NEW ZEALAND

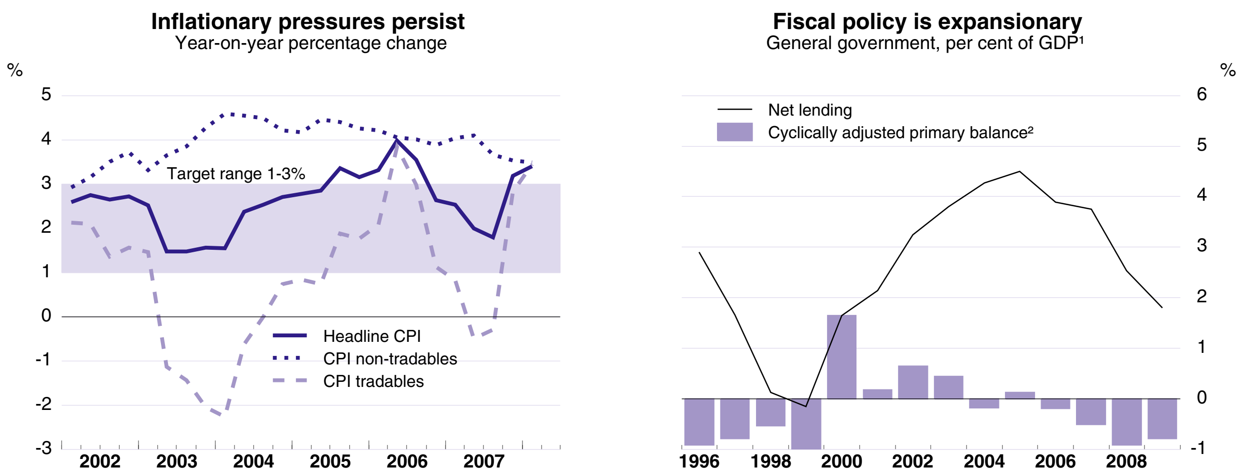
Strong growth, booming commodity prices, tight labour markets and capacity constraints have driven up inflation recently, requiring a very tight monetary policy stance since mid-2007. Real exchange rate appreciation, tight credit and widening credit spreads, together with drought conditions, are provoking slower growth in 2008. A widening output gap should reduce inflation pressure by year-end, allowing monetary policy to be eased and growth to pick up in 2009.

Personal and corporate income tax cuts are a good use of the budget surplus, and the low level of gross public debt will help to prepare for population ageing. However, heavy foreign debt is a point of vulnerability, especially if external funding were to dry up. It is important to reduce tax distortions favouring housing over productive investments, as well as those that discourage labour supply.

Demand is slowing

The economy grew by 3½ per cent in 2007, driven by record commodity prices, greater housing wealth and robust wage and employment growth in the context of tight labour markets. Housing investment faltered by year-end, reflecting the pass-through of high policy interest rates into borrowing costs, topped up by widening interest margins. Thus far in 2008, soft retail and slow house sales together with a sharp decline in consumer confidence suggest substantial further demand weakening. Consumers face headwinds from higher interest rates and inflation, and smaller house price rises are hitting balance sheets. Moreover, employment fell sharply in the first quarter, though a decline in labour market participation limited the increase in unemployment that occurred. Net outward migration (mostly to Australia) has been intensifying domestic labour-market tightness and has contributed to the weakness in the housing market. Drought conditions have prevented exporters from profiting more fully from

New Zealand



1. Per cent of potential GDP for cyclically adjusted primary balance.
2. Change from previous year. Negative sign denotes a fiscal expansion, positive sign a fiscal restriction.

Source: Statistics New Zealand and OECD Economic Outlook 83 database.

