1

Economic Outlook

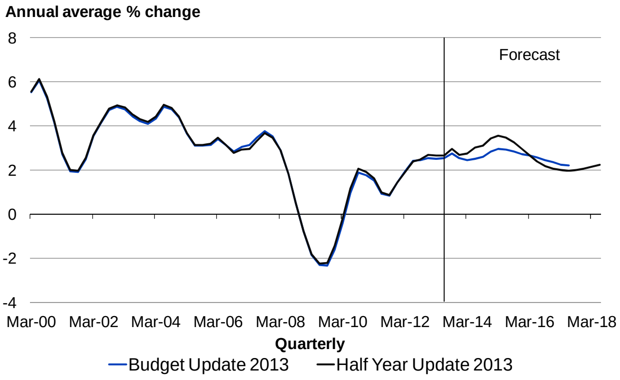
Overview

The near-term outlook for the New Zealand economy is robust, with an increasingly embedded and broad-based pick-up in activity anticipated following a drought-affected first half of 2013. Real GDP growth is expected to exceed its potential rate over the coming years, peaking at 3.6% in the March 2015 year, before easing to a more moderate rate of around 2.0% towards the end of the forecast period.

Growth outlook reflects net influence of supportive and constraining factors

The growth outlook continues to reflect the net impact of a number of large supporting and constraining forces. The Canterbury rebuild remains a key factor on the supportive side, along with a high terms of trade, stimulatory monetary policy settings and rising incomes on the back of a strengthening labour market.

Figure 1.1 – Real GDP growth



Sources: Statistics New Zealand, the Treasury

The supportive influences on the domestic economy are set against a backdrop of familiar constraining factors. These include the forecast reduction in the fiscal deficit, which will continue to lean against demand, an elevated exchange rate that will remain a near-term headwind for growth in the export sector, and a steady, but uneven, outlook for global economic growth.

The main influences on the outlook for the economy are broadly similar to those in the *Budget Update*. However, higher-than-expected net migration inflows over the year to date contribute to stronger near-term demand growth, and add to the supply potential of the economy further out.

Domestic demand pressures building in the near term...

The Canterbury rebuild is expected to provide significant impetus to demand over the forecast horizon and beyond, chiefly through additional residential and business investment, but also through related consumption spending on consumer durables.

The merchandise terms of trade are forecast to remain elevated and close to historic highs across most of the forecast period, supported by rising demand for New Zealand's commodity exports. This is a key driver of income growth and nominal GDP growth.

An additional inflow of approximately 26,000 net migrants compared to the *Budget Update* will boost the productive capacity of the economy over time, but will add to demand pressures in the near term – particularly in the housing market in Auckland.

Households are assumed to be broadly comfortable with the amount of debt reduction undertaken over recent years (as a share of income). That said, households are expected to remain cautious in their spending decisions, with increases in consumption coming from rises in income, rather than from running down assets or increasing debt.

...against a backdrop of familiar offsetting factors

Ongoing steps to reduce the fiscal deficit will remain a constraining factor on demand over the coming years, but will free up resources enabling additional activity elsewhere, such as the Canterbury rebuild. The reduction in the deficit will also allow interest rates and the exchange rate to remain lower than they would otherwise be.

The elevated New Zealand dollar will constrain activity in exchange rate-sensitive parts of the economy over the coming years, including the non-commodity and service export sectors, but will also support investment and consumption by making imported goods cheaper. The assumed decline in the exchange rate is expected to begin to stimulate activity in the external sector towards the end of the forecast period.

The near-term outlook for trading partner growth is slightly weaker than forecast in the *Budget Update*, primarily owing to slower growth in the Australian economy as mining investment moderates. Although the medium-term outlook for this growth is relatively benign, there are risks arising from the diverging trends in the global economy.

Interest rates expected to begin to rise next year

With the economy set for a period of above-potential growth, increasing price pressures are expected to see the Reserve Bank begin to increase the Official Cash Rate (OCR) in the first half of 2014. The forecast track for short-term interest rates in the *Half Year Update* is broadly similar to that in the *Budget Update*, but is around 30 basis points lower than it would have been in the first half of the forecast period if loan-to-value (LVR) lending restrictions had not been implemented.

Having been the subject of a range of revisions since the *Budget Update*, the annual current account deficit is expected to narrow further in the near term, before widening to 6.4% of GDP in the March 2018 quarter.

