Monthly Economic Indicators

THE TREASURY
Kaitohutohu Kaupapa Rawa

May 2011

Executive Summary

- **A range of indicators point to business conditions improving in the near term…**
- **…but this is tempered by weak consumer confidence**
- **Inflation expectations lift markedly, driven by the expected Christchurch rebuild**

A range of indicators point to business conditions improving over the year ahead. In the May National Bank Business Outlook, business confidence and the key own activity expectations measure lifted back to around levels seen prior to the February earthquake. In addition, profit expectations, investment and employment intentions all rose above their long-term averages. Business credit expanded for the seventh consecutive month in May, following a marked decline over the recession which reflected investment plans being postponed or cancelled. Unlike in early 2010, when expectations were not matched by activity, the factors expected to drive the economy over the year ahead appear more certain: the Rugby World Cup is scheduled to take place in the second half of the year and the earthquake rebuild is expected to gather speed from early 2012.

In contrast to business confidence bouncing back in recent months, consumer confidence has failed to rebound. The headline consumer confidence measure comprises a mix of current and forward-looking questions and, in the May survey, the former declined while the latter rose. With consumer confidence having a close relationship with private consumption (over 60% of expenditure GDP), the result tempers some of the forward-looking business indicators.

Inflation expectations lifted markedly in May, registering the largest percentage point increase and the highest outturn for more than 20 years. Over the past decade, inflation expectations (and inflation) have trended up, with the two-year-ahead measure now at the top of the Reserve Bank's 1 to 3 percent target range. In the Budget, we forecast annual inflation to peak over 5% in the current quarter, before falling to 2.5% in June 2013, ie, two years out. The Reserve Bank's next Monetary Policy Statement is due for release on 9 June.

There was a loss of momentum in the world economy during May, with data releases generally weaker than market expectations. The softer data, concerns around China's growth and increasing inflationary pressures have all contributed to the slowdown. However, the international outlook remains unchanged from our Budget forecasts, although the balance of risks has shifted slightly towards our downside scenario.

May's data reveal a domestic economy that is currently fairly flat, but both consumers and businesses are confident that better times lie ahead. The relatively stronger forward-looking outlook from businesses is likely a reflection of a more robust environment for tradable industries, with agriculture and manufacturers benefitting from high world commodity prices and exposure to the Australian economy. All up, these data suggest the recovery will continue to be business-led, with households following as employment and income growth lift.

The first of our special topics looks at labour market participation and finds that the stabilisation of participation during the recession was largely driven by increased participation of older age groups. The second special topic discusses global fiscal consolidation, noting the impact on the world and the New Zealand economies has already been incorporated in the Budget 2011 forecasts.

New Zealand Government

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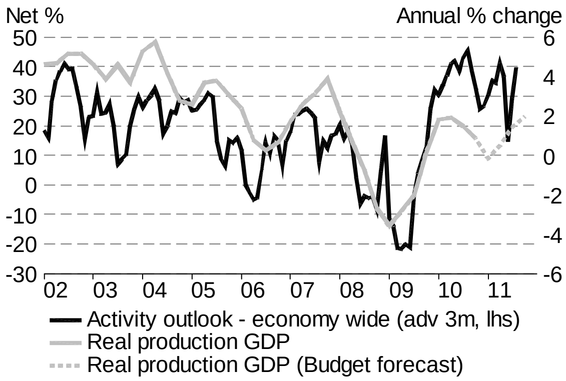
Analysis

Business confidence bounces back…

Business confidence in the National Bank Business Outlook (NBBO) lifted strongly in May, with a net 38 percent of respondents expecting better economic times over the year ahead. The increase followed a similar-sized increase in April, returning confidence to around levels seen prior to the February earthquake. Optimism in the survey was broad based, with profit expectations, investment and employment intentions all rising above their long-run averages. Firms' own activity outlook (a better indicator than confidence for economic growth), also rose strongly, returning to around pre-earthquake levels (*Figure 1*).

Figure 1 – Own activity outlook and GDP



Source: National Bank, Statistics New Zealand, Treasury

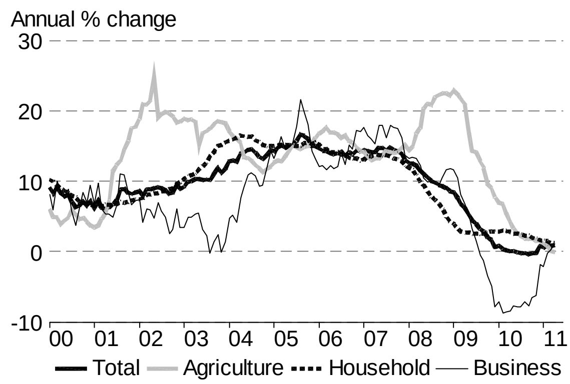
Figure 1 shows high activity expectations in early 2010 failed to translate into increased economic growth. The degree of consolidation by the household and agriculture sectors surprised many firms and was compounded by a series of negative events over the latter part of the year. Unlike 2010, the factors expected to drive the economy over the year ahead appear more certain; the Rugby World Cup is scheduled to take place in the second half of the year and the earthquake rebuild is expected to gather momentum from early 2012.

… supported by rising business credit

Business credit continues to expand as firms and banks increasingly have more confidence in the economic recovery. Since falling to a trough in September 2010, seasonally-adjusted business credit has expanded for seven consecutive months. Credit growth slowed rapidly from the onset of the recent recession as businesses, along with households, looked to pay down debt in order to strengthen their financial position.

While growth is modest, up 3.4% since September and 1.1% on an annual basis (*Figure 2*), businesses appear to be resuming investment after projects were postponed or cancelled during the 2008/09 recession and in the following year.

Figure 2 – Credit growth



Source: Reserve Bank of New Zealand

Service and manufacturing indicators up

The BNZ-BusinessNZ Performance of Services Index indicated growth lifting in the service sector in April, rising 1.5 points to 52.6 on the back of an increase in new orders/business (over 50 indicates expansion). While the index has pointed to increased activity in each month for the past year and a half, the rate of expansion has risen since the start of the year, providing momentum into the June quarter. Services activity is expected to expand over the second half of the year, thanks to recovering activity and increased tourist spending as a result of the Rugby World Cup.

