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Economic and Tax Outlook

Introduction

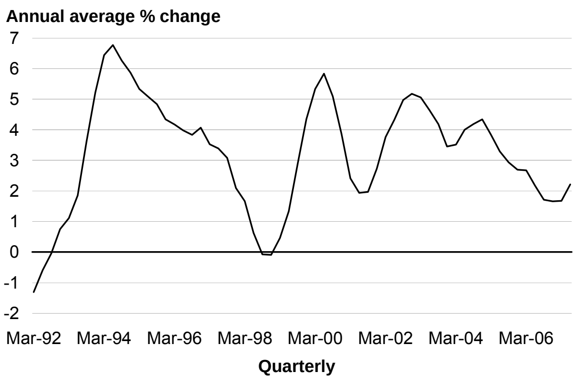
This chapter summarises the recent course of the New Zealand economy and the most likely path for its future development. Economic growth has slowed recently following a sustained expansion, but it is expected to continue, although at a slower pace. Higher dairy prices will boost returns to the agricultural sector, but global financial turmoil poses risks for the world economy. Domestically, the assumed reduction in tax revenue and continuing momentum in the labour market will be partially offset by tight monetary conditions, high oil prices, lower net migration inflows and high household debt. Tax revenue is forecast to be higher, even with the assumed reduction in tax revenue.

Growth slows after a long expansion

The New Zealand economy has experienced a period of sustained growth …

The New Zealand economy has expanded on an annual basis for nearly nine years and the expansion looks likely to continue, albeit at a slower pace. Real Gross Domestic Product (GDP) has increased 34% since the trough of the previous recession in 1998 which was marked by the Asian financial crisis, two successive droughts and monetary tightening (Figure 1.1). A number of factors, some related to the international economic environment and some arising from specifically New Zealand origins, have sustained the recent period of growth.

Figure 1.1 – Real GDP



Source: Statistics New Zealand

… thanks to a number of international and domestic factors

- Growth in the world economy has been robust since the late 1990s, apart from a brief dip in 2001 following the bursting of the “tech boom” in the United States.
- This sustained expansion, combined with reductions in supply for some commodities, took the terms of trade to a 30-year high in 2007.
- The greater participation of China in world trade helped suppress global inflation as its low labour costs reduced the price of manufactured products.
- A surplus of savings and low investment rates in Asia, in conjunction with increased oil revenues being available for investment, increased global liquidity.

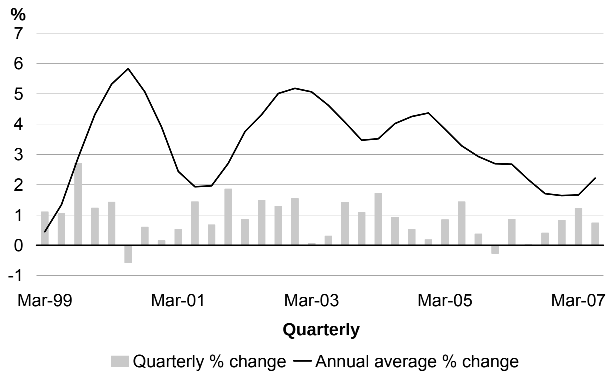
- Low inflation and a ready supply of capital led to low long-term interest rates becoming embedded in the major economies and provided a cheap source of debt.
- Financial market innovation and a greater willingness to borrow led New Zealand households to increase their debt levels.
- Net permanent and long-term (PLT) migration inflows averaged 20,000 per annum in the six years to 2006, twice their average in the past decade.
- Labour income increased by nearly 7% per annum in current dollar terms in the six years to 2006 as both employment and wages expanded rapidly.
- House prices more than doubled between 1998 and 2007, boosting wealth for homeowners and providing additional collateral for borrowing.
- The economy is more flexible and resilient, which has made it better able to respond to changes in the global economy and sustain growth.

The combined effect of these developments has been a period of sustained growth in the New Zealand economy, especially in nominal GDP thanks to the higher terms of trade. The value of nominal GDP has increased by 64% since mid-1998 and tax revenue increased by 70% over the same period.

Economic growth dipped in late 2005-early 2006 …

The rate of expansion began to slow on a quarterly basis in the second half of 2005 as some of the drivers of growth weakened (Figure 1.2). Net PLT migrant inflows fell to 6,000 in the year to October 2005 (from 17,000 the year before) as a result of lower student arrivals and a continuing increase in departures, especially to Australia. The Reserve Bank increased the Official Cash Rate by 50 basis points to 7.25% in late 2005 to counter increasing inflationary pressures. As a result, the housing market began to cool in late 2005-early 2006 and residential investment declined.

Figure 1.2 – Real GDP



Source: Statistics New Zealand

Increases in oil prices in the second half of 2005 reduced disposable income and detracted from household consumption growth. In addition, the appreciation of the exchange rate through this period curtailed growth in exports, particularly of services. Growth in production GDP fell to 1.7% in the year to September 2006 and remained at that rate for three quarters, its lowest rate since the late 1990s.

… but picked up again in late 2006-early 2007

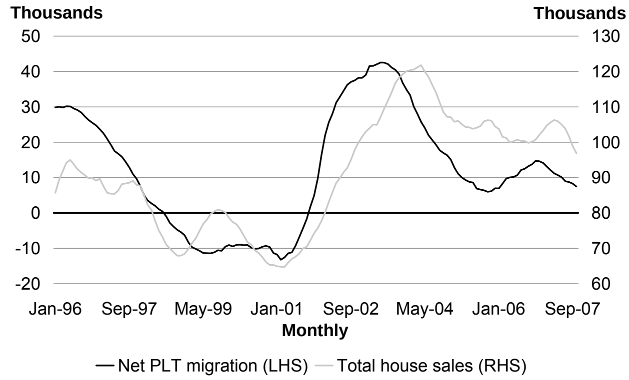
The slowdown in the economy was relatively short-lived as some of the same factors recovered towards the end of 2006 and brought a rebound in growth in late 2006 and early 2007. Net migration inflows increased from their low point in late 2005 to peak just below 15,000 in late 2006 as departures fell and arrivals increased. The faster population growth contributed to a recovery in the housing market, with house sales nearly one-fifth higher in the 2006/07 summer than a year before and a recovery in annual house price growth to just below 14% in June 2007.

