
Monetary Policy Statement¹

December 2004

This *Statement* is made pursuant to Section 15 of the Reserve Bank of New Zealand Act 1989.

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¹ Projections finalised on 30 November 2004. Policy assessment finalised on 8 December 2004.

1 Policy assessment

The OCR will remain on hold at 6.50 per cent.

As indicated in our October Review, we continue to expect that the current policy position will achieve inflation between 1 and 3 per cent on average over the medium term. This outlook assumes that significant pipeline effects from past interest and exchange rate increases will eventuate and act to further constrain the economy over the period ahead.

Since the last review, overall economic indicators have continued to surprise on the upside. As a result, we have revised upwards our GDP estimates for the second half of 2004 and pushed out our expected timing of the economic slowdown. But the slowdown is still expected in 2005. The easing in house sales, residential building consents and net immigration remain in line with our earlier projections. Reinforcing this outlook is a weakening exports picture, based on softer world growth and the constraining effects of the strong NZ dollar.

Inflation is projected to rise close to 3 per cent before easing back later in 2006. The risks to the inflation outlook are two-sided. On the upside there is clearly a risk that the current momentum in household demand will hold up longer than expected. Rising wage and salary pressures also present an upside inflation risk given the current labour market tightness. On the downside there is the possibility of more exaggerated movements in the US dollar and US interest rates, leading to a stronger New Zealand TWI, weaker exports and less inflation pressure.

The tightening in monetary policy over the past year currently looks sufficient to keep medium term inflation pressures in check. However, with inflation expected to remain toward the top of the 1 to 3 per cent target band over the medium term, there is little headroom to absorb stronger than expected inflation pressures. If such pressures emerge, a further policy tightening cannot be ruled out. Further, the current outlook offers little scope for an easing in policy in the foreseeable future. We will continue to assess inflation pressures carefully as the economic data come to hand.



Alan Bollard
Governor

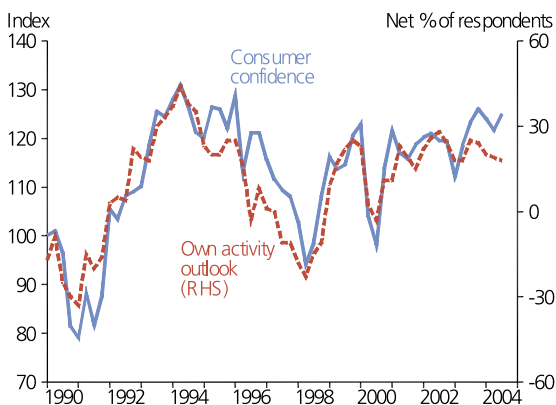
2 Overview and key policy judgements

The economy continues to perform strongly with few signs of easing in the strain on productive resources. Recent data indicate strength in activity over 2004 and our updated projections incorporate a slightly stronger cyclical starting point. However, at this juncture monetary policy is on hold. The full effects of recent policy tightenings and the high exchange rate are still to work their way through the economy. Further, we consider that the turning point in the business cycle is near. We believe these factors will be sufficient to contain medium-term inflation pressures. However, if economic activity continues to surprise on the upside, a further policy tightening cannot be ruled out. Certainly, there is little scope for an easing in the foreseeable future.

Recent developments

GDP growth in the June quarter was slightly stronger than expected and recent data suggest buoyant activity for the remainder of 2004. Strong retail sales through the September quarter suggest that household spending growth remains robust, consistent with the confident mood of consumers (figure 1). Consumer confidence continues to be underpinned by recent increases in household wealth, a strong labour market, and high commodity prices. Further, the strong exchange rate has improved the relative purchasing power of household incomes by lowering the price of imported goods and services.

Figure 1
Consumer confidence and domestic trading activity



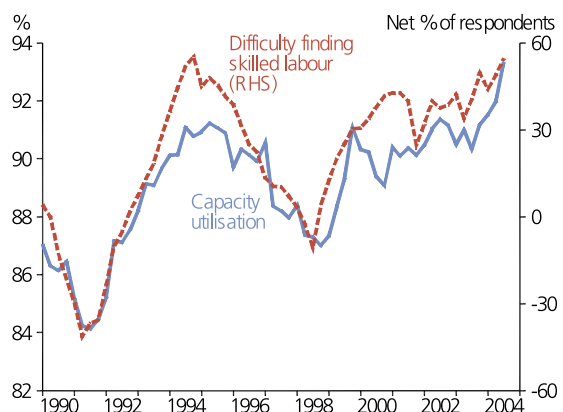
Source: Westpac McDermott Miller, NZIER.

In contrast, the business sector is facing a more diverse range of influences:

- The high exchange rate has exposed domestic operators to a greater degree of import competition and adversely affected export revenues.
- The outlook for export demand has weakened since September. *Consensus* forecasts for trading partner growth over 2005 have been revised lower, reflecting concerns over high oil prices. The US dollar has also weakened, as concerns mount over structural imbalances in the US economy.
- To date, high world commodity prices have provided some offset to the rising NZD/USD exchange rate. Also, over recent weeks there has been some marginal respite for non-commodity exporters to Australia with the NZD/AUD exchange rate retracing from its September peak.
- A sustained period of strong demand has stretched firms' productive capacity, with capacity utilisation rising to new records. Labour resources are also tight (figure 2).

Despite these influences, businesses have remained relatively upbeat on their own activity outlook (figure 1).

Figure 2
Capacity utilisation and difficulty finding skilled labour



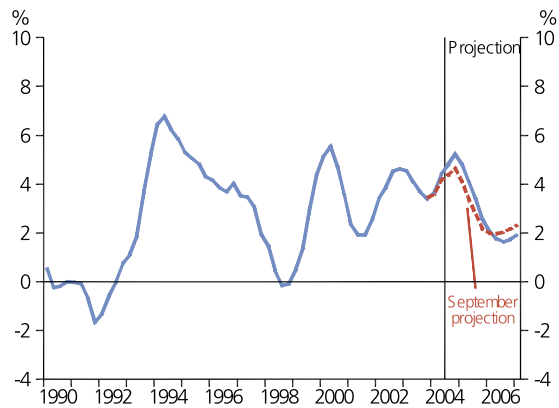
Source: NZIER.

