NEW ZEALAND

Activity accelerated in the second half of 2006, while currency appreciation has set back the return to a more balanced growth path and underlying inflationary pressures have not yet dissipated. Recent further monetary tightening should gradually rein in household spending, and wages are expected to slowly moderate as the unemployment rate rises: growth may be modest over the projection period.

Once excess demand has been eliminated and underlying inflation pressures have been tamed, there should be room to start easing monetary policy early next year. This would reduce the attractiveness of New Zealand dollar assets and facilitate a shift to export-led growth. Additional budgetary stimulus beyond present plans would delay the economy's adjustment to a more sustainable level of domestic demand and should be avoided.

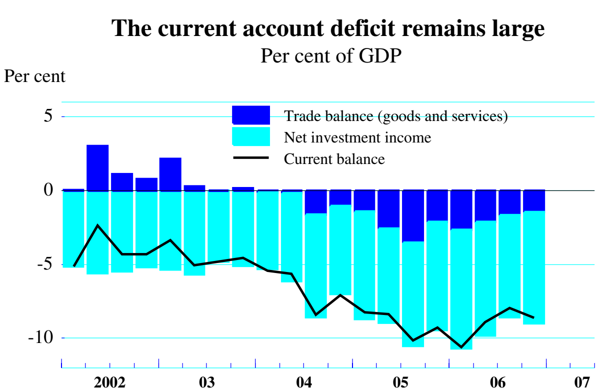
Activity has picked up pace

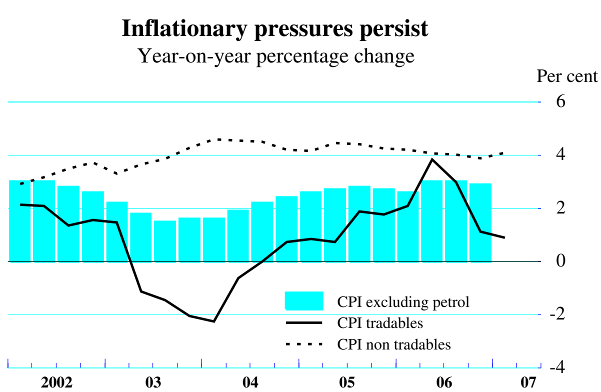
Domestic demand accelerated in the second half of 2006, with ongoing increases in government consumption and a surge in private consumption in the fourth quarter. Household incomes remain buoyant, with real wage growth running at around 2% and higher government transfers. The housing market has regained momentum, with house prices continuing to move up by around 10% per year. Business fixed investment showed considerable volatility over the course of the year, but remained weak overall. There was also significant inventory accumulation in the final quarter of the year. Imports rose considerably, reflecting not only these demand pressures but also the appreciating exchange rate. Currency movements also curbed exports, offsetting extremely favourable dairy prices. As a result, the current account deficit has diminished only slightly, and the internal and external rebalancing required to return to a sustainable growth path has been postponed.

But underlying inflationary pressures persist

Resource constraints remain tight. Capacity utilisation in the fourth quarter of 2006 was once more above its five-year average. Employment shrank in the third and fourth quarters of 2006, but this was more than offset by labour market withdrawal, reducing the unemployment rate and leaving it well below the OECD's estimated structural rate. These labour

New Zealand





Source: Reserve Bank of New Zealand and OECD, Economic Outlook 81 database.

StatLink http://dx.doi.org/10.1787/032478581042

New Zealand: Demand, output and prices

	2003	2004	2005	2006	2007	2008
	Current prices NZD billion	Percentage changes, volume (1995/1996 prices)				
Private consumption	80.4	6.0	4.7	2.0	2.5	1.3
Government consumption	23.6	5.7	4.1	4.2	4.5	4.0
Gross fixed capital formation	30.4	10.9	3.3	-3.4	-0.2	1.4
Final domestic demand	134.4	7.1	4.2	1.1	2.3	1.8
Stockbuilding[1]	0.0	0.1	-0.2	-0.6	0.4	0.0
Total domestic demand	135.6	7.2	4.0	0.4	3.0	1.8
Exports of goods and services	40.4	5.8	-0.6	2.0	1.7	5.8
Imports of goods and services	39.5	15.8	5.5	-2.5	4.6	6.4
Net exports[1]	0.9	-2.9	-1.8	1.3	-0.9	-0.3
GDP at market prices	136.4	4.0	2.5	1.7	2.1	1.6
GDP deflator	_	3.7	2.2	2.2	3.3	2.1
Memorandum items						
GDP (production)	_	4.5	2.2	1.5	1.5	1.6
Consumer price index	_	2.3	3.0	3.4	2.0	2.3
Private consumption deflator	_	1.2	1.9	2.9	2.0	2.0
Unemployment rate	_	3.9	3.7	3.7	3.9	4.4
General government financial balance[2]	_	3.7	4.4	3.9	3.2	2.3
Current account balance[2]	_	-6.7	-9.0	-9.0	-8.4	-9.1

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 81 database.

