September 1994 Forecasts: Overview

Economics Department

These forecasts update the March 1994 Economic Forecasts and the inflation projections published in the June 1994 Monetary Policy Statement. The forecasts of economic activity cover the period to March 1996, while the inflation outlook covers the period to March 1997. The summary table opposite details the key aggregates discussed in this release. The forecasts incorporate material available until 2 September.

Since our real economy and inflation 'forecasts' are strictly conditional on the exchange rate, interest rate and other assumptions, they should be interpreted as 'projections'.

The economy is projected to continue on a sustainable growth path over the next two years

The growth momentum in the New Zealand economy has been stronger than expected over the past year. The Reserve Bank's projection of a moderation in the pace of growth over the next two years is based on cyclical influences on consumption and investment, as well as the effect of the recent, and projected further, firming in monetary conditions. The latter will assist in ensuring that the economy continues on a sustainable growth path without excessive cyclical stresses, such as sharply rising inflation pressures and a significantly widening current account deficit.

Growth in GDP is expected to moderate over the forecast period, but to remain strong

Reflecting evidence since our March forecasts, we have changed our view about the strength and profile of growth in economic activity. GDP[1] growth is now expected to be stronger in 1994/95 and a little weaker in 1995/96 than we projected in March. After growing by 5.3 percent in the year to March 1994, GDP is forecast to increase by 4.4 percent over the year to March 1995, followed by 3.1 percent in the year to March 1996.

1 The aggregate GDP statistic referred to in this release is the production-based measure of GDP, which Statistics New Zealand have noted to be the more reliable measure of GDP currently available. However, as in the past, we have used an 'expenditure on GDP' framework to help develop these projections.

New experimental 'expenditure on GDP' statistics were released by Statistics New Zealand in late July as an interim step toward providing more reliable data. Statistics New Zealand have noted that the expenditure estimates *should not be regarded as official statistics and are subject to revision.* This caveat must be borne in mind when reading these forecasts. Nevertheless, the statistics have been improved in several important ways and, since they are the only comprehensive set of estimates available, we have used them in the preparation of these forecasts. The implications of the recent changes to the expenditure statistics are discussed in the various sections of this release.

The projections assume some further firming in monetary conditions

Our outlook incorporates the assumption of a further gradual rise in the real exchange rate, in addition to the increases already seen over the past year. Moreover, we have assumed some further increases in domestic interest rates, in line with expected overseas trends as reflected in international forecasts. The firming in monetary conditions is projected to reinforce the moderation in growth of each of the aggregate demand components discussed below.

Stronger world activity will assist exports

The outlook for world economic activity, on which we have based our projections, has continued to improve in recent months, especially in those countries of most relevance to New Zealand. We are expecting a further relatively strong contribution to growth from exports over the next two years, although one that continues to be restrained by local supply constraints in the agricultural sector and weakness in some international commodity markets.

Some of the impetus behind the recent consumption growth is expected to moderate

Rising incomes through further strong employment growth will continue to underpin consumption activity. However, recent 'catch-up effects' after years of weak economic growth, as well as asset price related wealth effects, are expected to reduce gradually over the forecast horizon. This will imply only a very moderate further reduction in the household savings rate, as consumption is expected to grow only marginally faster than incomes.

A further strong increase is projected for investment in the near term, but growth is likely to moderate thereafter

As recent strong investment growth has caused less of a reduction in capacity utilisation than we expected, we project a further significant increase in investment over the 1994/95 year. In line with the slowing expansion in the other demand components, we are projecting a moderation in investment growth thereafter. Stronger economic growth than was seen over most of the 1980s has necessitated a sharp rise in investment to improve the level and quality of the capital stock. Following that transition, however, the rate at which the capital stock will need to grow in order to sustain the higher growth path is likely to move closer to the rate of GDP growth itself.

Our current account projections reflect the cyclical pattern of domestic demand growth

The cyclical pattern of domestic demand is reflected in our projections for import growth and the current account. The trade surplus is forecast to reduce in 1994/95, before recovering in the year thereafter. Combined with the adverse effect on the investment income balance of rising world interest rates and the improving profitability of overseas-owned domestic companies, this will lead to current account deficits of 2.4 percent of GDP in 1994/95, and 1.8 percent in the year thereafter.

Employment is expected to rise strongly

On the basis of the outlook for the real economy, we expect 67,000 more people to be in employment by March 1996, compared to June 1994. The rate of unemployment is projected to decline to 7.6 percent by March 1996.

