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BANK

O F N E W Z E A L A N D

## ECONOMIC FORECASTS

Prepared by the ECONOMICS DEPARTMENT

### September 1995 Executive Summary

Embargoed until 9.00 am on Thursday, 14 September 1995

#### Introduction

These forecasts update the March 1995 *Economic Forecasts* and the inflation projections published in the June 1995 *Monetary Policy Statement*. The forecasts incorporate information available up to 5 September. The text was finalised on 8 September.

#### Key Policy Assumptions

*Monetary conditions to remain relatively firm*

From a starting point of 61.5 in the September quarter, these projections assume that the nominal trade-weighted exchange rate (TWI) appreciates by 1.8 percent per annum, reaching 64.3 by March 1998. The 90 day bank bill rate is assumed to remain above 9 percent over the remainder of this year and, although declining in early 1996, to remain above 8 percent over the entire period covered by these projections.

*Fiscal policy to become less contractionary as tax cuts are implemented in 1996 and 1997*

Tax cuts are assumed to be implemented on 1 July 1996 and 1 July 1997. These cuts are assumed to be delivered via a reduction in personal tax rates, and to be worth \$1.5 billion each year.

#### Forecast Summary

*GDP growth to moderate at first and then accelerate as tax cuts impact on demand*

The impact of firm monetary conditions will see GDP growth moderate further over the remainder of 1995/96, before rising gradually in response to slightly lower interest rates and the impact of tax cuts on domestic demand. In point-to-point terms, we project GDP growth rates of 2.0 percent, 3.3 percent and 4.0 percent in the years to March 1996, March 1997, and March 1998 respectively.

*Underlying inflation to remain within the 0 to 2 percent target range from September 1995*

Annual underlying inflation is expected to fall from its current peak of 2.2 percent in the June quarter, reaching 1.1 percent in September 1996, before gradually rising to 1.7 percent over the year to March 1998. The decline in underlying inflation over the next year primarily reflects declining contributions from construction costs and fresh fruit and vegetable prices. In response to stronger domestic demand, increased profit margins and increased unit labour costs see underlying inflation pick up in 1997/98. Headline inflation is projected to fall steeply over the next year to around 0.5 percent.

*Consumption growth to slow at first, and then accelerate as tax cuts raise household incomes*

Relatively firm monetary conditions will result in a further slowing in consumption growth over the remainder of 1995/96, followed by strong growth as tax cuts raise household disposable incomes. A slight rise in the household savings rate is projected.

*Investment growth also responds to tax cuts*

High levels of business investment are expected in response to the current high level of capacity utilisation, the need for further efficiency gains, and the tax-cut-driven rise in domestic demand. Residential building activity is also expected to recover after contracting in 1995/96.

*Export volumes continue to grow at a faster rate than overall GDP*

Despite a stronger real exchange rate, export volume growth of around 5 percent per annum is projected, based primarily on continued growth in international demand, further expansion into new markets and products, and strong growth in tourism receipts.

*Current account deficit to stabilise at first, and then deteriorate as domestic demand accelerates*

Movements in the trade balance dominate the current account outlook. The current account deficit stabilises at first, and then deteriorates by March 1998, reflecting the impact of higher domestic demand on import volumes, reinforced by a small reversal of positive effects stemming from the terms of trade.

*Unemployment rate to remain around current level*

The unemployment rate is projected to stabilise at around its current rate, with increased employment just offsetting the projected rise in labour supply.

*The Government's operating balance improves more slowly due to tax cuts*

Compared with recent years, relatively small improvements in the Government's operating surplus are projected as the assumed cuts in personal tax rates largely offset the impact of continued economic growth on tax revenues. A surplus of \$3.3 billion is projected in 1997/98, while the net debt-to-GDP ratio falls to around 25 percent.

# Summary of Economic Forecasts

(Percentage changes of annual totals or averages)

March Years	Actuals/ Estimates		Forecasts		
	1994	1995	1996	1997	1998
<b>Real Expenditures on GDP</b>					
Final Consumption Expenditure					
- Private	3.0	6.0	3.0	3.9	6.0
(March qtr to March qtr)	(4.1)	(6.4)	(1.7)	(5.5)	(6.0)
- Public Authority	-2.6	-0.6	0.5	-0.2	-0.4
Total	1.8	4.6	2.5	3.1	4.8
Gross Fixed Capital Formation					
- Market Sector					
- Residential	16.2	12.3	-9.9	2.8	11.0
- Business	22.1	25.7	16.8	9.7	15.6
(Business excluding Computers) <sup>1</sup>	(17.1)	(12.9)	(7.4)	(0.3)	(10.2)
- Non-Market Government Sector	4.0	19.1	3.0	2.3	2.0
Total	18.9	22.6	11.1	8.1	13.9
(Total excluding Computers) <sup>1</sup>	(15.1)	(13.5)	(3.0)	(1.0)	(9.3)
Final Domestic Expenditure	5.9	9.4	5.1	4.7	7.7
Stockbuilding <sup>2</sup>	1.1	-0.5	-0.7	0.9	0.2
Gross National Expenditure	6.8	8.7	4.4	5.4	7.8
(GNE excluding Computers) <sup>1</sup>	(5.6)	(6.0)	(1.9)	(3.4)	(5.9)
Exports of Goods and Services	8.9	7.1	4.6	5.2	4.8
Imports of Goods and Services	12.0	18.1	9.4	9.9	12.0
(Imports excluding Computers) <sup>1</sup>	(9.3)	(12.7)	(4.7)	(6.5)	(9.1)
<b>GDP (PRODUCTION BASED)</b>	5.5	6.0	2.8	2.8	3.9
(GDP (Production based) March qtr to March qtr)	(6.0)	(5.2)	(2.0)	(3.3)	(4.0)
<b>Government Accounts<sup>3</sup></b>					
Operating Balance (\$m.)	755	2,770	3,240	2,920	3,310
- (% of Nominal GDP)	(0.9)	(3.1)	(3.5)	(3.1)	(3.3)
<b>External Accounts</b>					
BOP Current Account Balance (\$m.)	-1,311	-2,498	-2,670	-2,360	-3,910
- (% of Nominal GDP)	(-1.6)	(-2.9)	(-2.9)	(-2.5)	(-3.9)
Terms of Trade	1.5	-0.4	-0.6	2.1	-1.3
<b>Incomes</b>					
Real Household Disposable Incomes	1.8	4.8	2.0	4.5	6.2
Household Savings Rate (level)	5.5	4.5	3.4	4.0	4.3
<b>Inflation<sup>4</sup></b>					
Consumer Price Inflation	1.3	4.0	1.3	0.9	1.5
Underlying Inflation	1.1	1.9	1.5	1.1	1.7
<b>Labour Market</b>					
Employment (000's) <sup>5</sup>	1,532	1,608	1,639	1,672	1,709
Change in Employment <sup>4</sup>	3.9	5.0	1.9	2.0	2.2
Official Unemployment (000's)	161	120	119	119	118
Official Unemployment Rate (%) <sup>6</sup>	9.0	6.6	6.5	6.3	6.2

