



Hon Dr Michael Cullen
MINISTER OF FINANCE

Half Year Economic & Fiscal UPDATE 2005

19 December 2005



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 *Half Year Update* incorporates the fiscal and economic implications both of Government decisions and circumstances as at 7 December 2005 that were communicated to me, and of other economic and fiscal information available to the Treasury in accordance with the provisions of the Public Finance Act 1989.



John Whitehead
Secretary to the Treasury

9 December 2005

This Update has been prepared in accordance with the Public Finance Act 1989. 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 Public Finance Act 1989.

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 7 December 2005 of which I was aware and that had material economic or fiscal implications.



Hon Dr Michael Cullen
Minister of Finance

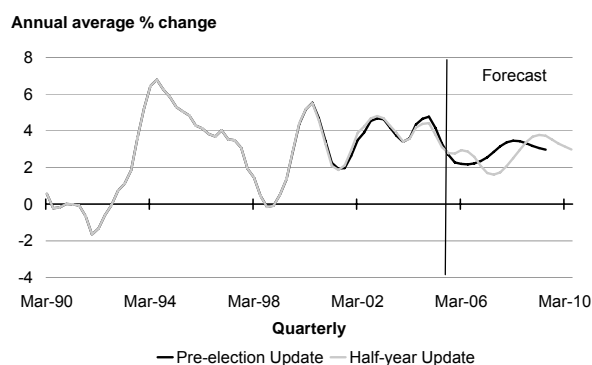
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Economic and Tax Outlook

Summary

- The *Half Year Update* economic forecasts show a more cyclical path for the economy than the *Budget* and *Pre-election Updates* with higher growth in the near term but a deeper slowdown in the 2007 and 2008 March years.
- Real GDP growth of 2.9% is forecast in the year to March 2006. The economy is then forecast to record two years of sub-trend economic growth, with growth slowing to 1.7% in March 2007, before recovering to 2.5% in March 2008, compared with 2.6% and 3.5% respectively in the *Pre-election Update*. This forecast would represent the weakest two consecutive years of growth since 1998 and 1999 following the Asian Crisis and drought.
- Growth is forecast to rebound to 3.8% in 2009 and back to trend growth of around 3% in 2010. Trend growth prospects remain the same as in the *Pre-election Update*. The forecasts reflect the interaction of differing cyclical factors influencing the domestic and external sectors of the economy.
- Across the forecast period we see labour productivity making a bigger contribution to growth than has been the case in recent years. This reflects in part changing relative prices between capital and labour, with higher real wages on average over the forecast period expected to see a period of capital deepening. Business investment has increased sharply in recent years.
- While aggregate real GDP growth in the year to June 2005 has slowed broadly in line with previous forecasts, the composition of GDP growth has been different. Domestic demand growth has not slowed as much as expected, while export growth has been weaker.

Figure 1.1 – Real GDP



Sources: Statistics New Zealand, The Treasury

- A consequence of this growth performance has been that the imbalances and pressures in the economy that were noted in the *Pre-election Update* have intensified, highlighted by rising inflation, an expansion of the current account deficit and over valuation of house prices.

- A number of the factors forecast to lead to slower growth have been in place for some time, including lower levels of net migration, a high exchange rate, interest rate increases. We have also seen weak agricultural production. To date, these effects have been offset by continued strong household income and house price growth and high world prices for key exports, which have all contributed to an on-going willingness of households to take on more debt.
- A slowing in domestic demand through weaker consumption and residential and business investment, together with falls in house prices largely due to higher effective interest rates and the flow-on from lower net migration, is a key contributor to a period of weak GDP growth. The forecast slowing in domestic demand growth is more abrupt than in the *Pre-election Update*.
- Export growth is forecast to be constrained by a muted recovery in agricultural production and by the effect of the high level of the exchange rate on some other components of exports. The outlook for exports is substantially weaker than in the *Pre-election Update*. Export growth recovers in the March 2008 and 2009 years on the back of an assumed exchange rate depreciation.
- These developments are forecast to see the current imbalances unwind in a gradual manner.
- While more positive scenarios are possible, our view is that the current mix of global and domestic growth drivers and imbalances carry with them increased risk of a more abrupt adjustment in the economy. Some of these risks are explored in the Risks and Scenarios chapter.
- Tax revenue growth falls to 3.2% and 2.8% in the 2007 and 2008 June years, from the double digit growth rates in the last couple of years. The period of weak GDP growth contributes to a fall in profits in 2007. This is associated with slowing growth in corporate tax revenue, and some increase in tax loss utilisation.
- In the Central Forecast the response of businesses to weak growth in profits is muted due to strong corporate balance sheets. This is a key judgment underpinning the forecasts. The response of households to these developments is another key judgement underlying the Central Forecast. If there is a bigger response to high interest rates, or if firms shed labour, with a consequent effect on income, then the slowing in private consumption and residential investment would be greater than forecast in the Central Forecast.

Table 1.1 Economic Forecasts

| Economic outlook: central forecast¹ | | | | | | |
|---|---------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| (Annual average % change, year to 31 March) | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
| | Actual | Forecast | Forecast | Forecast | Forecast | Forecast |
| Private consumption | 5.9 | 4.4 | 1.8 | 1.0 | 2.2 | 2.3 |
| Public consumption ² | 5.6 | 5.8 | 6.2 | 3.5 | 3.7 | 1.7 |
| Total Consumption | 5.9 | 4.7 | 2.8 | 1.6 | 2.6 | 2.1 |
| Residential investment | 2.0 | -4.4 | -11.0 | -1.2 | 4.8 | 5.4 |
| Central government investment | -0.4 | 16.5 | -1.1 | 3.7 | 3.6 | 3.3 |
| Other investment | 12.9 | 11.1 | -1.6 | 0.5 | 4.1 | 3.8 |
| Total Investment | 8.6 | 7.6 | -3.5 | 0.4 | 4.2 | 4.1 |
| Stock change ³ | 0.3 | 0.5 | -0.7 | -0.1 | 0.0 | 0.0 |
| Gross National Expenditure | 6.8 | 5.8 | 0.8 | 1.2 | 2.9 | 2.6 |
| Exports | 3.8 | -1.2 | 2.5 | 5.3 | 4.6 | 4.4 |
| Imports | 12.9 | 7.7 | 0.7 | 0.6 | 2.3 | 2.9 |
| GDP (Production Measure) | 3.8 | 2.9 | 1.7 | 2.5 | 3.8 | 3.1 |
| - annual % change | 2.3 | 3.0 | 1.5 | 3.2 | 3.6 | 2.9 |
| Real GDP per capita | 2.6 | 2.0 | 0.8 | 1.6 | 2.9 | 2.3 |
| Nominal GDP (expenditure basis) | 7.5 | 5.6 | 2.9 | 3.7 | 5.2 | 5.1 |
| GDP deflator | 3.8 | 2.5 | 1.2 | 1.0 | 1.5 | 1.9 |
| Employment ⁴ | 3.6 | 2.8 | 0.4 | 0.6 | 1.2 | 1.3 |
| Unemployment ⁵ | 3.9 | 3.4 | 3.8 | 4.1 | 4.3 | 4.5 |
| Wages ⁶ | 3.3 | 4.7 | 4.1 | 3.6 | 3.5 | 3.4 |
| CPI inflation | 2.8 | 3.4 | 3.1 | 2.4 | 2.2 | 2.0 |
| Export prices ⁷ | 3.7 | 1.3 | 9.7 | 2.3 | -1.2 | -0.7 |
| Import prices ⁷ | -2.0 | 1.0 | 11.5 | 3.6 | -0.5 | -1.3 |
| Current account balance | | | | | | |
| - \$ million | -10,903 | -14,250 | -13,226 | -11,973 | -11,572 | -10,768 |
| - % of GDP | -7.4 | -9.1 | -8.3 | -7.2 | -6.6 | -5.9 |
| TWI ⁸ | 69.6 | 67.8 | 61.2 | 59.3 | 58.7 | 58.5 |
| 90-day bank bill rate ⁸ | 6.9 | 7.5 | 6.8 | 6.3 | 6.0 | 5.8 |
| 10-year bond rate ⁸ | 6.0 | 6.0 | 6.2 | 6.1 | 6.0 | 6.0 |

