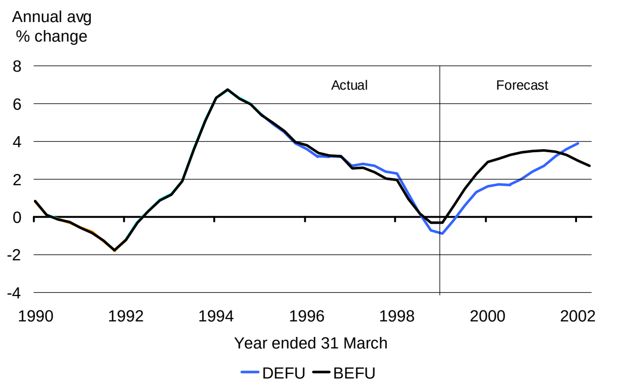
1

Economic Outlook

Overview

- Following a slight contraction in 1998/99, the economy is expected to grow steadily over the forecast period. Growth is expected to be 2.9% in 1999/2000, 3.5% in 2000/2001, and 3.0% in 2001/02.

Figure 1.1 - Real GDP Growth

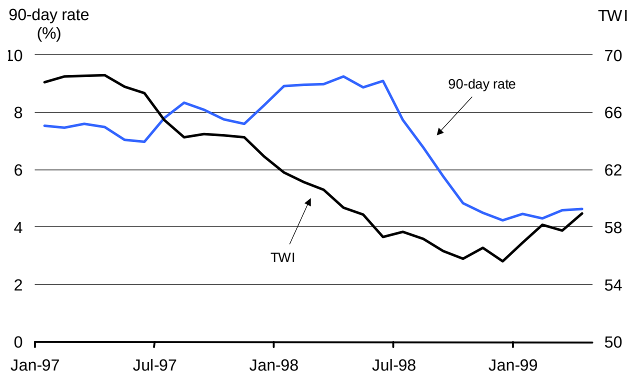


Sources: Statistics New Zealand, The Treasury

- World economic prospects have improved through 1999, although compared to the mid-1990s the world environment is still not expected to be particularly strong. Trading partner growth is expected to consolidate in 1999 at around 2% before showing a mild strengthening over the forecast horizon.

- The lagged impact of the significant easing in monetary conditions since mid-1997 set against a more stable world environment will help drive the economy forward over the forecast period. Tax rate reductions of recent years will also support activity.

Figure 1.2 - Interest Rates and the TWI



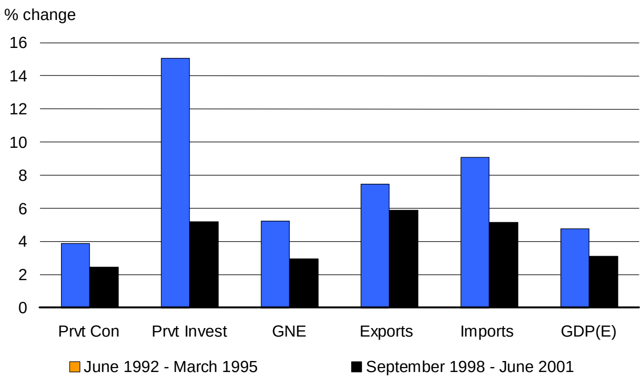
Sources: Statistics New Zealand, Telerate, The Treasury

- Near-term growth will be maintained by strength in residential investment and associated consumer spending, as well as firms building up stocks as demand conditions improve. One-off events including the America's Cup and Millennium celebrations add to momentum at the end of calendar 1999. The lingering effects of two consecutive droughts are, however, expected to restrain growth over the year to March 2000.

- Growth throughout the forecast period reflects solid contributions from both domestic demand and exports rather than any one sector leading the way. Imports also pick up as the economy strengthens so that net exports make little contribution to growth. As a consequence the current account deficit is still around 6% of GDP by the end of the forecast period.

- There are a number of influences that will make for more moderate growth than that seen in the previous recovery. These include a relatively weaker global economy, higher household debt levels, less catch-up and replacement spending and weaker net migration.

Figure 1.3 - Forecast Recovery versus Early 1990s Recovery - Average Growth per Annum



Sources: Statistics New Zealand, The Treasury

- In addition, a very gradual tightening of monetary conditions is anticipated, ensuring the economy continues to grow at a sustainable pace. Short-term interest rates are expected to rise gradually from the start of 2000 while the exchange rate shows a modest appreciation over the next three years.

- A strengthening labour market and a firming of international prices over the next three years contribute to rising inflationary pressures. However, inflation remains within the Reserve Bank's target range throughout the forecast period.

- In each of the three years to March 2002, the nominal economy is expected to be larger than forecast in the *December Update.* This is a product of stronger economic growth, principally reflecting a stronger near-term outlook for the world economy, as well as a stronger inflation profile.

- Downside risks to the central forecast track are centred on the world outlook. There remain a number of potential threats to the sustainability of the global recovery currently underway. Deteriorating global prospects could focus attention on New Zealand's current account deficit and net external liability position.

- On the upside, the export responsiveness to the past easing in the exchange rate may be stronger than anticipated. Alternatively current strong confidence levels may be pointing to a stronger domestic recovery than envisaged here.

