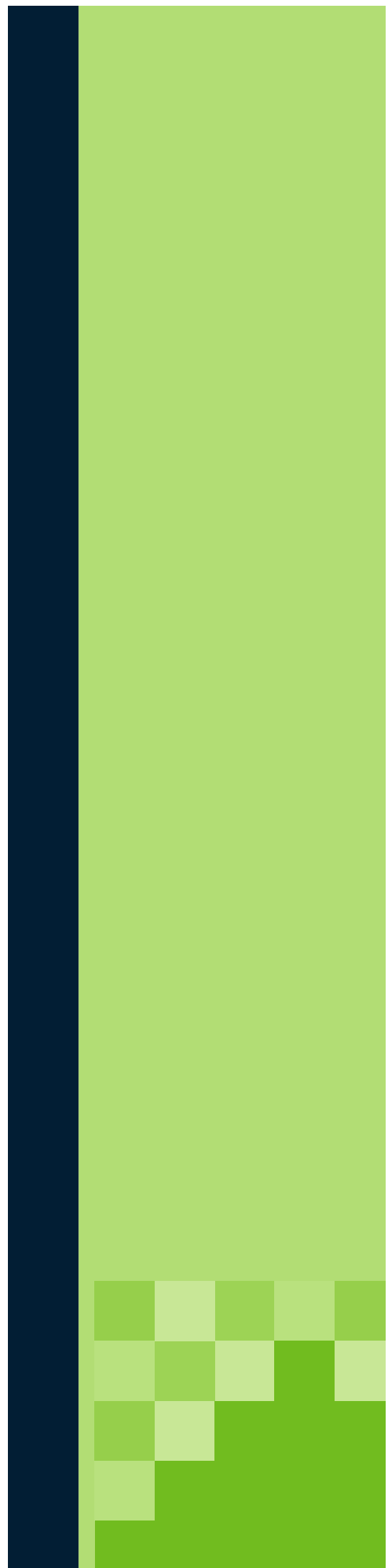


economic forecasts

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1.	Forecast Story	4
	Confronting the demons of past excesses	4
	Wages punching above their weight	5
	Mind the Bollard.....	5
	Second wind or last gasp for housing?	6
	Pressure showing on external safety valve.....	6
	Election year: quick, everybody to the centre	7
2.	Household Forecasts	8
	As good as it gets?	8
	Labour supply lets us down easy	8
	Unemployment, what unemployment?.....	10
	Sticky wages come unglued.....	11
	Galloping consumption.....	13
3.	Business Issues Forecasts	16
	Budgeting for growth.....	16
	Getting better all the time	16
	The coming wage-price squeeze	17
4.	Financial Markets Forecasts	20
	Inflationary effects of an endless expansion	20
	Bank keeps a firm grip.....	22
	A strong economy, a strong currency	23
5.	Fiscal Forecasts	26
	Lies, damned lies, and the fiscal position.....	26
	Helen, I shrunk the surplus.....	26
	More than just tilting at windmills?.....	29
6.	External Forecasts	32
	Pushing our luck	32
	How bad is it?	32
	The current account – when will it matter?.....	33
	Exports – signs of fatigue	34
	Importing more for less.....	36
7.	International Forecasts	37
	In pretty good shape	37
	The American upturn matures.....	37
	Japan’s flirtation with growth ends	38
	Australia avoids a housing collapse	40
	Europe’s exchange rate squeeze.....	40
	Weaker house prices and more tax for Britons	41
8.	Household Articles	45
	The stocks and the flows of our population	45
	Part one	45
	Part two	49
9.	Business Issues Articles	54
	What the government can do to improve productivity.....	54
	Please participate	56
	Women in work.....	56
	More work, worse lives?.....	56



10.	Financial Markets Articles.....	58
	Who ends up forking out for your pay increase?	58
	Boosting expectations.....	58
	Good times are for passing the buck.....	58
	Summary	59
11.	Fiscal Articles	60
	The taxing question of redistribution	60
12.	External Articles	64
	Scaling the Great Wall	64
	Facts and figures	64
	The rationale for an FTA.....	64
	Winners and losers	65
	Our concerns	66
	Conclusion	66
	Outsourcing manufactured exports	67
	Conclusion	69
	Terms of trade magic.....	70
13.	International Articles.....	72
	Korea's credit card hangover	72
	A mixed outlook	73
	Effects for New Zealand	73

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Summary of March 2005 forecasts

Annual average percentage changes

<i>March years</i>	Average 1995-2004	2002/03	2003/04	2004/05 Forecast	2005/06 Forecast	2006/07 Forecast	Forecast Average
Real expenditures							
Private consumption	3.8%	4.6%	5.6%	5.2%	3.3%	3.3%	3.9%
Government consumption	2.8%	2.5%	3.1%	8.3%	5.7%	3.5%	5.8%
Private investment	6.3%	10.4%	15.2%	9.9%	4.2%	2.8%	5.6%
Government investment	9.2%	-4.9%	6.8%	4.2%	2.7%	2.2%	3.0%
Inventories (1)	0.0%	-0.5%	0.2%	0.2%	0.0%	0.0%	0.1%
Gross national expenditure	4.2%	4.2%	7.2%	6.8%	3.8%	3.1%	4.6%
Exports of goods and services	4.6%	7.6%	1.0%	5.6%	5.2%	5.4%	5.4%
Imports of goods and services	6.6%	7.4%	11.9%	13.4%	7.5%	6.1%	8.9%
Gross domestic product	3.5%	4.3%	3.4%	4.3%	3.3%	2.8%	3.4%
Production-based GDP	3.4%	4.6%	3.6%	4.4%	3.3%	2.8%	3.5%
Nominal GDP	5.4%	3.9%	6.3%	7.9%	6.3%	6.1%	6.8%
Operating surplus - private	8.0%	-2.2%	8.0%	7.8%	5.2%	8.8%	7.3%
Priv. Investment (% of GDP)	18.0%	19.3%	21.4%	21.9%	22.0%	22.1%	22.0%
Households							
HLFS employment	2.3%	2.4%	2.7%	3.5%	2.1%	1.3%	2.3%
HLFS unemployment rate (2)	6.4%	5.1%	4.5%	3.6%	3.1%	3.5%	3.4%
Labour productivity	1.1%	1.2%	1.2%	-0.2%	0.8%	2.1%	0.9%
Hourly wage	2.8%	2.8%	3.4%	3.3%	4.0%	4.6%	4.0%
Real disposable income	2.3%	-2.1%	4.8%	4.9%	2.4%	2.3%	3.2%
CPI (3)	2.0%	2.5%	1.5%	3.1%	3.0%	3.1%	3.1%
Budget balance, \$m (4)	2,680	1,966	7,424	6,411	6,711	6,261	6,461
Govt spending (% of GDP) (4)	n/a	42.3%	37.8%	39.3%	39.1%	39.3%	39.2%
External sector							
Current a/c balance (\$bn)	-4,870	-4,330	-6,328	-9,352	-8,671	-9,765	-9,263
as % of GDP	-4.7%	-3.4%	-4.6%	-6.3%	-5.5%	-5.8%	-5.9%
Financial (annual average rates)							
Exchange rate - TWI; level	58.5	56.4	63.6	66.9	66.4	67.2	66.8
Annual % change	1.4%	12.3%	12.7%	5.3%	-0.8%	1.2%	1.8%
International bond rate	4.8%	3.6%	3.4%	3.6%	3.5%	3.8%	3.6%
plus NZ risk premium	2.1%	2.8%	2.5%	2.5%	2.8%	2.5%	2.6%
NZ interest rates - bonds	6.9%	6.4%	5.8%	6.1%	6.3%	6.3%	6.2%
less bills	6.8%	5.9%	5.3%	6.5%	6.6%	6.1%	6.4%
yield gap	0.0%	0.5%	0.5%	-0.3%	-0.3%	0.2%	-0.1%

(1) Contribution to GDP growth

(2) Annual average for year ended

(3) March on March, CPI ex credit prior to June 99

(4) June years

These forecasts are based on GDP figures produced by Statistics NZ to September 2004, and other data available to 25 February 2005.

The source for all data in this publication, unless otherwise stated, is Statistics NZ.



1. FORECAST STORY

Confronting the demons of past excesses

New Zealand economic boom has produced a growing list of economic imbalances that threaten to derail the growth process. The economy is running beyond capacity, and this is showing itself through faster inflation, increasingly severe labour shortages, a blow-out in the current account, and a marked decline in housing affordability. Although these imbalances will weigh down the growth process, we do not see them becoming triggers for a dramatic change in average growth – we expect growth will linger in the vicinity of 3%pa.

It has been said that things that can't go on forever don't. New Zealand is recording some of its best economic growth since the 1960s (on a 5-year average basis). But after so many years of above-potential growth, we are running out of capacity – motorway gridlock, power crises and an unreliable rail system. The most serious concern is that firms will raise their selling prices in response to demand in excess of their capacity to deliver (increasingly common in the building industry).

That is increasingly visible in rising inflation, which has so far only been kept under 3%pa by an appreciating dollar. But demand pressures are also creating imbalances in other areas of the economy:

- Employment growth is outstripping labour supply. Wage pressure is the logical consequence.
- The current account deficit, at 5.8% of GDP, is entering the danger zone for foreign investor confidence.
- The housing cycle has reached the stage where new building is outpacing demand growth, and price rises are putting home ownership out of reach for many.

In our last economic forecasts we signalled our conviction that New Zealand was entering a new phase of economic growth: a faster and more sustainable underlying band of growth. We are currently operating at the upper extreme of the band and the economy is clearly out of kilter in a number of areas.

Addressing the imbalances will eventually result in economy growth slowing from 4.4%pa in 2005 to 3.3% in 2006, and 2.8% the following year:

- Higher interest rates are the first step to bringing consumption and investment under control, but they are slow-acting instruments. With inflation threatening, the Bank will keep its foot on the brake peddle.
- We are simply running out of labour, and what is left will be increasingly expensive. Businesses will have to stop relying on labour to grow, which in many cases means not growing as fast.
- Slower population growth, and a weakening housing market, will further deflate consumption growth, while building activity will drop off.

Escaping the capacity straitjacket will involve slightly slower growth, new investment aimed at lifting productivity, a reallocation of scarce labour to more valuable tasks, a higher participation rate, and less crowding out by government. The key is to increase the efficiency with which capital and labour are used within the economy. Increasing competitiveness or contestability within the economy will be important to achieving greater productivity and capacity.

Despite slower growth to fix some speed wobbles New Zealand's economic performance will remain impressive. Households are likely to remain confident about their jobs and incomes; businesses will use sumptuous profits to invest in additional capacity; and the government stands ready to spend the surplus.

Wages punching above their weight

Two striking paradoxes have emerged from the labour market over the last year. Unemployment is at a 20-year low, and skill shortages (according to businesses) are a bigger impediment to growth than at any time since 1974, yet:

- employment growth is still accelerating;
- real wage growth is slowing.

Over the forecast period, we expect both trends to reverse. Labour force growth is slowing, and unemployment is (for all practical purposes) eliminated. This will place a natural cap on the rate of employment growth – we forecast it to fall from 3.5%pa in 2005 to 1.3% in 2007. However, we do not believe that an unemployment rate permanently in the region of 3.5% is a short-term product of a thriving economy; rather, it is a harbinger of the tight labour market conditions likely to prevail over the next 20 years.

As a result of the entrenched tightness in the labour market, we expect wages rises to make inroads into business margins. For much of the last 15 years, the opposite has been occurring, but now workers will be bargaining from a position of strength. We forecast nominal wage growth to accelerate from 3.3% to 4.6%pa over the forecast period (in real terms, from 0.7% to 1.3%pa).

Higher wages will provide an important price signal to businesses to change their strategy for long-term growth. This change is likely to involve one or more of the following:

- an increase in investment in labour-displacing or augmenting capital;
- more efficient use of existing staff;
- a shift to the delivery of higher value goods or services;
- outsourcing some production or service functions (increasingly to lower cost foreign suppliers).

Mind the Bollard

Wage inflation is not the be-all and end-all for the Reserve Bank. The Bank couldn't care less whether workers secure a bigger slice of the pie,



providing employers don't try and recoup their wage outlays through higher prices for their products.

We think that, by and large, businesses will be forced to wear a fair chunk of the increase in input prices, especially those operating in the traded goods sectors. It will only become harder to raise prices as demand growth calms down.

However, the Reserve Bank is engaged in a delicate balancing act. It has precious little margin for error, with inflation likely to become established at or above 3% over 2006 and 2007. At the same time, it wants to give the "pipeline" of tighter monetary conditions time to act – especially when raising interest rates further could push the dollar higher, exacerbating the external account imbalance.

Given the current economic momentum, we think the Bank will be pragmatic about the rate at which a slowdown should occur. As evidence emerges over the next six months of cooler activity in construction and retail, the Bank will be willing to settle for a prolonged course of higher interest rates, rather than short-term shock-treatment.

Second wind or last gasp for housing?

There is a lot of noise in the housing data at the moment, following the December quarter interest rate price war. But everything in the data is aligned against the housing market at the moment. Population growth continues to fall, while interest rate rises begin to bite.

Two years of double digit house price inflation has really stretched housing affordability, while supply of new housing is now running comfortably ahead of what we estimate to be underlying demand. Over the next three years, both these imbalances will be addressed. House price inflation will turn (slightly) negative, and residential investment will ease 19% from its peak.

However, unlike previous housing cycles, full employment, higher wage settlements and some help for first-home buyers from the government will blunt the size of the downturn and the ramifications for household wealth and confidence.

Pressure showing on external safety valve

The worsening current account deficit is not a pretty picture. The virile currency, in combination with aggressive growth in domestic spending, has stimulated demand for imports. Despite high world prices for commodities, more astute forward covering, and reasonably favourable weather conditions, exporters haven't come close to matching the thirst for imports.

The current account is now reflecting this imbalance. It leapt to 5.8% of GDP in September and we predict it will deteriorate to a trough of around 6.5% over 2005. However, we think financial markets will continue to back New Zealand's growth story, especially given that the returns for taking this risk have been handsome so far – meaning no major change in direction for the currency over the next 18 months.

The blow-out in the current account is not all bad news. The tradeables deficit is an economic safety valve: when domestic demand growth

exceeds domestic supply, businesses respond by importing substitute goods, rather than raising prices.

We expect trading partner growth to remain relatively robust at around 3.2% over the next three years, and for the currency to ease back to 57 (on a TWI basis) over 2007, underpinning faster export growth.

Election year: quick, everybody to the centre

New Zealand's triennial round of political musical chairs has begun, with the two main parties trying desperately to secure the electoral middle-ground. The Labour Party has already started this process: all its contentious legislation is out of the way, and its election year issues (productivity, labour force participation, national savings) are relatively uncontroversial.

With the economy continuing to perform well, especially in terms of jobs and wages, and with the promise of more government handouts to come (Working for Families and a fourth week of holiday) re-election should be a shoo-in for Labour. The biggest risk for Labour is that after six years, the public has become complacent about Labour in charge. Come election night, Labour could find itself losing too much ground to minor single issue parties, which could in turn result in some embarrassing policy concessions on Labour's part.

The unprecedented health of the crown accounts ensures that the next government has the fiscal freedom to spend money on almost anything it desires; but it would be in the national interest to do as little of this as possible. With capacity constraints likely to persist, more spending will be counter-productive. The next government needs to make productivity more than a political mantra by increasing allocative efficiency in the public sector, and obtaining better returns on the money it is already spending.

The new political focus on economic fundamentals makes a welcome change. After six years of "solving" social problems through spending more money, the government is now addressing aspects of the economy that contribute to our status as a "low-middle income" nation (according to OECD jargon). Relative to others, the deficit in national income is a greater shortcoming than our education, health, and crime standards. Given the pressing nature of the imbalances in capacity and national savings outlined above, it is about time these issues made the political agenda.



2. HOUSEHOLD FORECASTS

As good as it gets?

Just when it seemed that the labour market couldn't get tighter, it has. Full employment looks set to burst back onto New Zealand's economic stage, bringing faster wage inflation with it. Job security, real wage gains, and fiscal goodies mean households will keep digging deep into their wallets. For a Reserve Bank looking to rein in spending excesses over 2005, high interest rates and a quieter housing market will have to be the ticket. With population growth still easing, and further substantial employment gains unrealistic, consumption growth won't have quite the same oomph, though it will still underpin solid growth.

Labour supply lets us down easy

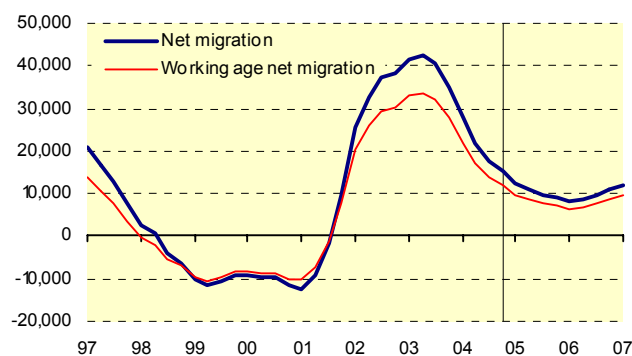
Labour force growth is set to remain relatively strong over the forecast period. After an increase of 2.6%pa in 2004/05, growth will still come in at 1.6%pa and 1.7%pa in 2005/06 and 2006/07. Migration is slowing (but only to near the long-run average) but the supply of labour will be bolstered by a lift in the participation rate and slightly quicker growth in the natural rate of increase in the working-age population.

Missing migration

Annual net migration will more than halve over the year ended March 2005, from 28,000 to 11,500, and of the 16,500 reduction in the inflow, nearly 10,000 will be of working age. New Zealanders are now becoming the main driver of the deterioration, with departures of New Zealand citizens currently up 11% (on an annual average basis).

Migration migraine

Annual totals



Graph 2.1

We have been predicting a pick-up in New Zealand departures for some time now, although we did not think it would establish itself in earnest until the strong performance of the New Zealand economy, and especially the labour market, began to wane. We have revised down our net migration forecasts for 2005/06 and 2006/07, to 8,300 and 12,000 respectively. Although we expect departures to continue to rise, three restraining factors will be:

- New Zealand businesses' appetite for labour;
- rising real wages domestically;
- moves by the British government to re-impose restrictions on New Zealanders' working holidays.

The good news for the labour market is that the decline in other arrivals (i.e. excluding New Zealanders and Australians) has been arrested, with slight increases recorded over the September and December quarters. On an annual basis, residency approvals are now rising again. But, we predict them to fall around 5,000 short of the government's target of 45,000 for the 2005 June year. Over the 2006 June year we expect approvals to meet or exceed the 45,000 target.

An increasingly large piece of the migration puzzle is temporary residents (work permits and student approvals – for more detail see *The stocks and the flows of our population – p49*). The rapid growth in work permit numbers (35% on an annual average basis over the 2004 calendar year – 22,000 permits) is a testament to employers' willingness to import labour, and the government has recently changed policy to remove or raise quotas on work permits from a number of countries. Offsetting this, however, is a declining number of student permits, and presumably a shrinking population of international students onshore.

In summary, we do not expect net migration to fall much further, but a stable outcome will hide increasing flows of immigrants and emigrants. Past research has shown that the skills of immigrants are roughly equivalent to the skills of the New Zealanders they replace. However, the increasing churn in the migration flows tends to have the effect of depositing more people in the main centres at the expense of the regions. In terms of the itinerant population of temporary residents, the exchange of student permits for work permits is driving an improvement in the quality of the labour force, even though it is not significantly affecting overall migration numbers.