Dwelling consents picked up in the first half of 2007 and residential investment increased in mid-2007 following the recovery in the housing market in late 2006. A fall in retail fuel prices in the December 2006 quarter boosted household disposable income and retail sales recovered in the second half of the year and the first quarter of 2007. The anticipation of higher dairy prices and the increase in the exchange rate in mid-2007 may have also played a role in higher consumption growth. Quarterly growth in real GDP accelerated from no change in the second quarter of 2006 to a 1.2% increase in the first quarter of 2007, boosted by consumption growth of 2.1% in the quarter.

Nevertheless, the economy was slowing from mid-2007

After the pick-up in the economy in late 2006-early 2007, there are signs that growth started to ease in mid-2007. Growth in real GDP declined to 0.7% in the second quarter of 2007 from 1.2% in the first quarter. Fuel prices have increased throughout 2007 as a result of higher international oil prices, the Reserve Bank increased the Official Cash Rate a further percentage point to 8.25% between early March and late July, net PLT migration inflows tracked down to 7,500 in the year to October, house prices were practically unchanged in the six months to September and annual house sales have fallen nearly 10% in the past six months (Figure 1.3). As a result of these developments, growth in retail sales and building consents has slowed, pointing to lower growth in private consumption and residential investment.

Figure 1.3 – Annual net migration and house sales



Sources: Statistics New Zealand, REINZ

But some negative factors have had less impact than expected …

The New Zealand dollar exchange rate has strengthened again, after falling in the immediate aftermath of the global financial turmoil in July-August. Despite the high exchange rate, export volumes were still robust in mid-2007 and manufacturers' outlook for exports remained positive in September. Local finance company collapses, while significant for those directly affected, are not considered likely to have much impact at the aggregate level. They may have some impact on consumer confidence, however.

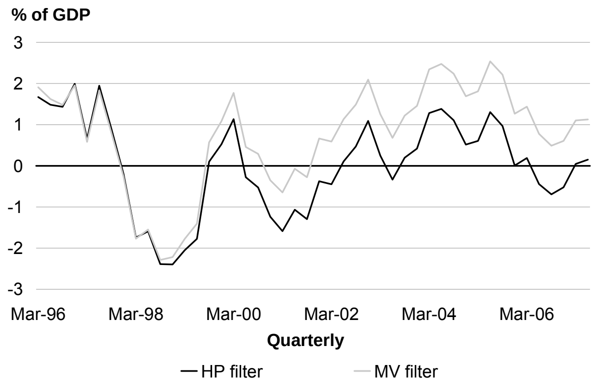
… and there are still some positives

There are also some factors which have supported growth in the second half of 2007. Higher dairy prices (discussed in the next section) have started to flow through, unemployment remains low and wage growth high, consumer confidence is moderately positive, and businesses' outlook for their own activity – although easing – is also still positive, pointing to ongoing growth next year. We expect growth in real GDP of around ½% in each of the September and December quarters of 2007. Combined with high growth over the first half of the year, this will lift growth to 3.0% on an annual average basis in March 2008.

The economy continues to operate at or above potential

Even with the slower growth from late 2005, the economy remains at or above its potential level of output. Capacity utilisation is just below its recent peaks and businesses are experiencing increasing difficulty finding staff. Wage pressures are high, input costs – especially for non-tradable items – are increasing steadily and firms' pricing intentions point to continuing inflationary pressure. The output gap (a measure of how far above potential the economy is) is estimated to be positive on two main indicators (Figure 1.4).

Figure 1.4 – Measures of the output gap

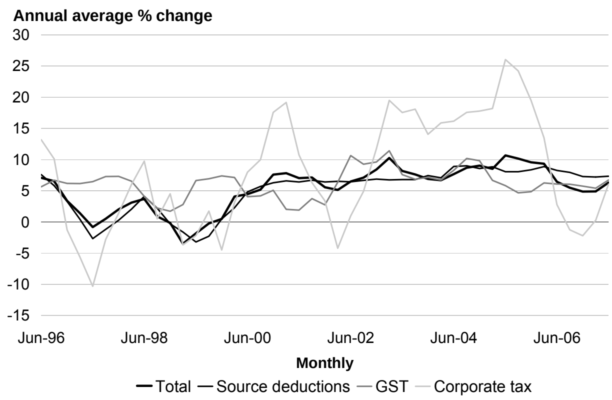


Source: The Treasury

Tax revenues continue to grow

Higher growth in nominal GDP led to faster growth in tax revenues in the recent period, especially in the June quarter 2007 (Figure 1.5). Corporate tax growth was flat to slightly negative through much of 2006 and then accelerated through the first half of 2007. The pick-up in corporate tax appears to be related more to investment returns than what would usually be thought of as business profits.

Figure 1.5 – Tax component growth



Source: The Treasury

GST growth also increased markedly towards the end of the June 2007 year, with the level of GST 10% higher in the 2007 June quarter compared with the 2006 June quarter, after hovering around the 5% mark through the previous three quarters. The unusually high growth in the June quarter may be related to the recovery in domestic consumption and increased residential investment through the first half of 2007.

With unemployment remaining low and wage growth high, source deductions (the largest single tax type) maintained steady growth through the June 2007 year. Although growth was down on the previous year, source deductions still grew by 7.5% in the year to June 2007. Overall, growth in total tax revenue declined through the end of 2006, but recovered again through the first half of 2007 on the back of the acceleration of GST and corporate tax.

