11 NEW ZEALAND

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2004: GROWTH SQUEEZES RESOURCES

The New Zealand economy expanded at a solid pace in 2004. Real GDP grew by 4.8%, up on the 3.4% growth recorded in 2003. The December 2004 quarter was the 18th in succession of positive growth for New Zealand and resources are stretched thin. Rising household spending was a key component of growth last year. Household spending was fuelled by very strong activity in the labour market driving income growth and surging house prices boosting households' wealth. In the year to December 2004 employment grew 4.4%, salary and wage rates grew 3.1% and two years of rapidly rising house prices led to negative real mortgage interest rates. In addition to persistent income growth, a stronger New Zealand dollar has raised the international purchasing power of that income. New Zealand's terms of trade rose 7%, on an annual average basis, by year end 2004. Increased buying power saw import volumes surge 15.7% over the year.

Three and a half years of robust economic growth has led to strong employment growth and declining unemployment. In the December 2004 quarter, New Zealand's seasonally adjusted unemployment rate reached 3.6% of the labour force — its lowest level in almost 20 years and the lowest unemployment rate in the OECD. Activity in the housing market was brisk. Real residential investment grew 4.5%, on the back of 19.8% growth in the previous year. During the latest period house prices grew by 17.1%. Residential investment has been driven by strong population growth from large net inflows of migrants in the past few years. The rise in house prices through 2003 and 2004 has provided considerable impetus for growth in private consumption. Indeed the wealth effect on private consumption can scarcely be understated in view of the fact that New Zealand households hold a little under 90% of their net financial wealth in residential property. This is very high compared with less than 40% of net financial assets held in residential property in the US, and approximately 75% in Australia.

In 2004 business investment recorded its strongest burst in a decade. Investment (excluding housing) grew 16% in 2004 following 10.3% growth in 2003. A number of factors combined to stimulate business investment last year. The persistently high value of the New Zealand dollar has lowered the price of plant, machinery and transport equipment, much of which is imported. At the same time, with labour in short supply, upward pressure on wages has provided incentive for businesses to substitute capital goods for relatively expensive labour. In addition, productive resources are stretched thin. In December 2004, the capacity utilisation measure (CUBO) from the New Zealand Institute of Economic Research reached its highest level since the survey began in 1961.

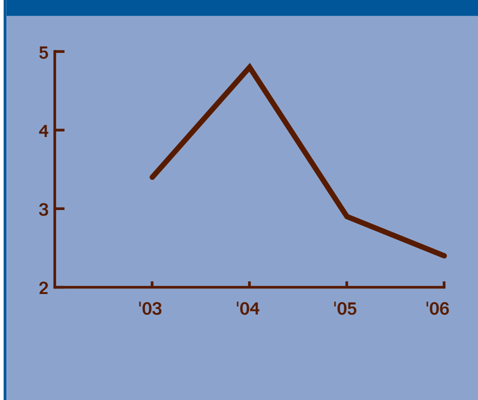
Strong wage inflation, high capacity utilization and continued high levels of activity in the housing market put upward pressure on inflation in 2004. The consumer price index (CPI) spent most of 2004 in the upper half of the central bank's target inflation band of 1-3% ending 2004 at 2.7% annual inflation. Last year saw a rapid tightening in monetary policy in response to the inflationary pressure in the economy. The Reserve Bank of New Zealand lifted its benchmark rate seven times between January 2004 and March 2005, from 5% to 6.75%. This has led to some of the tightest monetary conditions in eight years.

Strong household spending and business investment widened the current-account deficit to 6.4% of GDP for the year ending December 2004. However, the expansion of the current-account deficit has had little impact on the value of the New Zealand dollar which recorded a record high in March of $1.34 against the US dollar (a record since the kiwi was floated in 1985). The rise in the currency has been supported by high world prices for exports and high interest rates and economic growth relative to other economies. Moreover, pressure on the US dollar to devalue has been finding an outlet in floating currencies such as the New Zealand unit.

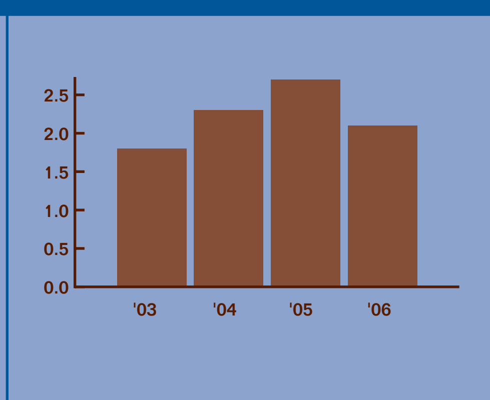
New Zealand's export performance in 2004 was solid despite the rise in value of the currency. Growth of 5.2% in the year to December 2004 was supported by solid demand and higher world prices for New Zealand's major export commodities. World prices for dairy and meat, which make up a third of the country's exports, hit historically high levels in 2004.