Pushing participation higher

With migration no longer providing a significant boost to the working age population, more pressure will come on utilising the existing working age population via a higher participation rate. Over 2004, the participation rate rose an impressive 1.3 percentage points, or 42,000 workers, which suggests that, although it is already high, the participation rate can still respond to labour market pressures.

The December quarter Household Labour Force Survey (HLFS) probably overstated the most recent increase in participation (and employment) because of seasonal factors (most of the employment gains were for young people, presumably students on holidays). We suspect that the March release will show participation eased back 0.3-0.5 percentage points. Nevertheless, participation will continue to rise on an annual average basis from 67% to 67.6% over the forecast period – a slower rate of increase than over the last year, but still reasonable. The changing composition of temporary migration (mentioned above) will help push up the participation rate, as will rising real wages.

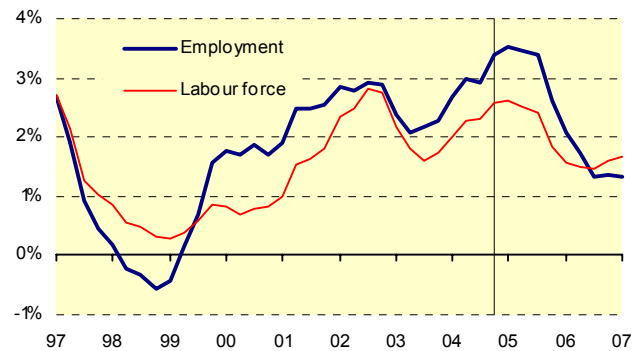
The most obvious source of further participation increases is still the female population, especially the 25-34 age bracket. Whether this is



socially desirable in the long-run is debatable, but it does provide a short-term fix. Helen Clark has targeted this as an area for action in the forthcoming budget, which will almost certainly mean larger subsidies for childcare and early childhood education.

Lapping it up

Annual average % changes



Graph 2.2

Unemployment, what unemployment?

The stark reality is that growth in the labour force is nowhere near enough to meet employers' demand for labour – employment will grow by 3.5%pa over the March 2005 year. According to the NZIER's Quarterly Survey of Business Opinion, employment intentions are at their highest level since 1973, and there is little evidence that the desire for extra staff is on the wane:

- Labour shortages are a larger constraint to expansion now than at any time since 1974.
- Persistent skill shortages have created a cut-throat market for skilled labour.
- Economic growth remains strong.
- The diminishing quality of spare labour, paradoxically, means that employers need to compensate for it with quantity.

It seems increasingly unlikely that much more labour can be wrung from the shrinking pool of unemployed people. The same observation has been made in the past as the unemployment rate fell to 6%, 5%, and 4%. The Pakeha unemployment rate reached 2.3% in the December quarter suggesting there is still some downside. Nevertheless, there are four indicators that suggest we're approaching a limit:

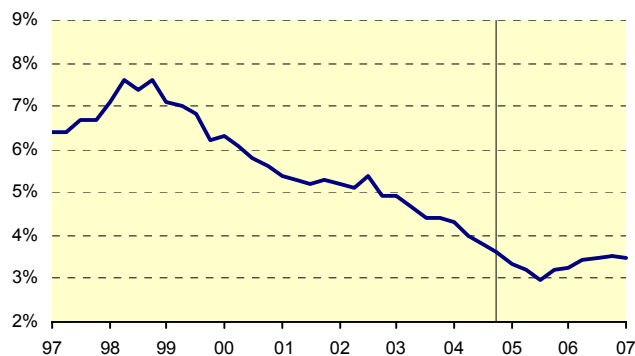
- Staff turnover rates are at 20-year highs, suggesting that poaching of staff is now commonplace. A rising turnover rate should, *ceteris paribus*, also push up the unemployment rate, and we expect turnover to continue increasing as labour becomes more aware of its "market power" (unemployed people will also be willing to spend more time searching for attractive jobs).
- Unemployment has been falling much faster for the long-term unemployed (26 weeks plus) than for the short-term unemployed.

- The real cost of labour is already rising for businesses, and will continue to do so over 2005/06.
- Employment growth in the December quarter was heavily concentrated in part-time employment (73% of the 33,000 new jobs were part-time).

Our conclusion, therefore, is that employers will largely have to settle for the employment growth they can get, rather than the employment growth they want. Employment growth will slow to 2.1% and then 1.3%pa over the March 2006 and 2007 years. This leaves room for the unemployment rate to touch 3% in the next year, but ultimately we predict it will settle at 3.5%.

Unemployment runs dry

Seasonally adjusted



Graph 2.3

Sticky wages come unglued

In our November forecasts, we expected average hourly wage growth to spike towards 4.8%pa by March 2005 (as measured by the Quarterly Employment Survey). But over the last two quarters, wages actually fell 0.1%. As a result, annual average wage growth will only be 3.3%pa over 2004/05.

While we admit to getting the timing on wage growth wrong, we see no reason to alter our expectation that faster widespread wage inflation will break out over the forecast period. We are forecasting annual average wage growth of 4% and 4.6%pa over 2005/06 and 2006/07.

Why are we sticking to our forecast of accelerating wage inflation?

- It takes a long time for labour market tightness to result in higher wages. Given that labour shortages will not peak until mid-2005, it is consistent with past experience to anticipate nominal wage growth accelerating over the entire forecast period.
- The labour market has tightened more than we had predicted and potential sources of relief are fading.
- Overtime wage rates have bolted according to the Labour Cost Index (rising 3.4%pa – an all-time high), suggesting employers are willing to pay more to obtain a short-term fix for labour shortages. Even more compelling is the unadjusted (no quality adjustment) LCI, which shows annual wage inflation of 4.8% overall, and 4.9% in the public sector.



And all official wage measures exclude any bonuses that employers use to attract labour.

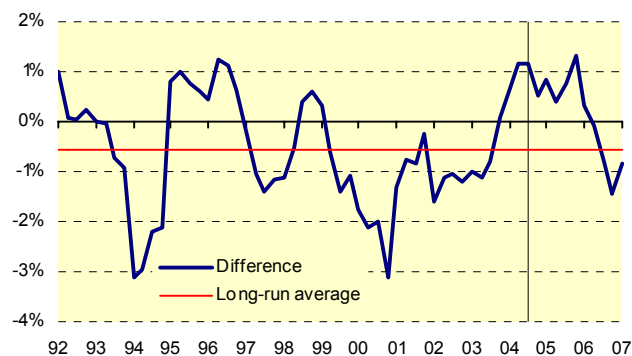
Although higher wages will put pressure on business margins, they will signal to employers to shift to less labour intensive growth strategies (see *Business Issues Forecasts – p16*).

Absorbing a wage shock

We can think of wages rises as comprising three components: a cost of living adjustment for inflation, compensation for increased labour productivity, and a bargained share of a businesses operating surplus. The first two – what we consider to be “warranted” wage increases – are not real costs for businesses.¹ However, any nominal wage increases in excess of warranted wages represent an increase in the share of operating surplus captured by labour.

Nominal wage less warranted wage

Annual average % changes



Graph 2.4

As Graph 2.4 shows, over the period 1992-2004, nominal wages were on average lower than warranted. Alternatively, national accounts data shows that compensation of employees fell from 48.5% of GDP in 1987 to 41.8% in 2002. Only in the last year has this trend started to turn around – we expect that over the 2004-2006 period workers will capitalise on the bargaining power afforded them by the tightness of the labour market to secure a large share of profits – as they did between 1995 and 1997.

However, the majority of the predicted pick-up nominal wage growth will be attributable to inflation, which will average 3%pa. Productivity growth will be slow over 2004/05 and 2005/06, which will provide a slight restraint on wage demands. When gains from productivity finally appear in the March 2007 year (2.1%pa), we expect businesses to lay claim to the benefits:

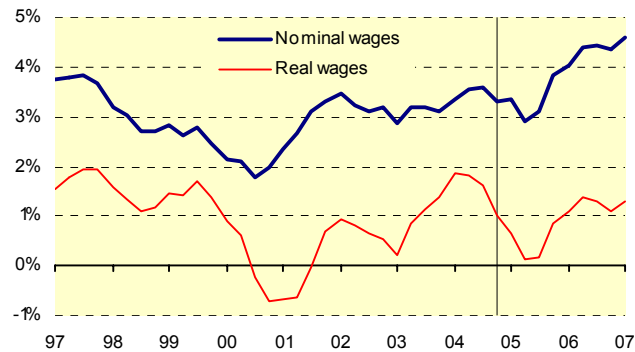
- Businesses will be seeking return on extensive capital outlays;

¹ There is a further simplification here, in that we assume that all productivity gains accrue to labour. In the current climate of very strong investment, we might expect that productivity increases are due to increased capital utilisation, and that businesses would seek to retain a greater share of profits arising from higher productivity.

- Three years of strong nominal wage increases, good real wage increases, and boosted government transfers, will largely satisfy workers' demands;
- Businesses will be adjusting to the permanently tight labour market, and be better at managing their staff without pecuniary inducements.

Incoming wage wave

Annual average % changes



Graph 2.5

Incomes

Real wage growth will be sustained over the forecast period at 0.9%pa on average, although the source of that increase will change from capturing operating surplus back to productivity increases. However, slower employment growth will start to cramp total income growth, despite lavish cash boosts from the Working for Families package.

As households start to feel the bite from higher interest rates, real disposable income growth will ebb away from 4.9%pa over the March 2005 year to 2.3%pa by March 2007.

Galloping consumption

At the heart of household spending over the last three years has been a sustained period of population, employment and wage growth – nominal aggregate compensation of employees has risen by an average of 6.9%pa over the 2001-2005 period. This pace cannot continue, primarily because labour can no longer be added at the same rate. But while household confidence in the labour market remains so high, the pace of consumption growth is not going to fall much of its own accord.

The Reserve Bank is counting on its “pipeline” of higher interest rates to deliver reduced spending. Given the long lags in monetary policy due to the pre-eminence of fixed mortgage rates, the effective interest rates on households will continue to rise over the whole forecast period. And those higher interest rates will be over a much larger stock of household debt than has ever existed in the past.

The Bank gets further help from slowing net migration. Although the worst of the population slowdown will be over by the end of 2004/05, the lagged impact of fewer new migrants (who typically have large household establishment expenses) will continue to be felt over the forecast period.

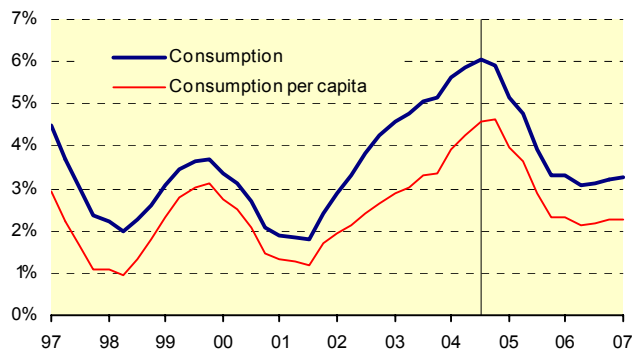


The above three are negative impacts, but ones that will occur gradually – slowing consumption with gentle braking, rather than by shredding household confidence. The wildcard remains the housing market: although we have revised up our outlook for prices in the context of a stronger economy, there will still be a period of negative real house price inflation (-4% in real terms, but only -1% nominal) over 2005/06. Although we think this will put a short-term hole in household confidence that year, we also believe it will give the Reserve Bank breathing room to wait for interest rate effects to work through the household sector.

We expect consumption growth to ease sharply over the next year, from 5.2%pa in the March 2005 year, to 3.3%pa in 2006. Over 2006/07, the effects of a slower housing market will be replaced by the lagged impact of higher interest rates and weaker population and income growth, establishing a soft landing for consumption.

Brace yourselves

Annual average % changes



Graph 2.6

See articles:

- *The stocks and the flows of our population – p45.*

Labour market projections

Annual average % changes

Year ended March	2001	2002	2003	2004	2005	2006	2007
Annual working age net migration ¹	-10,346	20,377	33,117	21,927	9,792	6,492	9,430
Working age population	0.7%	1.1%	1.9%	2.0%	1.6%	1.4%	1.3%
Participation rate ²	65.5%	66.4%	66.5%	66.5%	67.2%	67.3%	67.6%
Labour force	1.0%	2.3%	2.2%	2.0%	2.6%	1.6%	1.7%
Employment	1.9%	2.8%	2.4%	2.7%	3.5%	2.1%	1.3%
Unemployment rate ²	5.7%	5.3%	5.1%	4.5%	3.6%	3.1%	3.5%
Hourly wages	2.3%	3.4%	2.9%	3.4%	3.3%	4.0%	4.6%
Productivity	0.6%	2.5%	1.2%	1.2%	-0.2%	0.8%	2.1%
Unit labour costs	1.7%	0.9%	1.6%	2.1%	3.5%	3.2%	2.4%

Source: Statistics NZ Household Labour Force Survey, Quarterly Employment Survey, Infometrics

¹ Year ended total ² Annual average

Table 2.1

The outlook for households

Annual average % changes

Year ended March	2001	2002	2003	2004	2005	2006	2007
Wage income	5.0%	7.5%	6.4%	7.0%	7.6%	6.6%	5.2%
Total receipts	1.8%	4.7%	1.6%	5.4%	7.7%	6.1%	5.3%
Tax payments	4.6%	2.6%	5.9%	4.1%	7.3%	7.2%	5.0%
Nominal disposable income ¹	0.4%	5.2%	-0.5%	5.2%	7.0%	5.5%	5.7%
CPI excl. credit charges	3.0%	2.5%	2.7%	1.5%	2.7%	3.0%	3.3%
Real disposable income	-2.1%	3.0%	-2.1%	4.8%	4.9%	2.4%	2.3%
Real private consumption ²	1.9%	2.9%	4.6%	5.6%	5.2%	3.3%	3.3%
Savings rate ³	-4.1%	-4.0%	-11.2%	-12.0%	-12.3%	-13.2%	-14.3%

Source: Statistics NZ SNA Household Income and Outlay Account, Infometrics

¹ After tax, interest payments and transfers ² Excluding spending by private non-profit organisations

³ Annual average, % of disposable income saved

Table 2.2



3. BUSINESS ISSUES FORECASTS

Budgeting for growth

Businesses could be excused for underestimating prospects for the economy and demand for their products and services. The general tenor of most forecasts has been for conditions to soften. We remain confident that the pace of economic growth will slow, but it would be a mistake to translate this change of pace as a signal to batten down the hatches. Demand in the domestic economy will continue to expand at over 3%pa presenting good growth opportunities for businesses. What firms will need to be wary of is squeezed margins as input costs (particularly labour) rise faster than output prices.

Getting better all the time

Since 2000 consumer spending has risen by 4.2%pa and investment spending has lifted by a sizzling 8.4%pa. The latter includes new house construction, which has risen strongly, but the real grunt has come from investment in new machinery and equipment. Both these key indicators of domestic demand recorded faster growth over the year ended September 2004 suggesting, if anything, that we are still in the up-phase of the economic cycle.

The sustained high rate of economic growth has fed through into strong growth in company earnings and that in turn has been reflected by a 25% rise in the New Zealand sharemarket (NZSE 50) – one of the best performances in the developed world last year.

Companies have the capital, the confidence and, in many instances, a compelling case to invest in new capacity. There has been a noticeable jump in business spending on new capital equipment since mid-2003 and although we predict that businesses will become a little more cautious over the forecast period, double-digit growth will persist until later this year.

The 20%-plus lift in spending on new plant and equipment over the past year is consistent with the need to increase firms' capacity to fill ever more, or bigger, orders. We have revised up (marginally) our forecast of business investment spending (excluding residential) for 2005/06 from 8% to 10%. Faster than expected growth in non residential investment is one reason for the higher trend, but we also expect the strong growth in spending on new capital to be sustained for longer. Businesses will be under increasing pressure to raise productivity and investment in labour displacing or extending equipment will be an important part of the solution.

According to NZIER's Quarterly Survey of Business Opinion, a net 10% of businesses intend to increase their investment spending over the coming year. In the past there has been a useful relationship between current investment intentions and actual investment in plant and equipment around a year ahead. As Graph 3.1 shows, the relationship is looking less sturdy with actual investment spending currently growing far faster than past intentions suggested. What is surprising is that investment

intentions have not risen significantly over the past year suggesting that the surge in actual investment will be short-lived.

Our view is that the relationship has broken down to some degree. We would also observe that businesses have been bombarded by talk of an economic slowdown for the past year so not surprisingly only a small majority have expressed an intention to lift investment spending.

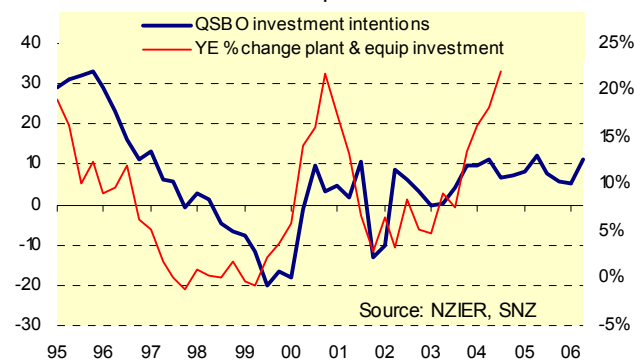
Investment conditions have turned out to be considerably more favourable than forecast, and businesses have therefore pushed ahead with capital expenditure projects. Factors that have persuaded them to spend include:

- Racier growth than expected – the consensus forecast at the beginning of 2004 pointed to GDP growth for calendar 2004 of 3.1% – it will be close to 4.5%
- A higher than expected currency that has kept the cost of imported plant and equipment down
- Stable interest rates, especially at the longer end – the 10-year bond rate has oscillated between 5.8% and 6.2% for most of the past 12 months
- An increasingly tight labour market

We expect most of these factors to continue to support solid growth in business investment spending over 2005/06.

Actions exceed intentions

Intentions shifted forward 5 quarters



Graph 3.1

The coming wage-price squeeze

Businesses have been grumbling about a lack of labour, skilled and unskilled, for at least a year. The impressive decline in the unemployment rate suggests the problem has become much more acute. A logical consequence is that wages will rise.

In the previous Chapter we covered the developing labour market pressures in some detail. Our conclusion is that wage inflation will accelerate to more than 4%pa over 2005/06 and 2006/07.



The question for this chapter is how will businesses respond to a significant rise in the cost of labour? There are at least five possible reactions:

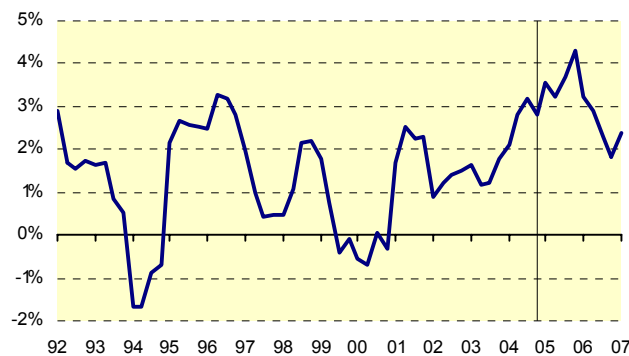
- increase productivity to reduce the amount of labour required;
- invest in labour displacing capital;
- cut costs elsewhere in the business – switch to imported components/products, or shift production offshore;
- absorb the increased cost of labour in thinner margins, or lower profits;
- lift selling prices.

