Monthly Economic Indicators

THE TREASURY
Kaitohutohu Kaupapa Rawa

May 2012

Executive Summary

- **Global sentiment has deteriorated as the Greek debt crisis has become more serious.**
- **Despite this, our central *BEFU* forecast remains appropriate at present as it incorporated financial market volatility and below-consensus euro area growth. However, downside risks have increased.**
- **Domestic business and household data in May were consistent with the modest GDP growth we had incorporated into *BEFU* for coming quarters.**

During May the Greek debt crisis became more serious, as 70% of votes in the 6 May general election went to anti-austerity parties and a government was unable to be formed, requiring another election on 17 June. These problems have resulted in talk by European leaders of Greece leaving the euro area and discussion about the ramifications of doing so. Our *BEFU* forecasts included volatility in financial markets and below-consensus euro area growth, making our central scenario still appropriate at present. However, downside risks have increased since we finalised the forecasts on 27 April and our downside scenario can be seen as illustrative of a situation where Greece leaves the euro area and contagion is limited.

The escalation of the debt crisis has resulted in a deterioration in global sentiment, which has impacted on financial markets both internationally and domestically. Global equities have fallen to multi-month lows, safe haven bond yields have hit all-time lows and peripheral euro bond yields have risen substantially. We have seen some negative impacts on New Zealand, although there have been offsets. New Zealand commodity prices have fallen significantly and while some of the fall can be put down to rebounding supply, deteriorating global conditions have contributed. There have been offsets through a fall in the exchange rate which has cushioned the drop in NZD commodity prices, as well as decreases in the interest rates faced by both the government and households.

Domestic data releases this month showed that both households and businesses are tracking much as we had expected when finalising the *BEFU* forecasts. Consumer confidence, electronic card transactions and house prices are all consistent with modest private consumption growth in the next few quarters. Households will also receive support from rising wages and an improvement in the employment rate, despite a tick up in the unemployment rate. Business activity indicators point to GDP growth of around ½% in coming quarters, similar to our current forecasts which are close to the average of other forecasters. However, business margins do appear to be getting squeezed as firms struggle to pass on cost increases to customers in the current subdued trading environment.

The first of our special topics this month looks at Statistics New Zealand's GDP revisions which close the gap between the levels of the production and expenditure measures of GDP. The revisions paint a slightly different picture of the recovery from recession. We are analysing the impacts they will have on our forecasts. The second special topic examines the trade-off between austerity and growth. It concludes that New Zealand is different from the USA and the euro area in that fiscal consolidation is likely to have less of a negative impact on growth.

New Zealand Government

ISSN-1175-6780 – Text finalised 1 June 2012

Analysis

The *Budget Economic and Fiscal Update (BEFU)* was released on 24 May 2012, with our macroeconomic forecasts finalised on 27 April. Since finalising these forecasts, international sentiment has deteriorated as the Greek debt crisis has become more serious. Our *BEFU* forecasts allowed for some volatility in financial markets and incorporated below-consensus growth for the euro area, covering recent developments to some extent. Our base case is still that Greece remains in the euro area for now and leaders "manage through" the crisis. Therefore, we believe our central forecast track remains valid at this stage, although downside risks have increased. Our downside scenario in the *BEFU* was based on a global slow-down emanating from Asia, although could also be seen as illustrative of Greece leaving the euro area but contagion remaining limited. In this downside scenario, nominal GDP and tax revenue were $25 billion and $8.1 billion lower than the central scenario over the forecast period, respectively.

Domestic data have been fairly consistent with our *BEFU* forecasts and point to moderate growth in coming quarters. Treasury forecasts annual average growth to be 1.6% in the March 2012 year, before rising to 2.6% in 2013 and 3.4% in 2014.[1] Other forecasters of the New Zealand economy had published views close to those of Treasury at the time of *BEFU's* release. The average of 11 other real GDP growth forecasts was the same in the 2012 March year and 0.1% points and 0.3% points below in 2013 and 2014 respectively. The averages of other forecasts are also close to Treasury's forecasts for inflation and the unemployment rate for those years. However, escalation of the euro crisis could see revisions.

Risk of Greek exit increases…

The Greek crisis escalated significantly in May as voters rejected the ongoing austerity in the 6 May election, with almost 70% of votes going to anti-austerity parties. A government was unable to be formed, with a new election to take place on 17 June. The resulting uncertainty has led to the possibility of a Greek exit from the euro area being openly talked about by the ECB and by some European leaders. The main concerns surrounding a Greek exit are the contagion arising from credit losses to the rest of Europe if Greece defaults, weighed up against the cost of any further bailout programme. Of further concern is the withdrawal of funds from the banking system, estimated to be around €700m per day since the election. If this were to accelerate into a full bank run, regardless of how the political situation plays out, Greece could be forced to leave the euro area and adopt a new currency. An exit from the euro would be accompanied by a large devaluation of the new Greek currency and likely partial default on its foreign debt. While the devaluation would help with competitiveness, it would also lead to much higher inflation.

… putting markets into retreat...

The increased risk of Greek exit saw market participants become much more risk averse during the month. Global equities were down around 6% to levels not seen since January. US, UK and German government bonds saw strong safe-haven demand, with yields for all three falling to record-low levels. The USD also strengthened in line with the risk-off tone. Spanish bond yields, on the other hand, have jumped from below 6% to around 6.6%, in part owing to ongoing banking-sector problems. These yields are unlikely to be sustainable for a significant duration of time, and there is increasing talk that Spain could require a bailout. Italian yields also crept up, but not to the same extent as Spain's.

...impacting New Zealand commodity prices...

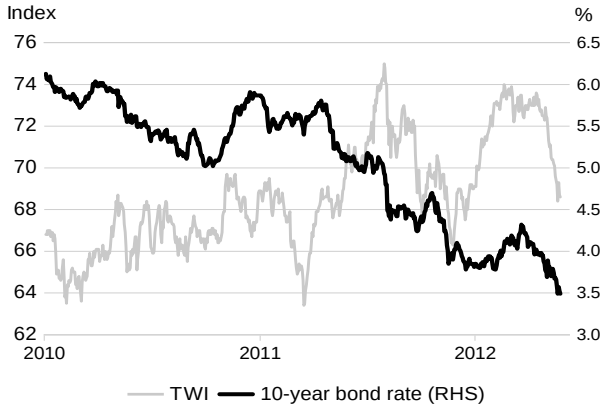
The risk-off tone seen in global markets has flowed through to impact on New Zealand. New Zealand commodity prices have suffered large falls recently, as they continue to come off their 2011 peaks. While some of these falls can be put down to increased supply, the deterioration in international sentiment has contributed. The ANZ Commodity Price Index fell 4.5% in world terms in April, the largest decrease in over three years, to reach an 18-month low.