Similar to the services measure, the BNZ-BusinessNZ Performance of Manufacturing Index pointed to activity expanding in April, with the seasonally-adjusted measure rising to 51.5 following the earthquake-affected 50.2 read-out in March. Manufacturing activity plummeted over the recession but is expected to grow relatively strongly in the near term, supported by stronger trading-partner growth and a cross rate with the Australian dollar that has been well below its long-run average for many months. The composition of New Zealand's exports is becoming increasingly weighted towards the Australian economy and fast-growing economies in emerging Asia (particularly China). In the recent Budget, we forecast exports of goods and services to grow 2.5% per annum on average over the next four years, constrained by a high currency over the year ahead and long lags to export volume growth, particularly for agricultural products.

Record trade surplus for April month…

Goods exports to China rose 27% on year-ago levels, helping drive the largest monthly trade surplus on record in the April 2011 month. Compared to April 2010, total goods exports rose 17% on the back of large increases for dairy products, meat and forestry, helped by surging commodity prices. Import values rose significantly less than exports (up 7% on April 2010), with higher prices for crude oil imports accounting for most of the increase.

… driven by strong commodity prices

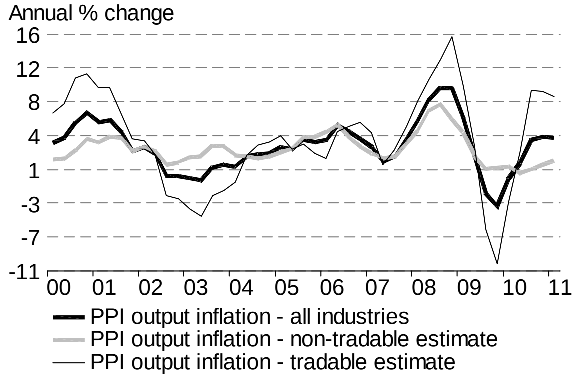
Export price increases outstripped rising import prices for the sixth consecutive quarter in March, lifting the merchandise terms of trade (the ratio of export to import prices) 0.9% in the quarter to reach a new 37-year high. Surging demand over the past two years has driven higher prices across a range of hard (eg, minerals) and soft (eg, food) commodities; with New Zealand's goods exports weighted significantly more towards commodities than goods imports, this has driven the terms of trade to multi-decade highs. In addition, the latest ANZ Commodity Price Index and Fonterra online auctions (and forecast payouts) suggest commodity prices may be consolidating at these high levels. However, very recent developments in global growth point to some easing in commodity prices, as expected in the Budget.

Producer price inflation picking up…

Rising commodity prices are flowing through to higher input and output prices for producers. The Producers Price Index (PPI) for outputs rose 1.7% in the quarter and 4.3% in the March 2011 year, led by higher prices in primary and manufacturing industries. The recent run-up in international milk prices flowed through to output prices for dairy processing while rising commodity prices, more generally, were evident in output price movements across a range of sub-industries.

With large commodity price swings driving PPI output inflation in recent years, the headline figure has been less relevant to firms with non-tradable goods and services. Estimates of tradable and non-tradable industries in the PPI suggest that while output prices for tradable industries rose sharply over 2010 and remain high, output prices for non-tradable industries have remained low by historical standards, in line with the weak domestic trading environment (*Figure 3*).[1]

Figure 3 – Output price inflation



Source: Statistics New Zealand, Treasury

The PPI inputs index rose 2.2% in the quarter and, similar to the outputs index, was driven by commodity price rises. On an annual basis, the 5.3% lift in input prices outstripped the 4.2% rise in output prices, indicating material inputs are placing pressure on profit margins. However, inflation for other inputs has either been falling (capital goods) or weak (labour costs) recently, helping to limit average inflation for firms' inputs.

… but capital goods prices remain flat…

The Capital Goods Price Index remained flat in the March 2011 quarter, recording a 0.2% increase, with prices down 0.1% in the March 2011 year. While commodity prices have driven up input prices, a subdued construction sector and a rising exchange rate - reducing price pressure for imported capital goods - have resulted in flat prices overall for capital goods in recent quarters. Capital goods price inflation is expected to remain subdued in the near term, reflecting a continuation of these factors for the remainder of 2011. However, the medium-term outlook is for stronger capital goods price inflation, reflecting a strong pick-up in the construction sector as a result of the Christchurch rebuild and a forecast fall in the exchange rate from the start and middle of 2012 respectively.

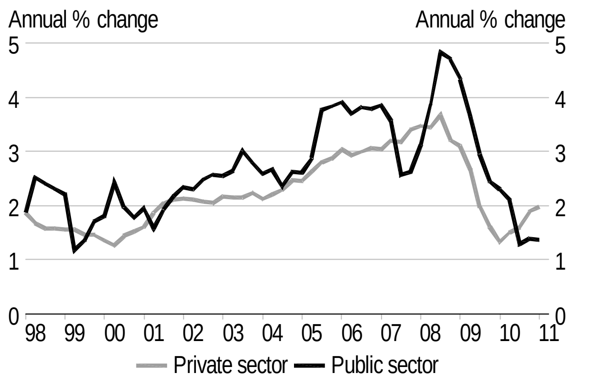
… and labour cost growth weak, but rising…

Measures of salary and wage growth in the March 2011 quarter were generally soft, but lifting from cyclical lows. The Labour Cost Index (LCI) showed salary and wage rates for a fixed quality and quantity of labour rising 1.8% in the year to March 2011. The latest outturn is weak by

[1] Tradable estimate includes agriculture, mining, and manufacturing. Nontradable estimate includes all other industries although they will be tradable to some extent (eg, tourism).

historical standards but continues to edge higher from the 1.5% low recorded a year earlier. The recovery in wage growth is being driven by the private sector, with public sector wage growth levelling off (*Figure 4*).