StatLink http://dx.doi.org/10.1787/367013565204

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

	2004	2005	2006	2007	2008	2009
	Current prices NZD billion	Percentage changes, volume (1995/1996 prices)				
Private consumption	86.3	5.0	2.5	4.3	1.5	2.2
Government consumption	25.9	4.2	4.7	4.4	4.2	3.0
Gross fixed capital formation	34.8	3.9	-1.6	4.9	1.9	0.9
Final domestic demand	147.0	4.6	1.9	4.5	2.1	2.1
Stockbuilding[1]	0.0	-0.2	-0.7	0.3	-0.5	0.0
Total domestic demand	148.7	4.3	1.0	5.0	1.7	2.1
Exports of goods and services	43.1	-0.4	1.7	3.6	3.2	4.2
Imports of goods and services	43.8	5.4	-2.8	8.9	4.7	4.1
Net exports[1]	- 0.7	-1.7	1.3	-1.7	-0.5	0.0
GDP at market prices	147.9	2.8	2.3	3.4	1.3	2.1
GDP deflator	_	1.8	2.4	4.1	3.9	1.8
Memorandum items						
GDP (production)	_	2.7	1.5	3.1	1.6	2.1
Consumer price index	_	3.0	3.4	2.4	3.4	2.8
Private consumption deflator	_	1.8	2.8	1.7	2.7	2.2
Unemployment rate	_	3.7	3.8	3.6	3.8	3.8
General government financial balance[2]	_	4.5	3.9	3.8	2.5	1.8
Current account balance[2]	_	-8.5	-8.6	-7.9	-7.7	-8.1

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 83 database.

StatLink http://dx.doi.org/10.1787/365376185244

elevated dairy prices, while the high exchange rate is squeezing tradable-goods producers. Business confidence has plummeted in response to decelerating demand and profits, pointing to easing investment despite record capacity utilisation, and labour and skills shortages.

Yet inflation keeps rising

Consumer price inflation rose further to reach 3.4% in the first quarter of 2008, above the Reserve Bank's target band, led by price rises for food, petrol, electricity, rents and education. After correcting for increased subsidies to education and health, non-tradables inflation was close to 4%. Firms' pricing intentions and widespread cost increases point to even higher inflation ahead. Despite the weakening economy and downside global financial risks, the Reserve Bank has sent a strong anti-inflation signal in maintaining its official cash rate unchanged at 8¼ per cent, well above the OECD's estimate of the neutral rate. The government's recent decision to delay the introduction date for parts of a greenhouse gas emissions trading scheme removes an additional contributor to near-term inflation pressures.

Fiscal policy stimulus is ample

A medium-term (2008-12) fiscal stimulus of nearly 2¾ per cent of GDP was announced with the 2007 and 2008 budgets, with main new measures appearing on the tax side. The corporate tax rate was cut from

33 to 30% on 1 April 2008, and the government signalled its intention to cut personal income taxes going forward. Together with NZD 1 billion less than expected investment returns by New Zealand Superannuation and other government funds in 2007, this fiscal expansion will slow and eventually stop net asset accumulation ongoing since 2002.

Imbalances in the economy should unwind

GDP growth is projected to slow to under 1½ per cent in 2008, given the damping effect of high interest rates and inflation on domestic demand, and that of exchange-rate appreciation and drought on net exports. After peaking around mid-2008, inflation should abate as persistently tight monetary policy results in a widening of the negative output gap. It is assumed that the Bank could start easing by end-2008 or early 2009. Together with the return to normal weather patterns, this should enable growth to rebound, reaching a 2½ per cent annual rate by end-2009 while inflation moderates to 2½ per cent. The current account deficit should stabilise at around 8% of GDP.

