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Hon Dr Michael Cullen
MINISTER OF FINANCE

Half Year Economic & Fiscal UPDATE 2006

19 December 2006

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Statement of Responsibility

On the basis of the economic and fiscal information available to it, the Treasury has used its best professional judgement in supplying the Minister of Finance with this Economic and Fiscal Update. The Update incorporates the fiscal and economic implications both of Government decisions and circumstances as at 8 December 2006 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

8 December 2006

This Economic and Fiscal Update has been prepared in accordance with the Public Finance Act 1989 for the 30 June 2007 forecast year. In 2008 and outyears the fiscal forecasts depart from the requirements of FRS-29. This standard requires prospective information to be prepared in accordance with the financial standards that will be effective in these periods, which will be New Zealand International Financial Reporting Standards (NZ IFRS). As the impacts of the transition to NZ IFRS have yet to be fully identified and clarified, forecasts for 30 June 2008 and outyears have been prepared under current financial reporting standards.

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 8 December 2006 of which I was aware and that had material economic or fiscal implications.

Hon Dr Michael Cullen
Minister of Finance

8 December 2006

1

Economic and Tax Outlook

Summary

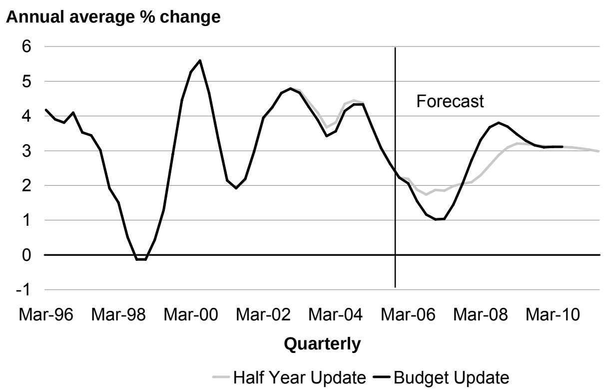
***Economic growth has been stronger than expected in the* Budget Update**

Growth in the first half of 2006 was stronger than forecast in the *Budget Update*.

- Stronger than expected economic activity, and higher employment and wage growth, have led to tax revenue exceeding forecasts by around $300 million in the period from July to September 2006.

- Annual average gross domestic product (GDP) growth is forecast to be 1.8% in March 2007 and 2.3% in March 2008 before further recovering to 3.2% in 2009. The economy is forecast to have passed its weakest period of quarterly growth, which occurred at the end of 2005, and has entered a period of modest growth.

Figure 1.1 – Growth in real GDP



Sources: Statistics New Zealand, The Treasury

- The cycle in GDP growth is forecast to be smoother than was anticipated in the *Budget Update*, where growth of 1% was forecast in March 2007 followed by a rebound to 3.3% in March 2008.

- Tax revenue is forecast to be around $1 billion higher in March 2007 than forecast in the *Budget Update,* with this higher revenue expected to flow through the whole forecast period, largely due to increased forecasts of nominal GDP.

Imbalances in the economy are likely to exist for longer than previously forecast

- The long period of strong growth in the economy has seen the emergence of macroeconomic imbalances – a rise in inflation pressures and a large current account deficit. The corollary of these imbalances has been tighter monetary policy and a high exchange rate that has seen the export and import-competing sectors come under pressure.

- Imbalances are forecast to continue throughout the 2007 calendar year. At the time of the *Budget Update* a faster reorientation in growth away from components of domestic demand and towards exports was forecast during late 2006 and early 2007. This reorientation is now forecast to occur during 2008, with the unwinding of the imbalances expected to be slow but orderly.
- Despite slow growth, inflationary pressures in the non-tradables sector of the economy are expected to remain during 2007. Consumer Price Index (CPI) inflation is forecast to be volatile in the short term, due to the impact of falling oil prices and the appreciation of the exchange rate in the second half of 2006. Inflation is forecast to ease to 1.9% in June 2007, before lifting back to 2.8% in December 2007.
- Export growth is forecast to be constrained by the appreciation of the exchange rate in the middle of 2006. As a result, the current account deficit is expected to narrow at a slow rate, remaining at 8.8% of GDP in the year to March 2008.

Inflation and the current account deficit are forecast to reduce in an orderly fashion

- Soft growth in most components of domestic demand during 2007 is expected to be the first element of some reorientation of growth in the economy. This forecast is underpinned by some consolidation in the household sector, with households less willing to take on debt in the face of high debt servicing ratios. With growth expected to be soft and profits continuing to be squeezed, market investment is expected to fall 6.9% in the year to March 2007 and 1.2% in the year to March 2008.
- Soft domestic demand growth is forecast to lead to an easing in inflationary pressures in the economy, with inflation forecast to be 2% by 2009.
- Exchange rate depreciation during 2007 is forecast to lead to a recovery in export growth in 2008 providing some further rebalancing of growth in the economy and boosting GDP growth to 3% or more in the remaining years of the forecast period. This recovery in export volumes, together with a rise in the terms of trade, and soft import volume growth due to a weak outlook for domestic demand, are forecast to lead to a gradual narrowing of the current account deficit to 6.3% in the year to March 2010.

There are a number of risks to the outlook

- The behaviour of households is a key judgement underlying the central forecast. If households remain willing to take on a higher level of debt, domestic demand is likely to remain stronger than forecast and inflationary pressure is likely to be larger than forecast.
- The imbalances in the economy present a risk to the outlook. In the central forecast, the imbalances are forecast to resolve gradually, in an orderly manner. It is possible that there could be a sharper adjustment in the economy. The *Risks and Scenarios* chapter considers a scenario where there is an abrupt current account adjustment and consequent sharp fall in growth and the fiscal position.