The risk-off tone has also resulted in a fall in commodity currencies, including the NZD. The fall in the NZD has helped cushion the fall in commodity prices. The TWI has fallen from 72.2 to 68.4 (5.3%) in May (Figure 1). The updated Fonterra forecast payouts demonstrated some of

[1] These forecasts were finalised before Statistics NZ revised past GDP on 15 May. All graphs and figures in the MEI text refer to the old GDP. The tables at the end and the Chart Pack show the revised data. Our first special topic looks at the revised GDP data.

this effect. The 2011/12 payout was revised down by 30 cents to $6.05 per kg of milk solids (kgMS), while the opening 2012/13 forecast was $5.50 per kgMS. The fall was relatively small considering the GlobalDairyTrade (GDT) index had fallen 20.3% since the last forecast. The GDT only reflects part of Fonterra's supply and the recent fall in the NZD would have helped support the payout. The falls in dairy prices have resulted from high production levels both domestically and internationally and a deterioration in international sentiment. The fall has brought forward the decline we had expected later in the year. Despite the falls in commodity prices, export returns are still high by historical standards; the ANZ NZD commodity price index is still 12% higher than the 2000-2009 decade average, despite a 21% fall from its March 2011 peak.

Figure 1 – TWI & 10-year government bond rate



Source: Reserve Bank of New Zealand

...government and household interest rates

New Zealand government bond rates have also fallen significantly over the last month on the back of increased demand, as investors move into less risky assets and look to diversify their holdings out of European debt as the crisis has intensified. The 10-year government bond rate began the month at 3.8% before falling to an all-time low of 3.5% (Figure 1). In *BEFU* it was estimated that a 1% lower government bond rate would improve the operating balance by around $1.1 billion dollars over the forecast period (to June 2016). If this 30 basis point fall is maintained over the forecast period the government would save around $350 million dollars in interest expenses, if nothing else changes.

The two-year swap rate was down over 30 basis points at one stage this month and is currently trading at a rate just below the OCR. Markets are now pricing in almost 40 basis points of OCR cuts by the December Monetary Policy Statement (MPS) and a more than 50% chance of a 25 basis point cut at the June MPS. Most banks have responded to falling wholesale interest rates (which their funding costs are based on) by cutting fixed mortgage rates by up to 50 basis points. On a $300,000 loan over 25 years, a decrease in the mortgage rate from 6% to 5.5% would save a household $28.77 per week in interest payments. These lower domestic interest rates loosen monetary conditions and provide an offset to negative global developments. When combined with the lower exchange rate, they may reduce the need for the OCR cuts that the market has priced in.

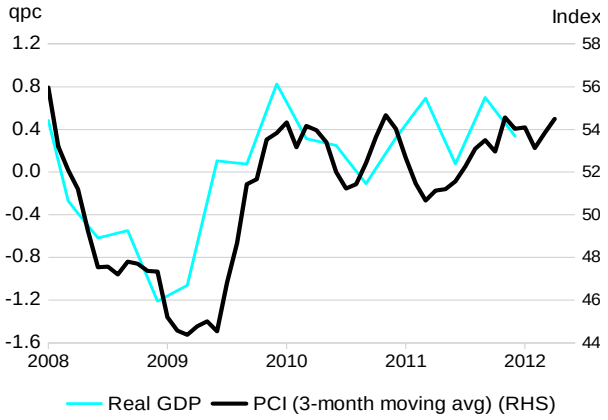
These interest rate falls could reverse if the euro debt crisis worsens significantly. If Greece exited the euro area and contagion occurred, overseas bank funding may become more constrained and expensive. Banks would likely pass these higher costs on to customers in the form of hikes in interest rates. There could be potential offsets through the Reserve Bank cutting the OCR or enacting liquidity provisions set up during the Global Financial Crisis.

Another major channel whereby a deterioration in the global outlook can impact New Zealand is through confidence. ANZ-Roy Morgan consumer confidence fell slightly in May as a decrease in current conditions outweighed a rise in future conditions. However, confidence remains in optimistic territory. The National Bank Business Outlook (NBBO) business confidence measure showed a substantial fall in May, but it remains optimistic and above average. The fall in confidence was likely influenced by developments in Greece and their potential implications.

Businesses look likely to continue with moderate expansion of production...

The BNZ-BusinessNZ Performance of Services Index (PSI) rose 2.5 points to a highly expansionary 56.7 in April. This contrasts with the Performance of Manufacturing Index (PMI) that fell into contraction (below 50) at 48.0. Combining the two series still gives a relatively expansionary result, with the GDP-weighted Performance of Composite Index (PCI) sitting at 55.6. This figure is consistent with our modest GDP growth forecasts of around ½% over the next three quarters (Figure 2). The JPMorgan global PMI fell to a five-month low of 52.2, with the euro area well below 50, showing New Zealand is relatively well placed in the current global environment, especially with the earthquake rebuild set to be a major growth driver.

Figure 2 – PCI and GDP



Sources: Statistics New Zealand, BNZ-Business NZ

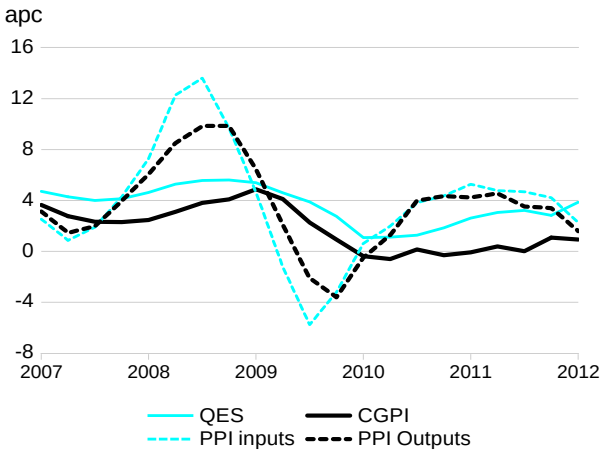
The NBBO own activity outlook fell slightly in May but is still consistent with solid growth in coming quarters. The result was fairly strong considering the negative developments occurring in Europe and activity outlook is a better indicator of growth than business confidence which fell further.

...but struggle to pass on cost increases

Releases this month show that business costs are increasing at an annual rate of 2-3%. This compares to business output prices which are increasing at an annual rate of 1-2%. It appears that business margins are being squeezed as a subdued trading environment is constraining firms from fully passing on rising costs to customers. The results fit with corporate tax and other persons tax revenue being slightly below *PREFU* forecasts in the nine months to March 2012.

Producers Price Index (PPI) input prices rose 0.3% in the March 2012 quarter, as higher electricity generator input prices were partly offset by lower prices paid by food manufacturers, resulting from falls in soft commodity prices. Input prices were up 2.3% for the year (Figure 3).

