1

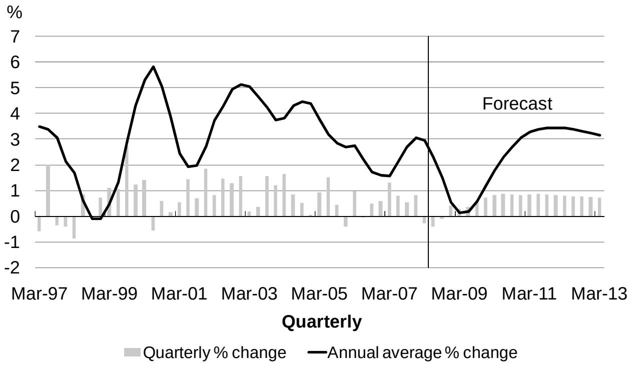
Economic and Tax Outlook

Introduction

This chapter presents the most likely path for the New Zealand economy and tax revenue and forms the basis for the *Fiscal Outlook* chapter. The forecasts were prepared during a period of heightened uncertainty in the global economy and they depend on a number of judgements about the associated risks. The *Risks and Scenarios* chapter discusses those risks in more detail and develops two scenarios based on different judgements about them.

Economic Growth and Tax Revenue Lower than Previously Forecast

Figure 1.1 – Real gross domestic product



Sources: Statistics New Zealand, The Treasury

The New Zealand economy, like a number of others, is currently facing imbalances in the areas of inflation, household debt, house prices and the current account. As a result of drought, higher consumer prices and previous monetary tightening, output declined in the first two quarters of 2008 and is expected to have declined marginally in the September quarter. Growth is forecast to be positive in the final quarter of 2008 thanks to the recovery from the drought and tax cuts, but will remain subdued throughout most of 2009 as negative influences continue to affect the economy. As the world economy recovers, the domestic economy picks up and inflation and monetary conditions ease, growth will return above trend later in the forecast period, driven initially by increased exports (Figure 1.1). With economic activity forecast to be lower than in the *Budget Update*, core Crown tax revenue is expected to be $3,148 million lower in aggregate over the next four years.

Table 1.1 – Comparison of core Crown tax revenue forecasts

June years, $million	2007/08 Est./actual	2008/09 Forecast	2009/10 Forecast	2010/11 Forecast	2011/12 Forecast	2012/13 Forecast
Budget Update 2008	56,673	56,523	58,228	60,319	62,712	N/A
Pre-election Update	56,747	56,058	57,415	59,268	61,893	65,084
Difference	74	(465)	(813)	(1,051)	(819)	N/A

Source: The Treasury

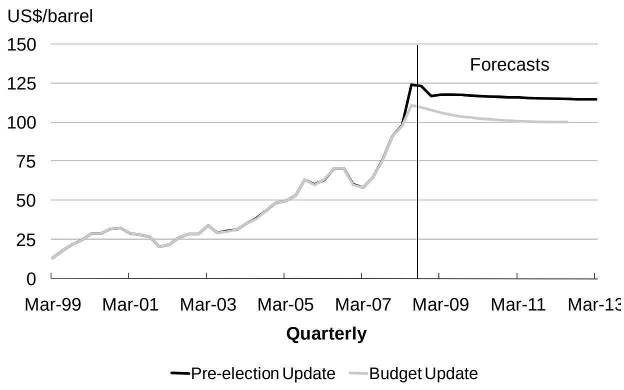
Assumptions for the Forecasts

Trading partner growth - *Consensus* forecasts for economic growth in New Zealand's top 20 trading partners in 2008 and 2009 have been revised down steadily over the course of 2008. In anticipation of further revisions, we have reduced the August *Consensus* forecasts from 3.1% and 3.0% in 2008 and 2009 (respectively) to 2.9% and 2.8%. Growth is estimated to recover subsequently to around 3.5%. Recent developments in financial markets since these forecasts were finalised on 28 August have increased the risks of further downward revisions in the forecasts. The *Risks and Scenarios* chapter presents a case based on lower world growth.