1 For explanatory notes, refer to Box 2 on page 12 of the Forecast document.

2 Percentage point contribution to growth rate of GDP.

3 June years.

4 March quarter to March quarter percentage changes.

5 Level in March quarter.

6 Seasonally adjusted March quarter rate.

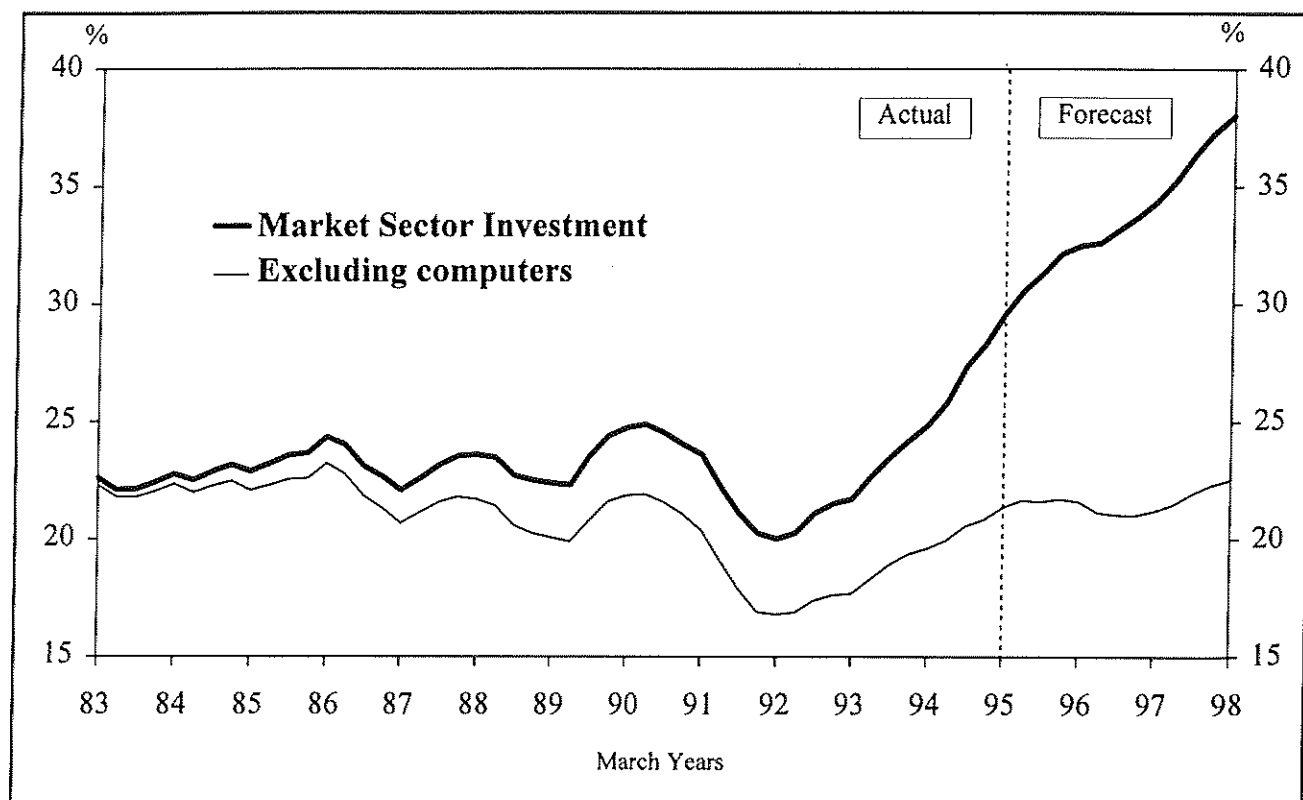
## ERRATA

On page 18 the first line of the second paragraph should read:

"At this stage this acceleration in wage growth has **not** been reflected in official aggregate labour cost statistics."

In addition, the figure below replaces Figure 4.

**Figure 4.**  
**Market Sector Investment (As a Share of GDP)**







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# ECONOMIC FORECASTS

**EMBARGOED**

until 9.00 AM, THURSDAY 14 SEPTEMBER 1995



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ISSN 0114-023X

## Policy Implications of the September 1995 Forecasts

The September *Forecasts* indicate that the overall stance of monetary policy will need to stay firm during the remainder of this year, and that there is likely to be somewhat less scope for an easing of monetary conditions next year than was projected in June.

The outlook for activity over the near term is not significantly different in these *Forecasts* from that portrayed in the Bank's June *Monetary Policy Statement*. We expect that the trend towards a more moderate pace of economic activity will continue through the second half of 1995 and into 1996, leading to an easing of upward pressures on inflation.

The near-term outlook for inflation is also essentially the same as in our June projections. The marginally lower-than-expected increase in the June quarter means that the annual underlying inflation rate is now projected to re-enter the 0 to 2 percent target range slightly sooner than previously thought. Even so, annual underlying inflation is expected to have been 2 percent in the year to September, and to remain uncomfortably close to the upper end of the target range until the end of this year.

The longer-term outlook for activity, inflation and the required stance of monetary policy is somewhat different than previously projected, mainly because these *Forecasts* include in the central projection, for the first time, the assumption of a shift in the stance of fiscal policy - in the form of income tax cuts - beginning in the September quarter of 1996. Previously, tax cuts had been treated as one of the uncertainties - albeit an important one - surrounding our central projections.

Since it appears that the Government's criteria for implementing tax cuts will be met, the tax cuts must now be judged as more likely than not. For this reason, it is appropriate to take them into account in our projections. At the same time, however, it should be emphasised that the exact form and magnitude of any fiscal policy initiative is necessarily uncertain - the Government is not expected to announce details of the fiscal measures until late this year at the earliest.

As indicated in these projections, tax cuts will tend to stimulate aggregate spending in the economy. In the absence of corresponding increases in the productive capacity of the economy, upward pressure on prices will tend to be stronger than would otherwise be the case. The incorporation of tax cuts into our projections, therefore, largely explains why our *Forecasts* now show somewhat less scope for an easing of monetary conditions next year and beyond than was suggested by the June *Monetary Policy Statement*.

In assessing the appropriate stance of monetary policy, the Bank needs to focus primarily on the outlook for inflation one to two years ahead. This is because there are long lags between adjustments to the stance of monetary policy and their ultimate impact on underlying inflation. Our projections indicate that underlying inflation is likely to bottom out at around 1 percent in 1996 and to gradually rise thereafter. This suggests that a more significant easing of monetary conditions than is incorporated in our projections would run the risk of a more significant escalation of inflation in 1997, threatening the upper end of the 0 to 2 percent inflation target range.

The Bank's judgment as to the appropriate level of monetary conditions will need to be reviewed when the Government lays out its fiscal programme in more specific terms. Our views can also be expected to evolve as new information is received regarding the abatement of inflation pressures in the economy.

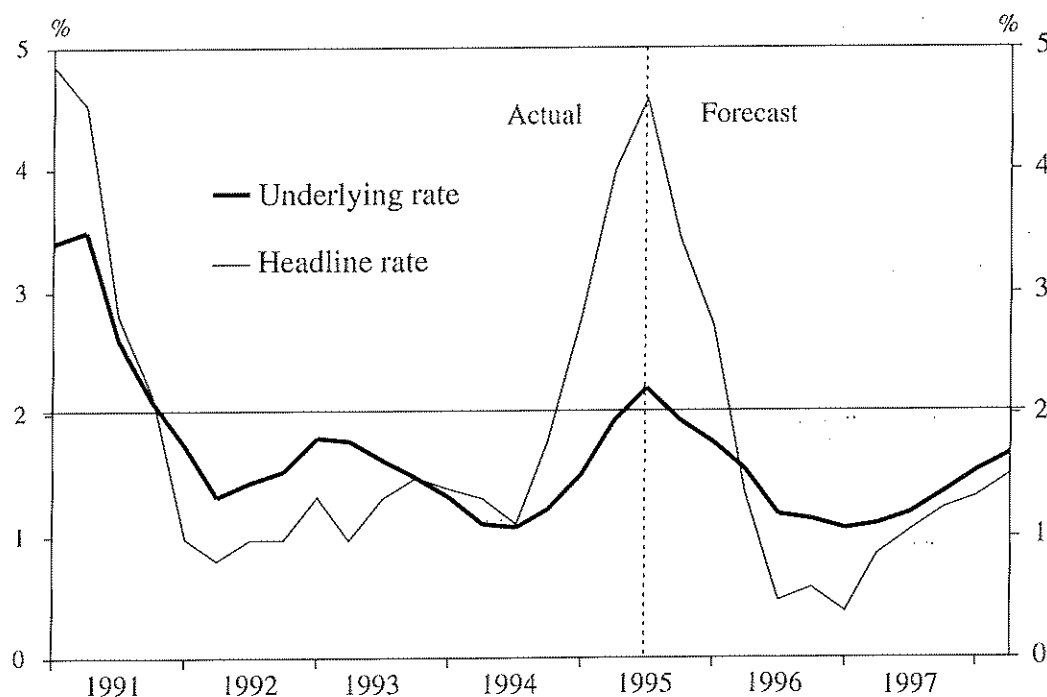


The precise paths of the exchange rate and interest rates embodied in these projections are illustrative. We recognise that, within limits, a somewhat stronger exchange rate than portrayed in the projections could be coupled with somewhat lower interest rates, or vice versa, without significantly affecting the outlook for inflation. As and when such changes occur, the Bank will remain vigilant to ensure that the overall mix of monetary conditions remains consistent with an outlook for inflation which is firmly within our target range.

*Donald T. Brash*

Donald T Brash  
Governor

**Figure 1**  
**Consumer Price Inflation**  
(Annual Percentage Changes)



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6 Seasonally adjusted March quarter rate.

## Box 1: Key Policy Assumptions

The outlook for the real economy and inflation contained in these projections is strongly influenced by key assumptions regarding the stance of fiscal and monetary policy.

### Fiscal Policy

This time we have built the prospect of tax cuts into our central projection. The exact size, structure and timing of the fiscal policy initiative built into our projections are necessarily illustrative - the Minister of Finance is not expected to announce details of the fiscal measures until late in 1995 at the earliest. However, the Bank now believes that the probability of tax cuts is sufficiently high that our tax cut scenario will prove more accurate than one which excludes tax cuts.

We have assumed that tax cuts will be implemented on 1 July 1996 and 1 July 1997. These cuts are assumed to be delivered via a reduction in personal tax rates for individuals, and to be worth \$1.5 billion in each fiscal year. In total, this raises household disposable income by around 5 percent. Households are assumed to save around one quarter of the additional income, and little labour supply response is incorporated (in line with most international experience). The implications of uncertainties surrounding these assumptions are discussed in Section 9.

### Monetary Policy

The assumed tax cuts are projected to result in an increase in domestic demand and some pressure on inflation. Consequently, monetary conditions are assumed to remain relatively firm during the forecast period.

In line with our normal technical assumption, the nominal exchange rate is assumed to appreciate annually by the average difference over the forecast period between expected trade-weighted foreign CPI inflation (2.8 percent according to the most recent international *Consensus Forecasts*) and the mid-point of the Bank's inflation target range (1 percent). Therefore, from a starting point of 61.5 in the September quarter, these projections assume that the nominal exchange rate appreciates by 1.8 percent per annum, reaching 64.3 by March 1998. (The June 1995 *Monetary Policy Statement* assumed a September quarter TWI of 61.0, rising to 64.1 by March 1998.)