Figure 4 – LCI – total salary and wage rates

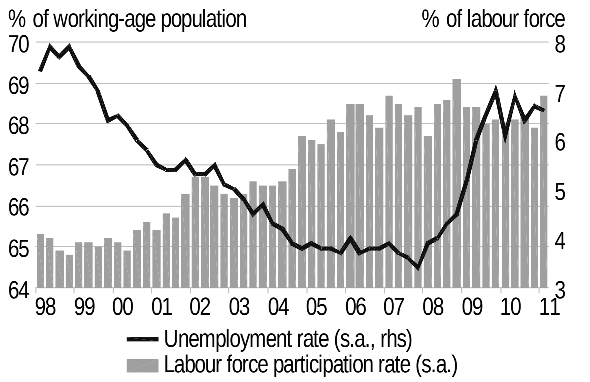


Source: Statistics New Zealand

…reflecting the labour market recovery

Labour market data for the March 2011 quarter did not capture the impact of the 22 February earthquake, owing to timing and data collection issues, but provided an indication of ex-earthquake labour market activity. Employment surged 1.4% (or 30,000 workers) in the quarter, significantly greater than expectations and taking the level beyond the late-2008 peak to 2.21 million. Full-time jobs continued to lift, but a 4.0% rise in part-time employment was the main driver of the headline figure. With the number unemployed falling slightly, the unemployment rate fell to 6.6% from a revised 6.7% in the previous quarter (*Figure 5*).

Figure 5 – Unemployment and participation rates



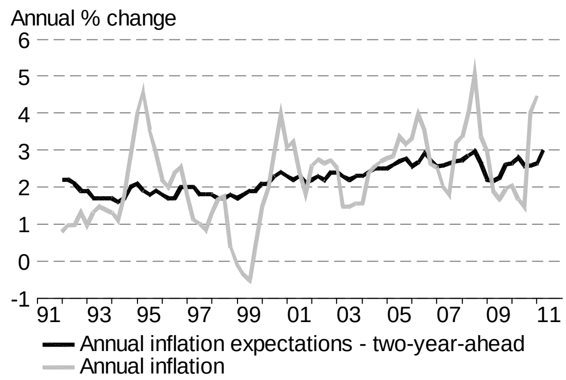
Source: Statistics New Zealand

Higher demand for labour drew more people into the labour force, with the participation rate rising sharply from 67.9% to 68.7%. The first of our special topics looks at recent trends in labour force participation. As in the Budget 2011 forecasts, we expect the unemployment rate to lift slightly to 6.8% in the current quarter, as the resumption of Christchurch surveying is reflected in higher unemployment. We expect the labour market to strengthen from the second half of the year and tighten rapidly over 2012, reflecting momentum increasing in the Christchurch rebuild. The extent of the Christchurch rebuild is likely to place upward pressure on resources and nontradable inflation over 2012 and 2013.

Inflation expectations lift sharply

The Reserve Bank's Survey of Expectations showed two-year-ahead inflation expectations lifting from 2.6% in February to 3.0% in May – the largest percentage point increase and the highest outturn for over 20 years. Over the past decade, inflation expectations (and inflation) have trended up, with the two-year-ahead measure now at the top of the Bank's 1-3% target range (*Figure 6*).

Figure 6 – Inflation and inflation expectations



Source: Reserve Bank of New Zealand, Statistics NZ

The May survey is the first since the 22 February earthquake so a significant proportion of the increase in inflation expectations is likely owing to respondents factoring in higher utilisation of resources (and consequent inflation pressure) as the Christchurch rebuild picks up in intensity. This theme was evident in the NBBO (discussed earlier), which showed elevated construction intentions, the capacity utilisation measure rising to a 9-year high, and pricing intentions heading back to mid-2008 levels.

Movements in the series can be influenced by sharp price changes, particularly for petrol. Between the February and May surveys, petrol prices rose above $2.00 per litre, peaking at $2.22 around the time the survey was conducted – a large 3-monthly increase relative to history. Finally, current inflation can also be a driver of expectations. At 4.5%, inflation is well above the 1-3% target and, although just under half of this can be attributed to the 1 October rise in the GST rate, the high headline level may also have been a factor.

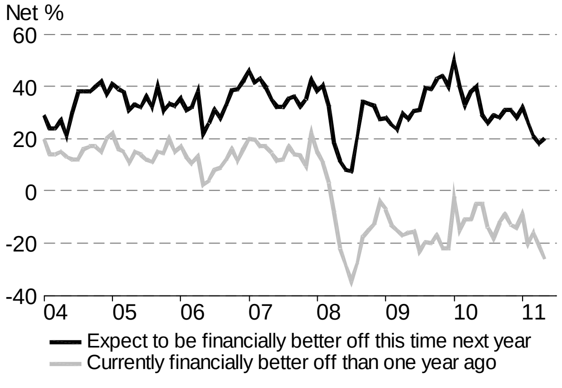
Looking ahead to the August survey, the recent trend has been falling petrol prices, with prices down sharply in recent weeks. Some of this decline can be put down to the strengthening currency, which recently reached a post-float high against the US dollar and will reduce inflationary pressure on other tradable goods and services in coming months. In the Budget, we forecast annual inflation to peak at over 5% in the current quarter, before falling to 2.5% in June 2013, ie two years out. The Reserve Bank's next Monetary Policy Statement is due for release on 9 June.

Consumer confidence remains weak…

In contrast to business confidence bouncing back in recent months, consumer confidence has failed to rebound. The ANZ Roy Morgan measure remained stuck in a range of 101-103 in the three months to May after being as high as 117 in January (over 100 indicates optimism).

Unlike the single forward-looking question measuring business confidence in the NBBO, the headline consumer confidence measure comprises a mix of current and forward-looking questions. Similar to businesses, confidence around future conditions has risen in recent months (albeit modestly), but the headline measure has been held back by declining perceptions around current conditions. History shows consumers tend to be over-optimistic, with expectations of future financial positions more positive than perceptions of current conditions; the gap has widened since the onset of the recession, driven by lower current perceptions (*Figure 7*).

Figure 7 – Consumers' financial positions



Source: ANZ Roy Morgan

… tempering high business confidence

The relationship between consumer confidence and private consumption is relatively strong, with the latter making up over 60% of expenditure GDP. As the latest confidence data suggests, consumers remain cautious and, as noted in the recent Budget, we expect this to be a theme over the medium term. Debt positions remain very high by international standards and we consider the consolidation process, that has been in place for around three years, still has longer to run. While the Christchurch rebuild will provide a boost to the economy, particularly for the construction sector, activity in other nontradables industries across New Zealand is not expected to benefit to the same extent.

World recovery loses some momentum...

May saw a loss of momentum in the world economy, with data releases mainly weaker than market expectations. The softer data, concerns around China's growth and increasing inflationary pressures have all contributed to the slowdown. However, we do not see this as the start of another downturn, more as a temporary lull.