Global inflation and interest rates - Inflation has increased in all our major trading partners as a result of rising food and fuel prices but is expected to decline as these prices stabilise or fall. Despite higher inflation, policy interest rates have been lowered in all major economies except Japan and the Euro area in response to the financial crisis and weaker economic growth. Commercial interest rates, however, are higher as inter-bank rates have increased. Interest rates are expected to return to neutral levels by 2010.

Oil prices - We have assumed that the price of West Texas Intermediate (WTI) oil will decline from an average of US$124/barrel in the June quarter of 2008 to US$115/barrel at the end of the forecast period. These forecasts were based on the average futures prices in August 2008 and average 13% higher throughout the forecast period than in the *Budget Update* (Figure 1.2). Since the end of August, the price of WTI has fluctuated widely, showing the increased uncertainty associated with these forecasts.

Figure 1.2 – West Texas Intermediate oil price



Sources: Datastream, The Treasury

Terms of trade - The merchandise terms of trade (as measured in the System of National Accounts) are estimated to have peaked in the March quarter of 2008 and to decline 7.0% in the following five years as commodity prices fall from their peaks. The terms of trade are approximately 1.5% lower throughout the forecast period than in the *Budget Update* mainly because of lower dairy prices and higher oil prices.

Monetary conditions - We have assumed that the New Zealand dollar (NZ dollar) exchange rate will decline 22.7% from 69.2 on the Trade Weighted Index (TWI) in the June quarter of 2008 to 53.5 at the end of the period. Ninety-day interest rates are assumed to fall from 8.8% in the June quarter of 2008 to 6.3% at the end of the period. These forecasts were finalised before the Reserve Bank reduced the Official Cash Rate by 50 basis points on 11 September 2008. That may hasten the fall in interest rates in the near term.

External migration - The net inflow of permanent and long-term migrants is assumed to increase from a low of 4,700 in the year to June 2008 to its 10-year average of 10,000 per annum by March 2010 as outflows, particularly to Australia, ease and inflows, including returning New Zealanders, increase as economic growth slows elsewhere.

Policy and tax - The forecasts assume no change in government policy and incorporate the tax cuts effective from 1 October 2008 and 1 April 2010 and 2011, as did the *Budget Update*.

Table 1.2 – Economic forecast[1]

Annual average % change, year to 31 March	2008 Actual	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast	2013 Forecast
Private consumption	3.3	0.0	0.6	0.9	1.5	1.5
Public consumption[2]	4.2	4.1	3.9	3.8	3.1	2.7
Total consumption	**3.5**	**0.9**	**1.3**	**1.6**	**1.9**	**1.8**
Residential investment	3.7	-17.4	-9.4	8.0	10.1	8.9
Central government investment	-0.5	12.2	4.2	2.0	2.0	2.0
Other investment	6.2	4.4	-2.9	2.0	4.7	5.4
Total investment	**4.2**	**-1.2**	**-4.4**	**3.1**	**5.7**	**6.1**
Stock change[3]	0.9	0.3	-0.4	-0.2	-0.1	0.0
Gross national expenditure	**4.5**	**0.6**	**-0.4**	**1.7**	**2.6**	**2.8**
Exports	2.3	-2.4	4.7	4.9	4.7	4.1
Imports	9.7	0.4	-2.5	0.3	2.4	3.2
GDP (production measure)	**3.0**	**0.1**	**1.8**	**3.3**	**3.4**	**3.1**
- annual % change	1.9	0.2	2.5	3.4	3.4	3.0
Real GDP per capita	1.9	-0.8	0.8	2.3	2.5	2.2
Nominal GDP (expenditure basis)	7.4	3.1	3.0	4.6	5.1	5.0
GDP deflator	4.9	3.4	1.2	1.3	1.7	1.8
Employment[4]	0.8	0.3	-0.3	0.4	1.3	1.8
Unemployment[5]	3.7	4.4	5.1	5.1	4.8	4.6
Wages[6]	4.2	5.5	4.3	4.0	3.8	3.5
CPI inflation[7]	3.4	4.5	2.3	2.4	2.4	2.4
Export prices[8]	2.8	17.4	3.4	4.2	3.7	3.3
Import prices[8]	-4.5	13.5	6.5	5.4	4.7	3.8
Current account balance						
- $million	-13787	-14597	-12234	-11477	-11020	-10994
- % of GDP	-7.8	-8.0	-6.5	-5.8	-5.3	-5.0
TWI[9]	71.9	62.7	59.7	57.1	55.0	53.5
90-day bank bill rate[9]	8.8	7.5	7.0	6.7	6.5	6.3
10-year bond rate[9]	6.3	6.3	6.3	6.2	6.1	6.0