StatLink http://dx.doi.org/10.1787/035115651617

market pressures have fed into strong wage growth. Headline inflation fell back at the end of last year, largely as a result of petrol price movements and the rebasing of the consumer price index, and now lies within the Reserve Bank's target range. But non-tradable inflation has barely diminished and remains close to 4% per year. Inflation expectations have eased but remain relatively high.

Monetary policy has been tightened further

Against this backdrop, in March and April the Reserve Bank raised the official cash rate by another ½ percentage point to 7¾ per cent. At the same time, fiscal policy is providing a stimulus to domestic demand, both through higher Working for Families and New Zealand Superannuation transfers and rising government consumption. A period of slow output growth will be needed before inflation pressures dissipate and the Reserve Bank can ease monetary policy: on current projections, there should be room to start lowering the official cash rate in early 2008.

Output growth may be modest…

Given the technical assumption of a high exchange rate, the path to restoring internal and external imbalance is likely to be slow, although the present restrictive stance of monetary policy will eventually rein in household spending and lead to more stable house prices. But the adjustment is expected to involve a further squeeze on exporters' profits, despite recent terms-of-trade gains. Unemployment may rise to its structural level next year, thereby allowing wage growth to gradually moderate. In this climate, fixed investment is likely to remain anaemic. Government transfers are projected to continue contributing to the expansion of private consumption, while government consumption is set to continue absorbing a growing share of GDP.

… and the adjustment path might be bumpy

Monetary policy decisions at the current point in the cycle will require careful judgements about the strength of competing forces. A stronger pick-up in activity before there are clear signs that inflationary pressures have been extinguished would require a tighter monetary response. A shift in foreign investor sentiment about the external balance could induce a period of heightened financial volatility and a more difficult adjustment path.

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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

	2006	2007	2008	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4	Fourth quarter 2006	Fourth quarter 2007	Fourth quarter 2008
	Per cent												
Real GDP growth													
United States	3.3	2.1	2.5	2.5	2.3	2.5	2.5	2.6	2.7	2.7	3.1	2.1	2.6
Japan	2.2	2.4	2.1	1.8	1.9	2.0	2.1	2.2	2.1	2.2	2.5	2.0	2.2
Euro area	2.8	2.7	2.3	2.6	2.5	2.4	2.3	2.2	2.1	2.1	3.3	2.5	2.2
Total OECD	3.2	2.7	2.7	2.7	2.6	2.7	2.7	2.7	2.7	2.7	3.2	2.6	2.7
Inflation													
United States	2.9	2.6	2.2	2.3	2.0	2.2	2.4	2.2	2.1	2.1	2.5	2.6	2.2
Japan	-0.9	-0.4	0.2	-0.4	0.0	0.1	0.2	0.3	0.4	0.6	-0.5	-0.3	0.4
Euro area	1.7	2.0	2.0	1.0	2.0	2.0	2.0	2.1	2.2	2.2	1.6	2.0	2.1
Total OECD	2.2	2.1	2.0	1.9	2.0	2.0	2.0	2.0	2.0	2.0	1.8	2.3	2.0
Unemployment rate													
United States	4.6	4.6	4.8	4.5	4.6	4.7	4.8	4.8	4.8	4.9	4.5	4.7	4.9
Japan	4.1	3.8	3.6	3.8	3.7	3.7	3.6	3.6	3.6	3.6	4.1	3.7	3.6
Euro area	7.8	7.1	6.7	7.1	7.0	6.9	6.9	6.8	6.7	6.6	7.5	6.9	6.6
Total OECD	5.9	5.6	5.5	5.6	5.6	5.6	5.5	5.5	5.5	5.4	5.7	5.6	5.4
World trade growth	9.6	7.5	8.3	7.7	8.2	8.4	8.3	8.3	8.2	8.2	8.6	7.7	8.3
Current account balance													
United States	-6.5	-6.1	-6.2										
Japan	3.9	4.8	5.4										
Euro area	0.1	0.4	0.4										
Total OECD	-1.9	-1.5	-1.5										
Cyclically-adjusted fiscal balance													
United States	-2.5	-2.8	-2.8										
Japan	-2.2	-2.7	-3.2										
Euro area	-1.0	-0.8	-0.7										
Total OECD	-1.7	-1.8	-1.9										
Short-term interest rate													
United States	5.2	5.3	5.0	5.3	5.3	5.2	5.1	5.1	5.0	4.9	5.3	5.2	4.9
Japan	0.2	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.7	0.4	0.6	0.7
Euro area	3.1	4.1	4.3	4.0	4.2	4.3	4.3	4.3	4.3	4.3	3.6	4.3	4.3

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.

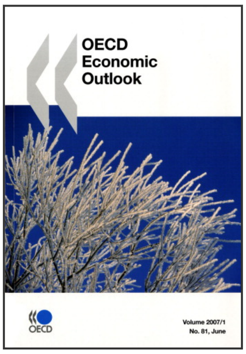
Assumptions underlying the projections include:

- no change in actual and announced fiscal policies;
- unchanged exchange rates as from 9 May 2007; in particular 1$ = 119.72 yen and 0.74 euros;

The cut-off date for other information used in the compilation of the projections is 15 May 2007.

Source: OECD Economic Outlook 81 database.

StatLink http://dx.doi.org/10.1787/036245131153



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