Risks appear symmetric

Further global financial turbulence could harm growth prospects, given substantial external indebtedness boosted by annual current account deficits of 7 to 10% of GDP since 2004, with most such borrowing having been channelled into consumption and housing rather than business investment. Even so, persistently tight labour markets and energy price rises imply upside risks to 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

	2007	2008	2009	2007	2008				2009				Fourth quarter		
				Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2007	2008	2009
								Per cent							
Real GDP growth															
United States	2.2	1.2	1.1	0.6	1.0	-0.5	0.7	0.2	1.0	1.4	2.2	3.0	2.5	0.3	1.9
Japan	2.1	1.7	1.5	2.6	3.3	1.1	1.0	1.3	1.6	1.6	1.7	1.7	1.5	1.7	1.6
Euro area	2.6	1.7	1.4	1.2	3.1	0.2	1.1	1.2	1.4	1.7	1.8	1.9	2.1	1.4	1.7
Total OECD	2.7	1.8	1.7	1.7	2.1	0.5	1.2	1.2	1.7	2.0	2.4	2.7	2.6	1.3	2.2
Inflation[1]															
United States	2.5	3.2	2.0	3.9	3.5	3.6	2.4	2.0	1.8	1.7	1.6	1.6	3.4	2.9	1.6
Japan	0.1	0.9	0.4	1.6	1.2	0.6	0.3	0.3	0.3	0.4	0.5	0.6	0.5	0.6	0.5
Euro area	2.1	3.4	2.4	4.8	4.2	3.3	2.6	2.4	2.3	2.2	2.1	2.0	2.9	3.1	2.1
Total OECD	2.2	3.0	2.1	3.5	3.4	3.2	2.5	2.3	2.0	1.9	1.8	1.8	2.8	2.8	1.9
Unemployment rate[2]															
United States	4.6	5.4	6.1	4.8	4.9	5.2	5.5	5.8	6.0	6.2	6.2	6.1	4.8	5.8	6.1
Japan	3.9	3.8	3.8	3.9	3.8	3.8	3.8	3.9	3.9	3.8	3.7	3.7	3.9	3.9	3.7
Euro area	7.4	7.2	7.4	7.1	7.1	7.2	7.2	7.3	7.4	7.4	7.5	7.5	7.1	7.3	7.5
Total OECD	5.6	5.7	6.0	5.5	5.6	5.7	5.7	5.9	6.0	6.0	6.0	6.0	5.5	5.9	6.0
World trade growth	7.1	6.3	6.6	4.8	6.5	6.1	6.1	6.3	6.6	6.9	7.0	7.1	7.2	6.2	6.9
Current account balance[3]															
United States	-5.3	-5.0	-4.4												
Japan	4.8	4.4	4.4												
Euro area	0.2	0.1	0.0												
Total OECD	-1.4	-1.3	-1.1												
Cyclically-adjusted fiscal balance[4]															
United States	-3.2	-5.2	-4.4												
Japan	-2.6	-1.6	-2.5												
Euro area	-0.7	-1.0	-0.8												
Total OECD	-2.0	-2.8	-2.5												
Short-term interest rate															
United States	5.3	2.7	3.1	5.0	3.2	2.6	2.6	2.5	2.3	2.6	3.4	4.0			
Japan	0.7	0.8	0.7	0.8	0.8	0.9	0.9	0.8	0.7	0.7	0.8	0.8			
Euro area	4.3	4.5	4.1	4.7	4.5	4.5	4.5	4.4	4.2	4.1	4.1	4.1			

Note: Real GDP growth, inflation (measured by the increase in the consumer price index or private consumption deflator for total OECD) 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. 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:

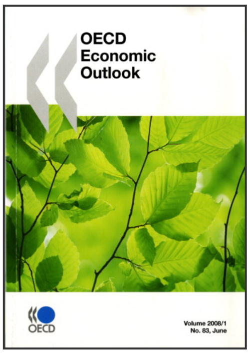
- no change in actual and announced fiscal policies;
- unchanged exchange rates as from 13 May 2008; in particular 1$ = 104.44 yen and 0.64 ;

The cut-off date for other information used in the compilation of the projections is 23 May 2008.

1. USA; price index for personal consumption expenditure, Japan; consumer price index and the euro area; harmonised index of consumer prices.
2. Per cent of the labour force.
3. Per cent of GDP.
4. Per cent of potential GDP.

Source: OECD Economic Outlook 83 database.

StatLink http://dx.doi.org/10.1787/362700336726



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