Figure 3 – Firm costs and prices



Source: Statistics NZ

PPI output prices fell 0.1% in the March quarter and were only up 1.6% for the year. Last month's March quarter CPI release also showed annual inflation of 1.6%.

The Quarterly Employment Survey (QES) showed a significant pickup in wages in the March quarter. Total average hourly earnings were 3.9% higher than a year earlier, compared to 2.8% in December. This means real wages rose an annual 2.3% (QES wage growth minus CPI inflation). The Labour Cost Index (LCI), which keeps the quantity and quality of labour fixed, showed a more subdued 2.0% annual increase in wages and salaries.

The Capital Goods Price Index (CGPI) was unchanged in the March quarter, but is up 0.9% for the year. Residential building and civil construction prices are 2.4% and 5.8% higher than a year earlier, respectively. These rises demonstrate some of the pressures developing from the Canterbury rebuild as well as a general pickup in the construction industry.

Weaker labour market headlines...

The Household Labour Force Survey (HLFS) showed the unemployment rate rose to 6.7% in the March quarter, from an upwardly revised 6.4% in the December quarter. Total hours worked were only up 0.1% in the quarter for a 1.1% annual rise. In the QES, hours paid fell 0.5% in March to be up 0.7% for the year. The headlines would suggest limited support for household spending going forward, but there were offsets.

...but details show positive signs...

However, looking at the details of the labour market outturns paints a brighter picture. The rise in the unemployment rate came about because of a 0.6% point rise in the participation rate, to the second highest figure on record of 68.8%, rather than a fall in employment which rose by 9,000. The rise in participation came about chiefly as more people in formal study were actively seeking and available for work. The employment rate (the portion of the working age population in work) actually rose 0.3% points to 64.2% in the quarter.

There are signs of improvement in Canterbury, with the unemployment rate 0.9% points lower over the past year and the employment rate 0.3% points higher. As has been the case in previous quarters, the retail trade, accommodation, and food services industry had the largest decrease in employment for the year. The largest increase in employment for the region was in the construction industry as it gears up for the rebuild.

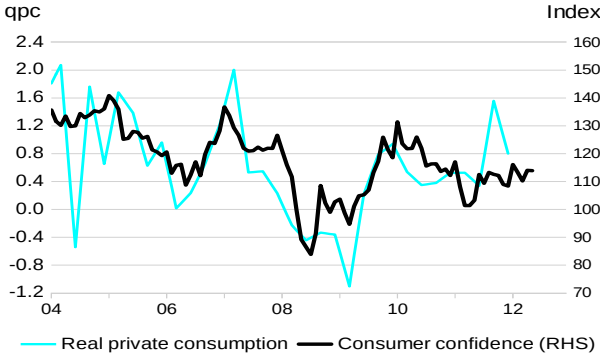
…supporting modest consumption growth in coming quarters...

Indicators of private consumption are in aggregate consistent with our *BEFU forecasts* of modest growth in private consumption in coming quarters. While consumption looks to have fallen slightly in the first quarter, this was mostly anticipated as the result of a normalisation following a boost received from the RWC.

Core retail Electronic Card Transactions (ECT) were up 0.7% in April and 1.1% for the year. This was driven by increases in consumables and hospitality spending. Total ECT spending increased 0.6% as vehicle-related spending fell. The momentum in ECT values has picked up slightly with the three-month rolling average up 0.5% from 0.4% in the March quarter, in line with our private consumption growth forecasts for a pickup in the June quarter.

The REINZ house price index fell 0.3% in April and annual growth fell to 2.7% from the strong 4.2% growth seen in March. The growth in house sales has lost momentum in recent months with sales volumes down 8.1% following a 3.8% decline in March. Auckland and Christchurch continue to lead the market in sales volumes and price growth. The trend for house prices is in line with forecast and consistent with our view of a sluggish recovery in the housing market.

Figure 4 – Consumer confidence & consumption



Sources: Statistics NZ, ANZ-Roy Morgan

Food prices fell 0.1% in April, following a 1.0% fall in March. Food prices are unchanged for the year, further reinforcing subdued inflationary pressures. Also, as mentioned earlier, consumer confidence remains in optimistic territory. The housing market recovery, subdued inflationary pressures and optimistic consumer confidence are consistent with our forecast consumption growth of around 1/2% in the next few quarters (Figure 4).

…following post-RWC slump

Core retail sales volumes experienced the largest quarterly contraction in the 17-year history of the series, dropping 2.5% in the March quarter. A rise in vehicle-related sales meant total volumes were down a lesser 1.5%, but still the largest fall in three years. This followed 2.3% and 1.8% rises in the September and December quarters respectively, boosted by the RWC. The fall in sales was broad based with contractions in 10 of the 15 store types, but the main driver was a 7.4% drop in supermarket volumes. While the core sales volume result appeared weak, it was understandable in the wake of the RWC and we had factored a fall in retail sales into our March quarter GDP pick. However, the weak result does provide some downside risk to our flat private consumption forecast. Abstracting from the volatility caused by the RWC, core sales are still up 3.2% for the year.

Euro weakness leads to deterioration in the global outlook...

In addition to the ongoing risks of a Greek exit from the euro area, data have been on the weak side. GDP growth was flat in the March quarter, albeit above expectations, driven by 0.5% growth in Germany. However, the growth outlook is poor, with the manufacturing PMI declining to 45, driven by falls in the German PMI. The overall services PMI also fell during the month, remaining well below the expansionary 50 level.

… which along with softer domestic data sees policy easing to support growth in China

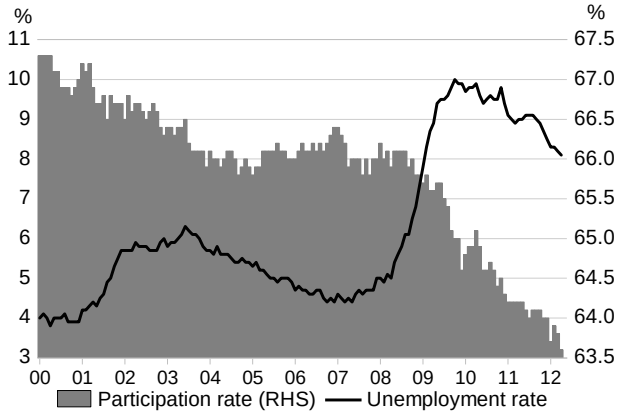
Data for April revealed a softer picture for China, with authorities responding with a loosening in monetary and fiscal policies. Industrial production growth eased to 9.3% from 11.9% in March, well below market expectations. Retail sales growth disappointingly eased to 14.1%. Fixed asset investment was also below the market pick. The HSBC manufacturing PMI also fell slightly, signifying its longest below-50 run since the GFC. As mentioned above, authorities responded to the softness, lowering the reserve requirement ratios (RRR) 50 basis points, and also announced subsidies for energy-saving appliances and other products. Additional loosening is also expected over the coming months, likely through more RRR cuts and investment spending. Annual inflation declined in line with expectations to 3.4% in April, after 3.6% the previous month, allowing authorities to ease.