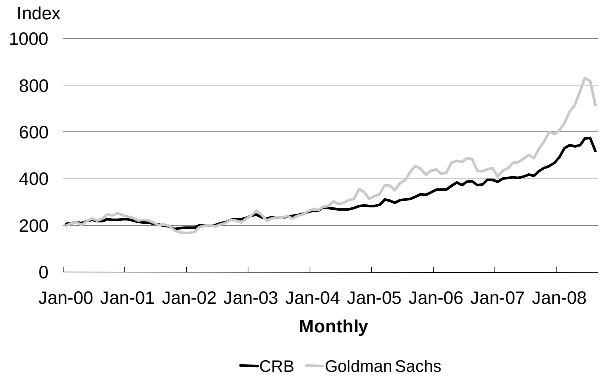
Notes: 1 Forecast finalised 28 August 2008 incorporating data up until that date.
2 The forecast profile for public consumption is influenced by government defence spending.
3 Contribution to GDP growth.
4 Household Labour Force Survey, full-time equivalent employment.
5 Household Labour Force Survey, 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

Weaker Growth as Global Economy Adjusts to Imbalances

The global economy is adjusting to significant imbalances

Figure 1.3 – World commodity prices



Sources: Commodity Research Bureau, Goldman Sachs

High consumption growth in developed economies in recent years and increased production in developing economies led to developing economies building up large trade surpluses which provided funding for the rapid growth in the developed economies. The greater integration of low-cost developing economies into the world trade system helped suppress inflation and allowed interest rates to become established at low levels, encouraging investment in housing and inflating house prices. The search for higher yields led investors to under-estimate the risks of some investments. At the same time, growth in the developing economies was resource-hungry, pushing up commodity prices (Figure 1.3).

The sub-prime mortgage crisis, which developed in the United States (US) in mid-2007, was the trigger for the unwinding of these imbalances and the world economy, especially the US economy, is now undergoing the necessary adjustment. House prices have fallen in many countries and market interest rates have increased. High commodity prices, particularly for food and fuel, are impacting on household budgets in both developed and developing economies. Production costs are increasing in the developing economies, making them a source of inflation rather than deflation in the world economy. Trade imbalances are being corrected as the pattern of growth in developed economies shifts away from consumption towards exports. This process of adjustment is expected to be protracted and to involve both developing and developed economies.

Performance of the Australian economy is key for New Zealand

So far, these developments have had little direct impact on the New Zealand economy. In this regard, the performance of the Australian economy is particularly important for New Zealand as it is our largest single merchandise trade export market, our main tourist market, the top destination for emigration and our main investment partner. In addition, our major retail banks are Australian-owned. The Australian economy has performed strongly until recently, but it is currently undergoing a significant re-appraisal as the domestic economy slows despite the high terms of trade resulting from the continuing strong demand from China and other emerging economies for mineral resources. Any slowdown in the Australian economy arising from the global financial crisis is likely to have a direct impact on the New Zealand economy.

Since our forecasts were finalised at the end of August, there have been further developments in the global financial crisis, particularly in the US. These developments increase the downside risks to these forecasts. The *Risks and Scenarios* chapter discusses these risks in more detail and develops a scenario based on lower world economic growth.

