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Economic Outlook

Key Features

- **In the year to December 1996 the economy grew by 2.7%, as expected in the *December Economic and Fiscal Update*. The non-tradeables sector enjoyed stronger growth than the tradeables sector.**
- **Growth in the second half of the year was boosted by dairy exports. The July tax reductions and stronger activity in residential construction were also supporting growth.**
- **Weak employment growth, the delay to the second round of tax reductions and the tight monetary conditions of 1996 dampened confidence and activity in early 1997.**
- **An upturn in growth is anticipated towards the end of 1997 with past falls in interest rates boosting spending. With confidence improving, a cycle of increased demand and production will be set in motion. On average, growth in 1997/98 is forecast to be 2.4%.**
- **Momentum is expected to increase further in 1998/99 as a number of factors stimulate growth. These include increased government spending, tax reductions, the lagged effects of earlier monetary easing and strong world growth. Growth increases to 4.2%.**
- **Slower growth will reduce inflationary pressures in the short term, but monetary conditions will need to tighten from early 1998.**
- **In the medium term growth returns to around its sustainable rate of 3% to 3½%.**
- **There are a number of uncertainties surrounding the central forecasts. The outlook could vary if confidence and spending remain subdued for longer in 1997, or if inflation pressures remain stronger than expected.**

Table 1.1 - ECONOMIC OUTLOOK[1]

(Annual average % change, March years)	1995/96 Actual	1996/97 Estimate	1997/98 Forecast	1998/99 Projection	1999/2000 Projection
Private consumption	4.0	3.1	1.9	4.5	3.5
Public consumption	2.0	1.4	8.7	2.6	-2.1
Total Consumption	**3.6**	**2.8**	**3.2**	**4.1**	**2.4**
Private investment	8.5	1.5	2.9	10.2	7.4
Public investment	4.9	13.9	3.0	4.5	3.6
Total Investment	**8.0**	**3.2**	**2.9**	**9.4**	**6.9**
Stocks[2]	-0.3	-0.5	0.1	0.1	0.1
Gross national expenditure	4.2	2.3	3.2	5.3	3.4
Exports	1.7	4.9	2.8	5.8	5.3
Imports	6.8	6.0	5.2	8.9	4.9
GDP (prod measure)[3]	**3.1**	**2.5**	**2.4**	**4.2**	**3.5**
(March qtr to March qtr)	***2.8***	***2.2***	***3.1***	***4.4***	***2.8***
Current account balance[4]	-3326	-4187	-4896	-5655	-5066
% of GDP	-3.7	-4.5	-5.0	-5.5	-4.6
Employment[5]	4.5	2.1	0.2	2.0	2.0
Unemployment[6]	6.2	6.4	6.8	6.2	5.7
TWI	62.2	66.5	68.0	68.8	69.5
Interest rates					
90-day bill rate (%)[7]	8.8	9.0	7.6	8.6	7.4
10-year bond rate (%)[7]	7.5	7.9	7.4	7.4	7.5
CPI Inflation (%)[8]	2.2	1.8	0.8	1.2	0.9
Underlying Inflation (%)[8]	2.1	2.0	1.0	1.3	1.6

Notes:
1. Projections finalised 21 May 1997.
2. Contribution to GDP growth.
3. Owing to statistical divergences between expenditure and production measures of GDP, the components of expenditure GDP do not necessarily sum to production GDP.
4. $ million.
5. HLFS full-time equivalents, annual average percent change.
6. Official HLFS unemployment rate for March quarter.
7. Annual average for the year to March.
8. Annual percent change, at March quarter.

Sources: Statistics New Zealand
The Treasury

Assumptions underlying the central forecast

No change in announced government policy. The effects of the possible introduction of a compulsory retirement savings scheme are therefore not included.

The forecasts assume a constant real exchange rate. This means that the nominal exchange rate (TWI) is assumed to appreciate at an annual rate equal to the difference between domestic inflation and the trade-weighted inflation rate of New Zealand's five main trading partners.

The international outlook conforms with that presented in recent Consensus Forecasts.

Normal weather patterns will be experienced over the forecast period.

Comparisons with the *December Economic and Fiscal Update* forecasts

Growth over the whole forecast period is very similar to that forecast in the *December Economic and Fiscal Update*. It is more the profile and composition of growth that have changed with growth peaking in 1998/99, a year later than in the *December Update*, and government spending displacing some private spending.

Over the whole forecast period the price level is expected to rise by a similar amount to that projected in the *December Update*. However, while the *December Update* projected a continuing gradual decline in interest rates through to 2000, we now anticipate a rise in interest rates from early 1998 until the end of 1998.

Our changed views since the *December Update* are based on the new economic data that has come to hand as well as the new economic policy initiatives announced by the Coalition Government. In particular:

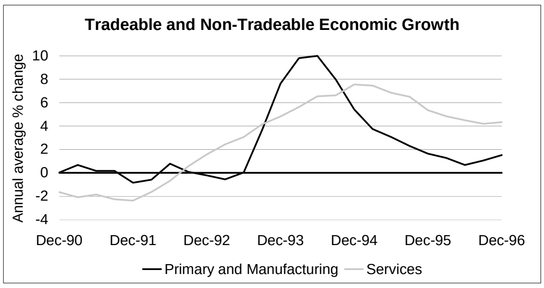
- deferral of the tax reductions originally scheduled for July 1997 to July 1998
- additional government spending and the abolition of the surcharge totalling up to $5 billion over the 1997/98 to 1999/2000 period
- the new Policy Targets Agreement specifying an inflation band target of 0% to 3%
- significantly weaker employment outturns in the six months to March 1997 than those forecast in the *December Update*
- higher savings by households than anticipated at the time of the *December Update*.

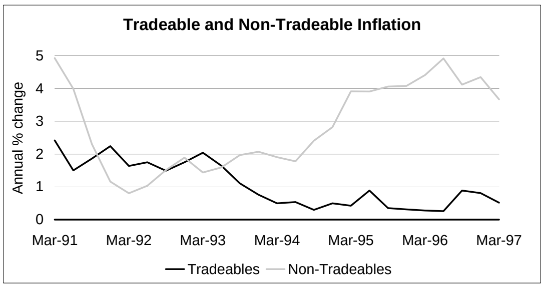
Central Forecast

During 1996 the economy grew steadily ...

The economy enjoyed steady economic growth last year, growing by 2.7% in the year to December 1996, in line with the December forecasts. Growth, however, was not evenly spread across economic sectors. The non-tradeables sector led growth, expanding by 4.3% in the year to December, while the tradeables sector posted growth of 1.5% over the same period. This divergence in performance between the sectors continued a pattern seen over the last couple of years and reflects the effects of a strong New Zealand dollar on the ability of firms in the tradeables sector to compete in both domestic and world markets.