Table 1.1 – Economic outlook: central forecast[1]

Economic outlook: central forecast[1]

(Annual average % change, year to 31 March)	2006 Actual	2007 Estimate	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast
Private consumption	4.5	1.6	1.6	1.0	1.3	1.5
Public consumption[2]	5.4	4.7	3.0	3.9	3.4	4.0
Total consumption	**4.7**	**2.2**	**1.9**	**1.7**	**1.8**	**2.1**
Residential investment	-4.7	-5.1	0.0	3.5	2.6	0.3
Central government investment	25.6	6.2	1.6	2.0	2.0	2.0
Other investment	6.7	-6.4	-1.2	4.4	5.8	5.7
Total investment	**5.6**	**-5.1**	**-0.7**	**4.0**	**4.8**	**4.3**
Stock change[3]	-0.3	-0.9	0.3	0.1	0.1	0.1
Gross national expenditure	**4.5**	**-0.5**	**1.7**	**2.3**	**2.6**	**2.8**
Exports	-0.1	3.6	1.4	4.1	4.6	4.0
Imports	5.0	-2.6	0.9	2.1	3.2	3.4
GDP (production measure)	**2.2**	**1.8**	**2.3**	**3.2**	**3.1**	**3.0**
- annual % change	2.1	2.0	2.7	3.2	3.1	3.0
Real GDP per capita	1.3	0.8	1.3	2.3	2.2	2.2
Nominal GDP (expenditure basis)	4.7	3.3	4.3	5.6	5.0	4.9
GDP deflator	2.5	1.5	2.0	2.4	1.9	1.9
Employment[4]	2.7	1.9	-0.2	0.8	1.3	1.5
Unemployment[5]	3.9	4.0	4.8	4.6	4.4	4.3
Wages[6]	4.7	4.8	3.9	3.7	3.4	3.4
CPI inflation[7]	3.3	2.8	2.7	2.0	2.0	2.0
Export prices[8]	1.0	10.1	4.7	4.5	3.4	2.5
Import prices[8]	1.8	9.6	4.4	2.8	2.6	2.5
Current account balance						
- $ million	-14920.0	-14975.9	-14741.0	-12027.8	-11665.6	-12261.7
- % of GDP	-9.6	-9.3	-8.8	-6.8	-6.3	-6.3
TWI[9]	68.3	63.5	60.1	57.3	54.9	54.4
90-day bank bill rate[9]	7.6	7.5	6.0	6.0	6.1	6.0
10-year bond rate[9]	5.7	6.1	6.0	6.0	6.0	6.0

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

NOTES:

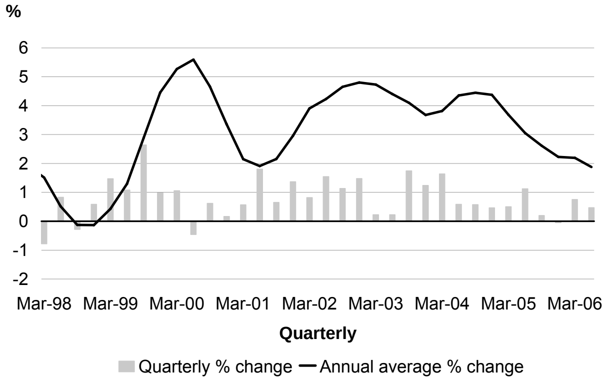
1 Forecasts finalised on 15 November 2006.
2 The forecast profile for public consumption is influenced by government defence spending.
3 Contribution to GDP growth.
4 Household Labour Force Survey, full-time equivalent employment.
5 Household Labour Force Survey, percentage of the labour force, March 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.

Recent Economic Environment

Annual GDP growth has slowed over the past 18 months

GDP increased 0.8% in the March 2006 quarter and 0.5% in the June quarter, rebounding from two soft quarters in the second half of 2005 which saw the economy record close to zero growth. Looking across this period of volatility in quarterly growth reveals a picture of an economy where growth has slowed compared with the strong growth of the preceding few years. However, our assessment is that the economy is past the weakest period of growth, which occurred at the end of 2005, and is well into a period of modest growth, despite the build-up of a number of imbalances in the economy that cloud the future outlook.

Figure 1.2 – Growth in real GDP



Source: Statistics New Zealand

Imbalances still exist in the economy, highlighted by a current account deficit of 9.7% of GDP …

A number of recent Budget and Half-Year *Updates* have highlighted imbalances in the economy. The long period of strong growth in the economy has seen the emergence of macroeconomic imbalances – a rise in inflation pressures and a large current account deficit. The corollary of these imbalances has been tighter monetary policy and a high exchange rate that has seen the export and import-competing sectors come under pressure.

… and headline inflation of over 3%

The CPI increased 1.5% in the June quarter, which took annual CPI inflation to 4.0%. A spike in oil prices to US$78/barrel during the conflict in Lebanon saw petrol prices and international airfares both make large contributions to the quarterly increase in the CPI. Cheaper prices for cars and a smaller than expected increase in international airfares both contributed to a 0.7% increase in the index in the September quarter. The quarterly increase was smaller than forecast in the *Budget Update*.

Annual inflation was 3.5% in September, higher than the 3.1% rate forecast in the *Budget Update*. While petrol price increases have contributed to some of this result, non-tradables inflation has also proved to be higher than forecast, with the demand pressures in the economy continuing to push prices up. Annual non-tradables inflation was running at 4% in the September quarter and has now been at or above 4% since December 2003. Some of the largest contributions to non-tradables inflation have come from the housing and household utilities group.

Pressure on resources and the persistence of non-tradables inflation have contributed to the Reserve Bank keeping the Official Cash Rate steady at 7.25%. With this still representing a sizeable wedge between New Zealand and offshore interest rates, New Zealand has remained an attractive destination for international investors, contributing towards a lift in the

Trade-Weighted Index (TWI) measure of the New Zealand dollar to around 66, up from 60 in July 2006.

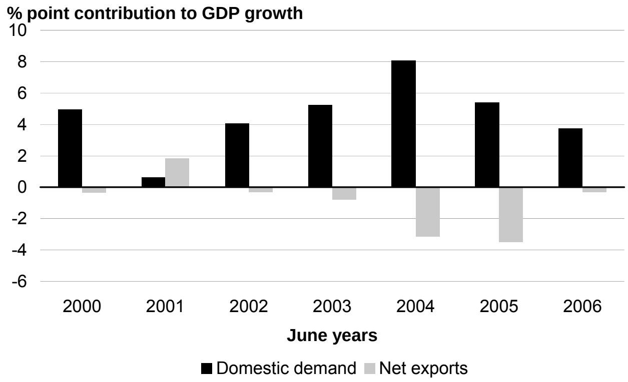
Recent GDP growth has exceeded the forecasts underlying the **Budget Update** *…*

At the time of the *Budget Update*, GDP growth was forecast to slow to 1% in the year to March 2007, with quarterly growth of 0.2% to 0.4% forecast across the 2006 calendar year. This outlook was built around a slowing in domestic demand, while exports were forecast to be weak due to the effects of a poor agricultural season combined with a high exchange rate. Growth was subsequently forecast to rebound in the year to March 2008, owing to the effects on exports of an expected decline in the exchange rate. While services exports have been stronger than forecast, most of the difference on the export side has been in agricultural exports, owing to a surge in dairy exports from inventories, with dairy exports increasing much more than production.