Sources: Statistics New Zealand, Datastream, The Treasury

Notes:

- 1 Forecasts finalised 18 November 2005.
- 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 outlook: global economic growth, inflation and interest rates are assumed to conform to those presented in the October *Consensus Forecasts* and *Asia and Pacific Consensus Forecasts*. Economic growth for New Zealand's 14 largest trading partners is forecast to be 3.2% in 2005 and 3.2% in 2006. There are some risks around the global outlook, including how high oil prices affect growth and inflation.

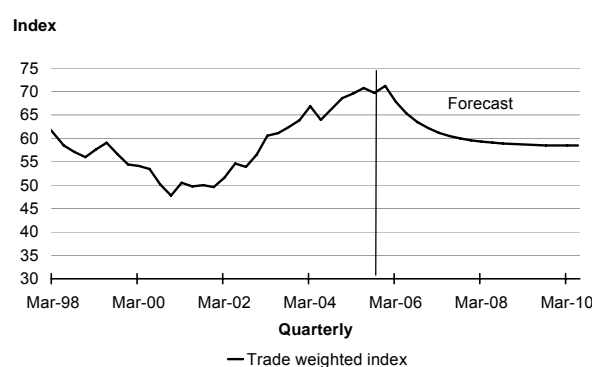
Climatic conditions are assumed to return to normal in the 2006/07 growing season. The 2005/06 season has been affected by a wetter than usual beginning to spring in the North Island and drier than usual conditions in the South Island. The North Island also began to become dry late in spring.

Oil prices temporarily moved above US\$70/barrel in September due to a combination of strong demand and disruptions to supply and refining capacity around the Gulf of Mexico during Hurricanes Katrina and Rita. Since that time prices have declined, and are forecast to hold at around US\$59 throughout the 2006 calendar year, then gradually decline to US\$54 at the end of the forecast period. The outlook is based on futures prices at the time the forecasts were finalised.

Net migration inflows have declined from a peak of over 40,000 in the middle of 2003. Net inflows are assumed to be 7,000 in the year to March 2006, then hold steady at 10,000 people a year for the rest of the forecast period.

The TWI measure of the **exchange rate** is assumed to decline to around 68 early in 2006, 61 by the beginning of 2007 and then decline gradually to 58.5 by the end of the forecast period.

Figure 1.2 – TWI



Source: RBNZ

Recent Economic Developments

The rate of economic growth has moderated ...

Economic growth has slowed from over 4% through much of 2004 to 3.1% in the year ended 30 June 2005. The final two quarters of 2004 and the first half of 2005 have seen three quarters of below trend growth rates, with growth of 1.1% in the June quarter breaking the pattern of below trend out-turns. The June quarter result was stronger than the 0.7% expansion in activity forecast in the *Pre-election Update*.

... following a period of strong growth.

A variety of factors have contributed to a period of strong growth from 2000 to 2005:

- The Overseas Trade Index measure of the terms of trade increased 9.7% from the beginning of 2003 to June 2005, through a period of accelerating world prices for New Zealand's exports and declines in some categories of import prices, particularly plant and machinery imports. This has boosted incomes in the economy and reduced the cost of some investment projects.

- Net migration inflows, which peaked at just over 40,000 in 2003, lifted domestic demand and labour supply.
- A period of relatively low interest rates, compared with New Zealand's historical experience.
- Strong employment and wage growth and a low unemployment rate.
- Rising household wealth due to house price increases.

On the supply side, labour utilisation growth has been strong in the 12 months to June 2005 while labour productivity growth has been subdued.

Much of the growth in GDP has come from increases in labour utilisation, with increases in working age population, labour force participation, average hours worked and a decline in the rate of unemployment. The contribution to GDP growth from growth in labour productivity in the year to June 2005 has been weak.

Sources of growth have deviated from forecast.

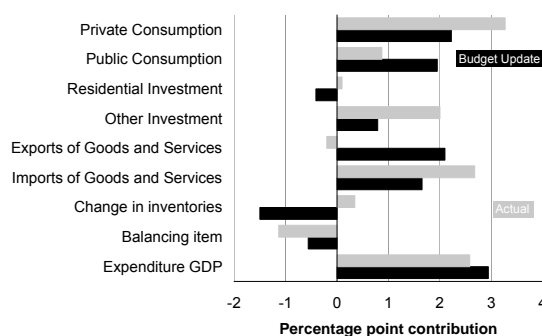
Headline GDP growth has been broadly consistent with the forecasts in the *Budget Update* and the *Pre-election Update*, slowing at a similar speed to forecast. The composition of GDP growth has however been quite different from forecast. Domestic demand growth has exceeded expectations, leading to strong growth in imports, while export growth has been weaker than expected. Imbalances and pressures have built up in the economy due to a sustained period of above trend growth and interest rates and the exchange rate have increased. A consequence of the recent growth performance is that the pressures have intensified, highlighted by rising inflation, an expansion of the current account deficit and a rise in household debt.

Recent growth has been constrained by a weak export sector ...