US growth took markets by surprise, with March quarter growth only 0.5%; markets had expected much more than the annualised 1.8% rate. The UK failed to rebound significantly from its December quarter weather-related slump, with growth only recovering the 0.5% fall in March. Japan fell into a recession as the devastating earthquake and tsunami significantly affected output, after an already weak December quarter.

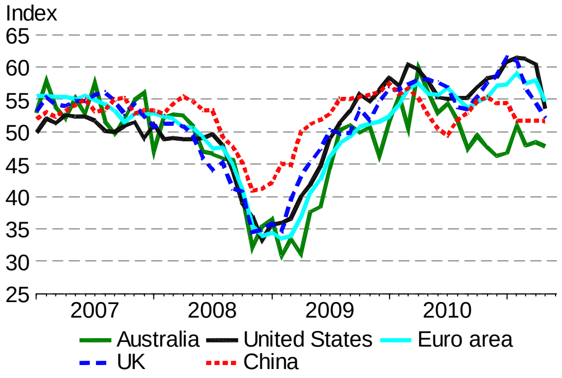
The Australian economy contracted 1.2% in the March quarter, although this was mainly due to a negative contribution from net exports, attributed to adverse weather events in January (Queensland floods, Cyclone Yasi). Despite this, domestic demand was actually stronger than expected. We expect Australian growth to rebound in the June quarter, as coal and other exports recover, and strong investment, mainly in the mining sector, provides stimulus.

Euro area growth was stronger than anticipated, at 0.8% in the March quarter, although large disparities are apparent between the major Euro countries (Germany, France), and the periphery. For example, Germany has grown 5.2% over the last year, compared to Greece's -4.8%. These disparities create tensions around monetary policy and wider policy issues, such as how to make some of the smaller countries more competitive when they are unable to devalue their currency.

... but indicators still positive

The loss of momentum is apparent in indicators such as manufacturing Purchasing Manager Indices (PMIs) and the US version, the ISM. PMIs around the world fell during May, particularly in Europe and the US (*Figure 8*), indicating a slowing in growth, but not a fall in output, as most PMIs around the world remain at an expansionary levels (apart from Australia). China's PMI fell slightly in May, but remains above 50. The OECD's recent economic outlook report reiterates that they see the global recovery as becoming more self-sustaining, but with significant risks. One of the risks they identify is the relationship between fiscal consolidation and economic growth; a special topic discusses this issue.

Figure 8 – Selected manufacturing PMIs



Source: Datastream

Higher inflation negatively impacting growth

Rising world inflation has been negatively impacting on growth through rising oil and food prices over the first half of this year, putting pressure on disposable incomes throughout the world. However, underlying inflation has been more subdued. This has been evident in the large difference between headline and core inflation (headline inflation excluding food and energy). For example, the current headline inflation rate in the US is 3.2%, whereas the core rate is much more subdued at 1.3%. Core inflation, the price measure preferred by many central banks, has remained relatively low, allowing them to hold policy rates. We do, however, see rate hikes as inevitable due to increasing underlying inflationary pressure as economic slack is used up, particularly in Australia, the UK, the Euro Area and many developing countries in Asia.

Commodity and equity markets fall in May

China is one economy where monetary tightening is well underway already as inflation reached 5.3% in April, with five reserve requirement ratio hikes so far this year, as well as policy rate increases and quantitative controls. This tightening continues to concern markets; as China is the main driver of world growth, a hard landing would result in a large fall in demand. These concerns contributed to the fall in equity and commodity markets during May. WTI oil prices fell around $16 per barrel, although they have recovered somewhat from their low. Other commodities have declined too, as negative sentiment gathered momentum. So far, New Zealand's main export commodities have not been adversely affected.

Equities also fell, but less than in May 2010. US 10-year Treasury yields fell below 3.0%, levels not seen since December last year, as demand for government bonds increased. As some positive sentiment returned (helped by some stronger-than-expected NZ data) later in the month, NZ government bond yields fell to around 5.12% from 5.63% in late April and the NZD peaked at US 82.6 cents in early June.

The Euro area continues to keep markets on edge, particularly the situation in Greece. There has been speculation of a possible restructuring of debt, with bond-holders possibly having to take a "haircut" (receive less than the amount invested). Officials have been quick to quell fears, but the future remains uncertain. Portugal's bailout package was confirmed, with further cuts to spending and tax hikes included as conditions.

Overall, the international outlook remains broadly unchanged from our Budget 2011 forecasts, although the balance of risks has shifted slightly towards our scenario based on slower global growth arising from high inflation and monetary tightening.

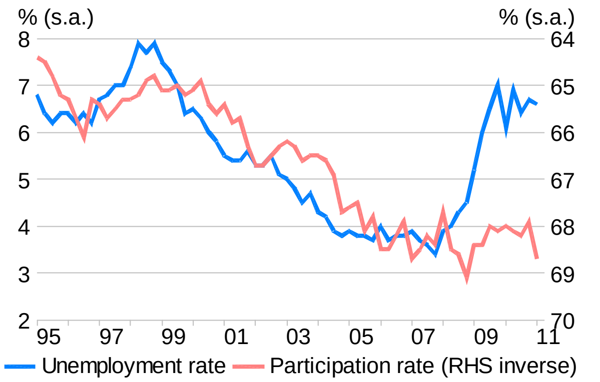
Economy on track, as expected in the Budget

May's data reveal an economy that is currently fairly flat, but both consumers and businesses are confident that better times lie ahead. The relatively stronger forward-looking outlook from businesses is likely a reflection of a more robust trading environment for tradable industries, with agriculture and manufacturers benefitting from high world commodity prices and exposure to the Australian economy respectively. All up, these data suggest the recovery will continue to be business-led, with households following as employment and income growth lift, as expected in the Budget.

Special Topic 1: Recent trends in labour force participation

In the decade prior to the recent downturn, there appeared to be a strong inverse relationship between the labour force participation rate (the percentage of the working age population either employed or unemployed) and the unemployment rate (Figure 9). This is owing to the “discouraged worker” effect: when unemployment is higher, it is more difficult to find a job and so some people will drop out of the labour force; the reverse occurs when unemployment is low. Since the start of the recent downturn, however, this relationship appears to have broken down – unemployment has risen but the participation rate has not fallen markedly (*Figure 9*).

