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Economic Outlook

Introduction

This *Pre-election Update*, like its 2008 predecessor, has been prepared during a period of heightened uncertainty in the world economy. The repercussions of the financial crisis that erupted in 2008 are a key source of today's uncertainty. In many countries debt levels remain high and economic growth is weak. Many governments face unprecedented challenges in seeking to reverse fiscal deficits, and to stabilise, and eventually reduce, their debt levels. The global process of debt reduction has a long way to run and concerns about the sustainability of government debt, the strength of banking systems and economic growth are likely to continue to create periodic bouts of turbulence in financial markets for some time to come.

In contrast to the weak and fragile recovery in the major developed economies, growth in China and east Asia has been solid. Income growth in the region has led to its increased importance as an export destination and has helped lift New Zealand's terms of trade to their highest level in 37 years. Despite an easing in the short term, the terms of trade are expected to remain elevated over the forecast period, providing a significant boost to nominal GDP. But history shows that commodity prices are volatile and, particularly in the current environment, the risks of a more significant fall than forecast here are substantial.

In New Zealand, as elsewhere, fiscal support for the economy will be withdrawn and a return to surplus is expected in the year ending June 2015. Monetary conditions are also expected to tighten as output expands and spare capacity is used up. However, the speed of the tightening process is conditional on the strength of world economic growth – slower world growth could delay the start of the tightening cycle.

For households in New Zealand, the rise in unemployment, combined with falls in asset prices and losses in wealth, has contributed to a change in saving behaviour: household saving is positive for the first time in more than a decade and the household debt-to-income ratio is declining. The change in behaviour is expected to be enduring and to result in lower consumption growth relative to that experienced over the past decade.

The rebuild following the Canterbury earthquakes provides an internal driver of growth that offsets the negative impact coming from abroad. Much of the rebuild cost is met from insurance claims, which means that progress is largely independent of the state of the world economy. Recent information has led us to revise our estimates of the damage to

$20 billion from our initial estimate of $15 billion. As a consequence the rebuild will be larger and take longer than assumed in the *Budget Update*.

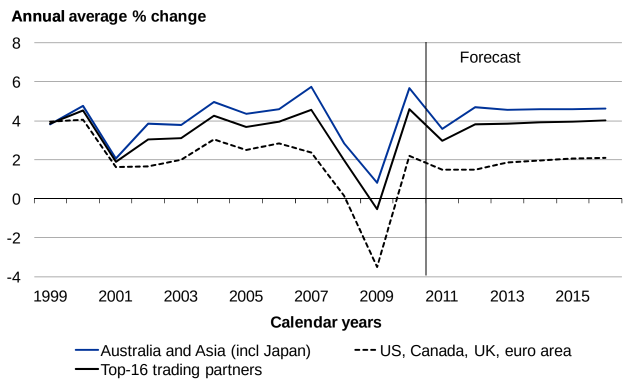
The Treasury's view of the most likely path for the economy over the forecast horizon is based on judgements around the impact of each of these forces and their interaction. However, in the current environment of heighted uncertainty, the range of plausible outcomes is wide. The Risks and Scenarios chapter presents a view based on a weaker outlook for the world economy.

Economic Outlook

Trading partner growth is slowing

In recent months the outlook for the world economy has deteriorated. In Europe, concerns about public debt, the stability of the financial system and the slowdown in growth have generated considerable volatility in global financial markets. Growth in the United States has also weakened and forecasts of growth in both regions have been reappraised as business confidence has faded and financial market volatility has increased. Euro area growth is forecast to slow to 0.9% in calendar year 2012, and forecast growth in the United States of 1.8% in 2012 is up only marginally from 2011 (see box on page 9).

Figure 1.1 – Trading partner growth



Sources: IMF, Consensus Forecasts, The Treasury

Our forecasts assume that European governments implement measures to manage the region's debt issues and stabilise financial markets, and that additional fiscal stimulus is adopted in the United States in 2012, while recognising the need for consolidation over the medium term. Weaker demand in these economies is expected to flow through to slower export growth in other countries. How substantive these flow-on impacts will eventually be is difficult to gauge and there is a significant risk that trading partner growth will slow further than assumed in these forecasts. Trading partner growth of 3.0% in the year to December 2011 is forecast, down from 4.6% last year, which was boosted by cyclical factors, such as inventory rebuilding and policy stimulus. Despite the deterioration in the world outlook, trading partner growth is expected to rise to 3.8% in 2012. The increase in 2012 is largely a reflection of the recovery from temporary disruptions to output in Australia and Japan early in 2011 – growth in China slows in 2012 and growth in Other Asia is steady (see Table 1.1). The gradual recovery in the United States, United Kingdom and euro area and continued solid growth elsewhere lift trading partner growth to around 4% by 2015 (Figure 1.1).

New Zealand's trade links with Other Asia and China, in particular, have strengthened in recent years and they now take around a third of New Zealand exports. Recent data point to an easing in activity across the region and, while further moderation is expected, the rate of expansion will likely remain solid. Economies in this region have scope to use fiscal and monetary policies to stimulate demand, although there are risks to inflation and asset prices to be navigated. The reasonable rates of growth expected in this region will provide opportunities for New Zealand exporters and support for commodity prices.

Outlook for the World Economy

The outlook for the world economy is one of the main assumptions in our forecasts and also one of the major uncertainties. The greatest uncertainty is associated with the euro area sovereign debt crisis, which we expect to be resolved only gradually, with risks around key developments. The outcome of meetings of European leaders scheduled to occur between the finalisation of this text and its publication, and in the period closely following publication, could change the outlook for the euro area and the global economy. Future developments and responses will carry similar risks.