Table 1.1 – Economic forecasts[1]

(Annual average % change, March years)	2013 Actual	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast
Private consumption	2.3	3.7	2.8	2.8	1.9	1.6
Public consumption	0.4	0.1	0.4	0.7	0.6	0.7
Total consumption	**1.9**	**2.9**	**2.3**	**2.4**	**1.6**	**1.4**
Residential investment	19.1	16.7	25.5	16.4	3.7	0.6
Market investment	6.2	11.7	8.1	3.1	0.7	1.0
Non-market investment	-12.2	15.2	-3.7	2.4	2.4	2.4
Total investment	**7.1**	**14.6**	**12.1**	**6.2**	**1.7**	**1.1**
Stock change[2]	-0.4	0.2	-0.2	-0.1	0.0	0.1
Gross national expenditure	**2.3**	**5.7**	**4.4**	**3.3**	**1.6**	**1.3**
Exports	3.0	-2.2	2.4	1.9	2.9	3.0
Imports	0.7	7.3	5.1	4.3	2.1	0.8
GDP (expenditure measure)	**2.9**	**2.4**	**3.4**	**2.5**	**2.0**	**2.2**
GDP (production measure)	**2.7**	**2.7**	**3.6**	**2.7**	**2.0**	**2.2**
Real GDP per capita	2.0	1.6	2.2	1.6	1.0	1.2
Nominal GDP (expenditure measure)	2.4	6.5	4.9	5.2	4.0	3.7
GDP deflator	-0.5	3.9	1.5	2.6	2.0	1.5
Output gap (% deviation, March quarter)[3]	-0.9	-0.2	0.9	0.5	0.0	0.0
Employment	0.3	2.0	2.6	1.4	1.0	1.3
Unemployment rate[4]	6.2	5.8	5.6	5.4	5.2	4.7
Participation rate[5]	67.9	68.5	68.9	68.7	68.5	68.5
Nominal wages[6]	2.1	2.7	3.1	3.2	3.4	3.4
CPI inflation[7]	0.9	1.4	2.4	2.4	2.3	2.2
Terms of trade[8]	-6.1	10.6	-0.9	1.6	0.3	0.0
Current account balance						
$billion	-9.5	-9.5	-13.0	-15.7	-16.7	-17.2
% of GDP	-4.5	-4.2	-5.5	-6.3	-6.5	-6.4
Net international investment position						
% of GDP	-71.8	-70.6	-72.8	-75.5	-79.0	-82.6
TWI[9]	75.9	77.0	75.3	73.9	70.0	65.3
90-day bank bill rate[9]	2.7	2.7	3.6	4.4	4.9	5.2
10-year bond rate[9]	3.7	4.8	4.9	5.1	5.2	5.2

Notes: 1 Forecasts finalised 11 November 2013.
2 Contribution to GDP growth.
3 Estimated as the percentage difference between actual real GDP and potential real GDP.
4 Percent of the labour force, March quarter, seasonally adjusted.
5 Percent of the working-age population, March quarter, seasonally adjusted.
6 Quarterly Employment Survey, average ordinary-time hourly earnings, annual percentage change.
7 Annual percentage change.
8 System of National Accounts (SNA) and merchandise basis, annual average percentage change.
9 Average for the March quarter.

Longer time series for these variables are provided on page 129.

Economic Outlook

Economy set for period of above-potential growth in the near term...

The near-term outlook for the New Zealand economy is robust, with an increasingly embedded and broad-based pick-up in activity anticipated following a drought-affected first half of 2013. The Canterbury rebuild is showing signs of gaining momentum, the labour market is strengthening and monetary conditions remain stimulatory. Strong external demand for New Zealand's commodity exports, particularly dairy, has underpinned a rebound in the terms of trade to near-record highs and domestic demand has received further support from a marked turnaround in net migration inflows since the start of the year.

Overall, real GDP growth is forecast to accelerate above its potential rate in the coming years, peaking at 3.6% in the March 2015 year. This will result in an increase in price pressures and will necessitate withdrawal of monetary policy stimulus in the first half of 2014. There is likely to be some variation in growth and activity at a regional level.

...followed by a moderation in the later years

Real GDP growth is expected to moderate to a more sustainable pace later in the forecast period, in line with the Treasury's estimate that potential growth will average around 2.4% over the forecast period. This reflects the Treasury's assessment of growth in the labour force and productivity in the longer run.[1]

The assumed depreciation in the New Zealand dollar is forecast to begin to stimulate activity in the exchange rate-sensitive parts of the economy, such as the services and non-commodity export sectors, towards the end of the forecast period.

Outlook reflects net impact of large influencing factors

The growth outlook for the New Zealand economy reflects the net influence of a number of large supportive and constraining forces.

Many of the supportive factors that are expected to influence domestic activity over the forecast period do so in a similar manner, and to a similar extent, as forecast at the *Budget Update*. These include the impetus from the Canterbury rebuild, stimulatory monetary policy settings and a strengthening labour market.

Overall, however, the net impact of the supportive influences on demand in the near term is slightly stronger than forecast at the *Budget Update,* including a larger-than-expected turnaround in net migration flows reflecting the recent weaker performance of the Australian economy. We judge the balance of risks to the central forecast to be balanced, but explore alternative economic scenarios in the Risks and Scenarios chapter.

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[1] See the note, *Potential Output in the 2012 Half Year Update*, published as part of the *2012 Half Year Economic and Fiscal Update*, for background information (available on the Treasury website).

Canterbury rebuild remains a key influence across the forecast period...