Notwithstanding the observed strength in activity, some indicators still suggest a turning point is near. This assessment is largely based on continued signs of slowing in housing market activity and lower net immigration. Monthly

house sales and residential building consents have tracked lower over recent months, and the median number of days to sell a house has increased. Monthly net immigration has been consistently lower than the large inflows observed over the past couple of years. These influences were the key drivers of strong domestic activity and they will also be the key factors that moderate economic activity next year. In addition, we expect a further braking effect on export activity over the coming months from the high New Zealand dollar (figure 3).

Given pressures on the economy's productive resources, medium-term inflation pressures are projected to remain strong. At this stage, however, we believe that the policy tightening to date will be sufficient to ensure that CPI inflation remains consistent with the Policy Targets Agreement (PTA). Inflation in the non-tradables sector is currently high, but expected to ease as economic activity slows. Inflation in the tradables sector is low, but is expected to rise based on our

Figure 3
GDP
(annual average percentage change)



Source: Statistics New Zealand.

assumption that the exchange rate is near its peak. These influences, taken together, suggest that overall CPI inflation should rise next year to around 3 per cent before easing towards the end of the projection period (figure 5).

Box 1

Review of recent monetary policy decisions

Early last year, we projected the economy to slow due to the strong appreciation of the currency, drought in some areas of the country and electricity shortages. This projected slowdown was expected to reduce inflation pressures. Hence between April and July 2003, the Official Cash Rate (OCR) was reduced from 5.75 per cent to 5 per cent.

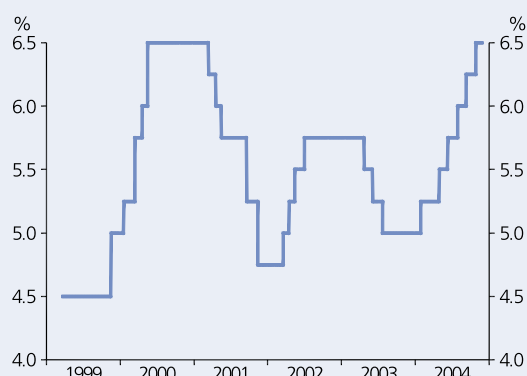
In the latter part of 2003 economic activity was proving to be more robust than expected. Strong domestic activity, particularly in the housing and construction sectors, was placing pressure on resources and adding to inflation pressures. As a result, it was viewed as prudent to move monetary policy to less stimulatory levels, and between January and July 2004, the OCR was gradually increased from 5 per cent to 6 per cent.

At the time of our September *Statement*, economic activity and inflation pressures had remained strong. While the rise of the New Zealand dollar had limited import price inflation, resources were still stretched and were expected to remain so for some time. Consequently,

we increased the OCR by 25 basis points and signalled that further tightening was likely to be necessary.

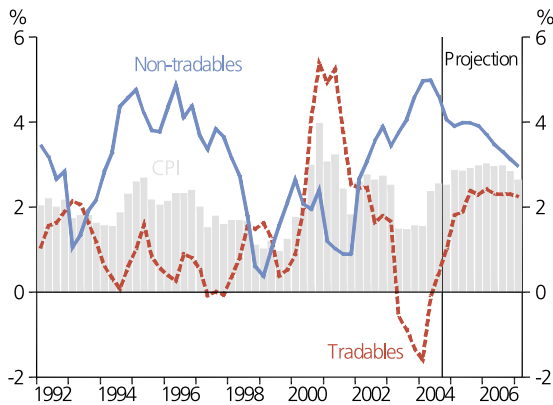
At our interim review in October we increased the OCR by 25 basis points. However, we noted that recent monetary policy tightenings and the high exchange rate would take some time to work their way through the economy. We considered that the full effect of current policy settings would be sufficient to ensure price stability, as defined in the Reserve Bank's PTA.

Figure 4
Official cash rate



Source: RBNZ.

Figure 5
Tradables and non-tradables inflation
(annual rate)



Source: Statistics New Zealand, RBNZ estimates.

Our central projection shows inflation near the top of the target range providing policy with limited headroom. Were inflation pressures to prove stronger than our projections show – particularly in the non-tradables sector – a further tightening cannot be ruled out. Certainly, the outlook leaves little room for an easing anytime soon, even if near-term inflation outcomes surprise on the downside.

Policy judgements

In achieving price stability, we seek to avoid unnecessary instability in output, interest rates and the exchange rate. This requires a more delicate balancing act around turning points in the cycle, as this is when the policy risks are arguably

greater. If we are not on top of inflation pressures now, these pressures may continue to build, or remain persistent, even after activity eventually slows. However, responding too aggressively at the peak of the cycle may exacerbate the eventual slowdown in activity.

To date, the adjustment of prices and wages to the stresses on labour and capital resources has been relatively contained. This largely reflects an economic environment that has enjoyed price stability over the past decade and provides some degree of confidence that inflation expectations will remain settled through the cycle.

While the OCR remains unchanged, actual monetary settings will tighten as recent increases in the OCR fully work their way through the economy. This pipeline effect partly reflects the usual policy lags. But those lags have lengthened in the current situation due to the growing proportion of fixed rate mortgages and the exaggerated competitive pressures in this segment of the home mortgage market.

We are assuming that recent moves by banks to lower fixed rate mortgages are to some extent temporary, as there is little to suggest that current margins between wholesale and retail rates are sustainable. We therefore expect that effective mortgage rates will rise over the next year as margins move up (see box 2). Increases in world long-term interest rates are expected to reinforce this trend. Pipeline effects from the exchange rate are also present in the economy and should feed through as currency hedges roll off.