Our forecasts for economic growth in our main trading partners have been revised down from the *Budget Update* as outturns have been lower and the outlook has deteriorated (Table 1.1). While temporary factors, including natural disasters, account for some of the weaker growth to date, there is increasing acceptance that the recovery from the global financial crisis will be more protracted as household income growth is low and governments reduce debt.

Table 1.1 – Trading partner growth (calendar years)

PREFU forecasts	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
percent change	*actual*	*actual*	*actual*	*estimate*	*forecast*	*forecast*	*forecast*	*forecast*
Australia	2.6	1.4	2.7	1.7	3.5	3.2	3.2	3.2
China	9.6	9.2	10.3	9.3	8.8	8.7	8.7	8.5
United States	-0.3	-3.5	3.0	1.5	1.8	2.0	2.2	2.4
Euro area	0.4	-4.3	1.8	1.5	0.9	1.5	1.5	1.5
Japan	-1.2	-6.3	4.0	-0.7	2.3	1.5	1.4	1.4
United Kingdom	-0.1	-4.9	1.4	1.0	1.6	2.0	2.1	2.2
Canada	0.7	-2.8	3.2	2.3	2.2	2.5	2.5	2.5
Other Asia*	3.2	0.3	8.3	5.0	5.0	5.2	5.1	5.1
Trading Partners	**2.0**	**-0.5**	**4.6**	**3.0**	**3.8**	**3.8**	**3.9**	**4.0**
Consensus (October)	2.0	-0.5	4.6	3.0	3.7	3.9	4.0	4.0
IMF WEO (September)	2.0	-0.5	4.6	3.1	3.8	4.1	4.2	4.3
Pre-Election Update Downside	2.0	-0.5	4.6	2.8	1.7	3.5	3.7	3.8
Budget Update 2011 (May)	**1.9**	**-0.5**	**4.6**	**3.7**	**4.4**	**4.1**	**4.1**	**4.1**

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

Sources: IMF, Consensus Economics, The Treasury

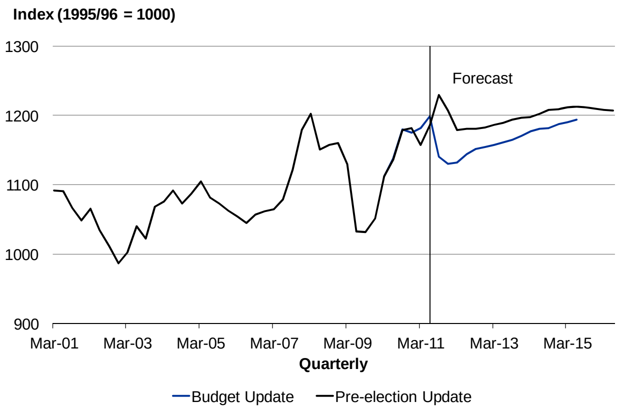
Our forecasts for trading partner growth are similar to October *Consensus Forecasts* (released after we finalised) and the IMF September *World Economic Outlook* (WEO), released just before we finalised. Our forecasts assume an orderly resolution of the euro area debt crisis, although it is acknowledged that this may take a few years to be fully resolved. Euro area growth is expected to slow to 0.9% in 2012 and to rise to 1.5% thereafter. A scenario where the euro area debt crisis is not contained is explored in the Risks and Scenarios chapter. The scenario is based on the IMF's recent WEO downside scenario, but the impact of the crisis is twice as large with trading partner output 3% below the main forecasts at the end of the period in our scenario.

The downside scenario does not envisage as sharp a downturn in the world economy as in the Global Financial Crisis (GFC) when our trading partners' output contracted. In essence, we think policy makers have learned from the GFC and are better placed to respond should financial markets become disorderly. A rapid recovery followed the GFC as authorities responded with monetary and fiscal stimulus and stocks were rebuilt. In the downside scenario presented here, growth dips to 1.7% in 2012 and remains subdued through the forecast period because authorities' ability to stimulate their economies is more limited now and households and governments still need to strengthen their financial positions.

In Australia, the terms of trade are very high, providing a substantial boost to income. Investment in the resources sector is growing strongly, contrasting with more subdued growth in the manufacturing and retail sectors of the economy. Commodity prices have fallen in recent weeks, although generally they remain high. Growth in Australia is likely to slow as the weaker outlook for developed economies flows through to Asian economies, which account for around half of Australia's exports. However, while demand growth may moderate, Australia's commodity export prices are likely to remain well supported, underpinning continued growth.

Prices for New Zealand's major export commodities increased more strongly than expected in the *Budget Update.* While they have fallen from their record highs, they have not slumped the way they did in 2008, although that is a distinct possibility, which we explore more fully in the Risks and Scenarios chapter. Our forecast of a 4% decline in the terms of trade over the coming year reflects both the weaker demand outlook and an easing of supply constraints. In the medium term, increasing emerging market incomes, combined with rising world production costs, suggest that recent gains in the terms of trade will endure (Figure 1.2).