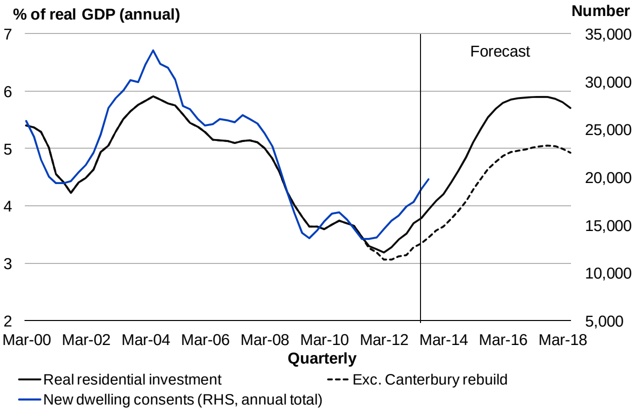
The Canterbury rebuild is expected to provide significant impetus to demand over the forecast horizon and beyond, chiefly through additional residential and business investment, supported by higher private consumption, particularly of consumer durables.

Estimating the level of investment activity associated with the Canterbury rebuild is inherently difficult and subject to much uncertainty. The Treasury's estimate of the total level of investment that relates to the Canterbury rebuild is similar to that in the *Budget Update* at around $40 billion. Approximately half of this total investment is forecast to have taken place by the end of the forecast period in mid-2018.

...underpinning strong growth in residential investment...

After a soft patch in the middle of the year, a surge in building consents in the Canterbury region in the September quarter suggests that residential rebuild activity is about to increase significantly. Annual real residential investment growth is forecast to accelerate to a peak of around 26% in the March 2015 year. This peak in growth occurs slightly later and at a lower level than forecast in the *Budget Update*, but the broad picture is similar in level terms. Over two-thirds of the residential rebuild is expected to be completed by the end of the forecast period in 2018.

Figure 1.2 – Real residential investment[2]



Sources: Statistics New Zealand, the Treasury

While the Canterbury rebuild is expected to provide a large proportion of the impetus for the surge in residential investment over the forecast period, activity in other parts of the country is also expected to rise significantly, particularly in the Auckland region. The drivers of the underlying growth include a catch-up for past population growth, expected future population increases (including through migration), rising household income, and low, albeit rising, interest rates. Figure 1.2 shows the share of real residential investment with and without the Canterbury rebuild. Including rebuild-related activity, residential investment is forecast to peak at around 6% of real GDP – in line with the share reached in the early-2000s.

Rapidly rising house prices, particularly in the Auckland region, are expected to encourage an increase in new home building, although this will take time. The implementation of LVR lending restrictions by the Reserve Bank makes it less certain how the supply and demand dynamics in the housing market will play out. Higher-than-expected net migration inflows mean that annual house price inflation is forecast to be stronger in the near term than in the *Budget Update*. However, the impact from migration is offset to some extent by the LVR lending restrictions, which are expected to impose a modest dampening effect on house price inflation in the near term. Annual house price inflation is forecast to peak at around 10% in the December 2013 quarter, before moderating to 2.4% towards the end of the forecast period.

2 Note that the "Excluding Canterbury rebuild" line is only illustrative and should not be interpreted as an alternative forecast of what would have occurred in the absence of the Canterbury earthquakes.

The forecast track for short-term interest rates in the *Half Year Update* is broadly similar to that in the *Budget Update*, but is around 30 basis points lower in the first half of the forecast period than it would have been if LVR restrictions had not been implemented (consistent with the Reserve Bank's estimates).

...as well as market investment

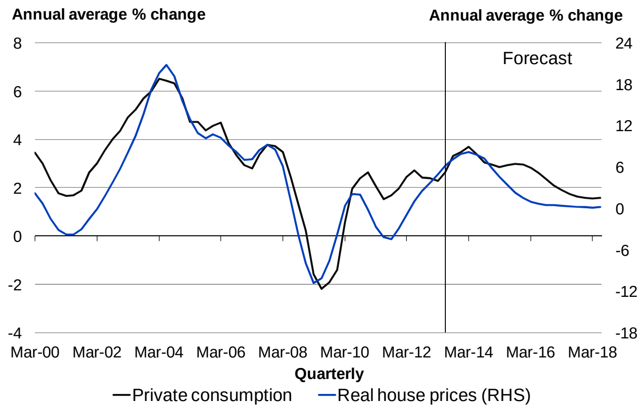
The current environment of low interest rates, strong business confidence and an elevated exchange rate (which makes imported capital goods cheaper) is also expected to drive a sharp increase in market investment in the near term. The Canterbury rebuild is expected to contribute to an increase in market investment as well. Later in the forecast period, higher interest rates and a lower exchange rate are expected to see market investment growth moderate.

Robust outlook for private consumption...

The large increase in residential investment over the forecast period is also expected to provide significant impetus to private consumption in the form of related and additional spending on consumer durables. Private consumption growth is expected to accelerate to 3.7% in the March 2014 year – its fastest pace since the end of 2007 – as consumer confidence remains elevated and real incomes are boosted by the current subdued inflation environment.

The pace of private consumption growth is expected to slow later in the forecast period as real income and house price growth slow, and interest rates rise (Figure 1.3).