These projections assume a somewhat higher track for domestic interest rates than that contained in our June 1995 *Monetary Policy Statement*. As in the *Statement*, the 90 day bank bill rate is assumed to remain above 9 percent over the remainder of this year, before declining early in 1996. The 90 day bank bill rate is assumed, however, to remain above 8 percent during the entire forecast period.

We reiterate the purely technical nature of these assumptions. The actual paths required for the nominal exchange rate and domestic interest rates (which are not independent) will depend on the extent to which indicators of inflation turn out to be consistent with maintaining underlying inflation in the 0 to 2 percent target band.

## Overview

*These forecasts update the March 1995 Economic Forecasts and the inflation projections published in the June 1995 Monetary Policy Statement. The forecasts of economic activity and inflation cover the period to March 1998. The summary table details the key aggregates discussed in this release. The projections incorporate information available up to 5 September 1995. The text was finalised on 8 September 1995.*

*Our real economy and inflation "forecasts" should be interpreted as "projections", as they are strictly conditional on assumptions regarding, amongst others, the exchange rate, interest rates, and tax cuts.*

### **The medium-term outlook for the real economy and inflation is dominated by our assumption of tax cuts**

For the first time, we have built the prospect of tax cuts into our central projection (see Box 1). Our analysis suggests that tax cuts will stimulate spending throughout the economy, imparting upward pressure on inflation. Indeed, if the tax cuts are of about the magnitude assumed in these projections, the upward pressure on spending and prices is likely to be sufficiently large that some offsetting restraint from monetary policy will be necessary in order to avoid a risk to the 0 to 2 percent inflation target. Accordingly, these projections assume firmer monetary conditions than those assumed in our June 1995 *Monetary Policy Statement*. The consequences of alternative assumptions about tax cuts are discussed, along with other uncertainties surrounding the projections, in Section 9.

The analysis of the impact of tax cuts on the real economy and inflation involves a range of complex issues. In arriving at the projected outlook, a number of key judgements had to be made.

### **The underlying strength of the economy is uncertain**

Over recent years, the level of government savings have increased markedly, while the net savings position of the economy overall has not improved, as reflected in the broadly unchanged current account deficit. This suggests that households and businesses have offset the contractionary effect of fiscal policy on the economy through expansionary behaviour, which

has involved a worsening in their overall net borrowing position.

It is our interpretation that this behaviour has been primarily driven by firms' and households' confidence in the sustainability of comparatively high rates of demand, employment and income growth. It is remarkable, and unusual by international standards, that this process of the private sector offsetting the effect of fiscal contraction has continued during the past eighteen months, the time during which monetary conditions have substantially firmed.

In terms of analysing the effect of tax cuts, it is interesting to pose the question of what would happen in their absence. Clearly, continued private sector net borrowing is not sustainable in the long run, given its adverse impact on balance sheets. Thus, an adjustment process will have to commence at some stage. However, the nature and timing of such a process is rather uncertain. The relevant issue for these projections is whether it should be assumed that this adjustment process will begin over the period to March 1998. Such a scenario would imply that the considerable slowing in "underlying" economic demand (in the absence of tax cuts) would simply offset the expansionary effects of the tax cuts, rather than add to the pressures in the economy.

At this stage it is difficult to find evidence that the economy is rapidly slowing or is about to turn down sharply, with many indicators proving surprisingly robust despite high real interest and exchange rates. This may be a reflection of the fact that the deterioration in the private sector net borrowing position has not been, and is not projected to be, unduly large. It may also reflect the considerable increase in private sector wealth over recent years (due to increasing asset prices), and the generally healthy state of balance sheets. Thus, the assumption underlying these projections has been that the required long-term adjustment process will not commence to any significant degree over the period to March 1998.

### **Tax cuts will push economic activity slightly above the sustainable level**

A second key consideration regarding the inflationary effects of tax cuts involves an assessment of the economy's position is relative to "potential" output (the level of output at which there is no upward or downward pressure on inflation), and of the rate at which potential output is growing. It is the Bank's judgement that the

economy has moved slightly above potential output over the last 18 months and that the current slowing in growth to below the potential growth rate will permit a convergence back onto the sustainable path. Based on projected growth in the labour force and our assumption for trend labour productivity growth, the Bank maintains its assumption that growth in potential output is around 3.5 percent per annum.

The extra demand stemming from the tax cuts is projected to be satisfied through increased imports to some extent, but will also push the economy again slightly above the potential growth path, with the consequence of a pick-up in inflation pressures.

#### **GDP growth moderates at first and then accelerates as tax cuts impact on demand**

On balance, we expect the firm monetary conditions to contribute to a further moderation in GDP growth over the remainder of 1995/96. However, thereafter, growth is projected to accelerate in response to the impact of tax cuts on domestic demand. In point-to-point terms, we project GDP growth rates of 2.0 percent, 3.3 percent and 4.0 percent in the years to March 1996, March 1997, and March 1998 respectively. The unemployment rate is projected to stabilise at around its current rate of 6.3 percent, with increased employment just offsetting the projected rise in labour supply.

#### **Both consumption and investment are boosted by the tax cuts**

Relatively firm monetary conditions will result in a slowing in consumption growth over the remainder of 1995/96. Thereafter, consumption growth recovers sharply as tax cuts increase household disposable incomes. A slight rise in the household savings rate is projected. High levels of business investment are expected in response to current high levels of capacity utilisation, the need for further efficiency gains, and the tax-cut-driven rise in domestic demand. Residential building activity is also expected to recover after contracting in 1995/96.

#### **The current account deficit deteriorates somewhat despite solid growth in export volumes**

Movements in the trade balance dominate the current account outlook. Despite a stronger real exchange rate, export growth of around 5 percent per annum is pro-

jected, based on continued growth in international demand, further expansion into new markets and products, and solid growth in tourism receipts. The current account deficit stabilises at first, and then deteriorates by March 1998, reflecting the impact of higher domestic demand on import volumes, and a small reversal of positive effects stemming from the terms of trade.

#### **A relatively small increase in the Government's operating balance is projected**

Compared with recent years, relatively small improvements in the Government's operating surplus are projected, as the assumed cuts in personal tax rates largely offset the impact of continued economic growth on tax revenues. A surplus of \$3.3 billion is projected in 1997/98, while the net debt-to-GDP ratio falls to around 25 percent.

#### **Underlying inflation will remain within the 0 to 2 percent target range from September 1995 onwards**

Annual underlying inflation is expected to fall from its current peak of 2.2 percent in the year to June 1995 to 1.1 percent by September 1996, before gradually rising to 1.7 percent by March 1998. The decline in underlying inflation over the next year is primarily a reflection of declining contributions from construction costs and fresh fruit and vegetable prices. Increasing profit margins and unit labour costs see underlying inflation pick up in 1997/98.

Headline inflation is projected to fall steeply over the next year, although the rate of decline is less than that projected in the June 1995 *Monetary Policy Statement*. This reflects our assumption of a more modest decline in mortgage interest rates, with a consequent reduction in the downward contribution from falling credit costs.

#### **The uncertainties surrounding the inflation outlook are broadly balanced**

Looking first at those associated with the real economy outlook, the uncertainties surrounding the projections for domestic and external demand (those not related to the size or structure of the fiscal package) appear balanced. Over the next year, the possibility of an early pick-up in consumer spending growth or residential building appears to have diminished, as has the prospect of a greater cycle in investment activity. Despite

the impact of declining profitability due to exchange rate movements, significant underlying momentum in the manufactured export sector suggests that uncertainties related to export growth demand are also balanced.

The risks to the real economy outlook over the latter part of the forecast horizon are predominantly associated with the private sector's reaction to tax cuts. Stronger-than-projected pressure on inflation could arise from a higher-than-assumed consumption propensity with respect to the additional income, or from a lower-than-assumed investment response by firms. On the other hand, a downside risk to inflation could arise from a stronger-than-projected labour supply response. The general issue of uncertainty surrounding the projected underlying strength of the economy during the period covered by the tax cuts has already been discussed.