Weak growth in export volumes has been one of the contributors to the slowing in GDP growth. Export volumes grew only 0.5% in the year to June 2005, compared with 4.4% in the previous June year.

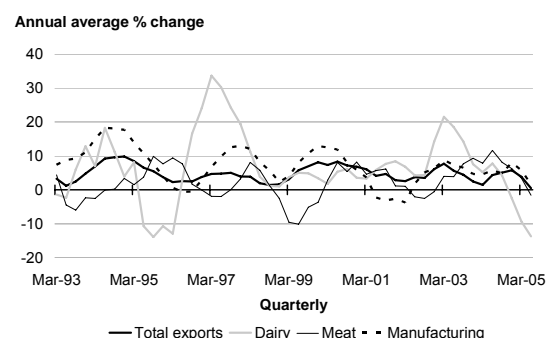
Agricultural exports were particularly weak, in large part due to a poor season of dairy production. Both dairy and meat export volumes recorded declines. A rising exchange rate dampened NZD prices, discouraging forestry export volumes, while the growth of manufactured exports has slowed in the face of a higher exchange rate. The effect of the exchange rate can also be seen in services exports where volumes increased less than 1% in the year to June, as it became more expensive for visitors to come to New Zealand.

Figure 1.3 – Contributions to real GDP growth, first half of 2005 annualised



Source: Statistics New Zealand, The Treasury

Figure 1.4 – Growth in export volumes



Source: Statistics New Zealand

... however, a strong labour market and buoyant housing market have helped sustain solid growth in domestic demand ...

House prices measured in Quotable Value NZ data have increased 43.7% since the beginning of 2003, including solid rises during 2005, lifting household wealth, contrary to our expectations of an easing in price increases over the course of 2005. Meanwhile, growth in employment, which has seen the unemployment rate fall to 3.4% in September, has boosted incomes. These wealth and income effects have seen a sustained period of growth in private consumption and residential investment, despite some recent slowing in the growth of the latter, and have been coupled with a steady rise in household debt levels. Business investment has also increased as firms have sought to expand productive capacity during a period of strong demand and difficulty finding workers. Growth in real public consumption has also contributed to the strength in domestic demand, growing 5.2% in the year to June 2005. Non-market investment, largely through construction activity in a variety of infrastructure projects, has further contributed to domestic demand.

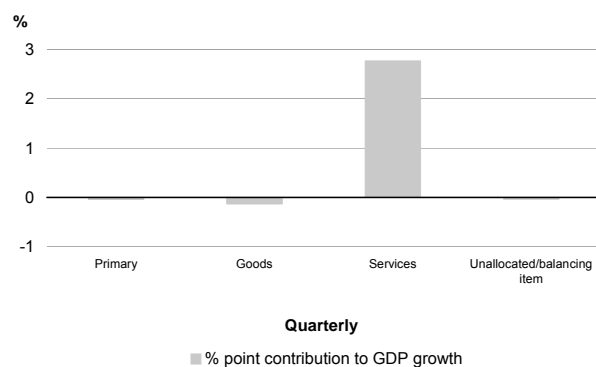
... leading to strong growth in import volumes.

Import volumes have been growing at double digit rates since the beginning of 2004 in response to strong domestic demand, a lack of spare capacity in New Zealand and the high level of the exchange rate. Growth has been broad-based with high capital imports on the back of growth in business investment and solid growth in imports of consumption goods.

In production terms the service sectors have provided the strongest growth

Over the year to June the service sectors have accounted for almost all of the growth in GDP, with the largest contributions coming from finance and business services, wholesale and retail trade and transport and communication, all reflecting strong domestic activity. The primary sector has made little contribution to growth, while the goods producing industries, with the exception of the construction sector, have subtracted from growth. Weak manufacturing performance, perhaps reflecting the effect of the high level of the exchange rate on exporters, has been one of the key reasons for the sluggish performance of the goods producing industries. These trends have been mirrored in the labour market, where most of the largest increases in employment between September 2004 and 2005 have come in the services sectors and in the construction industries. The levels of employment in the primary sector and manufacturing have both fallen.

Figure 1.5 – Contributions to production GDP growth



Source: Statistics New Zealand

There are growing signs of imbalances in the economy.

Growth in imports and weak exports have seen the deficit in the merchandise goods balance in the current account reach high levels, despite increases in the terms of trade. The strength in the domestic economy has translated into solid business performance and high profits, which have boosted corporate tax revenue but also expanded the deficit on investment income in the current account. All of these factors have seen the current account deficit reach 8% of nominal GDP in June 2005.

Increasing pressure on available resources, as suggested by high capacity utilisation and rising pricing pressures, with inflation increasing over 3%, together with the expansion in the current account deficit, suggest increasing imbalances and pressures in the New Zealand economy as was noted in the *Pre-election Update*. There has been little alleviation in these imbalances since the publication of the *Pre-election Update*, and if anything they have intensified.

Tax revenue has been marginally higher than forecast in the Pre-election Update.

Since the *Pre-election Update* forecasts were finalised, tax revenue has evolved broadly in line with forecast. However, some higher revenue flows than forecast are becoming evident in source deductions, fuelled by a strong labour market, and interest withholding tax, where we have previously underestimated the effect of relatively high domestic interest rates on the deposit base.

Although it is now starting to show signs of slowing, tax revenue is still growing at just under 10% per annum.

Imbalances in the Economy

Divergent growth in the economy

As discussed in the main body of this chapter, recent economic growth has featured a divergence in growth in different sectors of the economy. In expenditure GDP terms this has been highlighted by strong growth in elements of domestic demand, including household spending, market and non-market investment and public consumption, all lifting growth in Gross National Expenditure. Strong domestic demand has drawn in imports, while export growth has been weak, due to a combination of a high exchange rate and poor agricultural conditions. In production GDP terms the divergence is highlighted by the differing fortunes of the services sectors versus the rest of the economy. Almost all of the GDP growth in the last 12 months has come from the service sectors.

On-going strength in domestic demand, at above trend rates of growth, has gradually increased the pressure on available resources. This has shown up in a high level of capacity utilisation and firms facing difficulty finding skilled labour. In turn this has lifted pricing intentions as firms face rising costs, all of which has ultimately fed into rising inflation in the non-tradable sector.

Expanding household debt

Domestic demand has been partially funded by increases in income. It has also been funded from increased borrowing. Household debt has expanded sharply in the last few years, increasing to 158% of disposable income, compared with 136% in 2003.