… despite tentative signs of a rebalancing in growth as domestic demand has slowed …

Domestic demand growth has slowed over recent months. The large contributions to growth from the household sector in the form of private consumption and residential investment have eased. This reflects the impact of interest rate increases during 2005 on households and an easing in net migration from its peak of over 40,000 per annum in 2003. In addition, declines in the terms of trade at the end of 2005 and the beginning of 2006 have effectively reduced household disposable income through rising import prices, especially petrol, and some falls in international prices of some New Zealand exports.

Figure 1.3 – Contributions to real GDP growth



Source: Statistics New Zealand

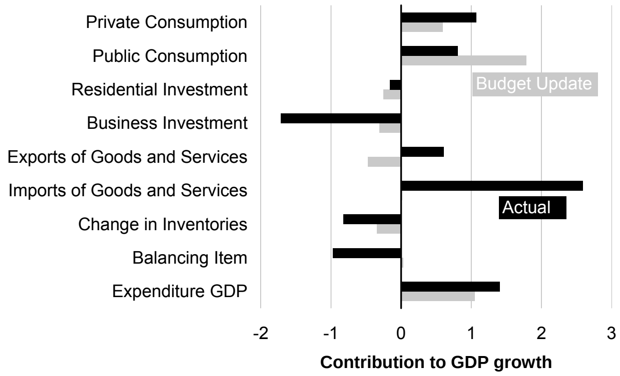
The corporate sector has also experienced a slowdown, with firms trimming investment. Firms' margins have been under pressure during the past 12 months, with firms unable to fully pass on to customers rising cost pressures, especially for labour and petrol. Firms have responded by cutting back investment, with the depreciation of the exchange rate early in 2006 raising the cost of imported investment goods and discouraging new investment.

… with net exports the key reason for the divergence from forecast

The easing in domestic demand described above has broadly matched the forecasts in the *Budget Update*. Private consumption declined 0.4% in the June quarter, with high petrol prices in the quarter acting to constrain spending.

Strength in net exports (exports minus imports) has been the source of the upside surprise to forecasts. The decline in the exchange rate early in 2006 appears to have boosted services exports. However, much of the upward surprise has come from dairy exports. The 2005/06 dairy production season started poorly owing to cold conditions in the spring of 2005. Favourable conditions at the end of the season boosted production, with Fonterra announcing a record production season. This helped boost dairy exports, together with what looks to have been a run-down of dairy stocks in the June quarter, with a 20.3% increase in dairy exports volumes in the June quarter greatly exceeding the lift in production.

Figure 1.4 – Annualised contributions to half year growth



Source: Statistics New Zealand, The Treasury

Weaker domestic demand, together with the decline in the exchange rate making imports more expensive, saw import volumes fall in the March and June quarters after also falling in December 2005. This easing in imports was sharper than the gradual easing forecast in the *Budget Update*.

GDP is estimated to have increased 0.6% in the September quarter

After declining 0.4% in June, private consumption is estimated to have increased 0.7% in the September quarter. Residential investment is also expected to post a small gain in the September quarter after declining in June, with building consent data pointing to some rebound in activity in the second half of the year. In the external sector, export volumes are estimated to have recorded another rise in the quarter, albeit not as large as the 4.7% increase in June. However, as in the June quarter, some of the dairy exports look to have been met by running down inventories, which will detract from growth in the quarter. Import volumes are estimated to have been relatively flat in the quarter, recording only a small increase. These components are estimated to add-up to GDP growth of 0.6% in the quarter.

The labour market has remained stronger for longer than expected …

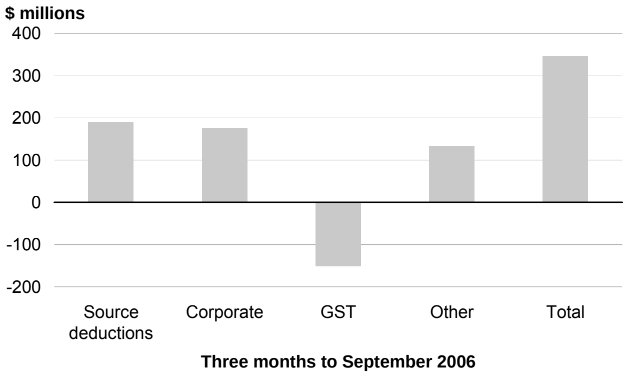
Employment growth in the first half of 2006 was stronger than forecast in the *Budget Update*, growing at or over 1% in each quarter and taking annual employment growth to 3.1% in June 2006. Employment growth has been substantially stronger than economic activity more generally. One result of this is that productivity growth, measured on a total economy basis, has been particularly weak, with little growth since the middle of 2004. The September quarter saw some signs of an easing in the labour market with employment falling 0.4%, suggesting that activity in the labour market is becoming closer to activity in the rest of the economy. The labour force participation rate fell from its record high of 68.7% to 68.3% and the unemployment rate rose to 3.8% from 3.6% in June. The central track incorporates some further easing in the labour market during 2007, with employment forecast to be flat.

… contributing to continued growth in tax revenue

Strong demand for labour boosted annual wage growth to close to 5% in September 2006, with firms continuing to report difficulty finding skilled staff. This growth in wages, together with the growth in employment, has led to growth in labour income of close to 8%, boosting source deductions tax revenue growth to just over 8%.

Total tax revenue is around $300 million ahead of forecast, after removing the effect of some one-off effects, with source deductions and corporate taxes contributing most of the increase.

Figure 1.5 – Difference from forecast by tax type



Source: Inland Revenue Department, The Treasury

Nominal GDP growth has slowed

Despite rising inflation, the recent decline in real GDP growth, as well as falls in the terms of trade, have seen nominal GDP growth drop from over 8% in 2004 to 4.2% in the year to June 2006, with annual growth estimated to have declined to 3.6% in the September quarter. The level of nominal GDP in the year to June 2006 was around $700 million higher than forecast in the *Budget Update*.

Assumptions Underlying the Central Forecast

Global economic activity – global economic growth, inflation and interest rate forecasts are taken from the October 2006 *Consensus Forecasts* and *Asia Pacific Consensus Forecasts*. The general global outlook is positive as growth becomes more broad-based. Growth in the United States is expected to continue to soften to 2.6% in 2007, before recovering to 3.1% to 3.2% for the rest of the forecast period. Australia is expected to see growth recover to 3.3% in 2007, up from 2.8% in 2006. Japan has emerged from recession but growth is forecast to be modest at around 2% per annum, with similar rates of growth forecast in European GDP. Economic growth for New Zealand's top 14 trading partners is forecast at 3.5% to 3.6% across the forecast period.

