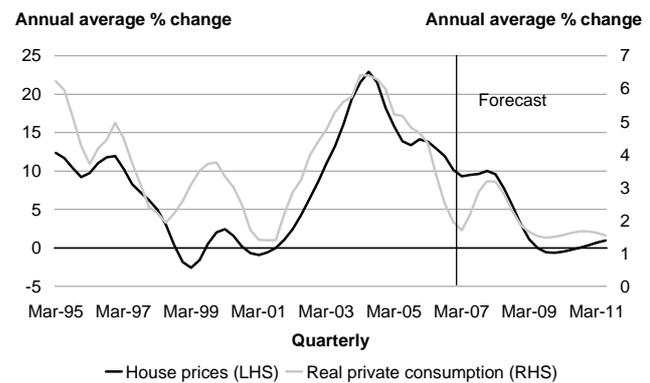
**... has seen economic growth re-accelerate and led to a reappraisal of the near term outlook**

Real production GDP increased 0.8% in the December 2006 quarter – stronger than the 0.4% increase forecast in the *Half Year Update*. The expenditure measure of GDP, at 1.2%, increased to an even greater extent, with 3.3% gross national expenditure (GNE) growth. Partial activity indicators point to the pace of growth being maintained in the first quarter of 2007. GNE growth of 4.4% is now forecast for the year to March 2008, compared with 1.7% forecast in the *Half Year Update*.

**Net migration increased in late 2006 ...**

The increase in net migration inflows from their trough of 6,000 in late 2005 to 15,000 in late 2006 contributed to the resurgence in house price growth and private consumption recorded in late 2006 and early 2007. Private consumption expenditure grew 1.1% in the final quarter of 2006, more than in the first three quarters of the year as a whole. Consumption growth is expected to remain solid over the next couple of quarters, lifting annual average growth from 1.7% in March 2007 to 3.2% in March 2008. House price growth has picked up recently and further solid increases are expected until mid-2007, supporting private consumption and encouraging residential investment growth.

**Figure 1.8 – Consumption and house prices**



Sources: Quotable Value New Zealand, Statistics New Zealand, The Treasury

**... the terms of trade continue to reach new cyclical highs ...**

The terms of trade increased sharply in the December quarter of 2006, and are expected to increase further during 2007. International dairy spot prices increased 45% in the six months to March 2007, as a result of the drought in Australia and increases in stockfeed prices in the United States, and are likely to remain high through 2007. World oil prices fell 15% in the December quarter of 2006 from their average of around US\$70/barrel in mid-2006, and eased a further 3% in March 2007. These developments will support private consumption growth in the near term as lower petrol prices translate into increased household disposable incomes.

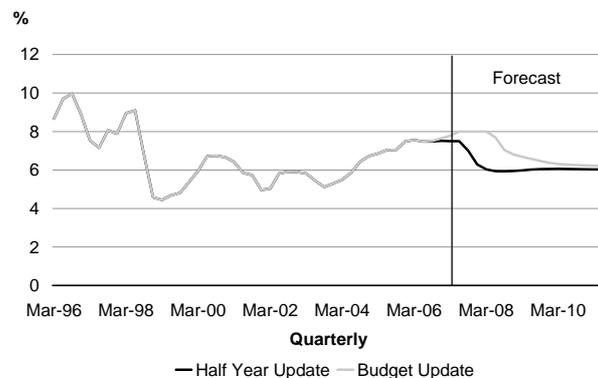
**... and the labour market remains buoyant**

Labour income growth remained buoyant in the second half of 2006, despite a slight fall in employment. Solid labour income growth is expected over much of 2007 as wage growth remains around recent levels and employment levels remain high. These are forecast to support private consumption growth and residential investment in the near term. The increase in Working for Families payments that took effect on 1 April 2007 will work in the same direction by increasing household incomes.

### **Domestic demand expected to remain solid in 2007, despite higher interest rates ...**

Ninety-day interest rates increased to around 8.0% in April 2007 as the Reserve Bank increased the official cash rate to 7.75% on 26 April. In addition, local banks have raised their retail mortgage rates for two-year and five-year fixed-rate loans to increase their margins. Interest rates are now expected to be higher for longer than in the *Half Year Update*, because of the stronger domestic demand and increased inflation pressures that are expected to arise as a result. The increase in interest rates, and the impact of past rate rises progressively being reflected in effective mortgage rates, are expected eventually to dampen consumption and investment demand. However, over the near term other factors (discussed above) are forecast to dominate, resulting in some continued momentum in domestic demand growth in 2007. How long this lasts is a key judgement which is explored in the *Risks and Scenarios* chapter.