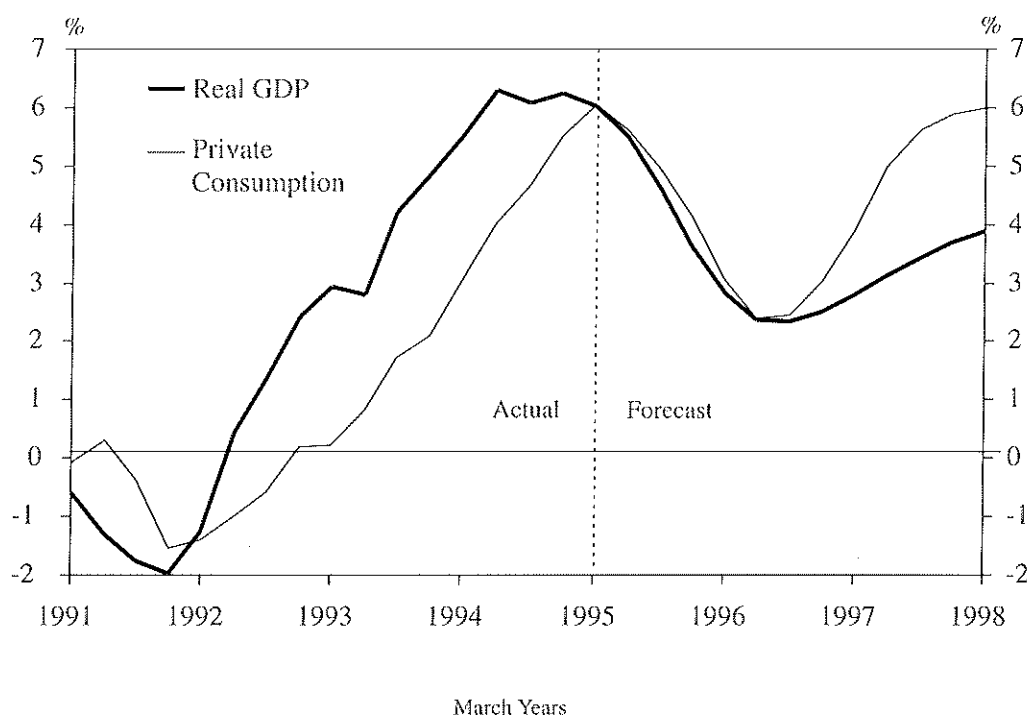
A number of uncertainties about the inflation outlook exist even if the real economy develops as projected. Over the next year, these appear balanced. On the one hand, downside risks continue to be associated with the construction cost projection and with the outlook for fresh fruit and vegetable prices. On the other hand,

import price pressures may feed through into domestic inflation to a greater extent than assumed, given the continued uncertainty surrounding the size of the exchange rate pass-through coefficient.

Over the medium-term, while there may be a degree of upside risk to the unit labour cost outlook, given our projection of sustained labour market tightness, international commodity prices may fall by more than assumed in the central projection, given historical amplitudes of commodity price cycles. In addition, although a rebalancing of monetary conditions in favour of, for example, a lower real exchange rate (via a reduction in the nominal exchange rate) and higher real interest rates would leave overall monetary conditions unchanged (and thus result in no change in the degree of monetary policy pressure on price formation viewed in a medium-term context), the direct price effects of a weaker-than-projected nominal exchange rate would result in a temporary deterioration in the projected outlook for inflation.

Finally, risks stem from the illustrative nature of the tax cut assumption used, with the impact on the real economy and inflation depending on the size, structure and timing of the fiscal package implemented.

**Figure 2**  
**GDP and Private Consumption**  
(Annual Percentage Changes)



## 1. Consumption

### Household spending grew strongly over the year to March 1995

The most recent data on Expenditure GDP indicate that the momentum of consumer spending growth was maintained in the early part of 1995. Private household consumption increased by 1.8 percent in the March 1995 quarter, and was 6.4 percent higher than in the March 1994 quarter. The March quarter out-turn was somewhat higher than expected, with the sharp increase in net tourist spending (reflecting the difference between New Zealand residents' spending abroad and foreign residents' spending in New Zealand) accounting for much of the forecast error.

Retail sales data indicate that spending growth may have slowed further in the June 1995 quarter. The volume of retail sales increased by 0.8 percent, with annual growth in sales falling to 4.4 percent. The estimated slowdown in consumer spending is supported by anecdotal evidence from our recent round of business visits. Regional data suggest that the fall in sales growth has been especially marked in the South Island, particularly outside the Canterbury region, where sales have declined by 3.3 percent over the year.

Spending growth is expected to slow in the near term

The strong growth in household spending over the last year or so has been underpinned by substantial growth in household incomes, a rise in wealth stemming from rapidly increasing house prices, and robust levels of consumer confidence. However, these factors are expected to provide a weaker stimulus to consumer spending over the coming year.

In particular, the maintenance of firm monetary conditions is expected to result in a further slowing in demand and income growth. In addition, farm incomes have been particularly hard hit given inclement weather and unfavourable world prices for meat (although buoyant dairy prices have offset this to some extent). With employment growth projected to moderate during the coming year, growth in real household disposable income is projected to slow sharply in 1995/96. Despite the number of adverse influences, comparatively high levels of consumer confidence and relatively solid growth in the credit aggregates suggest that consumer spending is unlikely to contract. Therefore, relatively modest growth in household consumption has been projected for the near term.

**Table 1**  
**Household Incomes and Consumption**  
(Percentage change in annual totals)

March Years	<u>Actuals/ Estimates</u>		<u>Forecasts</u>		
	1994	1995	1996	1997	1998
Compensation of Employees	3.1	6.9	3.5	5.2	6.2
Other Income	3.1	7.5	6.6	2.0	4.6
Total Income	3.1	7.2	5.1	3.5	5.4
Nominal Disposable Income <sup>1</sup>	2.7	5.8	3.6	5.8	7.8
Consumption Deflator	0.8	0.9	1.6	1.2	1.5
Real Disposable Income <sup>1</sup>	1.8	4.8	2.0	4.5	6.2
Real Household Consumption	3.0	6.0	3.1	3.9	6.0
Savings Rate (level) <sup>1</sup>	5.5	4.5	3.4	4.0	4.3

<sup>1</sup> Reserve Bank estimates



## Tax cuts will stimulate household spending

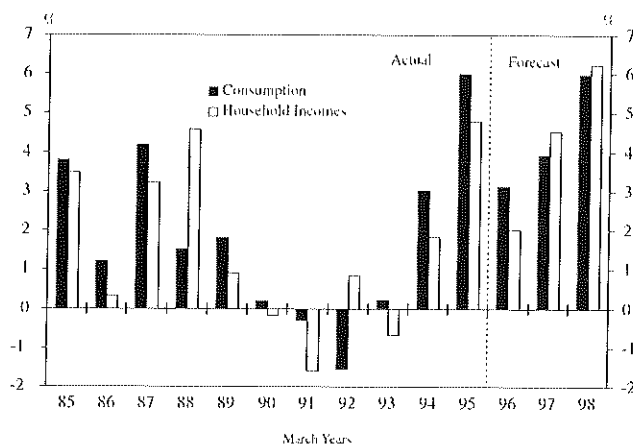
The incorporation of tax cuts into the projection is the dominant factor explaining consumption trends in the latter part of the forecast period compared with those published in our March forecasts. With tax cuts assumed to take effect from the September 1996 quarter onwards, real household disposable incomes are expected to increase sharply during both 1996/97 and 1997/98. As a result, household spending is projected to rise substantially over the forecast period, with demand for durable goods and services expected to record the most significant increases.

## A small increase in the household savings rate is projected

Our projections imply a further small fall in the household savings rate during 1995/96. However, the savings rate is expected to recover thereafter, reflecting the assumed increase in savings following the implementation of tax cuts, combined with the maintenance of relatively high real interest rates. We continue to expect a gradual increase in household savings over the longer term, due to the impact of both demographic factors and the greater need for private savings as a result of the Government's superannuation and education policies.

Figure 3

## Household Incomes and Consumption (Annual Percentage Changes)



## 2. Investment

### Business Investment

#### Rapid plant and machinery investment has failed to reduce capacity utilisation

Excluding computer equipment (see Box 2, overleaf), plant and machinery investment has increased rapidly since 1991, and is now close to a historic high. Despite this, data from the Quarterly Survey of Business Opinion (QSBO) imply that capacity utilisation in the manufacturing sector increased marginally over the June quarter. This suggests that, at this stage, net investment has been short of that required to generate the increase in the capital stock that is necessary to cope with continued growth in demand. Consequently, with pressures on capacity remaining, the level of investment is likely to remain very high, notwithstanding the slowdown in economic activity, relatively high interest rates, and declining profitability. Indeed, many of our business contacts suggested that difficult trading conditions are likely to reinforce the need for a continued emphasis on efficiency enhancing investment. Skill shortages (and consequent pressures on labour costs) are also seen as a motivating factor for maintaining overall levels of investment.

#### Investment growth will slow, before accelerating in response to increased domestic demand

In the near term, *growth* in business investment will slow in line with the general slowing in growth in economic activity, although as discussed above, we expect the *level* of investment to remain very high. The general flattening off in investment demand is supported by the results of both the QSBO and National Bank survey of business investment intentions, and anecdotal evidence obtained from our discussions with businesses.

