JOHN STEPHENSON
DOUG STEEL
MARK WALTON
New Zealand Institute of Economic Research

NEW ZEALAND

2003: MIXED RESULTS

New Zealand's economic performance in 2003 was positive, though slightly more mixed than recent years. Growth eased from 4.4% in 2002 to 3.5% in 2003. Some features of strong growth from previous years continued in 2003, particularly strong growth in consumer demand. The performance of other aspects of the economy in 2003, particularly the export sector, was in marked contrast to that of 2001–02.

The economic story of 2003 was the rise of the NZ dollar. The dollar's value increased by over 25% against the US dollar in 2003 and by more than 13% against other currencies on a trade weighted basis. Attributed, in part, to New Zealand's strong economic growth and high interest rates relative to its major trading partners. Of course, much of the rise against the US dollar is attributable to negative international sentiment towards the US currency. Export revenues fell. Merchandise exports fell by NZ$4.3 billion between 2001 and 2003.

On the upside, forecast reductions in migrant inflows for 2003 turned out to be overstated, although inflows dwindled in the second half of the year. Despite continued net inflows of migrants, the labour market tightened further in 2003. Official unemployment fell from an average of 5.2% in 2002 to an average of 4.7% in 2003, the lowest level experienced in New Zealand since 1987.

Strong net migration, a tight labour market, and low real interest rates boosted demand for consumer goods and housing.

The downside was almost entirely confined to the export sector of the economy.

Business saving remained relatively high in 2003, though it dipped slightly after the significant growth in business savings in 2001 and 2002. In late 2001 and early 2002 the low NZ dollar and high commodity prices saw export revenue surge. Some of this extra revenue was saved (as the high level of uncertainty at the time postponed some investment) and then spent expanding capacity in 2003.

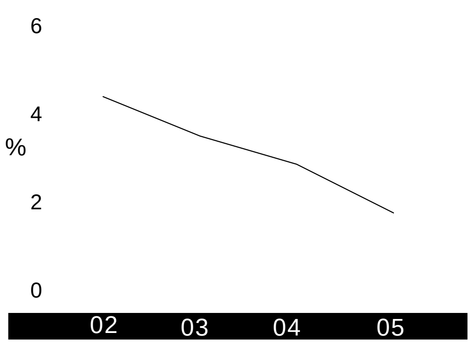
Import-friendly exchange rates and underlying constraints in the labour market made capital a comparatively attractive option for business investment in 2003. These conditions, coupled with strong residential investment, led to an increase in the contribution of fixed investment to GDP growth in 2003—2.9% up from 1.9% in 2002.

As world growth improved and the housing boom continued in early 2004 the Reserve Bank lifted interest rates. The key question is: when will the lower export revenues from the past 2 years and the reduced inflow of migrants dampen the current very buoyant domestic spending growth?

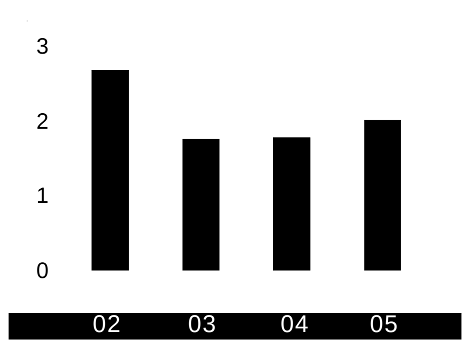
OUTLOOK

We forecast GDP growth to ease to 2.8% in 2004 then to reach a low of 1.7% in 2005. This compares to average growth of 3.2% over the past five years. Thus the forecast is for a

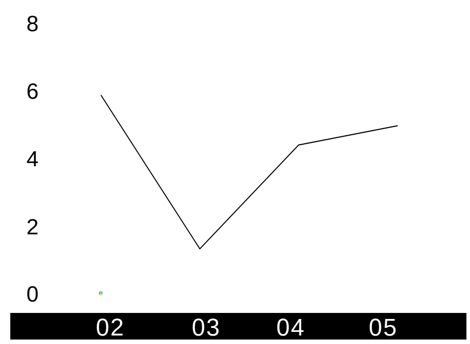
GDP growth



CPI inflation



Export growth



reasonably soft landing from the recent high flying rates of expansion of around 4% or above.