Table 1.1 - Economic Outlook: Central Forecast[1]

(Annual average % change, March years)	1997/98 Actual	1998/99 Forecast/ Actual	1999/00 Projection	2000/01 Projection	2001/02 Projection
Private consumption	3.1	1.5	2.0	2.8	2.7
Public consumption	6.4	(1.0)	5.6	(3.0)	(0.1)
Total Consumption	**3.7**	**1.0**	**2.7**	**1.6**	**2.2**
Residential investment	0.8	(15.0)	6.6	5.6	3.4
Business investment	(0.3)	4.4	3.0	6.5	9.5
Total private investment	0.0	(0.8)	3.9	6.3	8.1
Public investment	9.5	(7.0)	4.4	6.3	3.4
Total investment	**1.5**	**(1.8)**	**4.0**	**6.3**	**7.3**
Stock change[2]	0.2	(0.9)	0.7	0.3	(0.0)
Gross national expenditure	3.4	(0.5)	3.7	2.9	3.3
Exports	3.6	1.0	4.5	5.6	4.4
Imports	4.8	2.5	6.2	3.9	5.3
GDP (Production Measure)	**2.0**	**(0.3)**	**2.9**	**3.5**	**3.0**
Employment[3]	(0.1)	(1.0)	1.5	2.1	2.0
Unemployment[4]	7.1	7.6	7.4	6.7	6.0
Wages[5]	2.6	2.9	1.7	2.6	3.2
CPI inflation[6]	1.3	(0.1)	1.6	1.8	2.0
CPIX inflation[6,7]	1.7	1.0	1.7	1.8	2.0
Nominal GDP (expenditure)	3.3	0.4	3.8	5.2	4.6
Current account balance					
- $ million	(6,488)	(6,186)	(7,037)	(6,444)	(6,656)
- % of GDP	(6.6)	(6.3)	(6.9)	(6.0)	(5.9)
- ex migrants' transfers $ million	(6,663)	(6,364)	(7,397)	(7,004)	(7,376)
- ex migrants' transfers % of GDP	(6.8)	(6.5)	(7.2)	(6.5)	(6.5)
TWI[8]	61.2	57.6	59.0	59.8	60.5
90-day bank bill rate[8]	8.9	4.5	4.8	5.8	6.5
10-year bond rate[8]	6.8	5.7	6.3	7.3	7.4

Sources: Statistics New Zealand, Telerate, The Treasury

Notes:
1 Projections finalised 27 April 1999.
2 Contribution to GDP growth.
3 Household Labour Force Survey full-time equivalent employment, annual percentage change.
4 Percentage of the labour force, March quarter, seasonally adjusted.
5 Quarterly Employment Survey average hourly ordinary time earnings, annual percentage change.
6 Annual percentage change, March quarter.
7 CPIX refers to the Consumer Price Index excluding credit services.
8 Average for the March quarter.

The Forecast Story

Global growth now looks more assured.

Global economic growth slowed markedly in calendar 1998 as the recession in Japan deepened, several other Asian economies contracted sharply and economic conditions in Latin America weakened. World financial markets saw considerable volatility, with particular turmoil occurring around last September in the wake of Russia's debt default and the near collapse of the hedge fund Long-Term Capital Management. The losses incurred in Russia and in other emerging market economies raised investors' risk aversion. Fears of a credit shortage in the US led some forecasters at the time to make significant downward revisions to their US growth forecasts.

Inflation across the OECD world has been subdued even in those countries such as the US that are operating close to full capacity. The sharp slowdown in global GDP growth resulting from the Asian crisis widened an already large global output gap, pushing commodity prices to record lows and intensifying competitive pressures in the traded goods sector. These forces contributed to a low inflationary world environment through 1998.

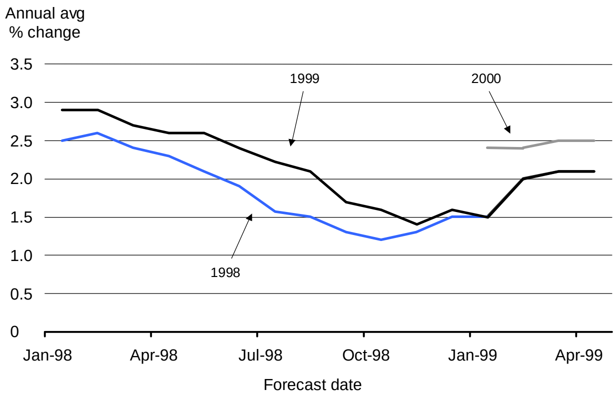
The global environment has changed markedly over the past six months. Widespread monetary easing, led by the US Federal Reserve, helped restore calm to world financial markets in the final quarter of 1998. In the early months of this year, a clear improvement in sentiment towards global growth prospects emerged.

In particular, continued strong growth in the US economy has helped dissipate fears of a sharp global slowdown. The Australian economy has also headed into 1999 on a strong note, while activity in some of the adversely affected Asian economies is showing signs of stabilising or recovering. Calmer world financial markets and lower interest rates in the developed world have enabled interest rates in some of the emerging market economies to fall, and even Brazil's devaluation in early 1999 proved to have limited financial market repercussions. Some commodity prices have been rising recently from the lows of last year.

The *December Update* macroeconomic forecasts were finalised at the height of last year's financial market turmoil. At that point we incorporated a sharp slowdown in the US and Australia into our world growth assumptions. Deteriorating world growth prospects not only dampened our expectations for the export growth outlook but just as importantly made for a negative shock to domestic confidence.

Since then, forecasts for Europe and most of Asia have moved in line with our expectations. We and most other forecasters have, however, been surprised by the continued momentum in the US and Australian economies.