Figure 9 – Participation and unemployment



Source: Statistics NZ

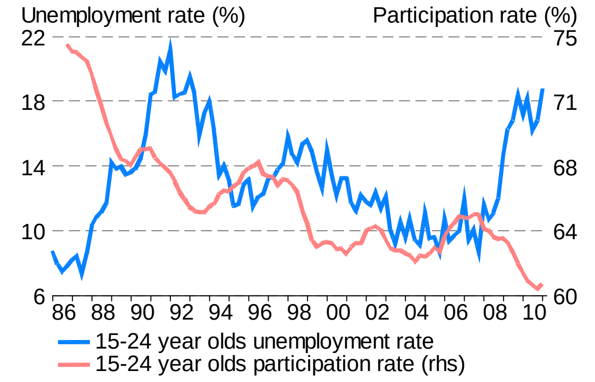
This special topic examines the reasons for this apparent change in the relationship, and examines potential outcomes for participation in the future. It is useful to examine participation by gender and age group to see what cyclical, behavioural and demographic factors are affecting aggregate participation.

Falling youth participation...

Younger people are traditionally more affected by recessions, and this is reflected by a fall in the participation rate for 15-24 year olds in the recent downturn (*Figure 10*). Youth participation is likely to be more sensitive to poor labour market conditions, as their lower skill base and lack of experience makes them particularly vulnerable.

Youth unemployment rates were already substantially elevated relative to the overall rate prior to the recession, and have increased quickly since its onset, recently reaching 18%. Policies such as the increase of the youth minimum wage to equal the adult minimum wage from 1 April 2008 may have exacerbated youth unemployment (as well as encouraging participation), although these effects are the subject of debate.

Figure 10 – Youth participation and unemployment



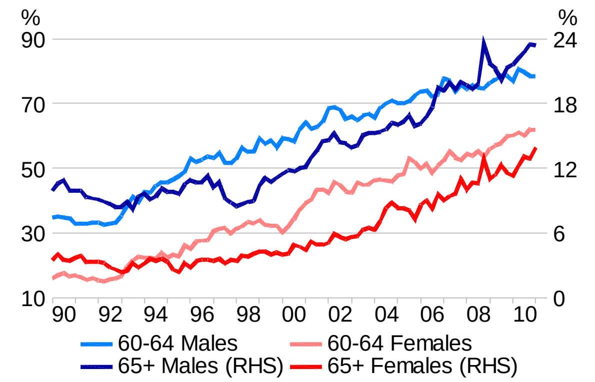
Source: Statistics NZ

Interest-free student loans, accompanied by a wide range of courses available, may make education a more attractive prospect than trying to find a job. The number of people who are not seeking work and list “attending educational institution” as their main activity has more than doubled in the past three years from 8,500 to 18,700.

...offset by older people participating more...

Males aged 55 and over, and females aged 50 and over, have had steadily increasing rates of participation generally beginning in the early 1990s. In 1992 the superannuation eligibility age began progressively increasing from 60 to 65, which is likely to be responsible for triggering this trend (*Figure 11*).

Figure 11 – Participation rates for older groups



Source: Statistics NZ

However, these trends have continued at the same pace even after the completion of the increase in the age of superannuation entitlement. This may be reflecting continued adaptation to the new policy, younger cohorts who are more likely to participate, legislative changes removing compulsory retirement and age discrimination, and improving health and education amongst those entering these age groups. The large increase in participation amongst these groups, accompanied by their large share of New Zealand's working age population, means that the increase in participation amongst these older groups more than offset the downward pressure from falling youth participation.

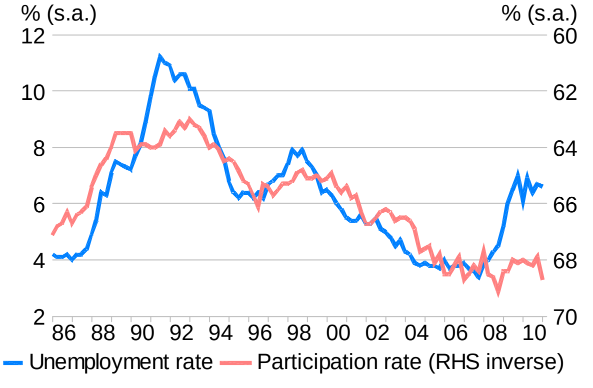
...but population ageing is negating increases

In the absence of population ageing (ie, only taking account of demographic changes and not allowing for behavioural changes), the aggregate participation rate would have risen over the recent downturn, but the effect of population ageing – the movement of more people from age brackets with higher participation to older brackets with lower participation – has subtracted around half a percentage point from the aggregate participation rate over the past three years. The downward pressure from population ageing will begin to accelerate as baby boomers continue to enter progressively older age groups, placing long-term downward pressure on the aggregate participation rate.

A similar pattern to previous downturns...

Examining previous downturns in New Zealand reveals a similar pattern. Large changes in the unemployment rate are associated with smaller changes in the participation rate (*Figure 12*).

Figure 12 – Participation and unemployment



Source: Statistics NZ

Modelling suggests that participation may not be as sensitive to unemployment as expected (and particularly in downturns) with a one percentage point rise in unemployment associated with around a quarter of a percentage point fall in participation on average. A general downward trend in the unemployment rate and a general upward trend in the participation rate over the past few decades may make the relationship appear slightly stronger than it actually is.

… but for different reasons

In previous downturns in New Zealand, population ageing had not begun to have a negative effect on participation. The moderate falls in participation that can be observed were due to decisions by people to exit the labour force. In contrast, during the current downturn, the moderate fall in participation arose partly from demographic changes - an increasing proportion of the population becoming composed of groups with lower average participation. In the absence of such changes, participation would have increased, even taking into account the fall in participation of 15-24 year olds.

A positive short-term outlook...

Given the signs for an improving economy in the second half of 2011, the short term outlook for participation is positive. Even if labour market conditions recover relatively slowly, participation may increase in the short term as the fall in youth participation stabilises and eventually begins to reverse, and the participation of older age groups continues to trend upward. If the recovery becomes more robust, participation could even reach new highs over 69% by the end of 2012.

...but demographics dominate the long term

This optimistic outlook depends on current trends in the participation of older age groups continuing for the next few years. While this seems likely, looking over a longer time horizon raises some concerns. As some of the age groups with strong trends approach the levels of participation of their younger counterparts, these trends will begin to level off, and this point does not appear to be too far off – particularly amongst males. Coupled with ageing population effects increasing over time, the longer-term outlook for participation is almost certainly for a downward trend.