Moderate growth in the US…

The moderate US recovery is ongoing, with GDP rising 0.5% in the March quarter, up 2.0% for the year. Private consumption was up 0.7%, a strong sign for retail and the labour market. On the other hand, the government's ongoing fiscal consolidation saw the sector again have a negative contribution to growth; this is expected to continue, and could be even larger in 2013. Our second special topic this month looks at the trade-off between austerity and growth in the USA and Europe compared with New Zealand.

The labour market recovery continued at a modest pace, with US non-farm payrolls rising below expectations at 115,000 in April, although upwards revisions over the previous two months helped to temper market reaction. The unemployment rate edged lower to 8.1%, although this was largely owing to another decline in the participation rate, now at 63.6%, its lowest level since the 1980s (Figure 5).

Figure 5 – US unemployment and participation



Source: Haver

Other data were mixed, with industrial production up strongly in April, and existing and new home sales up in the month. On the other hand, regional PMIs generally declined and retail sales were flat.

... with mixed signs in Australia

Weaker-than-expected inflation and GDP outturns, as well as a softening in other data including the PMI and terms of trade, saw the RBA cut its policy rate by a greater-than-expected 50bps to 3.75%. Some commentators expect further cuts. The main risk to the Australian economy is still a hard landing in China, which could possibly be precipitated by a severe euro area crisis. If this were to happen, there is still significant room for the RBA to cut its policy rate, and the government is in a relatively strong position to provide fiscal stimulus.

However, if the downside risks do not eventuate, the rate cuts may not be necessary, especially if the labour market continues its recent trend. Australian employment growth was stronger than expected in April, and along with a decline in the participation rate, brought the unemployment rate down from 5.2% to 4.9%. Retail sales fell slightly in April following a strong 1.1% increase in March, in part owing to seasonal effects. Overall, retail sales look be on a slightly improving trend.

The Australian Budget was also released during the month. As expected, it revealed a forecast of a small surplus of 0.1% of GDP in the 2012/13 year. This implies a fiscal contraction equivalent to 3.1% of GDP over the next year, although in reality, owing to the type of cuts and possible slippage, the macroeconomic impact of the contraction is likely to be less than half the budget figure.

Trade balance falls into deficit

A deterioration in the global outlook will be a negative for New Zealand trade, likely resulting in export demand declining and commodity prices dropping further. Already, the annual trade balance has declined to a deficit of $541 million for the April year, the first deficit recorded since March 2010. Export values fell slightly in April to be down 17% for the year, driven by a decline in dairy and meat export prices. A fall in crude oil imports, partly offset by a large increase in imports of plant and machinery, drove a fall in merchandise imports for the month with little change from the previous year. The outlook is for the trade balance to decline further over the year ahead as import demand rises, partly due to the earthquake rebuild, and the terms of trade continue to fall.

Overall, despite a deterioration in the global outlook as a result of the escalation of the Greek debt crisis, the central scenario from our *BEFU* forecasts remains valid at this stage. Downside risks have increased and our downside scenario can be seen as indicative of Greece leaving the euro area with limited contagion. Domestic data, for both businesses and households, are consistent with modest growth in coming quarters, before a ramp-up in the Canterbury rebuild leads to a pickup in economic activity.

Special Topic 1: Revised New Zealand GDP Data

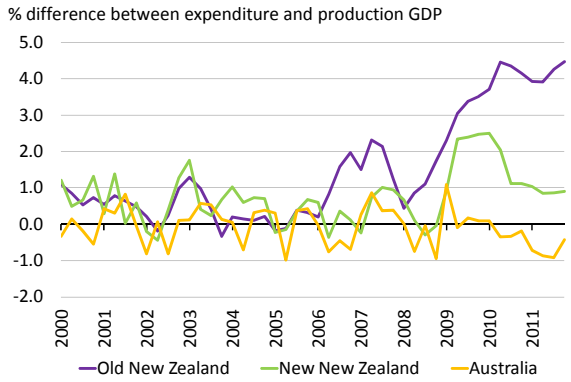
Statistics New Zealand released revised Gross Domestic Product (GDP) data on 15 May 2012 that made reasonably significant changes to how we view the economy in recent years. These changes were made in the week before *BEFU 2012* so were not included in the economic and fiscal forecasts. This note outlines some implications of the revised data.

A number of changes were made to GDP...

The revisions affected the two measures of real quarterly GDP available in New Zealand: production (ie, value-added output by industry) and expenditure (ie, consumption, investment, exports and imports). Production is the headline measure in New Zealand. The changes incorporated a new industry classification (the Australian and New Zealand Industrial Classification or ANZSIC 2006) and methodology improvements, plus updated annual benchmarks and chaining weights. The largest impact was from the new annual benchmarks.

The main feature of the revisions is a reduced gap between the two measures of real GDP. These measures should give the same result in theory, but prior to the revisions the expenditure measure was 4.5% higher than production in the December 2011 quarter (Figure 6). With the revisions, the gap is now 0.9% as expenditure was revised down 2.9% and production moved up 0.6%.

Figure 6 – Gap between expenditure and production

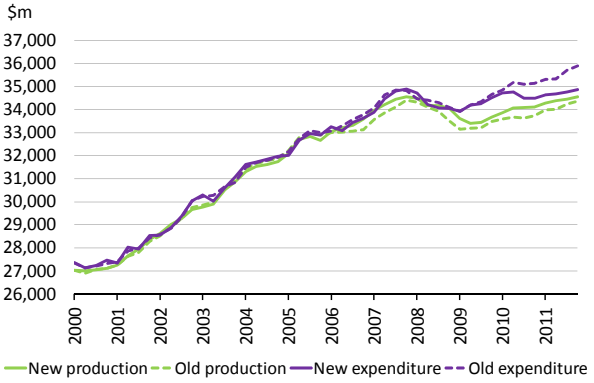


Sources: Statistics NZ, Australian Bureau of Statistics

...but still a gradual recovery from recession

The new data do not change the gradual pace of recovery following a moderate contraction in 2008/09, but in confirming this they were rather disappointing (Figure 7). There was some hope that production GDP would be revised much higher than it actually was. The size of the recovery is even more gradual than previously at 3.4% since September 2009 (rather than 3.6% since June 2009). Nevertheless, real GDP has not contracted over the past 10 quarters, a record which only eight other OECD nations can claim. The December 2010 quarter is now barely a rise, up just 0.003%, so it is prudent to say 9 of the last 10 quarters have shown growth.