Business investment is expected to strengthen gradually in 1996/97, followed by much stronger growth in 1997/98. This reflects the need for firms to invest in order to create the productive capacity required to satisfy the additional demand generated by the tax cuts. From our business discussions we expect firms to take a cautious approach to assessing the implications of the tax cuts, with most firms confident that they can install plant quickly if the need arises. Our projections suggest that this will indeed be necessary, with many firms



**Table 2**  
**Investment**

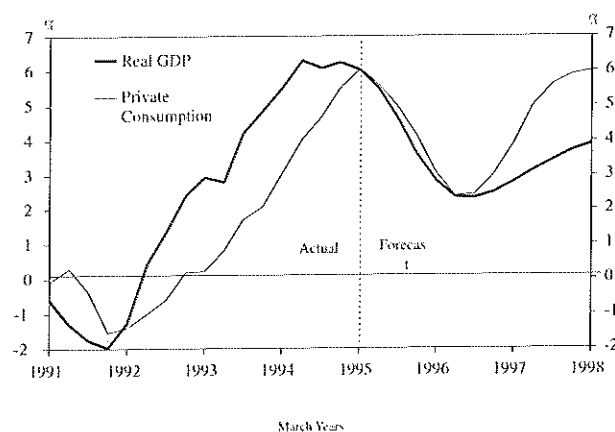
(Percentage change in real annual totals)

March Years	<u>Actuals</u>		<u>Forecasts</u>		
	1994	1995	1996	1997	1998
Market Sector Business Investment					
Plant and Machinery	27.6	31.9	21.7	15.1	18.0
(P&M excluding Computers)	(19.4)	(11.8)	(8.6)	(3.4)	(11.7)
Transport Equipment	20.3	15.5	3.1	-5.3	8.7
Commercial Buildings	26.8	27.3	7.4	-6.0	10.6
Other	-9.9	-11.1	12.2	10.0	3.5
Total	22.1	25.7	16.8	9.7	15.6
(Total excluding Computers)	(17.1)	(12.9)	(7.4)	(0.3)	(10.2)
Market Sector Residential Investment	16.2	12.3	-9.9	2.8	11.0
Total Market Sector Investment	20.9	23.0	12.0	8.7	15.0
Government (Non-Market) Investment	4.0	19.1	3.0	2.3	2.0
<b>Total Investment</b>	18.9	22.6	11.1	8.1	13.9
<b>(Total excluding Computers)</b>	<b>(15.1)</b>	<b>(13.5)</b>	<b>(3.0)</b>	<b>(1.0)</b>	<b>(9.3)</b>

likely still to be running at relatively high rates of utilisation at the time that the increase in demand becomes apparent.

**Figure 4**

**Market Sector Investment**  
(As a Share of GDP)



## **Box 2: Problems with the Computer Deflator**

The rapid improvement in the quality of data processing and computing equipment has created a substantial problem in the interpretation of national accounts statistics for investment and import volumes, both in New Zealand and abroad. Statistics New Zealand uses a quality-adjusted computer price index to derive volume data from the value of investment in computers. With spending on computer investment having remained relatively unchanged over the years, the sharp reduction in quality-adjusted prices suggests that there has been a significant rise in the volume of computer investment.

Problems arise from the methodology used by Statistics New Zealand, which aggregates the various System of National Accounts (SNA) investment indices by using fixed weights derived from relative prices that existed in 1982/83. This methodology implies an over-proportionately large weight for investment in computers. With the volume of investment in computers having exceeded growth in other components, this has led to an overstatement of total investment growth rates in the official statistics (see Table 2). Indeed, investment in computers now accounts for around 50 per cent of total plant and machinery investment in real terms, but only around 10 per cent in nominal terms.

It should be noted, however, that there is little, if any, impact on overall Expenditure on GDP. As most computers are imported, a bias exists in the import volume aggregate, which offsets the bias inherent in the investment data.

## **The Construction Sector**

### **Indicators suggest that residential building activity will fall during 1995/96**

Recent data show that the number of residential building consents has continued to fall at a trend rate of around 2 percent per month - a more rapid decline than we had anticipated. A combination of relatively high real interest rates and little prospect of further significant capital gains means that "affordability" of housing is currently low. With consumer confidence unlikely to improve substantially in the near term, and the demand for new housing likely to have been satisfied to some extent by the surge in building in 1994, residential building activity is projected to decline by around 10 percent in 1995/96.

### **Increased incomes will result in an increase in residential building in 1997/98**

Looking ahead, slightly lower interest rates and the impact of continued growth in per capita incomes (reinforced by the assumed tax cuts), are expected to lead to growth in residential building of around 11 percent in 1997/98. Although recent changes to immigration policy are likely to reduce the rate of migrant inflow compared to that projected for the current year,

growth in household formation is expected to remain above the average rate experienced over the last decade, and to underpin demand for new accommodation.

### **Non-residential building activity appears to have plateaued**

There has been a flattening off in the trend level of consents issued for non-residential construction over the last year. Therefore, following growth in excess of 27 percent in 1994/95, non-residential construction activity is expected to rise by a more modest 7.4 percent in 1995/96.

### **Demand for retail and factory/warehouse premises will recover in 1997/98**

At this stage, relatively high (although falling) vacancy rates for office accommodation, leading to insufficient rental returns, suggests that the construction of new office buildings is unlikely to be economically viable over the forecast horizon. Recent increases in rental returns have, however, been sufficient to encourage the refurbishment of existing buildings. In addition, higher demand for business and tourist accommodation, which has resulted in a substantial rise in hotel occupancy and room rates, has seen a number of buildings converted into hotels, with further conversions expected to proceed. As work on the Auckland Casino/Sky Tower

winds down, this will lead to a marked fall in construction activity in 1996/97, although the underlying level of activity is expected to remain broadly unchanged. Activity is expected to pick up thereafter, as stronger economic growth leads to increased demand for retail and factory/warehouse premises.

## **Stocks**

### **An involuntary build-up of stocks will require some adjustment in the short term**

Recent data from the Quarterly Survey of Business Opinion suggests that the slowdown in economic growth, combined with higher stockholding costs, has resulted in sharply increased levels of dissatisfaction with stock levels. Consequently, we project a negative growth contribution from stockbuilding for 1995/96, as production is adjusted to return stocks to more satisfactory levels. Thereafter, we forecast a bounce back in the stockbuilding contribution as firms adjust stock levels in line with the higher level of domestic sales.

## **3. Exports**

### **Export Volumes**

#### **Export volumes grew strongly during 1994/95**

Export volumes of goods and services grew by 7.1 percent in 1994/95, slightly stronger than estimated in our March forecasts. Non-commodity manufactures continued to record the strongest rate of growth. The performance of commodities was mixed, with high wool and dairy growth rates offset by weak meat exports.

#### **A weaker growth outlook for manufactured exports and tourism is weaker than previously expected**

The outlook for manufactured export growth remains positive despite a slightly weaker outlook for OECD economic growth (particularly for Japan), and a higher real exchange rate than assumed in our March forecasts. The rapid economic growth in Asia, combined with as yet largely untapped markets, continues to present significant export possibilities for New Zealand firms. Furthermore, increasing world demand,

combined with ongoing efficiency gains will continue to underpin New Zealand's exports into more mature markets. However, although annual non-commodity export growth rates are expected to remain in double figures, our projections suggest substantially weaker growth than experienced over the last three years, as indicated by the most recent out-turns.

Although the appreciation of the real exchange rate is likely to exert a downward influence on tourist arrivals (and this has been reflected in a downward revision to the outlook for exports of services), tourism growth is expected to continue to display strong growth, with real tourism receipts projected to grow by around 8 percent on average over the forecast horizon.

#### **Prospects for exports of primary products remain mixed**

Following a strong performance in 1994/95, the outlook for exports of primary products is rather mixed. In part, this reflects a return to "normal" climatic conditions, together with the impact of reduced destocking. Dairy export volumes are expected to fall in 1995/96, with slow growth thereafter insufficient to return export volumes to the levels seen in 1994/95. Meat export volumes are projected to increase slowly over the forecast horizon, with higher volumes in 1995/96 expected to be partly reversed in subsequent years. Exports of wool are also projected to fall sharply in 1995/96 following substantial de-stocking in 1994/95, before recovering slightly towards the end of the forecast period.

Forestry exports and other primary product exports are projected to show somewhat stronger growth. Indications are that higher volumes of log exports can be expected in 1995/96 in response to falling international prices, as firms seek to maintain overall returns. This is expected to be more than sufficient to offset downward revisions to timber exports to Australia, the latter reflecting a downturn in residential construction, higher Australian production, and reduced price competitiveness.

#### **Export volume growth will still exceed growth in overall GDP**

Overall, notwithstanding the recent strong appreciation of the exchange rate, export volumes are still expected to grow at rates in excess of GDP, averaging around 5 percent per annum over the forecast horizon.

**Table 3**  
**Export Volumes**

(Percentage change in real annual totals)

March Years	<u>Actuals</u>		<u>Forecasts</u>		
	1994	1995	1996	1997	1998
Goods	8.0	5.8	4.3	4.7	4.8
Services	12.7	12.0	5.9	6.6	4.7
<b>Total Exports</b>	8.9	7.1	4.6	5.2	4.8
<u>Selected Categories:</u>					
Manufactured Goods	13.9	14.5	9.8	10.3	11.1
Meat	-2.5	2.1	1.9	-1.0	0.3
Dairy	7.9	15.8	-4.3	1.4	1.7
Forestry	0.1	7.5	6.3	2.4	1.8
Wool	9.7	12.9	-13.1	-1.6	1.4
Other Primary Goods	3.3	1.8	6.9	0.6	3.5

## World Export Prices

World export prices are expected to be weaker than previously projected

Although commodity prices in 1994/95 were higher than estimated, our export price profile is lower than previously projected, particularly over the first half of the forecast horizon. This reflects our weaker outlook for the world economy, combined with the a number of commodity-specific influences.