Figure 1.3 – Private consumption and house prices



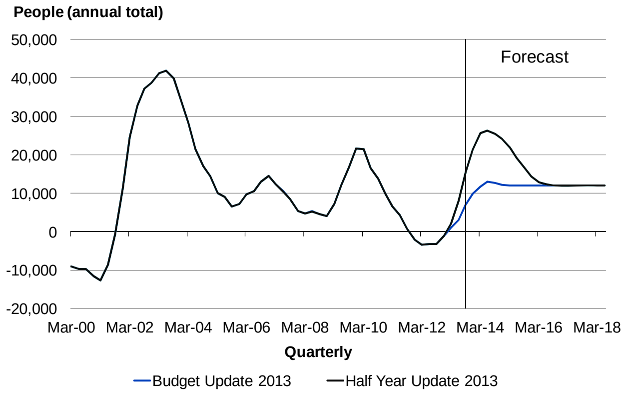
Sources: Statistics New Zealand, QV, the Treasury

Migration and Regional Activity

One of the main differences between the *Half Year Update* and the *Budget Update* forecasts is the more pronounced turnaround in net permanent and long-term migration flows. After registering a net outflow of migrants throughout 2012, the annual net flow of migrants moved into positive territory in January 2013, and has since climbed to a three-year high of 17,500 in the year ended October 2013.

Net migration flows often exhibit large cycles as arrivals and departures move in different directions at the same time. In a reflection of the recent divergence in performance between the New Zealand and Australian economies, fewer migrant departures, mostly to Australia, account for around two-thirds of the turnaround in net migration flows since the start of 2013. Moreover, just over half of the increase in arrivals since the start of the year was accounted for by arrivals from Australia, two-thirds of whom were returning New Zealanders. All told, the *Half Year Update* incorporates an additional net inflow of around 26,000 migrants over the forecast period compared with the *Budget Update*, mainly in the next two years (Figure 1.4).

Figure 1.4 – Net migration



Sources: Statistics New Zealand, the Treasury

Additional migrants will add to the economy's supply potential over time...

Additional people in New Zealand will flow through to an increase in the labour force, and add to the underlying productive capacity of the economy. An additional inflow of migrants may also help to relieve regional pressures and bottlenecks in the labour market – particularly arising out of the ongoing Canterbury rebuild.

...but will add to demand pressures in the near term

However, it will take time for the full supply impetus to be felt and, in the meantime, higher net migration inflows will exacerbate near-term demand pressures. With the economy already operating close to capacity, any additional demand impetus will complicate the task for the Reserve Bank of setting monetary policy in the near term.

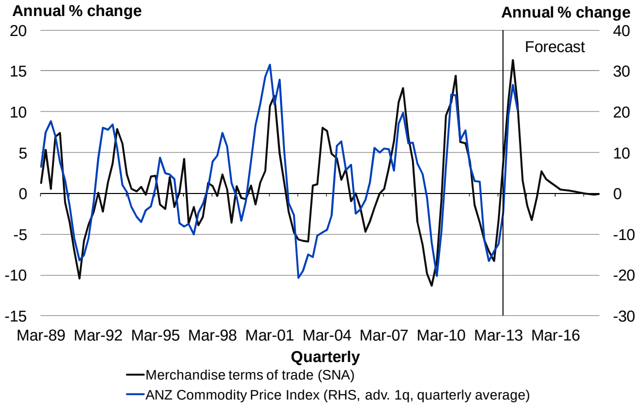
Moreover, the concentrated nature of the demand associated with higher net migration will also contribute to sustained upward pressure on house prices, particularly in the Auckland region. While aggregate annual house price growth in the *Half Year Update* is forecast to peak at a slower pace than in the previous housing cycle in the early-to-mid-2000s, the aggregate picture masks significant variation at a regional level.

Overall, to the extent that stronger near-term demand pressures elicit a more aggressive tightening of monetary policy, the wider risk is of a more pronounced economic cycle than in the central forecast. The Risks and Scenarios chapter contains an alternative scenario in which the net migration inflow is greater than in the *Half Year Update's* main forecast.

...supported by the historically-high terms of trade...

The positive outlook for the terms of trade is another strongly supportive factor in the *Half Year Update* forecasts. This will continue to underpin incomes and nominal GDP over the forecast period. The near-term rebound in the merchandise terms of trade reflects sustained high dairy prices as well as support from forestry and meat during the middle of the year. In keeping with commodity price indicators, the merchandise terms of trade are expected to be around 15% higher in the December 2013 quarter than in the same period a year ago (Figure 1.5). Dairy prices are expected to fall back as global supply increases. The timing is uncertain and global supply remains constrained, but the *Half Year Update* forecasts assume a drop in dairy prices, and a corresponding modest correction in the terms of trade, during the first half of 2014.