Table 1.1 – Economic forecast[1]

Annual average % change, year to 31 March	2007 Actual	2008 Estimate	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
Private consumption	2.4	3.8	2.2	2.6	1.5	1.1
Public consumption[2]	4.1	2.8	3.6	4.2	4.0	3.8
Total consumption	**2.8**	**3.6**	**2.5**	**2.9**	**2.1**	**1.8**
Residential investment	-2.1	5.7	-3.9	-5.0	-1.6	1.0
Central government investment	1.2	-8.6	16.5	2.5	2.0	2.0
Other investment	-3.3	5.6	4.9	1.1	2.0	3.5
Total investment	**-3.1**	**4.9**	**3.8**	**0.0**	**1.3**	**3.0**
Stock change[3]	-0.7	0.8	-0.1	0.4	0.0	0.0
Gross national expenditure	**0.7**	**4.7**	**2.7**	**2.6**	**1.8**	**2.0**
Exports	3.0	1.6	2.6	3.4	3.7	4.0
Imports	-1.4	6.1	4.0	2.7	1.3	1.4
GDP (production measure)	**1.7**	**3.0**	**2.1**	**2.8**	**2.7**	**2.9**
- annual % change	2.5	2.3	2.3	2.8	2.7	3.0
Real GDP per capita	0.5	2.0	1.1	1.8	1.7	2.0
Nominal GDP (expenditure basis)	4.7	7.3	5.4	4.1	4.2	4.6
GDP deflator	2.5	4.0	3.3	1.3	1.5	1.7
Employment[4]	2.0	1.4	0.8	1.1	0.9	0.9
Unemployment[5]	3.7	3.8	3.8	3.9	4.1	4.1
Wages[6]	4.8	4.2	4.4	4.4	4.2	3.9
CPI inflation[7]	2.5	3.1	2.8	2.7	2.6	2.5
Export prices[8]	9.1	3.1	11.1	4.1	4.7	3.3
Import prices[8]	7.2	-4.4	2.5	6.0	6.5	4.6
Current account balance						
- $million	-13522	-12963	-11851	-13804	-14109	-13552
- % of GDP	-8.3	-7.4	-6.4	-7.2	-7.0	-6.5
TWI[9]	68.8	70.0	67.0	62.2	58.9	57.1
90-day bank bill rate[9]	7.8	8.5	8.5	8.3	8.0	7.4
10-year bond rate[9]	5.9	6.4	6.5	6.7	6.6	6.4

Notes:
1. Forecast finalised 8 November 2007 incorporating data up until 2 November 2007.
2. The forecast profile for public consumption is influenced by government defence spending.
3. Contribution to GDP growth.
4. Household Labour Force Survey, full-time equivalent employment.
5. Household Labour Force Survey, percentage of the labour force, March quarter, seasonally adjusted.
6. Quarterly Employment Survey, average ordinary time hourly earnings.
7. Annual percentage change.
8. Overseas Trade Index basis, annual average percentage change.
9. Average for the March quarter.

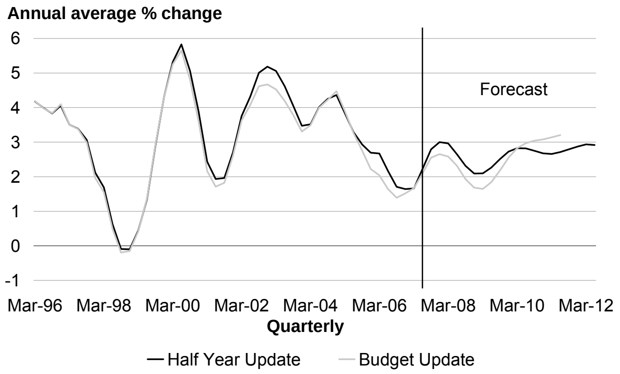
Sources: Statistics New Zealand, Reserve Bank of New Zealand, The Treasury

Outlook is for continuing but easing growth

The most likely path for the economy is continuing but easing growth

The most likely path for the economy is continuing but slowing growth until late 2008, when the rate of expansion will start to return towards its trend rate of around 3%. The robust growth in late 2006-early 2007 will boost the annual average rate of growth to 3.0% in the year to March 2008, but it will decline to 2.1% in the year to March 2009 before increasing again to 2.9% in the year to March 2012 (Figure 1.6). The key international and domestic influences determining the development of the economy are discussed in the following two sections. Considerable uncertainties surround this view and they are discussed in the *Risks and Scenarios* chapter.

Figure 1.6 – Real GDP



Sources: Statistics New Zealand, The Treasury

Weaker world growth, but higher terms of trade

Slowdown in the United States led to a reappraisal of the near-term outlook

The prospect of slower economic growth in the United States, largely as a result of heightened concerns about the fallout from the financial turmoil arising from the sub-prime mortgage market and the deepening downturn in the housing market, has led to a reappraisal of the prospects for United States and world growth since the *Budget Update*. Our forecasts of the international economy are based on the October 2007 *Consensus Forecasts*, a monthly survey of more than 240 forecasters worldwide. Compared with those underlying the *Budget Update*, they contain downward revisions for the United States, Japan and the euro area in the near term, partly offset by upward revisions for Australia and non-Japan Asia. Economic growth for our top 20 trading partners is now expected to decline from an estimated 4.0% in 2007 to 3.5% in 2011, compared with stable growth of 3.6% throughout the period in the *Budget Update*.

The latest views of major international forecasting agencies are consistent with the downward revision of the outlook for the world economy. In October the International Monetary Fund revised down its forecasts for global growth in 2008 from 5.2% to 4.8%, with lower growth expected in the United States and in most other economies. Since our forecasts were finalised, the OECD has commented that “more recent economic news points towards a more protracted adjustment” in the United States and the world economy.[1] In its December 2007 *Economic Outlook*, the OECD commented that the probability distribution around its baseline scenario (which incorporated downward revisions to growth from their mid-year *Outlook*) is skewed to the downside, with the main negative risks being greater cooling in housing markets, additional turbulence in financial markets and further upward pressure on commodity prices.

[1] Financial Market Trends No. 93, OECD 2007.

Risks to the outlook for the world economy

Our forecast for the world economy is based on the most common view which is that a recession is unlikely. However, the risks of such an event have increased since we finalised the forecast.

We have taken the outlook for our main trading partners from the October *Consensus Forecasts*, the latest available when we finalised the forecast and in line with our standard practice. Since that survey of other forecasters was released in mid-October, the outlook for the world economy has changed as fresh concerns have emerged regarding the effects of the financial turmoil and the United States housing market has weakened further.

Interest rate spreads between commercial and government securities in the United States and elsewhere have increased again close to their levels in August when the financial turmoil first developed. This is occurring as more losses by commercial banks and finance companies become apparent and the full implications of the sub-prime mortgage crisis unfold. The need to consolidate balance sheets prior to the end of the financial year may also be bringing some of these problems to light.