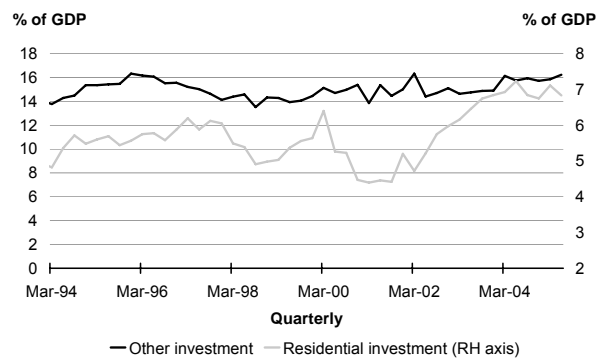
Much of the expansion in debt has been more than matched by increasing house prices, such that household net wealth has increased. We do not believe that further gains in house prices can be sustained beyond the next couple of quarters. Vacancy rates have increased above historical levels and rental returns have not matched increases in prices, with many rental owners budgeting on future capital gains. We do not expect this to continue; indeed, prices are likely to decline a little as they move back in line with fundamental determinants, such as the growth of the population and income growth. This may leave some people, who have increased debt in the expectation of future capital gains, exposed to substantial debt servicing costs.

Widening Current Account Deficit

The current account deficit has expanded to 8% of nominal GDP. The current account can be analysed as the flow of goods, services and income, and the main body of this chapter touches on the influences of imports and exports on the current account. It can also be analysed as the difference between national saving and investment. From a saving and investment perspective, the increase in the current account deficit over the past few years has been due to a combination of a slightly lower national saving rate and increased investment in the economy. As a country, New Zealand has spent more than it has earned.

The government has been increasing its saving, which has been more than sufficient to meet its investment requirements. The expansion in the current account deficit has been due to the decisions and behaviour of people in the private sector. Growth in consumption has exceeded growth in income. On the investment side, the accompanying graph shows the pattern of nominal residential and other investment as a proportion of GDP, and suggests that much of the saving-investment shortfall has been due to growth in residential investment. With national saving not sufficient to cover New Zealand's investment, the savings of foreigners have been required to finance the shortfall, raising net liabilities in the International Investment Position (IIP), which adds up all of New Zealand's foreign assets and liabilities, to over 80% of GDP and lifting household debt.

Figure 1.6 – Nominal investment as a proportion of GDP



Source: Statistics New Zealand

We do not believe that such a current account deficit can be sustained indefinitely. It would imply an ongoing increase in the net liability position, with consequent increases in servicing costs that have to be met by New Zealanders. As an example, even in the current account outlook in the Central Forecast there needs to be a sizable capital inflow, which would be likely to increase the IIP position to 90-100% of GDP. Valuation changes mean that it is difficult to be precise about where the IIP will end up but this highlights that if there is no closing in the deficit then it is likely to expand even further. Such a level of the IIP would be difficult to maintain as it would be associated with an increasing share of national income devoted to servicing international liabilities. New Zealand has not been able to sustain prolonged deficits in the order of 8-9% in the past.

Imbalances forecast to unwind

While the imbalances are expected to remain in the short-term, they are eventually forecast to unwind due to an easing in domestic demand through private consumption, residential investment and business investment and an easing in house prices. The reaction of households to interest rate increases is a key component of this unwinding of imbalances. The fall in residential investment is particularly important. The judgement underlying the forecasts is that housing market activity has gone beyond what can be explained by fundamental drivers of activity. Certainly, household incomes have been rising and job security is strong. However, slower population growth would normally be expected to put some downward pressure on prices. In addition higher house prices for rental properties have not been justified by higher rents; weekly rents have risen barely faster than consumer price inflation, and far more slowly than house prices.

It is possible that there will be a more abrupt adjustment in the household sector, if for example foreign investors react to the high current account deficit, triggering a sharp fall in the exchange rate, or if households feel the effects of higher interest rates more severely and curtail spending more sharply.

Economic Outlook

Growth is expected to slow over 2006 ...

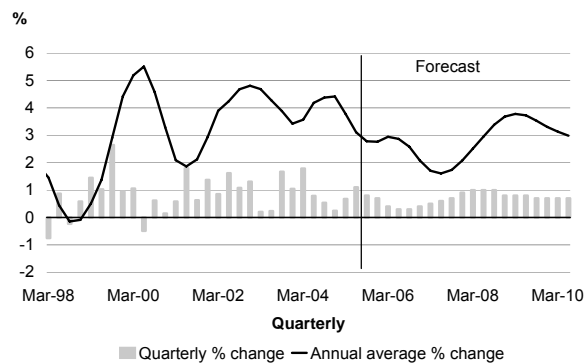
In the short-term some further momentum in domestic demand is expected. Solid GDP growth of 0.8% and 0.7% a quarter is forecast for the last two quarters of 2005. Growth of 2.9% is forecast in the year to March 2006. Below trend quarterly growth rates are forecast for 2006 through a combination of weak export growth and a slowing in domestic demand, as higher interest rates and an end to wealth gains from housing see a period of household consolidation.

... and the economy is forecast to record two years of sub-trend growth in March 2007 and 2008 ...

During 2006 the combination of subdued export volumes and slowing domestic demand sees GDP growth slow to 1.7% in the year ended March 2007 and 2.5% in March 2008, compared with 2.6% and 3.5% respectively in the *Pre-election Update*. Growth is forecast to recover further to 3.8% in 2009 and to trend rates of growth of around 3% at the end of the forecast period. This outlook sees two years of sub-trend economic growth in 2007 and 2008 and would represent the weakest two consecutive years of growth since 1998 and 1999 following the Asian Crisis and drought.

The outlook for growth is more cyclical than in recent forecasts. Part of the reason for this is the forecast adjustment in domestic demand. Some of the recent growth has been driven by household borrowing and growth is forecast to slow as past interest rate increases begin to affect behaviour. In a cyclical sense this is compounded by the outlook for exports, where volume growth is forecast to be limited due to a forecast weak recovery in dairy exports and the effect of the exchange rate on some other categories of exports. The combination of these domestic and external influences is forecast to lead to a bigger and more prolonged slowing in growth than forecast in recent Updates. The view of trend growth underlying these cyclical patterns is unchanged from the *Pre-election Update*.

Figure 1.7 – Real GDP



Sources: Statistics New Zealand, The Treasury

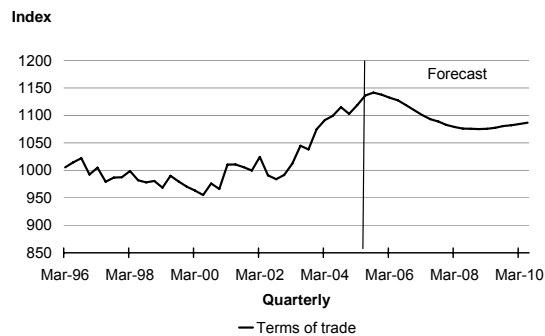
... contributing to a slowing in tax revenue growth.