Figure 1.2 – Merchandise terms of trade (SNA)

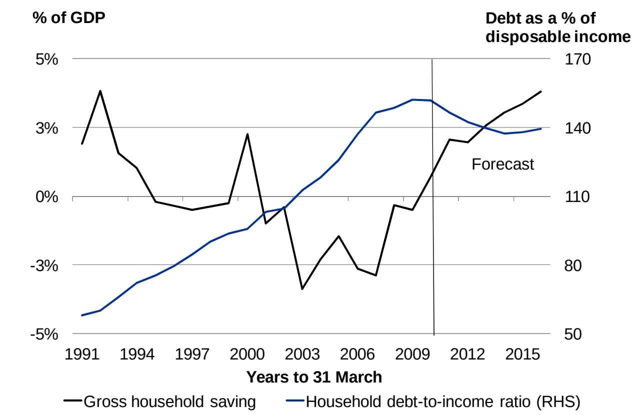


Sources: Statistics New Zealand, The Treasury

High commodity export prices have been reflected in increased profits in the agriculture sector, which have flowed through to lower agricultural sector debt. Household sector credit growth has also slowed, rising 2.0% in the past year, and with household disposable incomes growing 6.4% in the year, the household debt-to-income ratio has begun to decline (Figure 1.3). Income growth is expected to continue to exceed credit growth over the next few years, leading to further declines in this measure of household leverage.

Growth in household consumption spending has also fallen below the rate of income growth. In the year ended March 2011, the difference between income and consumption – saving – is expected to be positive for the first time in more than a decade. The change in saving behaviour is forecast to be persistent, and saving is forecast to continue rising over the forecast period. Factors behind this trend include: a desire by households to rebuild wealth lost through finance company failures and declines in financial and property values, a rise in job insecurity associated with the 2008/09 recession and changes in government policy for example, tax and KiwiSaver policies.

Figure 1.3 – Household saving and leverage



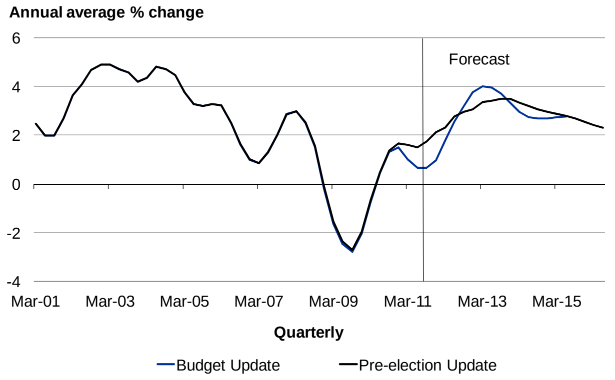
Sources: Statistics New Zealand, The Treasury

New Zealand's economic recovery continues

Economic activity over the first half of the year was disrupted by the Canterbury earthquake of 22 February and subsequent aftershocks. However, the economic disruption was not as severe as we had anticipated and real GDP is, at the end of the June quarter, higher than we forecast in the *Budget Update* (Figure 1.4). The increased strength in the economy is expected to persist over the second half of the year. Export prices are high, business confidence remains firm and the Rugby World Cup has provided some temporary support for consumption and for services exports. We expect growth of 2.3% in the year ending March 2012, up from 1.8% in the *Budget Update*.

In the year ending March 2013, growth rises to 3.4%, led by the construction work in Canterbury and the investment required to support it. Compared with the *Budget Update* growth is slower, reflecting the weaker world outlook and a more gradual pick-up in construction activity. The level of spare capacity in the economy is substantially absorbed by the middle of 2013 and growth moderates thereafter as economic growth returns to its sustainable or potential growth rate. Table 1.2 summarises our economic forecasts.

Figure 1.4 – Real production GDP



Sources: Statistics New Zealand, The Treasury

Measured in current prices, expenditure in the economy is in line with the *Budget Update* forecasts. Nominal GDP is expected to grow to $209 billion in the year ending March 2012, $2.5 billion above our *Budget Update* forecast. However, growth in the year ending March 2013 is now lower than in the *Budget Update* and GDP in current prices is $0.9 billion lower in the year ending March 2013 than it was in the *Budget Update*. In the year ending March 2015, we forecast GDP in current prices to be $0.3 billion higher than in the *Budget Update*. The cumulative impact of these revisions across the four years ending March 2015 is to raise nominal GDP by $1.7 billion.

The Canterbury rebuild will provide a significant boost to output and employment over the next few years, providing a powerful offset to the effects of the weaker world economy and, because much of the rebuild cost is met from insurance claims, there is a high degree of certainty that this activity will occur, although the precise timing of the rebuilding work is much less clear.

The earthquake rebuild is likely to take longer to begin than initially expected. This is primarily the result of continuing seismic activity in Canterbury and the implications of this activity for the reassessment of land damage and resulting building standards. So far, earthquake-related building consents remain at a low level. Nationally, the market for new houses is showing signs of a recovery from its trough. Over the past year, an estimated 12,000 to 13,000 houses were built, which is well below the 20-year average of around 22,000 houses built per year.

As well as taking longer to begin, the rebuild is expected to be larger and take longer to complete and we have revised our estimate of the extent and cost of damage up to $20 billion from $15 billion. The box on page 13 provides an update on the impacts of the

Canterbury earthquake. These revisions, combined with the cyclical rise in residential building activity, and the repair of leaky buildings, result in this sector contributing around 1.5 percentage points to GDP growth in each of the next two years to December 2013 as activity rises to its peak. A high level of activity is maintained through to the end of the forecasts.