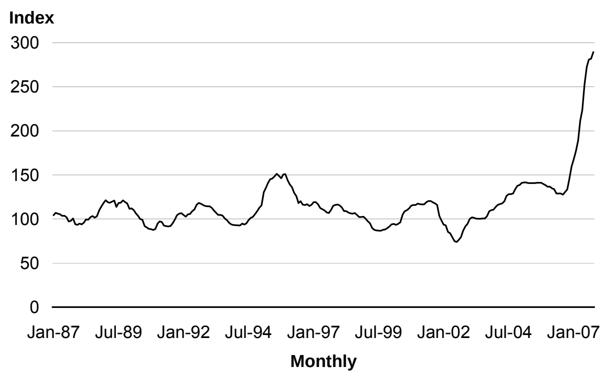
Although official forecasters are not picking a major downturn in the United States or world economy at present, the risks of such an event have increased recently. The most common view is still that the United States will not experience a recession, although most commentators consider that growth will be lower than previously forecast. The fresh concerns about the extent of the financial turmoil mean that the risks of a major downturn in the United States are greater than previously thought and these concerns have increased since we finalised our forecasts. This situation is developing rapidly and presents a major risk to the outlook presented in this forecast.

If there is a major downturn in the United States economy and it spreads to other parts of the world, there would be reduced demand for New Zealand exports. This would manifest itself primarily through lower terms of trade and lower real income. The *Risks and Scenarios* chapter explores the impact that lower terms of trade would have on key economic and fiscal aggregates.

Higher prices in world dairy markets …

An important development for the New Zealand economy since the *Budget Update* is the continued increase in world dairy prices. In the six months from September 2006 to March 2007, spot prices for dairy products in international markets increased 45%; in the six months since then they increased by a further 49% as a result of a combination of supply and demand factors (Figure 1.7).

Figure 1.7 – World dairy prices



Source: ANZ National Bank

Changes to the Common Agricultural Policy (CAP) have brought lower subsidies for European farmers and less incentive for increased production. In addition, the virtual elimination of butter stocks in Europe has removed downward pressure on prices, and milk production quotas and reduced export subsidies effectively place a ceiling on European Union dairy exports. In Australia, the effects of the drought have lingered and delayed recovery in dairy production. Persistent drought has cut the availability of irrigation water, reduced pasture growth and driven fodder costs higher. In the United

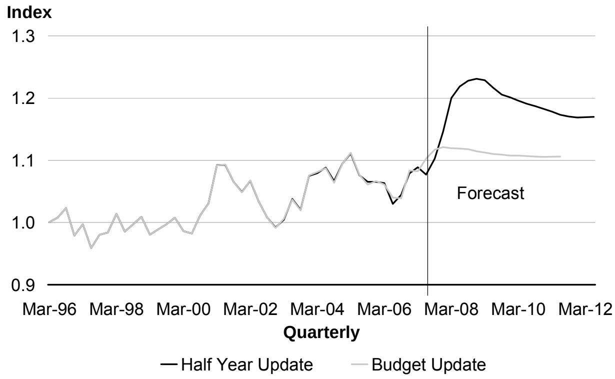
States, the expansion of ethanol production has limited the supply of feed corn and driven up its price, pushing up dairy prices at the same time.

Income growth in developing countries, along with changing consumer preferences towards more Western-style foods, has increased the demand for dairy products. High oil prices have also led to increased demand from oil-exporting nations as incomes have increased.

… will flow through to New Zealand exporters and the terms of trade

The increase in spot prices for dairy products in world markets in the past year has so far had little impact on dairy export prices, but we expect the majority of the increase to appear between the third quarter of 2007 and the first quarter of 2008. The full extent of the increase in spot prices will not be transmitted to local prices because the use of supply contracts by exporters smoothes the peaks and delays the flow-through. We have assumed that annual growth in the world dairy prices received by New Zealand producers peaks at 64% in the March quarter 2008 and that they will level off in mid-2008, before declining gradually from the December quarter of 2008. By that time we expect increased production from other exporters (such as South America and the United States) as well as increased domestic production in China, and that higher prices for consumer products will have started to reduce demand. Higher dairy prices will lead to significantly higher terms of trade than previously forecast (Figure 1.8).

Figure 1.8 – Goods terms of trade (SNA basis)



Sources: Statistics New Zealand, The Treasury

We expect dairy prices to remain above their pre-boom level at the end of the forecast period, reflecting higher costs of production (as a result of the factors outlined above) and increased global demand. However, further price declines are likely beyond the forecast period as world supply expands further. There is considerable uncertainty related to these projections for dairy prices and alternative scenarios are presented in the *Risks and Scenarios* chapter, including their implications for the economy and fiscal indicators.

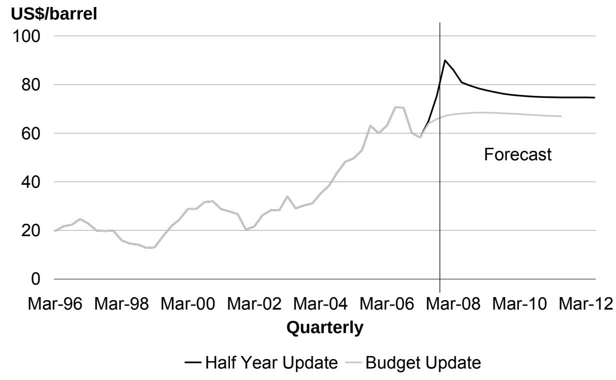
Meat prices are expected to increase as well

Meat prices are expected to increase modestly in the early part of the forecast period for similar reasons to dairy prices, namely lower production in Australia as a result of the drought, the removal of lamb production incentives in the CAP and expanding ethanol production in the United States leading to increased feed costs for beef farmers. This is expected to limit United States beef production, increase prices to final consumers and offset the effects of the re-opening of key north Asian markets to United States beef exports. Increased demand from developing countries for meat is also expected to lead to higher prices.