Oil prices – prices for West Texas Intermediate (WTI) in the March and June quarters were higher than forecast in the *Budget Update,* but falls in September have taken prices back close to forecast. Futures pricing at the time these forecasts were finalised suggests that prices will increase to US$68/barrel in September 2007 before declining to around US$65/barrel by 2011. Prices at the end of the forecast period are projected to be almost identical to those forecast in the *Budget Update*.

Net migration – net migrant inflows appear to have troughed on an annual basis in October 2005 at 6,000 and have since recovered to around 13,000. Net migration is assumed to stay at current levels during 2007 before declining to around 10,000 per annum by 2009, and then remain at that level for the rest of the forecast period.

Monetary conditions – the New Zealand dollar exchange rate as measured by the TWI is assumed to decline from a December 2006 quarter average of 65.6 to 54.5 by the end of the forecast period. A neutral short-term interest rate of 5.8% is assumed.

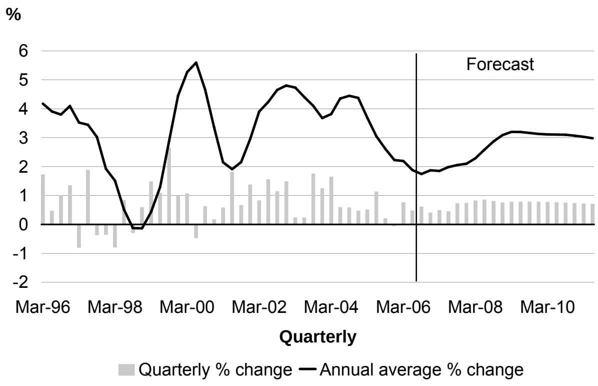
Climate – agricultural growing conditions and the level of hydro electricity storage lakes are assumed to be normal over the forecast period.

Economic Outlook

Modest quarterly GDP growth of 0.4 to 0.6% is forecast through the end of 2006 and much of 2007

Quarterly GDP growth is forecast to cluster around 0.5% per quarter from the December 2006 quarter through the first half of 2007. Annual average growth of 1.8% is forecast for March 2007, with 2.3% growth forecast in the year to March 2008. After growth of 2.2% in 2006, this outlook means that growth would have been below the trend, or potential rate of growth, which we assess as around 3%, for three consecutive years. This growth outlook is forecast to flow into softer labour market conditions and lower growth in tax revenue.

Figure 1.6 – Growth in real GDP



Sources: Statistics New Zealand, The Treasury

The weak period of growth is underpinned by some consolidation in the household sector, with households judged to be less willing to take on debt in the face of debt servicing ratios reaching record high levels, as well as a weak period of export volume growth owing to the lift in the exchange rate during the middle of 2006. This appreciation of the exchange rate is forecast to push out a recovery in exchange rate-sensitive categories of exports into the 2008 calendar year, based on an assumption of some falls in the exchange rate during 2007.

Imbalances are likely to continue to exist for some time …

The imbalances in the economy are forecast to remain for some time. The central forecast at the time of the *Budget Update* suggested that the imbalances would start to reverse early in 2007, with exports forecast to rebound quickly on the back of a depreciation of the exchange rate. Since the *Budget Update* was finalised, the exchange rate has increased back to 66 on a TWI basis. This lift in the exchange rate in the middle of 2006 is now forecast to delay the recovery in exports until the 2008 calendar year. As a result, the reorientation of growth in the economy will be relatively slow.

… with inflation expected to be close to 3% by the end of 2007 and the current account deficit close to 9% of GDP…

A period of forecast volatility in headline inflation, largely owing to the effects of petrol prices, somewhat clouds inflation pressure in the economy. Strong growth in domestic demand, accompanied by pressure on resources, has pushed non-tradables inflation to over 4% since late 2003. These pressures on resources, particularly in the construction sector, are forecast to continue during much of 2007 and non-tradables inflation is not forecast to fall below 4% until December 2007. Headline inflation is forecast to fall initially before rising back to 2.8% in December 2007.

With reorientation of growth in the economy forecast to occur in an orderly, but relatively slow way, the current account deficit is forecast to remain close to 9% of nominal GDP through 2007. Import volume growth is forecast to be weak, increasing 0.9% in the March 2008 year owing to weak domestic demand. Growth in export volumes, however, is also forecast to be muted, increasing 1.4% in the March 2008 year. As a result, while the current account deficit is forecast to become smaller during 2007, it is expected to remain close to 9% of GDP.

… however, two more years of sub-trend growth in the March 2007 and 2008 years is forecast to lead to an alleviation of inflationary pressures …

With domestic demand growth forecast to be weak owing to consolidation in the household sector, as well as further weakness in market investment, inflationary pressures in the economy are forecast to ease. This is expected to result in inflation moving back inside the Reserve Bank's target range. By 2008, inflation pressures are forecast to decline. Non-tradables inflation is forecast to fall below 3% by September 2008 and headline CPI inflation is forecast to be 2.2% by December 2008.

… with a rebalancing of growth towards the export sector forecast to lift GDP growth to 3% and contribute to some closing of the current account deficit

The exchange rate is assumed to depreciate from its current high level during the course of 2007. This depreciation is forecast to boost forestry exports. It is also forecast to lift services exports, after a lag of around one year, as New Zealand becomes a relatively cheaper destination for foreign tourists. Export volumes are forecast to increase 4.1% in March 2009, while the weakness in domestic demand described above means that import volumes growth will be muted. Both of these influences are expected to push the current account deficit to just under 7% by March 2009.

Inflation

Inflation reached 4% in June 2006. In the short term headline inflation rates are expected to be volatile due to the effect of oil prices and the exchange rate. However, inflationary pressures in the non-tradables sector are forecast to remain strong. The extent of this persistence is a key judgement in the forecasts.

Recent developments

The acceleration in inflation to over 3% since September 2005 has highlighted a number of imbalances in the economy, reflecting the pressure on resources in the domestic demand.

More recent data, as well as the forecast for the December quarter, show some falls in headline inflation. However, this largely represents the impact of falling oil prices and the rise in the exchange rate, with inflation in other components of the CPI, particularly non-tradable goods, expected to remain high.