Figure 1.4 - Consensus Forecasts for Calendar 1998, 1999 and 2000



Sources: Consensus Forecasts Inc, The Treasury

Overall, the consensus view[1] of global growth expectations improved over the first quarter of 1999. The picture is one of world growth consolidating in calendar 1999 with top-ten trading partner growth expected to be around 2%, the same as that in 1998. The following two years see a strengthening of world growth to around 2.5%.

The Global Outlook

Overall growth in New Zealand's top ten trading partners is expected to be around 2% in 1999, the same as that recorded in 1998. The composition of growth, however, is expected to be somewhat different. Slower growth is expected in Europe, and to a lesser extent, the US and Australia, but the economies of Asia are generally stabilising.

Economic growth in the **US** was stronger than expected in late 1998 and the first quarter of 1999. Evidence suggests that the manufacturing sector is recovering, and US consumers continue to spend at a rapid pace. The US economy is expected to grow by around 3.5% in 1999, only slightly slower than the 3.9% pace of 1998.

Australia also recorded strong growth in 1998 of 4.9%, buoyed by strong domestic spending. The consumer is expected to sustain the economy in 1999, even though investment is expected to slow and net exports remain weak. Overall, the economy is expected to enjoy robust growth of 3-3.5% in 1999.

The **Japanese** economy shrank by 2.8% in 1998, its weakest performance in the post-war period. Fiscal stimulus has begun to have some effect on GDP, and interest rates remain low. Nevertheless, the economy is expected to contract again in 1999 by around 1%. A rapid recovery is unlikely in the face of significant excess capacity and bad loan problems in the banking sector.

Confidence in the economies of **non-Japan Asia** has returned recently, and growth is expected to stabilise following the sharp contractions of 1998. The sharpest growth turnaround is expected in Korea where industrial production has already returned to 1997 levels. GDP is expected to grow by over 3% in 1999 following a 5.8% contraction in 1998. Positive growth is also expected in Thailand, Malaysia, Singapore and the Philippines.

Many of the major economies of Europe are slowing. The **UK** is expected to grow by just 0.6% in 1999, following growth of 2.1% in 1998. Growth within the Euro region is divergent: Germany and Italy have slowed sharply into early 1999 whereas the periphery Euro economies continue to perform well. **Germany** is expected to grow by 1.6% in 1999, down from 2.5% in 1998. However, looking ahead the monetary easings seen across Continental Europe and the UK should provide some support to these economies.

1 The world growth assumptions used in these forecasts are based on those compiled by Consensus Forecasts Inc in April 1999.

Stimulatory monetary conditions set against a more stable world environment will drive the New Zealand economy forward...

In comparison to the mid-1990s the global recovery is expected to be only moderate. It does, however, provide a more favourable backdrop to New Zealand's growth than we expected in October of last year when the *December Update* macroeconomic forecasts were finalised. The *December Update* story of negative confidence effects stemming from deteriorating global prospects has been replaced by a picture of more confident firms and households.

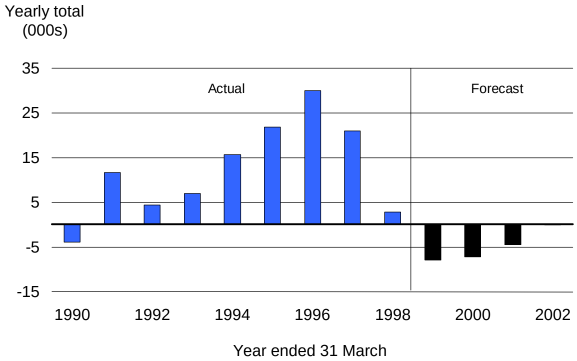
The lagged impact of the significant easing in monetary conditions seen since mid-1997 set against a more stable world background is expected to drive the economy forward. Tax rate reductions of recent years will also support activity. The reforms of the past 15 years have led to improved efficiency and competitiveness in the economy and provide a sound base for growth.

The exchange rate on a trade-weighted basis fell by around 20% over the period from April 1997 to December 1998, while short-term interest rates have fallen from around 10% to 4.5% over the past year. As always, there are lags between changes in monetary conditions and changes in economic activity. Renewed confidence in both the domestic economy and amongst exporters has already paved the way for solid growth in both domestic demand and exports. In addition to favourable monetary conditions, the upturn will be aided by a string of special events starting in 1999 with the APEC Leaders' Meeting and America's Cup, and continuing into 2000 with the Millennium celebrations and the Sydney Olympics.

There are, however, expected to be some moderating influences on growth over the forecast period. These keep the economy growing at a sustainable pace of around 3% rather than the 4-6% annual growth rates seen in the previous recovery.

Net migration, for example, is expected to remain negative through most of the forecast period, with the four years to March 2002 expected to see a net outflow of 19,000 migrants. This is in sharp contrast to the strong net inflows in the mid-1990s period. In other key contrasts with the previous cycle, we do not expect the high levels of catch-up and replacement spending nor do we expect households to accumulate debt to the same extent.

Figure 1.5 - Net Migration



Sources: Statistics New Zealand, The Treasury

...while a forecast tightening in monetary conditions will work to keep the economy on a sustainable growth path over the forecast horizon.

Moreover, a gradual tightening of monetary conditions is expected. Weakening demand over the past year has opened up spare capacity in the economy. However, the forecast pick-up in economic activity is expected to push the economy towards full capacity by the end of calendar 2000. Although inflation pressures are currently subdued, we expect some pre-emptive tightening by the Reserve Bank in order to ensure that the economy remains on a sustainable growth path over the forecast horizon.