Figure 7 – Real GDP revisions



Source: Statistics NZ

The size of the contraction in 2008/09 is now 3.3% from a peak level of activity in the December 2007 quarter (the pre-revision fall was 3.7%). However, the nature of this contraction is not as straightforward as previously – five consecutive quarters of declining real GDP from March 2008 to March 2009 now become two consecutive declines in the first half of 2008 followed by a steady quarter (0.01%) in the September 2008 quarter and then three further quarters of decline. This gives us two distinct recessions on the so-called "technical" definition of two consecutive quarters of contraction – the first a domestic recession induced by drought, the collapse of finance companies and tight monetary conditions, and the second an external recession after the global financial crisis in late 2008.

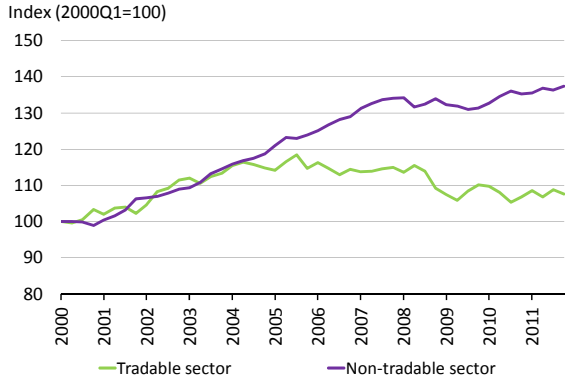
The size of the recovery (3.4% or $1.143 billion) in quarterly real GDP is almost identical to the size of the contraction (3.3% or $1.154 billion), hence the level is just $11 million below its all-time high. Also, annual average growth in real GDP was revised up from 1.2% to 1.5% for 2010 and revised down by an equal amount from 1.4% to 1.1% for 2011. With growth in 2011 now weaker than in 2010, the economy had less momentum heading into 2012 than previously thought.

Significant changes at detailed level...

The introduction of ANZSIC 2006 was partly to improve the measurement of services in the

economy. Interestingly, the size of the service sector was revised down (from 71% of GDP to just under 70%) as some industries moved into the goods-producing sector, which is now quite a bit larger. Agriculture was revised down, partly because the 2008 drought was better accounted for (although there is now no recovery from this drought). There were only minor changes to the tradable and non-tradable split presented in the last *Monthly Economic Indicators* (Figure 8).

Figure 8 – New tradable and non-tradable output



Sources: Statistics NZ, the Treasury

Around half of the revision to real expenditure GDP was accounted for by a reduction in private consumption (2.3% lower in the December 2011 quarter), partly caused by a 1.8% increase in the deflator (ie, consumer prices). Some of this appears to reflect a fuller flow-through from the rise in GST in 2010 to be more consistent with what we expected at the time, while the increase in 2011 seems out of line with the Consumers Price Index. Nominal expenditure GDP was revised down by 1.5%, of which 0.8% percentage points reflected a revision to public consumption. This revision seems inconsistent with growth in central government spending in recent years. The rest of the downward revision in nominal expenditure GDP came from weaker private consumption and investment.

...could have implications for potential output

Potential output and output gap measures based on production GDP may not be greatly affected given the small 0.6% upward revision to this series. For example, average labour productivity growth in the 15 years to March 2011 is now 1.2% per annum, up slightly from 1.1% previously. Of concern is the slightly weaker recovery since the recession ended and what this implies for future growth. However, it is interesting to note the immediate recovery in 2009/2010 is now stronger but growth rates since the 4 September 2010 earthquake have been weaker. This could give more weight to our initial estimate of a 1.5 percentage point hit to growth in 2011 from the earthquakes, which would suggest growth has a lot of room to bounce back. Measures of potential output built up from expenditure GDP will be affected negatively by the revisions. This includes the private sector estimate of potential output used in the New Zealand Treasury Model (NZTM), although the impact will be lessened by the government sector taking some of the hit.

Key lessons and implications

No GDP number is infallible: they are all subject to change. Revisions are an "occupational hazard" for economic forecasters, but the latest changes are large enough to call into question quarterly estimates of GDP. The December 2010 quarter has been revised from 0.2% on first release to 0.5% to 0.6% back to 0.3% and now 0.0% (our original pick in the preliminary *BEFU 2011* forecasts). The September 2008 quarter was revised from -0.5% to 0.0%, our original pick at the time. Despite the revisions, there are still differences between the two measures of GDP. Did real GDP fall 0.6% in the June 2009 quarter as the production measure suggests, or did it rise 0.8% as the expenditure measure shows? Although the levels gap is much smaller than previously, the correlation of quarterly growth rates between the two GDP measures has deteriorated over the period 2007-2011 since the revisions.

The revised data have little direct impact on *BEFU* forecasts, but there could be some effect depending on how the changes are interpreted. Even if we keep the same quarterly growth going forward, annual average growth for 2012 would be lowered from 2.2% to around 2% (2013 would remain at 3.5%). If the revisions do suggest either less momentum heading into 2012 or a lower level of potential than we previously thought, then these growth rates would be lower still. Fiscal numbers presented as shares of GDP will change slightly from those presented in the *2012 BEFU* – a surplus will stay a surplus but would appear larger if the downward revisions to nominal GDP continue to flow through, while debt levels as a share of GDP would be slightly higher. Tax revenue forecasts may not be impacted much or at all if nominal economic growth forecasts remain unchanged. We will continue to analyse the revised GDP data and its implications for our forecasts and understanding of the economy.

Special Topic 2: The Austerity vs Growth Debate and How NZ is Different

There is a robust international debate going on right now over the appropriate pace and extent of fiscal consolidation in the United States, the United Kingdom, and the crisis-hit economies of Europe. This note provides a brief summary of the key positions, and the difficulties in reconciling them, and then comments on the extent to which this debate is relevant for New Zealand. The bottom line is that the nature of the appropriate fiscal policy debate in New Zealand is quite different from the international debate. This is because New Zealand is a small open economy with a floating exchange rate, and because there is still some room for further monetary policy easing if necessary. Thus, under the current central scenario for the New Zealand economy, there is little reason to believe that the pace of fiscal consolidation will be detrimental for growth.

The International Austerity vs Growth debate

The Austerity vs Growth debate has now been going on for some time in a number of European economies and the United States. The crux of this debate is that the need for fiscal consolidation in these economies must be set against the evidence suggesting that consolidation right now might be damaging for economic growth.

Indeed, debt sustainability analyses do suggest a need for credible fiscal consolidation in many economies. Figure 9 shows that not only do many OECD economies have large fiscal deficits, but also that debt levels in some cases are very high.