Table 1.2 – Economic forecasts[1]

(Annual average % change, March years)	2011 Actual	2012 Forecast	2013 Forecast	2014 Forecast	2015 Forecast	2016 Forecast
Private consumption	2.0	2.1	2.2	2.9	2.9	2.2
Public consumption	3.8	1.8	-1.5	-0.2	0.5	0.7
Total consumption	**2.5**	**2.0**	**1.3**	**2.2**	**2.4**	**1.9**
Residential investment	2.3	-8.4	37.6	34.9	14.2	5.5
Market investment	5.0	1.1	-8.8	3.2	5.7	3.4
Non-market investment	7.8	8.9	9.8	10.3	4.1	-0.3
Total investment	**5.9**	**5.0**	**16.2**	**14.4**	**6.4**	**1.2**
Stock change[2]	1.4	-0.5	0.2	0.1	0.2	0.2
Gross national expenditure	**4.5**	**2.1**	**4.8**	**5.4**	**3.7**	**1.9**
Exports	1.9	2.8	2.3	1.9	1.7	1.8
Imports	10.5	3.6	6.1	8.0	4.3	0.7
GDP (expenditure measure)	**1.9**	**2.0**	**3.2**	**3.3**	**2.8**	**2.4**
GDP (production measure)	**1.6**	**2.3**	**3.4**	**3.3**	**2.9**	**2.4**
Real GDP per capita	0.5	1.5	2.6	2.4	1.9	1.5
Nominal GDP (expenditure measure)	5.7	5.5	4.7	5.8	5.1	4.5
GDP deflator	3.7	3.5	1.5	2.4	2.2	2.1
Output gap (% deviation, March year)[3]	-0.7	-0.8	-0.2	-0.1	-0.1	-0.2
Employment	1.2	1.8	1.5	1.5	1.4	1.3
Unemployment[4]	6.5	5.8	5.2	4.9	4.7	4.7
Nominal wages[5]	2.6	4.0	3.3	4.2	4.1	4.0
CPI inflation[6]	4.5	2.8	2.2	2.4	2.5	2.7
Merchandise terms of trade[7]	9.9	3.2	-1.4	1.0	1.1	0.3
Current account balance						
$billion	-7.2	-5.0	-7.9	-12.6	-15.6	-17.6
% of GDP	-3.6	-2.4	-3.6	-5.4	-6.4	-6.9
Net international investment position						
% of GDP	-68.7	-68.6	-69.1	-70.8	-73.8	-77.6
TWI[8]	67.2	70.0	70.1	69.6	67.2	63.3
90-day bank bill rate[8]	3.0	2.9	3.7	4.3	5.0	5.3
10-year bond rate[8]	5.6	4.4	4.6	5.0	5.2	5.4

Notes:
1 Forecasts finalised 26 September
2 Contribution to GDP growth
3 Estimated as the percentage difference between actual real GDP and potential real GDP
4 Household Labour Force Survey, percent of the labour force, March quarter, seasonally adjusted
5 Quarterly Employment Survey, average ordinary-time hourly earnings, annual percentage change
6 Annual percentage change
7 System of National Accounts (SNA) basis, annual average percentage change
8 Average for the March quarter

A longer time series for these variables is provided on page 118.

Sources: Statistics New Zealand, Reserve Bank of New Zealand, The Treasury

Economic and Fiscal Impacts of the Canterbury Earthquakes

This box summarises the economic and fiscal impacts of the Canterbury earthquakes that have been incorporated in the *Pre-election Update*, particularly the changes since the *Budget Update*.

Disruption to economic activity has been less than anticipated ...

Activity has been more resilient to the earthquakes than we expected. Real GDP rose 0.9% in the March quarter against our *Budget Update* expectation of a 0.3% fall. The impact was also less than for the natural disasters in Australia and Japan, where real GDP fell around 1% in the March quarter. But these disasters were different in nature from the Canterbury earthquakes and, crucially, affected exports. Goods exports were affected little by the Canterbury earthquakes as the primary and manufacturing sectors were relatively unscathed. Tourism and international education were affected significantly, but the full impact was not picked up in GDP until the June quarter. The smaller amount of disruption also meant less of a bounce back in subsequent quarters.

... but damage estimates are higher, partly owing to continuing aftershocks ...

Our estimate of the damage caused by the earthquakes in Canterbury has increased to $20 billion from $15 billion in the *Budget Update*. The bulk of the upward revision occurred for residential dwellings and reflects higher estimates of damage in the February event and the inclusion of damage from aftershocks since the *Budget Update*, particularly those on 13 June. As in the *Budget Update*, this remains a working assumption with much uncertainty.

Table 1.3 – Estimates of the damage caused by earthquakes (NZ$ billion)

	Residential	Commercial	Infrastructure	Total
Budget Update	9.0	3.0	3.0	15.0
Pre-election Update	13.0	4.0	3.0	20.0

Source: The Treasury

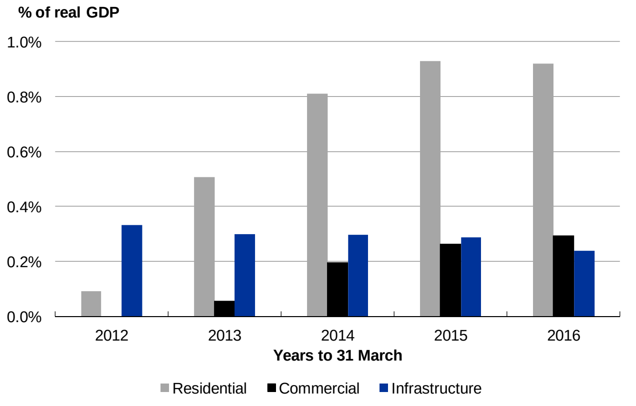
The damage estimates represent damage on property, contents and infrastructure valued at current prices. They do not include business disruption or additional costs from inflation, insurance administration or rebuilding to higher standards than existed before the earthquakes. These costs are important and their inclusion could lift the total cost to $30 billion or more. For example, incorporating inflation raises these estimates by over 20% within the forecast period, with a peak in residential construction cost inflation of around 7% per annum in 2013. The Balance of Payments estimate of $12.5 billion in reinsurance claims includes the impact of the wider insurance costs. These estimates may be revised higher over time as more information comes to hand. Adding the Balance of Payments estimate to the $7.5 billion from EQC's liability already gives an insurance cost of around $20 billion. Compared to the *Budget Update*, the treatment of reinsurance has been changed by Statistics NZ from the current to the capital account.