Robust growth in consumption, employment and profits contributed to an expansion in

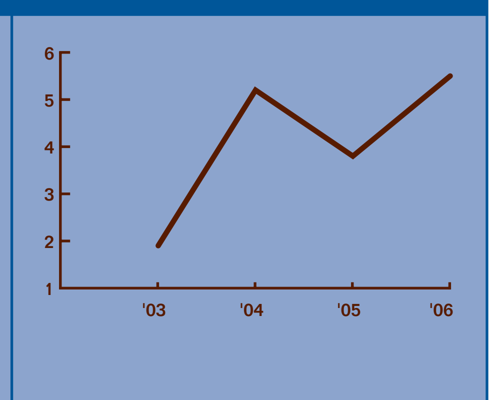
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



government surpluses in 2004. The government recorded a $7.4 billion operating surplus (5.3% of GDP) in the year to June 2004. Part of this has been used to reduce debt so that net government debt declined to 10.8% of GDP in June 2004, compared with 13.1% a year earlier. Households, on other hand, have expanded their debt positions in the past year to fund their way through the recent housing boom and to drive consumption spending. We estimate New Zealand households' consumption exceeded net disposable income by around 10.5%.

OUTLOOK FOR 2005 AND 2006

Growth is forecast to ease from 4.8% in 2004 to a more moderate 2.9% in 2005, with a further slowing to 2.4% in 2006. Net inflows of migrants, which have been a key component of growth in recent years, will decline throughout 2005. Growth in household spending will be subdued, but remain relatively firm compared to growth in other sectors of the economy. At the same time, moderate growth will be supported by continued low unemployment and rising wages. We forecast private consumption growth of 4.9%, year-on-year, in 2005 before declining to 3.4% in 2006.

The current investment boom will continue in the short term, helping to relieve capacity constraints. However, easing profit growth and reduced pressure on productive capacity will see investment growth tail-off in the second half of 2005, with overall year-on-year real growth in investment (excluding residential investment) of 6.1%. Residential investment will slow more rapidly than other investment. We forecast a 14% decline in residential investment in 2005, followed by a 0.6% decline in 2006. Total investment is forecast to record modest year-on-year growth of 2.1% and 0.4% in 2005 and 2006 respectively.

Exporters will continue to record solid volume growth despite a softening in demand among some major trading partners. Exports are forecast to grow 3.8% in 2005 and 5.5% in 2006. High world prices for our commodities are expected to persist for some time and a gradually depreciating NZ dollar will contribute to strong export revenues in the medium term.

Despite a slowdown in growth we expect tightness in the labour market to continue. As a result, the unemployment rate is forecast to decline to 3.4%, seasonally adjusted, in the December 2005 quarter, before rising to 3.6% in the December 2006 quarter. The lagged effect of low unemployment will pass through into increased wages in late 2005 and early 2006. Wages are forecast to rise 3% and 4.5%, year-on-year, in 2005 and 2006 respectively.

Easing domestic demand growth and the current capital expansion will help curb domestic price pressures at the same time as a strong New Zealand dollar will keep tradeable inflation at bay. As a result, consumer price inflation is forecast to peak at 3.1% in the year to March 2005, before declining to 2.2% by the December 2005 quarter. Wage inflation will, however, keep inflation in the top half of the Reserve Bank's 1-3% target band – averaging 2.4% annual inflation over the next two years.

Downward pressure on the currency from a ballooning current-account deficit will be partly offset by a weak US dollar. Thus, the New Zealand dollar is forecast to remain strong in the short term, before depreciating gradually over the medium term. The current-account deficit is forecast to reach 6.5% of GDP by year-end 2005. In 2006 the deficit will be pegged back slightly to 5.7% of GDP by slowing domestic demand, a depreciating currency, and export growth.

RISKS

Our forecast for economic growth represents our central view on a range of outcomes we consider possible. Key risks to the forecast for growth include

A decline in the terms of trade. A substantial fall in world prices for our key export products or further increases in the world price of oil will erode a key driver of future economic growth. A fall in the terms of trade is likely to see the New Zealand dollar decline more than expected. This could force up interest rates, reducing growth below the level forecast.

A greater ballooning of the current-account deficit, either via a fall in the terms of trade or from greater-than-expected imports. This may cause the New Zealand dollar to fall more sharply and/or further than forecast. This could halt the current boom in investment sooner than anticipated, reducing growth directly. Also, the resulting tradeable inflation from the depreciating currency would push up interest rates, depressing growth below that forecast.

A higher level of household savings than expected. The level of household dissaving is forecast to widen. However, a loss of consumer confidence could result in less desire to accumulate debt – prompting more saving from current income, less consumption and slower growth.

A larger increase in labour market participation than forecast, leading to more employment growth and stronger household spending.

Stronger labour productivity growth than forecast, following the rapid capital expansion currently taking place.