We predict that labour productivity growth, which has been pretty sluggish, will accelerate over 2006 and by the end of the forecast period will be over 2%pa. Increased capital investment spending (more automated equipment) will be a key factor behind the lift in labour productivity.

The degree of competition in individual markets is an important determinant of business behaviour when faced with rising unit labour costs. If competition is intense then businesses will be forced to absorb wage cost increases (either via productivity gains, cutting other costs, or in lower margins). However, even in some competitive markets (building and construction, for example) trading conditions may be so buoyant that firms paying higher wages to attract the required labour will be able to pass on the costs.

Unit labour costs

Annual average % changes



Graph 3.2

Where there is little competition (airports, health services, local body services) the increased cost of labour is likely to be largely passed on to customers, because the risk of losing sales is minimal.

Although it is difficult to determine what the balance will be between absorption via higher productivity, through lower margins, or simply through passing on the cost of higher wages, our rough estimate is:

- that 30% of firms will absorb the majority of the rise in real wages through lower margins;

- that another 30% will rely primarily on price increases to recover increased costs;
- and that the remaining 40% will drive for higher productivity, squeeze suppliers, and invest in more automated equipment.

In practice, most firms will take a combination of approaches.

However, with a significant proportion of organisations able to take the easy route and raise selling prices to offset higher wage costs, inflation will be the victim. In the next Chapter we discuss in more detail our higher track fro inflation over the forecast period.

An open and competitive economy is more likely to find ways of accommodating real wage increases. The risk is that too high a proportion of New Zealand's economy is not particularly open and competitive (the growing public sector) and therefore more of the wage increases find their way into consumer prices than we have assumed above.

The lack of pricing discipline in the provision of central and local government services means that big wage rises in areas like health and education will create real flow-on pressures for private providers of such services and the subsidies they require to keep operating (elderly care services, for example).

Interestingly, wage costs in Australia have been rising about 1%pa faster than in New Zealand and yet there is no evidence that such additional cost pressure has fed through into significantly higher general inflation. To a large extent Australian businesses have absorbed the additional wage increases.

Arguably a significant lift in the real price of labour would be valuable in forcing some realignment in economic activity – labour would be reallocated to higher value activities; capital would substitute for labour in some areas; and some firms would be squeezed out of business thus freeing up labour for use elsewhere in the economy.

See articles:

- *What the government can do to improve productivity – p54.*
- *Please participate – p56.*



4. FINANCIAL MARKETS FORECASTS

Inflationary effects of an endless expansion

Inflation is set to hover around 3%pa over the entire forecast period, with economic growth failing to slow sufficiently to free up much spare capacity. The lack of any further rises in the dollar will also result in tradable inflation picking up after a weak couple of years. The Reserve Bank's policy response will be to hold the official cash rate at (or above) 6.5% throughout 2005, with only limited rate cuts likely in 2006 and 2007.

The sustained period of rapid GDP growth over the last three years is placing considerable stress on the economy. Apart from in specific areas such as the construction sector, the resultant pressures have not been that visible. With the New Zealand dollar climbing at about 12%pa between the end of 2001 and December 2004, prices in the tradable sector have been understandably muted.

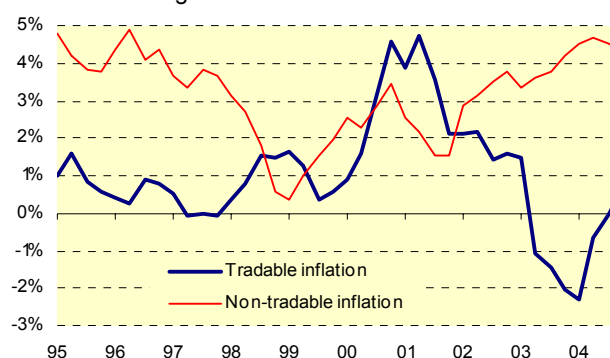
Those friendly forces are no more. Although we are not predicting that the dollar is about to plummet, further significant rises are almost certainly off the agenda. The implication is that the currency, while not actively adding to the CPI, will not be slashing a chunk out of inflation either.

Graph 4.1 shows the early signs that tradable inflation is accelerating. And as we have repeatedly revised up our economic growth forecasts over the last year, the domestic inflation outlook has become less benign. We now believe things are coming to a head:

- The unemployment rate is at 3.6% and unions are clamouring for larger wage increases – metalworkers are aiming for a 7% wage hike.
- The NZIER's measure of capacity utilisation is at a record high of 92.6%, despite strong investment growth over the last two years.

Tradable prices start to rise again

Annual % changes



Graph 4.1

The economy has galloped ahead of its long-term potential growth over the last two years – in its December Monetary Policy Statement, the Reserve Bank estimated the output gap would be around 2.25% by the first quarter of 2005. Although that gap will not widen any further over the next year, the pressure on capacity will remain (i.e., the problem will be sustained rather than becoming any more acute).

Consumers price index

Percentage changes

		Quarter on previous quarter	Quarter on year earlier quarter	Year on previous year
2004	Mar	0.4	1.5	1.5
	Jun	0.8	2.4	1.7
	Sep	0.6	2.5	2.0
	Dec	0.9	2.7	2.3
2005	Mar*	0.8	3.1	2.7
	Jun*	0.6	2.9	2.8
	Sep*	0.6	3.0	2.9
	Dec*	0.9	2.9	3.0
2006	Mar*	0.8	3.0	3.0
	Jun*	0.9	3.2	3.0
	Sep*	1.0	3.5	3.2
	Dec*	0.8	3.4	3.3
2007	Mar*	0.5	3.1	3.3
	Jun*	0.7	2.9	3.3

* Infometrics forecasts

Table 4.1

Ongoing economic buoyancy will provide some businesses with the opportunity to pass on cost increases (including higher wage bills) – those firms that raise prices will perceive there being little risk of taking a hit to sales. We have discussed the potential effects of higher wages on inflation in *Who ends up forking out for your pay increase?* – p58.

Our inflation forecasts are markedly different from those published in November, when we predicted that inflation would drop back below 2% by the end of this year. This reflects the following factors:

- Economic growth will be sustained at or above potential for longer, particularly in the domestic sector of the economy. This will provide little opportunity for capacity to be freed up and price pressures to dissipate.
- Our outlook for tradable inflation is less sanguine, despite a higher exchange rate forecast. We recognise that we have probably underestimated the role of the rising currency in making a negative contribution to inflation over the last two years – an influence that is waning as the dollar holds up, but fails to appreciate any further. We estimate that the rising TWI may have removed as much as 1.6 percentage points from inflation over each of the last two years.
- With net working age migration set to drop below 7,000pa over the next year (compared to 33,800 in the year to June 2003), potential growth looks likely to slow as well. We believe the Reserve Bank's prognosis of potential growth holding in the 3.5-3.75% range is too optimistic.

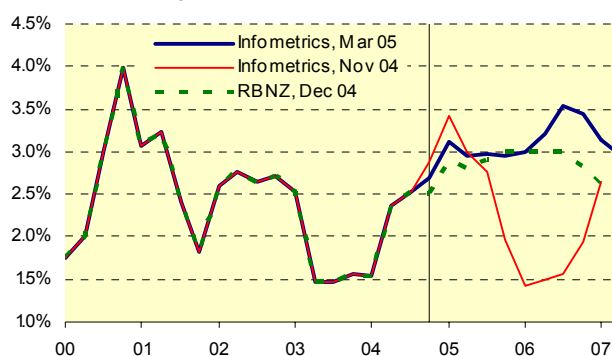
New Zealand's potential growth rate may have been boosted by as much as 1.5 percentage points per annum over the last three years by faster population growth. Arguably there have been other factors helping to



boost New Zealand's potential growth rate over the last few years as well – including the payoffs of a more flexible economy, generated by the reforms of the 1980s and early 1990s. But simply importing workers into the economy is an effective way of increasing a country's growth rate. It is therefore unsurprising that we are forecasting higher inflation than the Reserve Bank – particularly given our forecast of stronger economic growth from the second half of 2005 onwards.

Inflation forecast comparison

Annual % changes



Graph 4.2

Bank keeps a firm grip

The ongoing momentum of the economy has affected expectations of monetary policy over the next year. Back in November, we pointed out that although we expected interest rates to fall over 2005, the extent of that decline was likely to be relatively limited (with the official cash rate bottoming out at 5.75%). We now see no room for rate cuts this year. And although it is not our forecast, we acknowledge there is a growing school of thought that the Reserve Bank may raise rates to 6.75% in the first half of 2005.

The change in our monetary policy outlook is consistent with our stronger outlook for economic growth and the associated inflationary pressures that will generate. In our previous forecasts, we expected the rate of economic growth to ease back below potential by March 2006, with an associated fading of widespread price pressures. The modest slowdown in growth would have enabled the Reserve Bank to shift monetary settings back towards neutral (an OCR of about 5.75%). However, our latest numbers imply that such an easing in monetary policy is neither needed nor warranted within the next year. With strong economic growth and inflation holding stubbornly above 3%pa, the OCR looks unlikely to be cut before 2006.

Even through into 2007, the outlook for monetary policy remains on the tight side. With the gap between domestic and global bill rates holding above three percentage points until mid-2006, we anticipate a high floor under the currency. Thus the dollar will contribute to tight monetary conditions as well.

Higher inflation will feed through into increased inflation expectations. This is most evident in the change in our bond rate forecasts. Although the actual rates are not significantly different from our November report,

we have pushed up the gap between New Zealand and world bonds by as much as half a percentage point.

Official Cash Rate

Reviews over the next two years*

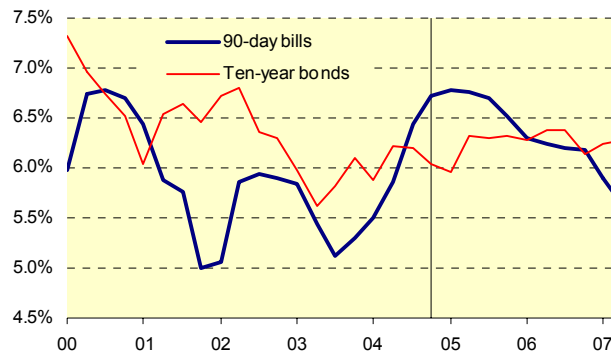
2005	Mar	Unchanged at 6.50%
	Apr	Unchanged at 6.50%
	Jun	Unchanged at 6.50%
	Jul	Unchanged at 6.50%
	Sep	Unchanged at 6.50%
	Oct	Unchanged at 6.50%
	Dec	Unchanged at 6.50%
2006	Jan	Unchanged at 6.50%
	Mar	Down 25 basis points to 6.25%
	Apr	Unchanged at 6.25%
	Jun	Down 25 basis points to 6.00%
	Jul	Unchanged at 6.00%
	Sep	Unchanged at 6.00%
	Oct	Unchanged at 6.00%
2007	Jan	Unchanged at 6.00%

* Infometrics forecasts

Table 4.2

Yield curve holds negative

Quarterly averages



Graph 4.3

A strong economy, a strong currency

Market forecasts are for the New Zealand dollar to decline over the next year, most sharply against the US dollar and the yen. In the short-term, however, some forecasters are predicting the exchange rate with America could go as high as US75c.

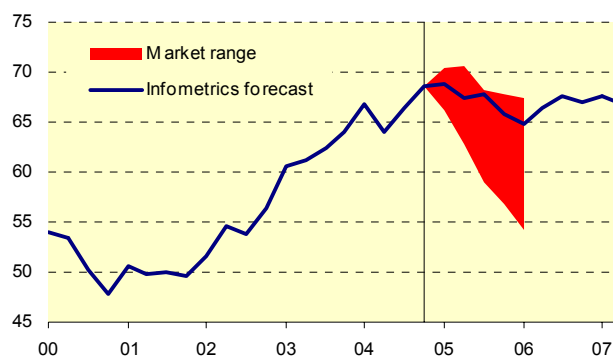
Graph 4.4 shows our TWI forecasts in the context of the market range of forecasts over the next year. It is clear that our outlook for the currency is towards the top end of the range, despite the dollar appearing to be overvalued against the currencies of our main trading partners. Our bullish view for the dollar is based on the following factors:



- Interest rate differentials at the short end of the yield curve will remain relatively attractive for international investors;
- The current account deficit will peak at around 6.3% of GDP. This is an ugly number, but much of the deterioration has been due to the investments balance rather than the trade balance. The investment outflows are simply a reflection of New Zealand's strong economic performance.
- Economic growth in New Zealand will remain healthy, albeit not quite as spectacular as the last two years.
- Strong international commodity prices will continue to limit the negative effects of the high dollar on export incomes.

A high TWI

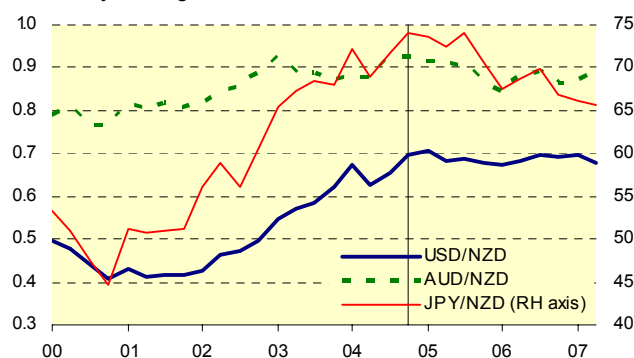
Quarterly averages



Graph 4.4

Cross rates

Quarterly averages



Graph 4.5

The biggest risk we perceive to our financial forecasts is a more rapid depreciation of the dollar. Such an outcome would prevent domestic demand from being satisfied by foreign-sourced goods and services without incurring price rises for those imports. That would force the Reserve Bank to push interest rates higher than we have predicted in a dual effort to keep inflation in check and quell domestic demand growth.

See articles:

- *Who ends up forking out for your pay increase? – p58.*

**New Zealand interest rates****New Zealand exchange rates**

Period averages		90-Day Bill	10-Yr Bond	Bond gap ¹	Bill gap ¹	Yield gap ²	Base rate	Float mortg	\$A/NZ	Euro/\$NZ	Pnd/\$NZ	Yen/\$NZ	\$US/\$NZ	TWI
2004		6.1	6.1	2.5	4.6	0.0	10.4	8.0	0.90	0.53	0.36	71.7	0.66	66.4
2005*		6.7	6.2	2.8	4.3	-0.5	11.1	8.7	0.90	0.53	0.37	72.7	0.69	67.4
2006*		6.2	6.3	2.5	3.1	0.1	10.7	8.3	0.87	0.54	0.38	68.2	0.69	66.5
2007*		5.7	6.2	2.3	2.4	0.5	10.3	7.8	0.87	0.57	0.38	64.6	0.67	66.0
2004	Mar	5.5	5.9	2.4	4.3	0.4	9.8	7.4	0.88	0.54	0.37	72.3	0.67	66.9
	Jun	5.9	6.2	2.4	4.5	0.4	10.1	7.8	0.88	0.52	0.35	68.8	0.63	63.9
	Sep	6.4	6.2	2.5	4.8	-0.2	10.6	8.3	0.92	0.53	0.36	71.8	0.65	66.3
	Dec	6.7	6.0	2.5	4.8	-0.7	11.0	8.7	0.92	0.54	0.37	74.0	0.70	68.6
2005	Mar*	6.8	6.0	2.5	4.6	-0.8	11.1	8.8	0.92	0.54	0.38	73.6	0.71	68.9
	Jun*	6.8	6.3	2.9	4.4	-0.4	11.2	8.8	0.91	0.53	0.37	72.5	0.68	67.3
	Sep*	6.7	6.3	3.2	4.3	-0.4	11.1	8.7	0.91	0.53	0.37	74.1	0.69	67.7
	Dec*	6.5	6.3	2.9	3.9	-0.2	11.0	8.5	0.86	0.52	0.36	70.6	0.68	65.8
2006	Mar*	6.3	6.3	2.5	3.3	0.0	10.7	8.3	0.85	0.52	0.37	67.5	0.67	64.7
	Jun*	6.2	6.4	2.5	3.1	0.2	10.8	8.3	0.88	0.53	0.38	68.6	0.68	66.5
	Sep*	6.2	6.4	2.5	3.0	0.2	10.6	8.2	0.89	0.55	0.38	69.9	0.70	67.7
	Dec*	6.2	6.1	2.5	2.9	0.0	10.8	8.2	0.87	0.56	0.39	66.7	0.69	67.0
2007	Mar*	5.9	6.2	2.4	2.5	0.3	10.5	7.9	0.87	0.58	0.39	66.2	0.70	67.5
	Jun*	5.6	6.3	2.4	2.3	0.6	10.3	7.7	0.89	0.57	0.39	65.7	0.68	66.9

(1) NZ bill/bond less average overseas bill/bond rates, market weighted

(2) Bond less bill

* Infometrics forecasts

Table 4.3



5. FISCAL FORECASTS

Lies, damned lies, and the fiscal position

Those darned surpluses just won't go away, no matter how much the government spends. Worse still, people are starting to notice. The government's cunning plan is redefine the surpluses out of existence, before they become a political liability. However, the real imbalance in the government accounts is not how much money they haven't spent, but how much they have. On the political front, grand ambitions are back in fashion, as the government shapes up to tackle economic soft spots.

Helen, I shrunk the surplus

The fiscal accounts remain in the best health for generations, so why has the finance minister mounted a campaign to disguise this fact?

The fiscal surpluses, which look set to remain around \$6bn, are a political weakness for the government in an election year. The public perception is that the government has a treasure trove of money to spend, and it makes it very easy for opposition parties to suggest radical changes in government policy (for example, ACT's alternative tax regimes, which Treasury concluded would lead to a permanently higher growth rate).

To quote Dr Cullen:

"In political economy terms [the OBERAC] can create the illusion of spending options that do not really exist, and it leaves me as finance minister defending complex truths against an attack of appealing half-truths".

So from now on, Michael Cullen intends to focus on the cash surplus, a measure of how much cash the government has left over after it uses the operating balance to fund new capital investment. Conveniently, the cash surpluses over the next three years will be small (in fact, Treasury is forecasting a slight rise in nominal debt after 2004/05).

Dr Cullen is correct when he claims that the government could not spend more than it currently plans without borrowing, and thus raising the debt to GDP ratio. But regardless, by proposing to use the cash balance as an indicator of the fiscal position, the government is engaging in some grand scale creative accounting.

The cash position is virtually irrelevant as an indication of the government's finances. By focusing on it, Cullen is attempting to gloss over the difference between current expenditure – government outlays to provide goods and services (for consumption) and transfers – and capital expenditure, which creates an asset with ongoing value. It is reminiscent of the fiscal trickery Robert Muldoon used to indulge in by redefining, where possible, current spending as capital expenditure and therefore not part of the reported deficits.

At the moment, the government is creating a large cash surplus by taking in more revenue than it needs for current expenditure; then it is using the surplus cash to undertake a large capital expenditure programme (the

New Zealand Super Fund, student loans, and infrastructure investment being the main items).

The fact that the latter creates a lasting asset is the important distinction. Although the cash balance may be small, an operating balance of \$6bn means that the government has \$6bn more assets (net worth). The dividends from those assets (or the sale of the assets themselves) can then be used to fund future government expenditure, as is the plan for the NZSF. Likewise non-financial assets (roads, power plants) produce an economic return that is perceived to be greater than the opportunity cost of simply putting that money in the bank, conceivably through a higher tax take flowing from faster economic growth.