Box 2

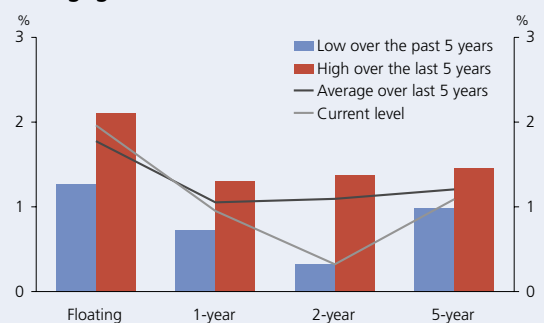
Pipeline interest rate effects and the mortgage market

The response of mortgage rates to increases in the OCR this year has been slower and more limited than in the previous two monetary policy cycles.¹ For much of 2004, this has largely reflected the increased prevalence of fixed rate borrowing and the impact of low global interest rates. A more recent development has been strong competition amongst the major New Zealand banks in the home lending market, particularly in two-year fixed rate mortgages. This can be seen in figure 6, which shows that the margin

¹ See the *Monetary Policy Statement, September 2004* for a discussion of monetary policy and mortgage interest rates.

between two-year mortgage and wholesale interest rates is currently at its lowest level in over five years.

Figure 6
Margins between wholesale interest rates and mortgage rates



Source: RBNZ.

(continued on p6)

Overall, the effective mortgage rate (the average interest rate paid by households on outstanding mortgage debt) has risen by around 45 basis points since its lows in late 2003, compared with an increase of 150 basis points in the OCR this year. However, the impact of recent tightening on the wholesale yield curve is still working its way through the pipeline to retail interest rates. It is impossible to forecast with precision when and how quickly effective retail rates will rise, but on the basis of some assumptions, we can gain insights about the potential magnitude and timing of adjustment by looking at two possible scenarios.

For the purposes of these scenarios we assume that:

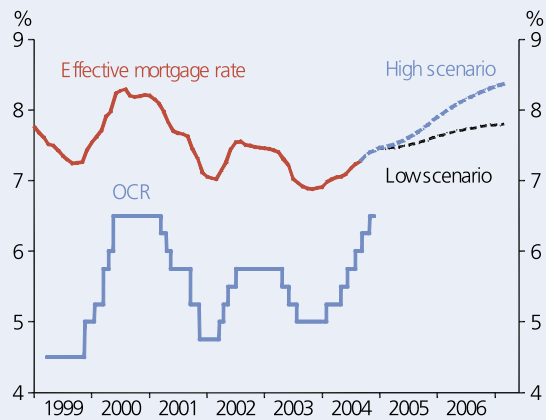
- the OCR remains at 6.50 per cent and, consequently, there is little movement in floating mortgage rates from their current levels;
- borrowers continue to gravitate towards the lowest mortgage rates on offer, with new borrowing concentrated in one- and two-year fixed term mortgages;
- in line with trends over the past six months, \$500 million per month of existing mortgages move from floating rates to one- and two-year fixed rates;
- global interest rates continue to rise over the next 12 to 18 months in line with *Consensus Forecasts* which have US 10-year bond yields increasing from around 4.2 per cent currently to 5 per cent by December 2005 (the extent to which this occurs will have a crucial impact on local wholesale interest rates, and hence the funding costs for fixed mortgages);
- margins on two-year fixed rate lending return to more normal levels within the next few months.

Our two scenarios are shown in figure 7. To some extent, regardless of fixed rate movements, the effective mortgage rate is likely to move up by around 20 basis points by early 2005. This reflects lags in the full effect of current advertised rates feeding through to floating rate mortgages and to existing fixed-rate mortgages as they run off.

Our low scenario embodies the presumptions that banks' fixed rate margins only recover to 'break-even' levels (thought to be around 60 basis points) and global interest

Figure 7

Effective mortgage rates and the OCR



Source: RBNZ.

rates increase, but by less than *Consensus Forecasts*. From current levels, the effective rate would increase by around 40 basis points by March 2006, and by a total of 55 basis points by March 2007. Under these circumstances, the lowest mortgage rate available in the market would drift up to between 7.5 and 8 per cent by the end of 2005.

Alternatively, if fixed margins recover most of their lost ground and global interest rates rise to a greater extent than *Consensus Forecasts* currently anticipate, it is likely that mortgage rates will follow a path closer to our high scenario. From current levels, the effective mortgage rate would move up by 70 basis points by March 2006, and a total of 110 basis points by March 2007. The lowest mortgage rate available in the market would rise toward 8.5 per cent by the end of 2005.

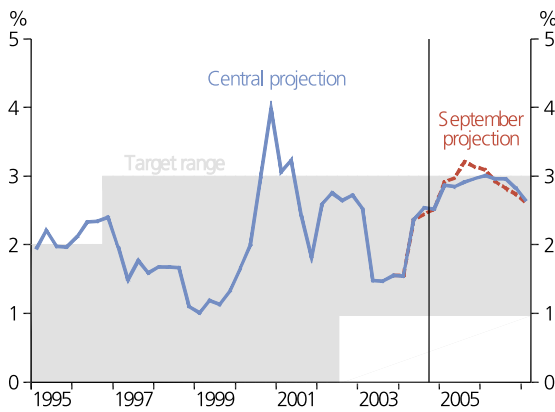
There remain both upside and downside risks to the economic outlook. The downside risks remain weighted towards the external sector. Global demand could slow by more, particularly if concerns over imbalances in the US economy lead to higher long-term interest rates in the US. Weaker global demand could impact on export volumes, and could have a more immediate adverse effect on commodity prices.

The upside risks remain focussed on domestic demand. Growth in consumer spending may continue to sustain

economic activity as household confidence remains supported by strong employment prospects and past improvements to wealth. In these circumstances, inflation would likely be higher and could spark unhelpful changes to price- and wage-setting behaviour.