At the same time, there is a growing body of empirical analysis suggesting that the appropriate pace for fiscal consolidation should be carefully tailored to the economy, according to the size of the fiscal multipliers (ie, the estimated impact of fiscal policy on GDP). In particular, research suggests that fiscal multipliers are likely to be quite positive right now for the United States, and most individual European economies (ie, fiscal contraction will lead to lower economic growth).[2]

These results are partly owing to the recession and the current environment of private sector deleveraging, but also, probably more importantly, because of constraints on monetary policy: the zero lower bound for nominal interest rates in the United States, the UK, and Japan; and the lack of an independent monetary policy for individual euro zone members.

All this suggests a risk that significantly contractionary fiscal policies could have the unintended effect of reducing growth in the near-term and increasing the persistent effect of the downturn on trend output, potentially exacerbating the longer-term fiscal sustainability challenges, as DeLong and Summers, among others, have pointed out.[3]

Yet, despite this evidence, a number of governments are pursuing a relatively fast pace of fiscal consolidation.4 This reflects a fear that if they are not seen to be taking decisive action to get their debt under control, their bond yields will rise, with the accompanying risk – if their fiscal position is bad enough – that they could be pushed into a crisis (as, say, Ireland, Portugal and Greece have already been).

So, who is right? Those who argue that there is a case for a slower pace of consolidation? Or those who want to be seen to be doing something right now, to ensure the confidence of markets? The answer is most likely that they are both right. Something does need to be done immediately. That something, ideally, might be to seek an adjustment path where credibility can go hand-in-hand with a slower consolidation path. This would likely involve near-term structural reform to boost competitiveness and potential output, combined with a setting out of credible medium term fiscal consolidation plans.[5] Unfortunately, political constraints (such as those apparent in the United States) and the inability to credibly commit to future consolidation, can make it difficult to achieve the ideal mix.

---

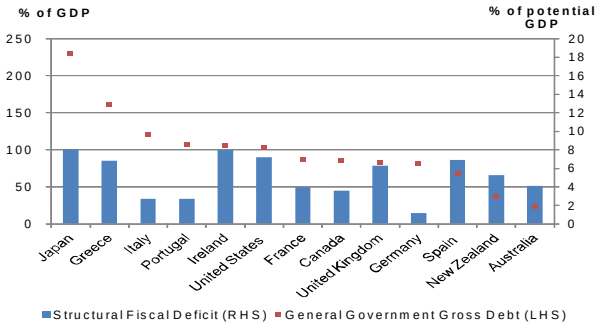
[2] For empirical estimates see, for example, Ilzetzki, Mendoza and Vegh (2011), How Big (Small?) are Fiscal Multipliers?, IMF working paper 11/52, www.imf.org/external/pubs/ft/wp/2011/wp1152.pdf\ and for the impact of the crisis see Romer (2012), "Fiscal Policy in the Crisis: Lessons and Policy Implications", elsa.berkeley.edu/~cromer/Lessons%20for%20Fiscal%20Policy.pdf

[3] J Bradford DeLong and Lawrence Summers, (2012), "Fiscal Policy in a Depressed Economy", NBER Working Paper: www.brookings.edu/~/.../2012_spring_bpea_delongsummers.pdf

[4] For details, see the IMF Fiscal Monitor: www.imf.org/external/pubs/ft/fm/2012/01/pdf/fm1201.pdf

[5] For further discussion of how to implement fiscal consolidation in a growth-friendly way, see Cottarelli and Jaramillo (2012), "Walking Hand in Hand: Fiscal Policy and Growth in Advanced Economies", IMF Working Paper 12/137. http://www.imf.org/external/pubs/ft/wp/2012/wp12137.pdf

Figure 9 – Public sector debt and fiscal deficits in 2011 for selected OECD economies



Sources: IMF Fiscal Monitor, April 2012

Note: The structural fiscal deficit is the deficit adjusted for the effects of the economic cycle. If also adjusted for the effects of earthquake-related spending, the New Zealand structural deficit would be closer to 3% for 2011.

How is New Zealand different?

As illustrated in Figure 9, New Zealand has a structural fiscal deficit of similar magnitude to many other OECD economies. It is clear that significant fiscal consolidation is required to stabilise New Zealand government debt.[6] But what is the appropriate pace of fiscal consolidation in New Zealand, especially in the context of our lower-than-average level of general government debt as a percentage of GDP?

There are a number of considerations here. First, the appropriate level of government debt for New Zealand needs to be considered in the broader context of our high level of net external debt (most of which is private sector debt), which is often cited by credit rating agencies as posing risks to New Zealand macro-stability. One of the best ways the government can mitigate this vulnerability is by keeping the level of public debt relatively low.

Second, there are a number of reasons to believe that a given pace of fiscal consolidation will be less contractionary for the New Zealand economy at present than it would be for most other economies. In other words, New Zealand's fiscal multipliers are thought to be quite small, meaning that New Zealand would get less of a boost from fiscal spending than most OECD economies.

The explanation for why New Zealand is thought to have relatively small fiscal multipliers, stems from the fact that New Zealand is a small, relatively open economy with a floating exchange rate and an independent inflation-targeting central bank. The key point is that – as part of their inflation-targeting mandate – the Reserve Bank has an important role to play in stabilising aggregate demand in the economy. Thus as long as monetary policy is not hitting the zero lower bound for interest rates, a well-signalled and credible fiscal consolidation path should – all else equal – be offset by lower-than-otherwise interest rates, and associated exchange rate depreciation, which should boost net exports. It is this interaction between fiscal policy and monetary policy which should result in fiscal multipliers that are close to zero.

This explanation for close-to-zero fiscal multipliers does not apply to individual euro-zone economies which do not have an independent monetary policy, nor to the United States, the UK or Japan, where monetary policy is at the zero bound.

Some economists would argue that the zero lower bound for nominal interest rates does not really bind monetary policy effectiveness, given the existence of quantitative easing tools. Indeed, such tools are widely agreed to have some effect. But the uncertainties and limitations of quantitative easing suggest that we should be cautious about attributing to it the same degree of effectiveness as conventional monetary policy.

Interestingly, there is evidence that Australia does not fit neatly into the category of a country that would be expected to have 'close to zero' fiscal multipliers. This is because Australia's trade shares are not particularly high (exports + imports as a percentage of GDP are around 40% in Australia, vs around 60% in New Zealand). The more closed an economy is, the less the impact of fiscal contraction on domestic economic output will be offset by the associated exchange-rate-depreciation-driven boost to net exports. As a result the conventional view is that fiscal multipliers are typically positive in Australia.[7]

Empirical evidence for New Zealand

So what does the empirical literature tell us about fiscal multipliers in New Zealand? Unfortunately there isn't a big NZ literature, but what there is, is broadly consistent with there being small positive fiscal multipliers in the short-term (ie, the next few quarters) and close to zero fiscal multipliers in the medium term (ie, over the 1 – 3 year horizon).[8]

[6] Eg, see Merola and Sutherland (2012), "Fiscal Consolidation: Part 3. Long-Run Projections and Fiscal Gap Calculations", OECD Economics Department Working Paper No. 934.