Now if the government needed to borrow money to finance current expenditure, it would be a concern. It implies that the government is living beyond its means, and that either tax increases or expense cuts will soon be necessary. But borrowing money to finance capital expenditure is standard practice. Despite what the government says, it is under no compulsion to fully fund its capital expenditure from the budget surplus (with the exception being the NZSF, where the stated intention is to increase the government's net worth position).

It is not clear why the government feels the need to expand the nation's net worth so rapidly. Arguments might include the following:

- Current demographics are particularly favourable and the government is acting responsibly by "banking" such temporary good fortune.
- The economy is operating at capacity and therefore prudent fiscal policy requires the government to offset fiscal spending growth by also saving more.
- The government is forcing the baby-boom generation to "catch up" on the deficiency of infrastructure investment in their earlier working lives.
- The government can achieve a better long-term return through investing tax money than leaving it in the hands of taxpayers.

The government appears to think that duping the public is preferable to spelling out potentially unpopular arguments. Alternatively, there is no particular rationale – fiscal policy is on autopilot for a government that lucked into a sustained economic boom.

Tax and spend ... and spend ... and spend

Although the operating balance surpluses may be justifiable, the rate at which spending has been increasingly under the Labour government is not. This is the true imbalance in the fiscal position.

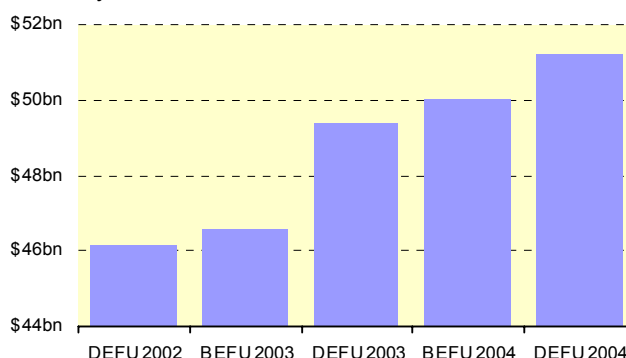
On current Treasury forecasts, core crown government spending is set to increase 38% from the June 2004 year to June 2009 (23% in real terms) – taking expenses as a percentage of GDP from 29.6% to 32.3%. Actual spending in 2009 is likely to be much higher than this, given the rate at which new spending initiatives have been materialising in recent times. Graph 5.1 shows how projected spending for the final year of our forecast (2006/07) has been revised up at each of the last five Treasury economic fiscal updates. The cumulative effect is that the government now intends



to spend \$5bn more (11%) in that year than it felt was necessary just two years ago.

Core crown expenses, 2006/07

Treasury forecasts



Graph 5.1

We generally expect government spending to rise at around the rate of GDP – as people become richer, they demand more health and education services. However, it is unusual that government spending is able to keep up with economic growth when it is racing at well over 4%. There are two obvious problems with increasing spending at 10%pa (as is forecast for 2004/05) in order to maintain the surplus as a constant ratio of GDP:

- With capacity tightly stretched throughout the economy, it is inevitable that most of that new spending is going to translate into higher prices, but little in the way of increased outputs.
- Although recent economic growth has been fast, it has been driven more by rising employment than lifting productivity. Hence revenue growth has resulted from a level shift in the number of taxpayers, rather than growth in individual earnings. Therefore, raising government spending on the basis of a “richer” population makes no sense (in fact, increased employment, which reduces inequality and demand for government safety net services, should have lowered government spending).

After embracing the idea of rapid spending growth, the challenge for the government is going to be reining it in as the economic growth returns to normal.

We do not expect there to be too much pressure in this regard over the next three years. We have a more mild slowdown than Treasury is expecting – growth of 2.4%pa and 2.6%pa over the June 2006 and 2007 years. As a consequence, we expect revenues to be around \$1bn above Treasury forecasts in each of those years.

In the context of Graph 5.1, we feel slightly nervous about only building in an additional (to Treasury’s estimates) \$1bn of annual new expenditure over the forecast period. Although much of the signalled spending in out years is still only an allowance (in other words, the government can announce a number of new spending initiatives without increasing the

overall level of spending), it would represent a decisive break with the recent trend if the government didn't increase that allowance further.

We believe that most of that increase in spending (\$750m) will come over 2005/06, as a result of the inevitable election year budget bonanza. However, with the economy facing major capacity constraints over the whole forecast period, we expect the government to become more wary of incurring the Reserve Bank's wrath. The government has already signalled the major issues for its next term of government, and they largely require some cultural changes rather than financial intervention (see below).

More than just tilting at windmills?

Despite it being an election year, the government has settled on some relatively low-key issues (to the general public) to tackle in the 2005 Budget. In her speech from the throne, Helen Clark signalled that three priorities would be:

- lifting labour productivity;
- lifting participation rates in the workforce;
- new savings initiatives.

Productivity

Productivity is the least controversial. Everyone is in agreement that a faster rate of productivity growth is necessary if we are to raise New Zealanders' incomes up the OECD league table, and respond to the current pressure on resources in the economy.

Unfortunately, the solution to our productivity problems remains elusive. The main role for the government is to ensure competitive and contestable markets, and the absence of economic rent-seeking opportunities (for more detail, see *What the government can do to improve productivity – p54*).

Participation

Although only a short-term fix to labour market shortages, higher participation does raise national income. However, the obvious fiscal policies for raising participation – lifting the financial reward for working – tend to be the kinds of things this government opposes: lower taxes, reduced benefits/entitlements, and less income support.

Of those things, the only forthcoming move by the government is the introduction of a single benefit system, although it is not immediately clear whether this will affect incentives for beneficiaries. Shifting Work and Income's focus to the problem of skill shortages, rather than the problem of joblessness, is an appropriate step given the dramatic decline in the unemployment rate over the last decade.

The government was politically clumsy in singling out female participation for improvement (for discussion of this, and other participation issues, see *Please participate – p56*). Nevertheless, our low rates of female participation do represent the single largest opportunity for increasing overall participation rates further.



For women with children, there is a case that the current market outcome is sub-optimal. After childcare costs and taxes, returning to work often has no financial reward for many women. Choosing not to work costs the government tax revenue, while the cost to women is reduced experience and hence reduced future earning potential. If subsidising childcare creates a large enough participation response, it could be fiscally neutral. We expect the government to further expand the subsidies available for childcare and early childhood education, as well as increasing financial support for such centres.

Savings

Equally controversial is the government's new infatuation with the "ownership society" – there is no compelling evidence that a lack of domestic savings is detrimental to a country's growth rate. However, it is a concern that private savings rates in New Zealand are among the worst in the developed world.

The government has two goals: to make it easier to buy a first home and to encourage retirement savings. Possible initiatives for the former include:

- covering interest payment for a short period of time;
- providing a lump sum deposit assistance for first home buyers (similar to Australia);
- making mortgage interest tax deductible for a short period for selected households;
- extending the Kiwibank scheme that allows for no-deposit home loans.

However, given the highly-heated state of the housing market at the moment, the government is not going to be too generous in this area, for fear of further exciting the market. It is possible that government will instead incorporate its plans for encouraging home ownership into its plans for encouraging workplace retirement savings schemes, and allow for home-deposit related withdrawals.

To make retirement savings schemes work, two things are generally required: compulsory enrolment (people have to choose to opt out), and matching contributions. Both of these things will create added costs for businesses – so the government is either going to need to finance it directly, or come up with a sweetener (ie corporate tax cuts) to make businesses go along.

See articles:

- *The taxing question of redistribution – p60.*

Forecast Statement of Total Crown Financial Performance
for the years ending 30 June

	\$ million					% of GDP				
	2003 Actual	2004 Actual	2005 Forecast	2006 Forecast	2007 Forecast	2003 Actual	2004 Actual	2005 Forecast	2006 Forecast	2007 Forecast
Revenue										
Taxes on wages and salaries	19669	20485	21865	23115	24213	15.0%	14.6%	14.5%	14.4%	14.3%
Company taxes	5940	6858	7728	8230	8448	4.5%	4.9%	5.1%	5.1%	5.0%
Other income taxes	1169	1239	1429	1486	1412	0.9%	0.9%	1.0%	0.9%	0.8%
GST	8738	9718	10368	10624	11261	6.7%	6.9%	6.9%	6.6%	6.6%
Other indirect taxes	4269	4232	4432	4818	5087	3.3%	3.0%	2.9%	3.0%	3.0%
Levies, fees, fines, penalties	2763	2986	3012	3171	3295	2.1%	2.1%	2.0%	2.0%	1.9%
Sales of goods and services	10385	10200	11155	12183	13170	7.9%	7.3%	7.4%	7.6%	7.8%
Investment income	1859	2653	3388	3307	3759	1.4%	1.9%	2.3%	2.1%	2.2%
Other revenue	2235	2016	2021	2155	2230	1.7%	1.4%	1.3%	1.3%	1.3%
Total Crown Revenue	57027	60387	65397	69087	72876	43.6%	43.0%	43.5%	43.2%	42.9%
Expenses by input type										
Total social security and welfare	17084	16038	17167	18102	19575	13.1%	11.4%	11.4%	11.3%	11.5%
Education	7788	8349	8908	9602	10185	6.0%	5.9%	5.9%	6.0%	6.0%
Health	7412	7623	8665	9432	10265	5.7%	5.4%	5.8%	5.9%	6.0%
Transport and communications	5619	5443	5862	6405	6944	4.3%	3.9%	3.9%	4.0%	4.1%
Economic and industrial services	4280	4070	5035	5444	5767	3.3%	2.9%	3.3%	3.4%	3.4%
Finance costs	2550	2602	2698	2711	2681	2.0%	1.9%	1.8%	1.7%	1.6%
Other expenses	10491	8932	10788	10820	11335	8.0%	6.4%	7.2%	6.8%	6.7%
Total Crown Expenses	55224	53057	59124	62515	66753	42.3%	37.8%	39.3%	39.1%	39.3%
Operating Balance*	1966	7424	6411	6711	6261	1.5%	5.3%	4.3%	4.2%	3.7%
Crown Balance (Net Worth)	23781	31114	37525	44237	50498	18.2%	22.1%	25.0%	27.6%	29.7%
Total Crown Debt	38285	36825	34073	35284	35350	29.3%	26.2%	22.7%	22.1%	20.8%

*Includes net surplus TEIs and minority interest

Table 5.1



6. EXTERNAL FORECASTS

Pushing our luck

The current account deficit, which expanded to 5.8% of GDP in September, will remain large until domestic demand weakens or there is decisive drop in the exchange rate to curb demand for imports and improve returns for exporters. New Zealand's high rate of growth and high interest rates are delaying the day of reckoning. We think it could be as late as 2006 before there is a significant change in sentiment toward the dollar and therefore any marked improvement in the current account deficit.

How bad is it?

The last time New Zealand recorded a balance of payments surplus was in 1973. Since then the current account deficit has swung wildly depending on the state of domestic demand, world demand (commodity prices), trade policies, and the weather. The currency has been a powerful factor driving the current account from time to time.

The current account deficit is again deteriorating – in September it was equivalent to 5.8% of GDP (up from 4.8% in June), and we expect it to bottom at around 6.5% by mid 2005. New Zealand's external deficit will continue to occupy the bottom rungs of the OECD league table.

The fact that we have been running a current account deficit for so long means that we have accumulated a heap of debt. The latest numbers (as at September 2004) show the net foreign asset position at -\$118bn – we owe foreigners \$90bn more than they owe us in straight debt terms, and they own \$28bn more of our economy in terms of equity investment than we own foreign equity.

Balance of payments ratios

Year ending June	Current account deficit as % GDP	Debt service cost as % goods & services exports	Goods & services exports as % GNE	Net investment income as % goods & services exports
1995	-4.7	15.1	29.6	-21.4
1996	-5.8	14.9	28.8	-23.3
1997	-6.9	16.8	27.9	-27.2
1998	-4.9	18.0	28.8	-20.1
1999	-3.9	16.3	29.7	-15.3
2000	-6.1	15.9	32.4	-19.3
2001	-3.5	13.0	35.0	-17.7
2002	-2.9	10.9	33.3	-15.1
2003	-4.0	10.4	30.8	-16.2
2004	-4.8	9.6	29.4	-17.4

Source: Statistics New Zealand, Table 14, Balance of Payments release

Table 6.1

But the cost of servicing our foreign debt relative to receipts from goods and service exports is currently lower than it has been for more than ten years. That reflects the world-wide decline in interest rates, the strong

New Zealand dollar and the steady growth (5%pa) in the value of goods and services receipts.

The ratio of goods and services receipts to gross national expenditure (GNE) shows that the economy has not become more open over the past decade despite a marked increase in the volume of imports (their price has fallen almost as fast). The last ratio in Table 6.1 – net investment income to goods and services receipts – shows some improvement, especially between 1997 and 2002. However, the rising level of foreign ownership and the good returns these and other businesses are making in New Zealand means this ratio is edging out again. In one sense this is reassuring – foreign investors are getting a return on their investment in the country and might therefore reinvest their profits. But it appears that foreign investment is not particularly export focused. In some cases foreign ownership has resulted in a reduction of exports (Deltec and more recently Interlock).

Balance of payments					
Year end June, \$m	2003	2004	2005	2006	2007
BOP exports	29,814	30,142	31,258	34,261	36,019
BOP imports	30,097	31,148	33,189	36,871	38,929
Trade balance	-283	-1,006	-1,931	-2,610	-2,910
Services exports	11,230	11,254	12,073	13,511	14,159
Services imports	9,729	10,002	10,496	11,366	11,904
Services balance	1,501	1,252	1,577	2,145	2,256
Goods & services balance	1,218	246	-354	-465	-655
Investment credits	2,179	2,278	2,284	3,010	3,365
Investments debits	8,838	9,535	11,564	11,750	12,970
Investments balance	-6,659	-7,257	-9,280	-8,740	-9,605
Transfers balance	190	235	134	354	377
Current Account	-5,251	-6,776	-9,500	-8,851	-9,883
As a % of GDP	-4.0%	-4.8%	-6.3%	-5.5%	-6.1%
Terms of trade⁽¹⁾	1,098	1,164	1,187	1,193	1,199

(1) Index: 1980-89 = 1000; Source: Statistics NZ; Infometrics forecasts

Table 6.2

In our November report we forecast the current account would bottom out at just over 5% in 2005. That was a much more positive view of the current account than we had in our March and June reports last year, and has proven too optimistic. We now have the current account tracking lower to a trough of 6.3% later this year – a forecast not dissimilar to our June 2004 forecast. In absolute terms, though, the deficit expands further over 2006/07, but the economy expands faster.

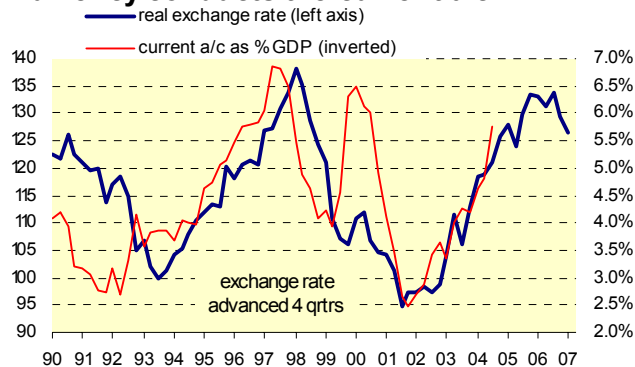
The current account – when will it matter?

Firstly, let's accept that the current account deficit does matter – it indicates an important imbalance (a lack of savings) in the economy. Having noted that, New Zealand's 30-year record of continuous current



account deficits suggests that most of the time the deficit does not matter. When it does the currency responds.

Currency conducts the current a/c



Graph 6.1

Graph 6.1 indicates the relatively close relationship between the real currency (price competitiveness of exports and imports) and the current account. When the currency falls decisively we can be sure the current account deficit has become big enough to spook financial markets.

For the time being good returns from both interest and equity investments are working to prevent a stampede out of the New Zealand dollar, but we are predicting that the currency will ease over the next two years in response to a combination of a high current account deficit and narrowing interest and growth differentials. That will put a floor under the deterioration in the current account deficit, at least as a percentage of GDP.

Exports – signs of fatigue

Exports have shown remarkable stamina over the past year – export volumes have continued to rise steadily despite what has been regarded as a punishing exchange rate. More astute forward covering, better margins in the local market, and long-term commitment to export markets and raising the quality of the products being offered, have all helped maintain export momentum.

However, there are signs that some exporters are becoming fatigued, suggesting the rate of export growth could stutter over the forecast period. We predict that export volume growth will slow to 2.2% over the year ended June 2005 before picking up to more than 5%pa over the two remaining years of our forecast.

In the **manufacturing** sector there are obvious signs of stress. Interlock is shutting down its New Zealand production sooner than expected, and Fisher & Paykel is clearly struggling to remain profitable in the face of the high exchange rate. The rising cost of labour (higher wages, increased holiday loadings, maternity leave provisions, and the possible introduction of work-based pension schemes) will add to the squeeze on exporters' margins.

The most obvious dent to export growth in the short-term will come from an estimated 3% decline in milk production over the current season,

reflecting cold spring weather conditions. **Dairy export** volumes over the September quarter were 26% lower than a year earlier and we predict dairy export volumes will be down as much as 4% over 2004/05.

Further out we expect dairy export volumes to increase steadily (2-4%pa) on the back of improved milk yield per cow as well as progress toward exports of higher-value products. Interestingly the drop in milk production this season will reduce sales of low-value product to low-value markets, and thereby raise overall returns. World market prices for dairy products have been strong offsetting the effects of the rising effective exchange rate faced by dairy farmers. We predict the value of dairy exports will hold up this year at around \$6bn and rise by about 5% over 2005/06.

Food products account for around 50% of the total value of goods exports, with dairying at about 20%. The significance of the sector has persuaded the government to set up a joint industry-government taskforce with the ultimate view of enhancing growth amongst food and beverage businesses. The growth in other food and beverage export volumes has recently accelerated to over 10%. Wine and kiwifruit are the two main contributors to the faster growth, but a whole host of smaller exporters are also growing rapidly, from fruit puddings to avocado oil.

Summary of export volume forecasts

Annual average % change

June years	2001	2002	2003	2004	2005	2006	2007
Exports							
Meat	6.5%	-3.0%	3.9%	10.9%	1.8%	3.5%	1.0%
Dairy	5.2%	3.7%	15.2%	5.5%	-4.0%	4.5%	3.8%
Fish	-3.3%	12.9%	-0.3%	2.0%	3.5%	0.0%	-1.0%
Forestry	-1.9%	10.2%	5.0%	-1.7%	6.5%	7.5%	8.0%
Manufacturing	-2.0%	2.3%	6.9%	5.8%	3.9%	5.5%	7.2%
Other	7.5%	1.9%	-2.1%	4.7%	3.8%	6.5%	6.5%
Total goods exports	2.5%	2.9%	5.5%	5.1%	2.2%	5.3%	5.2%
<i>Jun 04 forecasts</i>					4.7%	5.1%	5.9%

Based on Statistics NZ national accounts data, Infometrics forecasts

Table 6.3

Although **meat** export volumes will not grow much over the forecast period (see Table 6.3), prices are likely to remain high and therefore the big lift in meat export receipts since 2000 will be sustained.