Slower population growth, as net inflows of migrants reduce, will play a major role in the reduction in overall growth and the effect will be most pronounced in the housing market. We forecast a small decline in residential investment in 2004, followed by a significant fall in 2005 as the lower population growth takes full effect.

On the other hand, we expect that growth in GDP excluding residential investment will lift over the coming years. This is due to a forecast improvement in export volumes. While we can expect that the effects of the high NZ dollar will continue to impact on exports well into 2004, leading to below average volume growth, growth in export volumes will be stronger than in the SARS-and-electricity-shortage affected 2003.

A recent announcement by the Reserve Bank on intervening in the foreign exchange market spooked the markets and the NZ dollar fell by more than 1% against most of our major trading partners' currencies (further details on this will cause more volatility; see risks below). More generally, the NZ dollar will weaken as domestic growth eases and the strong recovery continues overseas. This will be reinforced when other central banks lift interest rates as their economies slowly use up existing spare capacity. This will narrow the gap between interest rates in New Zealand and overseas, reducing upward pressure on the NZ dollar.

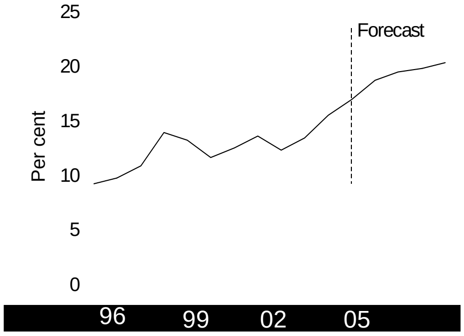
Stronger world growth will help arrest the decline in NZ dollar export prices. World prices for many of our commodities, particularly dairy products, have already increased as a result of stronger economic growth overseas.

Tourism is also expected to experience growth in coming years, expanding rapidly in 2004 compared to 2003. Key factors behind this forecast include the low base of 2003 as a result of SARS, stronger world growth, increased seat capacity into New Zealand (especially on the trans-Tasman route) and recent high international exposure, including coverage from the multiple OSCAR-winning performance of the third *Lord of the Rings* film. Tourism will increase its share of overall foreign exchange earning to over 20% by 2008.

The outlook for inflation is subdued. Prices for internationally tradable goods have been falling as a consequence of the appreciating NZ dollar. Meanwhile, prices for non-tradable goods, such as housing, have been rising rapidly. As domestic demand growth eases, and as the housing market in particular cools, non-tradable inflation will ease. Meanwhile, prices for tradable goods will stop falling and begin rising as the effect of a higher exchange rate abates. We forecast inflation to be around 2% through 2004 and 2005. This is the middle of the Reserve Bank target band. With inflation subdued, we do not expect any major change to interest rates in 2004.

Tourist spending: share of total exports

Tourist spending will be a key foreign exchange earner for New Zealand in coming years—a reflection of the diversification of New Zealand's export base.



RISKS

Our forecast includes a significant easing in net migration over the next two years. Net migration is a key variable underpinning the future shape of growth through its impact on house building.

The housing boom has been accompanied by a rise in household debt. While household net worth has increased, the lift in debt has increased the vulnerability of the household sector to an adverse shift in asset prices, particularly a fall in house prices. While we are not forecasting a fall in house prices, if one was to occur this could cause households to increase savings from current income, thus slowing consumption and economic growth.

A significant upside risk to our forecast for growth over the coming 2 years is a greater lift than expected in government spending. With an annual surplus of around 4.7% of GDP expected in fiscal year 2004, there is potential for greater increases in spending than currently forecast. If the government decides to increase spending, however, growth would increase in the short term but with resources reasonably stretched, this could prove to be inflationary.

World growth will play a key role in New Zealand's future performance. A protracted continuation of the recent surge in world commodity prices may lead to higher economic growth in New Zealand than forecast.

The Reserve Bank of New Zealand has provided advice to the Minister of Finance recommending that, as one of its monetary policy tools, it should have the capacity to intervene in the foreign exchange market to influence the level of the exchange rate. This announcement has increased uncertainty about the future value of the NZ dollar, especially in the short term.