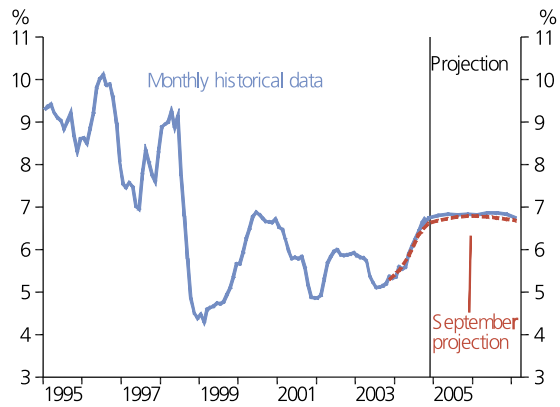
Given the limited inflation headroom that we have, a further tightening in policy cannot be ruled out. But for now, we anticipate the degree of policy tightness in the pipeline will be sufficient to ensure that inflation remains consistent with the PTA.

Figure 8
Consumer price inflation
(annual rate)



Source: Statistics New Zealand.

Figure 9
90-day interest rates



Source: RBNZ.

3 The current economic situation

Overview

The New Zealand economy grew by 5.7 per cent in the year to June, with significant growth in consumption, residential investment and business investment. The economy is now more stretched than it was at the time of the September *Statement*. Recent data has, on balance, come out stronger than expected and indicates that economic activity will remain robust over the second half of 2004, particularly household consumption and business investment. However, there are continued signs that the housing market is slowing.

A sustained period of strong growth has resulted in a significant build up of inflation pressures in the non-tradables sector, particularly in the construction sector. Inflation in other areas of the non-tradables sector has also been high – annual non-tradables inflation was 4.7 per cent in the year to September. In contrast, the rapid appreciation of the exchange rate over recent years has resulted in lower prices in the tradables sector. Overall, CPI inflation has been comfortably inside the target range, but there remains a considerable gap between the level of non-tradables and tradables inflation.

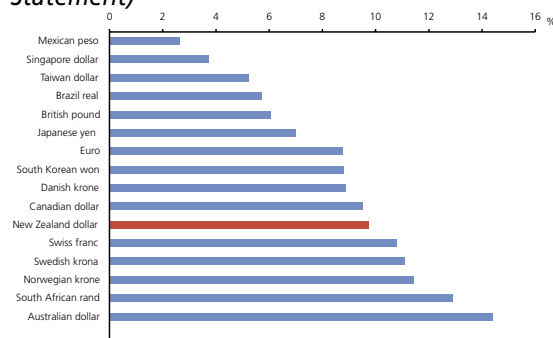
Global and financial market developments

The strong pace of global expansion that began in the second half of last year has eased. Over the coming 12 months, the economies of our main trading partners are expected to grow at close to trend.

The US dollar has continued to depreciate, as concerns mount over the sustainability of the US current account and fiscal deficits (figure 10). Analysts are concerned about the potential re-alignment in currencies arising out of the US savings-investment imbalance. Future developments for the New Zealand dollar remain heavily dependent on developments in the US.

In the US, a run of upside surprises in economic data and a fall in crude oil prices has raised cautious optimism about the US economic recovery. The Federal Reserve (Fed) increased its policy rate to 2 per cent in November, and reiterated that its accommodative policy settings will be removed at a measured pace. Fed officials have suggested that as more interest rate stimulus is removed, future policy

Figure 10
Exchange rates against the US dollar
(percentage change since the September *Statement*)



Source: RBNZ.

rate increases will become more contingent on economic data.

Recent data have been weak in Japan with GDP only growing 0.1 per cent in the September quarter. Markets are now questioning whether Japanese growth peaked earlier in the year. Conversely, momentum in the Chinese economy has remained strong. The Peoples Bank of China surprised markets by increasing its official interest rate for the first time in nine years, which markets saw as suggestive of a movement towards a more market-based approach to financial management. The Bank of Korea, on the other hand, surprised markets by cutting rates by 25 basis points. Continued weakness in domestic demand and a slowdown in the pace of export growth have raised concerns that downside risks to Korean growth may be increasing.

In Europe, analysts expect the European Central Bank to keep rates on hold until mid- to late-2005. The European recovery continues to look fragile, with the outlook characterised by continuing uncertainty, particularly that stemming from high oil prices and the strength of the EUR/USD exchange rate.

Market analysts expect the Bank of England (BOE) to leave interest rates unchanged in the foreseeable future. Growth in the UK appears to be losing some momentum as industrial production and the housing market cool. The BOE is expecting growth to remain close to trend, but the risks are skewed to the downside, particularly in relation to oil prices, international imbalances, and housing market developments.

Box 3

Uridashi and Eurokiwi bond

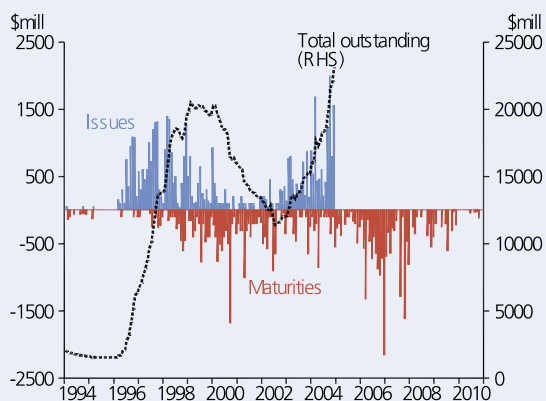
issuance

The New Zealand dollar has been supported this year by New Zealand's relatively high interest rates, which have attracted foreign demand for New Zealand investments. Foreign investment comes in several forms, but one of the more prominent this year has been Uridashi and Eurokiwi bond issuance. These bonds are denominated in New Zealand dollars and are sold to small- and medium- sized retail investors in Japan (in the case of Uridashi bonds), or Europe (in the case of Eurokiwi bonds.²) Several characteristics of these bonds make them attractive to foreign investors, aside from New Zealand's relatively high interest rates. First, the bonds are generally easily accessible to retail investors. Second, the bonds are generally issued by internationally recognised institutions, such as the World Bank.

