New Zealand

Activity is projected to slow and capacity constraints to ease, but some imbalances will persist. While rapidly expanding household incomes are likely to temper the effects of higher interest rates on consumer spending, rising wages and other input costs will squeeze business profitability further and curtail investment. Exports should recover as the effects of the exchange rate appreciation wear off and external markets improve. Inflationary pressures will remain important.

Significant monetary tightening has not yet produced a material slowdown in domestic demand growth, and risks of a sharp correction are increasing. The task of bringing the economy back onto a sustainable growth path would be made easier if the government delayed the planned easing in its fiscal stance, thereby allowing a more balanced policy mix for managing current macroeconomic challenges.

Domestic demand has remained strong, but exports have softened…

Domestic demand remained buoyant in the first half of 2005. Large increases in household real disposable incomes along with wealth effects from surging house prices have sustained private consumption, despite rising interest rates. Government consumption has also been expanding at a rapid pace. But despite only a slight fall in capacity utilisation, business investment is decelerating, reflecting declining profitability and weaker business-sector confidence. Exporters are finally feeling the effects of the higher exchange rate, while falling prices for New Zealand's key commodity exports and rising oil prices together bring to an end the terms-of-trade gains of recent years. Weak export volumes combined with a further upsurge in imports have led to a marked widening in the current account deficit.

… while prices and wages have accelerated

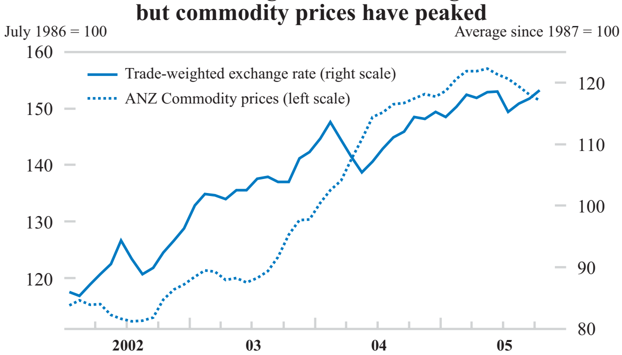
Labour-market constraints persist, even though a remarkable expansion in employment has been largely matched by additions to the labour force: unemployment has now fallen to 3.4%. With many businesses still reporting difficulties in finding skilled and unskilled labour, wages and non-wage labour costs have accelerated. Inflation shows no signs of easing, even after looking through the impact of higher oil prices. Producer output prices have thus far risen more slowly than wages and other input costs, suggesting that further price hikes may be in the pipeline as businesses try to restore margins. Inflation expectations remain close to 3%, the upper limit of the Central Bank's policy target band.

Monetary and fiscal policy are pulling in different directions

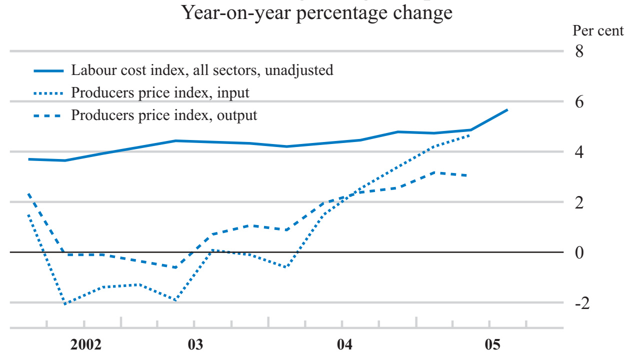
With excess demand still apparent despite significant monetary tightening, the Reserve Bank raised its official interest rate by a further ¼ percentage point in October. Further monetary tightening may be necessary to bring the economy back onto a more sustainable path. In any case, there is no room for easing monetary policy without risk-

New Zealand

The exchange rate remains high but commodity prices have peaked



Business are facing rising cost pressures
Year-on-year percentage change



Source: Reserve Bank of New Zealand, Statistics New Zealand and ANZ Bank.