Inflation trends of the last year have mirrored this tradeable/non-tradeable split with tradeables inflation of 0.8% in the year to December being well below the 4.3% recorded in the non-tradeables sector.





Sources: Statistics New Zealand

The rate of economic growth was faster in the second half of 1996 than in the first half. The growth rates of around ½ a percent per quarter seen in the four quarters to June 1996 were surpassed by quarterly growth rates of around ¾ of a percent in the latter part of the year. This pick-up in growth, however, looked somewhat at odds with weaker employment growth, muted business confidence levels and lower company tax receipts. Total employment in the six months to December grew by just 0.2% compared with 1.9% in the six months to June. Business confidence, after plunging in mid-1996 on account of political uncertainty, did recover but showed no spectacular upturn. Company taxes (including non-resident withholding taxes) fell by an estimated $250 million in the year to June 1997, reflecting lower company profits.

… but growth in the second half of the year was boosted by one-off factors ...

Looking more closely at the latest GDP data provides an explanation for this apparent discrepancy between reasonably strong growth but weaker results in other economic indicators. Although residential investment picked up towards the end of the year and the July tax reductions were helping to underpin activity, consumer spending slowed down in the second half of last year. This could have been owing to higher spending earlier in the year in anticipation of the pre-announced tax reductions, but also seems to reflect an increased preference on the part of households to save rather than spend additional disposable income. Household savings are estimated to have increased from $800 million in 1995/96 to $1,370 million in 1996/97.

With weaker domestic demand, it was the external sector that was helping to support the faster pace of growth seen in the second part of 1996. The tradeables sector grew by 1.9% in the last six months of the year, a much stronger pace than the 0.4% growth seen in the first half of the year. Manufacturing picked up in the second half of 1996, following a period of falling output earlier in the year, and growth in the tradeables sector was also boosted by strong dairy production, resulting from favourable weather conditions. Dairy exports were particularly strong on the back of increased production and the technical effect arising from abnormally low growth in dairy exports in 1995/96[1]..

While at first glance the economy appeared to be moving up a gear in terms of growth in the second half of 1996, the stronger quarterly growth rates look to have been partly supported by special circumstances, in particular weather suited to agricultural production, rather than any broadly-based upswing. This picture seems more consistent with trends in employment, business confidence and consumption.

It also suggests that for many firms trading conditions were more difficult than the GDP figures would imply. Companies in the tradeables sector were already feeling the strains imposed by a strong dollar at the start of 1996 but by the end of the year some service sector firms were also facing more testing times owing to slowing consumer spending. The service sector, previously a major driver of growth, showed some slowing in the final quarter of the year.

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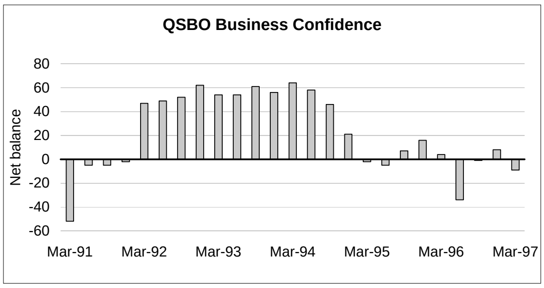
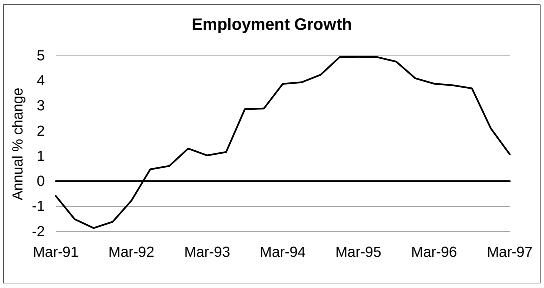
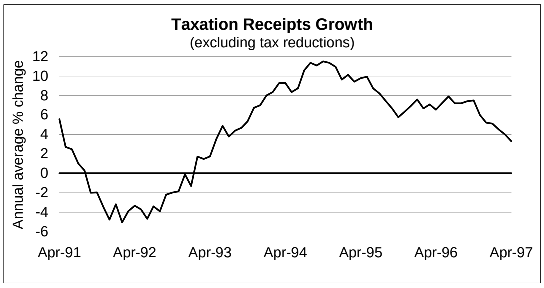
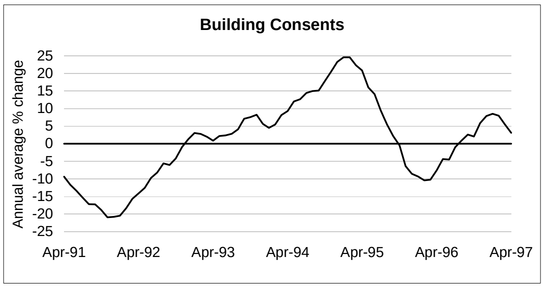
1 Despite a good production season, dairy exports in 1995/96 were weak as the Dairy Board rebuilt stocks. Dairy stocks were run down in 1994/95 as exports were maintained in the face of poor production owing to drought conditions.









Sources: NZIER
Statistics New Zealand
IRD

... and recent indicators point to slower activity in the first part of 1997.

At the start of 1997 the stage looked set for a pick-up in economic activity. Both business and consumer confidence might have been expected to respond positively to the completion of the government formation process while lower interest rates (which had been falling since October 1996) could have worked to boost household and business spending. An increase in growth, however, has failed to materialise.

Early 1997 has seen signs of weaker economic activity. For the March quarter retail sales, building consents, and house sales were all down on a year ago while business confidence turned negative. The March inflation outturns for both headline inflation (1.8% in the year to March) and underlying inflation (2.0% in the year to March) were also lower than market expectations and employment fell slightly in the March quarter.

The Easter Effect

Much of the monthly economic data for March 1997 showed significant falls on a year ago. This was followed by some bounce-back in the April data. For example:

- the number of new dwelling consents in March 1997 was down 17.7% on a year ago, but in April consents were down just 2% on a year earlier
- REINZ house sales were down an annual 18.3% in March 1997 but April saw a fall of just 3.5% on a year ago
- nominal retail sales fell by 4.8% in March 1997 on a year ago but in April posted 2.9% growth on a year ago
- credit card billings showed little annual change in March 1997 but were up an annual 17.5% in April.

This pattern can partly be explained by the fact that Easter fell in March this year but in April last year. Trading days (Monday to Friday) were therefore 9.5% fewer in March 1997 than in March 1996.

Data for the first quarter as a whole will have been affected not only by this Easter effect but also by the fact that 1996 was a leap year. Consequently February 1997 had 5% fewer trading days than February 1996.

Altogether there were 4.9% fewer trading days in the first quarter of 1997 compared with the corresponding period in 1996. On balance, we expect both the level of, and growth in, GDP in the March quarter to be brought down simply because of fewer trading days. Correspondingly, output growth in the June 1997 quarter, which will have 3.3% more trading days than the June 1996 quarter, should be lifted by the trading-day effect.