[7] Eg, as discussed in this speech by David Gruen: http://www.treasury.gov.au/PublicationsAndMedia/Speeches/2011/Lessons-about-Fiscal-Policy-from-the-2000s.

[8] Claus, Gill, Lee and McLellan (2006), "An Empirical Investigation of Fiscal Policy in New Zealand", Treasury Working Paper 06/08; Dungey and Fry (2009),

To say that fiscal multipliers in NZ are small or "close to zero" is not to say that fiscal policy has no impact. A switch in the mix of macroeconomic conditions would be expected to have sectoral impacts even if the impact on aggregate GDP more or less nets out. For example, in the mid-2000s we think that the loosening in fiscal policy and the consequently tighter monetary policy had the impact of boosting non-tradable sector output and hindering tradable sector output.

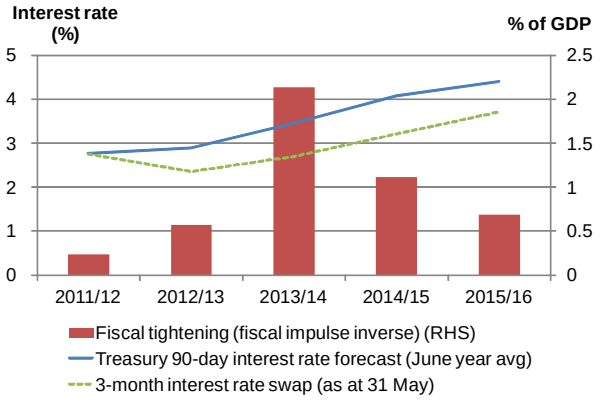
In addition, for unanticipated fiscal changes, the short-term fiscal multiplier is probably positive (ie, would most likely boost GDP in the initial few quarters). But there are a number of reasons why we would not normally advocate the use of fiscal policy for "fine tuning" the economy.

There is, of course, lots of uncertainty about these estimates and we need to remain open to new evidence. But for the meantime both the theoretical and empirical evidence suggests that fiscal consolidation is unlikely to have big adverse GDP effects in New Zealand, as long as there remains room to ease monetary policy.

The key question for NZ then becomes how much room there is for additional monetary policy easing. Figure 10 shows that the government's planned fiscal consolidation is expected to occur against a backdrop of gradually rising interest rates over the next few years (reflecting above-trend growth driven in part by the expected Canterbury rebuild).

While the market is pricing in a lower level of interest rates than the Treasury (dashed line in Figure 10), that path is also expected to follow a gradually rising profile from next year onwards. This, together with the fact that the OCR is still 250 basis points above zero, suggests that there is still room for monetary policy to ease if growth slows and the inflation outlook improves.

Figure 10 – NZ Fiscal and Monetary Policy



Sources: New Zealand Treasury, Thomson Reuters

Overall, although the government's planned fiscal consolidation is significant (Figure 10 shows that it is estimated to take around four percentage points out of demand over the next four years), this is not expected to hold back aggregate growth, as it will allow interest rates to stay lower than otherwise.

Of course, if New Zealand were to be hit by a large negative shock and we were to run out of monetary policy easing room, then our fiscal multipliers would likely move into more positive territory, and there would be a case for reconsidering the appropriate pace of fiscal consolidation.

Conclusion

The Fiscal Austerity vs Growth debate in the US and Europe reflects the genuine difficulties in designing structural reform and fiscal consolidation packages that boost near-term credibility without unnecessarily dampening near-term growth.

However, this debate is not so relevant for New Zealand as long as we think monetary policy has further room to ease, if required. In fact, given New Zealand's vulnerabilities of rising public debt, high external debt, and an over-valued exchange rate, there is a strong argument for the government to adhere to its fiscal consolidation plans. Indeed, as set out by Treasury in our Briefing to Incoming Ministers,[9] it is important that the forward fiscal consolidation path always be set out clearly and credibly, so that monetary policy can respond appropriately, in the event of a further slowing of the New Zealand or global economies.

"Identifying Fiscal and Monetary Policy in a Small Open Economy VAR", Economic Modelling, Vol. 26, 1147-1160; and Fielding, Parkyn and Gardiner (2011), "Explaining some puzzles in the estimated response of New Zealand GDP to fiscal shocks", Paper presented at the New Zealand Association of Economists Annual Conference, Wellington, July 2011.

[9] For the 2011 Briefing to the incoming Minister of Finance see: http://www.treasury.govt.nz/publications/briefings/2011

Monthly Economic Indicators is a regular report prepared by the Forecasting and Monitoring team 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