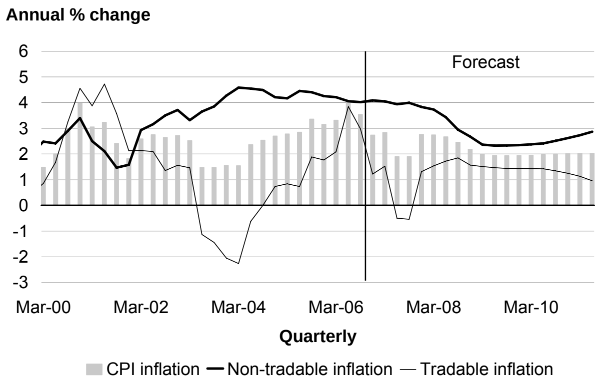
Table 1.2 – December quarter CPI

Group	Quarterly % Change	% Point Contribution
Food	-0.2	0.0
Alcoholic Beverages and Tobacco	0.5	0.0
Clothing and Footware	0.6	0.0
Housing and Household Utilities	1.4	0.3
Household Contents and Services	0.2	0.0
Health	1.0	0.1
Transport	-3.3	-0.6
Communications	0.5	0.0
Recreation and Culture	0.4	0.0
Education	0.5	0.0
Miscellaneous Goods and Services	0.6	0.0
All Groups	**-0.1**	**-0.1**

Sources: Statistics New Zealand, The Treasury

The 0.7% increase in the CPI in the September quarter was weaker than most market analysts expected at the time. When these forecasts were finalised, petrol alone was forecast to subtract 0.8 percentage points from the CPI in the December quarter, owing to a series of falls in prices. The impact of falling prices will be compounded by changes in the weightings given to goods in the construction of the CPI. Weights are generally updated every three to four years to reflect changing consumer spending patterns and the introduction of new goods. The change has given petrol a larger weighting in the make-up of the CPI. As a result, the fall in petrol prices is expected to have a larger dampening effect on inflation than would have been the case in the past.

Figure 1.7 – CPI inflation



Sources: Statistics New Zealand, The Treasury

This is forecast to lead to a 0.1% fall in the CPI in the quarter, taking the annual rate of inflation to 2.7%. The rise in the exchange rate in the middle of 2006 is also contributing to falls in the price of other imported goods as it generally takes two to three quarters for this effect to be passed on to consumers.

A result of these recent developments is that the short-term outlook for annual rates of inflation is volatile. This volatility is apparent in the rate of inflation for tradables (sectors of the economy exposed to significant international competition), which is forecast to fall below zero early in 2007 owing to the combined impact of falling oil prices and appreciation of the exchange rate in 2006. Tradables inflation is forecast to return during 2007 with higher oil prices and the exchange rate assumed to begin to gradually depreciate back to close to historical averages.

However, capacity constraints remain high and inflationary pressures are forecast to still be strong is some sectors of the economy. This is illustrated in the outlook for persistence in non-tradables inflation, which is expected to remain close to 4% throughout 2007. However, weak domestic demand growth is forecast to gradually reduce the pressure on non-tradables inflation, which is forecast to be below 3% by the second half of 2008. The output gap continues to contribute to inflationary pressure throughout 2007. The size of the output gap is in part determined by our assessment of potential growth in the economy.

The combined effect of the outlook for tradables and non-tradables inflation is that CPI inflation falls to 1.9% by June 2007, rises back to 2.8% in December 2007 then slowly declines to around 2%.

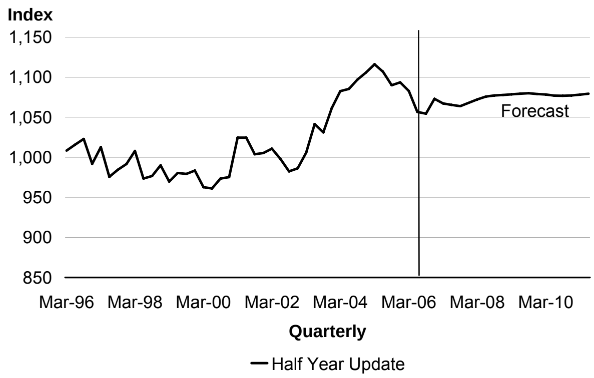
The outlook for trading partner growth remains supportive of growth, underpinning a lift in the terms of trade

The outlook for trading partner growth, while not as strong as in the period of high growth in 2004, is likely to underpin solid demand for New Zealand's exports. In addition, current drought conditions being experienced in Australia may restrict the supply of some agricultural commodities to international markets. Meat prices are forecast to decline a little initially after recent increases, with drought in Australia likely to lead to some early slaughtering of animals increasing supply, and putting downward pressure on prices. Further out we expect prices to increase with herd numbers likely to be smaller until climatic conditions are more favourable. Dairy prices declined during the first half of 2006 but have increased recently. World prices are forecast to continue this upward move, with demand remaining solid and Australian supply likely to ease as the effects of drought conditions take hold on dairy production.

World prices of oil are forecast to lift to US$68/barrel in the short term, based on futures prices at the time the forecasts were finalised. This is likely to contribute to a lift in import prices. However, oil prices are forecast to decline somewhat from 2008. The prices of a number of other categories of imports are forecast to decline, with capital import prices in particular forecast to continue their downward trend in international price terms.

These movements in export and import prices are forecast to see the terms of trade recover somewhat from its recent dip, contributing to the recovery in growth forecast in the March 2009 year.

Figure 1.8 – SNA total terms of trade



Sources: Statistics New Zealand, The Treasury

Soft domestic demand growth is forecast during 2007 …

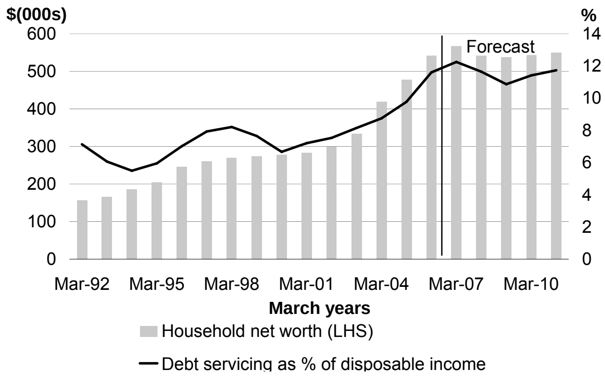
Domestic demand growth fuelled economic growth during much of the past five to six years. Growth in domestic demand has slowed during the past 12 months as the impact of interest rate increases has begun to constrain households. This recent trend is forecast to continue, with growth in private consumption and residential investment forecast to ease on the household side, while market investment is forecast to continue to decline.