New Zealand: **Demand, output and prices**

	2002	2003	2004	2005	2006	2007
	Current prices NZD billion	Percentage changes, volume				
Private consumption	75.5	5.4	6.3	4.8	3.0	2.5
Government consumption	22.5	2.4	5.4	5.0	5.0	3.3
Gross fixed capital formation	26.2	11.5	13.9	6.9	1.1	-1.1
Final domestic demand	124.3	6.1	7.8	5.3	2.9	1.9
Stockbuilding [1]	1.6	-0.3	0.4	0.6	-0.2	0.0
Total domestic demand	125.9	5.8	8.1	5.2	2.8	1.8
Exports of goods and services	42.7	2.1	5.9	0.0	7.3	8.5
Imports of goods and services	41.1	8.4	16.6	8.0	7.6	6.0
Net exports [1]	1.5	-2.0	-3.1	-2.4	-0.3	0.5
GDP at market prices	127.5	3.7	4.4	2.7	2.6	2.4
GDP deflator	_	1.8	3.7	2.5	2.5	2.0
Memorandum items						
GDP (production)	_	3.4	4.4	2.8	2.5	2.4
Consumer price index	_	1.8	2.3	3.1	3.7	3.1
Private consumption deflator	_	0.5	0.7	1.9	2.9	2.5
Unemployment rate	_	4.6	3.9	3.6	3.9	4.1
General government financial balance [2]	_	5.3	5.5	5.3	4.6	4.3
Current account balance [2]	_	-4.5	-6.6	-8.7	-9.1	-9.0

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see OECD Economic Outlook Sources and Methods, *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.

Source: OECD Economic Outlook 78 database.

Statlink: *http://dx.doi.org/10.1787/043668355606*

ing higher inflation. Although the overall budget surplus remains substantial, the government's present policy settings imply a pro-cyclical fiscal stimulus in the period ahead. This is counteracting the Bank's efforts to damp domestic demand, resulting in higher interest rates than would be needed under a more neutral fiscal stance.

Activity will slow, but inflation pressures remain high…

GDP is projected to expand more slowly than potential in the coming two years, with excess demand gradually dissipating. But its composition will remain somewhat unbalanced. Private consumption is likely to remain strong, underpinned by swelling household incomes from both wages and income transfers. Government consumption is set to continue on its rapid expansion path. In contrast, business sector investment could be squeezed by the fall-off in profitability due to the combined effects of higher interest rates and continuing high wage rises. Exporters face somewhat brighter prospects as foreign markets expand more rapidly, but only if they are able to keep their costs under control to avoid losing competitiveness. With consumption strength feeding through to imports, the current account deficit could remain very large. Inflation is likely to remain near the top of the target band.

... and the downside risks are considerable

The risks of a sharp slowdown in growth have increased. The squeeze on business sector profitability could be even more pronounced, if there were more significant upward pressure on costs. Alternatively, higher interest rates or a more pronounced correction in house prices could lead households to cut back household spending. And with inflation expectations already high, any signs of second-round effects of higher oil prices would require a further response from the Central Bank. Additional fiscal stimulus beyond that projected would only exacerbate the present imbalances. Finally, foreigners' willingness to finance the large current account deficit could diminish, leading to a sharp fall in the exchange rate and further pressure on inflation.

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Conventional signs

$	US dollar	.	Decimal point
¥	Japanese yen	I, II	Calendar half-years
£	Pound sterling	Q1, Q4	Calendar quarters
€	Euro	Billion	Thousand million
mb/d	Million barrels per day	Trillion	Thousand billion
. .	Data not available	s.a.a.r.	Seasonally adjusted at annual rates
0	Nil or negligible	n.s.a.	Not seasonally adjusted
–	Irrelevant		