**Figure 1.9 – 90-day interest rates**

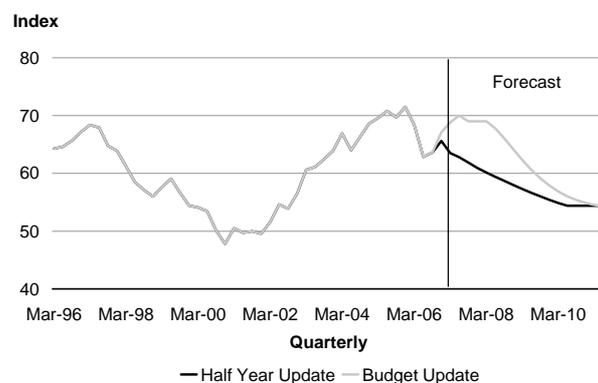


Sources: Reserve Bank of New Zealand, The Treasury

### **... but the high NZ dollar will limit export growth and increase import growth**

The NZ dollar reached a new post-float high of just under US\$0.75 in April 2007. At its current level above 70.0 on the TWI, the NZ dollar is well above its estimated equilibrium value and adversely affecting returns to many exporters. Together with robust domestic demand growth, the high dollar is expected to see import growth remain strong. The dollar is assumed to average around 69.0 on the TWI through to March 2008, higher than in the *Half Year Update*. Export volume growth is expected to decline to 0.4% on an annual average basis in March 2008, while import volume growth is expected to peak at 5.6% in the 2007 calendar year.

**Figure 1.10 – TWI exchange rate**



Sources: Reserve Bank of New Zealand, The Treasury

### **Businesses are positive about their own prospects ...**

Business investment growth increased in the second half of 2006. This likely reflected the renewed strength in domestic spending, the high exchange rate reducing the cost of imported investment goods, as well as difficulties in finding labour and increasing labour costs. Businesses remained positive about the outlook for their own activity in early 2007 and investment and employment intentions were positive. Business investment is estimated to have remained strong in the first quarter of 2007 and the annual average rate of growth is expected to reach 5.8% in March 2008.

**... and growth in domestic demand is forecast to remain strong over most of 2007**

Production GDP is estimated to have increased by 0.9% in the March 2007 quarter, taking annual average growth to 1.7%, off its low of 1.4% recorded in September 2006. Quarterly growth rates are expected to ease over the next two quarters, but annual average growth will reach 2.9% in September 2007. Growth in GNE is estimated to be stronger at 1.4% in the March quarter and forecast to be 1.0% in each of the next two quarters, taking annual average growth to 4.7% in 2007 as a whole.

**Non-tradables inflation will remain high for some time**

The resurgence in domestic demand in the last quarter of 2006 and the first quarter of 2007 led to higher inflation in non-tradable goods and services in the March 2007 quarter, with a quarterly increase of 1.2% and an annual increase of 4.1%. Consumer price inflation is expected to fall below 2.0% in June and September 2007 but to increase again to 2.6% in December 2007, with past changes in petrol prices responsible for the volatility. With the recent resurgence in domestic demand, inflation is expected to be higher throughout the forecast period than forecast in the *Half Year Update*.

**Growth Forecast to Slow and Imbalances Expected to Subside During 2008 and 2009**

**The impetus to growth from a number of current drivers is expected to weaken**

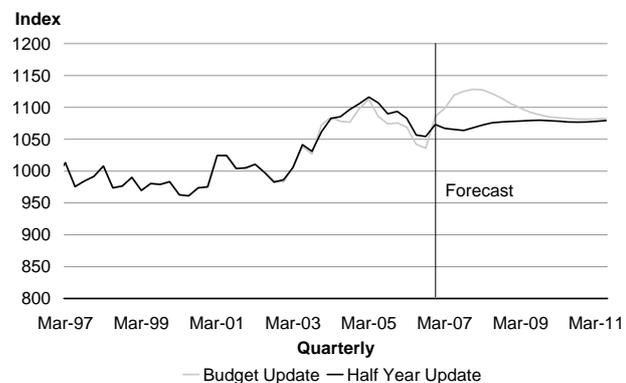
The aggregate effects of the above forces that are currently boosting growth are expected to wane as 2007 progresses. From late 2007 and through most of 2008, we expect the influence of the high exchange rate and higher interest rates to become the more dominant driver of the economy.