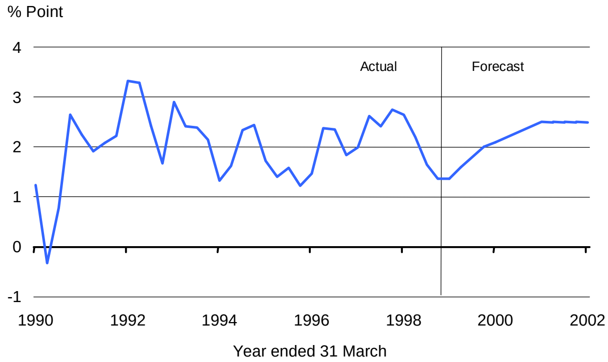
In terms of the mix of monetary conditions, it is anticipated that short-term interest rates will remain at around 4.5% for the remainder of calendar 1999 and then climb gradually over the forecast period to peak at 6.5% in the final year of the forecast.

The trend expected for the nominal exchange rate is for a modest appreciation over the forecast period. However, there are likely to be some short-term fluctuations around this trend. For example, since finalising the Budget macroeconomic numbers, the TWI has strengthened markedly.

The forecast appreciation is a product of counteracting influences. On the one hand, a widening differential between New Zealand interest rates and world rates is expected to persist over the forecast period exerting some upward pressure on the exchange rate. On the other hand, a continuing large current account deficit limits the extent to which the exchange rate is expected to rise.

The persistence of a large current account deficit over the forecast period also means we have incorporated a gradual increase in the risk premium,[2] built into New Zealand's long-term interest rates, over the next two years. This reverses the downward trend in New Zealand's risk premium seen over the last year or so, taking the risk premium to a level somewhat above the average seen over the last five years.

Figure 1.6 - New Zealand's Risk Premium



Sources: Statistics New Zealand, Consensus Forecasts, The Treasury

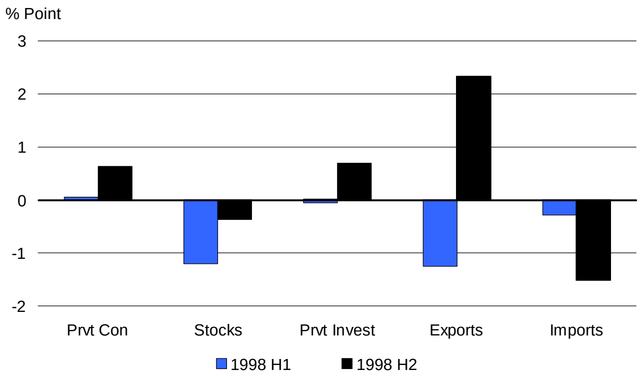
New Zealand's recovery started in the second half of 1998

Over the second half of 1998 the New Zealand economy recovered, expanding by 1.3% following the contraction of 1.6% in the first half of the year.

2 The risk premium is defined as the difference between New Zealand's 10-year interest rate adjusted for inflation and G3 10-year interest rates adjusted for inflation.

Export volume growth stands out in terms of contributing to both the downturn and recovery in overall GDP growth last year. While exports contributed about 1.25 percentage points to the slowdown in the first half of the year, they rebounded strongly in the second half. This reflected a strong bounce-back in primary exports from the effects of the 1997/98 drought and the collapse in some of the Asian markets following the 1997 crisis. While primary exports fell by nearly 8% in the first half of the year, they posted growth of over 13% in the second half of 1998.

Figure 1.7 - Contributions to GDP Growth



Sources: Statistics New Zealand, The Treasury

Domestic activity also strengthened in the final quarter of last year. Subsequent indicators of continued economic momentum include: steady growth in retail sales, a pick up in employment growth, strong consumer and business confidence, growth in tourist numbers and the upward trend in new dwelling consents.

And while drought-related effects are lingering...

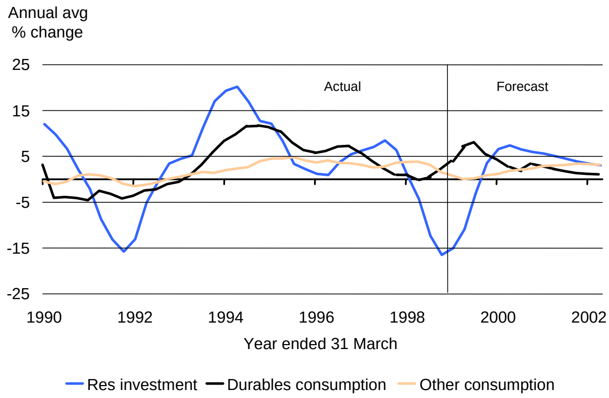
Negative effects on agricultural production of the 1997/98 and 1998/99 droughts are expected to persist through the year to March 2000. Dairy exports are expected to be weak over the March and June 1999 quarters with a marked fall in dairy production expected to make a negative contribution to GDP growth in the March 1999 quarter. Agricultural production losses translate into income losses. Consequently, farm incomes are expected to fall for the fourth consecutive year in the March 2000 year with flow-on effects for consumption in the wider economy.

...near term growth reflects strength in the interest-rate sensitive sectors and stockbuilding. Special events begin to add to momentum at the end of 1999.

The drought effects, however, only partially offset momentum in other areas of the economy. In particular, those sectors that typically respond to interest-rate movements are expected to show near-term strength and service exports are expected to continue to grow solidly over coming quarters.

Residential building activity turned up in the December quarter following a significant contraction in the earlier part of the year. While the housing market will not, as in the mid-1990s upswing, be shored up by strong migrant inflows, low interest rates are expected to foster solid growth in residential investment over the next 18 months or so. Lower interest rates and increased housing demand are also supportive of an upturn in associated consumer durables expenditure, which reaches a peak early in the forecast period.