Kiwifruit exports will reach record levels over 2004/05 as a result of a 25% increase in the 2004 harvest reflecting good growing conditions and new vines coming to maturity. The harvest is likely to be down over 2005/06, by as much as 10%, but returns should continue to edge higher as the Zespri brand and a good range of product generate a premium. A lower currency will translate into better New Zealand prices. Apple exports are likely to fall on the back of another disastrous season.

Forest exports have been in the doldrums over the past two years reflecting poor international returns, a high currency and a significant lengthening of the harvest cycle as forest owners (many new foreign ones) took a longer view about the commercially optimum age to harvest. A big jump in shipping costs also severely dented export returns. But prices for logs and wood products in key Asian export markets have



picked up helping to offset the effects of a strong dollar and high shipping costs. Furthermore, more trees are reaching the new target age for harvesting. This combination of factors point to the forest industry fulfilling some of the growth promised since 2000. We predict the volume of forest exports will grow at between 6 and 8%pa over the forecast period, although there is a risk of a spike in the rate of felling over 2007 as forest owners seek to avoid carbon liabilities under Kyoto.

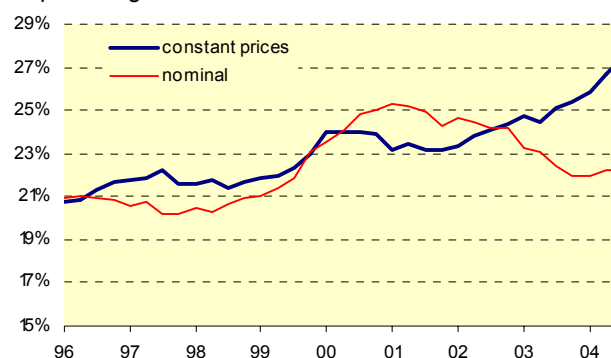
Importing more for less

Raging domestic demand growth (over 6%pa since 2002) and a high currency have put enormous demand and price pressure on New Zealand producers of goods and services. Firms have responded by investing (imported capital) in additional capacity and in many cases resorting to imports of finished goods to meet burgeoning final demand. Imports have been a crucial safety valve in the scramble for capacity to satisfy demand. The result has been a surge in imports that is pushing the trade balance deeper into deficit.

Another reason for the lift in imports is that the rising currency and improving terms of trade have markedly increased the quantity of imports New Zealanders can purchase with their incomes. Import penetration, when measured in constant prices (volumes) has risen significantly, but in nominal terms is no higher now than it was in the mid 1990s.

Imports popular

Imports of goods as % GDP



Graph 6.2

We noted above that imports act as a safety valve for rampant domestic demand implying that capacity strains can be resolved. However, relying on imports simply shifts imbalances in the domestic economy to the current account. As the latter increases in size the risk of a currency collapse increases. At that point the cost of imports rises forcing the adjustment process back into the domestic economy – most likely higher interest rates to counter the inflationary effects of a declining currency. The probability of such an outcome in our view remains low.

See articles:

- *Scaling the Great Wall – p64.*
- *Outsourcing manufactured exports – p67.*
- *Terms of trade magic – p70.*

7. INTERNATIONAL FORECASTS

In pretty good shape

Despite a few problem areas, the world economy has performed well over the last year, and the outlook for global growth is on the good side of average. The US economy has withstood ongoing difficulties with the fiscal and current account deficits, and both businesses and households are now contributing to the expansion. Both Australia and the UK look set to avoid a slump in activity as their housing markets soften. On the downside, Europe continues to grapple with the high exchange rate, while the Japanese economy has sunk back into recession – again.

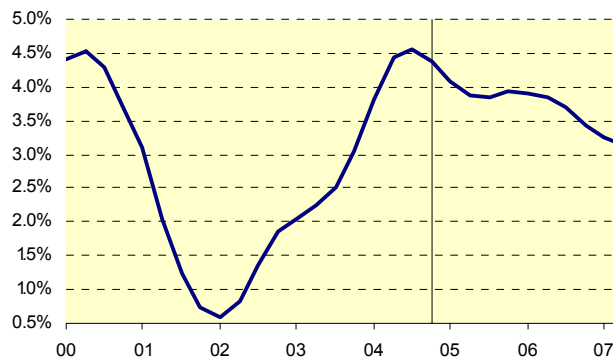
The American upturn matures

There may be ongoing concerns about the fiscal and current account deficits in the US, but notwithstanding these, the American economy has grown well over the last two years. The most positive aspect of 2004's increase in GDP of 4.4% was that business investment grew (10%pa) at a faster rate than consumption spending, for the first time in four years. The lift in investment was underpinned by three consecutive years of rapid profit growth. And the strongest private consumption growth since 2000 added to a good year for the US economy.

The American economy won't maintain quite the same momentum over the forecast period, but we still expect growth to hold above 3%pa through to 2007. The stabilisation of global oil prices has reduced a possible trigger of weaker growth and should feed through into improved business and consumer confidence.

Positive prospects

US GDP, annual average % change



Graph 7.1

Households are also feeling happier as job creation has picked up. At 1.7%, employment growth is running at its fastest in over four years, and the unemployment rate (currently 5.2%) is on a steady downward trend.

The Federal Reserve has stated that it expects to continue raising interest rates at a “measured” pace over 2005. That will result in the Fed funds rate reaching 3.25% by the middle of this year. Further interest rate increases are possible over the second half of 2005 if economic growth remains sufficiently robust. A “neutral” interest rate for the US is



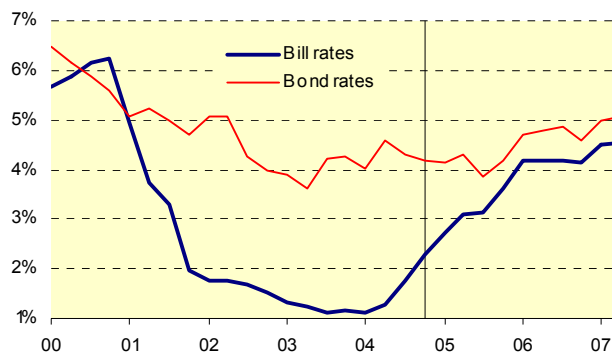
likely to be somewhere between 4% and 5%. We expect American 90-day bill rates to return to this range by early 2006.

A curious feature of US interest rates over the last nine months has been the reaction of the bond market. Since the Fed started tightening monetary policy in June last year, ten-year bond rates have dropped by 60-70 basis points. One explanation is that bond investors are not particularly confident that short-term rates will need to go much above 3.5%, and that the US economy is not as robust as everyone thinks.

However, it seems more likely that bond markets are complacent about inflation and have underestimated the amount of tightening required from the American central bank. Later this year, as the Fed continues to lift short-term rates, we expect to see long-term rates climb as well.

Bond rates must rise

US interest rates, quarterly averages



Graph 7.2

Deficits set to linger

The ongoing current account and fiscal deficits have weighed heavily on the US dollar, with the American TWI falling 6.7% over 2004. It is now down 27% since its peak in March 2002. Despite rising interest rates, we expect the greenback to remain weak over the next year.

Nevertheless, we predict some recovery in the US dollar over the second half of the forecast period. Ongoing solid growth in the American economy is likely to underpin a lift in demand for US shares by international investors, with P/E ratios looking much more attractive than they did five years ago. The weak US dollar also means that American stocks look relatively cheap in international terms.

An outlook of solid economic growth will also aid efforts by President Bush to reign in the fiscal deficit. Although it seems unlikely he will be successful in halving the deficit over the next four years, a shift towards more frugal fiscal policy would be favourably viewed by global financial markets.

Japan's flirtation with growth ends

Japan's stellar growth performance of more than 4% GDP growth over 2004 is no more. Changes in methodology by Japan's Economic and Social Research Institute mean that economic growth for the year was

scaled back to just 2.6%. Most worryingly, the economy shrank 0.6% over the last nine months of the year.

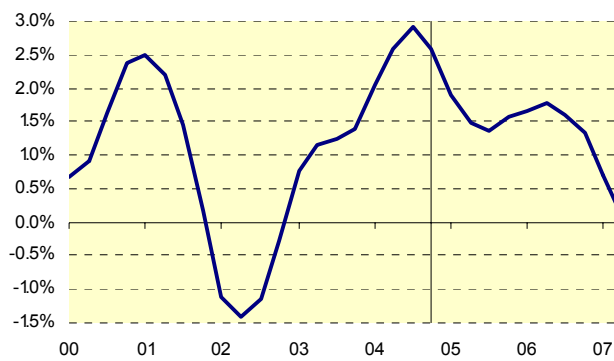
The slowdown was widespread, with private consumption growth turning negative, stocks being run down, government investment shrinking, and growth in exports evaporating. Foreign demand has been widely acknowledged as a key driver in the Japanese recovery, but the latest dip in exports has come as something of a surprise – particularly given that world growth is still relatively robust, and authorities in China have failed to dampen economic activity.

Adding to factors behind a continued slowdown this year is the government’s plan to slash income tax breaks, aimed at reigning in the fiscal deficit and getting government debt (currently 165% of GDP) under control. Private consumption growth is almost certain to suffer as a result of this policy, and the government may yet delay changes to the tax system, given that economic growth is already looking shaky.

We maintained a healthy dose of scepticism throughout 2004 as to whether the Japanese economy could sustain its momentum. Our latest forecasts see growth slowing to back under 2%pa this year.

Return to recession

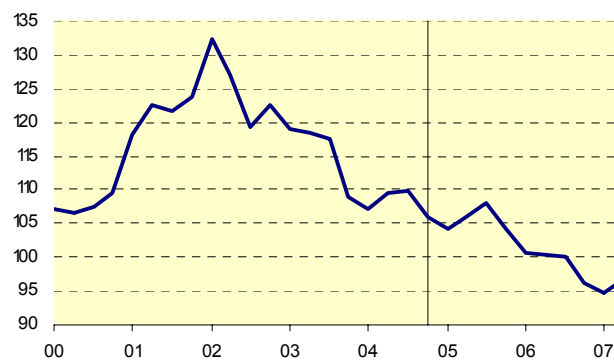
Japanese GDP, annual average % change



Graph 7.3

Weak economy, strong currency

Yen/\$US exchange rate, quarterly averages



Graph 7.4

We have also revised up our outlook for the yen over the forecast period due to ongoing weakness in the US dollar. The Bank of Japan is likely to



intervene in the foreign exchange market to prevent a significant lift by the currency, but we still expect the US dollar to drop below ¥100 during the next two years, for the first time since 1995.

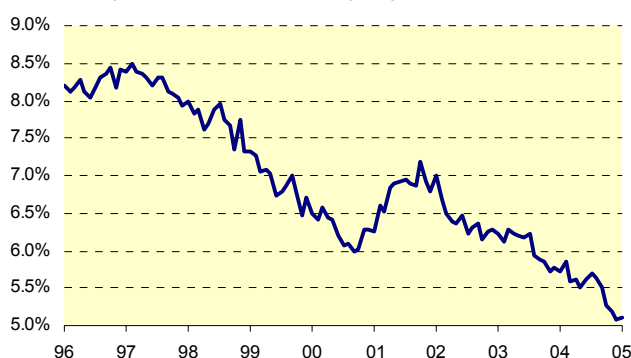
Australia avoids a housing collapse

Australian house price inflation slowed from 19%pa at the end of 2003 to 8.2% by the third quarter of 2004, with average prices falling 0.7% over the September quarter. Despite a lot of angst about the potential for substantial price falls in certain areas of the property market, there has been little evidence of the drop in prices intensifying further.

Household consumption has grown at more than 4%pa over each of the last three years, including an estimated surge of 5.4% over 2004. The weaker housing market will result in more subdued spending growth over the next two years. But with the unemployment rate hitting its lowest level since 1976 (5.2%), consumers are likely to maintain solid growth in spending activity despite high household debt levels. Private consumption is likely to grow at 3-4%pa over the next two years.

Australia runs out of labour as well

Unemployment rate, seasonally adjusted



Graph 7.5

A slowdown in the residential building sector will eliminate some inflationary pressures, while the strong Australian dollar is also helping to keep tradable prices down. With GDP growth set to hold above 3%pa, the Reserve Bank of Australia may consider raising interest rates again this year, for the first time since late 2003. However, the Bank will be wary of pushing the currency even higher and cramping the export sector – particularly given the current account deficit is already at 6% of GDP.

Some tightening in economic conditions is likely to occur courtesy of the government. Fiscal policy was loosened ahead of last year's election, and government spending growth will start to be pegged back in the middle of this year to ensure the budget balance stays in the black.

Europe's exchange rate squeeze

Europe's economic performance remains less than convincing, with the annual growth rate likely to stay below 2% over the next couple of years. The acceleration in European growth that occurred over 2004 seems unlikely to continue into 2005 – parts of the export sector are being cramped by the strong currency. The exchange rate with the US ended 2004 having risen 9.1% over the year.

Consumer confidence across the continent has been weak, with high unemployment rates feeding through into slack household spending. Germany, Europe's largest economy, has been one of the worst performers. Recent welfare reforms, aimed at getting more of the jobless back into work, have pushed up the measured unemployment rate – people must now seriously be seeking work to keep getting a benefit. Although the medium-term effects of this policy are likely to be positive for the economy, publicity of the continued rise in the unemployment rate appears to be stunting retail sales activity in the meantime.

With economic growth holding below 2%pa, the European Central Bank is under little pressure to tighten monetary policy. The high currency and sluggish domestic demand will help keep inflation under control.

The one area of concern is the housing market, with prices continuing to rise rapidly. Over the year to September, Spain, France, and Ireland all experienced house price inflation of over 10%pa. However, the ECB is unlikely to be distracted by this segment of the economy, given the broader outlook for inflation and growth. We expect short-term interest rates in Europe to remain on hold at 2% until late 2005 or early 2006.

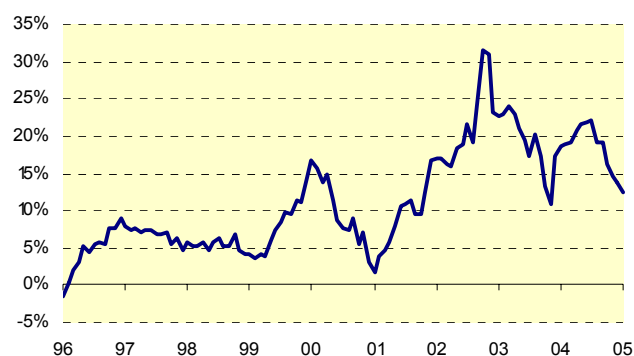
Weaker house prices and more tax for Britons

The British economy recorded its strongest growth over 2004 in four years, as consumer spending picked up towards the end of the year. The outlook is more modest over the forecast period, with two key factors limiting the likely expansion in GDP:

- The Halifax house price index has showed a clear downturn in the real estate market. Annual house price inflation has slipped from 22% to 12%pa over the last six months, and average house prices have fallen over each of the last four months. We expect the weaker housing market to have a negative effect on growth in household spending. Nevertheless, the tight labour market and solid income growth will help offset any negative wealth effects from falling property prices.
- The government may be forced to tighten fiscal policy within the next two years. A tax hike before this year's election is improbable, so it is likely that the 2006 budget will signal the government's desire to boost revenue.

British house prices start to soften

Annual % change, Halifax house price index



Graph 7.6



An outlook of slightly slower economic growth has meant that the Bank of England is beginning to entertain thoughts of interest rate cuts. There may be limited scope for an easing in monetary policy later in 2005 if the housing market continues to soften.

As in New Zealand, the Conservative opposition has shown little ability to differentiate itself from Labour and stands little chance of winning the upcoming election.

See articles:

- *Korea's credit card hangover – p72.*



	International GDP growth						International inflation					
	Avg 99-03	2003	2004*	2005*	2006*	2007*	Avg 99-03	2003	2004*	2005*	2006*	2007*
US	2.7	3.0	4.4	3.9	3.4	3.2	2.5	2.3	2.7	2.5	2.2	2.4
Japan	1.0	2.5	2.9	1.6	1.3	0.1	-0.6	-0.3	-0.1	0.0	0.7	0.0
UK	2.6	2.2	3.2	2.4	2.2	2.5	2.3	2.8	2.2	2.6	2.5	2.3
Euro Zone	1.8	0.4	1.8	1.9	2.0	2.2	1.9	2.0	2.1	1.7	1.7	1.8
Australia	3.5	3.3	3.5	3.3	3.2	3.8	3.2	2.8	2.3	2.5	2.6	2.4
China	8.0	9.3	9.4	7.6	7.5	7.9	0.0	1.2	4.1	2.5	2.4	2.6
Hong Kong	3.8	3.2	7.9	4.7	4.3	4.2	-3.0	-2.6	-0.4	1.1	1.8	1.4
India	5.7	8.2	6.1	6.5	6.7	6.7	3.9	3.9	4.6	5.4	5.1	6.6
Indonesia	3.7	4.5	4.9	5.3	5.1	3.9	10.9	6.7	6.2	6.5	6.1	10.9
Malaysia	4.9	5.3	7.1	5.0	5.5	6.4	1.7	1.2	1.4	2.4	2.6	2.8
Singapore	3.5	1.1	8.1	4.5	4.5	6.2	0.5	0.5	1.7	1.2	1.0	1.2
S Korea	6.7	3.1	4.6	4.7	3.3	4.5	2.7	3.6	3.6	3.1	2.9	3.7
Taiwan	3.2	3.3	5.9	4.1	3.6	5.0	0.2	-0.3	1.6	1.2	1.7	2.3
Thailand	4.7	6.9	6.1	5.2	6.0	3.9	1.2	1.8	2.7	2.2	2.6	2.9
Non-Japan Asia excl China	5.1	4.8	5.8	5.2	4.8	5.1	2.9	2.7	3.3	3.5	3.5	4.7
Non-Japan Asia	6.2	6.6	7.2	6.1	5.9	6.2	1.8	2.1	3.6	3.1	3.0	3.9
Major Country ^	2.1	2.0	3.2	2.8	2.5	2.3	1.8	1.8	2.0	1.8	1.8	1.8
Trading Partners (TWI)	2.3	2.4	3.3	2.8	2.6	2.4	1.9	1.8	1.9	1.8	1.9	1.8
Trading Partners (All)	3.0	3.2	3.9	3.2	3.0	3.1	1.6	1.6	1.9	1.8	1.9	1.9

* Infometrics forecasts

^ Major country definition now includes Euro Zone rather than Germany only - figures are not directly comparable to those previously published

Table 7.1



International interest rates

Period Averages

	US		Australia		Japan		Germany		UK	
	Bills	Bonds	Bills	Bonds	Bills	Bonds	Bills	Bonds	Bills	Bonds
2004	1.6	4.3	5.5	5.6	-0.1	1.5	2.0	4.1	4.5	4.9
2005*	3.1	4.1	5.6	5.3	0.0	1.3	2.0	3.5	4.4	4.3
2006*	4.2	4.7	5.7	6.3	0.1	1.2	3.3	4.1	5.1	4.7
2007*	4.6	5.0	4.7	5.6	0.0	0.9	3.2	4.3	5.0	5.2
2004 Mar	1.1	4.0	5.6	5.6	-0.1	1.3	2.0	4.1	4.0	4.8
Jun	1.3	4.6	5.5	5.9	-0.1	1.6	2.0	4.3	4.4	5.1
Sep	1.7	4.3	5.5	5.6	-0.1	1.6	2.1	4.1	4.8	5.0
Dec	2.3	4.2	5.4	5.4	-0.1	1.5	2.1	3.8	4.8	4.7
2005 Mar*	2.7	4.2	5.5	5.4	0.0	1.4	2.1	3.5	4.7	4.6
Jun*	3.1	4.3	5.7	5.3	0.0	1.2	2.1	3.6	4.5	4.3
Sep*	3.2	3.9	5.7	5.2	0.0	1.1	2.0	3.5	4.4	4.2
Dec*	3.6	4.2	5.7	5.3	0.1	1.6	2.0	3.4	4.1	4.1
2006 Mar*	4.2	4.7	5.7	5.5	0.1	1.5	2.3	3.6	4.4	4.3
Jun*	4.2	4.8	5.7	6.1	0.2	1.4	3.1	4.1	4.8	4.6
Sep*	4.2	4.9	5.7	6.7	0.1	1.1	3.7	4.2	5.3	4.9
Dec*	4.2	4.6	5.9	7.0	0.1	0.8	4.2	4.4	5.8	5.1
2007 Mar*	4.5	5.0	5.4	6.0	0.0	0.7	4.0	4.5	5.6	5.2
Jun*	4.6	5.1	4.8	5.2	0.0	0.8	3.5	4.4	5.2	5.2

International exchange rates

Period averages

	Yen/\$US	\$US/\$A	\$US/Euro	\$US/Pnd
2004	108	0.74	1.24	1.83
2005*	106	0.76	1.30	1.86
2006*	99	0.79	1.28	1.82
2007*	96	0.78	1.18	1.75
2004 Mar	107	0.77	1.25	1.84
Jun	110	0.71	1.20	1.81
Sep	110	0.71	1.22	1.82
Dec	106	0.76	1.29	1.86
2005 Mar*	104	0.77	1.30	1.88
Jun*	106	0.75	1.29	1.85
Sep*	108	0.76	1.29	1.88
Dec*	104	0.78	1.30	1.85
2006 Mar*	101	0.79	1.30	1.84
Jun*	100	0.77	1.28	1.82
Sep*	100	0.78	1.28	1.84
Dec*	96	0.80	1.24	1.76
2007 Mar*	95	0.80	1.21	1.79
Jun*	97	0.76	1.19	1.76

* Infometrics forecasts

Table 7.2

8. HOUSEHOLD ARTICLES

The stocks and the flows of our population

When we think of New Zealand's population, we tend to think of the stock – the 4,060,900 of us usually resident here. In doing so, we ignore the increasingly complex flows of temporary population, which now make up a small but significant chunk of the people involved in the economy. Furthermore, the trend towards increasing globalisation of our labour market, and the growth of our service exports, suggest this revolving-door population base will play a larger role in the economy in the future. Part one of the following article takes stock of these flows to estimate the effective population of New Zealand. Part two delves into the composition and trends of temporary population.