Oil prices are expected to remain high throughout the period

Prices for West Texas Intermediate (WTI) crude oil have increased in US dollar terms throughout most of 2007. The increase partly reflects the weakness of the US dollar, but also increased demand and concerns about supply. In accordance with our usual practice, we have assumed that the average futures prices recorded in the month prior to finalising the forecast will apply over the forecast period. The resulting projection declines from an assumed US$90 per barrel in the fourth quarter of 2007 to just below US$75 per barrel in the fourth quarter of 2010 (Figure 1.9). Oil prices are forecast to be approximately one-third higher than in the *Budget Update* in the December 2007 quarter, gradually declining to 12% higher in 2011. These higher prices will offset some of the increase in dairy and meat prices on the terms of trade.

Figure 1.9 – WTI oil prices



Sources: Datastream, The Treasury

Higher terms of trade will benefit the wider economy …

The direct impact of the increase in dairy prices will be concentrated in the agricultural sector, but with some flow-on to supporting service sectors and the rest of the economy. Higher export prices will lead to higher incomes and so increased consumption and investment. The indirect benefit from the higher terms of trade will accrue to the wider economy via the exchange rate which we now expect to remain higher than in the *Budget Update*. This will make imports cheaper and raise real incomes for households, boosting consumption.

… and bring a reduction in the current account deficit

Despite the higher consumption, the higher terms of trade are expected to bring a rapid reduction in the current account deficit from 8.3% of GDP in the year to March 2007 to 7.4% of GDP in the following year and to 6.4% in the year to March 2009. However, as the terms of trade begin to decline from their peak in the final quarter of 2008, the current account deficit is expected to increase again briefly to 7.2% of GDP in the year to March 2010. It then resumes its gradual decline as export volume growth, especially for services exports, outstrips import volume growth and the continuing decline in the terms of trade.

Export production is expected to increase in response to the higher terms of trade

We expect that there will be an increase in dairy production as farmers increase herd sizes through stock retentions and boost output in the short term through productivity-enhancing measures, and as dairy conversions increase. Meat production is expected to remain practically unchanged in the forecast period, but forestry export volumes are forecast to increase by 4% per annum from 2009 with supportive New Zealand dollar prices (as the exchange rate depreciates) and as the volume of wood available for harvest increases.

In the March 2008 year, export volumes will be boosted by production from the Tui oilfield. Exports began in the September quarter 2007 and were expected to peak in the December quarter 2007. Since the forecast was finalised, the reserves in the Tui oilfield have been revised up by some 30%, so production is now considered likely to remain high for longer. Non-commodity export volumes are forecast to continue to increase as manufacturers target production to their markets and as the assumed fall in the exchange rate supports the profitability of exporting. The fall in the exchange rate is also expected to lead to an increase in the volume of services exports from 2009 as New Zealand becomes a more competitive tourist destination. Total export volume growth is forecast to increase steadily from 2.6% in the year to March 2009 to 4.0% in the year to March 2012 as producers respond to higher returns.

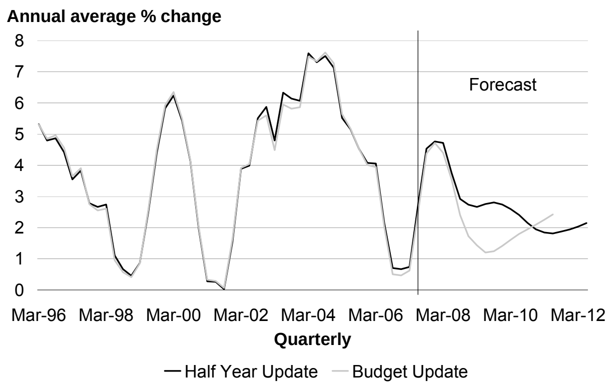
Domestic stimulus and momentum offset by some constraints

Positive and negative factors balanced in the domestic setting

Some key developments in the domestic economy will also be important in determining the path of the economy over the forecast period. The main supportive factors are an assumed reduction in personal income taxes and continuing momentum in the labour market, both of which will support private consumption, and continuing capacity constraints for firms which will encourage them to invest. These positive factors will be offset to some degree by continuing restrictive monetary conditions (combined with high debt levels for households), slower population growth as a result of lower net migration inflows, continuing high fuel costs and moderating house price growth.

Growth in real Gross National Expenditure (GNE) is estimated to be relatively high at 4.7% in the year to March 2008 as a result of the resurgence in consumption and residential investment in the first half of 2007 and higher market investment in the second half of 2007. In the 2009 and 2010 March years, growth in GNE is forecast to ease to 2.7% and 2.6% respectively, and then to ease further to 1.8% in the following year as the negative influences predominate, picking up slightly to 2.0% in the final year of the forecasts (Figure 1.10).

Figure 1.10 – Real GNE



Sources: Statistics New Zealand, The Treasury

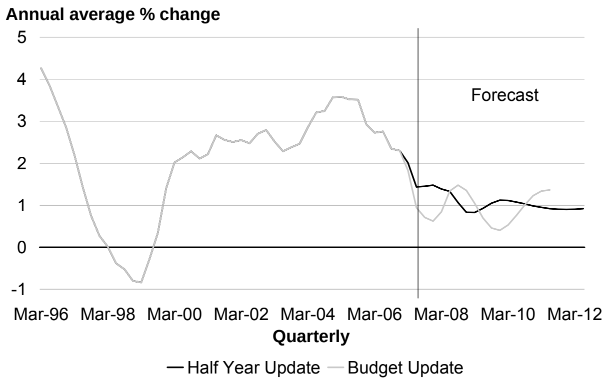
Assumed reduction in personal taxes stimulates private consumption

The forecast incorporates the implications of a reduction in tax revenue of around $1.5 billion per annum from April 2009, which is discussed in the *Budget Policy Statement* and the *Fiscal Outlook* chapter. It has been assumed that the revenue reduction will be applied to personal income taxes, thus supporting private consumption with some flow-through to higher imports, especially in the year to March 2010. The higher level of consumption will continue in subsequent years as net incomes will be higher than they would otherwise be. No assumptions have been made about the nature of the tax revenue reduction, apart from its aggregate value, and no response has been assumed in labour supply.