A number of reasons have been given publicly for dampened confidence and activity levels in early 1997. These include the fall-off in employment growth which has increased concerns over job security, the tight monetary conditions of 1996 and the deferral of the tax reductions originally scheduled for July 1997. Export growth is also expected to slow in 1997/98 largely owing to the following factors:

- Dairy product export growth, in volume terms, is expected to slow from rates approaching 30% in 1996/97 to more "normal" single-digit growth.

- A return to more normal growing seasons is expected to lead to a reduction in lamb and mutton exports which reached a peak in 1996/97.

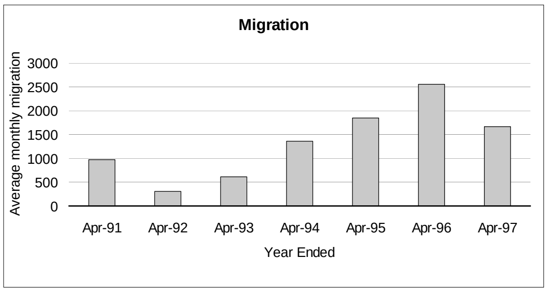
- Hail damage to pipfruit crops in 1997 will dampen horticultural exports.

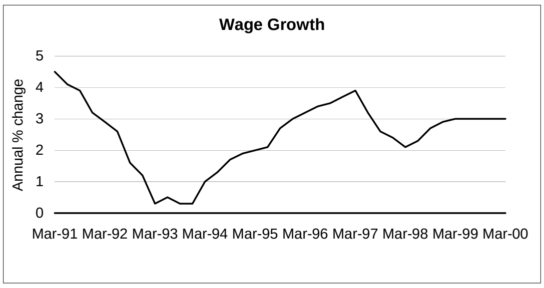
Weaker activity in the first part of 1997 inevitably pulls down growth for the year as a whole relative to the December forecasts. Overall GDP growth is projected to be 2.4% in the year to March 1998, little changed from the annual average growth of the previous year. Slower growth in early 1997 is expected to lead to firms cutting back on hiring staff and force some firms into making layoffs. As a consequence, employment barely grows during this year and the unemployment rate is forecast to rise to 6.8% in the March 1998 quarter.

Inflation will be muted in the near term ...

Underlying inflation is expected to fall steadily over the next year or so to be just under 1% by mid-1998. There are a number of factors working to keep short-term inflationary pressures at bay. These include:

- The housing market, a major source of inflationary pressures in 1995 and early 1996, is not expected to generate significant price pressures over the forecast period, partly owing to the fall-off in net migration numbers. Latest data highlight the downward trend in migration with net migration averaging about 900 per month in the three months to April, well down on the 3,300 per month seen in the 1995 peak period.





Sources: Statistics New Zealand

- Unit labour costs have also made a significant contribution to inflation over recent years given a poor productivity performance and rising wage inflation. Unit labour costs are however, expected to fall sharply until mid-1998 reflecting productivity gains before rising modestly over the remainder of the forecast period.

- Past rises in the exchange rate will continue to feed through into domestic prices both by reducing the cost of imported inputs and by increasing the competitive pressures on those firms competing with imports. Subdued domestic demand in the short-term could push firms into passing on these reduced costs to customers to a greater extent.

- In the short term, slower economic activity sees the emergence of some spare capacity in the economy, allowing growth to pick up above its potential growth rate without an immediate risk to inflation.

Growth is set to rebound towards the end of the 1997/98 year ...

However, towards the end of 1997 a rebound in growth is expected, kick-started by previous cuts in interest rates. Overall monetary conditions eased in the latter part of 1996 and eased further in April and May 1997 primarily owing to short-term interest rates falling by around three percentage points as compared with October 1996.

Both households and firms typically take some time before they react to lower interest rates. Towards the end of this year it is anticipated that activity, especially in areas such as the residential building industry, typically a sector sensitive to interest changes, will begin to pick up. In turn, this will drive increased spending on consumer durables, serving to add momentum to the economy more generally. Additional government spending (of $900 million) planned for this fiscal year will also be adding to overall demand. A cycle of increased demand, production and investment will be set in motion.

... and pick up strongly in 1998/99, on the back of household spending and government spending …

In 1998/99 momentum in the economy strengthens as a number of factors work together to boost growth:

- Increased government spending.

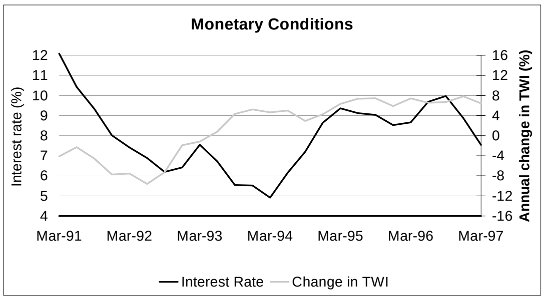
- Tax reductions scheduled for July 1998.

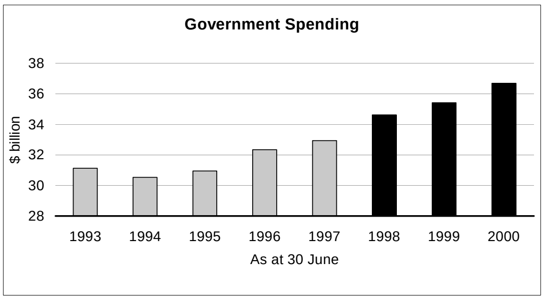
- The abolition of the superannuation surcharge in April 1998.

- The lagged effects of earlier monetary easing.

- A rise in exports supported by a background of favourable global economic conditions.

As a result of these factors, economic growth is expected to pick up to 4.2% in the year to March 1999.





Consumer spending and confidence will be spurred along by higher disposable income levels, which are expected to grow by nearly 5% in real terms in 1998/99. This reflects the tax reductions (of around $1.1 billion), the abolition of the superannuation surcharge (worth around $230 million in 1998/99) and on going real wage growth. A stronger labour market will also improve perceptions of job security. The forecast does not take into account the macroeconomic implications of the introduction of a compulsory retirement savings scheme which, if the September 1997 referendum allows such a scheme to go ahead, would come into effect from July 1998.

Impact of retirement savings scheme

A referendum is to be held on the introduction of a retirement savings scheme. These forecasts use existing government policy. Given the referendum has not been held, these forecasts do not assume any change in the current arrangements. Therefore they assume that tax reductions occur in 1998/99 but these are not matched against any retirement savings contributions.

Assessing the economic impact of the scheme will depend on its details. These will be released after the Budget. Therefore at present it is not possible to determine the likely impacts.