Part one

The stock

How does Statistics New Zealand calculate New Zealand's population? They get a definitive answer every five years through the census; in the meantime they adjust the most recent census results for births, deaths, and net permanent and long-term (PLT) migration.

Over the last ten years natural population increase (births minus deaths) has added on average 30,000 people to the population each year. Permanent and long-term net migration has added on average 14,000 people per year over the same period, although it is primarily the volatility of migration that drives the variance in population growth.

It follows that errors in population estimates are primarily due to flaws in the migration count, which relies on the self-identification of arrivals and departures on the basis of the intended length of their stay/absence – specifically, whether this duration is for twelve months or more. If so, the traveller is lumped in with the PLT migration statistics, and included in the population estimates.

Self-identification can lead to a miscounting of PLT migration if the intentions of travellers change: for instance, if someone enters New Zealand intending to take a three-month working holiday but is offered a permanent job and successfully applies for residence, then this person will not be counted as a permanent resident (until the next census). This phenomenon is known as category jumping, and we have argued previously that it might lead to a slight undercount of population growth.²

Over the last three years, for instance, total migration flows – all arrivals minus all departures – substantially exceeded the PLT migration flows, by as much as 42,000 over the year to March 2003. One explanation for this effect is a rise in category jumping. An alternative explanation, however, is that this discrepancy captures a rapid rise in the quantity of short-term flows, rather than a change in the long-term stock. A rise in short-term visitor arrivals, even if it is shortly matched by a rise in short-term visitor departures, could produce a net gain of total migration.

² 'Who are category jumpers', <http://www.infometrics.co.nz/article.asp?id=3014>

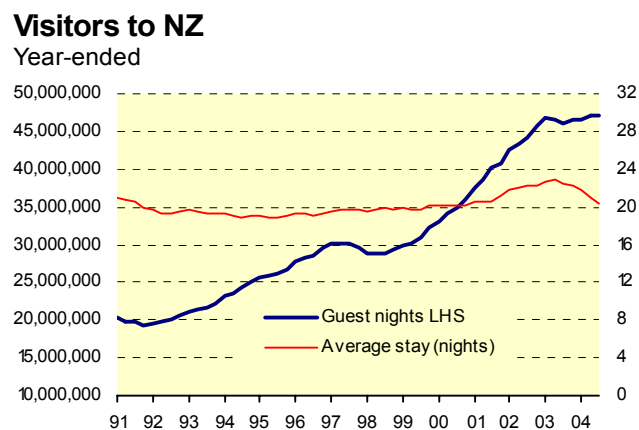


To see why this is so, imagine if the number of tourists on one month holidays to New Zealand suddenly doubled (on a permanent basis). One month later, the number of tourists departing would also double. Clearly, there is no PLT migration gain. But the number of tourists holidaying in New Zealand *at any point in time* would also have doubled, adding to the total size of New Zealand's population.

If we only focus on the traditional measure of population growth – that is, excluding population flows of the non-PLT variety – we overlook the impact that these alternative flows of people have on demand (and in some cases supply) for goods and services. Nor is there any distinction made between true short-term arrivals (e.g. holiday makers, business trips) and the more intermediate classes of temporary visitors (e.g. students and people with work permits). In the second part of this article we will examine the latter in more detail.

The flows

To overcome inadequacies in the resident population measure, we adjust the standard population estimates for all the visitors in the country intending to stay less than twelve months, and likewise for all the New Zealanders overseas. This allows us to estimate what we will call New Zealand's effective population – the number of people present in the country at a given point in time.³



Graph 8.1

To derive New Zealand's effective population we can use data on the intended length of stay (for stays of less than twelve months i.e. non PLT) of travellers to and from New Zealand.⁴ Using the simple relationship that every 365 days of temporary flows is equivalent to 1 full-time resident on

³ Technically, the number of people present in New Zealand on average over any given year.

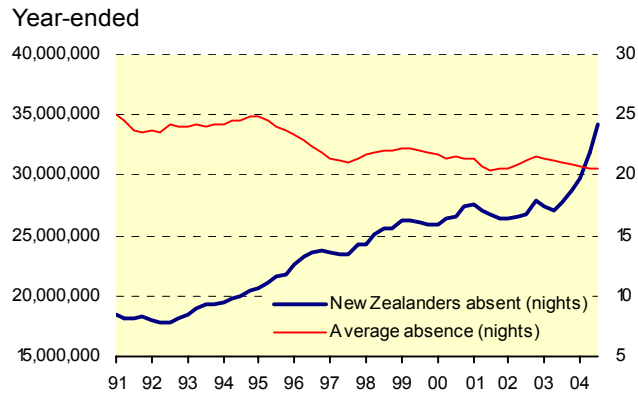
⁴ We have to rely on the data from airport arrival and departure cards. Given that most trips are relatively short (less than 28 days) we assume there is no systematic bias. However, for groups like student visitor arrivals (average stays of 90 days) we once again have the problem that actual plans may deviate from intentions.

an annual basis, we can impute the influence of temporary flows on the effective population.⁵

Over the twelve months to September 2004, visitors entering the country intended to stay for a combined total of 47 million nights. Divide by 365, and that is the equivalent of 129,000 full-time residents of New Zealand (3.2% of the resident population).

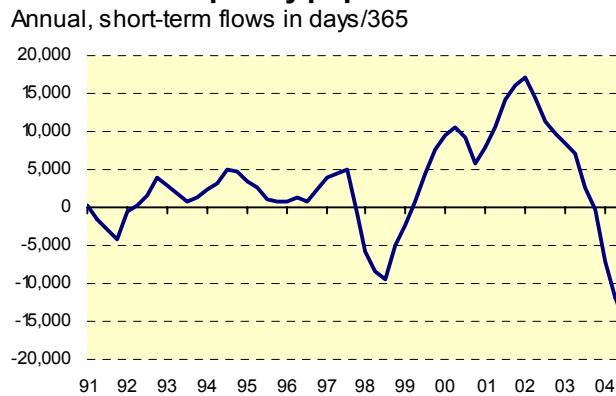
Of course, visitors to New Zealand are balanced by New Zealanders temporarily overseas. In the year to September 2004, around 1.67 million New Zealanders travelled overseas, intending to be absent for approximately 21 days each. This is equivalent to 94,000 full-time residents of New Zealand absent over the last year. Thus, the net tourism contribution to effective population was 35,000 people (an additional 0.9% on top of the resident population).

New Zealanders overseas



Graph 8.2

Growth in temporary population



Graph 8.3

⁵ We make the unrealistic assumption that traveller's expenditure is similar to locals. In reality, 365 days of temporary flows probably accounts for more expenditure than 1 normal resident. This would suggest that changes of effective population have slightly more impact than changes in resident population.



Using the same assumption that 365 days of stay is equivalent to one extra member of the population, Graph 8.3 shows the annual change in the effective population attributable solely to changes in short-term net flows.

From Graph 8.3 we can conclude that changing volumes of temporary flows explain some but not all of the category jumper effect (although the two series align well, the discrepancy between PLT migration and total migration in peaked at 42,000 in 2002). Nevertheless, these flows do at times make a significant contribution to population growth – a net 15,000 people is equivalent to 0.4% population growth.

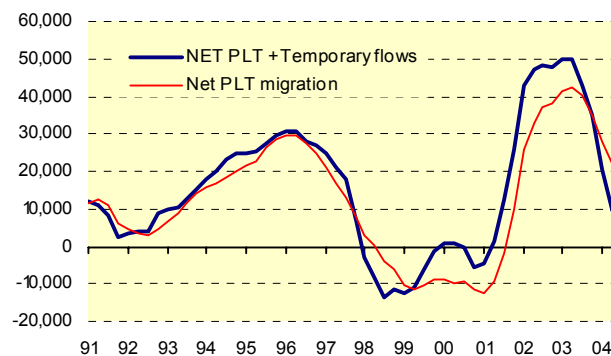
The recent surge in numbers over 2000-2003 is attributable to a range of factors:

- This period saw a rapid increase in visitor numbers as the New Zealand dollar plunged.
- The average length of stay for visitors increased, driven by exponential growth in student numbers, which increased from 22,600 in the 2000 June year to 52,500 in the 2003 June year.⁶ Students stay in the country for an average of 96 days each, compared to the average of 19.6 days for non-students.
- The above effects were compounded by a reduction in the number of nights spent abroad by New Zealand tourists over 2001-2002, due to the weak New Zealand dollar.

Over the last two years, however, temporary flows have become a drain on the effective population. This reflects a slump of student in inflows, a more widespread decline in the intended days of stay across all categories (possibly related to the high dollar), and, most importantly, rapid growth in temporary outflows of New Zealanders over the last eighteen months.

Effective population growth

From total flows, Annual



Graph 8.4

⁶ These numbers actually refer to the education/medical category for the purpose of visit question. We assume that medical visitor numbers are relatively small and stable. Again, this only includes those intending to stay for less than twelve months.

Graph 8.4 shows the combined effects of the short-term flows with PLT migration. Although PLT migration is still the main driver of changes to the effective population, over the last four years short-term flows have amplified the cyclical movements. Specifically, when the net effects of changes to the temporary population are considered, the drop-off in annual population growth over the last eighteen months has been 46,000 rather than 25,000.

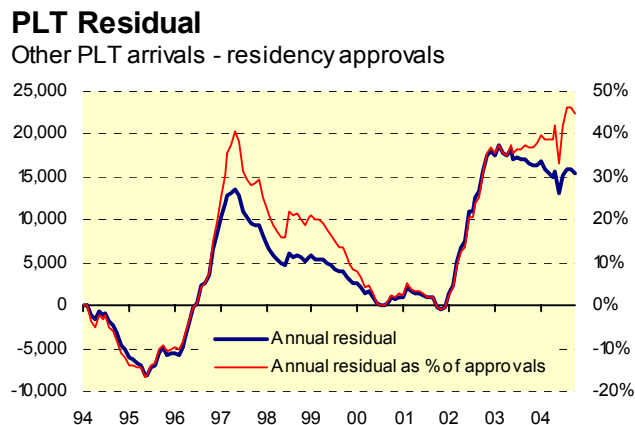
This suggests, *prima facie*, that a more pronounced fall in aggregate demand growth has taken place than is conventionally thought, especially for goods and services that cater to the needs of temporary population (e.g. accommodation, rental cars, etc.). However, the current negative impact of temporary flows is being driven primarily by increasing numbers of New Zealanders travelling overseas, and it is not clear that this produces the same drop-off in domestic demand than a fall in foreign visitors would.

Part two

Temporary is the new permanent

In the second part of our examination of population flows, we take a qualitative approach to identify trends within the migrant flows under the jurisdiction of the New Zealand Immigration Service. We explain why these groups are likely to be of greater importance in the future, and ask whether the idea of “permanent” migration is now passé.

The first part of this article used the official data from Statistics NZ on population flows to relate temporary flows to permanent and long-term (PLT) migration. An alternative perspective on this issue can be garnered by examining the data the New Zealand Immigration Service produces on work, student and residence approvals. Unfortunately, there is currently no way to reconcile the official statistics with the NZIS data: regardless of what kind of visa is used to enter New Zealand, classification as PLT is dependent only on whether the migrant indicates an intention to remain in New Zealand for 12 months or more. No data exists that tells us how long people with work or student visas remain in the country.



Graph 8.5

Nevertheless, there is reason to believe that work and student permits are playing a growing roll in boosting population. Graph 8.5 shows the difference between the number of PLT arrivals (excluding New



Zealanders and Australians) and the number of residence approvals granted. Over the last three years, this residual has been very significant, and compared to the number of residence approvals it is now at an 11-year high.

In recent forecasts, we have assumed that the above residual largely appeared as a result of arrivals lagging behind falling approvals (as was the case in 1997). If this is the case, then the residual could disappear over the next year, as approvals emerge from a trough. However, the size and persistence of the residual suggests that it is in part systematic – and that it reflects the growing numbers of PLT arrivals with (or intending to acquire) work or student permits.

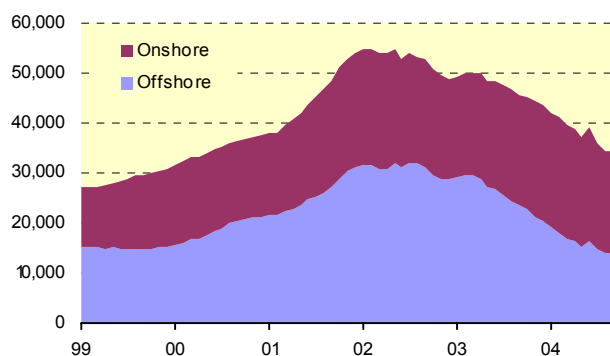
Certain trends in NZIS data – namely the rapid growth in work permits, and the increasing number of residence approvals being issued to onshore applicants – imply a new paradigm for New Zealand immigration. The residence programme is becoming a process by which immigration is formalised, rather than a method for generating immigration. Presumably the labour market has taken over as the main driver of immigration, but the caveat is that current inward flows are much less firmly tethered to New Zealand.

Residence approvals

Conventionally, we think of residence approvals being granted to desirable applicants from foreign countries, who then immigrate to New Zealand within the year. This was always a simplification, but now it's starting to look plain wrong. Residence approvals of onshore applicants have risen from a low of 41% of the total in 2003, to 60% today (an all-time high).

Residence permits

Source: NZIS, year-ended



Graph 8.6

In a sense, the importance of onshore applicants to New Zealand's labour market is much higher. Each onshore application covers 1.63 people on average, compared to 2.35 for offshore. Hence onshore approvals are more likely to be principal applicants, and thus well qualified to enter the labour market.

The idea that residence approvals largely just legitimise past immigration is given credence by statistics that show that at least 75% of principal applicants for residence in the June 2004 year had previously held some form of New Zealand visa or permit. Of these, 74% most recently held

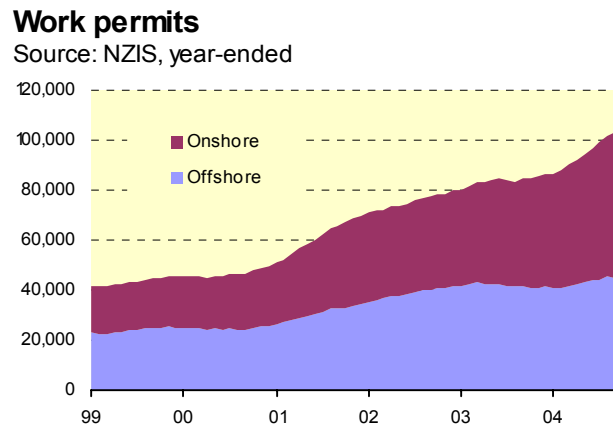
work permits. Alternatively, of the people issued with work or student permits in the June 1998 year, 29% have since been granted permanent residence.

On the other hand, even a residence approval is no guarantee that a migrant will prove to be permanent. NZIS research suggests that approximately 20-25% of residence approvals are no longer resident in New Zealand in five years.

Work permits

At a time when residence approvals are in decline, the number of work permits issued has soared. Permits issued have risen by 23% over the year-ended October to 104,000, which went to around 79,000 separate people (some people receive more than one permit in a year). Around 37% of these people received skill shortage work permits – which allow the recipient to undertake full-time work, but can only be issued for occupations in shortage (at the moment, the list is very broad). However the number of skill-shortage work permits that may be issued is uncapped. Whereas the next largest category of work permits, working holiday scheme, have quotas (although the government has recently announced its intention to raise this quota from 31,000 to 40,000 over the next two years, and for countries with reciprocal schemes, it will become unlimited).

Growth in work permits has stemmed from both onshore and offshore applications. This appears to reflect both increased recruitment of workers from overseas, and growing numbers of temporary migrants taking part in the workforce on a permanent or semi-permanent basis.



Graph 8.7

If we assume that each person with a work permit is equivalent to half an FTE, then we would conclude that work permits currently make up 2.2% of our workforce. However, the growth in work permits over the last year suggests that 13% of new employment was made up of temporary migrants.

Student permits

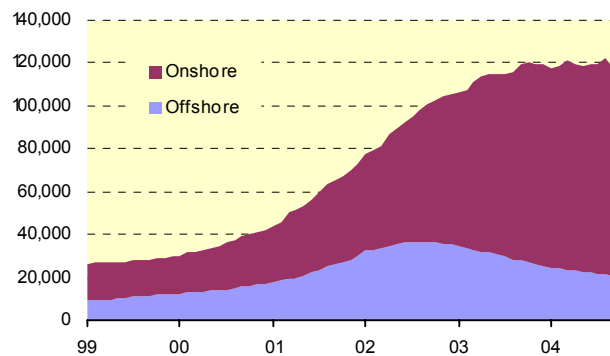
Although international students are more loosely affiliated with the labour market, and less likely to become a permanent resident, the sheer number of student permits issued means they are an important category



for the economy. In the year to June 2004, there were 119,000 permits issued to 87,000 separate people.