Continuing momentum in labour market …

Labour income growth was slightly higher in the first half of 2007 than our *Budget Update* forecasts, with higher employment growth offsetting lower wage growth. This increased momentum in the labour market is expected to continue in the forecast period as capacity constraints and high employment intentions point to continued robust employment growth. We expect full-time equivalent employment growth of 1.4% in the year to March 2008, but averaging just below 1% per annum over the following four years (Figure 1.11).

Figure 1.11 – Full-time equivalent employment



Sources: Statistics New Zealand, The Treasury

With a lower starting point for the unemployment rate than assumed in the *Budget Update* and slower labour force growth (as a result of lower net migration inflows), the unemployment rate is forecast to be lower than in the *Budget Update* throughout the forecast period, especially in the March 2009 and 2010 years. It is forecast to remain below 4% until the March quarter 2010 and then to rise only slowly to 4.1% by the end of the forecast period as growth in employment falls below growth in the labour force.

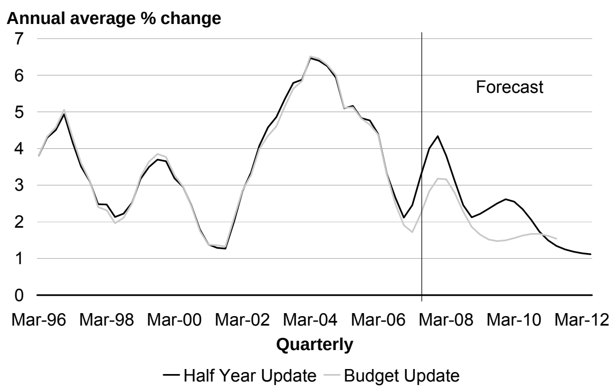
… will support earnings growth

With lower unemployment and continuing difficulties for firms in recruiting staff, as well as higher inflation, nominal wage growth is expected to be higher than in the *Budget Update*. Average ordinary time hourly earnings are forecast to increase by more than 4% on an annual average basis until the last year of the forecast period. Moderate but easing wage growth, combined with steady employment growth, is expected to lead to labour income growth continuing to decline from its recent peak of 7.5% annual average growth in mid-2006 to 6.1% in the year to March 2008, but remain at or above 5% until the end of 2011.

Consumption growth maintained in the short term

Continuing, although easing, momentum in the labour market is expected to support private consumption growth. The boost to private consumption in late 2006 and early 2007 keeps annual average growth high in the second half of 2007 and first quarter of 2008 (Figure 1.12). Other positive factors supporting consumption growth throughout this period are the higher dairy payout and associated higher exchange rate in the early part of the forecast period, making imports of goods and services cheaper. Growth in private consumption, which accounts for more than 60% of GDP, is expected to slow over calendar 2008 to a low of 2.1%, but the assumed reduction in personal taxes from April 2009 boosts annual

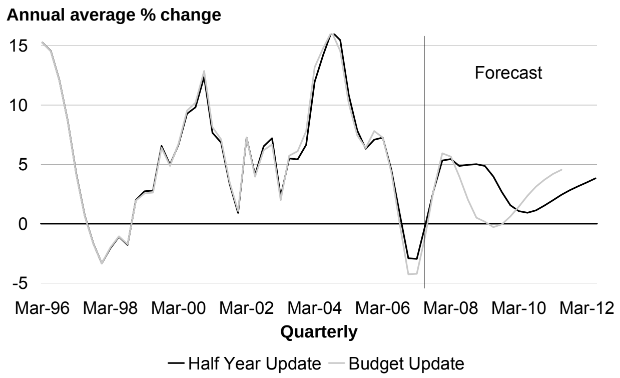
Figure 1.12 – Real private consumption



Sources: Statistics New Zealand, The Treasury average growth in the following year to 2.6%, before growth slows over the remainder of the forecast period.

Capacity constraints encourage businesses to continue to invest …

Figure 1.13 – Real market investment



Sources: Statistics New Zealand, The Treasury

Capacity constraints and labour shortages will continue to support market investment in the short term as firms seek to expand output and supplement or complement labour input. The increase in the terms of trade and resultant higher profits (not only for the dairy industry), plus the associated higher exchange rate, are also expected to support market investment in the near term. However, as the economy slows and the exchange rate declines, growth in market investment is expected to ease from a peak of 5.6% in the March 2008 year (boosted by high quarterly growth in late 2006 and early 2007), to a trough of less than 1% in the year to June 2010 as a result of continuing high interest rates (Figure 1.13). It subsequently recovers somewhat in the final two years of the forecast.

… and labour productivity growth is expected to increase

The reversal of some cyclical factors, along with the increased market investment, is expected to lead to a further recovery in labour productivity growth in the forecast period. Growth in labour productivity slowed in 2005 and 2006, possibly as firms held onto staff because of the difficulty of replacing them. As growth strengthened again without a commensurate increase in labour input, labour productivity growth began to increase and we expect this trend to continue. In addition, many new workers in the recent period may have been less productive than more experienced workers; as they learn by doing, labour productivity will also increase. Growth in labour productivity is expected to average 1.8% per annum in the forecast period, higher than its average of 1.2% in the past seven years.

Non-market investment and public consumption also expected to increase

Non-market investment (ie, central government and Crown entities) is forecast to grow at a high rate in the short term (partly reflecting a bounce-back from a sharp drop in mid-2007), boosting growth in the year to March 2009. Thereafter, non-market investment is forecast to grow at around 2% per annum as the Government continues to expand infrastructure for public services. The Government's current expenditure is also forecast to increase throughout the forecast period, averaging growth of nearly 4.0% per annum, up from 2.8% growth in the year to March 2008.