... and the amount of rebuilding will be higher, although somewhat delayed

We now assume investment related to the earthquakes will not start in earnest until the second half of 2012. This represents a delay of six to nine months compared with the *Budget Update*. The delay is the result of a further significant earthquake on 13 June and continuing seismic activity, which in turn has implications for the reassessment of land damage and building code requirements.

Higher damage estimates flow through to more investment in the forecast period, but this investment is less than it could have been owing to this delay, the nature of the extra damage (some of it is to land), and the capacity of the building industry.

Figure 1.5 – Canterbury rebuild profile



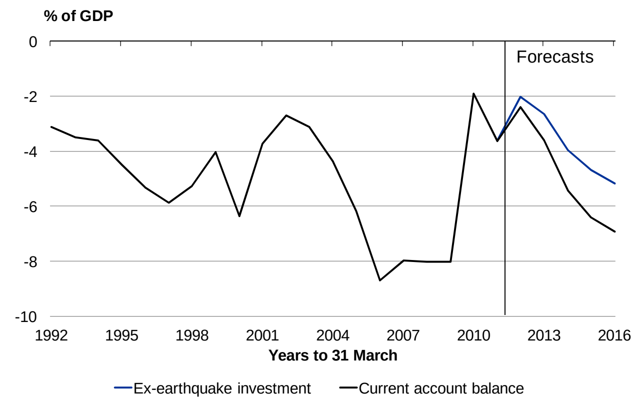
Source: The Treasury

Wider impacts on the economy

Investment related to the earthquakes contributes around 2 percentage points of the rise in gross national investment from around 20% of GDP in the March 2011 year to over 26% of GDP in the March 2016 year. Although gross national saving is also expected to rise, it is not expected to keep pace with investment. The excess of investment over saving is reflected in the annual current account deficit widening to 6.9% of GDP in the March 2016 year.

Excluding earthquake-related investment, the current account deficit would rise to about 5% of GDP. Beyond 2016, when the rebuilding in Canterbury winds down, and assuming the exchange rate depreciates as in our forecasts, the current account deficit would be expected to return to more sustainable levels of around 4% of GDP.

Figure 1.6 – Current account balance



Sources: Statistics New Zealand, The Treasury

Fiscal impacts

The Canterbury earthquakes will continue to have a significant impact on the Government's fiscal position over the next few years. At the time of the *Budget Update* the estimated total cost (including Earthquake Commission (EQC) insurance costs) was $8.8 billion spread over the next six years. A large portion of this expenditure ($3.2 billion) was unallocated, pending future decisions or additional costs of current obligations or decisions.

The costs of insurance have increased and are reflected in higher payments to foreign reinsurers and a larger current account deficit. There may also be a long-term impact on the level of economic activity as a result of the earthquake (eg, lower services exports and the diversion of resources into the construction sector).

The estimated total net cost to the Crown is now estimated to be $13.5 billion (Table 1.4). The majority of the increase since the *Budget Update* is in relation to insurance costs incurred by the EQC.

Table 1.4 – Forecast earthquake expenses (impact on the operating balance before gains and losses)

Year ending 30 June	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**Total**	***Budget***
$million	**Actual**	**Forecast**	**Forecast**	**Forecast**	**Forecast**	**Forecast**	**Forecast**	***Update***
Local infrastucture	160	883	128	128	128	128	1,555	*1,162*
State-owned assets	46	16	15	-	-	-	77	*85*
Welfare support and emergency services	363	116	27	27	21	-	554	*521*
AMI insurance contingency	335	-	-	-	-	-	335	*500*
Red Zone properties	653	194	-	-	-	-	847	*-*
Other costs	36	1,336	115	58	62	7	1,614	*-*
Yet to be allocated	-	270	120	45	45	45	525	*3,239*
Canterbury Earthquake Recovery Fund	**1,593**	**2,815**	**405**	**258**	**256**	**180**	**5,507**	***5,507***
EQC	7,471	225	156	125	-	-	7,977	*3,050*
ACC	7	-	-	-	-	-	7	*181*
Other SOEs and CEs	16	-	-	-	-	-	16	*40*
Total Crown	**9,087**	**3,040**	**561**	**383**	**256**	**180**	**13,507**	***8,778***

Source: The Treasury

Costs in relation to the Canterbury Earthquake Recovery Fund are still expected to reach $5.5 billion. Although significant expenditure uncertainties remain, a number of expenditures have now been identified and estimated (eg, the purchase of Red Zone properties), reducing the amount set aside as “yet to be allocated”. As a result, no additional funding is required in the *Pre-election Update* (Table 1.5).