Figure 1.5 – Merchandise terms of trade (SNA) and ANZ commodity price index



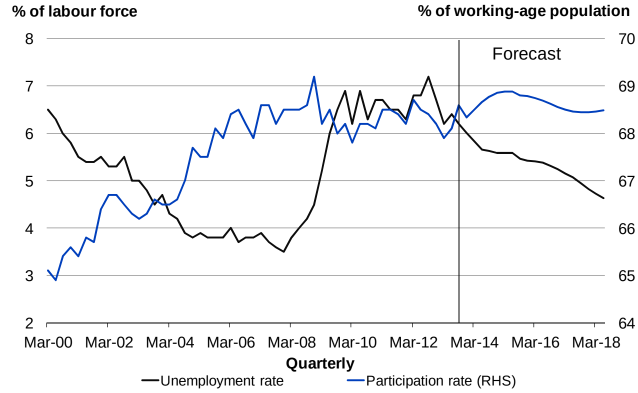
Sources: Statistics New Zealand, ANZ, the Treasury

Overall, though, the terms of trade are expected to remain near record highs over the medium term, at a similar level seen in the *Budget Update*, supported by structural factors including rising demand for New Zealand's commodity exports, particularly from China.

...and a strengthening labour market

Having shown signs of improvement over the past year, the labour market is expected to strengthen further over the forecast period, with the unemployment rate falling gradually and employment continuing to increase. The Canterbury rebuild will be a large contributor to the strengthening in the near term, along with rising activity in the Auckland region. (See the Migration and Regional Activity box.) Nominal wage growth is expected to be solid throughout the forecast period, with annual growth remaining broadly in the range of 2.5% to 3.5%. This is consistent with moderate real wage growth of around 1% per year on average over the forecast period.

Figure 1.6 – Unemployment rate and participation rate



Sources: Statistics New Zealand, the Treasury

The labour force participation rate is expected to increase over the coming years as stronger employment conditions encourage more workers to enter the labour force. Ongoing welfare reform is expected to strengthen job-search incentives and have an additional positive influence on labour force participation. The participation rate is expected to moderate slightly towards the end of the forecast period reflecting the effect of an ageing population.

However, consumers expected to remain cautious...

As outlined in the *Budget Update*, developments in household net worth, partly driven by house price movements and reduced uncertainty about future growth, underpin our assumption that households are broadly comfortable with the amount of debt reduction undertaken over recent years (as a share of income). That said, households are expected to remain cautious in their spending decisions in the coming years, with increases in consumption coming from rises in income, rather than from running down assets or increasing debt further.

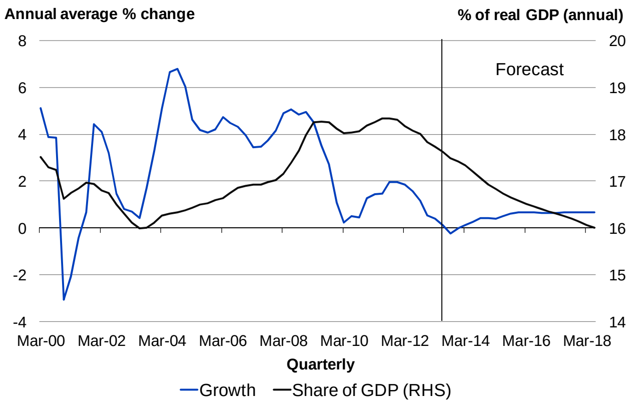
All told, household saving as a percentage of household disposable income is expected to remain broadly flat over the forecast period, as it has been for the past few years.[3] This represents a shift in behaviour from the mid-2000s and its continuation will be an important factor influencing demand in the economy.

...and there is a backdrop of familiar constraining factors, including fiscal restraint...

The supportive influences on the domestic economy are set against a familiar backdrop of factors that will constrain growth, including continued steps to reduce the fiscal deficit, an elevated exchange rate and a steady, but uneven, outlook for global economic growth.

Ongoing steps to reduce the fiscal deficit will remain a constraining factor on demand over the coming years. The combined impact of fiscal decisions in the 2013 and previous Budgets will see real government consumption rise only modestly over the forecast period, averaging growth of just 0.5% per year compared to around 4% over much of the 2000s (Figure 1.7). As a proportion of real GDP, government consumption declines over the period towards the past decade's low of 16.0%. A lower share of government spending in the economy will free up resources enabling additional activity elsewhere, such as the Canterbury rebuild. In doing so it also allows interest rates and the exchange rate to remain lower than they would otherwise be.

Figure 1.7 – Real government consumption



Sources: Statistics New Zealand, the Treasury

...an elevated exchange rate...

An elevated exchange rate will also continue to present a near-term headwind to growth in parts of the external sector, particularly for non-commodity exporters and import-competing firms. Having weakened during the middle of the year on the back of market expectations of a "tapering" of quantitative easing in the US, the trade-weighted index (TWI) climbed back close to its record highs in the September quarter. The New Zealand dollar has gained particularly strongly against its Australian counterpart, with the cross rate currently near a five-year high.

3 Note that the historical time-series of the net household saving rate was revised higher in the annual National Accounts for the year ended March 2013, which were released after the finalisation of the *Half Year Update* forecasts. See Revisions in the 2013 Annual National Accounts box for further details.