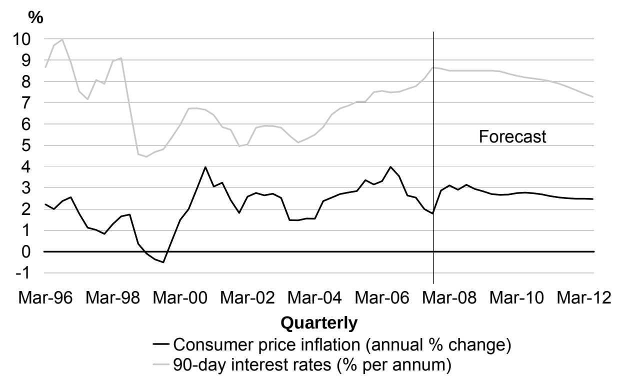
Inflation is expected to remain higher for longer …

Continuing growth in domestic demand, as a result of the reduction in tax revenue incorporated from April 2009 and the ongoing momentum in the labour market, is expected to lead to greater pressure on resources and increased inflationary pressure. Consumer price inflation is forecast to peak at 3.1% in March 2008 and average 3.0% for calendar year 2008. Non-tradables inflation will remain high as a result of the additional growth in private consumption and tradables inflation will be boosted by higher oil prices and the assumed fall in the value of the New Zealand dollar (discussed below). Higher international food prices will also push up tradables inflation. This forecast does not include the impact of the proposed emissions trading scheme which will result in higher prices for carbon-sourced energy.

… and high interest rates …

As a result of higher inflation than in the *Budget Update*, 90-day interest rates are expected to remain at or above 8.5% until the final quarter of 2009, when they will start to ease. Consumer price inflation is expected to decline gradually from 3.1% in September 2008 to 2.5% by the end of the forecast period (Figure 1.14). This is above the mid-point of the Reserve Bank's target band as the time required to bring inflation back to that rate is longer than the forecast period. As a result, short-term interest rates, at 7.3%, are still restrictive at the end of the period.

Figure 1.14 – Inflation and interest rates

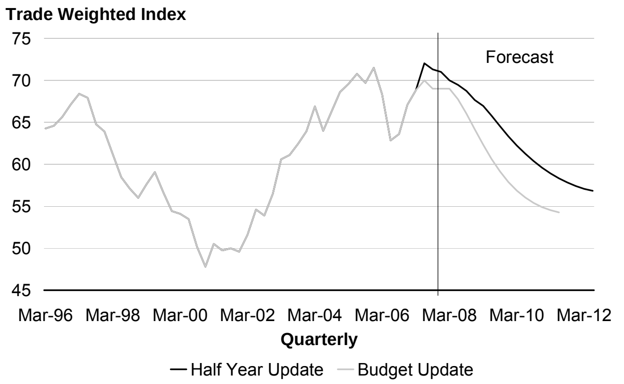


Sources: Statistics New Zealand, RBNZ, The Treasury

… will help keep the exchange rate up in the near term …

Higher interest rates will help keep the New Zealand dollar at an elevated level for longer than previously assumed. The Trade Weighted Index (TWI) is now expected to remain at around 70 until mid-2008 (Figure 1.15). The factors which will keep the dollar high in the near term are the higher terms of trade, the increased interest rate differential, especially against the US dollar for which policy rates have been eased recently (and may be eased further), and continuing robust growth in domestic demand.

Figure 1.15 – NZ dollar exchange rate



Sources: Reserve Bank of New Zealand, The Treasury

… but it will begin to ease in the second half of 2008

However, as domestic demand begins to slow in the second half of 2008, the exchange rate is expected to begin to decline gradually to 56.8 on the TWI by the end of the forecast. The decline in the terms of trade from the start of 2009 and the increase in the current account deficit are also expected to contribute to the gradual fall in the exchange rate.

The fall in the exchange rate helps bring about an adjustment in household debt to more sustainable levels by discouraging consumption and encouraging savings (by making imports more expensive). Higher interest rates will also support increased saving. The household saving rate is forecast to recover from -13.7% of disposable income in the year to March 2007 to -8.2% in March 2012. Further adjustment is needed in order to achieve a sustainable debt level and this occurs beyond the forecast period.

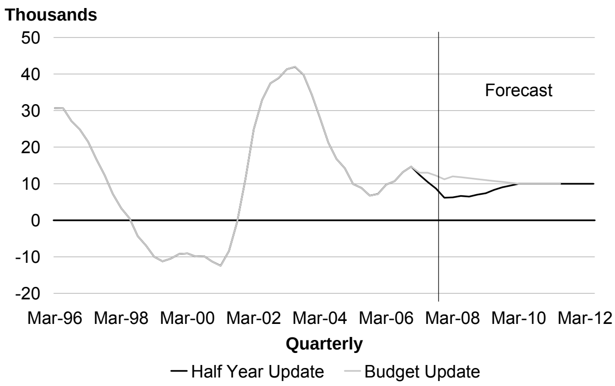
Lower net migration gains …

Annual net gains from permanent and long-term migration slowed over 2007 from a peak of 14,800 in November 2006 to 7,500 in October 2007. The net gain has declined as departures increased from 68,100 in the 2006 calendar year to 75,100 in the year to October 2007; higher departures to Australia accounted for most of this increase. Arrivals increased slightly in the past year, but not sufficiently to offset the increase in departures.

… are expected to continue

These trends are expected to continue in the short term, with net PLT migration inflows declining to 6,200 in the year to March 2008. Net migration gains are assumed to stabilise at around that rate through 2008, and then rise gradually back towards their average for the past decade of 10,000 per annum as arrivals increase slightly and departures fall (Figure 1.16). Immigration approvals, for both permanent residency and work permits, have been running at a high level recently, pointing to steady permanent and long-term arrivals. Departures to Australia are expected to ease from their recent high level as growth slows there and picks up here with the assumed tax revenue reduction beginning in April 2009.

Figure 1.16 – Annual net PLT migration



Sources: Statistics New Zealand, The Treasury

High oil prices will limit growth in consumption

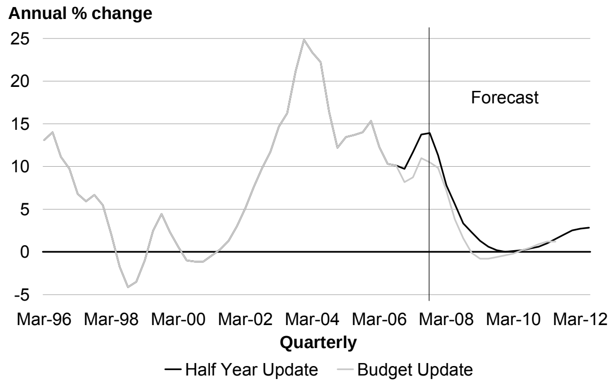
Some other factors will also serve to constrain growth in domestic demand later in the forecast period. As discussed above, oil prices are assumed to remain relatively high throughout the forecast period. The assumed decline in the New Zealand dollar from mid-2008 means that fuel prices will remain fairly steady in local currency terms for the following year, but will then begin to increase by around 1% per quarter as the fall in the New Zealand dollar outweighs the fall in the oil price. Recent increases in fuel prices will constrain growth in private consumption in the near term as they limit the expansion of disposable income and subsequently increasing fuel prices will suppress consumption growth slightly. Growth in private consumption falls to 1.1% in the final year of the forecast.