Some general observations, however, can be made. The impact of any scheme which increases the amount saved by households would be to move consumption from the present into the future unless contributions were matched by tax cuts. Households would reduce their consumption and residential investment spending. This would then be expected to lead to a reduction in investment spending by businesses. In the longer term, as households access their savings in retirement they would able to increase their spending, tending to raise consumption and investment.

While an increase in household savings would tend to reduce consumption in the short-term, this does not mean that economic growth will be lower. As a result of less demand pressure in the economy, inflation pressure would likely to be weaker. This will allow monetary conditions to be easier, which would tend to stimulate investment spending and, if it leads to a lower exchange rate, exports.

In other words, the impact of a retirement savings scheme could be to change the composition of growth - with initially less household spending, but more business investment and exports.

In addition, the lower interest rates of late 1996 and the first half of 1997 should be feeding through to raise household spending on both consumer goods and housing. Housing demand and residential investment growth are however, expected to be more modest in this upturn as compared to recent history. This reflects the fall-off in net migration seen over the last 18 months.

Additional government spending directed towards health, education, and social services will also be adding to aggregate demand in 1998/99.

… and with firms stepping up investment plans.

While recent discussions with business revealed an on-going commitment to investment, dampened business confidence levels are likely to deter some investment plans in 1997/98, even if they are financially viable. However, once the upswing in 1998/99 takes hold both cyclical conditions and longer-term drivers of capital spending will serve to strengthen business investment:

- Strong domestic demand will see firms expanding sales which, given high levels of capacity utilisation, means that they will need to invest.
- Modest investment growth in 1996/97 and 1997/98 when firms are expected to delay investment spending means that there is plenty of scope for catch-up investment.
- For some time now firms have focused on investment as the route to improving their competitiveness in domestic and international markets, as a means both to cut costs and improve product quality. As confidence strengthens this motive will once again come to the fore.
- Continuing real wage growth combined with the fall in the price of imported capital equipment has made for a drop in the cost of capital relative to labour, encouraging a switch to more capital-intensive production methods.

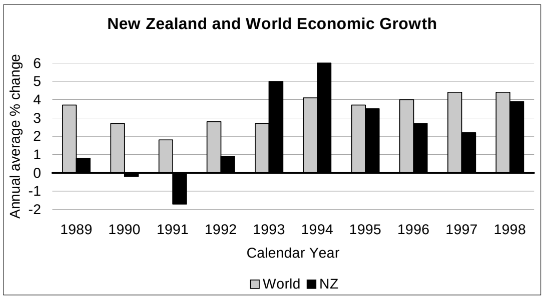
Despite pressures on profitability in the near term, companies’ balance sheets are expected to remain strong, providing firms with the wherewithal to fund this investment, both from internal sources and by reducing external financing costs. Clearly, once the upturn is into full swing a virtuous circle effect takes hold with higher investment and output leading to productivity gains, which in turn boost profitability, providing funds for further investment. As a result, business investment growth is projected to average 7.6% per annum between March 1997 and March 2000.

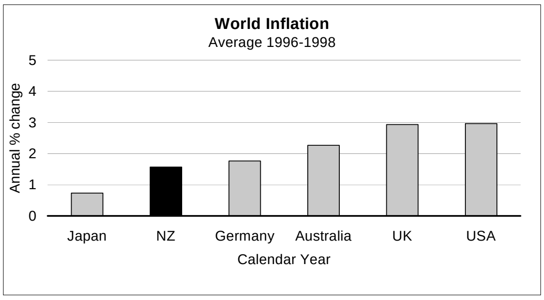
The commercial construction sector is expected to remain buoyant throughout the forecast period. While many of the larger construction projects are winding down there appears to be a sufficient number of small- to medium-sized contracts including hotels and shopping centres coming on stream to take up the slack. In the medium term the sector should receive a substantial boost from construction associated with the America's Cup.

Exports also grow in 1998/99 supported by a favourable world environment.

Export growth is also expected to pick up in 1998/99. Exporting firms that have stood up to the difficult trading conditions of recent times by continuing to strive for productivity gains and improved quality will be well placed to take advantage of a world economy enjoying sustained growth. The International Monetary Fund (IMF) puts world economic growth at 4% in 1996, the fastest rate for a decade, and its latest projections are for a slight pick-up on this over the next couple of years.

What stands out about the current global upswing is that inflation is low in the industrialised countries and falling elsewhere, with recent years having witnessed a general commitment to price stability and fiscal prudence. There is little sign at this stage of the global expansion becoming unsustainable and as a small, open economy New Zealand stands to gain from sustained, less volatile world growth.





Sources: Consensus Forecasts Inc

Outlook for trading partners

Australia continues to grow although growth is patchy across the economy. Indications are that the housing market is beginning to recover and consumption also picked up in the first quarter of 1997, after showing weakness throughout the second half of 1996. Unemployment remains high at 8.8% in May, but it is expected that the unemployment rate will fall modestly over the coming year as growth strengthens. Consensus Forecasts pick growth of 3.3% in 1997 and 4.2% in 1998. Australian inflation has also fallen and looks set to remain at low levels, with underlying inflation near the bottom of the target band at 2.1% in the year to March.

There appears to be a cautious optimism in **Japan** that the economic recovery will consolidate this year. Japan has experienced only weak economic growth over the past five years, although growth picked up in 1996 largely owing to public works and reconstruction following the Kobe earthquake. Tighter fiscal policy in 1997 will constrain the economy from a strong pick-up, but early indications are that the economy is well placed to ride out the April rise in the consumption tax, suggesting the stage is set for stronger growth in 1998. Consensus Forecasts are for GDP growth of 2.4% in 1998, up from 1.7% in 1997.

The **United States,** now into its seventh year of expansion, continues to impress. In the March quarter GDP grew by an annualised 5.8%, the largest quarterly increase since December 1987, and in May the unemployment rate fell to 4.8%, the lowest for nearly 24 years. Inflation however, remains subdued. Some slowdown in growth from the first quarter's fast pace is now widely expected but the strong labour market and high level of consumer confidence (at a 28-year high) will continue to support consumer spending. Consensus Forecasts are for GDP growth of 3.0% in 1997 and 2.0% growth in 1998. While the Federal Reserve has so far refrained from following up the March hike in interest rates a tight labour market and above-trend growth keep monetary tightening on the agenda.

After subdued growth in 1996 the outlook for **continental Europe** is for a pick-up in growth this year. While France saw only a modest gain in GDP in the first quarter of 1997, output growth strengthened in Germany and industrial production is growing in Italy. However, continued fiscal tightening in the lead-up to European Monetary Union, together with long-standing structural problems, will constrain any upturn. High unemployment looks set to persist. The **United Kingdom** is an exception in Europe and is currently experiencing strong service sector-led growth. A strong currency has helped dampen price pressures this year but wage inflation is rising. The granting of operational independence to the Bank of England should help reduce the likelihood of the characteristic boom/bust cycle developing.