Figure 1.8 - Consumption and Residential Investment



Sources: Statistics New Zealand, The Treasury

Over the next couple of quarters, improving demand conditions are also expected to encourage firms to build up stocks, making for a positive contribution to growth. In the year to March 2000, stock changes contribute around 0.7 percentage points to annual average growth.

The string of special events starting in September 1999 with the APEC Leaders' Meeting and continuing through the 2000 year will also be positive for growth over the first year or so of the forecast period.

Over the medium term all sectors of the economy make solid contributions to growth.

In the year to March 2001 the economy strengthens further. This reflects steady contributions from both domestic demand and exports, rather than any one sector leading growth. Rising imports, however, mean that net exports make very little contribution to growth over the forecast period.

The final year of the forecast sees some slowing of the economy, with annual average growth falling back to 3.0% from 3.5% in 2000/01. Rising interest rates from early 2000 slow some components of domestic demand, while the mildly appreciating exchange rate moderates export growth. This allows the economy to return to a sustainable growth path following a period of above-trend growth in the 18 months to March 2001. In addition, some fallback from the one-off boost to activity generated by the tourism-related events in 2000/01 is anticipated.

A strengthening labour market...

Labour demand picks up along with economic growth. Firms are expected both to use existing workers more fully, by increasing hours worked per employee, and to hire more workers.

Labour market data for the March quarter, published since finalising the Budget Forecasts, point to a stronger and earlier pick up in employment than embodied in these forecasts. While the composition of employment growth in the March quarter makes for some questioning of the strength of the outturn it does raise the possibility that the near-term labour market outlook may be more positive than that contained in the forecasts presented here. A stronger labour market would increase the possibility of stronger near-term domestic demand growth.

The unemployment rate is currently at 7.2%, somewhat lower than the 7.6% expected when finalising the Budget numbers. Unemployment is expected to fall gradually over the forecast period to around 6% by the March 2002 quarter. In the near term, the fall in unemployment is likely to be moderated, to some extent, by rising participation in the labour force. In part this is cyclically driven, with better job prospects encouraging more people to enter the labour market. It is also a product of newly work-tested beneficiaries flowing into the labour market over the next few quarters.

Rising participation offsets the reduction in labour force growth caused by net outward migration over the forecast period. Labour force growth is expected to average around 1.5% over the three years to March 2002. This is, however, down on the strong labour force growth of around 3% seen in the 1994-97 period.

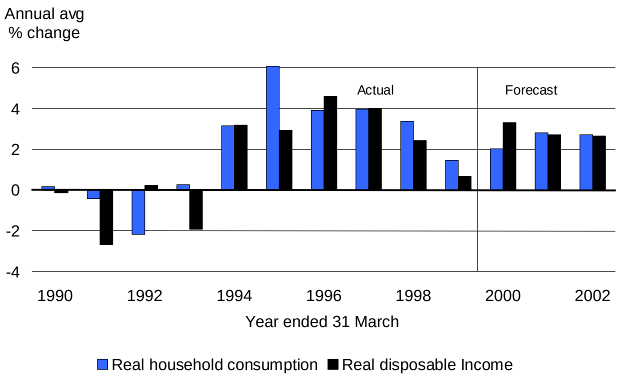
Wage growth is expected to moderate in the near term, reflecting past slackness in labour market conditions. The tighter labour market towards the end of the period is expected to put some upward pressure on wages, boosting unit labour costs.

...supports consumer spending.

An improving labour market provides a favourable background to household spending, which builds up steadily.

Consumer spending was flat in the first half of 1998, picking up in the second half of the year. Household spending has been supported by the July 1998 tax rate reductions and the AMP windfall. Mid-year tariff cuts also encouraged increased spending on cars. While these one-off influences will fade, strong consumer confidence and current low interest rates combined with strengthening incomes are expected to buoy consumption growth.

Figure 1.9 - Consumption and Income Growth



Sources: Statistics New Zealand, The Treasury

However, consumption is expected to pick up only modestly compared to that seen in the mid-1990s. This in part reflects the current absence of significant pent-up demand. In addition, net outward migration and modest wealth effects, due to a more subdued housing cycle compared to the previous upswing, will serve to moderate consumption growth over this recovery.

Improving job prospects and lower debt servicing costs provide some offset to the effect of a higher stock of household debt built up over the 1990s. However, households' appetite for taking on more debt to fund consumption is expected to be more limited over this upturn as compared to the previous upswing. Consequently, consumption is expected to grow only in line with incomes in the outer years of the forecast which makes for no change to the low household savings rate.

Past falls in the exchange rate and an improving world economy underpin demand-driven export growth …

Total export volume growth is expected to average around 5% per annum over the forecast period.

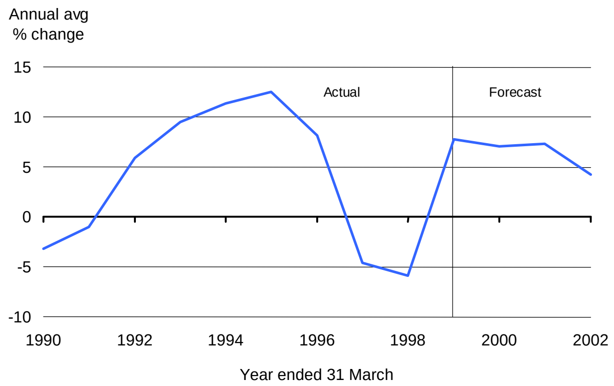
Exporters of manufactured goods can be expected to benefit both from the competitiveness gains associated with past easings in the exchange rate and solid growth in key markets. Growth in non-commodity manufactured exports is expected to average 2% per quarter over the forecast period. This is in line with recent experience, and pushes their annual average growth to around 10% in the year to March 2001.