Table 1.5 – Funding sources

Year ending 30 June	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**Total**	***Budget***
$million	**Actual**	**Forecast**	**Forecast**	**Forecast**	**Forecast**	**Forecast**	**Forecast**	***Update***
Absorbed by reprioritising within baselines	156	381	-	-	-	-	537	*537*
Budget 2010 contingency	64	135	-	-	-	-	199	*199*
Budget 2011	1,373	2,299	405	258	256	180	4,771	*4,771*
Canterbury Earthquake Recovery Fund	**1,593**	**2,815**	**405**	**258**	**256**	**180**	**5,507**	***5,507***
EQC	7,471	225	156	125	-	-	7,977	*3,050*
ACC	7	-	-	-	-	-	7	*181*
Other SOEs and CEs	16	-	-	-	-	-	16	*40*
Total Crown	**9,087**	**3,040**	**561**	**383**	**256**	**180**	**13,507**	***8,778***

Source: The Treasury

The timing of expenditure has also changed since the *Budget Update*. Earthquake spending for the year ended June 2011 was $1.2 billion less than forecast. It is now expected that these expenses will occur over the forecast period.

The forecasts for the Canterbury Earthquake Recovery Fund include a number of pending decisions and possible eventualities that may result in additional costs to the Crown and the Fund being exceeded. Examples of these risks are outlined in the Fiscal Risks chapter (page 57). To the extent that costs exceed those included in these forecasts, there will be an adverse impact on the fiscal position.

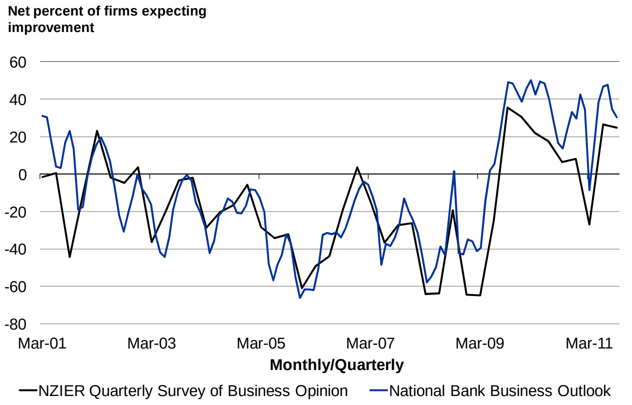
Employment will continue to expand …

Employment grew 1.7% in the year ended June 2011 and is expected to continue expanding at a similar pace over the year ahead. The recovery in the economy, combined with reconstruction in Canterbury, helps the unemployment rate to fall from a little under 6% at the start of 2012 to under 5% by the end of 2013. As the degree of spare capacity in the labour market reduces and firm profitability returns to more normal levels, wage growth is also expected to recover, rising from the current rate of around 3% per year to around 4% per year from 2014.

… and business confidence remains positive

Measures of business confidence have eased recently, although confidence remains high, suggesting that firms think the impact on New Zealand's growth from the weaker world economy may be mild (Figure 1.7). The recovery in business confidence from the lows of the 2008/09 recession has been reflected in higher business investment and business credit growth. Provided that downside risks to the world economy do not transpire and undermine confidence, business investment is expected to increase 8.9% in the year ending March 2012.

Figure 1.7 – Business confidence



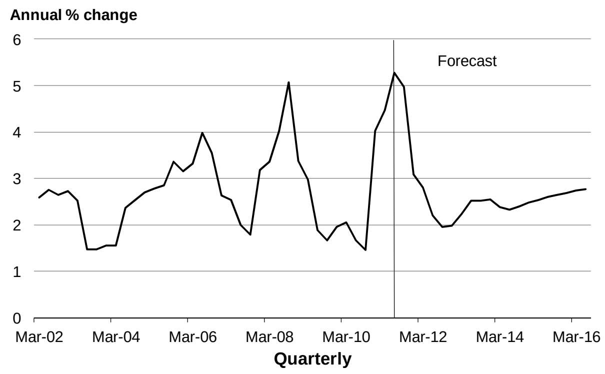
Sources: NZIER, ANZ/National Bank

Strong exporter incomes and the expected increase in both residential and non-residential construction help to sustain business investment growth of around 10% per year until 2014, when construction activity peaks. As the impulse from the earthquake fades, investment growth slows.

Inflation expected to ease

Annual Consumers Price Index (CPI) inflation likely peaked at 5.3% in the June 2011 quarter (Figure 1.8). Although CPI inflation is expected to ease in the September 2011 quarter, high food price inflation, rising insurance and house-building costs contribute to a still-elevated annual inflation rate of 5.0% in the quarter. In the December 2011 quarter the one-off impact from the GST increase falls out of the annual CPI calculation and inflation is forecast to fall to 3.1%. Over 2012 inflation eases further reflecting the impacts of the stabilisation and subsequent easing of international prices for food and the more general effects of the rise in the exchange rate over the middle of 2011. The weakening in tradables inflation provides some offset to rising domestic sources of inflation associated with a general tightening in capacity across the economy and inflationary

Figure 1.8 – Consumers Price Index

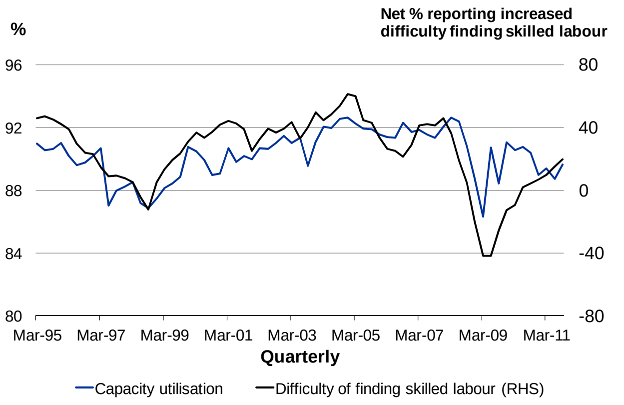


Sources: Statistics New Zealand, The Treasury pressures from the construction sector in particular. Towards the end of the forecast horizon, the falling exchange rate contributes to rising inflation.