Student permits

Source: NZIS, year-ended



Graph 8.8

However, offshore student approvals have been in serious decline for the last two years, and as a result total student permit numbers are now falling. This is almost entirely due to falling Chinese student numbers. Furthermore, if we make the assumption that onshore student approvals largely represent offshore approvals from previous years, then total foreign student numbers in New Zealand are likely to fall by around 40% over the next two years (also making the optimistic assumption that the fall in offshore approvals can be arrested).

A fall of around 35,000 in the stock of students in New Zealand has the following implications:

- Potentially, we could see a large increase in PLT departures, depending on how departing students fill out their airport departure cards.
- The international student education industry will come under significant pressure, along with the tertiary education sector, which is heavily reliant on foreign fee-paying students.
- The Auckland housing market may have 35,000 too many cubby-hole sized apartments.

There is some prospect of avoiding these outcomes. Firstly, onshore approvals may remain high as temporary migrants try to gain qualifications to increase their eligibility for residence under the Skilled Migrant Category. Secondly, the Chinese economy is growing strongly, which should support underlying demand for education services. A drop in the New Zealand dollar or an upwards revaluation of the Chinese yuan would increase the price competitiveness of the New Zealand education industry.

Conclusion

PLT arrivals are less likely to have residence approval, and more likely instead to have a work or student permit (or be intent on getting one). This suggests that in the future, the tightness of the labour market will be

a more significant factor in determining net migration than the exogenous immigration target set by the government.

However, because the economy will be more reliant on “capturing” temporary migrants already in the country and making them permanent or semi-permanent residents, PLT data may systematically undercount net migration inflows. Even if this does not occur, the changing quality of the immigration make-up may lead us to underestimate the impact of immigration on the labour market. Domestically located migrants with work permits will tend to crowd out overseas applicants in the residence programme, and as the former tend to have smaller family units than the latter, this will result in migrant flows that are more capable on average of finding work in New Zealand.

The rising demand for work permits shows that the labour market is fully capable of utilising foreign workers to deal with skill shortages. It is conceivable that this is one factor explaining why New Zealand has so far been able to sustain a low unemployment rate without accelerating wage inflation.

A potential pitfall, however, is that the New Zealand economy remains reliant on “lifestyle factors” rather than wages to compete for workers in global labour markets. And with labour increasingly footloose, the risk of strong migration outflows is also increasing.

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These forecasts are available on the internet: www.infometrics.co.nz.*



9. BUSINESS ISSUES ARTICLES

What the government can do to improve productivity

The government has put productivity at the top of its policy agenda. Sustained rapid growth has exhausted capacity and without some productivity magic the economy will be forced to pull its head in. But what can the government do to lift productivity growth?

One of the key messages from the 1980/90s reforms that formed the basis for the current growth surge, was the importance of institutions, market signals and the broad economic conditions. A deep philosophical resistance to the economic reforms and little evidence of a change in economic fortunes persuaded the new Labour government to adopt a much more proactive approach to economic management. The apparent success of such a change in policy direction has meant less attention has been paid to ensuring economic institutions are conducive to sustaining fast growth.

Areas this and future governments might address if it is serious about raising productivity and ultimately lifting New Zealanders' incomes to at least the average of the OECD include:

- Further simplify the tax system to reduce compliance burdens and minimise distortions to investment decisions
- Differentiating between requirements for government procurement and government provision (monopoly provision of services by government may not be the most efficient means of providing for needy groups)
- Encourage a more commercial approach to the provision and operation of infrastructure to ensure the efficient use of scarce capital
- Adopt political structures that encourage consensus building – policy reversals are very costly
- Strengthen institutions dedicated to the protection of property rights and the enhancement of competition

The primary goal of businesses is to maximise profits. They do that either via productive endeavours, or, if the opportunities and incentives are available, via rent seeking activities⁷. Minimising such rent seeking opportunities and incentives is the responsibility of the government and the institutions it operates through.

Taxes, grants, subsidies, tariffs are the most critical areas to address because by their very nature these actions distort economic behaviour and therefore tempt businesses to change what they do to collect something for nothing. Such behaviour transfers wealth at the margin

⁷ Rent seeking takes place when people or organisations seek to extract uncompensated value from others by manipulating the economic environment. For example, one can increase personal wealth by avoiding tax payments, but from a national perspective this simply shifts the onus of making up any shortfall in tax revenue onto others.

from productive firms to less productive firms – the opposite of what the government is trying to achieve.

Paradoxically the government's growth and innovation framework runs the risk of crippling the signals and incentives for innovation and entrepreneurial activity. The basic objective of business is to maximise profits and in doing so they often, but not necessarily, also generate economic growth. The key difference between successful and unsuccessful societies is the nature of the institutions and incentives facing entrepreneurs. These determine the extent to which business seek to maximise profits by "stealing" them from others or by creating new value.

The government has important role to play in helping lift New Zealand's rate of productivity growth. However, that role has more to do with ensuring the business environment both encourages and rewards innovation and entrepreneurial activities. Competition, property rights and transparent and high quality policy development are all areas the government has responsibility for and that directly affect the behaviour (performance) of firms.

To help offset the many disadvantages facing New Zealand businesses (small size of the economy, trade barriers, distance from markets) the government's focus should be on the quality of their policies and operations rather than becoming too involved with how businesses behave. The lesson from the current period of impressive economic growth is that economic fundamentals matter. Muddying the economic signals will lead to confusion, rent seeking and eventually slower economic growth.

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Please participate

The obvious shortage of workers, particularly skilled ones, raises the important question of participation rates (encouraging more people of working age to put themselves up for paid employment), and the allocation of labour.

Both major political parties see increased rates of participation as a solution to the dwindling stock of unemployed workers. But there are obvious diminishing returns involved with increasing participation rates.

Women in work

Despite New Zealand having a reasonably high rate of participation (above the median for OECD countries), participation rates for women aged 25-34 are relatively low. Both National and Labour see this as a potentially valuable source of extra, highly productive workers.

National is looking to squeeze more people off benefits and into the paid workforce. The number of people on social welfare (excluding unemployment and national super) has been surprisingly resistant to the good economic growth New Zealand has enjoyed over the past five years. National plans to tighten benefit criteria in the expectation that people will be encouraged to shift from welfare to work.

Meanwhile Labour has identified childcare as a key constraint to female participation. Indeed, studies have identified that access to childcare is a binding constraint on the ability for many women to return to the workforce⁸. But despite their rhetoric, the government has yet to do anything that addresses this issue. Subsidies to community crèches provide virtually no assistance to working mothers. The part-time nature of the services offered by community crèches means that their prime service is to provide some time-out for full-time caregivers (as well as introduce children to community living and perhaps begin the formal education process). It is commercial crèches that generally provide the full-day care services that enable women to work, and these crèches were explicitly excluded from recent government initiatives.

More work, worse lives?

This debate seems more about improving party political wellbeing than the wellbeing of New Zealanders in general. To begin with, while eligibility for the domestic purposes benefit might be open to abuse by a minority, its presence also improves the lives of many New Zealand families. Any moves to add stringency to eligibility requirements needs to be careful that it does not punish the majority because of the actions of a few.

It is not clear that increases in participation rates for women will improve national wellbeing. New Zealand's birth rate is high relative to other OECD countries. It may be that New Zealand's low female participation rate reflects this higher birth rate. Lower participation today may be necessary for sustaining wellbeing beyond the current decade.

⁸ See for example Department of Labour and Ministry of Social Development (2001) *Evaluating the Feb 1999 Domestic Purposes Benefit & Widows Benefit Reforms*

In many cases an increase in the female participation rate will simply substitute paid work for unpaid work. This “monetising” of the economy increases measured economic activity (GDP), but it does not necessarily imply an increase in national welfare or wellbeing. Ultimately this is a difficult to measure empirical issue: does the monetised benefit of more women working in paid employment exceed the benefit to society from unpaid activities such as the full time care of their own children? Irrespective of the answer to this question there is a deeper philosophical question: to what extent should decisions to participate in paid work be determined by societal laws or by the preferences of individual households?

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10. FINANCIAL MARKETS ARTICLES

Who ends up forking out for your pay increase?

The final Reserve Bank survey of expectations for 2004 showed wage expectations are at their highest in 14 years. Upward pressure on wage costs looks set to intensify over the coming year as the unemployment rate holds below 4% and employees look to take advantage of their increased bargaining power. What does the threat of bigger wage costs imply for inflation more generally?

Boosting expectations

The lack of a noticeable pick-up in wage inflation over the last 2-3 years given the constant decline in the unemployment rates has been an economic riddle. Although businesses have found it difficult to get suitable staff, they don't seem to have been willing to pay more to obtain them.

In January, the Engineering, Printing and Manufacturing Union decided that workers were being taken for a ride, and argued that "there has never been a better time to argue for a good pay rise." Their case was based on strong economic growth, good business profits, a rising cost of living, the shortage of labour, a perceived bias in pay increases towards senior management, the rising share market, and improved labour productivity. The campaign received a fair amount of media coverage and is likely to have added to the hope of some workers for a better pay deal.

Higher wages, even in real terms, are not necessarily inflationary. If the Union's claim about productivity growth of 1.5%pa is true, then workers have a justifiable case for seeking a real wage increase of the same magnitude. But the danger lies in the logic that "the Metals [Industry] agreement sets the benchmark for other settlements". A productive metals industry doesn't necessarily mean that postal service workers have lifted their productivity by the same amount, and therefore deserve a commensurate increase.

Good times are for passing the buck

The risk is, given current labour market conditions, that firms may have little choice but to concede to workers' wage demands. Many employees will have the very real option of getting another better-paying job elsewhere if they're dissatisfied with their current position. The key to how the labour market unfolds this year is the expectation of workers, and how important the issue of remuneration is to them.

If we assume that wage demands will be beefier this year, and real wages will rise faster than productivity, the next question centres on how willing or able firms are to pass the cost increases on to consumers. The strength of economic growth over the last 2-3 years has fattened corporate profits, and where costs have increased (e.g. fuel), these have often been directly passed on. In times of strong demand, why absorb a hit to the bottom line when your customers are willing to soften the blow?

The consensus among economists is that the rate of GDP growth will slow this year. In other words, conditions won't be as conducive for companies looking to push up prices further in response to higher costs. Instead, firms may accept thinner profit margins – industries that have done particularly well over the last couple of years, such as the residential building sector, may adopt this approach. An alternative is to increase investment in labour-displacing capital equipment, and thus keep wage costs down.

Consumers have already been hit with higher prices over the last year in response to increased labour costs. The much talked about surcharge put in place by many restaurants and cafes on public holidays demonstrates the readiness of firms to pass on costs to their clientele. Its prevalence is perhaps a reflection of the buoyant economy – in less upbeat times, we suspect that a heightened sense of competition would result in more businesses trying to gain a competitive advantage over their rivals by being “surcharge-free”.

Summary

The degree to which an acceleration in wage costs is inflationary depends on a number of factors, including:

- the growth in labour productivity of workers in a given situation;
- the profitability of firms and their ability to absorb cost increases;
- the strength of economic growth and the willingness of consumers to pay higher prices for goods and services.

The tone of our economic forecasts over recent months has been one of sustained growth – any slowdown in growth is likely to be modest, with the economy continuing to expand at over 2.5%pa. The generally positive nature of the growth outlook suggests that conditions are ripe for widespread wage claims of 3-4%pa. That will stimulate inflation expectations and cause the Reserve Bank to think hard before easing monetary conditions.

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11. FISCAL ARTICLES

The taxing question of redistribution

In December 1987, then Finance Minister Roger Douglas was on the verge of installing a flat income tax in New Zealand. As radical as that idea may seem now, it had almost unanimous support from the Labour cabinet. If not for Prime Minister David Lange's infamous decision to break from the reform process for "a cup of tea", New Zealand might still have a single income tax rate of 23%. Instead, debate on what tax structure would best suit New Zealand's growth ambitions has been largely silent for the last 17 years.

The flat income tax was not the sole element of Douglas's economic package, but it is the best remembered. In order to compensate for the transition costs of adopting a single tax rate, Douglas also intended to introduce a Guaranteed Minimum Family Income for low-income households, and shift to user-pays for health and education services for higher income earners. The proposed changes were driven by a desire to create a simpler, growth friendly tax system, without producing too many "winners or losers" overall.

In the 2004 Budget, the current Labour government introduced its own comprehensive family support package, but ignored the opportunity afforded by the large fiscal surplus to revamp the existing tax system. Instead of using "Working for Families" to mitigate the transition costs of a flatter tax system, the government opted for more complication, more administration, and a larger chunk of the population trapped by high effective marginal tax rates.

As we enter an election year, and with large projected surpluses still very much on the public radar, taxes are likely to be a point of political debate. The debate, however, will likely focus on the trivia of the tax system: what the top rate should be, what the thresholds should be, how much of a tax cut the government can afford. What has been lacking for the last 17 years is a willingness to address fundamental questions about why we have a tax system, and how it should function.

In this article we re-examine the case for a flatter tax system. We are not attempting to put the case for a smaller government, nor are we arguing that one income group deserves to be made better off at another's expense. Instead, we intend to explain why the tax base necessary for any chosen level of government expenditure (and indeed any chosen level of income distribution) would be more efficiently gathered through a flat tax system.

A completely flat tax system is not incompatible with government's social aspirations – whereas the current taxation system is incompatible with their economic growth ambitions. Progressive tax systems may be a popular notion – even a cornerstone of modern democracies – but ultimately they are intellectually dishonest. Despite popular opinion to the contrary, progressive taxation is not:

- an effective way of redistributing income; or

- an efficient way of raising tax for government spending.

Redistribution reconsidered

Progressive tax systems are seen as desirable because they directly redistribute income by taking proportionately more from high income than low income people (whereas a flat tax system would have no direct redistributive effects).

The extent to which the government should play a role in redistributing income is a complicated moral and political issue. However, regardless of what level of redistribution a democratic society finds acceptable, a progressive tax system is not an efficient way of achieving the desired reallocation of income. Why?

- Because there are many more tax payers in the lower income brackets than in the top one, taxing the top band at a higher marginal rate only ever produces small reductions in the amount of tax needed from individuals in the lower income brackets.
- Lower tax rates on the bottom income bands are inefficient because they also give tax reductions to those on higher incomes (who in fact receive more benefits in nominal terms, because their income exceeds the upper limit of the band). In order to recoup the lost tax revenue from high income earners, a much higher top marginal rate of tax is required than would otherwise be the case.

The last broad based review of New Zealand's tax system, the McLeod tax review of 2001 (from which the above arguments were drawn), concluded that redistributive aspects of the current progressive tax system were slight.⁹ So why do we persist with one?

The role of the tax system should simply be to finance the government's spending plans in the most efficient way. Once expenditure has been decided on, only one single tax rate is required to balance the books. There is no need to complicate the financing process by trying to coerce social policy goals into the system. If redistribution is required, the government can design its social policy in a manner that concentrates the benefits on lower income deciles (the status quo in New Zealand), and in this manner achieve the desired social outcome.

The tax system: flatter is better, but flat is best

All taxation distorts the incentives that people face when they make decisions about work, savings, and risk taking. These distortions lead to a smaller economy, and slower economic growth. But taxation is required for the provision of public goods and services. The aim of a good tax system, then, is to collect the necessary revenue with the minimum of distortion.

However, the complicated nature of the current tax system encourages high income earners to devise ways to avoid the higher marginal rates - by splitting their income through trusts, or through incorporating as businesses. Meanwhile, the government is forced to create a larger tax administration to combat such schemes. These efforts represent a loss of time and resources that could be put to more productive use.

⁹ Robert McLeod et al., "Tax Review 2001", 2001.



Another deficiency of a progressive tax system is that higher marginal tax rates are required than would otherwise be the case. Flattening the tax system and reducing marginal rates of tax would increase the incentive to work, save, and take enterprising risks. It would also lessen the appeal that emigration holds for highly paid, highly mobile workers.

A progressive tax system results in extra deadweight losses for any level of tax burden, and this inefficiency rises with the degree of progressivity. This is a reason why a flatter tax system is always preferable to the current structure. But the endpoint of such logic – a completely flat tax system with one single rate of income tax – has additional advantages:

- As the tax system becomes flatter, the remaining redistributive benefits of a progressive system are outweighed by the substantial efficiency gains a single rate of tax offers (by eliminating avoidance issues and administration costs).
- The decision to embrace a progressive system leads to complexity in deciding which of an infinite range of progressive systems is most preferable. Whereas a flat tax rate is a simple and transparent principle – it makes it easier for governments to resist calls to alter the tax regime for the benefit or detriment of one specific group.
- A flat tax makes it easy to explain to the public the level of taxation needed to fund the cost of alternative fiscal policies.¹⁰
- There are significant potential economic gains to be made by reorienting high value resources (e.g. lawyers, accountants, and IRD staff) to more productive tasks.

Making flat tax mainstream

The immediate stumbling block for advocates of a flat tax system is that the transition to such a system would produce a large number of short-term losers, whereas the short-term gains would be concentrated on the rich. For instance, if we introduced Douglas's flat tax rate of 23% today (a move that would be fiscally neutral overall), everyone with an income less than \$51,500 would have to pay more tax.¹¹

There are two effective solutions to this problem. The first is to accept that the shift to a flat tax system must inevitably be a drawn out process, involving many smaller reductions in the progressivity of the tax scale. The second is to offset the losses of lower income workers with added financial assistance and/or access to services (free health and education), funded either by reducing government services to high-income groups (as Roger Douglas envisioned) or through the fiscal surplus. Given that the government is currently enjoying record surpluses, and has already detailed an extensive programme of income support for low income families, conditions are currently ripe for starting the shift to a flatter tax system.

¹⁰ Richard A Epstein, "The Case for a Flat Tax", NZBR, 2004.

¹¹ Those earning \$38,000 would face the largest nominal tax increase of \$1,330, or \$26 a week.

The next hurdle that a flat tax proposal must overcome is convincing New Zealanders that it would lead to benefits for all in the long-run, if only for a few in the short-term.

A flat tax system is not a panacea for lifting New Zealand's long run growth rate. But reduced marginal tax rates and the removal of opportunities for tax avoidance would encourage faster growth, and a more productive use of New Zealand's resources – the benefits of which are shared among everyone.

If the prospect of participating in a richer economy in the future is not attractive enough by itself, then it is necessary that the government take steps to ensure that there are no short-term losers. This would either involve some of the surplus, or increasing use of user-pays and means-testing of government provisions for high income deciles.

The first step is acknowledging that there is no prima facie justification for a progressive tax system. But the status quo has considerable inertia, and there is currently no political appetite for difficult debates. We can only hope that another 17 years do not need to pass before the idea of serious reform can once again be mentioned.

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12. EXTERNAL ARTICLES

Scaling the Great Wall

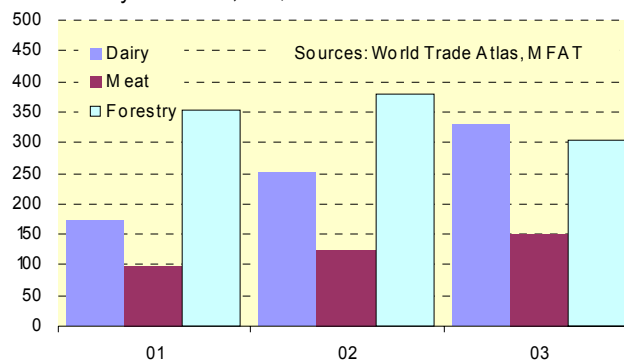
With a population of around 1.3 billion and an economy 18 times the size of New Zealand's, China presents gargantuan growth opportunities for New Zealand exporters. A recently published feasibility study of a free-trade agreement (FTA) between China and New Zealand supports this view, but there are some dangers in getting carried away with the hype.