Tax revenue growth is forecast to decline. Weaker domestic demand growth leads to slower growth in GST and a decline in profits sees a slowing in company tax growth. There are risks around the tax forecasts. If economic growth does not slow to the extent forecast in the Central Forecast then tax revenue is likely to be stronger; likewise, higher inflation would see more tax revenue. Should household spending or the labour market slow more quickly, or further, than forecast, this would be associated with a period of weaker tax revenue. The risks and scenarios chapter considers the fiscal implications of two scenarios where judgements around the economy evolve differently from forecast in the Central Forecast.

Some key drivers of activity have turned down in recent times, while others are forecast to turn down over the next 12 months.

The prices of many of New Zealand’s commodity exports have begun to ease from previous highs. This is forecast to feed into a decline in the terms of trade during the early stages of the forecast period. Net migration inflows have eased over the past two years, interest rates have increased and the exchange rate remains at a high level. All of these factors are forecast to contribute to a further slowing in the rate of growth in GDP. To date these factors have largely been offset by a strong labour market and wealth gains from house price increases.

Figure 1.8 – SNA terms of trade



Sources: Statistics New Zealand, The Treasury

The effect of interest rate increases on households is a key judgement underlying the forecasts ...

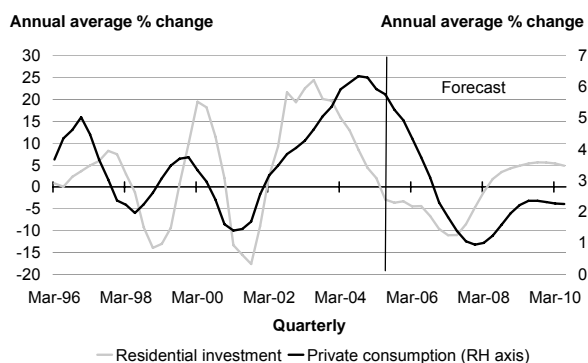
In the short-term, recent labour income growth and house price increases are forecast to continue to provide momentum to private consumption growth. We expect that house prices will have recorded further increases over the second half of 2005, and have forecast some declines during 2006 as recent interest rate increases begin to slow activity. Strength in the housing market, together with solid labour income growth, sees quarterly GDP growth of 0.8% in September and 0.7% in December. Annual private consumption growth is forecast to be 4.4% in the March 2006 year, before declining to 1.8% in 2007 and 1.0% in 2008.

... as it leads to a slowing in private consumption growth, falls in residential investment and house prices.

A number of the factors that have supported growth in recent times have already reversed or are forecast to do so. The factors contributing to the slowing of consumption growth include:

- The lagged effect of past interest rate rises on the effective mortgage rate faced by households.
- Higher oil and petrol prices which reduce the effective disposable incomes of households.
- Lower additions to the population from net migration.
- A slowing in house price growth and hence a reduction in wealth effects.
- A slowing labour market including slowing employment growth, slower labour income growth and rising unemployment.

Figure 1.9 – Private consumption and residential investment



Sources: Statistics New Zealand, The Treasury

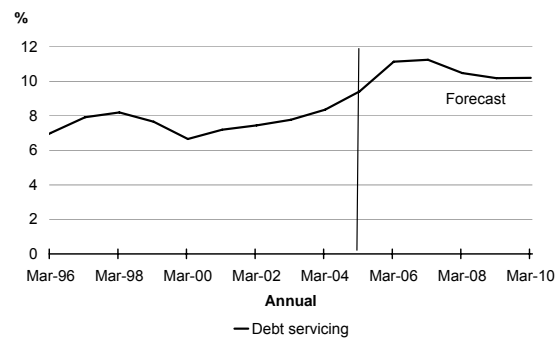
While interest rate increases appear to have had little effect on household spending over the last 12 months, over the forecast period growth is forecast to slow due to the lagged effect of past rate increases. Many households have been insulated from interest rate increases by fixed rate mortgages. As these roll over, borrowers will experience increases in the effective interest rates that they face, raising debt servicing costs. Households are forecast to react to this by reducing growth in private consumption and residential investment spending. Despite this slowing, debt servicing remains at a high level and the financial position of households is an important risk to the Central Forecast. The risks and scenarios chapter includes a scenario where households make a larger adjustment to spending. A larger correction in household spending would be likely to be associated with a larger slowdown in economic growth.

The slowdown in real consumption spending also sees nominal consumption growth slow, contributing to an easing in the growth of GST tax revenue. Higher interest rates than forecast in the *Pre-election Update* are forecast to boost Resident Withholding Tax (RWT) over the forecast period. Higher rates have already begun to have an effect with recent RWT revenue exceeding forecasts as attractive interest rates have lifted the deposit base.

Residential investment growth has already started to ease and this is forecast to continue with some of the fundamental drivers of activity, including the size of the population and interest rates increases, leading to declines in new building work. The box “Imbalances in the economy” discussed the increase in housing vacancy rates. With these already sitting at high levels, further expansion in investment in new dwellings is unlikely.

Some domestic demand growth is expected to be maintained by growth in real public consumption, which is forecast to growth at annual rates of around 6% until March 2007.

Figure 1.10 – Household debt servicing as a percentage of disposable income



Sources: Statistics New Zealand, The Treasury

Household Spending and Interest Rates

Since the beginning of 2004 the Reserve Bank has increased the OCR by 225 basis points, from 5% to 7.25%. During the same period floating mortgage rates have increased from around 7% to just over 9%, implying an increase of around 30% in the interest bill for a fixed level of borrowing. Yet to date interest rate increases appear to have had only a very limited effect on private consumption growth.

Part of the reason for continued strength in household spending is related to the strong labour market, which has provided additional jobs as well as strong wage growth. Low unemployment by historical standards is also likely to have buoyed consumers' confidence about job security and their ability to service increased debt levels in the future.

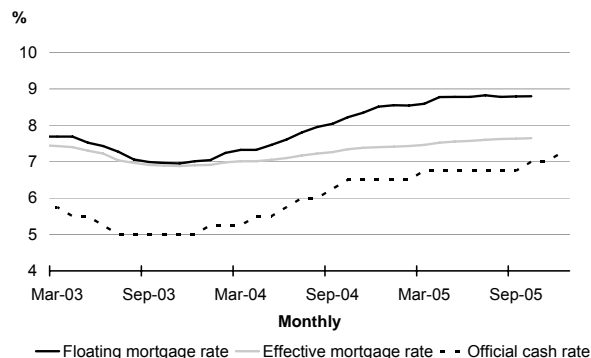
An additional factor has been the ability of mortgage borrowers to dilute the effect of higher short term interest rates by opting for relatively attractive fixed term rates. This opportunity has been available to borrowers due to a combination of low international and New Zealand bond yields, as well as active competition in the home-loan market towards the end of 2004 as banks actively competed to gain market share.