The **east Asian** and **China** economies slowed during 1996 reflecting a tightening of monetary policy and slower export growth in a number of countries. Concerns about "overheating" can be expected to keep monetary and fiscal policy tight this year so that generally output growth is likely to match that seen in 1996, on average around 7% to 8% per annum. Greater risks surround the outlook for **Thailand** with its declining property and equity markets and where the currency has recently been under pressure. **Taiwan** and **Hong Kong**, on the other hand, did not see such a deceleration in growth last year as compared with some of the other countries in the region and look set for a pick-up. China has managed to bring inflation down to single digits while still growing by an annual 9.4% in the first quarter of 1997. **South Korea** looks set to continue growing at around 5% per annum but has suffered this year from industrial disputes, corporate bankruptcies and political scandal.

With stronger growth, labour demand picks up in 1998/99 ...

Increasing momentum in the economy from late 1997 sees firms, over the course of 1998, once again taking on staff. Given this lag between employment and production growth there is an initial cyclical boost to labour productivity before it returns to its longer-term trend. The positive productivity growth seen over the forecast period is in marked contrast to the flat or negative productivity growth in the three years to March 1997.

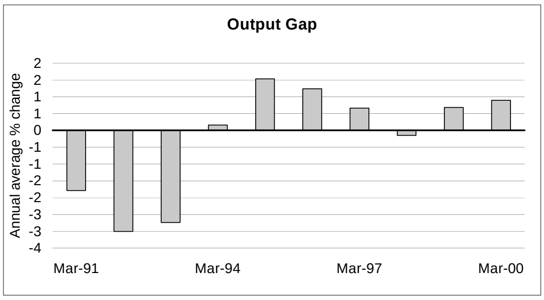
Buoyant economic conditions encourage more people to enter the labour market in 1998/99, pushing up labour force participation rates, but net migration is lower than that seen in recent years. As firms expand their hiring plans employment growth picks up and the unemployment rate falls from its peak of 6.8% over late 1997/early 1998 to 6.2% in March 1999.

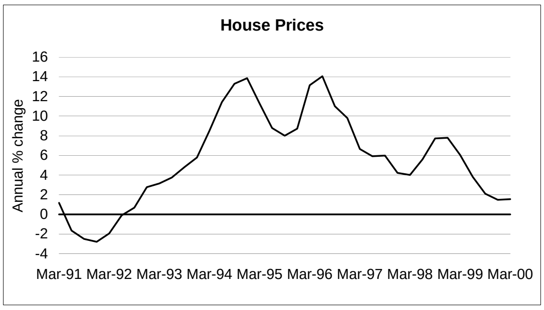
After dampened wage pressures in 1997/98 there is some moderate increase in wage growth in 1998/99 and beyond. The tighter labour market makes it easier for workers to demand higher wages, while productivity gains will make firms more likely to oblige as unit labour costs will not be significantly affected.

... and inflationary pressures build up, necessitating a tightening in monetary conditions.

Despite the factors working to dampen price pressures in the economy in the near term, the strong growth in 1998/99, fuelled by the monetary and fiscal impetus, will increase inflationary risk. The enhanced anti-inflationary credibility of the Reserve Bank, given low inflation, is expected to help moderate wage and price expectations and strong productivity growth will prevent significant inflationary pressures flowing from the labour market. The climate of strong demand will, however, encourage firms to try to raise prices in order to expand profit margins. In addition some house price rises can be expected.

As a consequence, demand will once again run ahead of productive capacity in 1998/99. This can be seen in the following chart of the output gap, which measures the divergence between the economy's actual level of output and its potential (or sustainable) level of output (at the zero line the level of actual output is equal to the level of potential output). A positive output gap re-emerges in 1998/99 after the opening-up of a small negative output gap in the previous year.





Sources: VNZ
The Treasury

In view of the inflationary potential the Reserve Bank is expected to raise interest rates from early 1998 in a pre-emptive move. The tightening of monetary conditions ensures that while spending both by firms and households picks up strongly in 1998/99 it does not accelerate to levels that will cause a significant rise in inflation. Therefore, although inflation is on a rising trend from late 1998 until the end of 1999, it remains comfortably within the 0% to 3% target band. In the absence of these higher interest rates, growth would accelerate to a rate well above the 4% mark, running the risk of significantly higher inflation.

Stronger growth is also reflected in a rising current account deficit.

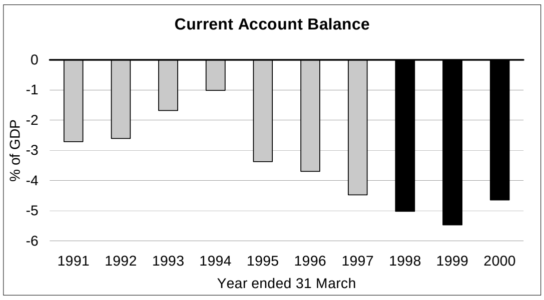
Strains on the economy’s productive capacity in 1998/99 will not only be reflected in the emergence of price pressures but also in accelerating import growth. This contributes to an increased current account deficit.

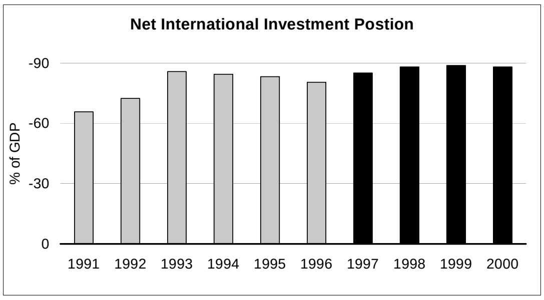
While the current account and import figures for 1997/98 and 1998/99 are distorted by the import of an ANZAC frigate in each of these years, the underlying trends (ie, excluding “lumpy” transport items) are driven largely by consumer and business spending. Underlying[2] import growth slows from around 5½%, in volume terms, in the year to March 1997 to 3¾% in the year to March 1998, reflecting relatively subdued economic growth. In 1998/99 the growth of underlying imports accelerates to around 10%, a consequence of firms investing more and consumers stepping up their spending in a buoyant economy.

The increasing current account deficit is a product not just of the merchandise trade balance trends but also reflects a steadily rising deficit on the international investment income balance, a result of past investment flows into New Zealand, as well as a fall-off in migrants’ funds entering the country.

2 Imports of goods excluding transport.

The overall effect on the current account is for the deficit to rise a fall to 5.5% of GDP by March 1999 from an estimated 4.5% in the year to March 1997. Taking out the impact of the high-value transport items sees a more modest rise in the current account deficit to 4.7% of GDP.