The central forecast assumes that the TWI will average around 69.0 through to March 2008, with most of the factors currently supporting the NZ dollar expected to remain in place. This level is below 71.7, the rate prevailing at the time the forecasts were finalised.

**Export revenue growth is likely to continue to be restricted by the high level of the exchange rate and a forecast decline in the terms of trade ...**

Export revenues are forecast to be flat through most of 2008. This reflects the impact of the level of the exchange rate, as well as a forecast decline in the terms of trade during the 2008 calendar year. We expect that the factors currently pushing the world prices of some exports, particularly dairy, to record high levels will not be sustained throughout the forecast period. Supply conditions in other parts of the world are expected to return closer to normal levels, while demand is expected to ease somewhat, given the current high prices.

**Figure 1.11 – SNA total terms of trade**



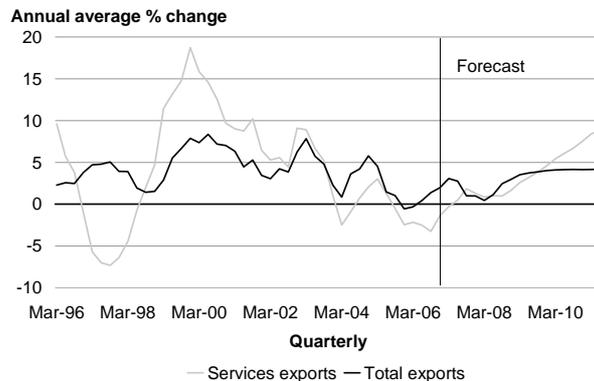
Sources: Statistics New Zealand, The Treasury

The assumed depreciation of the exchange rate during 2008 is consistent with the forecast decline in the terms of trade and a narrowing of interest rate differentials.

**... while volumes, particularly of services exports, are forecast to remain under pressure during 2008 ...**

Our estimates suggest that exchange rate sensitive components of export volumes, particularly services, forestry and manufacturing, are affected by the exchange rate with a lag of around three to four quarters. The high level of the exchange rate has limited export volume growth in recent times, and with the depreciation in the exchange rate in the central forecast not expected to occur until the middle of 2008, a sizeable increase in export volumes is not expected until the latter part of 2008 and then more strongly in 2009.

**Figure 1.12 – Export volumes**



Sources: Statistics New Zealand, The Treasury

**How long the exchange rate remains at elevated levels is a key judgement in the central forecast**

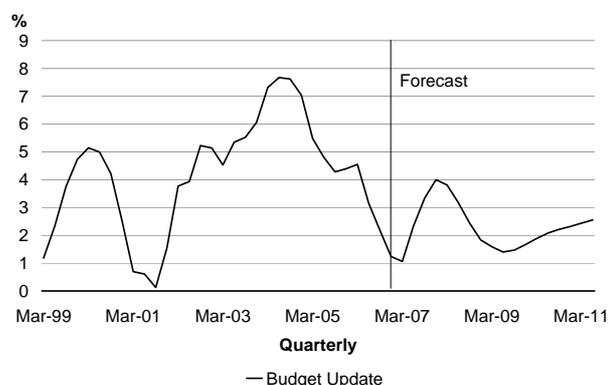
New Zealand’s historical experience shows that the exchange rate can move through large cycles. If the level of the exchange rate reached during April 2007 is maintained for only a short period of time, followed by a depreciation, the effect on export volumes will not be as large as in the central forecast. The *Risks and Scenarios* chapter highlights a scenario where the exchange rate depreciates quickly.

**Increases in effective interest rates during 2007 are expected to lead to an easing in domestic demand ...**

Most home loans in New Zealand are for fixed durations, albeit of a relatively short nature. As a result it takes time for increases in the Official Cash Rate (OCR) to flow into the actual interest costs faced by households, and therefore some time to affect their behaviour. Although people have moved onto longer-term loans, they will eventually feel the effect of past rate rises.

In such an environment we expect households to be more cautious about increasing their expenditure through the accumulation of debt than in the recent past and this is forecast to reduce private consumption growth. The level of household debt is forecast to increase, but the rate of increase is forecast to be slower than in the recent past. Households are also likely to be more reluctant to undertake substantial new investments in housing. Residential investment is forecast to fall by around 5% in the year to March 2009.