1 June 2012

Quarterly Indicators

		2010Q3	2010Q4	2011Q1	2011Q2	2011Q3	2011Q4	2012Q1
Gross Domestic Product (GDP)								
Real production GDP	qtr % chg[1]	0.1	0.0	0.5	0.3	0.2	0.3	...
	ann ave % chg	-0.6	0.2	0.9	1.3	1.4	1.3	...
Real private consumption	qtr % chg[1]	-0.1	-0.6	0.1	0.9	1.1	0.2	...
	ann ave % chg	2.2	2.2	1.6	0.8	0.7	1.1	...
Real public consumption	qtr % chg[1]	-1.0	0.6	0.1	0.1	0.4	-0.7	...
	ann ave % chg	0.3	0.6	0.3	0.0	0.3	0.2	...
Real residential investment	qtr % chg[1]	-4.9	-6.2	-3.4	-7.5	1.1	4.8	...
	ann ave % chg	3.7	4.0	4.3	-4.7	-10.9	-11.5	...
Real non-residential investment	qtr % chg[1]	6.6	4.1	3.3	-2.4	-0.8	0.7	...
	ann ave % chg	-4.4	2.3	7.1	11.6	10.9	7.5	...
Export volumes	qtr % chg[1]	-0.1	-0.3	0.9	-0.7	0.3	2.9	...
	ann ave % chg	4.4	3.3	2.1	1.1	0.7	1.1	...
Import volumes	qtr % chg[1]	2.7	6.9	-2.5	1.8	2.8	-2.4	...
	ann ave % chg	5.8	10.6	11.1	11.0	10.2	6.2	...
Nominal GDP - expenditure basis	ann ave % chg	1.9	3.2	4.0	4.6	4.9	4.5	...
Real GDP per capita	ann ave % chg	-1.8	-1.0	-0.3	0.2	0.3	0.3	...
Real Gross National Disposable Income	ann ave % chg	0.0	1.0	1.4	2.0	2.7	2.6	...
External Trade								
Current account balance (annual)	NZ$ millions	-6621	-6787	-7196	-7396	-8827	-8268	...
	% of GDP	-3.5	-3.5	-3.6	-3.7	-4.3	-4.0	...
Investment income balance (annual)	NZ$ millions	-9750	-9538	-9649	-9501	-10363	-10311	...
Merchandise terms of trade	qtr % chg	3.0	0.8	0.8	2.4	-0.6	-1.4	...
	ann % chg	17.9	12.3	6.7	7.1	3.4	1.1	...
Prices								
CPI inflation	qtr % chg	1.1	2.3	0.8	1.0	0.4	-0.3	0.5
	ann % chg	1.5	4.0	4.5	5.3	4.6	1.8	1.6
Tradable inflation	ann % chg	0.3	3.3	3.7	5.5	4.6	1.1	0.3
Non-tradable inflation	ann % chg	2.5	4.6	5.2	5.2	4.5	2.5	2.5
GDP deflator	ann % chg	4.2	6.9	3.9	4.6	3.5	0.9	...
Consumption deflator	ann % chg	1.3	3.3	3.6	4.6	4.0	2.0	...
Labour Market								
Employment (HLFS)	qtr % chg[1]	1.1	-0.3	1.1	0.1	0.2	0.2	0.4
	ann % chg[1]	1.8	1.3	1.7	2.0	1.1	1.6	0.9
Unemployment rate	%[1]	6.4	6.7	6.6	6.5	6.6	6.4	6.7
Participation rate	%[1]	68.2	68.0	68.6	68.4	68.4	68.2	68.8
LCI salary & wage rates - total (adjusted)[5]	qtr % chg	0.5	0.5	0.4	0.5	0.6	0.6	0.4
	ann % chg	1.6	1.7	1.8	1.9	2.0	2.0	2.0
QES average hourly earnings - total[5]	qtr % chg	1.0	0.5	0.4	1.1	1.2	0.1	1.4
	ann % chg	1.1	1.8	2.6	3.0	3.2	2.8	3.8
Labour productivity[6]	ann ave % chg	-0.8	-1.2	-1.1	-0.7	-0.6	-0.2	...
Retail Sales								
Core retail sales volume	qtr % chg[1]	-0.3	-0.1	1.4	1.0	2.5	2.3	-2.5
	ann % chg	1.5	0.3	1.4	1.9	4.5	7.3	3.2
Total retail sales volume	qtr % chg[1]	-0.6	-0.5	1.4	0.9	2.3	1.8	-1.5
	ann % chg	1.9	-0.1	0.8	1.1	3.9	6.4	3.4
Confidence Indicators/Surveys								
WMM - consumer confidence[3]	Index	114	108	98	112	112	101	102
QSBO - general business situation[4]	net %	6.4	8.1	-26.8	26.6	24.6	0.2	13.0
QSBO - own activity outlook[4]	net %	9.5	11.4	-1.6	18.5	30.0	9.9	16.9

Monthly Indicators

		2011M11	2011M12	2012M 1	2012M 2	2012M 3	2012M 4	2012M 5
External Sector								
Merchandise trade - exports	mth % chg[1]	0.7	1.9	-1.1	-8.8	-2.9	-1.7	...
	ann % chg[1]	7.0	12.0	12.2	-6.4	-9.0	-17.2	...
Merchandise trade - imports	mth % chg[1]	9.9	-9.8	17.4	-14.2	2.2	-2.9	...
	ann % chg[1]	17.1	-1.9	18.0	-7.4	-0.8	0.8	...
Merchandise trade balance (12 month total)	NZ$ million	288	806	637	659	262	-541	...
Visitor arrivals	number[1]	215740	220250	213710	204020	210380	212140	...
Visitor departures	number[1]	215630	220500	219090	215350	209290	218820	...
Housing								
Dwelling consents - residential	mth % chg[1]	-5.7	2.3	9.2	-6.2	19.6	-7.2	...
	ann % chg[1]	-4.7	17.8	19.7	20.8	46.7	34.5	...
House sales - dwellings	mth % chg[1]	7.3	4.6	0.9	7.2	-3.9	-7.4	...
	ann % chg[1]	17.7	20.6	26.6	37.2	25.1	13.3	...
REINZ - house price index	mth % chg	1.1	-0.1	-1.4	0.8	1.9	-0.3	...
	ann % chg	2.6	3.1	4.3	2.7	4.2	2.7	...
Private Consumption								
Electronic card transactions - total retail	mth % chg[1]	-0.6	-0.2	1.1	-0.6	0.3	0.8	...
	ann % chg	6.0	7.2	4.7	8.2	5.6	1.2	...
New car registrations	mth % chg[1]	7.9	4.0	1.7	-2.0	-3.5	3.2	...
	ann % chg	-7.9	4.2	4.5	2.3	-1.0	8.6	...
Migration								
Permanent & long-term arrivals	number[1]	7090	6710	6610	7180	7540	6430	...
Permanent & long-term departures	number[1]	7200	7240	7240	7520	7310	7280	...
Net PLT migration (12 month total)	number	-568	-1855	-3134	-4068	-3383	-4006	...
Commodity Prices								
Brent oil price	US$/Barrel	111.16	108.35	111.41	119.17	124.70	120.47	110.61
WTI oil price	US$/Barrel	97.11	98.57	100.10	102.30	106.19	103.33	94.87
ANZ NZ commodity price index	mth % chg	1.1	-0.6	-2.9	-4.0	-0.2	-4.0	...
	ann % chg	5.9	1.2	-4.4	-10.8	-17.6	-17.7	...
ANZ world commodity price index	mth % chg	-1.1	-0.8	1.2	0.0	-1.7	-4.5	...
	ann % chg	5.5	3.1	0.1	-2.5	-8.5	-14.0	...
Financial Markets								
NZD/USD	$[2]	0.7728	0.7697	0.8007	0.8343	0.8208	0.8190	0.7762
NZD/AUD	$[2]	0.7635	0.7603	0.7691	0.7780	0.7779	0.7908	0.7766
Trade weighted index (TWI)	June 1979 = 100[2]	68.20	68.60	71.20	73.30	73.00	73.00	70.00
Official cash rate (OCR)	%	2.50	2.50	2.50	2.50	2.50	2.50	2.50
90 day bank bill rate	%[2]	2.69	2.69	2.74	2.75	2.74	2.74	2.59
10 year govt bond rate	%[2]	4.14	3.91	3.86	3.98	4.17	3.98	3.66
Confidence Indicators/Surveys								
National Bank - business confidence	net %	18.3	16.9	20.2	28.0	33.8	35.8	27.1
National Bank - activity outlook	net %	28.8	25.7	25.6	31.2	38.8	36.1	34.9
ANZ-Roy Morgan - consumer confidence	net %	109	108.4	116.1	113.3	110.2	114	113.9

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, National Bank of New Zealand, NZIER, ANZ, Datastream, Westpac McDermott Miller, One News Colmar Brunton