Sources: Statistics New Zealand
The Treasury

An anticipated increase in the current account deficit to this level could well raise some concerns but there are good reasons to believe that it can be sustained. The current account deficit represents borrowing from abroad resulting from domestic investment opportunities exceeding the supply of domestic savings. Just as a company looking to invest more than it can finance from retained profits will seek external financing, a country in a similar position can draw on savings from the rest of the world.

In New Zealand's case the current account deficit reflects rising investment rather than low savings. Total savings have risen over recent years and an increase in both private and public savings is anticipated over the medium term. An increase in savings will reduce the need to borrow from abroad and hence the current account deficit. In addition foreigners are expected to remain confident about investing in New Zealand. The background of economic reform continues to provide a favourable investment climate while the ratio of debt servicing to exports is expected to remain stable over the forecast period.

Despite these factors pointing to the sustainability of the current account position, there is no guarantee that financial markets will not be alarmed by a current account deficit over 5% of GDP. If this were to happen capital inflows would diminish causing the dollar to depreciate. This in turn would reduce the size of the current account deficit but at the expense of potentially higher inflation and/or output.

In the medium term growth falls back towards its potential rate ...

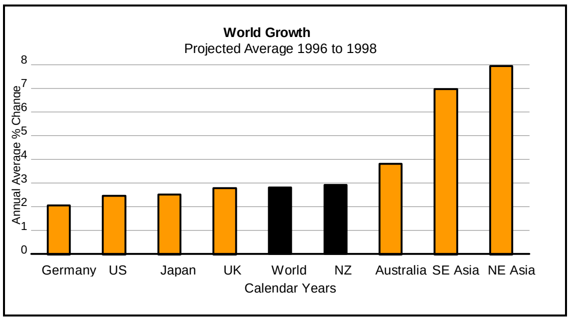
In the final year of the forecast the rate of growth is expected to fall back from the strong pace of 1998/99 to an annual 3.5%, with spending by both households and firms moderating. The on going effects of strong activity will, however, mean that the economy remains susceptible to inflation and monetary conditions will need to remain firm.

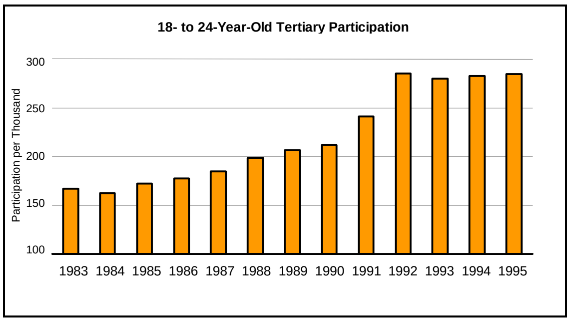
While the upturn in 1998/99 is led by domestic demand, growth becomes more broadly based over the medium term. Import growth falls in line with lower economic growth while annual export growth remains relatively buoyant at around 5%. The more open and competitive environment created by the economic restructuring undertaken since the mid-1980s means that exporters will remain in a strong position to compete on the basis of both price and quality. Against this background, non-commodity manufactured exports are expected to grow by around 10% per annum in the final two years of the forecast period, boosted in particular by strong growth in the important Australian market.

On the primary product side, exports are expected to grow at between 3% and 4% a year in the outer years of the forecast. After the exceptional growth rates of 1996/97 dairy export growth returns to steady single-digit rates while meat exports are forecast to rise from 1998/99, with beef exporters anticipating higher prices as the BSE scare in Europe recedes, as well as lower beef supplies in the US. World forestry prices are also expected to rise sharply from 1998/99 following a period of softness.

Amongst services, growth in tourism exports has fallen back recently reflecting some cyclical slowing in the east Asian economies as well as the rise in the New Zealand dollar. The stronger New Zealand currency appears to have brought down spending by tourists with budgets no longer stretching to extended stays or optional extras. Over the forecast period, however, tourism exports are expected to grow relatively strongly, at 6½% to 8% per annum, reflecting continued economic growth in the major source countries.

Over the medium term the Treasury’s analysis suggests that it is possible for the economy to sustain growth rates of around 3.5%. In part, this reflects the ongoing benefits of a more open and competitive economy created by the extensive reforms of the past 15 years. The benefit of these reforms is showing up in such things as tertiary education participation, which has risen greatly in recent years. A better educated workforce means New Zealand should be able to sustain faster rates of growth than we have in the past. A sustained growth rate of around 3.5% will mean that New Zealand will grow at somewhere around the rate of world growth, but a bit faster than most of the OECD economies.





Sources: Consensus Forecasts Inc
Ministry of Education
The Treasury

Scenarios

As always there are risks and uncertainties surrounding the outlook.

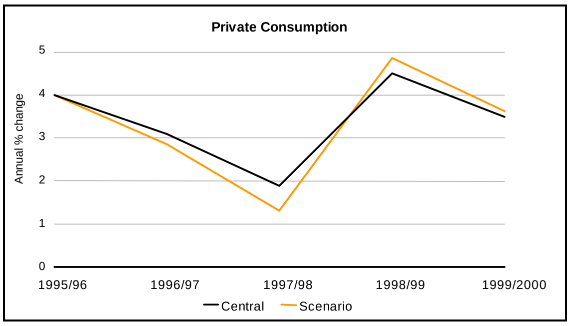
The central forecast contains the expected path of the economy over the next few years. This forecast is based on a set of judgments. If these judgments turn out to be incorrect, then the economy is likely to evolve differently. The following sections outline several alternative paths that the economy could follow.

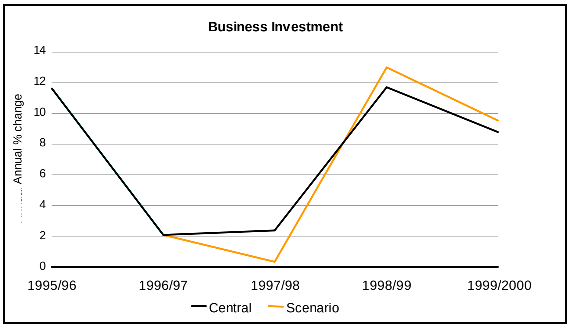
Rebound Postponed

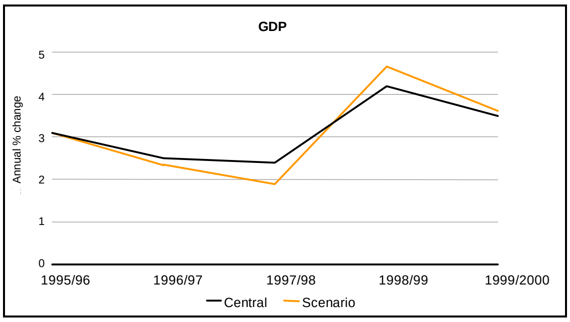
The central projection has slow growth in the March and June quarters of 1997, followed by a pick-up in the latter half of the year in response to the recent easing of monetary conditions. The timing of this pick-up is subject to some uncertainty. Consumer and business confidence might take longer to strengthen than is assumed in the central forecast and the current low growth could persist for most of 1997.