**Figure 1.13 – Final domestic demand – percentage point contribution to growth**



Sources: Statistics New Zealand, The Treasury

Further discussion of some of the factors affecting household decisions is provided in the box titled “Drivers of Private Consumption”.

**... and an end to house price increases**

Higher interest rates, as well as declining GDP growth rates, are forecast to lead to an easing in demand for houses. A small fall in house prices is forecast between March 2008 and March 2009. The end of large house price increases will see households’ net wealth position retrace some of the increases made over recent years, removing one of the key drivers of the recent strength in private spending.

**Fiscal policy is expected to make a smaller contribution to domestic demand**

Additions to government spending are forecast to be smaller during the 2009 March year than in the preceding years, with the additional impetus from Working for Families easing and slower growth in public consumption and non-market investment. The impact of government assistance through the Working for Families package is touched on in the “Drivers of Private Consumption” box.

While the contribution to domestic demand from government spending is expected to be smaller during the 2009 March year onwards, compared with the two to three preceding years, the combined influence of public consumption and non-market investment is forecast to provide a relatively steady contribution of just under ¾ percentage points to annual average growth.

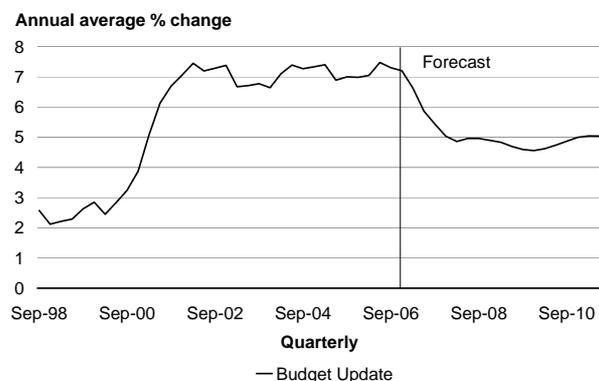
**Low export growth and slowing domestic demand add up to a period of weak GDP growth ...**

A period of below-trend GDP growth is forecast during the 2008 calendar year, with quarterly growth rates of ¼ -½% expected throughout the year. As a result, annual average GDP growth is forecast to fall to 1.6% in the 2009 March year.

**... and a softer labour market outlook**

The outlook for profit growth in the March 2009 year is weak. Slowing economic activity is forecast to be followed by an easing in employment growth, a lift in unemployment and easing in wage inflation. Slowing domestic demand is likely to adversely affect the profitability of firms and – as margins and profits come under pressure – it is likely that weak employment growth will see the unemployment rate rise. The unemployment rate is forecast to increase to 4.6% during the middle of the 2009 calendar year. A weaker labour market is also expected to lower the rate of income growth, with the annual average growth rate of compensation of employees expected to decline to 4.8% in March 2009, after generally being in the 6.5% to 7.5%

**Figure 1.14 – Compensation of employees**



Sources: Statistics New Zealand, The Treasury

range throughout the period June 2001 to December 2006. This leads to a fall in the rate of growth of tax revenue from source deductions.

***The reaction of households to the gradual removal of a number of the drivers of the recent re-acceleration in activity is an important judgement***

To date, household spending has proved resilient in the face of higher interest rates. This in part reflects the partially offsetting effects coming from steady labour income growth, low unemployment and the effect on import prices of exchange rate appreciation. While the central forecast incorporates a sustained period of weak growth, there is still a risk that domestic demand maintains momentum for a longer period of time. The *Risks and Scenarios* chapter describes the possible result of this outcome.

***The forecast easing in domestic demand and the eventual depreciation of the exchange rate are forecast to lead to a slow unwinding of imbalances ...***

A positive output gap (where GDP exceeds the economy's capacity to produce goods and services without generating high rates of inflation) has opened up in recent years. This generated pressure on available resources in the economy and led to the prolonged period of high non-tradables inflation recorded since 2004. Looking forward, sub-trend quarterly growth is expected to eventually generate a negative output gap, removing non-tradables inflation pressure from the economy.