An elevated exchange rate makes New Zealand a more expensive destination for tourists and foreign students, and is expected to constrain growth of services and non-commodity goods exports in the near term. Given that many of New Zealand's commodity exports are priced in US dollars, an elevated exchange rate also dampens New Zealand dollar export receipts from commodity exports, but spreads income gains to the broader economy.

Over the longer term, goods and services export volumes are expected to grow more strongly, driven in large part by an assumed depreciation in the New Zealand dollar. Both goods and services volumes are also expected to rise as global demand picks up, generating additional demand for New Zealand's goods and services. A weaker New Zealand dollar will boost New Zealand dollar receipts for commodity exports too, but will also increase import prices. As mentioned before, demand for dairy and other commodity exports is likely to continue to benefit from links with fast-growing Asian markets over the long term.

...and steady, but uneven, global growth

The near-term outlook for trading partner growth is slightly weaker than forecast in the *Budget Update*, primarily owing to slower growth in the Australian economy as mining investment moderates, and a weaker outlook for emerging economies including China. The outlook over the rest of the forecast period is broadly similar to that in the *Budget Update,* with growth of around 3.8% per year.

Table 1.2 – Trading partner growth (calendar years)

	2013 weights	2012 Actual	2013 Forecast	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast
Australia	*27%*	3.7	2.5	2.6	3.0	3.0	3.0	3.0
China	*17%*	7.8	7.6	7.4	7.3	7.1	7.0	7.0
United States	*11%*	2.8	1.7	2.6	2.5	2.5	2.5	2.5
Japan	*9%*	2.0	1.9	1.5	1.1	1.0	1.0	1.0
Euro area	*8%*	-0.6	-0.5	0.8	1.2	1.3	1.4	1.5
United Kingdom	*4%*	0.1	1.3	1.9	1.8	2.0	2.0	2.0
Canada	*2%*	1.7	1.6	2.2	2.4	2.5	2.5	2.5
Other Asia*	*23%*	3.8	3.8	4.4	4.8	4.9	4.9	4.9
Trading Partner Growth (TPG)	***100%***	**3.6**	**3.2**	**3.6**	**3.8**	**3.8**	**3.8**	**3.9**
TPG - Consensus (November 2013)		3.6	3.3	3.7	3.9	4.0	3.9	3.9
TPG - IMF WEO (October 2013)		3.6	3.2	3.7	3.8	3.9	4.0	4.0
TPG - The Treasury (2013 Budget Update)		3.5	3.4	3.8	3.8	3.8	3.9	-

* South Korea, Taiwan, Hong Kong, Singapore, Malaysia, Indonesia, Thailand, Philippines, India

Sources: IMF, Haver Analytics, Consensus Economics, the Treasury

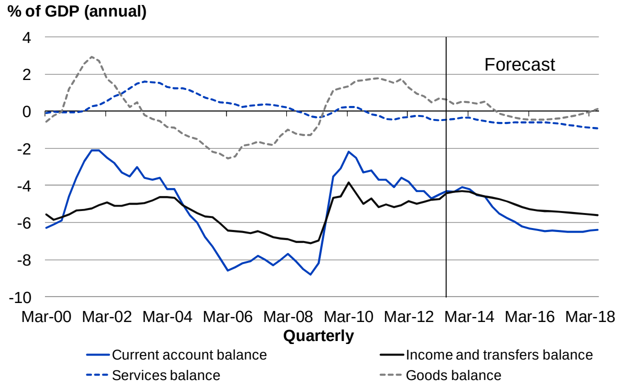
The factors behind the weaker near-term trading partner growth – particularly the gradual rebalancing of Australian GDP growth away from investment towards consumption, residential investment and exports – are unlikely to result in significant direct negative implications for New Zealand exporters. Ongoing income growth and increased demand for protein in Asian economies, particularly China, are also expected to underpin strong demand for New Zealand's commodity exports over the medium term.

However, the global economy continues to face significant challenges, and diverging trends pose risks to the relatively benign medium-term outlook for trading partner growth. The major developed economies are showing signs of more sustainable growth – particularly the US, Japan and the UK – while growth in emerging market economies (including some of New Zealand's trading partners in Asia) is slowing as a result of both structural and cyclical factors. As the developed economies begin to withdraw monetary stimulus, emerging market economies that have benefited from the loose global monetary conditions may come under pressure as capital inflows are reversed. Meanwhile, a combination of rapid credit growth and inflated property values poses risks to financial stability in China. The risks to the global outlook are explored in more detail in the Risks and Scenarios chapter.

Forecast widening in current account deficit reflects composition of growth

The current account has been subject to a range of historical revisions since the *Budget Update*, most recently in the annual set of National Accounts for the year ended March 2013, which were released after the *Half Year Update* forecasts were finalised. Estimates of the current account deficit from 2000 onwards are now on average 1.1% of GDP narrower than previously recorded. (See Revisions in the 2013 Annual National Accounts box for further details.)