Issuance of Uridashi and Eurokiwi bonds has been very strong this year, averaging around \$NZ900 million per month. To put this in perspective, New Zealand borrows around \$NZ550 million per month from foreign investors

to fund its current account deficit. Uridashi and Eurokiwi issuance creates a wider pool of offshore investors in New Zealand than would otherwise be the case, and therefore contributes to funding the current account deficit. With New Zealand interest rates likely to remain relatively high compared with the rates in both Japan and Europe, underlying conditions are likely to support further issuance in the near term.

Figure 11
New Zealand dollar bond issuance in offshore markets

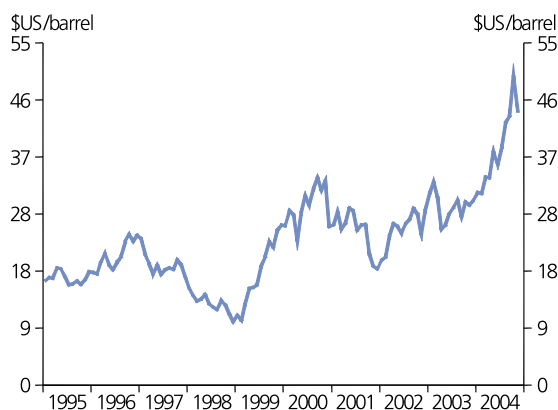


Source: RBNZ estimates.

After increasing interest rates to 5.25 per cent late in 2003, the Reserve Bank of Australia (RBA) has kept interest rates on hold. Despite CPI inflation remaining well contained (at 2.3 per cent in the year to September) the RBA kept a tightening bias in their November *Statement*. Markets and analysts expect the RBA to leave rates on hold until mid-2005.

Concerns remain about the impact of high oil prices on global growth and inflation. However, easing supply concerns and somewhat lower oil prices since October have allayed some of these fears (figure 12).

Figure 12
Brent oil prices



Source: Datastream.

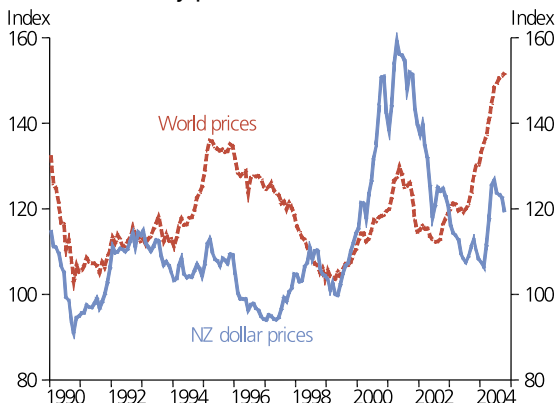
2 For a more thorough analysis of Eurokiwi bond issuance and its effect on financial markets refer to "Developments in the Eurokiwi bond market", *Reserve Bank of New Zealand Bulletin*, June 1998.

Tradables sector activity

The key developments affecting activity in the tradables sector have been the rising exchange rate and increases in world prices for New Zealand's key commodity exports. Export incomes were adversely affected between 2001 and 2003 by the rising exchange rate and some easing in commodity prices. Since then, the strength of commodity prices has led to some recovery in export incomes.

World prices for our commodity exports have been increasing since late 2002 (figure 13). Tight international supplies for some of our key commodities – such as beef, lamb and dairy products – combined with strong global demand, have driven prices to very high levels. However, these rising world prices have been largely offset by the rapid rise of the currency. While New Zealand dollar commodity prices rose significantly in the first half of 2004, in recent months the stronger exchange rate has outweighed the impact of stronger world prices, and New Zealand dollar prices have fallen.

Figure 13
ANZ commodity prices

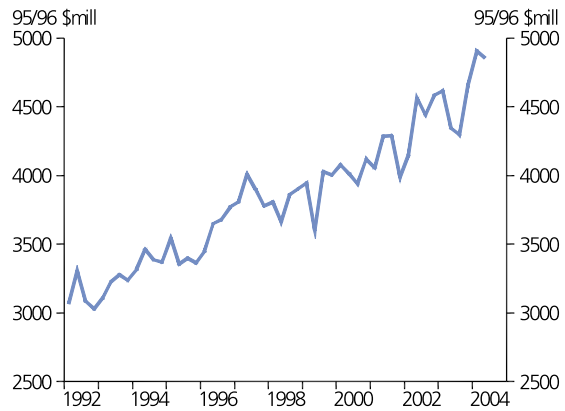


Source: ANZ Banking Group Ltd.

Although some industries have been under pressure, to date there has been limited evidence of a significant impact from the high currency on export sector activity levels as a whole. After falling in early 2003, primary export volumes grew strongly in early 2004 supported by good international demand for dairy, beef and lamb (figure 14). Since then, primary export volumes have moderated due to tightness in dairy and meat supplies.

Total non-commodity export volumes have also been performing well, and recently earnings from non-commodity exports picked up (figure 15).

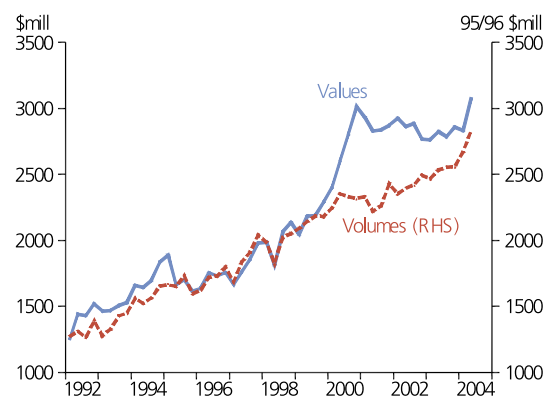
Figure 14
Primary export volumes
(quarterly total)



Source: Statistics New Zealand.

Since the aftermath of SARS, tourist numbers have recovered sharply. In particular, increased capacity and airfare discounting on trans-Tasman travel has boosted the number of Australian tourists to a record level (figure 16, opposite). However, Australian tourists traditionally spend less per person than visitors from other major tourist markets. The strong New Zealand dollar may also have negatively affected tourist spending.