… with households forecast to ease their rate of debt accumulation and slow their expansion of consumption spending …

Annual growth in private consumption is expected to continue to ease as households slow the rate at which they take on debt. Interest rate increases during 2005 have seen debt servicing costs increase, and the central forecasts are for interest rates to hold at current levels right through until September 2007. This leads to debt servicing costs reaching record high levels. Households are forecast to respond to this, as well as an expected easing in the labour market and a forecast end to large increases in wealth from house price gains, by slowing the rate of growth in their consumption. As a result, private consumption is forecast to increase 1.6% in March 2007 and 1% in March 2008, well down from the growth rates of 5% or more recorded in the period from 2003 to 2005.

While household debt levels are expected to continue to increase, the rate of increase is forecast to be substantially slower than has been the case in recent years. This is an important judgement underlying the central forecasts. If households remain eager to take on an increasing amount of debt, then growth in private consumption, and possibly residential investment, will be substantially stronger than forecast. *Scenario One* in the *Risks and Scenarios* chapter considers the outlook for the economy if this desire for a lower rate of debt accumulation does not occur.

Figure 1.9 – Debt servicing

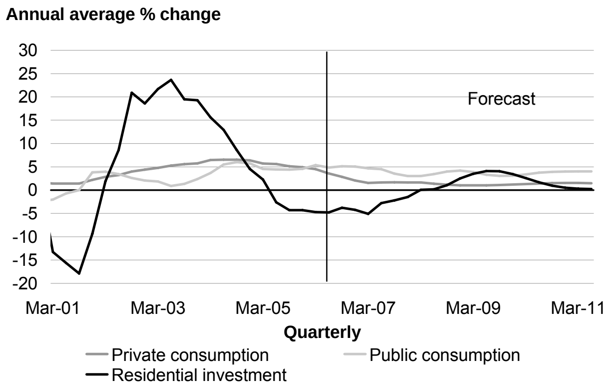


Sources: Statistics New Zealand, The Treasury

… and in the housing market

Residential investment has fallen during the period since the end of 2004 as net migration inflows eased and interest rates increased. Building consents fell in line with the easing in residential investment but have recently increased. This increase in building consents is forecast to lead to an increase in residential investment in the September and December quarters of 2006. However, residential investment is forecast to be flat over 2007, with the size of the population suggesting that the housing stock is already sufficiently large, reducing the incentive to build new houses. Weaker activity in the household sector is also likely to flow into the market for existing houses. House prices are forecast to fall 3% in the 2008 March year, removing an important source of wealth gains for households and further discouraging additional consumption spending.

Figure 1.10 – Selected components of domestic demand



Sources: Statistics New Zealand, The Treasury

Businesses are forecast to cut back investment during 2007…

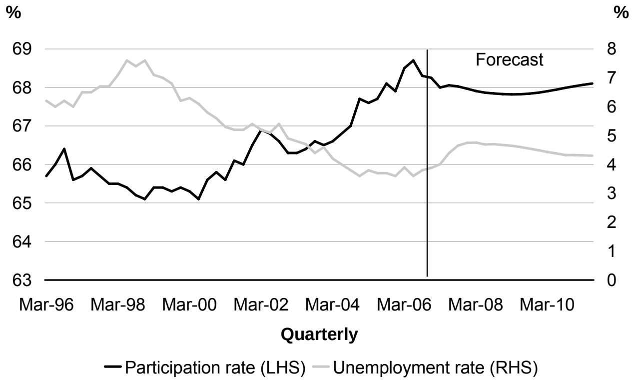
Market investment recorded quarterly falls in the first half of 2006 as firms trim their investment in the face of pressure on margins and falls in profits. With growth expected to be soft and profits continuing to be squeezed, market investment is forecast to continue to fall 6.9% in the year to March 2007 and a further 1.2% in the year to March 2008.

… as well as seeking some adjustment in the labour market …

To date, firms have responded to margin pressures by cutting investment. This behaviour is forecast to extend into the labour market as firms seek to limit their labour costs. As a result, employment is expected to be flat, with firms looking for productivity gains from their existing workforce, rather than adding staff. Nevertheless, firms are not forecast to seek significant falls in employment, due to the cycle in activity being relatively muted and firms looking to retain staff due to difficulties finding skilled workers. These developments are forecast to bring employment growth more into line with general economic activity, with the labour market tending to lag behind developments in the rest of the economy. With employment growth slowing, the labour force participation rate is forecast to fall as employment prospects diminish. The unemployment rate is forecast to rise to a peak of 4.8% in March 2008. The forecasts incorporate wage growth continuing at above 4.5% through most of 2007.

The labour market has outperformed forecasts for a sustained period of time and future developments continue to pose a risk to the central forecast, particularly the outlook for private consumption and residential investment growth.

Figure 1.11 – Labour market



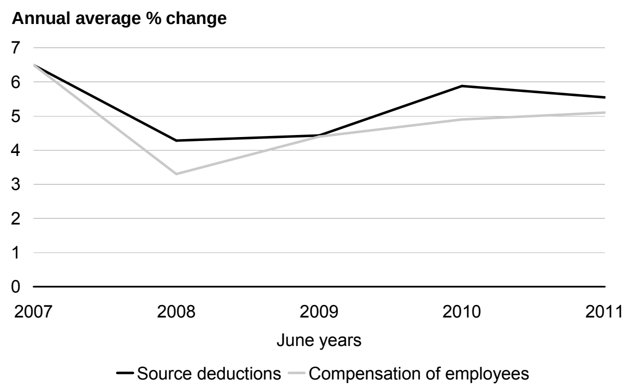
Sources: Statistics New Zealand, The Treasury

… leading to slower growth in source deductions tax revenue, despite strength in the period to June 2007 …

Wage increases and the expansion of employment during the first half of 2006 have combined to push source deductions tax revenue to a level around $200 million higher than forecast in the *Budget Update* in the period to September 2006. Source deductions are forecast to increase around 7% in the 2007 June year with the forecast easing in the labour market leading to slower growth in source deductions tax revenue of 4.3% in the year to June 2008. Revenue from source deductions is forecast to be around $700 million higher than the *Budget Update* in each of 2007 and 2008.