This is a solid performance but is some way off the 20% annual growth in manufactured exports reached in the 1993-1994 period. In part, the outlook reflects the fact that while the world economy is improving over the forecast horizon the global outlook is not particularly strong. Industrial production growth in our key markets, which has an important bearing on demand for our manufactured goods, is expected to pick up over the forecast period but remains weaker than that seen in 1994.

In addition, the extent of the New Zealand dollar's depreciation over the mid-1997 to end-1998 period has not been uniform against trading partner currencies. A fall in the value of the New Zealand dollar of around 25% against the US$, for example, needs to be set against an 8% depreciation against the Australian dollar, with Australia counting for around half of our manufactured exports. Talks with businesses have also confirmed that gaining access to new markets can be a costly and time-consuming process.

Following a subdued period through 1996 and 1997, tourism exports recorded strong growth in the final two quarters of 1998, with most of the growth coming from increased inbound tourism from Australia and North America. More recently non-Japan Asian tourist numbers have picked up, and there has been continued strong growth from the North American market. Over the 1999 and 2000 years tourism exports are expected to build on recent gains, with annual average growth picking up towards the 9% mark. The special events already mentioned will give a one-off boost to the tourism sector, which will also be benefiting from increased price competitiveness, continued strong income growth in key markets such as the US and Australia and a recovery in visitor arrivals from Asia.

Figure 1.10 - Services Exports



Sources: Statistics New Zealand, The Treasury

...while agricultural exports are expected to recover from drought-related effects.

On the primary export side, both meat and dairy exports are expected to recover from an overall weak performance in the year to March 1999. Meat exports, however, show modest growth in the year to March 2000 with the need to rebuild stock numbers in the wake of two successive droughts constraining export growth over the coming year. Dairy export volume growth picks up somewhat faster than meat in the first year of the forecast, on the assumption that weather patterns return to normal. Over the medium term, dairy exports continue to be underpinned by the long-term trend towards increasing dairy herd numbers and steady productivity gains.

Forestry exports recorded strong growth in the second half of 1998 following a weak first half. Solid growth is expected over the forecast period reflecting both the availability of more harvestable wood and, on the demand side, continued growth in Australia and the US, as well as a recovering South Korean economy.

Table 1.2 - Selected Exports Volume Growth

Annual Average % Change March Years

	1998/99	1999/00	2000/01	2001/02
Meat and dairy	-4.2	3.2	4.5	2.7
Forestry	-0.1	6.4	5.5	6.8
Manufacturing	3.8	7.4	9.8	8.4
Services	7.8	7.1	7.3	4.3
Total exports	1.0	4.5	5.6	4.4

Source: Statistics New Zealand, The Treasury

Investment spending picks up gradually with a strengthening economy.

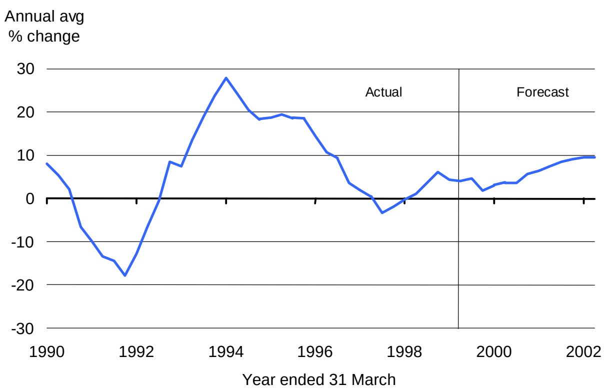
Firms are expected to have exercised some caution over investment spending during the first half of 1999 as they gauged the strength of the recovery. Over the medium term, investment spending generally picks up in line with gathering momentum in the exporting and domestic sectors.

Plant and machinery investment will continue to be underpinned by on-going investment in computer technology while a strengthening tourism sector improves the outlook for transport-related investment. On the other hand, growth in non-residential construction is expected to ease when a number of large projects wind down during 2000.

Strengthening corporate profit growth over the first two years of the forecast period will be supportive of rising investment. In the latter part of the forecast period the economy reaches full capacity, providing further impetus to investment spending.

The upturn in investment is, however, significantly more muted than that seen in the mid-1990s. While business investment growth was running at around 20% per annum in the 1993-1994 period, it has to be remembered that investment contracted significantly during the early 1990s period when a lot of capital scrapping occurred. The starting point for the current upswing is very different, with the last couple of years seeing a reasonably mild slowdown in investment spending. This is

Figure 1.11 - Business Investment



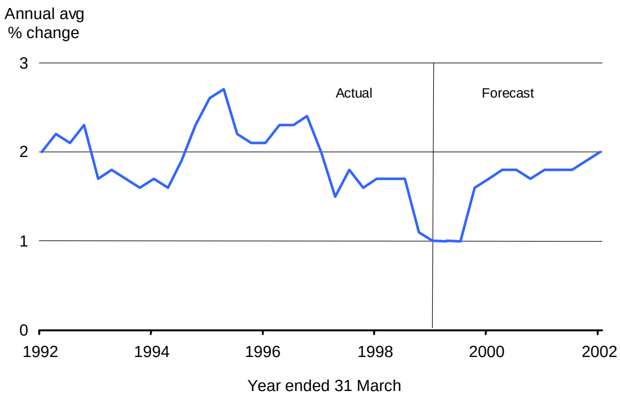
Sources: Statistics New Zealand, The Treasury tied to corporate balance sheets being in much better shape than in the late 1980s and early 1990s.