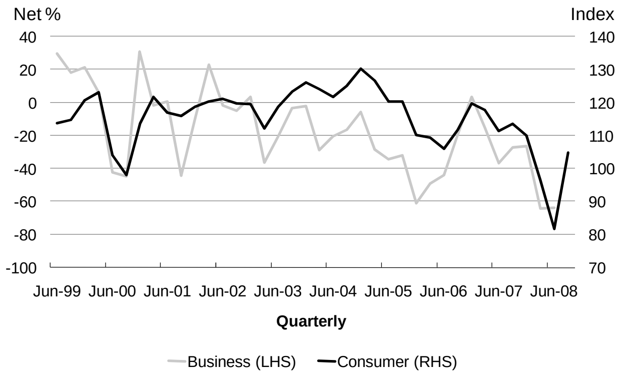
International developments will be transmitted primarily via the cost of credit, …

We expect that developments in the international economy will be transmitted to New Zealand by four main channels, the most important of which is the cost and availability of credit. Because New Zealand has a low domestic saving rate, local banks were dependent on borrowing from other countries to fund the growth in consumption and investment in housing in recent years. This borrowing is mostly short term, transmitting the tighter availability and increased cost of credit rapidly to the local financial sector and from there to businesses and households.

… a fall in confidence and lower wealth …

Confidence is the second channel by which international developments are likely to affect the New Zealand economy. Concerns about the strength of the global economy have been a factor in lower business and consumer confidence as firms expect a reduction in demand and consumers reduce their expenditure because higher prices have eroded disposable incomes. Business and consumer confidence both fell to low levels in mid-2008 (Figure 1.4). Consumer confidence recovered in September and business confidence was higher in monthly surveys, but both remained low.

Figure 1.4 – Business and consumer confidence



Sources: NZIER, Westpac McDermott Miller

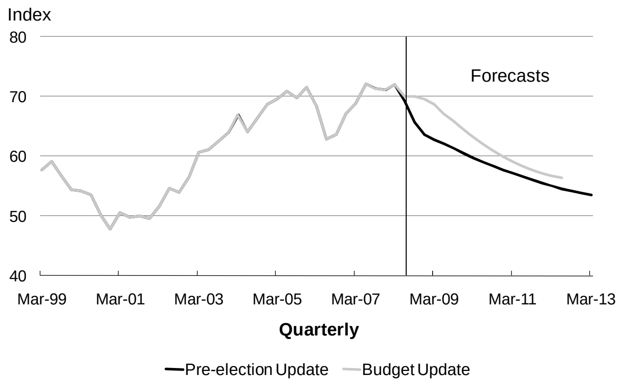
Loss of wealth is a less direct transmission channel for international developments. Asset values have fallen across a range of classes, from shares to housing, internationally as well as locally, with resultant effects on firms' ability to raise finance to fund investment and on households' wealth and access to collateral for borrowing. This is likely to constrain both firms' expansion plans (especially those with overseas ownership) and households' current consumption and investment in housing. It is also likely to lead to a consolidation of household balance sheets through an increase in precautionary saving and reduction in debt.

… and a lower terms of trade …

Lower world growth arising from the current international financial turmoil is also expected to result in weaker demand for New Zealand's export products and services, including tourism. The most direct effect of this is on the prices of commodities which have already declined as weaker world demand has become evident. International dairy prices peaked in late 2007 and their rate of decline increased in August 2008. Partially offsetting this, meat export prices increased in early 2008. Lower export prices (and higher import prices) have reduced the terms of trade by an average of 1.6% from our previous forecasts, leading to lower incomes for commodity exporters.

… leading to a lower exchange rate

Figure 1.5 – NZ dollar Trade Weighted Index



Sources: Reserve Bank of New Zealand, The Treasury

The NZ dollar has started to depreciate, consistent with the lower commodity prices, weak growth in the economy, the beginning of the interest rate easing cycle and the prospect of further cuts leading to a narrowing of the interest rate differential with other developed economies. The exchange rate is forecast to fall quickly in the near term, averaging 62.7 on the TWI in the March quarter 2009. In the longer term, we expect the NZ dollar to continue to decline because the current account deficit remains large and net external debt continues to grow (Figure 1.5). A lower exchange rate will offset some of the fall in world export prices, but will also raise the price of imported goods and services, restricting demand for them.

Export growth will chiefly reflect increased production …

Dairy production is expected to increase in late 2008 as a result of the recovery from the drought, as well as underlying growth in the industry. The drought and dairy conversions will have a negative effect on sheep meat production in the 2008/09 season, with some forecasts of lamb production down by a quarter from the previous season. Some increase in meat export volumes is expected from 2010 as higher dairy production leads to more dairy beef. Log exports are expected to increase as prices become more favourable with higher international prices and a fall in the NZ dollar, and a large quantity of forest plantings reach maturity.