Further gains in wool prices are now expected to be weaker than previously projected, due to a sharp fall off in demand from China in recent months. A lower outlook for beef prices is also expected, reflecting recent out-turns and prospects of a further deterioration in the US beef market. Prospects for a recovery in log and sawn timber prices have been undermined by continued weakness in the Japanese economy, and a sharp downturn in Australian residential construction.

In contrast, the outlook for international dairy prices is more optimistic than previously forecast. Low international stocks and reduced European and US subsidised exports have helped to push prices up to levels not seen since the late 1980s. However, recent gains are likely to be capped by the prospect of increased US dairy exports in response to these higher prices.

## 4. Imports

### Import Volumes

**Import volumes continue to grow strongly**

High rates of economic growth, particularly with regard to import-intensive capital equipment, combined with further increases in the rate of import penetration, have resulted in very strong growth in import volumes over 1994/95. However, as noted earlier in Box 2, and illustrated in Table 4, the aggregate SNA import numbers are distorted upwards as a result of the substantial fall in the relative price of computer equipment (which is almost totally imported) compared with non-computer imports.

**In the near term, growth in import volumes will moderate as the economy slows**

Growth in import volumes is expected to moderate in the near term as growth in domestic demand continues to slow. Nonetheless, our import growth profile is higher than that previously projected, reflecting a higher real exchange rate track than that assumed in our March forecasts.

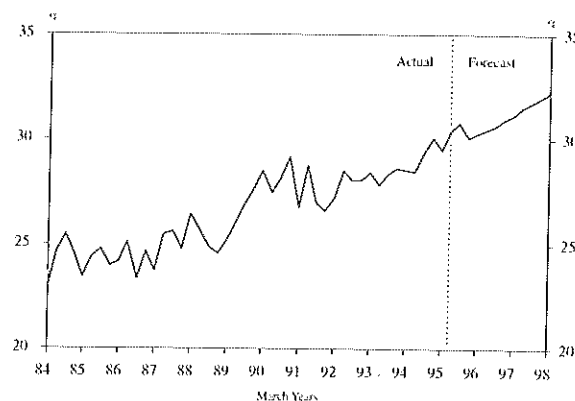
Growth in import volumes will accelerate as domestic demand responds to tax cuts

Growth in import volumes is expected to begin to accelerate in 1996/97, and strengthen considerably in 1997/98, as the impact of tax cuts filters through to domestic demand. Growth in import volumes is also underpinned by a further, although more gradual, increase in import penetration. This reflects the general trend of increasing internationalisation of the New Zealand economy, further tariff reductions, the ongoing shift in consumer tastes towards diversity, and our technical assumption regarding the path of the nominal exchange rate, which implies a further modest appreciation of the real exchange rate. The continued rise in aggregate import penetration is underpinned by compositional changes relating to the increasing share of manufactured goods in total output (the manufacturing sector uses a higher proportion of imported intermediate goods) and strong investment in import-intensive plant and machinery equipment.

Growth in imports of services is driven by continued growth in the volume of imports of goods, and the impact on out-bound tourism of rising domestic incomes and the real appreciation of the exchange rate (which lowers the relative price of overseas travel).

Figure 5

### Import Penetration Ratio (As a Share of GNE + Exports)



**Table 4**  
**Import Volumes**

(Percentage change in real annual totals)

March Years	Actuals		Forecasts		
	1994	1995	1996	1997	1998
Goods	15.5	20.5	10.1	10.7	12.8
(Goods excluding Computers)	(12.6)	(14.3)	(4.7)	(7.0)	(9.7)
Services	-4.4	4.7	5.2	4.1	5.9
<b>Total Imports</b>	<b>12.0</b>	<b>18.1</b>	<b>9.4</b>	<b>9.9</b>	<b>12.0</b>
<b>(Total excluding Computers)</b>	<b>(9.3)</b>	<b>(12.7)</b>	<b>(4.7)</b>	<b>(6.5)</b>	<b>(9.1)</b>
<u>Selected Categories:</u>					
Consumption Goods	7.2	12.5	5.9	8.1	9.6
Capital Goods					
(excluding Transport and Computers)	18.2	17.8	11.1	6.1	14.1
Intermediate Goods	11.9	9.2	3.4	5.7	6.1

## World Import Prices

**Declining commodity prices result in a weaker outlook for import prices in 1996/97**

In line with our usual assumption, world prices of imported manufactured goods are expected to continue to follow trends in world wholesale price inflation. With regard to non-oil commodity imports, movements in world prices have historically been closely related to the growth rate of OECD industrial production, typically with a four quarter lag. With industrial production growth having peaked late 1994, world non-oil commodity prices are projected to continue to be an upward influence on inflation over the 1995/96 year. However, with growth in OECD industrial production currently slowing, international commodity prices are expected to fall over 1996/97. When combined with our exchange rate assumption, import prices (in domestic currency terms) are expected to make a significant negative contribution to domestic inflation over that period. A modest recovery in world commodity prices is projected in 1997/98.

**The near-term outlook for oil prices is slightly firmer than previously assumed**

Recent higher-than-expected trends for world oil prices have led us to revise upward our near-term outlook. Over the forecast period, the overall profile remains a little higher than previously projected, consistent with upward revisions evident in international *Consensus Forecasts*.

## 5 The Current Account

**A projected deterioration in the trade balance dominates the current account outlook**

The current account profile is largely driven by the trade balance. The impact of continued growth in import volumes in excess of export volumes will be more than offset by a projected improvement in the terms of trade in 1996/97. In the following year, a deterioration in the terms of trade is projected to reinforce the sharp increase in import volumes stemming from strengthening domestic demand, thereby leading to a deterioration in the trade balance.

The investment income and transfers balances are also projected to weaken slightly over the forecast period. The weakening in the investment income balance reflects improved corporate profitability in the last year of the forecast horizon (thus increasing dividend payments and retained earnings to overseas owners of enterprises resident in New Zealand), as well as the need to fund the cumulative current account deficits. The lower level of net transfers is related to recent changes in immigration policy, which are expected to reduce the number of new immigrants arriving in the second half of the forecast period, leading to lower migrant cash transfers.

**Table 5**  
**Current Account**  
(\$ million)

March Years	<u>Actuals</u>		<u>Forecasts</u>		
	1994	1995	1996	1997	1998
Merchandise Trade Balance	3,135	2,090	1,330	1,420	390
Services Balance	-1,062	-680	-340	-130	-190
Investment Income Balance	-4,629	-5,493	-5,460	-5,240	-5,600
Transfers Balance	1,245	1,585	1,800	1,590	1,490
Current Account	-1,311	-2,498	-2,670	-2,360	-3,910
(% of Nominal GDP)	(-1.6)	(-2.9)	(-2.9)	(-2.5)	(-3.9)

### **An improvement in the services balance provides some offset**

As in our March forecasts, an improvement in the services balance is expected to provide some offset to the deterioration in the other components of the current account. However, the services balance is no longer expected to move into surplus during the forecast horizon, reflecting our lower forecast for growth in tourism receipts.

Overall, the current account deficit is projected to remain broadly unchanged over the next 18 months, before widening over the year to March 1998.

## **6. The Labour Market**

### **Employment growth slowed during the June quarter**

According to the Household Labour Force Survey, a further 76,000 people found work over the year to June 1995, with around 90 percent being in full-time employment. Focusing solely on the June quarter, employment growth has slowed in line with expectations. While an additional 12,000 people found work during the quarter, this result is well down on the rates of growth experienced over the preceding year. The slowdown in labour demand is confirmed by hours worked data from the same survey, which, while volatile, suggests a small fall in the number of hours worked during the June quarter.

### **Labour force participation has not risen to the extent expected**

The official unemployment rate fell to 6.3 percent (seasonally adjusted) in the June quarter, which gives New Zealand the third lowest unemployment rate in the OECD. Although our previous employment forecasts have proved quite accurate, the unemployment rate has fallen much faster than we had expected. The forecast error reflects our over-estimation of the rate of increase in labour force participation, which has remained broadly unchanged over the last three quarters.

### **Employment growth is expected to moderate**

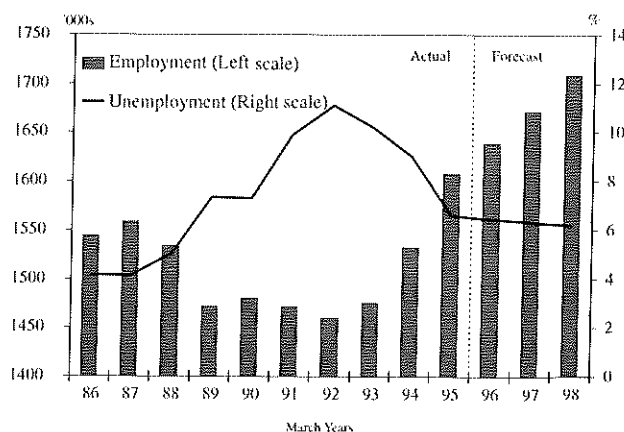
Our employment growth profile is broadly in line with our projections for economic activity, with an allowance made for a recovery in productivity growth rates, and a reduction in hours worked per person over the forecast horizon. Thus, we expect employment growth to average around 2 percent per annum (corresponding to an additional 100,000 people in employment over the three year forecast horizon).