Growth in source deductions is forecast to be stronger than the growth in labour income throughout the forecast period. This reflects the effects of “fiscal drag” with wage increases, whether owing to rising inflation or productivity increases, meaning that workers will move up the income distribution and be subject to higher marginal tax rates. Previous forecasts have allowed for some effect from this on tax revenues. The Treasury has changed its assessment on the impact of fiscal drag in the *Half Year Update* based on empirical analysis that suggests that the effect of wage growth

Figure 1.12 – Source deductions



Sources: Statistics New Zealand, The Treasury on tax revenue built into the *Budget Update* was too small. The result of this change in method is to add around $200 million a year to the forecasts of source deductions.

… while declining profits are forecast to put pressure on corporate taxes

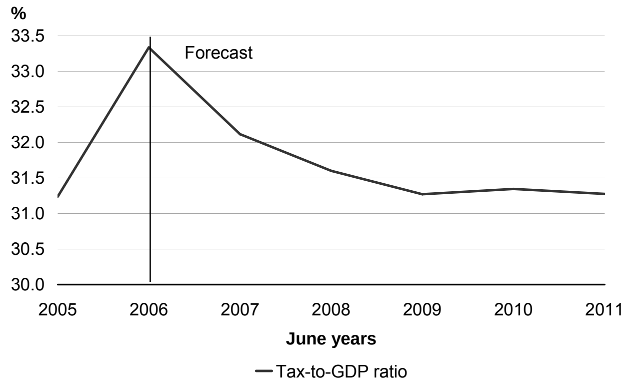
Rising costs, including wages, are forecast to constrain profit growth so that, in the year to March 2007, profits are forecast to decline, leading to a forecast fall of just under 13.3% in the corporate tax take. With profits (as measured by the business operating surplus) forecast to decline in 2007, some firms are likely to make losses, and the forecasts of tax revenue see some build-up in tax losses, which limit corporate tax growth to 0.9% in 2007/08 as the losses are utilised. The box entitled “Corporate Taxes” contains a more detailed discussion of the outlook for corporate tax.

However, total tax revenue is forecast to be around $1 billion higher than the level forecast in the Budget Update

The lift in tax revenue forecast in 2007 is expected to persist over the forecast period, despite some slowing in the growth in tax revenue as the economy slows. The level of nominal GDP is forecast to be higher than in the *Budget Update*, with the difference peaking at close to $2 billion during 2007. The ratio of tax to nominal GDP has increased sharply in recent years, but is expected to fall somewhat during the forecast period, largely owing to:

- compositional changes in GDP during a period of slow growth in labour income
- personal tax threshold adjustments in April 2008 and April 2011, and
- the forecast utilisation of tax losses in the corporate sector.

Figure 1.13 – Tax as a percentage of nominal GDP



Sources: Statistics New Zealand, The Treasury

Government spending is forecast to make a solid contribution to growth

Real public consumption is forecast to grow 3% to 4% per annum throughout the forecast period, with increasing prices meaning that nominal growth is forecast to peak at 8% early in 2007 before growth falls to 5% to 7% across the rest of the forecast period. Non-market investment, which increased around 25% the March 2006 year, is forecast to remain at a high level.

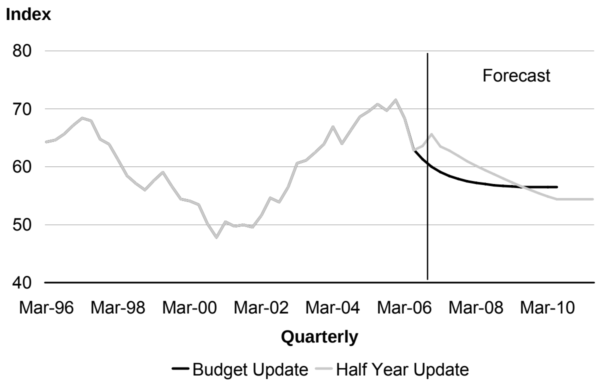
The forecast slow growth in domestic demand leads to an easing in inflationary pressures and sees interest rates fall at the end of 2007

As described in the box entitled "Inflation", weak domestic demand growth is expected to lead to an easing in inflationary pressures, with CPI inflation forecast to be 2% by March 2009. With inflationary pressures easing, 90-day interest rates are forecast to fall in September 2007, with rates expected to decline to 6% by March 2008.

Export growth is forecast to be constrained by the exchange rate …

The exchange rate appreciation during the middle of 2006 is forecast to delay any recovery in services exports, with the higher level of the exchange rate effectively making New Zealand a more expensive destination for tourists. The exchange rate is also forecast to dampen forestry exports as well as manufactured export volumes, although the impact of the exchange rate on the latter is relatively small. In addition, with a strong contribution to dairy exports from running down inventories in the June and September quarters of 2006, the quarterly level of dairy exports is forecast to decline in December 2006 and March 2007, based on a judgement that this stock rundown will not continue. As a result, the level of dairy exports is forecast to come back into line with production. These developments are expected to see export volumes increase only 1.4% in the March 2008 year.

Figure 1.14 – TWI exchange rate



Sources: Statistics New Zealand, The Treasury

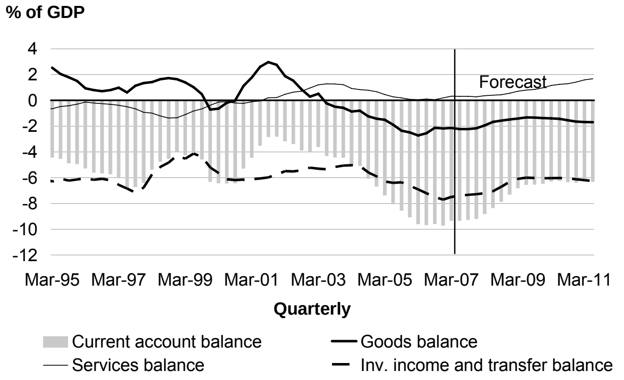
… and the current account is forecast to be 8.8% of GDP in March 2008 …

Weakness in export volumes, together with a large deficit on investment income, means that the current account deficit is likely to remain large, despite weak import volume growth owing to softness in domestic demand. The investment income deficit has emerged from the combination of high profits of foreign-owned firms in New Zealand and high interest costs associated with servicing the debt that has been accumulated by running a current account deficit in excess of 6% of GDP since the end of 2004. By March 2008 the current account deficit is forecast to slowly narrow to 8.8%, compared with 9.7% in June 2006.