Figure 1.8 – Current account balance



Sources: Statistics New Zealand, the Treasury

The annual current account deficit is expected to narrow further in the near term on the back of a narrower income deficit and a wider goods surplus than in the *Budget Update*. The wider goods surplus is mainly attributable to the dairy sector, in which prices have remained higher than expected, and also production has recovered more quickly than expected from last summer's drought.

The annual current account deficit is forecast to widen from 2014 onwards to 6.4% of GDP in the March 2018 quarter. This is expected to be driven by a widening in the income balance as business profits and international interest rates pick up.

The goods balance is expected to register a small deficit in 2015, primarily owing to increased goods imports associated with the expected pick-up in investment. The balance is expected to recover in the final years of the forecast period as investment growth slows and the assumed weakening in the exchange rate makes New Zealand's non-commodity exports more attractive overseas.

The services deficit is forecast to widen towards the end of the forecast period as the assumed fall in the exchange rate feeds through into increased services import prices (an example of the so-called "J-curve" effect). However, over time, a weaker exchange rate will make New Zealand a more attractive destination for tourists and also make service imports less attractive. As a result, the services deficit would be expected to narrow outside the forecast period, contributing to a narrower current account deficit.

Revisions in the 2013 Annual National Accounts

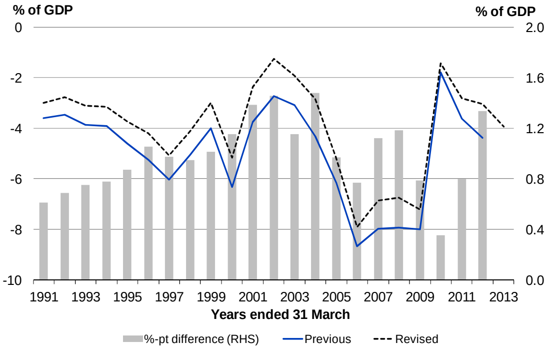
The annual National Accounts for the year ended March 2013 were released after the *Half Year Update* forecasts were prepared and finalised. The National Accounts provide information on national income, consumption, investment and saving by the different sectors of the economy. Overall, the level of nominal (expenditure) GDP in the March 2013 year was around $600 million higher than previously indicated by the quarterly GDP releases. This mainly reflected upward revisions to investment, with revised estimates for Canterbury making a significant contribution on the residential side.

As previously signalled by Statistics New Zealand, the release incorporated a range of historical revisions to the current account as well, stemming mainly from updated estimates of spending by foreign visitors in New Zealand. Exports of services are now 1.2% of GDP higher on average from 2000 onwards than previously estimated. This increase was partly offset by higher goods imports, which were revised up by 0.3% of GDP on average from 2004 onwards on account of a new estimate for goods imports valued under $1,000 – a known area of undercoverage. Accordingly, the current account deficit is now on average 1.1% of GDP narrower than was reported in the 2012 National Accounts (Figure 1.9). The largest positive impacts were in 2002 and 2004, when the current account deficit is now 1.5 percentage points of GDP narrower than was previously estimated. The peak current account deficit reached in 2006 was revised narrower too, to 7.9% of GDP compared to 8.7% of GDP previously. When incorporated into the quarterly data, these changes are likely to lead to a narrower current account deficit than that presented in the *Half Year Update*.

Higher estimates of spending by foreign visitors in New Zealand reduced the amount of activity that was previously attributed to private consumption. This flowed through to a level shift in the household saving rate, which is now between 0.5 and 2.5 percentage points of disposable income higher across history than was previously estimated, and increased national saving too. As shown in Figure 1.10, the narrower current account almost entirely reflects higher national saving across history.

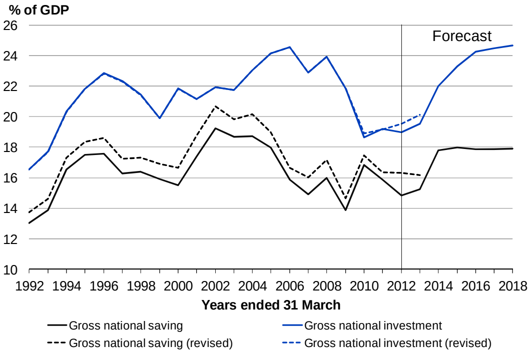
The widening current account deficit in the *Half Year Update* forecasts reflects investment increasing by more than saving over the forecast period, partly as a result of the Canterbury rebuild. However, with a large proportion of the Canterbury rebuild to be paid for by overseas insurance inflows, the investment-saving gap does not flow through fully into new borrowing. Statistics New Zealand currently estimates a total of $18.7 billion of reinsurance claims from all of the Canterbury earthquakes. At the end of the June 2013 quarter, a total of $10.5 billion of these claims had been settled with overseas reinsurers, with these inflows recorded in the financial account of the balance of payments.