As borrowers have opted to allocate a greater proportion of their mortgage debt to fixed rate loans, the percentage of mortgage debt on floating rates has fallen from around 34% at the beginning of 2004 to just over 20% in October 2005. Over the same period the percentage of mortgage debt with interest rates having an existing fixed rate period of up to 2 years has increased from 50% to 65%.

A consequence of the move to allocating a greater proportion of mortgage debt to fixed term rates has been that the effective (or weighted average) mortgage rate faced by households has not increased as rapidly as movements in the OCR. Between the beginning of 2004 and October 2005, the effective mortgage rate increased from approximately 6.9% to 7.6%, an increase of only 70 basis points compared to the 200 basis point increase in the OCR over the same period.

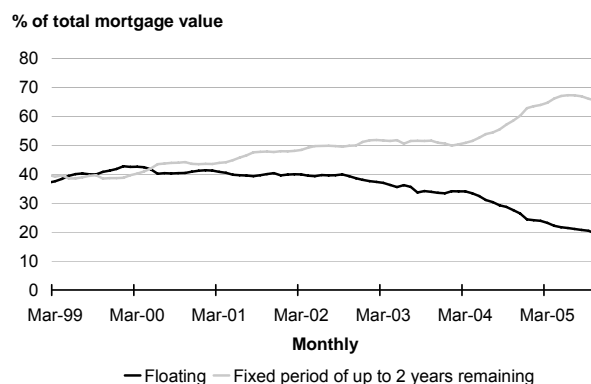
Over recent months fixed mortgage interest rates have increased. Over the next year or so a number of mortgage borrowers are going to have their home loans (or some part of them) come up for renewal. For a large proportion of these borrowers the lowest available rates available at the time will represent an increase relative to their current fixed rates. As a consequence the effective mortgage rate faced by borrowers is going to increase further, even in the absence of further increases in the OCR. The weighted average interest rate on mortgages due for renewal in less than a year was 7.3% in October 2005, with these loans representing just under a third of all mortgages by value. With one to two year fixed rate loans generally in the 8.2% to 8.5% range at the time of writing, borrowers will be facing higher debt servicing costs over the coming year.

Figure 1.11 – Interest rates



Source: RBNZ

Figure 1.12 – Mortgage allocation



Source: RBNZ

Household debt levels have shown rapid increases over the past couple of years with mortgage debt estimated at \$113 billion at June 2005, an increase of nearly \$30 billion since June 2003. High debt levels coupled with rising effective mortgage rates will increase the debt servicing costs faced by households and contribute to a slowing in private consumption growth over the next couple of years. Debt servicing costs as a percentage of disposable income (prior to the deduction of interest expenses) are forecast to increase to 11.3% in the year to March 2007, up from 8.4% in 2004.

The extent to which households respond to increasing debt levels is an important judgement in the forecast. As the effect of higher debt servicing begins to impinge on household budgets there is a risk of a bigger slowdown if households become more uncomfortable about their debt levels. This may be particularly so if firms begin to shed some labour and the unemployment rate rises, making households feel more insecure or if a larger negative wealth effect eventuates from a slowdown in house prices.

Slower GDP growth cuts profits and businesses react by reducing investment and slowing their demand for extra labour ...

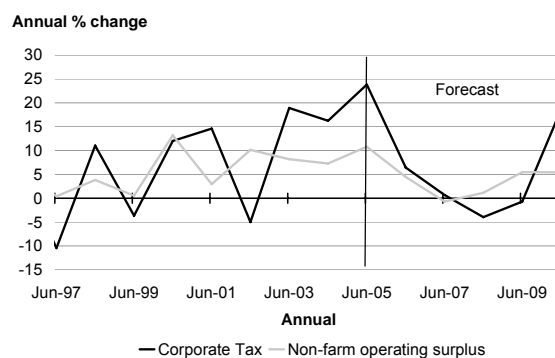
Business investment growth is forecast to slow. Profit growth has been strong in recent years with steady growth in the operating surplus component of nominal GDP. The rate of growth is forecast to slow in 2006 and operating surplus is forecast to fall in 2007. Firms are forecast to respond by cutting back on some investment projects and reducing their demand for new workers.

... while lower profits lead to slower growth in company tax

Weaker profits are forecast to be associated with two years of weak corporate taxes. Corporate tax is forecast to grow 0.7% in 2007, before falling in 2008 as an increase in tax loss utilisation, following above average loss accumulation through 2007, slows revenue growth. As the loss effects dissipate, corporate tax growth recovers to an average of 8.5% over 2009 and 2010.

“Other persons” tax forecasts are substantially lower than in the *Pre-election Update*. As with corporate profits, the entrepreneurial income forecast now includes a noticeable business cycle, prompting more of a cycle in the other persons tax forecast. Although entrepreneurial income forecasts are used as the primary driver of other persons tax forecasts, the historical link between the two is tenuous. There are many other factors that affect this tax type, for example personal investment returns, taxpayer choice of business structure. Some of these other factors may be contributing to the generally downward trend in this tax type over the last two years. However, even with a prominent business cycle present in the forecasts, we expect growth in this tax type to average around 3.5% over the next five years.

Figure 1.13 – Corporate taxes and operating surplus

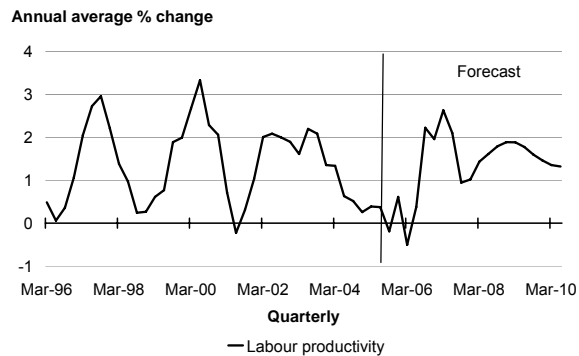


Sources: Statistics New Zealand, The Treasury

Labour productivity growth is forecast to lift

Labour productivity growth made little contribution to GDP growth in 2005 and is forecast to make little contribution in 2006. In large part this reflects the strong cyclical performance of the labour market, which has seen employment increase strongly and unemployment rates fall. Labour productivity made larger contributions to growth during the early stages of the upswing in activity. Over the forecast period the contributions to growth from labour productivity increase, averaging 1.4% across the forecast period as a whole, exceeding the average of 1.1% between 1993 and 2005.