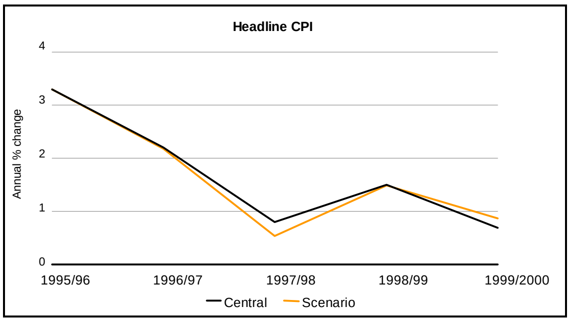
If this were to happen, growth in household spending and business investment would remain muted for all of calendar 1997. GDP growth would be knocked back by half a percentage point in the year to March 1998 compared with the central forecast and boosted by the same amount in the following March year.

Less spending in 1997 would mean less potential inflationary pressure and lower interest rates could be accommodated over the next few years compared with those of the central forecast. The lower exchange rate following from this in 1998, and onwards, means a higher trade surplus.





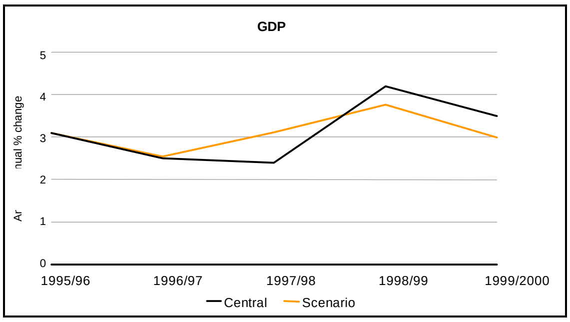


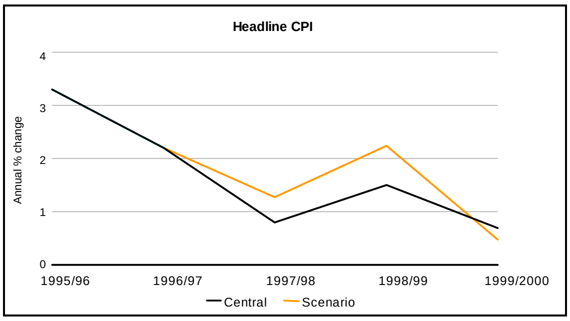


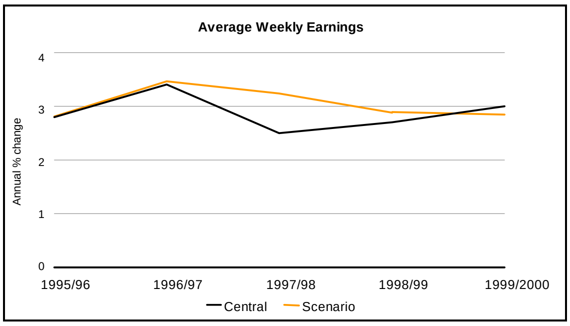
Lower interest rates spur investment adding to growth in the 1998/99 and following years.

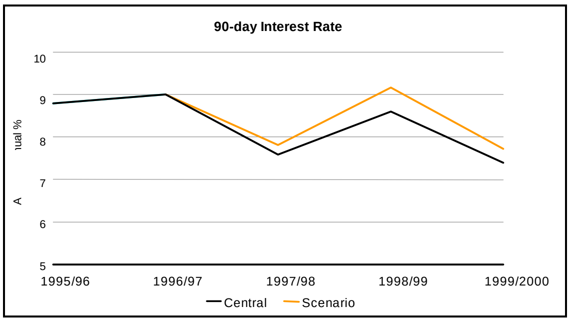
Short-term Growth Accelerates

Alternatively, the economy could pick up momentum sooner than assumed in the central forecast. This scenario indicates an earlier re-emergence of inflationary pressures. In particular, wage growth would not settle back as quickly in 1997/98 as depicted in the central outlook. A tighter labour market would encourage workers to push for higher wages and both wage and price expectations could be expected to remain higher than that assumed in the central forecast.







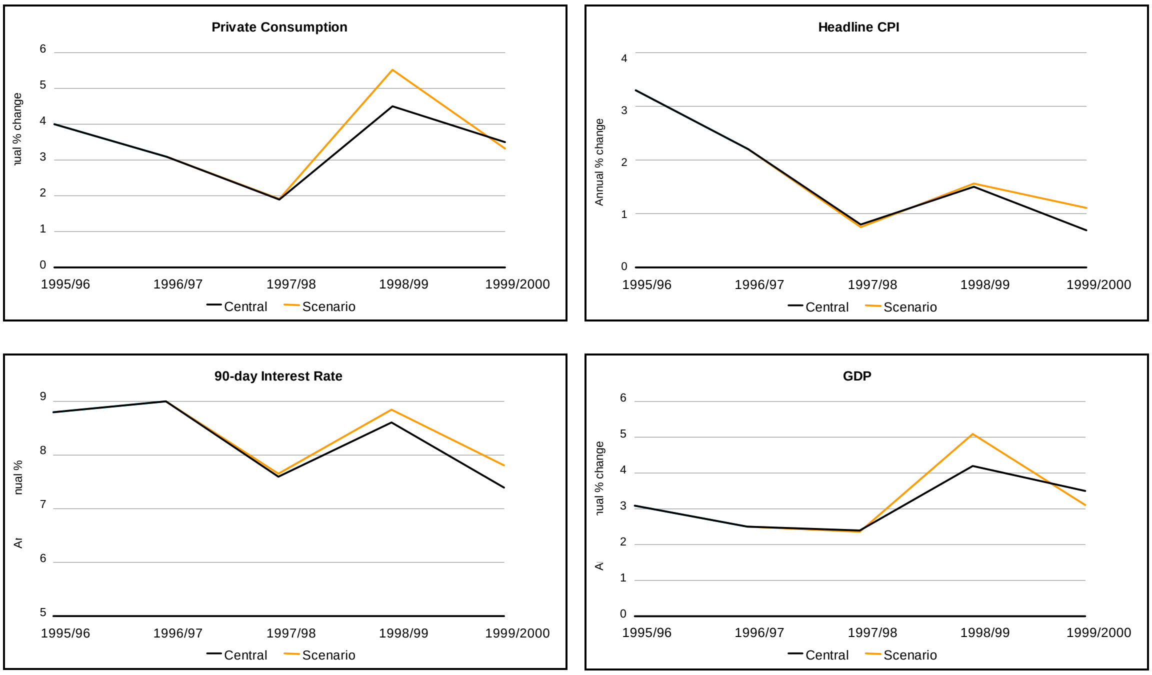


This scenario has household spending and business and residential investment growing by more in the near term than in the central forecast. The unemployment rate in the March 1998 quarter falls and wages continue to grow throughout the year at similar rates to those seen in the past year.