***... with CPI inflation forecast to ease, allowing room for cuts in interest rates***

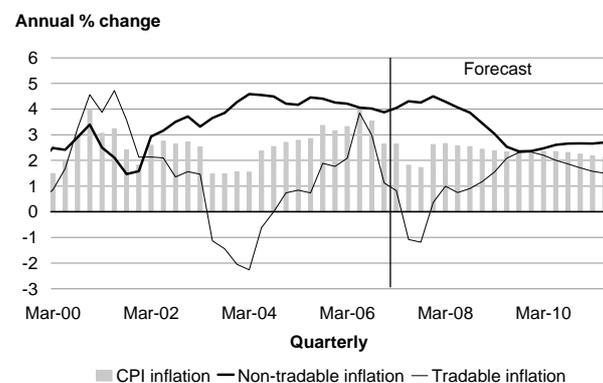
The easing of pressure on resources as the economy slows is expected to lead to slowing rates of non-tradables inflation. However, the assumed depreciation of the exchange rate during 2008 adds to tradables inflation and means that total CPI inflation is forecast to remain at 2.4% in 2009 and 2010.

The easing of non-tradables inflation is closely linked to productivity growth. The central forecasts incorporate productivity growth lifting to an average of around 1.5% over the

forecast period, following lower productivity growth over recent times. A period of weaker productivity growth during the forecast period would be associated with lower potential GDP, and consequently a combination of lower actual GDP growth and/or higher inflation.

With inflationary pressures dissipating during 2008 and GDP growth rates easing, interest rates are forecast to begin to fall during 2008, after remaining at high levels throughout 2007.

**Figure 1.15 – Inflation**



Sources: Statistics New Zealand, The Treasury

### Drivers of Private Consumption

A key area of judgement in our forecasts is the domestic demand outlook – particularly with respect to private consumption. Private consumption growth is forecast to rebound during 2007 after a period of weak growth during 2005 and 2006, before moderating again in the March 2009 year and remaining low thereafter. Some of the factors driving this are discussed in this box.

Increasing interest payments, rising debt levels and high petrol prices all contributed to slower consumption growth during 2005 and 2006. Table 1.2 provides some aggregate estimates of the net *additions* or *subtractions* to aggregate household cash flows/balance sheets from these different sources over recent years, as well as forecasts for the 2008 and 2009 years.

Factors contributing to the current rebound in private consumption spending include:

- ongoing labour income growth (increasing \$4 billion in the year to June 2007)
- the increase in Working for Families payments (around \$900 million in the year to June 2007)
- the drop in petrol prices (\$400 million in the year to June 2007), and
- house price growth is estimated to have added \$38 billion to household wealth over the year to June 2007).

On the downside, increased debt is estimated to subtract around \$11 billion from household net worth in the year to June 2007, while interest payments increase by around \$1.1 billion.

Interest payments are expected to increase by a total of \$3.9 billion across the period from 2006 to 2009 as a result of high interest rates and an increased level of debt. The fall in the NZ dollar is expected to lead to higher petrol prices and higher prices for other imports. The cumulative impact of these factors, as well as a smaller boost to incomes from the labour market and Working for Families, is expected to moderate private consumption growth by June 2009.

Changes in household wealth are also expected to affect the household decisions. Rising debt levels are forecast to curb consumption growth by causing households to become more

precautionary and less willing to take on an increasing amount of debt. A slowdown in the growth in value of housing assets from \$30 billion in the 2008 June year to \$10 billion by June 2009 is also forecast to reinforce the slowdown.

**Table 1.2 – Aggregate incremental impacts on households of selected drivers**

June years (\$ billion)	Past 2006	Current 2007	Forecast 2008	Forecast 2009
<b>Nominal private consumption</b>	5.2	4.6	4.8	3.8
<b>Changes in income and expenses<sup>1</sup></b>				
Petrol prices	-0.9	0.4	-0.3	0.0
Interest payments	-1.3	-1.1	-1.2	-0.3
Labour income	4.7	4.0	3.6	3.6
Tax on labour income	-1.5	-1.4	-1.3	-1.4
Total transfers	0.9	1.3	0.8	0.5
<i>of which...</i>				
Working for Families	0.5	0.9	0.3	0.0
<b>Balance sheet</b>				
Debt impact on net worth	-11.2	-9.5	-10.6	-10.2
Housing assets <sup>2</sup>	51	38	30	10

<sup>1</sup> A negative refers to an increase in an expense or decrease in income.