Spare capacity will be absorbed …

Most indicators of resource utilisation show that spare capacity in the economy has fallen from its recessionary highs but that resource utilisation remains below its normal or average level. For example, survey measures of capacity utilisation and difficulty finding skilled labour produced by the New Zealand Institute of Economic Research (NZIER) have risen but remain below historical averages (Figure 1.9). Similarly, the level of unemployment has fallen but is still relatively high. Other measures of spare capacity in the economy, such as the output gap used in these forecasts, also show the economy's resources are less than fully employed.

Figure 1.9 – Capacity measures



Source: New Zealand Institute of Economic Research

Slack in the economy is drawn in over the next two years or so as growth picks up. Labour demand will increase, but initially increased output will be reflected more in the intensity of capital and labour use, rather than in hours worked or employment. Labour productivity (measured using hours worked) is forecast to grow 2.2% in the year to March 2013 but to slow thereafter, as firms take on more staff and output growth slows, in part a reflection of growth in the relatively labour-intensive construction sector. Over the forecast period labour productivity grows at an average rate of 1.5% per year.

Estimates of how fast the economy can grow without running into resource constraints depend on judgements around growth in the capital stock and whether the economy can supply labour to the parts of the economy that need it. Over the forecast period we judge the sustainable or potential growth rate of the economy to be around 2.5% per year or around 1.5% per year on a per capita basis.

… leading to tighter monetary conditions …

These judgements around spare capacity and potential growth inform our assessment of inflationary pressure in the economy and the pace at which monetary stimulus is withdrawn, but other factors are also important. For example, the period of easier monetary conditions following February's earthquake has been extended as global financial and economic risks have increased. The pace at which interest rates rise over the forecast period is conditional on the outlook for inflation – a larger slowdown in the world economy would likely see a longer period of low interest rates (the Risks and Scenarios chapter provides further detail). Also important is our assumption that price rises induced by the Canterbury rebuild do not cause a material shift in medium-term inflation expectations. There are some initial signs of rising inflation in the construction industry, which we forecast to increase to around 7% over the next two years or so, and there is a risk that competition for labour and materials between construction-related industries and other parts of the economy generates greater inflationary pressures than assumed here.

… and tighter fiscal policy

Fiscal policy has also been supporting activity in the recovery from the 2008/09 recession and in the aftermath of the Canterbury earthquakes. The government's fiscal plans, announced in the 2011 *Budget*, see this support progressively unwound. Over the next few years, government revenue growth outstrips expense growth and the operating balance deficit narrows and is replaced by surpluses in the year ending June 2015. The withdrawal of fiscal stimulus helps to moderate the inflationary pressures arising from greater resource utilisation and allows for a more gradual pace of monetary tightening.

In the national accounts, the reduction in fiscal stimulus is reflected in a falling share of government consumption in GDP and, as a result of changes to government transfers, slower private consumption growth. The level of government consumption spending has been boosted by a number of one-off expenditure items in recent quarters, including the Canterbury earthquake, imports of spare parts for the Airforce and costs associated with the reorganisation of local government structures in Auckland. These one-offs, combined with data revisions, result in weaker public consumption growth going forward than forecast in the *Budget Update.*

New Zealand dollar to remain high

The New Zealand dollar has come off its recent peaks as growing uncertainty in the world economy has led markets to reassess New Zealand's growth prospects, but it remains high relative to most of New Zealand's post-float experience. Credit rating agencies have also reconsidered the sustainability of New Zealand's international debt position and the subsequent downgrade of New Zealand's foreign currency credit rating contributed to a further weakening in the currency. However, the economic outlook for New Zealand is more positive than in many advanced economies, which is expected to provide support for the New Zealand dollar over 2012 and 2013.

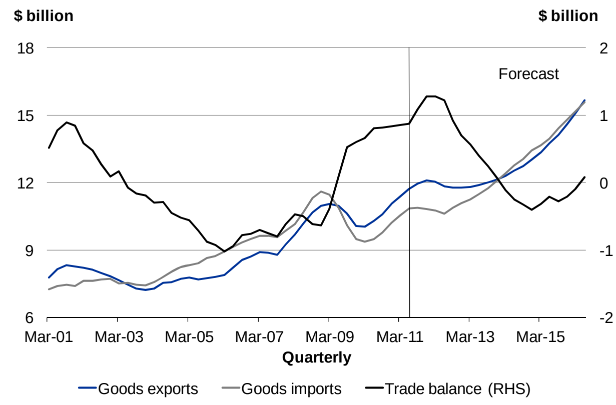
Long-run interest rates lower

The credit rating downgrades, which occurred after these forecasts were finalised, also increased long-term interest rates, which impact directly on government debt servicing expenses. We estimate the downgrade increased long-term yields by around 15 basis points. This relatively muted impact likely reflects the backdrop of downgrades in a number of countries in recent months. Despite the downgrades, long-term interest rates in New Zealand and around the world have fallen since the *Budget Update*, reflecting the weaker world economy. Long-term bond yields remain close to their average rate over the past three months or so, suggesting that our forecast for 10-year bond rates of 4.4% in the December quarter, rising to 5.4% by March 2016 remains broadly appropriate.