Increases in some other non-traditional export products are also expected to boost export volume growth. New Zealand's oil exports have become significant, with oil the third largest export category after dairy and meat in the year to June 2008 and equivalent to 40% of the value of oil imports in the year to June 2008. The Maari oil field and the Pike River coal mine are scheduled to begin production later in 2008 and methanol exports are scheduled to recommence later in 2008. The fall in the NZ dollar is expected to boost services exports (chiefly tourism) and manufactured exports from mid-2009.

… and the current account deficit will narrow

In the near term the current account deficit is expected to increase as a proportion of Gross Domestic Product (GDP) as a result of high import prices and lower export volumes owing to the drought. A lower exchange rate and slower growth in domestic demand help to bring about some rebalancing in the economy and the deficit on goods and services gradually diminishes as export values grow more strongly than imports. Services exports and imports respond strongly to the fall in the exchange rate and are chiefly responsible for the reduction in the deficit. The investment income deficit is the main constraint on the overall deficit because of the need to service the substantial net international debt. Despite a positive balance on goods and services, the overall deficit is still forecast to be 5.0% of GDP at the end of the forecast period.

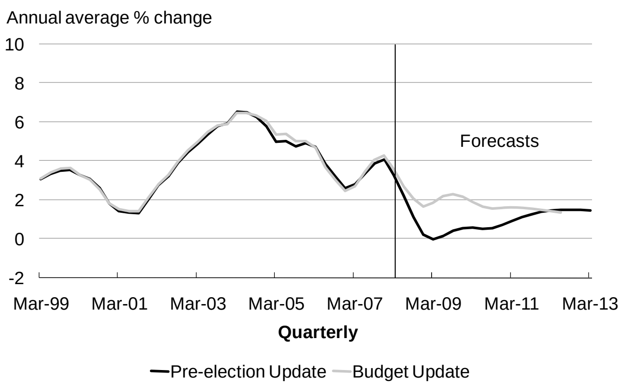
Domestic Imbalances Lead to Protracted Downturn

Domestic demand is expected to start to recover in the final quarter of 2008 with a modest pick-up in consumption as a result of the first instalment of the tax cuts on 1 October. In the following year, a number of the negative influences will continue to affect the economy, making the downturn protracted and the recovery only gradual. Eventually these negative influences will diminish and growth in domestic demand will begin to recover.

Tax cuts will boost household disposable incomes …

The October tax cuts will boost the disposable income of the average tax-payer by $16 per week. In aggregate, we assume that a large proportion of this fiscal stimulus will be spent, given the pressures currently faced by households. Most of the impact will be felt in the December quarter, but with a small amount anticipated in the September quarter. Although prices for food and fuel are expected to ease slightly as a result of weaker world growth, their rapid rise represents a shock to household budgets which will be relieved only slowly, constraining growth in consumption for some time. As a result, growth in private consumption will be lower than previously forecast (Figure 1.6).

Figure 1.6 – Private consumption



Sources: Statistics New Zealand, The Treasury

… but firms are still under pressure …

Higher global commodity prices, especially for oil, are also adversely affecting firms' costs. Price pressures for a range of inputs are expected to dissipate only slowly and may be offset by the expected fall in the exchange rate which will also make imported capital items more expensive. These factors will mean that firms' margins remain under pressure and that profitability is low, constraining market investment. There are some supportive factors for business investment in the near term with the reduction in the company tax rate on 1 April 2008 increasing after-tax profitability and lowering the threshold for projects; in addition, ongoing dairy conversions and capacity constraints in some parts of the economy will also support investment expenditure. After a period of weak quarterly growth throughout 2009, market investment is forecast to pick up from 2010.