Summary of projections

	2005	2006	2007	2005	2006				2007		Fourth quarter		
				Q4	Q1	Q2	Q3	Q4	Q1	Q2	2005	2006	2007
							Per cent						
Real GDP growth													
United States	3.6	3.5	3.3	3.7	3.3	3.5	3.5	3.3	3.2	3.2	3.7	3.4	3.1
Japan	2.4	2.0	2.0	1.7	1.9	2.1	1.9	2.0	2.0	2.1	3.2	2.0	2.1
Euro area	1.4	2.1	2.2	2.2	1.9	2.0	2.2	2.1	2.2	2.2	1.8	2.1	2.2
Total OECD	2.7	2.9	2.9	3.1	3.0	2.8	2.6	2.9	3.2	2.9	3.0	2.8	2.9
Inflation													
United States	2.7	2.5	2.3	2.9	2.2	2.3	2.3	2.3	2.6	2.2	2.9	2.3	2.2
Japan	-1.1	-0.1	0.6	-0.2	0.0	0.1	0.3	0.5	0.6	0.7	-1.3	0.2	0.8
Euro area	1.8	1.7	1.9	1.9	1.5	1.5	1.5	1.8	2.0	2.1	1.9	1.6	2.0
Total OECD	2.1	1.9	1.9	1.5	1.4	2.1	2.4	2.0	1.7	1.8	1.9	2.0	1.9
Unemployment rate													
United States	5.1	4.8	4.7	5.0	4.9	4.9	4.8	4.8	4.7	4.7	5.0	4.8	4.7
Japan	4.4	3.9	3.5	4.3	4.1	4.0	3.9	3.8	3.7	3.5	4.3	3.8	3.3
Euro area	8.7	8.4	8.1	8.6	8.5	8.5	8.4	8.4	8.3	8.2	8.6	8.4	8.0
Total OECD	6.5	6.3	6.0	6.4	6.3	6.3	6.2	6.2	6.1	6.1	6.4	6.2	5.9
World trade growth	7.3	9.1	9.2	9.3	8.8	8.8	8.9	9.1	9.3	9.4	8.1	8.9	9.3
Current account balance													
United States	-6.5	-6.7	-7.0										
Japan	3.4	3.9	4.7										
Euro area	-0.2	-0.2	-0.1										
Total OECD	-1.8	-2.0	-2.0										
Cyclically-adjusted fiscal balance													
United States	-3.6	-4.2	-3.9										
Japan	-6.3	-6.1	-6.4										
Euro area	-2.2	-2.1	-2.0										
Total OECD	-3.1	-3.3	-3.2										
Short-term interest rate													
United States	3.5	4.8	4.9	4.2	4.6	4.9	4.9	4.9	4.9	4.9	4.2	4.9	4.9
Japan	0.0	0.0	0.7	0.0	0.0	0.0	0.0	0.0	0.3	0.6	0.0	0.0	1.0
Euro area	2.2	2.2	2.9	2.2	2.2	2.2	2.2	2.3	2.6	2.8	2.2	2.3	3.3

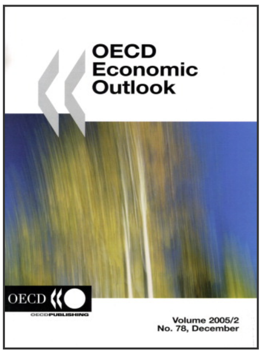
Note: Real GDP growth, inflation (measured by the increase in the GDP deflator) and world trade growth (the arithmetic average of world merchandise import and export volumes) are seasonally and working-day-adjusted annual rates. The "fourth quarter" columns are expressed in year-on-year growth rates where appropriate and in levels otherwise. The unemployment rate is in per cent of the labour force while the current account balance is in per cent of GDP. The cyclically-adjusted fiscal balance is in per cent of potential GDP. Interest rates are for the United States: 3-month eurodollar deposit; Japan: 3-month certificate of deposits; euro area: 3-month interbank rate.

Assumptions underlying the projections include:

- no change in actual and announced fiscal policies;
- unchanged exchange rates as from 11 November 2005; in particular 1$ = 118.00 yen and 0.85 euros;

The cut-off date for other information used in the compilation of the projections is 22 November 2005.

Source: OECD Economic Outlook 78 database.



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