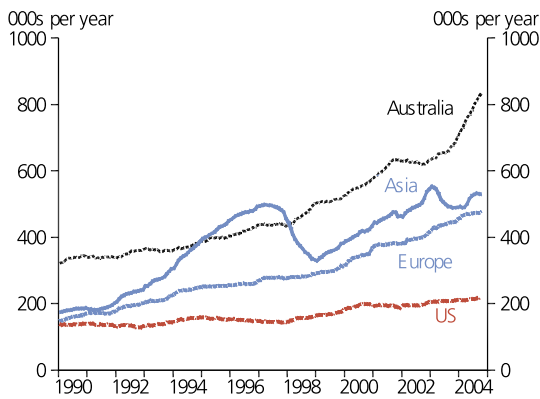
Figure 15
Non-commodity manufactured exports
(quarterly total)



Source: Statistics New Zealand.

The rapidly-rising exchange rate, and low inflation amongst our trading partners, has dramatically reduced import prices over the past few years. However, this downward pressure is starting to ease. Although the

Figure 16
Overseas visitor arrivals



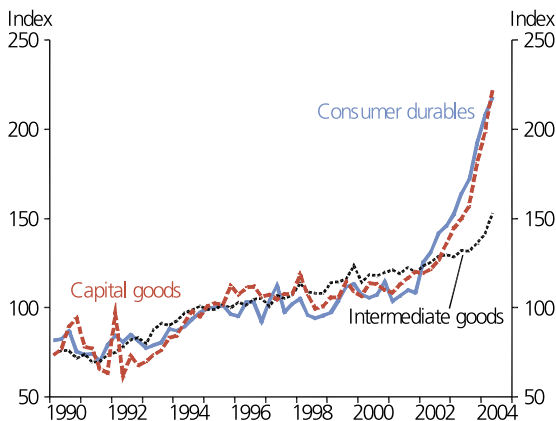
Source: Statistics New Zealand.

exchange rate remains high, high oil prices and continuing strong global demand, particularly in Asia, are pushing up some import prices. Strong global demand is also putting strain on the world's shipping resources – pushing up freight costs.

Growth in import volumes has been very strong during the past two years. In particular, growth in imports of consumer durables and capital goods has been high (figure 17). Strength in consumer durable imports has been driven by favourable consumer import prices, a buoyant housing market, and rising household incomes and wealth. Capacity constraints and relatively low interest rates have helped drive up imports of capital goods.

Recently, imports of intermediate goods have also picked up as firms have taken advantage of the high exchange

Figure 17
Import volumes



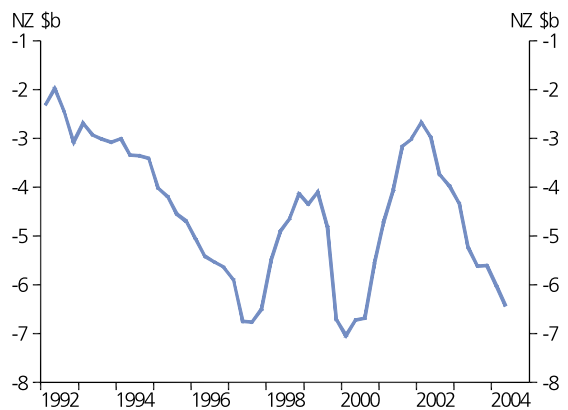
Source: Statistics New Zealand.

rate. Exporters may also be importing more inputs to form a natural hedge against exchange rate appreciation.

Imports of services increased by nearly 13 per cent in the year to June, as the strong exchange rate and low fares made overseas travel for New Zealanders more attractive.

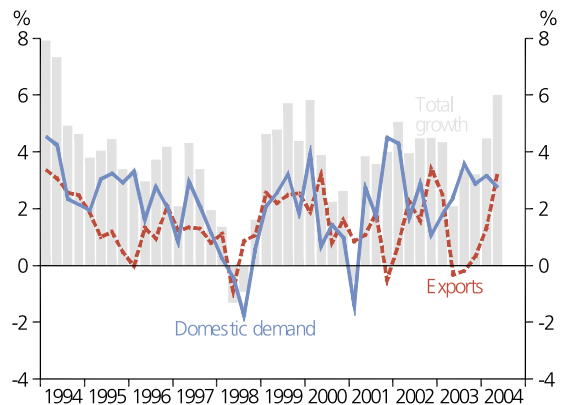
Overall, our current account deficit has widened significantly since early 2002 (figure 18). In itself, this is more of a reflection of the strength in the domestic sector drawing imports into the economy at a rapid rate, rather than our exports being weak. Indeed, exports' contribution to GDP growth has risen dramatically over the past 12 months (figure 19), but this has been outpaced by growth in import volumes.

Figure 18
Annual current account balance



Source: Statistics New Zealand.

Figure 19
Contributors to GDP growth³
(annual percentage change)



Source: Statistics New Zealand.

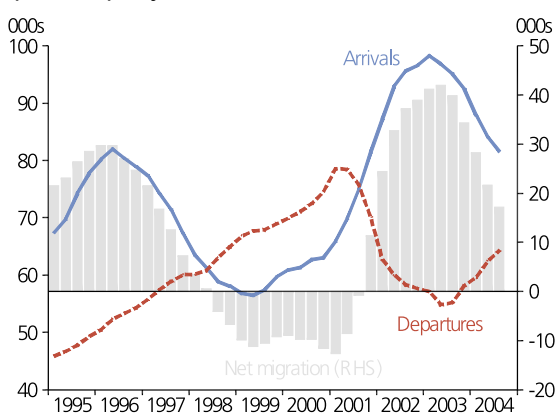
³ Domestic demand is calculated as GDP excluding exports.

Domestic demand

The domestic economy has experienced a period of robust economic growth over recent years. In part, this has been driven by rapid population growth resulting from strong net immigration. Strong population growth has placed pressure on housing resources, pushing up house prices, and fuelling increased residential investment. At the same time, wealth effects from rising house prices have supported consumer spending, as have strong employment growth, relatively low interest rates, and rising terms of trade.