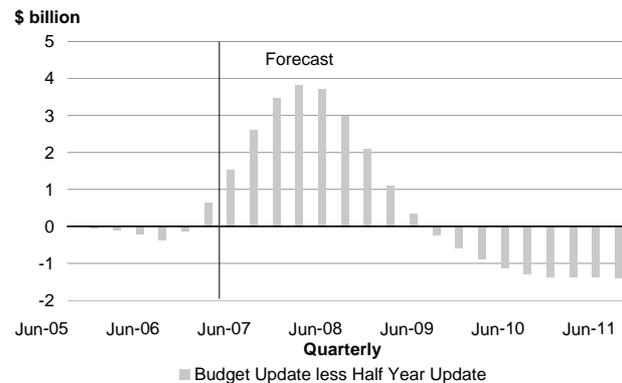
<sup>2</sup> The effect of changes in house prices (this figure does not include the effect on assets of additional residential investment).

Sources: The Treasury, Spicers, Statistics New Zealand

**Nominal GDP growth rates also fall but the level of nominal GDP remains higher than the Half Year Update until late 2009 ...**

Slow growth in real GDP, falls in the terms of trade and a fall in inflation all contribute to nominal GDP growth falling from 5.6% in March 2008 to 3.5% in March 2009. Nevertheless, a higher rate of inflation than in the *Half Year Update* throughout the forecast period together with a sustained higher terms of trade throughout 2008, combine to take nominal GDP to a substantially higher level than forecast in the *Half Year Update* in the March 2008 and 2009 years.

**Figure 1.16 – Change in nominal GDP**



Sources: Statistics New Zealand, The Treasury

**... boosting tax revenue**

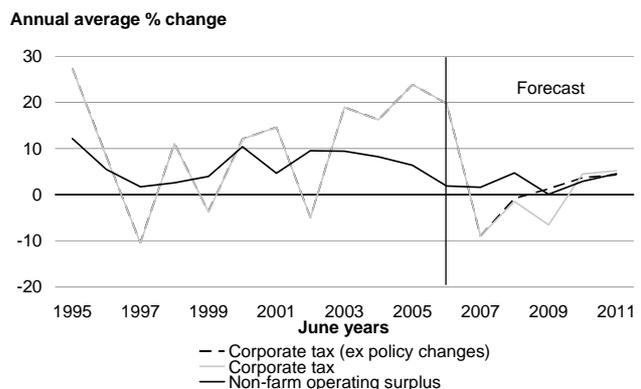
Tax revenue is forecast to be higher than in the *Half Year Update* throughout the forecast period. This reflects the higher level of nominal GDP in 2008 and 2009, as well as a reassessment of the effective tax rate on source deductions and company tax. The ratio of source deductions to labour income is forecast to stay at approximately the same rate as in recent years – a slightly higher rate than forecast in the *Half Year Update*.

**However, company tax changes see a fall in company tax revenue in 2008 ...**

In the year to June 2008, total tax revenue is forecast to grow by 4.3%, slightly below nominal GDP growth of 5.0%. For 2008, source deductions grow at just over 6%, somewhat higher than compensation of employees growth at just under 5%. Fiscal drag is forecast to add to tax revenue relative to GDP over the forecast period, given that the personal income tax threshold indexation announced in Budget 2005 is not proceeding. Solid consumption growth contributes to GST growth of 6.4%.

Running against this trend, corporate tax revenue is forecast to decline by 1.5% in the year to June 2008, despite forecast profit growth of 4.7%. In 2008, several tax measures are scheduled to take effect, including a cut in the company tax rate from 33% to 30% as part of the Business Tax Reform, the portfolio investment entity (PIE) regime and the fair dividend rate (FDR) method for calculating returns on overseas equity investments – all of which are expected to reduce the company tax take.

**Figure 1.17 – Corporate tax growth**



Sources: Statistics New Zealand, The Treasury

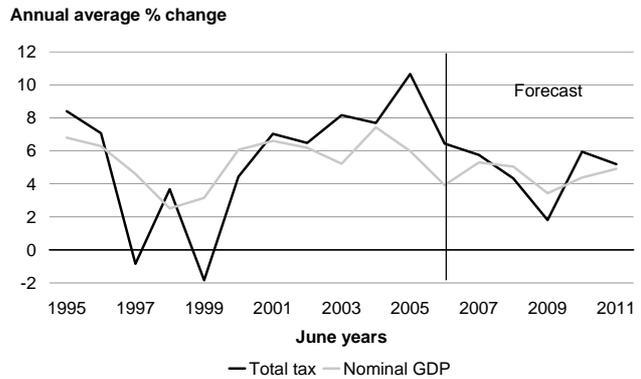
Without the policy changes, including the Business Tax Reform, the forecast growth in corporate tax for 2008 would have been higher than the *Half Year Update* forecast. This is because the prominent tax loss build-up that has been a feature of the corporate tax forecasts for the past two years has been moderated, as there is now convincing evidence