Cyclical, demographic, and underlying factors compete

The aggregate participation rate fell only moderately during the recent downturn despite downward pressure from the cyclical withdrawal from the labour force by youth, and the adverse effect on participation associated with an ageing population. The stabilisation of participation during the recession has been largely thanks to underlying upward trends in the participation of older age groups, reflecting policy, economic and social changes affecting older people in the workforce.

Special Topic 2: International fiscal consolidation and its implications

This piece considers the impact of international fiscal consolidation programmes on the global fiscal and economic outlook. The current fiscal consolidation plans announced overseas, if actually implemented as outlined, are likely to improve global public finances and would improve the economic outlook in the long run. However, risks to the global fiscal and economic outlook are substantially on the downside, if some countries are derailed from their planned fiscal consolidation programmes.

The pace of international fiscal consolidation accelerates in 2011 …

Most of the advanced countries with large budget deficits and high sovereign debts have announced fiscal consolidation plans for the medium term. However, there is considerable variation in the scale, timing and concreteness of fiscal consolidation plans.

In some countries, including Portugal, Ireland Greece and Spain, intense market pressure – expressed in sharp increases in their borrowing costs - has seen these countries front-load sizable deficit reduction policies in 2010 and 2011.

At the other extreme, Japan and the US – whose required fiscal adjustments are among the largest – have not yet detailed a medium-term strategy to achieve fiscal reduction targets. Their current approach has been to postpone the implementation of their plans until late 2012. In fact, the fiscal deficits in Japan and the US are expected to increase in 2011, as a result of the recently introduced stimulus packages.

...with uneven impact on economic growth

As tax revenues for Greece, Ireland and Portugal have already been negatively affected by lower economic growth, these countries have to implement substantial fiscal savings measures in order to lower their deficits. Discretionary fiscal savings policies, which include both revenue-enhancing and spending cut measures, will amount to 6.5% of GDP in Greece and over 3.0% for Ireland and Portugal (Table 1).

The abrupt and large-scale fiscal tightening in Greece, Ireland and Portugal will likely weigh on their economic growth in the short term. As there is currently no scope for these countries to manipulate their exchange rate to spur net exports, fiscal retrenchment can be relatively costly.

For other advanced economies, despite the large expected fall in their budget deficits in 2011 and 2012, the actual fiscal consolidation programmes are not so substantial as to put a significant brake on the economic recovery. In the US, the fiscal deficit is expected to reduce by almost 4% of GDP in 2012. However, economic recovery – which results in higher tax revenues – is the main factor behind the forecast reduction in the deficit as most of the fiscal savings policies announced in the 2012 Budget would not take effect until 2013.

Table 1 – Fiscal consolidation plans, 2011 - 2012

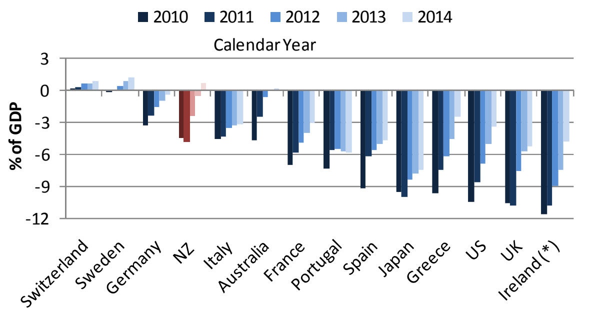
	Fiscal balance	Annual change in the fiscal balance		Discretionary fiscal savings measures	
	% of GDP	% of GDP		% of GDP	
Fiscal year	2010	2011	2012	2011	2012
Greece	-10.5	3.1	0.9	6.5	3.5
Ireland	-11.6	2.5	2.1	3.9	2.3
Portugal	-9.1	4.5	1.6	3.0	1.1
Spain	-9.3	3.3	1.6	2.2	0.8
Italy	-4.6	0.7	1.2	0.8	0.7
France	-7.7	1.7	1.4	0.7	0.7
United Kingdom	-11.1	1.2	2.0	0.6	2.0
Germany	-3.3	0.8	1.0	0.4	0.7
Australia	-4.3	0.7	2.1	0.2	0.1
Canada	-3.4	1.1	0.7	0.0	0.0
United States	-8.9	-2.0	3.9	-0.3	-0.1
Japan	-9.5	-0.5	1.6	not yet specified	

Source: individual country budget documents, except for Japan where the figures are obtained from the IMF. Ireland's fiscal balance for 2010 excludes financial sector support.

Risks to the fiscal and economic outlook remain on the downside

If governments actually implement fiscal consolidation programmes as currently planned, it will be an important step to restore the health of public finances and economic growth (*Figure 13*).

Figure 13 – Fiscal balance outlook, 2010 - 2014



Source: IMF; New Zealand's figures are the net lending forecast at Budget 2011 but presented on a Government-Financial Statistics and calendar year basis.

However, in the case that countries do not achieve their announced fiscal targets or governments fail to deliver their planned fiscal adjustment, the impact on the fiscal and economic outlook is likely to be significant. For the peripheral Euro-zone economies, lower-than-expected economic growth would feed back negatively on fiscal consolidation, while political uncertainty and weak institutional frameworks may prevent the implementation of the plans.

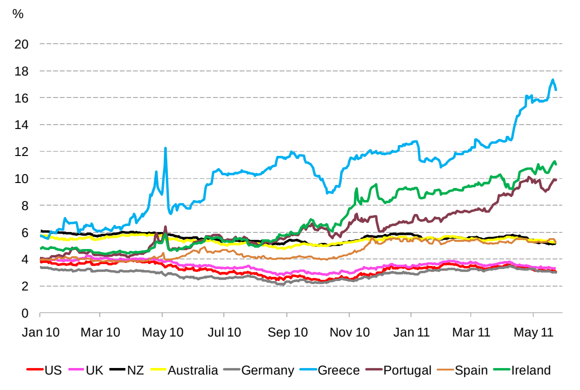
In other advanced countries, the back-loaded nature of fiscal consolidation plans increases concern whether some countries will actually implement their consolidation plans. The May 2011 OECD *Economic Outlook* identifies "the unsettled fiscal situation" in the US and Japan as one of the main risks to the global recovery.