Since the middle of 2003, net migration inflows have reduced significantly (figure 20). This slowdown in net immigration has been caused by both a pick-up in departures and a slowdown in arrivals. Increased departures are likely to reflect easing security concerns elsewhere, while the decline in arrivals has largely been driven by falls in arrivals from Asia (particularly China).

Figure 20
Net permanent and long-term immigration
(persons per year)

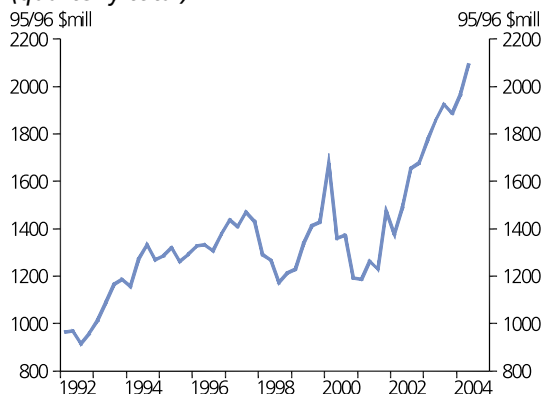


Source: Statistics New Zealand.

So far, residential investment has continued to grow strongly and has shown little response to the easing in net immigration (figure 21). This may reflect the backlog of work in the residential construction sector as capacity constraints have meant that demand has outpaced supply. However, forward indicators continue to suggest a cooling of momentum in the housing market. House sales have fallen by about 26 per cent from their peak in September 2003, and the number of dwelling consents issued has declined rapidly in recent months (figure 22).

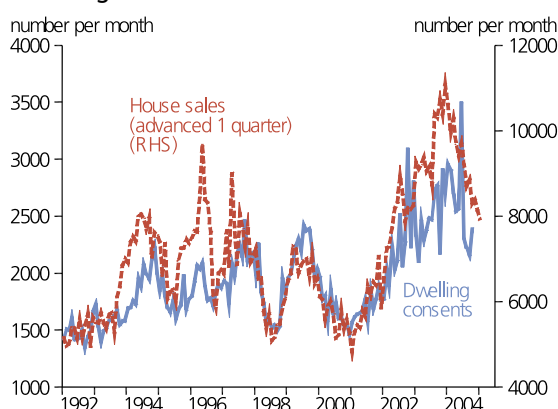
In addition, the median number of days taken to sell a house has increased from a low of 25 days to over 31 days.

Figure 21
Residential investment
(quarterly total)



Source: Statistics New Zealand.

Figure 22
Dwelling consents and house sales



Source: Statistics New Zealand, Real Estate Institute of New Zealand.

House price inflation has also started to slow, although it remains at a high level (figure 23).

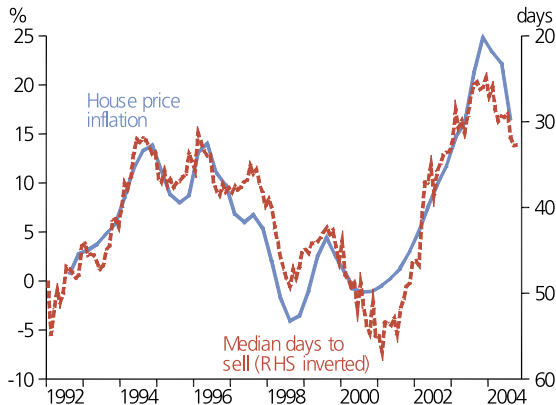
In recent years, consumption has been supported by population growth and rising house prices. Consumers have remained buoyant even as house price inflation has moderated (figure 24). The continued strength of consumer confidence is a reflection of a strong labour market and higher household incomes. Consumers have also benefited from lower prices in the retail sector with strong competition and the high exchange rate keeping prices down.

The debt-to-income ratio has risen sharply over the past two years. This has reflected low interest rates and rising housing-related wealth over this period. This has also been evident in high rates of household credit growth, although credit growth has slowed in recent months (figure 25).

Business confidence and firms' expectations for their own activity have remained relatively robust since recovering

Figure 23

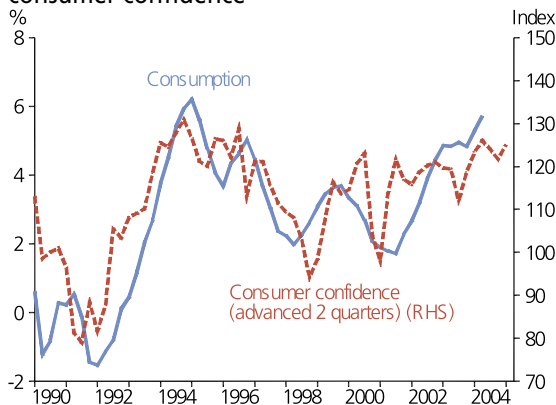
House price inflation and median days to sell



Source: Quotable Value New Zealand, Real Estate Institute of New Zealand.

Figure 24

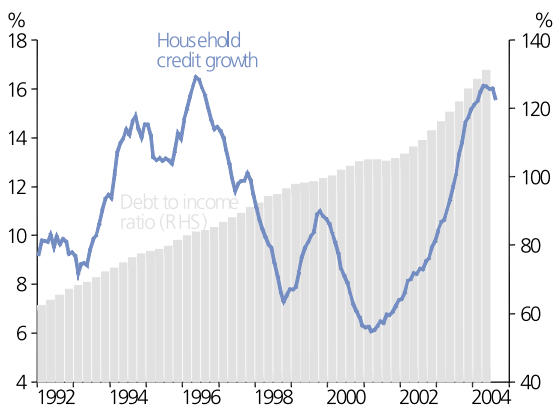
Annual average consumption growth and consumer confidence



Source: Statistics New Zealand, Westpac McDermott Miller.

Figure 25

Household debt and annual credit growth



Source: RBNZ.

from a low in early 2003. This optimism, as well as high capacity constraints, has led to strong growth in business investment – in excess of 18 per cent in the year to June 2004.