Inflation builds up over the forecast period to be above the mid-point of the Reserve Bank's target range.

The past year has seen a sharp reduction in inflationary pressures, with annual inflation in CPI ex credit services (CPIX) currently running at 1.0%. This reflects weak price pressures in the non-tradeable sector, with particular weakness in housing-related costs, in combination with only a very slight rise in tradeable sector inflation.

Price rises associated with increased costs arising from the exchange rate depreciation have been limited. Weak demand conditions have constrained the ability of firms to pass on increased costs. In addition, world import prices have been weak, falling in annual terms over the last 18 months or so. New Zealand, like other OECD economies, has benefited from the low inflationary world environment.

Figure 1.12 - CPI Excluding Credit Services



Sources: Statistics New Zealand, The Treasury

Annual CPIX inflation is expected to pick up from current levels, ending the forecast period at 2.0%. The expected rise in inflation reflects a mixture of different pressures on prices over the course of the next few years. Nevertheless, the gradual monetary tightening built into the forecast ensures that inflation remains within the Reserve Bank's target range throughout the forecast period.

In the near term, announced price rises for electricity and local authority rates will have a one-off impact on inflation, while the recent rise in international oil prices is also expected to feed into consumer prices.

In addition, the stronger activity in the housing sector – already seen, and forecast to continue in the early part of the forecast period – is expected to lead to stronger housing-related prices over the next 18 months or so. These fade towards the end of the period in response to the projected rise in interest rates.

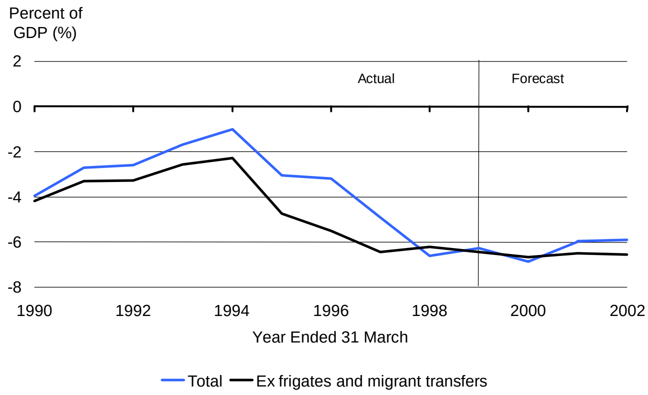
International prices are expected to firm throughout the forecast period as the world economy strengthens. Stronger growth in unit labour costs, stemming from a tightening labour market, as well as a widening in firms' margins, add to inflationary pressures in the latter part of the forecast period.

The current account deficit shows no noticeable decline over the forecast period.

As indicated earlier, the current account deficit shows little decline over the forecast horizon. After excluding migrant transfers from the current account balance (this follows the international convention) the current account deficit has been sitting at between 5.5% to 6.5% of GDP since 1996. It is expected to stay at around 6.5% of GDP over the forecast period.

The exception to this is the year to March 2000, when the government import of the second ANZAC frigate *Te Mana* worth $560 million (0.6% of GDP) inflates the current account deficit.

Figure 1.13 - The Current Account Deficit



Sources: Statistics New Zealand, The Treasury

Underlying the flat profile for the current account deficit over the forecast period is:

- a stable surplus on the goods balance of around 1.5% of GDP;
- a reducing deficit on the services balance, in part reflecting solid tourism exports;
- a moderate increase in the deficit on the investment income balance, which reflects New Zealand's large net external liability position and improving profitability of existing foreign direct investment in New Zealand.

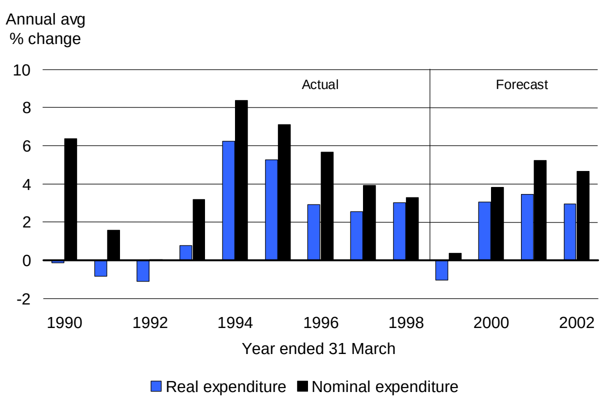
The nominal economy is stronger compared to the December Update Forecasts.

The forecasts for real economic activity and prices are key inputs into the fiscal forecasts contained in the next chapter. Combining real GDP and inflation produces forecasts for nominal GDP, from which tax revenue forecasts are derived. The inflation forecasts also feed into the expenditure side of the fiscal accounts, as welfare benefits are adjusted to keep pace with forecast movements in inflation.

Compared to the *December Update* the profile for real GDP growth and inflation is stronger over the forecast horizon, with the combined result being a stronger nominal economy in each of the three years to March 2002.

Following a flat 1998/99 year, nominal GDP growth picks up to average around 4.5% per annum over the forecast period.