Current account deficit to widen

The high exchange rate, combined with weaker export demand, is expected to result in export receipts falling in the year ending March 2013 compared to the March 2012 year. At the same time, the domestic recovery, driven by the rebuild in Canterbury, is forecast to increase import payments. As a consequence, the surplus on the goods balance in the Balance of Payments is forecast to become a small deficit in the year ending March 2014, contributing to a current account deficit of 5.4% of GDP in that year. The deficit on the goods balance begins to reverse after March 2015, as the falling exchange rate boosts export receipts (Figure 1.10). However, the current account deficit continues to widen, reaching 6.9% of GDP in March 2016, driven by increasing debt servicing costs as international interest rates rise and profit outflows increase (Figure 1.11).

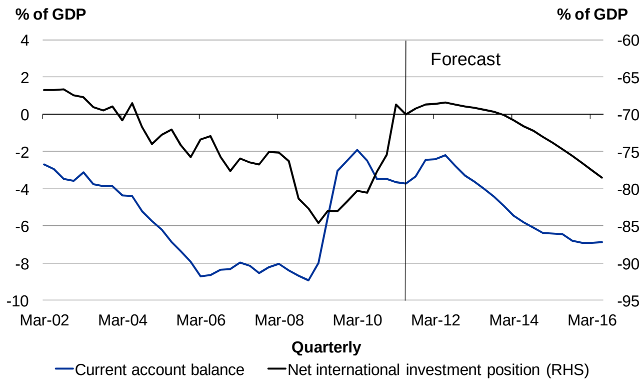
Figure 1.10 – Exports and imports



Sources: Statistics New Zealand, The Treasury

The widening of the current account deficit is reflected in the rising net liability position, which increases from 68.7% of GDP in March 2011 to 77.6% of GDP in March 2016 (Figure 1.11). However, in contrast to the period of high current account deficits in the mid-2000s, household and national saving is forecast to rise. The wider deficit and larger net debtor position therefore reflect higher investment spending, driven by the rebuild in Canterbury and by businesses, rather than consumption spending by households. The deficit is expected to stabilise as the Canterbury rebuild winds down.

Figure 1.11 – Current account and net IIP



Sources: Statistics New Zealand, The Treasury

Goods export volume growth slowed to 2.5% in the year ended June 2011 from the recovery-driven 6.5% in the previous year. At the same time services exports, including tourism, have been declining, with a significant drop in visitor numbers in the wake of the Canterbury earthquakes. Total export volume growth is expected to rise from 1.5% in the year ended June 2011 to 2.8% in the year ending March 2012, reflecting stronger commodity goods volumes and a rise in tourism from the Rugby World Cup. Further out, export volume growth, particularly for non-commodity goods and tourism, is restrained by the weaker world outlook.

Goods import volumes grew 11.6% in the year ended June 2011 driven by the recovery in business investment. However, import growth has trended lower over the first six months of the year and is expected to continue to weaken over the next few quarters before rising as the earthquake rebuild gets underway. Services imports have also been growing strongly, up 6.3% in the year ended June 2011, reflecting in part the high number of overseas trips taken by residents. Overall, real import volume growth is expected to ease to 3.6% in the year ending March 2012 but to rise to 8.0% in the year ending March 2014 as the Canterbury rebuild draws in imports.

The strength in import volume growth relative to exports means that net exports do not make a positive contribution to GDP growth until the final year of the forecasts.

Economic Forecast Assumptions

Earthquake – Details of the economic and fiscal impacts are discussed in the box on page 13 in chapter 1.

Trading partner growth – The economies of New Zealand's top-16 trading partners are expected to grow 3.0% in 2011, 3.8% in both 2012 and 2013, 3.9% in 2014 and 4.0% per annum thereafter. These are a cumulative 2% lower than in the Budget forecasts and similar to growth rates in the *Consensus Forecasts* report for October 2011.

Global inflation and interest rates – Annual inflation in the G3 countries (United States, Japan, euro area) falls from 2.0% in the June 2011 quarter to 1.5% in the December 2012 quarter and remains close to this rate over the forecast period. Short-term interest rates in the G3 begin to rise from their current rate of 0.6% in late 2013, reaching 2.4% in the June quarter 2016. G3 long-term interest rates begin to rise from their current rate of 1.9% in late 2012 to 3.1% in the June 2016 quarter.

Oil prices – The average price of West Texas Intermediate (WTI) oil rises from around US$87/barrel in the December 2011 quarter to US$93 in the June 2016 quarter. This projection is based on a monthly average of futures prices from the New York Mercantile Exchange recorded on 19 September 2011.

Terms of trade – The merchandise terms of trade, as measured in the System of National Accounts (SNA), are estimated to fall 4% over the year to September 2012 as commodity export prices fall from recent highs. The terms of trade remain higher than in the *Budget Update* owing to a higher starting point and offsetting weakness in merchandise import prices.

Monetary conditions – The New Zealand dollar Trade Weighted Index (TWI) exchange rate falls from 72.0 in the September 2011 quarter to 70.0 in the December quarter, holding there throughout 2012 and 2013. From 69.6 in March 2014, the TWI falls to 62.3 in the June 2016 quarter. Ninety-day interest rates are forecast to rise from 2.8% in the September 2011 quarter to 5.3% by the end of the forecast period.

External migration – The net inflow of permanent and long-term migrants of 2,300 in the year ending August 2011 becomes a net outflow of 1,000 in the year ending March 2012 as a result of the recent rise in departures to Australia (where labour market conditions have been stronger) and the impact of the Canterbury earthquakes. Additional activity related to the earthquake rebuild supports a rebound in net migration to 15,000 in the year ending March 2014 before settling at our long-run assumption of 10,000 in the year ending March 2016.