The medium-term inflation outlook has remained unchanged from our last forecast

In these projections, the TWI is assumed to rise by 1.9 percent per annum to around 60.0 by March 1997, from an assumed starting value of 57.2 for the September quarter 1994. Underlying inflation is projected to be 1.2 percent in the year to March 1995, before strengthening to 1.4 percent in the year to March 1996 and 1.5 percent by March 1997. The effect of the recent rise in oil prices has been excluded from the calculation of underlying inflation. Allowing for the higher exchange rate assumption used, and the different treatment of oil prices, the projections for the 1994/95 year reflect the outlook of a stronger economy through higher contributions from construction costs and margins than incorporated in the June *Monetary Policy Statement*. Thereafter, the differences to the inflation projections published in June are due almost entirely to the higher exchange rate assumption used.

Annual headline inflation is expected to move above 2 percent over the coming year

As the Bank has foreshadowed recently, annual headline inflation is projected to move outside the 0-2 percent target range over the coming year, rising to 3.0 percent in the year to June 1995. Compared to underlying inflation, the higher rate of headline inflation largely reflects the recent, and assumed further, increases in interest rates. Higher international oil prices and increases in government charges, both of which have been removed from the underlying inflation definition, account for the remainder of the difference. We expect headline inflation to move back within the 0-2 percent range by late 1995. A decline in interest rates is expected to reduce headline inflation below the rate of underlying inflation over 1996.

The risks surrounding these inflation forecasts remain on the upside

The growth outlook in these projections can be characterised as a 'soft-landing' scenario. Growth moderates gradually without the appearance of significant cyclical stresses that often arise in economies experiencing sustained economic expansion, including strong inflation pressures and a marked widening in the current account deficit. While the growth projections presented here are our best central estimate of the likely path of the economy, historical and overseas experience would suggest that the balance of risks continues to remain on the upside. An overheating of the economy could lead to higher than projected inflation and require a greater degree of tightening in monetary conditions than assumed in this outlook. While the risks to the inflation outlook relating to the underlying projections for the real economy have been outlined before, the new risk factor added recently is the potential adverse effect on wage and price expectations arising from the projected sharp increase in headline inflation.

A potential risk to the economic outlook that is of a different nature is currently associated with political uncertainties during New Zealand's transition to the MMP electoral system. We have made no allowance for this factor in these projections.

Summary of Economic Forecasts

(Annual percentage changes of annual totals or averages)

March Years	Actuals/Estimates 1993	1994	Forecasts 1995	1996
REAL EXPENDITURES ON GDP[1]				
Final Consumption Expenditure				
- Private	-0.2	3.3	4.4	3.0
- (March qtr to March qtr)	(0.0)	(4.3)	(3.9)	(2.9)
- Public Authority	-0.4	-1.5	-0.4	-1.0
Total	-0.3	2.2	3.4	2.2
Gross Fixed Capital Formation				
- Market Sector				
- Residential	5.9	15.4	3.1	2.8
- Business	10.8	21.5	17.9	5.8
- Non-Market Government Sector	-3.5	-6.2	2.7	-0.7
Total	8.3	17.5	13.9	4.8
Final Domestic Expenditure	1.6	5.9	6.2	2.9
Stockbuilding [2]	1.7	0.6	0.2	0.1
GROSS NATIONAL EXPENDITURE	3.3	6.4	6.2	3.0
Exports of Goods and Services	2.5	8.4	5.8	5.1
Imports of Goods and Services	7.9	11.2	8.0	4.7
GDP (PRODUCTION BASED)	2.4	5.3	4.4	3.1
(GDP (Production based) March qtr to March qtr)	3.0	5.6	3.7	3.0
GOVERNMENT ACCOUNTS[3]				
Adjusted Financial Balance ($m.)	-1,823	527	940	2,696
- As a % of GDP	-2.4	0.7	1.1	3.0
EXTERNAL ACCOUNTS				
BOP Current Account Balance ($m.)	-1,143	-1,652	-2,077	-1,626
- As a % of GDP	-1.5	-2.0	-2.4	-1.8
Terms of Trade	2.4	1.5	0.1	1.9
INCOMES				
Real Household Disposable Incomes	-0.4	3.0	4.1	3.0
Savings Rate[4]	4.8	4.4	4.1	4.1
INFLATION[5]				
Consumer Price Inflation	1.0	1.3	2.9	1.6
Underlying CPI Inflation	1.8	1.1	1.2	1.4
LABOUR MARKET				
Employment (000's)	1,475	1,532	1,579	1,612
Change in Employment (%)[5]	1.0	3.9	3.0	2.1
Official Unemployment (000's)	168	161	146	140
Official Unemployment Rate (%) [6]	9.8	9.0	7.9	7.6

1 Data for 1993 and 1994 are Statistics New Zealand's experimental series.
2 Percentage point contribution to growth rate of GDP.
3 June years; excludes currency effects on the value of Crown financial assets, as well as transactions relating to ECNZ redeemable preference shares in 1994/95.
4 Ratio of household savings to disposable incomes.
5 March quarter to March quarter percentage changes.
6 Seasonally adjusted series.