Figure 1.9 – Revised current account balance



Sources: Statistics New Zealand, the Treasury

Figure 1.10 – Saving and investment

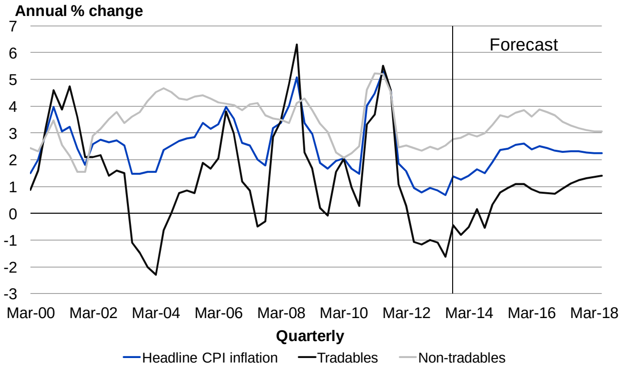


Sources: Statistics New Zealand, the Treasury

Inflation expected to pick up as spare capacity is used up...

With the economy set for a period of above-potential growth in the near term, non-tradables inflation is forecast to accelerate to a peak of around 4% in mid-2016, before easing back as real GDP growth moderates towards the end of the forecast period. Tradables inflation is expected to move back into positive territory over the coming years and to come under increased upward pressure from the assumed decline in the exchange rate. Overall, headline CPI inflation is forecast to peak at 2.6% in late-2015 and to decline gradually thereafter, albeit remaining slightly above the 2.0% mid-point of the target range. Increases in tobacco excises are expected to add 0.2 percentage points to annual inflation in each of the March 2014, 2015 and 2016 quarters.

Figure 1.11 – Inflation



Sources: Statistics New Zealand, the Treasury

...leading to a withdrawal of monetary stimulus next year

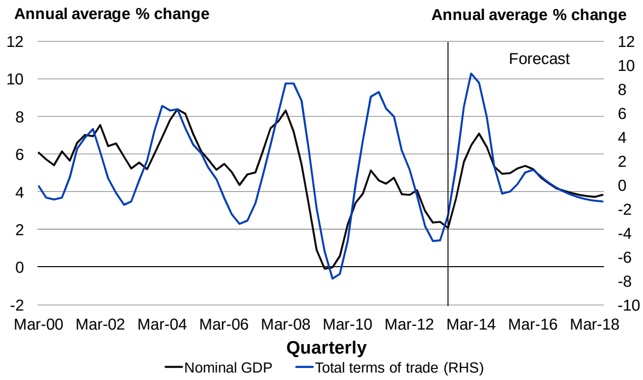
Increasing price pressures are expected to see the Reserve Bank begin to increase the OCR in early 2014. As mentioned earlier, the forecast track for short-term interest rates in the *Half Year Update* is broadly similar to that in the *Budget Update*, but is around 30 basis points lower than it would have been if LVR restrictions had not been implemented.

Nominal GDP growth expected to remain strong

Nominal GDP is particularly important for generating forecasts of tax revenue. The main components of nominal income GDP, namely compensation of employees and business operating surplus, are inputs for generating forecasts of PAYE and corporate tax revenues respectively.

Underlying growth in the volume of output, alongside strong gains in the terms of trade and a pick-up in pricing pressures, are expected to support nominal GDP growth in the near term. Nominal GDP is forecast to grow by 6.5% and 4.9% in the March 2014 and 2015 years respectively. Growth in nominal GDP is expected to ease somewhat later in the forecast period, as real GDP growth moderates, the terms of trade level off and pricing pressures are restrained by higher interest rates.

Figure 1.12 – Nominal GDP and terms of trade



Sources: Statistics New Zealand, the Treasury

Economic Forecast Assumptions

- Net permanent and long-term migration inflows rose to 17,500 in the year ended October 2013, although only data up to the September month (+15,200) were available when the *Half Year Update* forecasts were finalised. Net migrant inflows are forecast to rise to 26,300 in the June 2014 year before returning to the long-run assumption of 12,000 per year by the second half of 2016.
- The non-accelerating inflation rate of unemployment (NAIRU) is assumed to be around 4.5% by 2018.
- Average hours worked per week are assumed to be around 33 (near their current level).
- Economy-wide labour productivity growth is assumed to average around 1.1% per year between the years ending March 2014 and March 2018.
- Investment associated with the rebuild from the Canterbury earthquakes is assumed to be around $40 billion in 2011 prices (rounded to the nearest $5 billion), spread across residential property ($18 billion), commercial ($9 billion), and infrastructure and social assets ($11 billion). Around $18 billion of the total is forecast to be undertaken within the forecast period to June 2018.
- WTI oil prices are assumed to fall from around US$106 per barrel in the September 2013 quarter to around US$82 in the March 2018 quarter, in line with the latest oil futures prices.
- Ninety-day interest rates are assumed to increase from the first half of 2014 to 5.2% in the March 2018 quarter. Ten-year interest rates are also assumed to rise gradually from their current levels, reaching 5.2% by the March 2018 quarter.
- The TWI is assumed to remain around 75 until mid-2015 before falling to around 64 in the June 2018 quarter.
- Tobacco excise increases add 0.2 percentage points to annual inflation in each of the March quarters 2014, 2015 and 2016.
- The reductions to ACC levy rates will reduce contributions by households and employers by $387 million in the 2014/15 levy year rising to around $1 billion in the following levy year.