… before closing further, as exchange rate depreciation in 2007 boosts exports in 2008 …

The exchange rate is assumed to decline from high levels back closer to its historic average level. This decline will make New Zealand a cheaper destination for foreign tourists and is forecast to boost services exports with a lag of around one year, such that the falls in the exchange rate in 2007 do not begin to boost exports until 2008. With export volumes rising and the terms of trade at a high level, the rate at which the current account deficit narrows is forecast to accelerate, and the deficit is forecast to reach 6.8% of GDP in 2009 and 6.3% in 2010.

Figure 1.15 – Current account



Sources: Statistics New Zealand, The Treasury

… contributing to a lift in GDP growth to 3.2%

A recovery in exports, together with some recovery in domestic demand, due to a lift in residential investment on the back of interest rate declines and a rise in market investment, are expected to contribute to a recovery in GDP growth to 3.2% in the year to March 2009. Nominal GDP growth is forecast to peak at 5.6% in 2009, with real GDP growth of 3% and an increase in the terms of trade boosting nominal GDP.

Productivity gains are forecast to drive growth on the supply-side of the economy …

We expect labour productivity growth to rebound from its recent low rate of growth. Table 1.3 provides a supply-side breakdown of growth. Rising labour utilisation has made strong contributions to growth over recent years as labour force participation has increased and the unemployment rate has fallen. At the same time productivity growth has made little contribution to growth. Productivity growth has increased a little more recently, with a 1.3% contribution to growth expected in the year to March 2007 as the cycle in the labour market moves more into line with the cycle in the rest of the economy.

Table 1.3 – Supply-side contributions to GDP growth

March Years	GDP per Capita	GDP Growth	Labour Productivity Growth	Labour Input Growth
2004	2.1	3.8	1.6	2.2
2005	2.5	3.7	0.3	3.4
2006	1.3	2.2	0.1	2.2
2007	0.8	1.8	1.3	0.6
2008	1.3	2.3	2.6	-0.3
2009	2.3	3.2	2.5	0.6
2010	2.2	3.1	1.7	1.4
2011	2.2	3.0	1.4	1.6

Productivity growth is expected to be higher over the forecast period than in the recent past, reflecting a return from a period of strong market investment growth up to March 2006 and increases in the capital-to-labour ratio. This lift in productivity is an important judgement in the forecasts. It leads to an increase in GDP growth, and an increase in potential GDP. If productivity growth is lower than forecast, and potential lower, then this could lead to a larger than expected output gap, and consequently more pressure on inflation.

… and firms are expected to lift investment as profits rise …

Rising profits, increasing productivity and falling interest rates all contribute to a rise in market investment growth from the March 2009 year. The *Budget Policy Statement* signals that the Government has increased the 2008 Budget Allowance by $1 billion, using the additional fiscal headroom to counterbalance the cost of the business tax package. While the details of any changes are still under development and will be made in the lead-up to Budget 2007, the central forecast builds in the impact of lower business taxes, which are assumed to have the effect of making a larger number of potential investment projects profitable for firms, leading to an increase in market investment from 2009 onwards.

… and the labour market recovers

As growth in the economy lifts, employment is also forecast to rise, increasing 1.3% and 1.5% in 2010 and 2011 respectively. After declining during the period of weak growth, labour force participation is forecast to rise while the unemployment rate falls back to 4.3%, our assessment of the long-run structural rate of unemployment.

Corporate Taxes

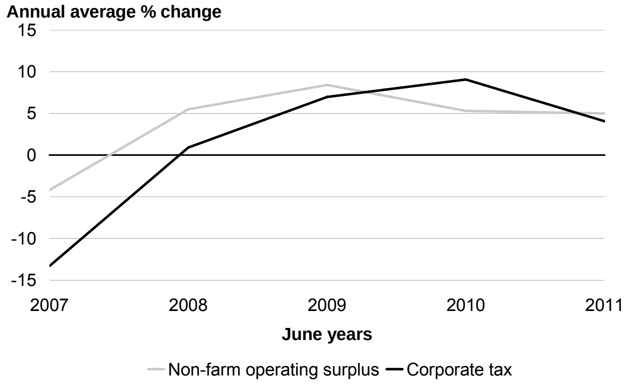
Corporate taxes have been a significant source of upside surprises in recent years. The future pattern of corporate taxes poses a risk to the fiscal outlook. This box discusses the drivers of the corporate tax forecasts.

The strong economic performance of recent years has contributed to strong growth in corporate profits. Profit growth has been relatively broad-based across most of the economy for the past several years. However, more recently the pattern of profit growth has altered, with the continued strength in the financial sector masking softer performance in other sectors. The growth in tax receipts from other sectors is lower than in the past, indicative of falling profits in other sectors of the economy, with many businesses facing rising costs and falling margins. Meanwhile, a strong housing market and high returns in financial markets have boosted profits in the finance sector. It is likely the strong performance of the financial sector is masking softer performance in other sectors.

With profits forecast to decline in 2007, the forecasts incorporate some build-up in tax losses. This mirrors the 1998 and 2002 tax years, the last two occasions when net taxable profits declined. This build-up in losses is based on a judgement that a period of falling growth in profits will be associated with some firms recording losses. Falling margins are likely to affect firms in some sectors, with exporters particularly at risk as their revenues are directly affected by movements in the exchange rate.

The accumulation of tax losses affects the growth in tax in subsequent years as firms utilise these losses. As a result, once profit growth increases in the year to March 2008, and the number of firms recording losses falls, growth in corporate tax revenue is suppressed by firms utilising the previous build-up in losses to effectively reduce their taxable income. This is forecast to result in a fall in corporate taxes of 13.3% in the 2006/07 year, a small increase of 0.9% in the 2007/08 year then a rebound to growth to 7.0% in the 2008/09 year, with profit growth forecast to rebound strongly.

Figure 1.16 – Growth of corporate tax



Sources: Statistics New Zealand, The Treasury

The build-up of losses is an important judgement in the forecasts. If a larger number of firms record losses, then tax revenue will grow more slowly as these losses are utilised. A smaller accumulation of losses would be associated with faster growth in tax revenue from 2008/09. By the time forecasts are finalised for the 2007 *Budget Update* there will be more information available that will provide an indicator of the extent to which losses are building up.

The outlook for corporate taxes is a significant driver of the differences between the revenue forecasts underlying the *Half Year Update* and the tax revenue forecasts prepared by the Inland Revenue Department (IRD). The IRD forecasts do not include the forecast accumulation of tax losses, with corporate taxes expected to grow from 2008 concurrent with the expected lift in profit growth. As a result, IRD's forecasts of corporate taxes are higher than the forecasts in the *Half Year Update*.