Figure 1.14 – Labour productivity



Sources: Statistics New Zealand, The Treasury

The recent increase in employment and fall in unemployment is likely to have attracted an increasing number of inexperienced and lower skilled people into the workforce. As these people become more experienced, labour productivity is forecast to increase. The expansion in the capital stock, through strong investment, that has occurred since 2003 should also contribute to increases in productivity. In addition, despite the period of cyclical declines in investment as profits fall, the underlying trend in investment growth is strong. Coupled with weak employment growth this is forecast to see increases in the capital-to-labour ratio, which is another factor forecast to lead to higher labour productivity.

Table 1.2 – Supply-Side Sources of Economic Growth

| March Years | GDP per Capita | GDP Growth | Labour Productivity Growth | Labour Input Growth |
|-------------|----------------|------------|----------------------------|---------------------|
| 2003 | 3.1 | 4.7 | 1.6 | 3.0 |
| 2004 | 1.9 | 3.6 | 1.3 | 2.2 |
| 2005 | 2.6 | 3.8 | 0.4 | 3.4 |
| 2006 | 2.0 | 2.9 | -0.5 | 3.5 |
| 2007 | 0.8 | 1.7 | 2.6 | -0.9 |
| 2008 | 1.6 | 2.5 | 1.4 | 1.1 |
| 2009 | 2.9 | 3.8 | 1.9 | 1.9 |
| 2010 | 2.3 | 3.1 | 1.4 | 1.8 |

Sources: Statistics New Zealand, The Treasury

In the short-term the labour market may continue to be stronger than forecast ...

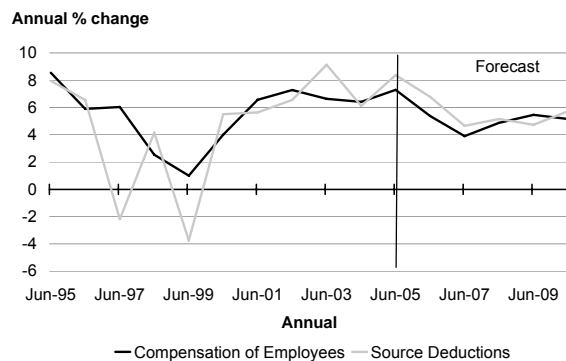
The unemployment rate has steadily declined since 1999 to 3.4% in September 2005. Employment growth is forecast to slow as the economy slows and the unemployment rate gradually increases to 4.5%. The slowing in employment growth is forecast to begin from December 2005. In the *Pre-election Update*, employment growth was forecast to slow in the September quarter; however, the labour market has continued to perform more strongly than forecast. With current momentum in domestic activity it is possible that employment growth will continue to exceed the forecasts. Wage growth has picked up over the last 12 months, matching our *Pre-election Update* forecasts, reflecting reported difficulties firms are having finding staff. Annual wage growth is forecast to remain above 4% through 2006, helping to underpin income growth. There is a risk that wage growth may continue to rise in the medium term.

... falling employment growth would add to downside risks further out in the forecast period

The reaction of firms to a period of weak profit growth is an important judgement underpinning the forecasts. During the period of weak profits described above, with the operating surplus component of nominal GDP forecast to fall in 2007, it is possible that employment growth will slow further or that firms will seek to cut employment in an attempt to maintain profit levels. The key judgement in the forecasts is that firms will make only small changes to their investment and employment plans.

Apart from periodic changes in tax rates and thresholds, for example in the 1997 and 1999 June years, source deductions tax revenue tends to track Compensation of Employees (COE), a measure of total labour income, fairly closely. We are already seeing source deductions growth in the 2006 June year in excess of that forecast in the *Pre-election Update* and have therefore increased the current-year source deductions forecast by nearly \$200 million, slightly more than the upward revision to COE would suggest. This represents a 1% change in the forecast of this \$20 billion tax type. Overall, the growth profile of source deductions revenue tracks COE fairly closely and the upward revisions to the out-years are largely due to the level increase in the current year.

Figure 1.15 – Source deductions tax revenue

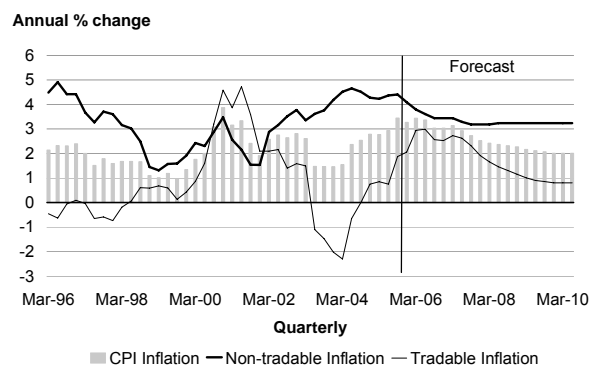


Sources: Statistics New Zealand, The Treasury

Weaker domestic demand sees import growth slow

The rate of growth in import volumes is forecast to slow sharply as household spending slows. As well as the direct impact of easing private consumption growth, the sharp slowing in residential investment is also forecast to add to slower consumption growth, with fewer durable goods needed to fit out new houses. The assumed depreciation of the exchange rate makes overseas travel more expensive, which is forecast to contribute to falls in services imports over much of 2007 and 2008. With business investment forecast to fall, imports of plant and machinery also decline.

Figure 1.16 – Inflation



Sources: Statistics New Zealand, The Treasury

Altogether, import volume growth is forecast to decline to 0.7% and 0.6% in the 2007 and 2008 March years respectively. The closure of a major tobacco processing plant, scheduled for mid-2006, is likely to have a small, upward effect on imports and results in a switch of about \$700 million per year from tobacco excise to customs duty.

Inflation pressures are forecast to moderate as domestic demand cools

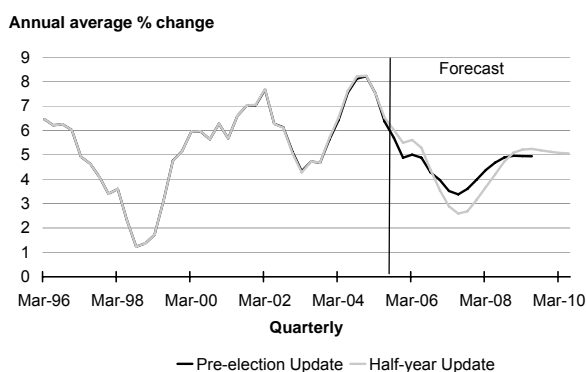
The short-term momentum in domestic demand ensures that inflationary pressures remain in the economy, with annual CPI inflation remaining above 3% until March 2007. A quarterly CPI increase of around 0.8% is forecast in December 2005 and a 0.6% increase in March 2006, with transportation, reflecting higher oil prices, and housing likely to make the largest contributions to inflation.