### **The unemployment rate is expected to remain broadly stable over the forecast period**

The unemployment rate is expected to remain broadly stable over the next three years, with the increase in employment only just sufficient to offset the projected increase in the number of people seeking work. We continue to project a gradual increase in labour force participation as the labour market tightens, although we have scaled back the assumed increase in line with recent out-turns. Importantly, we have not allowed for a significant increase in labour force participation in response to the tax cuts. While this is consistent with most international evidence, the potential for a labour supply response will depend crucially on the microeconomic design of the overall tax cut package.

**Figure 6**

### **Employment and the Unemployment Rate**



**Table 6**  
**Labour Market**

March Years	<u>Actuals</u>		<u>Forecasts</u>		
	1994	1995	1996	1997	1998
Labour Force					
Natural Increase (000's)	15.4	16.1	15.6	15.6	15.7
Net Migration (000's)	6.5	9.2	9.7	9.8	9.8
Increase in Participation (000's)	27.9	9.6	4.9	7.0	10.8
Change in Labour Force (000's)	49.8	34.8	30.2	32.4	36.3
Employment (000's)	1,532	1,608	1,639	1,672	1,709
Annual Growth (%)	3.9	5.0	1.9	2.0	2.2
Unemployment (000's)	161.0	119.9	119.0	118.8	118.3
Unemployment Rate (seas. adj.)	9.0	6.6	6.5	6.3	6.2
Labour Force Participation Rate (%)	64.3	64.7	64.8	65.1	65.5

## Labour Costs

### Recent data suggests that labour costs have developed in line with expectations

Revised data from the Quarterly Employment Survey (QES) for the March 1995 quarter indicate that private sector average hourly wage rates increased by 2 percent over the year to March, marginally lower than expected. However, other surveys based on collective contracts, such as those published by the Industrial Relations Centre at Victoria University and by the Labour Department, indicate a marked acceleration in wage growth more recently. Although these survey results are based on relatively small samples, and are thus subject to a greater sample error, this trend is consistent with information obtained from our business contacts.

At this stage, this acceleration in wage growth has been reflected in official aggregate labour cost statistics. The Labour Cost Index (LCI) indicates that the quality-adjusted private sector ordinary time wage rate - a concept close to unit labour costs (see Box 3) - rose by 1.4 percent over the year to June. This result was in line with our expectations, and, given relatively low productivity growth due to cyclical factors, is broadly consistent with our estimate of annual unit labour cost growth.

### Stronger increases in labour costs are projected as the labour market remains tight

With labour market conditions expected to remain relatively tight over the forecast period, wage inflation is projected to increase gradually. Given the expected recovery in productivity growth rates from the current cyclical low, higher wage inflation is expected to be translated into higher unit labour cost growth to only a relatively modest extent.



### Box 3: Interpreting Published Wage Data

There are a number of differences between the Quarterly Employment Survey (QES) and the Labour Cost Index (LCI) measures of wage inflation.

The LCI is a fixed-weight and quality-adjusted index, so that only changes in salary and wage rates for the same quality and quantity of work are reflected in the index. For this reason, bonus payments and other irregular payments are excluded from the index, as are increases in base rates due to promotions or service increments. In making these adjustments, Statistics New Zealand attempts to adjust the underlying nominal wage movements for changes in labour productivity. Thus, the estimated series becomes conceptually closer to a unit labour cost series rather than a measure of pure nominal wage movements.

In contrast, the QES measure adopts a flexible weight approach. The QES measure is derived by dividing total economy wage and salary earnings by total hours paid, thus yielding a measure of the economy average wage. No attempt is made to quality-adjust this wage series (which includes bonuses paid and related to the reference week), and changes in the composition of the labour force can result in a change in the average wage even if individual wages are not changing. Deflation by an appropriate labour productivity index will transform this series into a unit labour cost index conceptually similar to the LCI. Without this adjustment, the QES wage series will tend to increase at a faster rate than the LCI measure as long as labour productivity growth is positive.

## 7. The Fiscal Outlook

*The Bank's fiscal projections are based on the Government's June 1995 Budget, adjusted for differences in the underlying macroeconomic projections, and for the assumed changes in tax rates discussed in Box 1 at the front of this release.*

The net debt-to-GDP ratio will fall below 30 percent

The net debt-to-GDP is projected to fall just within the upper bound of the Government's desired target range of 20 to 30 percent by June 1997, and continue to fall to around 25 percent by June 1998.

### Tax cuts largely offset the impact of continued economic growth on the operating balance

The impact of assumed cuts in personal tax rates is projected to offset largely the effect on the Government's operating balance of continued economic growth (and thus growing personal, company and GST tax bases). Given the assumptions underlying these forecasts, fiscal operating surpluses are now expected to remain broadly unchanged over the forecast period.

Compared with the Government's Budget projections, our operating surplus forecast is some \$4.5 billion lower by 1997/98. This reflects the impact of the assumed tax cuts, our relatively weaker economic outlook (notwithstanding the fiscal stimulus), and the cumulative impact of smaller surpluses on the Government's financing costs.

**Table 7**  
**Fiscal Accounts**  
(\$ million)

June Years	<u>Actuals/ Estimates</u>		<u>Forecasts</u>		
	1994	1995	1996	1997	1998
Direct Taxation	17,585	19,630	20,870	20,260	19,800
Indirect Taxation	10,120	10,390	10,730	11,220	11,840
Non-Tax Revenue	2,478	3,290	2,690	2,880	2,940
Total Revenue	30,183	33,310	34,290	34,360	34,580
Total Expenses	29,639	30,080	31,370	31,860	31,850
Revenue less Expenses	554	3,230	2,920	2,500	2,730
Net Surplus Attributable to SOEs & Crown Entities	211	-460	320	420	580
Operating Balance (% of Nominal GDP)	755 (0.9)	2,770 (3.1)	3,240 (3.5)	2,920 (3.1)	3,310 (3.3)

## 8. Inflation

### Recent Trends

#### Volatile components account for half of underlying inflation over the year to June 1995

Underlying inflation was 0.6 percent in the June quarter, bringing the rate for the year to June to 2.2 percent. The quarterly out-turn was 0.1 percent lower than anticipated, reflecting lower-than-expected inflation in construction costs, used car prices, and household appliance prices. Half of underlying inflation over the year to June is explained by increases in fresh fruit and vegetable prices (0.4 percentage points) and construction costs (0.7 percentage points).

#### Inflation pressures in the non-tradeables sector show signs of easing

The June quarter out-turns for underlying inflation in the tradeables and non-tradeables sectors were identical at 0.6 percent. Excluding fresh fruit and vegetables (which explain a large part of recent inflation in

tradeables prices), underlying tradeables inflation was 0.1 for the year to June, compared to 0.9 percent when they are included.

The contribution of the Housing group of the CPI to non-tradeables inflation was considerably less dominant in the June quarter. Housing group inflation was 0.8 percent, compared with an average of 2 percent per quarter over the previous year. This mainly reflects a slowdown in the rate of inflation of construction costs and dwellings rentals. The annual rate of non-tradeables inflation over the year to June remained high at 3.9 percent, although the most recent out-turn suggests that the trend rate of inflation in this sector is falling.

#### Increased credit costs account for most of the difference between underlying and headline inflation

Headline inflation was 1.0 percent in the June quarter, taking the rate to 4.6 percent for the year to June. Interest costs accounted for most of the difference between underlying and headline inflation in both the June quarter and the year to June. Exclusions from headline inflation related to increases in world oil prices and government charges collectively accounted

for only 0.5 percentage points of the difference underlying and headline inflation in the year to June, compared to a 1.9 percentage point contribution from increased credit costs.

## The Outlook

### Underlying inflation is projected to decline over the coming year before increasing in 1997/98

The Bank's latest projections for underlying inflation and headline inflation for the period through to March 1998 are shown in Table 8. Also presented is the outlook for the *CPI ex Credit Services* series, which is taken as the base for calculating underlying inflation.

Underlying inflation is expected to fall gradually from the current peak of 2.2 percent in the year to June 1995, reaching 1.5 percent by March 1996 and 1.1 percent by September 1996. Beginning in mid-1997, underlying inflation is expected to gradually rise.

The decline in underlying inflation over the next year is mainly a reflection of declining contributions from construction costs and falling prices for fresh fruit and vegetables (the latter are estimated to lower the underlying inflation out-turn for the September quarter by approximately 0.2 percentage points). The lagged effect of rising world import prices is broadly offset by the appreciation of the nominal exchange rate over the past year, while stronger unit labour cost growth is roughly offset by a weaker contribution from margins.

Inflation is expected to remain relatively stable during the second half of 1996 and early 1997. Initial influences on profit margins from increasing demand growth are projected to be offset by cyclically weak prices of imported commodities. However, the latter effect is expected to taper off during the course of 1997. With strengthening demand pressures as a result of the second tier of the tax cuts, further growth in profit margins and unit labour costs are projected to lead to a gradual increase in underlying inflation.