that the build-up in tax losses through the 2007 tax year was not as large as previously expected. The size of the tax losses is now a downside risk to the corporate tax forecasts, especially since total profits are forecast to decline in 2009.

**... tax growth slows further in 2009, reflecting the weaker economy and the full effect of company tax changes**

In the year to June 2009, tax revenue is forecast to grow at just under 2%. With continued growth in compensation of employees of around 5%, source deductions revenue is forecast to increase by around 6%. However, 2009 is the first year in which the changes to company tax take full effect. This is expected to reduce company tax by over \$800 million in that year, resulting in corporate tax declining by 6.5% despite relatively flat profits.

**Figure 1.18 – Total tax and nominal GDP growth**



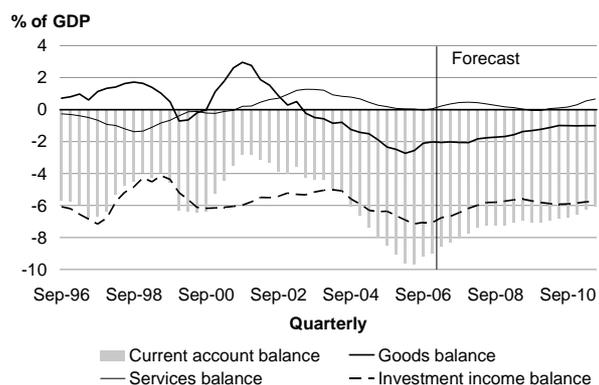
Sources: Statistics New Zealand, The Treasury

**Real GDP Growth Forecast to Return to Trend by 2010 and 2011**

**A reorientation of growth towards exports intensifies over the March 2010 year following depreciation of the exchange rate ...**

Export growth is expected to accelerate during the March 2010 year as services exports in particular show strong growth on the back of the lagged effect of the depreciation of the exchange rate. Import growth is expected to slow further in 2010 owing to continued weak domestic demand growth and the impact of the exchange rate on import prices, before exhibiting a modest increase to 1.6% in the year to March 2011 as market investment growth increases. This means that exports make a strong contribution to growth and also contribute, together with the decline in import volume growth, to the annual current account deficit being forecast to decline to a little over 6% of GDP by the end of the forecast period.

**Figure 1.19 – Current account**



Sources: Statistics New Zealand, The Treasury

The lower exchange rate also boosts the competitiveness of New Zealand exports, with export volume growth increasing 3.5% in the year to March 2009. The exchange rate impact on services exports is expected to show up progressively over the March 2010 year when services export volumes grow 5.4% taking total export growth to 4.1%.

Market investment is forecast to gradually pick up in 2010 owing the improved performance of exports, lower interest rates and some increases flowing from the Business Tax Reform.

**... contributing to a smaller current account deficit**

A high level of the terms of trade during 2008 is forecast to lift the goods balance in the current account, while the eventual reorientation of growth towards exports also drives a closing of the current account deficit. The investment income balance is expected to remain in deficit. However, the investment income deficit is forecast to become smaller as the weak outlook for growth in 2009 hits firms' profits, while the return on New Zealand investments abroad is expected to rise slightly.

**Economy-wide labour productivity is forecast to increase relative to the past couple of years, contributing to trend growth of around 3%**

Economy-wide labour productivity growth, as measured by economy-wide GDP per hour worked, has been low recently, falling 0.1% in the year to March 2006 before increasing to 0.7% in the year to December 2006. The GDP forecasts discussed in this chapter incorporate labour productivity growth that is generally higher than the rates that have prevailed over the past three years. We believe that the recent weak productivity growth has included a large cyclical component.