… leading to lower corporate tax revenue

With margins under pressure and profitability low, underlying corporate income tax is forecast to decline by 3% in the 2009 June year. Factoring in the company tax rate cut brings the total drop in corporate tax revenue to around 9% (close to 15% on receipts). In a period of low profitability, there are likely to be a significant number of firms making losses. Tax losses can be offset against profits when a firm returns to profitability and so have a small, but noticeable, lagged effect on corporate taxes. Thus growth in corporate tax is expected to be negligible in 2010, as tax losses offset profits, but is then forecast to exceed 5% per annum from 2011 onwards once those losses work their way out of the tax system.

Higher wage growth than in BEFU …

As a result of cost pressures and slower growth in demand, firms are expected to reduce their hiring in the second half of 2008, especially in the construction and retail industries. They are forecast to reduce staff levels marginally in mid-2009 and then to hold them unchanged until mid-2010. In the final years of the forecast, firms are expected to increase employment modestly by around 1.5% per annum as demand recovers. Wage growth is expected to remain relatively high in the near term, peaking at 5.8% annual growth in September 2008 as a result of a continuing shortage of skilled labour and increases in the cost of living. The net effect of softer employment and higher wage growth is slightly faster growth in labour incomes which will help offset some of the negative factors bearing on households and help support consumption growth.

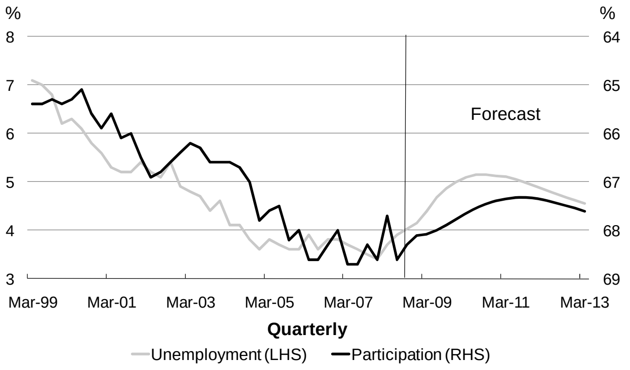
… will lead to higher PAYE tax income …

Despite the weak employment outlook, the wage growth forecasts would normally be sufficient to keep growth in PAYE at around 5.0% per annum owing to the effects of fiscal drag. However, three rounds of personal income tax rate/threshold cuts more than offset fiscal drag during the forecast period, bringing average growth in PAYE down to around 3% per annum over the next five years.

… but higher unemployment will constrain consumption growth …

With employment growth low over the next two to three years, the unemployment rate is forecast to increase from 3.9% in the June quarter 2008 to 5.1% in the March quarter 2010 and to remain at that level for the following five quarters. After that, it will decline to 4.5% at the end of the forecast period as growth in employment picks up with faster growth in output in the economy (Figure 1.7). The weaker outlook for the labour market, including a lower participation rate, will act as a constraint on private consumption growth in the forecast period and help bring about a reduction in the rate of accumulation of household debt necessary for rebalancing the economy.

Figure 1.7 – Unemployment and participation



Sources: Statistics New Zealand, The Treasury

… leading to lower GST revenue

The weak outlook for the household sector is the key economic factor underpinning the tax forecasts. The most direct effect of this on tax is via GST, which is forecast to grow by around 4% per annum over the next five years. This growth rate is much lower than the average of around 7.5% in the six years to 2007 when household consumption and residential investment increased rapidly. However, it also has flow-on effects for other taxes. For example, less household spending contributes to lower business profits, which ultimately feeds into the relatively weak forecasts for corporate taxes and “other persons” tax (income tax on the profits of unincorporated businesses and trusts).

The housing market is expected to remain depressed …

High interest rates, low net migration inflows and a lack of investor confidence will lead to continuing falls in residential investment. In addition, fallout from finance companies which have either failed or frozen investment funds, in some cases because of difficulties in the property development sector, will also inhibit investment in residential property. Confidence is also an important driver of residential investment and with economic growth expected to remain low, developers and households are less likely to start new residential projects.