Figure 1.14 - Nominal and Real GDP (Expenditure Measure)



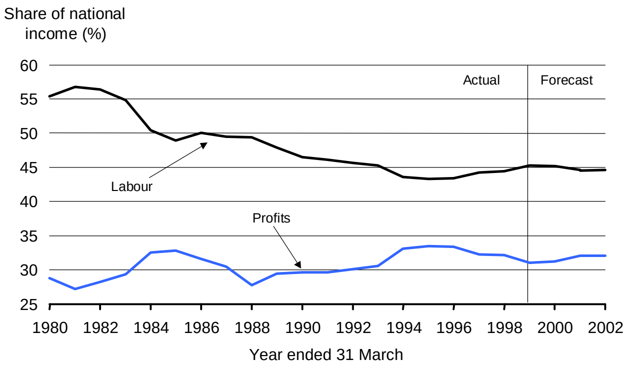
Sources: Statistics New Zealand, The Treasury

In terms of the income measure of nominal GDP, employees' compensation shows a modest increase in growth in the year to March 2000. Employment and hours worked are forecast to strengthen over this year. However, nominal wage growth is expected to slow, reflecting a lagged response to the previous slowing in the labour market. A pick up in both wage and employment growth over the final two years of the forecast period sees growth in employees' compensation strengthen to nearly 5% in the year to March 2002.

Following a period of weakness over the three years to March 1999, operating profits[3] are expected to rebound over the forecast period and are at their strongest in the year to March 2001 when their growth reaches 8%. The nature of the economic upturn, with all sectors of the economy contributing to growth, is reflected in improved profitability growth across the agricultural, manufacturing and service sectors.

Profits in the agricultural sector, however, take some time to recover, with the year to March 2000 seeing the fourth consecutive year of declining farm incomes. This reflects the ongoing drought-related effects and only slowly improving commodity prices.

Figure 1.15 - Shares of National Income



Sources: Statistics New Zealand, The Treasury

Over the three years to March 1999 growth in labour income outstripped profit growth resulting in wages and salaries rising as a proportion of national income at the expense of profits. This reflects a period when, although the economy was slowing, firms held onto labour. In contrast, profits' share of national income increases over the initial couple of years of the forecast period, while labour's share of national income falls. This period encompasses the initial stages of the upturn when firms' benefit from productivity growth exceeding real wage growth. The fall in labour's share of income over the forecast period is not, however, significant compared to the trend seen since the early 1980s.

Both upside and downside risks surround the central forecast.

As always there are risks and uncertainties surrounding the central forecast track.

It is not time yet to be too sanguine about the global economic outlook, with a number of potential threats to the sustainability of improved global growth remaining. Deteriorating global economic prospects would make for a background less conducive to New Zealand's growth. In addition, while proving difficult for anyone to quantify, the potential for Y2K associated disruption looms.

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3 Operating profits refer to operating surplus as defined in the New Zealand System of National Accounts. Included in the definition are profits received by both the private sector, including the farm sector, and the government sector.

Upside risks to the central forecast track stem from the possibility that there may be a greater export response to past easings in the exchange rate and/or a stronger recovery in the domestic economy. A stronger-than-anticipated recovery in the domestic sector would increase both inflationary and current account pressures.

Analysis of the risks to the central forecast is contained in Chapter 3.

Macroeconomic Impact of the Year 2000 Bug

The Year 2000 (Y2K) problem involves a risk that some computer-based systems will fail to recognise dates correctly, particularly on 1 January 2000. We have identified three main ways in which Y2K is likely to affect the economic outlook.

Spending on Fixing Y2K Problems: In the period up to 2000, investment spending on fixing Y2K problems is likely to add to economic growth to the extent that there is an increase in overall investment. To the extent that this is investment brought forward from future years, economic growth beyond 2000 will be reduced as investment spending unwinds. We estimate that spending on fixing Y2K will add around 0.1-0.3% to New Zealand's annual economic growth in the period 1997 to 1999, followed by a similar negative influence on growth beyond 2000.

Behavioural Responses: Individuals' and businesses' perception of possible Y2K impacts, and the perceived level of readiness, are likely to lead to behavioural effects. This includes an inventory build-up in order to avoid running out of supplies early in 2000. We estimate that this will add about 0.3% to quarterly GDP growth in the last part of calendar 1999, but will lower growth by a similar amount in the early part of 2000 as inventories are returned to more typical levels.

There may also be increased volatility in financial markets around the turn of the century, as domestic and foreign investors assess the situation.

Supply Disruption: There is potential for Y2K-related failures on 1 January 2000 to disrupt businesses and households, with flow-on effects to the macro economy, if adequate corrective action, both in New Zealand and amongst our major trading partners, is not carried out. There is still considerable uncertainty about the level of disruption that could actually occur. However, historical precedents such as the Auckland power crisis in 1998 show that such events, while having a significant impact on people's lives, have little impact on overall economic activity. This is because people generally find alternative ways to conduct their business and considerable new economic activity is often generated in fixing the problem.

Based on current information, and assuming a relatively high state of readiness, our view is that the New Zealand economy is most likely to experience only a small temporary negative impact on growth in early 2000 owing to Y2k-related disruption. If quantified, the impact could be around 0.1 to 0.3 of a percentage point of annual GDP. Scenarios involving major prolonged disruption leading to larger impacts have low probabilities.

Treatment in the Economic Forecasts

These Budget economic forecasts implicitly include the estimated impact of Y2K on inventories and spending on fixing Y2K problems. This is similar to the approach used by other forecasters. The forecasts have not been adjusted, at this stage, for potential impacts arising from disruption, owing to the uncertainty involved. We will update our view in subsequent forecasts, if necessary, as more information becomes available.