In the US, most of the savings measures outlined in the 2012 Budget will only start to take effect at the end of 2012 – around election time - and there is increasing doubt whether the government will have the required political support to tighten its spending. In Japan, the absence of any specific policy to reduce the budget deficit, combined with the uncertainty about the scale, timing and financing of the earthquake reconstruction costs, increases the risks that the government will not enact fiscal adjustment programmes.

Market perceptions continue to be polarised

Sovereign debt concerns have intensified again for Greece, Ireland and Portugal, despite the EU/IMF financial assistance programme and the front-loaded fiscal consolidation efforts. Investors have become increasingly sceptical whether the EU/IMF programme will help these countries solve their financing needs. In the last week of May, 10-year government bond yields reached almost 17% for Greece, 11% for Ireland and 10% for Portugal (*Figure 14*). At the same time, banks in the three countries are not able to access market finance and are dependent on liquidity provided by the European Central Bank.

Figure 14 – 10-Year Government Bond Yields



Source: Bloomberg

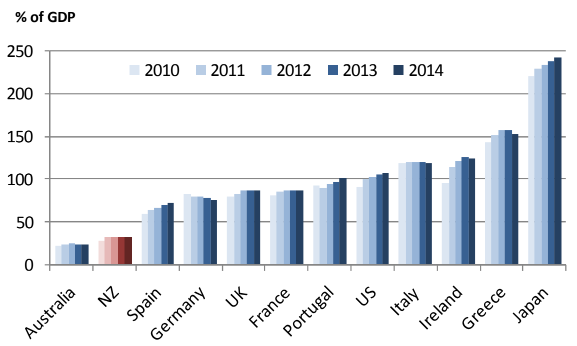
On the other hand, the Credit Default Swap (CDS) spreads remain broadly flat for large advanced countries, suggesting that the market continues to view these countries as having low fiscal risks. As a result, these countries continue to enjoy cheap financing conditions, expressed in the relatively low yields on their bond rates.

The market optimism for some large advanced countries may suggest that the risk of losing market confidence is remote for now. However, markets typically react late and abruptly, as seen in the case of Greece where the 5-year CDS spreads were as low as 100 basis points in 2009, surged to 965 in May 2010 and reached 1480 in the early weeks of May 2011.

New Zealand's fiscal position

New Zealand experienced a sharper reduction in its fiscal balance than some other countries and its improvement is occurring more slowly. This is in part due to the muted recovery arising from household and business consolidation and the short-term impact of the Canterbury earthquakes. Recognising this, the Government has outlined a fiscal savings plan in Budget 2011. New Zealand is expected to be one of the few advanced economies to have a fiscal surplus in the medium term. New Zealand's low level of public debt also compares favourably with other advanced countries (*Figure 15*).

Figure 15 – Government gross debt



Source: IMF; New Zealand's figures are the net lending forecast at Budget 2011 but presented on a Government Financial Statistics and calendar year basis.

The impact of the global fiscal consolidation on the world and the New Zealand economies has already been incorporated in the Budget 2011 economic forecasts. This set of forecasts allowed for some fiscal consolidation to take place in the US in the medium term.

Monthly Economic Indicators is a regular report prepared by the Macroeconomic Forecasting and Analysis section of the Treasury.

Contact for enquiries:
The Treasury
PO Box 3724
Wellington
NEW ZEALAND

information@treasury.govt.nz
Tel: +64 4 472 2733
Fax: +64 4 473 0982

New Zealand Key Economic Data

3 June 2011

Quarterly Indicators

		2009Q3	2009Q4	2010Q1	2010Q2	2010Q3	2010Q4	2011Q1
Gross Domestic Product (GDP)								
Real production GDP	qtr % chg[1]	0.2	0.9	0.7	0.1	-0.2	0.2	...
	ann ave % chg	-2.8	-2.1	-0.7	0.4	1.3	1.5	...
Real private consumption	qtr % chg[1]	0.8	1.0	0.5	0.2	0.4	0.2	...
	ann ave % chg	-1.3	-0.7	0.4	1.4	1.9	2.0	...
Real public consumption	qtr % chg[1]	0.3	0.6	1.6	0.4	-0.8	1.2	...
	ann ave % chg	1.9	0.6	0.2	1.1	1.5	2.3	...
Real residential investment	qtr % chg[1]	-3.4	5.8	-0.3	10.5	-7.5	-7.2	...
	ann ave % chg	-24.8	-18.1	-13.0	-4.3	3.5	2.8	...
Real non-residential investment	qtr % chg[1]	-3.4	-1.1	0.1	4.4	0.3	8.3	...
	ann ave % chg	-6.1	-8.1	-8.3	-7.1	-3.8	2.2	...
Export volumes	qtr % chg[1]	1.1	-0.6	1.3	0.4	-0.9	2.1	...
	ann ave % chg	-1.7	1.7	4.6	4.7	3.7	3.0	...
Import volumes	qtr % chg[1]	1.2	4.7	2.5	0.4	3.4	6.6	...
	ann ave % chg	-16.1	-14.6	-9.4	-1.8	5.6	10.2	...
Nominal GDP - expenditure basis	ann ave % chg	0.8	0.7	1.1	2.0	3.1	4.8	...
Real GDP per capita	ann ave % chg	-3.8	-3.1	-1.9	-0.8	0.1	0.3	...
Real Gross National Disposable Income	ann ave % chg	-1.8	-1.5	0.4	0.8	2.8	4.6	...
External Trade								
Current account balance (annual)	NZ$ millions	-5946	-5204	-4458	-5707	-4189	-4381	...
	% of GDP	-3.2	-2.8	-2.4	-3.0	-2.2	-2.3	...
Investment income balance (annual)	NZ$ millions	-8059	-7930	-7627	-9026	-10692	-10588	...
Merchandise terms of trade	qtr % chg	-1.6	5.8	6.1	2.0	3.0	0.8	0.9
	ann % chg	-14.1	-8.2	0.1	12.7	17.9	12.3	6.8
Prices								
CPI inflation	qtr % chg	1.3	-0.2	0.4	0.2	1.1	2.3	0.8
	ann % chg	1.7	2.0	2.0	1.7	1.5	4.0	4.5
Tradable inflation	ann % chg	-0.1	1.5	2.0	1.0	0.3	3.3	3.7
Non-tradable inflation	ann % chg	3.0	2.3	2.1	2.2	2.5	4.6	5.2
GDP deflator	ann % chg	0.9	-1.5	0.1	1.6	2.5	5.3	...
Consumption deflator	ann % chg	1.9	1.2	0.8	0.7	1.1	3.0	...
Labour Market								
Employment (HLFS)	qtr % chg[1]	-0.8	0.1	0.8	-0.2	1.1	-0.4	1.4
	ann % chg[1]	-1.8	-2.4	-0.1	0.0	1.9	1.3	1.8
Unemployment rate	%[1]	6.5	7.0	6.1	6.9	6.4	6.7	6.6
Participation rate	%[1]	68.0	68.1	68.0	68.1	68.2	67.9	68.7
LCI salary & wage rates - total (adjusted)[5]	qtr % chg	0.5	0.4	0.3	0.4	0.5	0.5	0.4
	ann % chg	2.1	1.8	1.5	1.6	1.6	1.7	1.8
QES average hourly earnings - total[5]	qtr % chg	0.9	-0.2	-0.4	0.7	1.0	0.5	0.4
	ann % chg	4.0	2.8	1.0	1.0	1.1	1.8	2.6
Labour productivity[6]	ann ave % chg	-1.1	0.0	2.0	1.9	1.3	0.1	...
Retail Sales								
Core retail sales volume	qtr % chg[1]	1.1	0.8	0.3	0.2	0.0	0.0	...
	ann % chg	0.6	2.2	3.0	2.6	1.5	0.3	...
Total retail sales volume	qtr % chg[1]	1.1	1.2	0.4	0.6	-0.4	-0.4	...
	ann % chg	-1.4	0.4	3.2	3.4	1.9	-0.1	...
Confidence Indicators/Surveys								
WMM - consumer confidence[3]	Index	120	117	115	119	114	108	98
QSBO - general business situation[4]	net %	35.6	30.7	21.9	17.5	6.4	8.1	-26.8
QSBO - own activity outlook[4]	net %	23.0	10.8	14.5	11.3	9.5	11.4	-1.6