GDP growth would be about 0.7 of a percentage point higher than in the central forecast in the year to March 1998, while inflation is boosted by half a percentage point. Anticipating the rising price pressures, monetary authorities would tighten earlier than in the central forecast. The appreciating exchange rate squeezes net exports, while growth in the interest-sensitive parts of the economy is pared back. As a result, growth slows relative to the central case in the final two years of the outlook.

A More Pronounced Cycle

The central outlook has annual growth in 1998/99 rebounding to 4.2%. This growth rebound is pushed along by increased government expenditure, the tax reductions, the lagged effects of monetary easing and export growth. Private consumption and investment could be boosted by more in 1998/99 than that assumed in the central forecast and annual GDP growth could reach 5% in the year to March 1999. The result would be an outlook with a more pronounced economic cycle in the final two years of the forecast.



The strains on productive capacity caused by this rise in demand would require a more significant tightening of monetary conditions to head off inflation than that assumed in the central forecast. Inflation would take a couple of years to settle back to the rate in the central outlook, while the rise in the exchange rate would push the net export position to below that of the central forecast.

Table 1.2 - TRADING PARTNER ECONOMIC OUTLOOK (GROWTH IN GDP)

(Calendar years)	1996 Actual	1997 Forecast	1998 Forecast	1999 Projection
US	2.4	3.0	2.0	1.7
Japan	3.6	1.6	2.4	2.3
Germany	1.4	2.2	2.6	2.5
Australia	3.9	3.3	4.2	3.4
UK	2.4	3.3	2.7	2.0
North East Asia[1]	6.7	6.6	7.0	7.0
South East Asia[2]	7.2	7.1	7.3	7.3
Total[3]	4.1	3.6	3.9	3.6

Notes:
1 Weighted by export share. North East Asia is defined as China, Hong Kong, South Korea and Taiwan.
2 Weighted by export share. South East Asia is defined as Indonesia, Malaysia, Singapore, Thailand and the Philippines.
3 Top ten trading partners, weighted by export share.

Sources: Consensus Economics Inc, April 1997
The Treasury

Table 1.3 - REAL PRIVATE SECTOR INVESTMENT AND OPERATING SURPLUS

(Annual average % change, March years)	1995/96 Actual	1996/97 Estimated	1997/98 Forecast	1998/99 Projection	1999/00 Projection
Private business investment:					
Non-residential construction	25.9	(2.1)	12.1	11.9	8.2
Transport	6.9	12.3	(1.2)	7.6	6.2
Plant and machinery	9.3	(0.4)	(0.4)	14.0	10.7
Total	11.6	2.0	2.4	11.7	8.8
Private operating surplus	5.7	3.0	5.5	8.2	6.1

Sources: Statistics New Zealand
The Treasury

Table 1.4 - EXPORT VOLUME GROWTH - MAIN COMPONENTS

(Annual average % change, March years)	1995/96 Actual	1996/97 Estimated	1997/98 Forecast	1998/99 Projection	1999/00 Projection
Export volumes					
Agriculture	(3.0)	7.5	0.5	2.3	3.5
Forestry	4.9	2.2	2.2	6.7	3.2
Commodity manufacturing	(5.9)	9.4	1.7	4.5	3.0
Non-commodity manufacturing	4.2	0.6	6.9	10.3	10.0
Tourism[1]	17.6[2]	2.0	6.5	7.3	8.0
Total[3]	1.7	4.9	2.8	5.8	5.3
Goods export prices[4]	(1.8)	(3.3)	(0.1)	0.9	2.9

Notes:
1 Excludes airfares, estimated.
2 Includes revisions for 1995 International Visitor Survey, from June 1995.
3 System of National Accounts basis.
4 Overseas Trade Index, merchandise trade.

Sources: Statistics New Zealand
Ministry of Agriculture
Ministry of Forestry
The Treasury

Table 1.5 - LABOUR MARKET

(Annual average % change, March years)	1995/96 Actual	1996/97 Estimated	1997/98 Forecast	1998/99 Projection	1999/00 Projection
Labour force	2.9	2.7	0.7	1.8	1.3
Employment - full-time equivalent (FTE)	4.5	2.1	0.2	2.0	2.0
Participation rate, March quarter (sa)	65.6	65.7	65.6	66.2	66.1
Unemployment rate, March quarter (sa)	6.2	6.4	6.8	6.2	5.7
Average ordinary hourly wage	2.8	3.4	2.5	2.7	3.0
Labour productivity (GDP/FTE)	(1.3)	0.4	2.3	2.1	1.5
Unit labour costs	4.1	3.1	0.3	0.6	1.5

Sources: Statistics New Zealand
The Treasury

Table 1.6 - HOUSEHOLD SECTOR

(Annual average % change, March years)	1995/96 Actual	1996/97 Estimated	1997/98 Forecast	1998/99 Projection	1999/00 Projection
Compensation of employees	6.6	5.7	3.3	4.8	5.1
Entrepreneurial income	7.6	1.5	3.9	6.0	6.3
Nominal disposable income	6.9	6.3	4.0	6.2	5.6
Nominal private consumption	6.6	5.4	3.3	5.7	5.3
Household savings ratio (%)	1.4	2.3	3.0	3.5	3.7
Real disposable income	4.9	4.0	2.7	4.9	3.9
Real private consumption	4.0	3.1	1.9	4.5	3.5
Real residential investment	0.6	(0.1)	4.2	6.1	3.2
Real imports of consumer goods	7.1	2.4	7.5	11.6	7.5

Sources: Statistics New Zealand
The Treasury

Table 1.7 - IMPORT VOLUME GROWTH - MAIN COMPONENTS

(Annual average % change, March years)	1995/96 Actual	1996/97 Estimated	1997/98 Forecast	1998/99 Projection	1999/00 Projection
Import volumes					
Capital goods[1]	9.1	4.4	0.4	12.6	13.4
Consumption goods[1]	7.1	2.4	7.5	11.6	7.5
Industrial supplies[1]	2.2	4.2	5.0	8.6	6.1
Passenger cars[1]	0.2	26.3	(9.0)	10.0	7.0
Tourism[2]	10.0	6.2	8.0	7.5	4.4
Total[3]	6.8	6.0	5.2	8.9	4.9
Goods import prices[1]	(0.7)	(4.5)	(2.6)	0.5	0.2
Import penetration[4]	22.6	22.2	22.1	22.6	22.6

Notes:
1 Overseas Trade Index, broad economic categories.
2 Excludes airfares, estimated.
3 System of National Accounts basis.
4 Nominal imports as a percentage of nominal gross national expenditure and exports.

Sources: Statistics New Zealand
The Treasury