Housing market expected to slow …

The market for existing houses slowed considerably in the middle of 2007. The median sale price was steady for the six months from March to September, annual house sales have fallen nearly 10% in the past six months and houses remained on the market longer before they sold. We expect these trends to continue as a result of the lower net migration inflows and the flow-through of high interest rates to homeowners as mortgage rates are re-set, offset to some degree by continuing, but easing, growth in labour incomes.

Past increases in house prices have been accompanied by rapid growth in residential investment (as increases in house prices show increased demand for housing which can be met only by further investment), but have also supported complementary consumption of consumer durables such as furnishings and appliances. The "wealth effect" of higher house values has also supported consumption, as have the increased collateral for borrowing and direct withdrawal of equity from housing. These effects will dissipate as house price growth slows in the forecast period (Figure 1.17).

Figure 1.17 – House prices

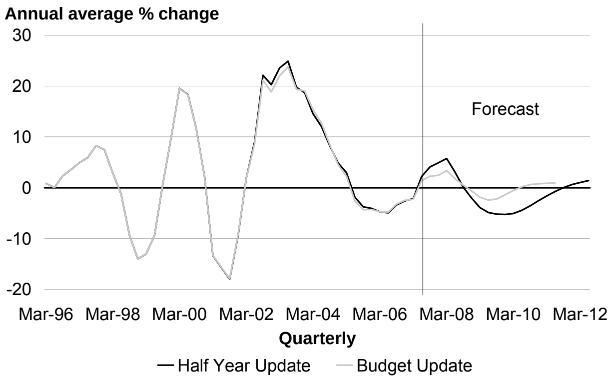


Sources: Quotable Value NZ, The Treasury

… with flow-on to residential investment

We expect house price growth to decline through 2008 and that prices will be flat in nominal terms through 2009, before beginning to increase again in 2010. This low rate of growth in house prices will lead to lower consumption growth, and residential investment is forecast to decline on a quarterly basis from late 2007 until later in the forecast period when some recovery is expected to occur. Continuing high interest rates will be the major factor constraining residential investment up until late 2010, along with lower net migration inflows in the preceding period. Lower interest rates will flow through to retail mortgage interest rates with a lag, and growth in residential investment is expected to recover by the end of the forecast period (Figure 1.18).

Figure 1.18 – Real residential investment



Sources: Statistics New Zealand, The Treasury

Growth in real GDP higher in the near term …

Private consumption expenditure is forecast to grow more rapidly through most of the forecast period than in our *Budget Update* forecasts and residential investment is expected to grow faster in the near term. These two components are chiefly responsible for faster growth in real GDP in the near term which is now forecast to be 3.0% in the year to March 2008, higher than the 2.6% growth expected in the *Budget Update*.

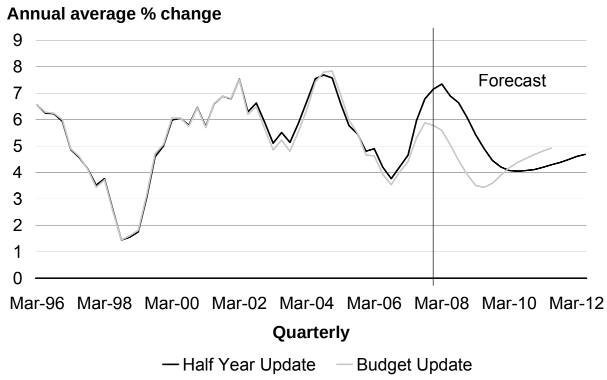
In the same way, higher private consumption growth in the March 2009 year, combined with higher non-residential investment, removes the trough of 1.6% growth projected in the *Budget Update.* Real GDP growth is now forecast to slip to only 2.1% in the March 2009 year, before strengthening again over the final three years of the forecast period towards its trend rate.

Higher domestic demand in the March 2008 and 2009 years leads to growth in the volume of imports of 6.1% and 4.0% respectively in those two years. Growth in imports tails off after that with the easing in growth in private consumption.

… and growth in nominal GDP …

Higher inflation and terms of trade lead to faster growth in nominal GDP than previously forecast. The higher terms of trade also result in higher real GDP as higher export prices lead to higher incomes and increased expenditure. Growth in nominal GDP is forecast to accelerate to 7.3% in the year to March 2008. This period of growth coincides with a peak in inflation of 3.1% and the peak in the terms of trade as past increases in spot dairy prices flow through to export prices. Thereafter, growth in nominal GDP is expected to ease as inflation and the terms of trade decline. Growth in nominal GDP is forecast to decline to 5.4% in the year to March 2009 and 4.1% in the following year, partly as a result of the fall in the terms of trade. As that fall moderates in subsequent years and consumer price inflation remains relatively high, growth in nominal GDP picks up again to 4.2% in March 2011 and 4.6% in March 2012 (Figure 1.19).

Figure 1.19 – Nominal GDP



Sources: Statistics New Zealand, The Treasury

… and tax revenue will also be higher

With higher growth in nominal GDP, tax revenue is also forecast to be higher. Total tax forecasts are higher than in the *Budget Update* by as much as $2 billion (around 4% of total tax) in some years, excluding the tax revenue reduction contingency. The terms of trade effect flows directly through to the income taxes, particularly other persons tax but also, to some extent, corporate taxes. Source deductions forecasts are up by an average of $400 million each year compared to the *Budget Update* owing to higher forecasts for employment and wages. Further discussion of the tax forecasts can be found in the *Fiscal Outlook* chapter.