Facts and figures

It is difficult to overstate the importance of China – the world's seventh largest economy, and one of its fastest growing. China is New Zealand's fourth largest export market for goods (NZ\$1.5bn in 2003¹²), behind Australia, the US, and Japan.

Value of NZ exports to China

Calendar year totals, NZ\$m



Graph 12.1

Moreover, since the beginning of 1999, China has become a rapidly growing source of tourism revenue. It now accounts for 3.5% of all tourists coming to New Zealand, and on average they are among the highest spending visitors. The enormous number of wealthy Chinese people means that the prospects of future tourism growth from that country are bright.

The rationale for an FTA

An important motivation for China in negotiating an FTA with New Zealand is the political kudos it secures. While New Zealand is an economic speck in terms of world markets, its reputation as a strong advocate of free trade and its liberal trading framework means that China can claim rather more credibility for its commitment to free trade than if it negotiates a deal with, say, Singapore. If, as we suspect, China and New Zealand eliminate virtually all trade barriers between the two countries, then China has a strong hand in negotiations with other countries.

¹² Figures in this article are quoted in New Zealand dollars. However, some have been converted from sources where figures were given in US dollars. Where this is the case, the amounts have been converted using the average USD/NZD exchange rate for whichever period is being examined.

From China’s point of view the risks to their economy of a “very-free” trade agreement with New Zealand are minimal – of course so are the economic benefits (in relative terms).

Winners and losers

Although China’s willingness to negotiate is politically driven, New Zealand stands to gain economically. The quantitative modelling carried out for the feasibility study¹³ returns a range of results in support of a deal, including the finding that between 2007 and 2027, the value of New Zealand’s goods exports to China would be expected to lift by an annual average of between NZ\$280-430m as a result of an FTA. Although these “extra” exports only represent about 1% of the current total annual value of our exports, the cumulative impact of an extra 1% each year over a 20-year period would be of worthwhile significance.

The forestry, dairy, and meat sectors all look set to receive a fair chunk of the increased export pie, as tariff elimination would give them a significant price advantage – see Table 12.1. The tourism sector would benefit from increased promotion and interest in New Zealand from Chinese tourists.

Import tariff levels

		2001	2002	2003	2004
China	Overall	15.3%	12.0%	11.0%	10.4%
	Industrial products	14.7%		10.3%	9.5%
	Agricultural products				15.6%
New Zealand	Trade-weighted overall	3.7%	3.7%	3.7%	3.6%
	Trade-weighted for goods from China				6.0%
	Clothing, carpet, certain footwear				17-19%
	Agricultural products				2.1%
	Industrial products				4.4%

Source: MFAT

Table 12.1

On the other hand, the New Zealand clothing and textiles industry shapes to be a major loser from an FTA with China (imports from China make up over 50% of New Zealand’s textiles and apparel imports). The textiles industry in New Zealand is currently protected by the country’s highest import tariffs, and even after reductions over the next 4-5 years, it is still likely to be hiding behind 10% tariffs in 2009. The Chinese textiles industry is so large that duty-free imports may well signal the end for New Zealand manufacturers. Although this would initially result in job losses, those unemployed would then be able to alleviate labour shortages in other areas of the economy (arguably a better resource allocation).

Of course, if the textiles industry can follow the lead of some other New Zealand producers (most notably lamb exporters – see our article, *Terms of trade magic – p70*) and move towards goods that are more closely

¹³ A Joint Study Report on a Free Trade Agreement between China and New Zealand can be viewed on MFAT’s website (www.mfat.govt.nz).



aligned with what consumers really want, then it might still have a future (probably in producing high value-added output).

Our concerns

As alluded to above, one effective way for businesses to protect themselves against competition from low-cost production (such as that in China) is to shift towards high-value “niche” goods. We reckon that a good proportion of the rise in the terms of trade (a measure of the purchasing power of our exports) that sees it now sitting at 30-year highs has been because of firms focusing more on quality rather than quantity.

An FTA with China may slow or even reverse this trend in some areas of the economy. Although the Chinese market is becoming more “modern”, it still demands large quantities of commodity products. Of the sectors that were identified as “winners” above, a fair proportion of their exports are commodities – 65% of forestry exports to China in 2003 were unprocessed logs and pulp, New Zealand is China’s largest supplier of low value-added milk powder, and our exports to China of animal offal for human consumption have also lifted in recent years. These goods are hardly “high-value”, but may well be items that increase their share of New Zealand’s production if we enter an FTA with China. At the very least, that would be likely to dampen further gains in our terms of trade.

There is also anecdotal evidence that large Australian and US corporations are interested in shifting some of their production to New Zealand to allow them to avoid tariffs on exports to China. Although this is probably a good thing for New Zealand (in the sense that it creates jobs), it may result in a trend towards us producing goods that we do not have a comparative advantage in – from an economic point of view this is undesirable, particularly since many of our inefficient industries have been successfully purged over the last 20 years.

Conclusion

Both intuition and economic modelling suggest that a free-trade deal with China is a significant step forward for New Zealand. Any costs that may result (for example, the potential closure of our textiles industry) are likely to be significantly outweighed by the benefits of a broader range of goods at lower prices for consumers, and tariff-free exporting.

However, there are caveats. If an FTA with China causes some of our production to shift back towards low value-added commodities, we may see slower, and possibly even negative, growth in our terms of trade and purchasing power.

In addition, given some recent difficulties experienced in the Doha round of multilateral trade negotiations (break-down of talks at Cancun), we hope that the proliferation of bilateral negotiations over the last year does not provide another hurdle to the overall aim of completely free-trade on a global scale.

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Outsourcing manufactured exports

To what extent is New Zealand's export growth being undermined by the steady shift of production to lower cost Asian factories? Over the past five years a significant number of successful export companies have decided to contract out the manufacture of their products to factories in China and other Asian countries. In some cases local firms (Macpac and Interlock) have been compelled to outsource their manufacturing operations to remain competitive both domestically and in international markets.

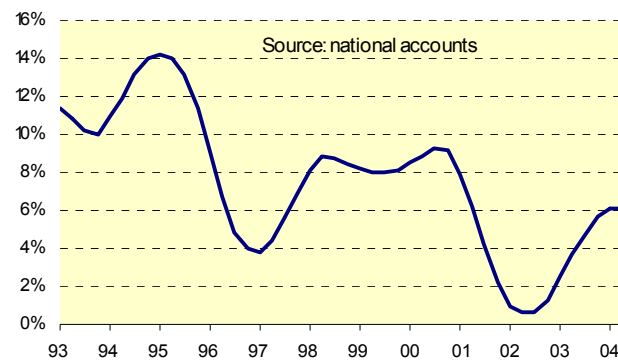
Traditionally manufactured exports from New Zealand have relied heavily on imported inputs including capital equipment, raw materials and components. As Asian economies have built large scale, state of the art factories, using an almost unlimited pool of cheap labour, it has become obvious that New Zealand businesses can go the whole hog and get their goods made in Asia and shipped directly to their export markets.

Some of the country's most successful exporters of manufactured goods (Pumpkin Patch, for example) in fact manufacture very little locally, and yet are regarded as high profile exporters. Effectively New Zealand manufacturers are becoming logistics and brand managers with strong design and distribution functions.

Evidence that the outsourcing of manufactured exports is undermining overall export growth is not overwhelming, but there are signs that manufactured export growth has slowed discernibly over the past ten years (see Graph 12.2). The slower rate of growth also reflects the increased maturity of the manufacturing export sector.

Manufactured export volumes

2 yr moving average % change, June yrs



Graph 12.2

The trade data, however, may not be very helpful in identifying the changes that are occurring. For instance, many manufacturers that outsource their production may still record the flow of goods as imports and exports – Pumpkin Patch almost certainly does because the majority of its product is distributed from its Auckland warehouse. This type of transaction might be picked up as re-exports or, in some cases, be recorded as exports on consignment and thus become part of the adjustment between merchandise trade and balance of payments statistics.



But some companies will simply ship goods from the Chinese factories they deal with to either foreign distribution centres or possibly directly to final customers. In some cases this will involve a change of ownership of the goods and in others Statistics New Zealand will record the net value of the transaction as merchandising receipts in the services account.

Since merchandising receipts statistics are gathered from a sample survey it is possible that Statistics New Zealand is significantly under-estimating the growth in the type of transactions described above. A full census of companies this year will help address this problem.

Another broad indicator of the impact of outsourcing manufacturing to Asia is the lack of growth in manufacturing employment over the past five years, despite strong growth in domestic demand. The trend in manufacturing employment contrasts with the steady growth in overall employment in New Zealand since 2000.



Graph 12.3

Many companies that have shifted their manufacturing to Asia are achieving higher export margins thanks to substantially lower production costs for the same final selling price. There are, however, some additional costs associated with operating this new export model, including:

- higher inventory management costs – production is less flexible forcing companies to hold more stock;
- discounting – bigger production runs and higher stock levels mean exporters are more often being forced to discount product than was the case when they had total control over production;
- higher logistics costs – there are additional costs of handling product coming in big dollops from a Chinese factory and having to be drip-fed to customers.

Besides lower manufacturing costs, firms that have adopted the new business model also find it easier to increase production and sales than if their manufacturing was still located in New Zealand. Most companies use only a fraction of a Chinese factory's capacity and therefore can reasonably easily crank up orders. In New Zealand, increased production may involve a slow and complex process of investing in additional factory space, new machinery and hiring more staff. These are by no means trivial tasks, especially in the current economic climate.

Conclusion

We predict more manufacturing businesses will shift their production to Asia, with a consequent fall in manufacturing employment and possibly also gross export receipts. The most likely movers will be those with well-established brands, where production costs are significant, and the product is made in reasonable quantities. An emphasis on research, design and product development will change the nature of manufacturing export businesses. The shift from goods to service exports has taken a while to gather momentum, but with more manufacturing export activity being classified as merchandising receipts the shift should accelerate.

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Terms of trade magic

Despite a slight fall in the terms of trade index over the September quarter the index is still hanging around a 15-year high. The terms of trade index (export prices divided by import prices) has a direct bearing on the nation's purchasing power – it measures the buying power of our exports.

Rob Muldoon used to blame foreigners for undermining our terms of trade and ultimately our standard of living. But blaming foreigners for falls in the terms of trade completely missed the point that New Zealand was exporting goods that foreigners were not particularly interested in buying, and therefore we had to keep discounting the price. To prevent a big blow out in the balance of payments and regular devaluations, the government maintained strict import controls, which not only cocooned local industries, but also quelled competition among importers.

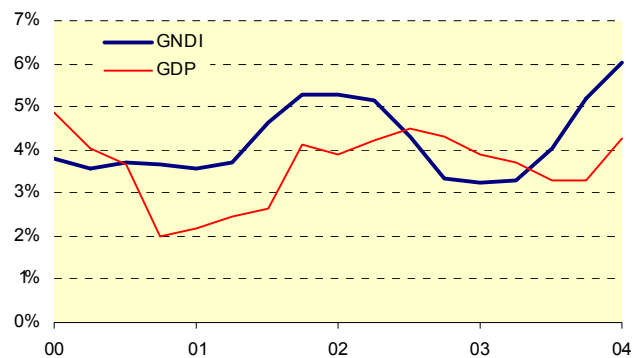
The opening up of the economy from the mid-1980s was intended to force exporters, importers and local industries to become more efficient and competitive. Bluntly, businesses had to produce and sell goods and services that people really wanted, otherwise they would be forced to close. Those firms that survived played a large part in lifting New Zealand's terms of trade.

Between 1985 and 1990 the terms of trade rose 24.4%, driven as much by falling import prices as by rising export prices. The world price of the goods we imported fell by around 13% over the five years ended March 1991 and has remained relatively stable since. We refer to this as "The Warehouse effect" – an efficient and focused business clearing away lazy importers.

Since 2000 the terms of trade index has edged higher. Indeed, on a five-year moving average basis it is higher now than at any time since the late 1960s. The positive impact this has on the nation's economic welfare is obvious if we compare growth in GDP with growth in GNDI (gross national disposable income – export receipts are deflated by import rather than export prices). In effect, GNDI is GDP adjusted for the terms of trade. Since June 2000 GNDI has grown on average by 4.2%pa – more than 0.5 percentage points per annum faster than GDP.

Terms of trade adjusted GDP

Year end (June) % change



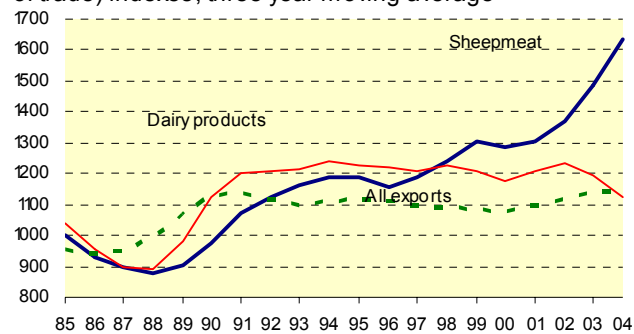
Graph 12.4

What does this mean? Well it tells us that the economy's purchasing power has been growing significantly faster than production (GDP), and that helps explain why the economy, particularly domestic spending and tax receipts, have exceeded everyone's expectations. It also tells us that what we produce matters, rather more than simply how much we produce. That message is increasingly relevant given the growing scarcity of labour, pressure on infrastructure, and worries about the environmental impact of increasingly intensive farming.

Probably the best example of what can underpin a rise in the terms of trade is the lamb industry. Since 1990, export lamb prices have increased by around 60% more than the price of all imports. In simple terms, sheep farmers buying a new ute today need to sell around 700 lambs, whereas 15 years ago they would have needed to sell over 2,000 lambs. The transformation of the lamb industry has been about a range of incremental gains in applying research, improved pasture and stock management, new genetics, productivity advances, and most of all steadily tailoring the product to customers' requirements.

Lamb - not the commodity it was

Export prices deflated by import prices (terms of trade) indexes, three year moving average



Graph 12.5

Interestingly, while the gains in the lamb industry have been substantial they have been driven primarily by players in the industry rather than by government initiatives. The success of lamb is not based on the current boom in commodity prices – we send very little lamb to China or the rest of Asia. It mostly goes to high value markets in Europe where economic growth has been lacklustre for several years. Another industry that has contributed significantly to the rise in the terms of trade has been kiwifruit, and again participants rather than the government have driven the gains.

Imagine what spending power the country could enjoy if we could translate some of the lessons from the lamb and kiwifruit industries to forestry, dairying, and better still tourism and education services. Focusing on what the world wants rather than how much we can produce is pretty basic business. There are signs that this lesson is being heeded by some industries, but if we are to add to the gains we have made in the terms of trade, these industries will need to kick on, and other big exporters will need to get their act together.

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13. INTERNATIONAL ARTICLES

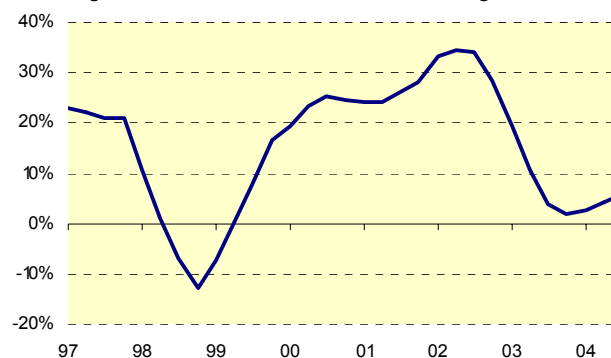
Korea's credit card hangover

Aside from China, South Korea is our largest trading partner not included in the trade-weighted index calculated by the Reserve Bank. It has also been one of our faster growing export markets over the last year, with the value of goods sent to Korea increasing at 14%pa. That has occurred despite the Korean economy not functioning as well over the last couple of years as it previously had since the Asian crisis.

Economic growth in 2001 and 2002 was largely fuelled by a boom in credit. Graph 13.1 shows that growth in lending to households accelerated to 34%pa by mid-2002, but was slashed to just 1.9%pa by the end of 2003. The rapid accumulation of debt by households was also evident in lending to small and medium-sized firms. Both sectors of the economy have been forced to try and scale back debt levels over the last 1-2 years, with banks wary of lending as debt servicing costs soared and defaults picked up. The result has been a lack of growth in both consumption and business investment.

A credit crunch

Lending to Korean h/holds, annual % change



Graph 13.1

Korean economic growth over the 2004 calendar year has been estimated at about 4.6%pa – slower than most other countries in the Asia/Pacific region. The growth that has occurred has been driven primarily by exports. Like most other countries in the area, Korea has benefited from China's seemingly limitless demand for both final products and inputs into its vast manufacturing sector.

With 19% of Korea's exports heading to China, it is vulnerable to weaker Chinese economic growth – something that didn't eventuate in 2004, despite Chinese officials moving to slow overheated investment activity. However, some slowdown in Chinese GDP growth appears more likely this year.

So what's being done to boost domestic economic activity in Korea? The government has announced a fiscal package of around 10 trillion won (approximately \$13.7bn) to boost the country's construction sector, building new infrastructure such as roads and schools; and it also plans to cut income taxes to try and boost consumer spending.

The Bank of Korea's call rate target is at a record low of 3.25%. With a relatively strong currency, this implies that the monetary stimulus is being applied where it is needed most – domestically, rather than to the export sector.

A mixed outlook

Canvassing economic forecasters on the outlook for Korea over the next 1-2 years shows a range of views – if not so much in the numbers, then at least in the tone of the forecasts. This is unsurprising given the probable need for a transition in GDP growth from external towards domestic drivers during that period.

Although only one out of 17 forecasters is predicting further contraction in household consumption over 2005, the outlook for consumption growth over the next 12 months is considerably more pessimistic than the year-ahead forecasts in January last year. Current forecasts are for 1.6% growth over 2005 (compared with 3.8% growth predicted for 2004 a year ago – the actual outcome looks like being closer to -0.8%).

Both consumer and business confidence in Korea are weak, but it is business investment that most forecasters anticipate will revive domestic economic activity. The key to this is investment by larger firms – they aren't saddled with the same debt problems as smaller companies. However, problems such as the rigid labour market and threats of strikes by unions have undermined potential returns on investment and worked to discourage capital spending.

Effects for New Zealand

Despite slack domestic demand in Korea, the value of imports from New Zealand has grown strongly. Imports have been led by meat (up 88%), mainly because of foot and mouth and BSE concerns in other supplier markets. A number of the other main product categories have recorded significant falls (skins and hides down 29%, wood products down 15%, and aluminium down 8.7%).

The advent of more broad-based economic growth will further boost export revenue from Korea.

Transport costs also present an ongoing issue for exporters of forest products (typically logs) to Korea. Although log prices in Korean won are at reasonable levels, profits for forestry companies are poor once shipping costs across the Pacific are taken into account. This situation is unlikely to change while global economic growth and oil prices remain strong.

The dip in household spending has also impacted on tourism activity. Growth in visitor numbers from Korea has stagnated over the last year, following strong positive contributions from 1999 through to late 2003. Visitor numbers remain 12% below the level reached before the Asian crisis, suggesting there is room for more growth once Korean household confidence returns.

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