Monthly Indicators

		2010M11	2010M12	2011M 1	2011M 2	2011M 3	2011M 4	2011M 5
External Sector								
Merchandise trade - exports	mth % chg[1]	0.8	-1.6	3.0	4.5	0.9	6.0	...
	ann % chg[1]	19.5	12.1	4.7	16.3	13.1	17.5	...
Merchandise trade - imports	mth % chg[1]	4.2	5.4	-1.4	6.7	-1.5	-6.8	...
	ann % chg[1]	15.2	16.6	15.4	22.6	15.7	7.9	...
Merchandise trade balance (12 month total)	NZ$ million	1363	1172	909	763	734	1187	...
Visitor arrivals	number[1]	211470	213910	218860	208660	191960	207690	...
Visitor departures	number[1]	210970	210580	220870	212160	201050	201220	...
Housing								
Dwelling consents - residential	mth % chg[1]	8.0	-18.4	9.1	-9.9	2.0	-1.7	...
	ann % chg[1]	-9.1	-26.5	-14.8	-29.0	-26.3	-32.5	...
House sales - dwellings	mth % chg[1]	19.8	3.7	-6.6	2.3	4.5	0.2	...
	ann % chg[1]	-14.9	-11.5	-10.0	-10.1	-5.1	-5.3	...
REINZ - house price index	mth % chg	1.9	-0.6	-2.6	2.3	0.5	1.1	...
	ann % chg	-1.9	-1.6	-2.6	-0.7	-1.8	-0.4	...
Private Consumption								
Electronic card transactions - total retail	mth % chg[1]	0.9	-0.8	2.4	0.0	1.6	1.5	...
	ann % chg	6.3	4.4	5.7	6.2	6.6	10.0	...
New car registrations	mth % chg[1]	12.3	-7.7	0.6	-1.6	-0.6	-5.7	...
	ann % chg	23.5	6.4	6.8	2.8	-1.0	-10.5	...
Migration								
Permanent & long-term arrivals	number[1]	6990	6890	7010	6930	7080	7130	...
Permanent & long-term departures	number[1]	6390	6170	6570	6480	7600	7220	...
Net PLT migration (12 month total)	number	11519	10451	8689	8249	6554	5508	...
Commodity Prices								
Brent oil price	US$/Barrel	85.80	91.96	96.95	104.24	114.92	123.33	114.93
WTI oil price	US$/Barrel	84.15	89.37	89.52	89.41	102.94	110.15	101.30
ANZ NZ commodity price index	mth % chg	1.3	4.5	2.3	2.9	8.1	-3.9	-0.8
	ann % chg	15.7	16.1	20.4	15.3	24.2	14.9	11.7
ANZ world commodity price index	mth % chg	4.5	2.0	3.8	2.7	4.8	1.6	0.3
	ann % chg	23.7	23.0	27.2	25.9	29.6	25.4	24.2
Financial Markets								
NZD/USD	$[2]	0.7727	0.7504	0.7653	0.7623	0.7408	0.7859	0.7959
NZD/AUD	$[2]	0.7805	0.7573	0.7692	0.7565	0.7333	0.7450	0.7447
Trade weighted index (TWI)	June 1979 = 100[2]	68.90	67.80	68.70	67.80	65.20	68.20	68.70
Official cash rate (OCR)	%	3.00	3.00	3.00	3.00	2.50	2.50	2.50
90 day bank bill rate	%[2]	3.17	3.17	3.19	3.13	2.69	2.65	2.66
10 year govt bond rate	%[2]	5.49	5.82	5.61	5.56	5.58	5.70	5.23
Confidence Indicators/Surveys								
National Bank - business confidence	net %	33.2	29.5	42.2	34.5	-8.7	14.2	38.3
National Bank - activity outlook	net %	35.3	34.5	41.1	36.6	14.7	29.5	39.7
ANZ-Roy Morgan - consumer confidence	net %	114.5	112.2	117.1	108.1	101.4	101.4	103.3

qtr % chg — quarterly percent change
mth % chg — monthly percent change
ann % chg — annual percent change
ann ave % chg — annual average percent change

1 Seasonally adjusted
2 Average (11am)
3 Westpac McDermott Miller
4 Quarterly Survey of Business Opinion
5 Ordinary time
6 Production GDP divided by HLFS hours worked

Sources: Statistics New Zealand, Reserve Bank of New Zealand, ANZ National Bank of New Zealand, NZIER, Datastream, Westpac McDermott Miller