**Table 8**  
**CPI Inflation Projections**  
(Percent changes)

		Underlying		CPI ex Credit Services		Headline	
		Quarterly	Annual	Quarterly	Annual	Quarterly	Annual
1994 -	Mar.	0.1	1.1	0.2	1.6	0.0	1.3
	June	0.3	1.1	0.5	1.6	0.4	1.1
	Sep.	0.5	1.2	0.9	1.9	1.2	1.8
	Dec.	0.6	1.5	0.7	2.3	1.2	2.8
1995 -	Mar.	0.5	1.9	0.5	2.6	1.2	4.0
	June	0.6	2.2	0.6	2.7	1.0	4.6
	Sep.	0.3	2.0	0.3	2.1	0.1	3.4
	Dec.	0.4	1.8	0.4	1.9	0.5	2.7
1996 -	Mar.	0.3	1.5	0.3	1.6	-0.2	1.3
	June	0.2	1.2	0.2	1.2	0.1	0.5
	Sep.	0.3	1.1	0.3	1.1	0.2	0.6
	Dec.	0.3	1.1	0.3	1.1	0.3	0.4
1997 -	Mar.	0.3	1.1	0.3	1.1	0.3	0.9
	June	0.3	1.2	0.3	1.2	0.3	1.0
	Sep.	0.4	1.4	0.4	1.4	0.4	1.2
	Dec.	0.5	1.5	0.5	1.5	0.4	1.3
1998 -	Mar.	0.5	1.7	0.5	1.7	0.5	1.5

### Domestically generated inflation influences are higher than previously projected

Compared with the inflation outlook published in the June 1995 *Monetary Policy Statement*, these projections indicate a higher profile for underlying inflation from the second half of 1996. Domestically generated inflation influences account for the majority of the upward revision. Higher profit margins are the most significant contributor to the stronger outlook for underlying inflation in the year to March 1997. Lower than previously assumed import prices make a partially offsetting contribution. Higher unit labour costs and higher profit margins contribute equally to the upward revision to the inflation outlook for the year to March 1998.

The marginally slower rate of TWI appreciation assumed in these projections also results in a small (0.1 percentage point) contribution to the upward revision to the inflation track, although the effect on the first half of the forecast period is more than offset by the assumed higher starting value for the TWI.

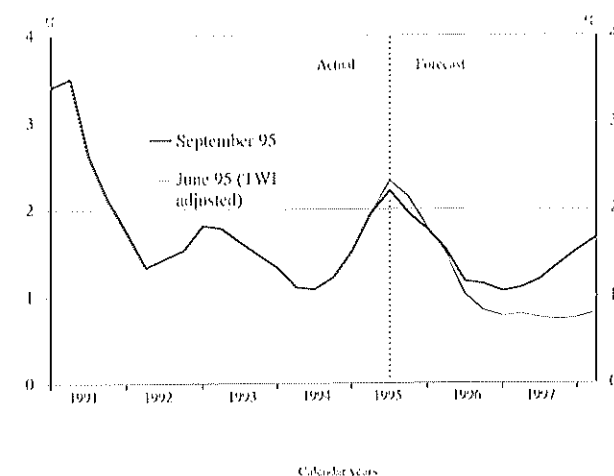
### Headline inflation will not fall to the extent previously projected

Headline inflation is projected to fall steeply from its peak of 4.6 percent in June 1995, reaching 1.3 percent by March 1996 and 0.9 percent by March 1997, before rising gradually to 1.5 percent by March 1998. However, the rate of decline in headline inflation is less than that projected in the June 1995 *Monetary Policy Statement*. This reflects our assumption of firmer monetary conditions, and thus a more modest decline in mortgage interest rates, with a consequent reduction in the downward contribution from falling credit costs.

### No further exclusions related to oil prices or Government charges are projected

Neither international commodity prices nor government charges are expected to be excluded from the calculation of underlying inflation over the next two quarters, given that the annual contributions over the previous or next year are not expected to reach the required threshold.

**Figure 7**  
**Underlying Inflation Projections**  
(Annual Percentage Changes)



Note: For reasons of comparability, the June projection has been adjusted to bring it on to the same exchange rate track as used for the September 1995 projection.

## 9. Risk Analysis

### Several factors could lead to departures from our central projection

As usual, the projections outlined above represent our best estimate of the outlook for inflation. However, as with all projections, the outlook is subject to a variety of uncertainties. On this occasion, these can be loosely grouped into three categories -those related to the outlook for the real economy, those uncertainties for the inflation outlook that exist even if the real economy develops in line with our expectations, and finally those uncertainties specifically related to the size, structure, and timing of the fiscal package.

### The uncertainties surrounding the activity outlook appear balanced

Looking at the year ahead, the uncertainties surrounding the projections for domestic and external demand appear balanced. The recent round of mortgage rate increases, combined with our assumption of only a modest reduction in 1996, suggest that the possibility of an early pick-up in consumer spending growth or residential building has diminished. On the other hand, the prospect of a greater cycle in investment activity, although commonplace in both New Zealand and overseas, is not supported by either surveyed investment

intentions, current high rates of capacity utilisation, or our discussions with business contacts.

Significant underlying momentum in the manufactured export sector suggests that the risks to external demand are also balanced. While profitability has suffered as a result of the appreciation of the exchange rate, and could lead to a more pronounced effect on expansion than that projected here, largely untapped opportunities in many markets - with the potential for significant growth in market share - could see export volumes continue to surprise on the high side. Uncertainties surrounding the outlook for the world economy appear to be balanced, with the possibility of further weakness in Japan offset by possibly greater strength in the US and in Europe.

#### **A number of uncertainties surround the private sector's reaction to tax cuts**

A general uncertainty relates to the possibility of households adjusting spending in advance of the tax cuts. However, the chance of this appears to be relatively small if low income earners turn out to be the main beneficiaries of the tax cuts (given liquidity constraints). The possibility of firms adjusting their investment plans in advance of the tax cuts is not seen as very likely, given the "wait and see" approach articulated by most of our business contacts, and the continued impact of relatively firm monetary and fiscal policies.

The uncertainty surrounding the real economy outlook over the latter part of the forecast horizon is predominantly associated with the private sector's reaction to tax cuts. Stronger-than-projected pressure on inflation could arise from a higher-than-assumed consumption propensity with respect to the additional income, or from a lower-than-assumed investment response by firms. On the other hand, a downside risk to inflation could arise from a stronger than projected labour supply response.

A further concern relates to the outlook for the underlying strength of the economy. Although fiscal policy is assumed to become relatively less contractionary over the next couple of years, in absolute terms both fiscal and monetary policies are assumed to remain relatively tight.

As noted in the *Overview*, the central projection implies that the contractionary effects of fiscal policy are nearly completely offset by private sector agents' expansionary behaviour. This behaviour appears to

have been primarily driven by households' and firms' confidence in the sustainability of comparatively high growth rates. The projected deterioration in the private sectors' net borrowing positions is not, however, unduly large by historical standards, particularly considering significant increases in private sector wealth due to rising asset prices in recent years, and the generally healthy state of private sector balance sheets. Thus, while some adjustment in households' and firms' investment or savings behaviour will be required at some stage, it is not clear that this would need to occur within the forecast horizon.

#### **Other risks to the inflation outlook also appear balanced**

On the one hand construction costs (currently very high in real terms) and fresh fruit and vegetable prices may make a greater downward contribution than we anticipate. On the other hand, import price pressures may feed through into domestic inflation to a greater extent than assumed. This latter possibility is accentuated by continued uncertainty surrounding the size of the exchange rate pass-through coefficient (still assumed in these projections to be approximately 0.3).

Over the medium term, there may be a degree of upside risk to the unit labour cost outlook, given our projection of sustained labour market tightness. However, international commodity prices may fall by more than assumed in the central projection, given historical amplitudes of commodity price cycles (resulting in lower import prices in particular).

In addition, we emphasise once again the purely technical nature of the nominal exchange rate and interest rate assumptions. The actual paths followed by the nominal exchange rate and domestic interest rates will depend on what is required to maintain underlying inflation in the 0 to 2 percent target band, and these paths are not independent. Although, a rebalancing of monetary conditions in favour of, for example, a lower real exchange rate (via a reduction in the nominal exchange rate) and higher real interest rates would leave overall monetary conditions unchanged (and thus result in no change in the degree of monetary policy pressure on price formation in a medium-term context), the direct price effects of a weaker-than-projected nominal exchange rate would result in a temporary deterioration in the projected outlook for inflation.

### Final outcomes will depend on the size, structure and timing of the fiscal package

Our tax cut assumption is necessarily illustrative in nature, given that the Government's fiscal package is still to be announced. The overall effect on the real economy and inflation will depend on the size, structure and timing of the package.

All things being equal, a larger package than assumed here would further increase domestic demand, the current account deficit and inflation. Moreover, the magnitude of the impact on inflation and the current account may rise more than proportionately if the

economy is pushed hard up against capacity constraints.

Similarly, all things being equal, a package more heavily weighted towards increased government (non-transfer) expenditure would tend to be more expansionary in the short-term, and would reduce the likelihood of a favourable response from labour supply, compared with a package based solely on tax cuts. The possibility of an increase in labour supply and of a positive savings response to the tax cuts - both of which will tend to mitigate pressures on the current account and inflation - depends crucially on the specific design of the tax cuts.

These forecasts are produced primarily for use within the Reserve Bank. The Bank accepts no responsibility for any use which is made of these forecasts.

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