**Table 1.3** – Productivity growth

March Years	GDP Growth	Labour Productivity Growth	Labour Input Growth
Average 1997-2006	3.0	1.2	1.8
2005	3.9	0.5	3.4
2006	2.0	-0.1	2.2
2007	1.7	0.8	0.8
2008	2.6	1.8	0.8
2009	1.6	0.9	0.8
2010	2.8	2.2	0.6
2011	3.1	1.7	1.4
Average 2007-2011	2.4	1.5	0.9

Sources: Statistics New Zealand, The Treasury

The following factors suggest that productivity growth is likely to lift over the forecast period:

- Despite slowing growth, labour market conditions have remained tight with firms still facing difficulties in finding labour. In such an environment firms are reluctant to reduce employment unless it is absolutely necessary. This is likely to have contributed to the lower labour productivity experienced recently, but potentially enables increases in production in the future without the need for a commensurate increase in labour input.
- Productivity growth may also be higher over the forecast period as returns from recent growth in business investment are realised.
- In recent years a number of new workers have been drawn into employment. It is likely that these new workers have been less productive than experienced workers. However, as these workers spend time in employment, developing on-the-job skills and experience, it is likely that their productivity will increase.
- The reorientation of growth towards the export sector, where firms tends to have a higher level of productivity, should boost average productivity.

**Annual growth in tax revenue is expected to be around 5%**

Tax revenue is forecast to grow by around 5% in each of the 2010 and 2011 June years. The two largest tax types, source deductions and GST, are responsible for the vast bulk of this growth, growing by around 6% and 4% respectively. With changes such as the Business Tax Reform bedded down by 2010, growth in corporate tax is forecast to resume, growing by 4.5% to 5% in each of 2010 and 2011.

### Impact of KiwiSaver Enhancements and the Business Tax Reform

The 2007 *Budget Update* incorporates a number of policy changes. The KiwiSaver enhancements and Business Tax Reform have both been incorporated into the economic forecasts.

The reduction in the corporate tax rate to 30% will increase the return on investment. In the forecasts this has the effect of making a larger number of investment projects profitable, and adds to the growth rate of market investment. The forecasts incorporate around \$300 million of additional real investment as a result. The lift in investment is not expected to be immediate and is spread from 2009 until the end of the forecast period. Around 50% of investment is sourced from imports, so the lift in investment sees import volumes increase by around \$150 million.

The main effects of the KiwiSaver enhancements are likely to be on household saving. However, there may be some impact on private consumption as some individuals may be able to switch from their current saving vehicle to saving through KiwiSaver and reduce their saving by the size of the tax credit, but still accumulate the same level of funds. The exact size of this impact is uncertain. Our estimate is that enhancements to KiwiSaver will lift nominal private consumption by around 10% of the cost of the enhancements (in turn, household saving increases by 90% of the cost), but the effect could be between -10% and 25%.

There may also be some effects on firms. The cost of the compulsory matching of employee contributions could affect firm profitability, particularly as the contributions increase beyond the level of the tax credit provided to employers. As a result, it is likely that employers will seek to recoup this additional cost through lowering future wage growth or through increasing prices. These possible effects have not been incorporated in the forecasts, in part because they will be heavily influenced by the state of the economy at the time, but also because the main effects are likely to occur towards the end of the forecast period.

The estimate that the programme will lead to a 10% increase in consumption is the key determinant of the effects of the enhancements to KiwiSaver on the rest of the economy. With the spillover from the KiwiSaver enhancements into private consumption spending expected to be small, the programme as a whole has only a limited effect on real economic activity. Nominal consumption is expected to rise by around \$30 million in the March 2008 year, with the impact rising to around \$120 million by March 2011 (the end of the forecast period). This sees domestic demand lift, rising by approximately \$300 million in total across the forecast period and this is forecast to lead to slightly higher inflation and interest rates.

The programme is expected to lead to an increase in annual pension fund contributions of \$1.3 billion by the end of the forecast period. The table below summarises the effect of KiwiSaver on a number of economic variables:

<b>(June years)</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
Fiscal cost of enhancements (\$ millions) <sup>5</sup>	\$303	\$693	\$1,006	\$1,214
Household saving effect (\$ millions)	+\$273	+\$624	+\$905	+\$1,093
Real GDP	+\$20	+\$42	+\$53	+\$68
Inflation	0	+0.02	+0.03	+0.02
Interest rates (percentage points)	0	+0.05	+0.05	+0.01

<sup>5</sup> Note that this includes the full cost of the fee subsidy for all KiwiSaver members (\$40) as the size of the subsidy has only recently been determined.