Inflationary pressures in the non-tradable sector are forecast to diminish as growth slows. This reflects an easing in the labour market and a slowing in domestic components of growth. The fall in the New Zealand Dollar contributes to higher tradable inflation over 2006.

If growth does not slow as quickly as forecast then pricing pressure in the non-tradable sector is likely to be maintained for longer. It is also possible that inflation will turn out to be more persistent than forecast, even if GDP growth develops as expected.

An easing in inflation pressures and the forecast slowing in real GDP growth see nominal GDP growth fall to 2.9% in the year to March 2007 and 3.7% in 2008. This is a substantial slowing from growth of over 7% in the March 2005 year.

Figure 1.17 – Nominal GDP



Sources: Statistics New Zealand, The Treasury

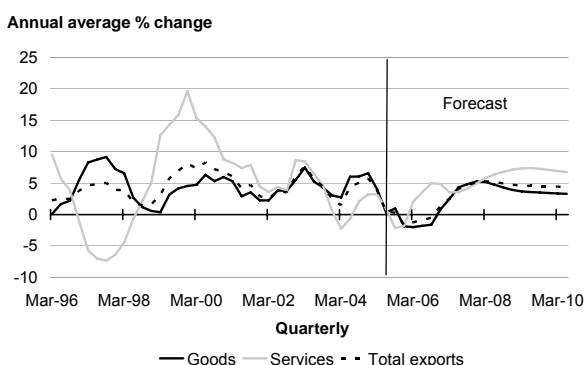
In the export sector the performance of the agricultural sector is an important judgement

The recovery in dairy production is likely to be later than previously forecast. Agricultural production was weak in the 2004/05 production season, resulting in falls in both meat and dairy exports in the year to June 2005. Weak dairy production was the result of a cold spring in 2004. In previous poor seasons that have been caused by climatic conditions, production has quickly recovered once conditions returned to normal. At the time of the *Pre-election Update* we expected production to return to normal in the 2005/06 season, leading to a sizable lift in export volumes.

Discussions with the Ministry of Agriculture and Forestry suggest that the 2005/06 season is also likely to be affected by slightly adverse climatic conditions, further delaying the expected recovery in export volumes. The Central Forecast is underpinned by this outlook over the current season. We expect to

see a small recovery in dairy production, leading to a small increase in exports over the course of the 2006, but the recovery is smaller than forecast in the *Pre-election Update*. The forecasts include some volatility, with merchandise trade data pointing to a sharp fall in dairy

Figure 1.18 – Export growth



Sources: Statistics New Zealand, The Treasury

exports in the September 2005 quarter, some of which we believe reflects a degree of stock-building, which will boost exports in December. The forecasts assume growing conditions return to normal in the 2006/07 production season, with a subsequent strong lift in dairy exports.

The exchange rate appreciation of the last couple of years is forecast to constrain some other categories of exports

The exchange rate is another important determinant of export volumes, particularly for services exports. Visitor arrivals have been relatively flat in recent times, albeit with some volatility associated with the Lions rugby team tour of New Zealand. This flat period of visitor growth has fed into services export volumes. New Zealand has been a more expensive destination for overseas visitors, reducing the growth in visitor arrivals and limiting the average expenditure of visitors. Growth in services exports is forecast to be muted over the course of 2006 in response to the previously high level of the exchange rate.

Manufactured export volumes have also been weak over the last 6 to 12 months. The transmission mechanism from the exchange rate is a little different from services exports. From our business talks we know that many manufacturing exporters try to maintain volumes even in the face of rises in the exchange rate, in order to maintain market share. However, volumes have fallen recently and are forecast to remain weak in the short term, with quarterly growth rates of around 1%, due to the impact of the exchange rate.

The outlook for the exchange rate poses some risks

The Central Forecast assumes that the exchange rate depreciates over 2006 and 2007 back towards its long-run average value. This appreciation is assumed to begin in the first quarter of 2006. Since the forecasts were finalised on November 18 the exchange rate has continued to appreciate. If the exchange rate appreciates further, or stays at a high level over 2006, this will pose some risks to the forecasts. Export volume growth is likely to be weaker than forecast while imports will be cheaper, and more attractive, increasing the likelihood of stronger import volume growth than forecast. Both of these factors would weaken real GDP growth and potentially see the current account deficit expand further. Inflationary pressures would be likely to be smaller.

The current account deficit narrows during 2007

The current account deficit is forecast to widen to around 9% of nominal GDP by March 2006. This reflects a combination of a forecast decline in the terms of trade, a weak outlook for export volumes and an on-going deficit on investment income due to strong domestic economic activity and solid profit growth of foreign owned firms. Over the rest of 2006 the deficit is forecast to narrow. Import volume growth eases with the slowing in domestic demand growth and export volumes lift, in part due to the depreciation of the exchange rate. Declining business profitability sees the investment income deficit narrow as the profits of foreign-owned firms decline.

Growth rebounds to 3% or above in March 2009 and 2010 years

Depreciation in the exchange rate and a return to normal agricultural growing conditions are forecast to contribute to a lift in export growth in the 2008 and 2009 March years.

Manufactured exports and services exports are both forecast to pick up as the exchange rate depreciates, albeit with some lag.

This, together with some recovery in both residential and business investment, underpins a cyclical lift in GDP growth to 3.8% in 2009, before returning to close to 3% in 2010.

Business investment rises

With the outlook for growth and profits improving, firms lift their planned new investment. Employment growth also rises. However, there is a period of capital deepening where the capital-to-labour ratio increases as firms seek productivity gains from their existing workforce, with wage growth remaining solid, making capital more attractive. As a result, the supply-side contributions to growth change, with smaller contributions to growth from increasing labour and greater contributions from increasing labour productivity.

Effect of Tax Policy Changes on Tax Forecasts

Table 1.3 – Material changes in tax revenue forecasts owing to changes in tax policy since *Budget Update*

| (\$ million) | 2005/06 Forecast | 2006/07 Forecast | 2007/08 Forecast | 2008/09 Forecast | 2009/10 Forecast |
|--------------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| Material policy changes | | | | | |
| Provisional tax dates | - | - | 600 | (600) | - |
| GST-based provisional tax | - | - | 160 | (160) | - |
| Total | - | - | 760 | (760) | - |

The implementation of the alignment of provisional tax dates with GST due dates and GST-based provisional tax calculation for small businesses has been delayed by one year.