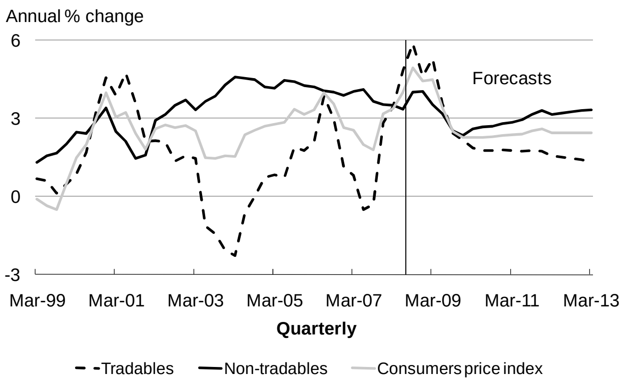
The lower residential investment will be accompanied by fall in demand for existing houses. We expect house prices to continue to fall in nominal terms, recording a 10% annual fall in March 2009 and a total fall of 11.3% from their peak in the December quarter of 2007. Prices are expected to remain essentially flat from mid-2009 until late 2010 when they will start to increase again.

… but government expenditure will help sustain growth

On the basis of Budget 2008, public consumption expenditure is expected to continue to increase by around 4% per annum throughout the first part of the forecast period, before easing off to around 3% in the final two years. Growth in non-market investment remains strong in the near term but reverts to around 2% per annum in later years.

Inflation forecast to ease from its peak in late 2008 …

Figure 1.8 – Consumers price index



Sources: Statistics New Zealand, The Treasury

High fresh produce prices in August make it likely that consumer price inflation will exceed our forecast of 4.9% in the year to September 2008. Non-tradables inflation is expected to ease as a result of the recent fall in output and weak growth over the next year. Lower demand in the economy will reduce capacity constraints and inflation pressures in key sectors such as construction and services. Tradables inflation is also expected to ease as commodity prices decline (Figure 1.8). The introduction of the Emissions Trading Scheme for stationary energy (primarily electricity) from 1 January 2010 and liquid fuels from 1 January 2011 will boost inflation by approximately 0.4 and 0.5 percentage points respectively, including indirect impacts which are spread over the subsequent period. (These figures are based on a price of €12.50/tonne for carbon credits.) As economic activity strengthens again towards the end of the period, headline inflation is still relatively high at 2.4% at the end of the forecast period.

… allowing interest rates to decline

As growth in consumption remains low and the outlook for inflation declines, the Reserve Bank is expected to continue to ease monetary policy. Ninety-day interest rates are expected to average 7.5% in the March quarter 2009 and to fall to 7.1% in the September quarter of 2009. The Reserve Bank's 50 basis point reduction in the Official Cash Rate on 11 September may bring forward some of the easing in 90-day interest rates. Easing tradables inflation later in the forecast period should allow the Reserve Bank to continue to ease policy so that 90-day rates fall to 6.3% by the end of the forecast period.

Lower level of nominal GDP …

The level of real GDP is forecast to be approximately $12.5 billion lower in aggregate over the next four March years than in our previous forecasts, chiefly because of lower consumption and residential investment, partly offset by lower imports. Since the general price level in the economy is higher than previously forecast, mainly because higher commodity prices result in higher consumer price inflation, the level of nominal GDP is forecast to be $8.1 billion lower in aggregate over the next four March years than in our previous forecasts.

… leads to lower tax revenue

The lower level of nominal GDP is forecast to lead to lower core Crown tax revenue over the forecast period as a whole relative to the *Budget Update*. The major revisions are for corporate taxes (down by $1,391 million), GST (down by $1,314 million) and other persons tax (down by $609 million). There are also downward revisions in resident withholding tax and other taxes. These reductions are offset by an increase in source deductions (primarily PAYE) of $494 million, leaving total core Crown tax revenue $3,148 million lower in aggregate over the next four years.

Table 1.3 – Core Crown tax revenue forecasts by major tax type

June years, $million	2007/08 Est./actual	2008/09 Forecast	2009/10 Forecast	2010/11 Forecast	2011/12 Forecast	2012/13 Forecast
Source deductions	23,356	23,082	23,712	24,419	25,526	27,211
Corporate tax	10,443	9,402	9,403	10,097	10,600	11,112
GST	11,115	11,687	12,024	12,476	13,187	13,762
Other taxes	11,833	11,887	12,276	12,276	12,580	12,999
Total	56,747	56,058	57,415	59,268	61,893	65,084

Source: The Treasury