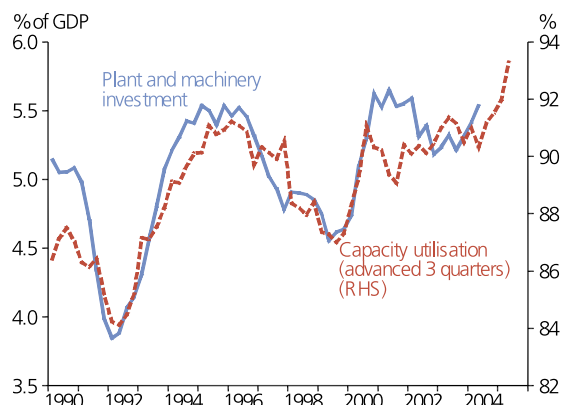
Investment has also been encouraged by the high exchange rate (making it cheaper to import capital equipment).

Despite the lift in investment, firms are still reporting high levels of capacity utilisation. This suggests that plant and machinery investment will remain robust in the second half of 2004 (figure 26).

In the past few years commercial construction has been relatively subdued in comparison to the strength in the residential construction sector. However, non-residential investment surged in the June quarter, and strong non-residential building consents data suggest that non-residential investment will continue to expand in the coming months (figure 27). This will prolong pressures in the already resource-constrained construction sector.

Figure 26

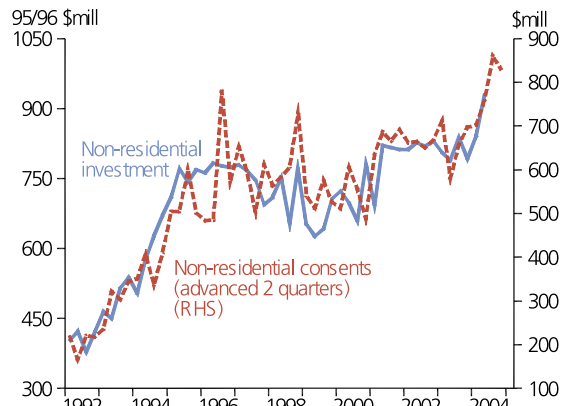
Plant and machinery investment and capacity utilisation



Source: Statistics New Zealand, NZIER.

Figure 27

Non-residential investment and consents (quarterly total)



Source: Statistics New Zealand.

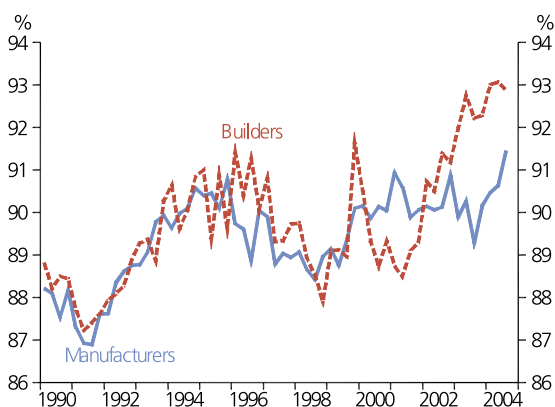
Fiscal policy

Over 2004, the Government's operating surplus has increased by more than expected at the time of the *Budget and Economic Forecast*. This is partly due to government departments spending less than budgeted, but also because tax revenue has been greater than expected as the economy continues to grow strongly.

Productive capacity

The sustained period of above-average growth in recent years has stretched the economy's productive resources, particularly in the construction and services sectors. This stretch is very apparent in the NZIER's Quarterly Survey of Business Opinion (QSBO) measure of capacity utilisation. Capacity utilisation has been at very high levels in recent years, and in the September quarter it rose to a historical high. Capacity utilisation has been highest in the building sector, although capacity utilisation in the manufacturing sector is now at a 30-year high (figure 28).

Figure 28
Capacity utilisation

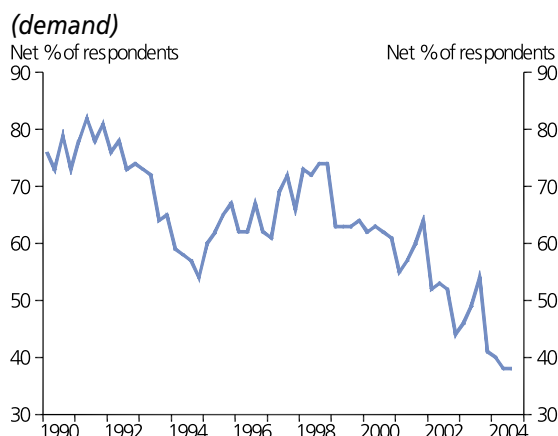


Source: NZIER.

Certainly, firms do not perceive lack of demand as being a factor that is limiting production – the proportion of firms citing a lack of forward orders as limiting their production has fallen to a 30-year low (figure 29).

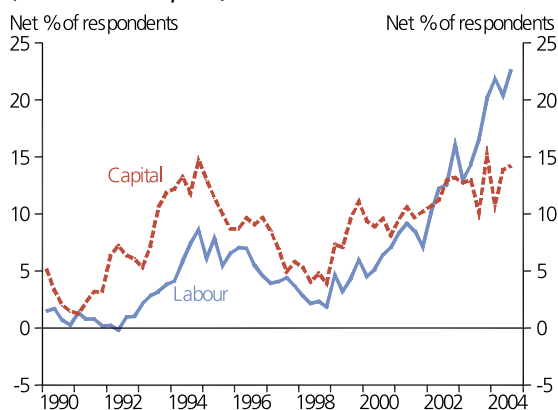
However, firms are increasingly citing labour as a factor limiting increased production (figure 30). Some businesses we have talked to on our business visits are also reporting difficulties retaining existing staff, due to strong competition for staff amongst employers. The proportion of firms citing capital as a limiting factor also remains at a high level.

Figure 29
Factors limiting increased production
(demand)



Source: NZIER.

Figure 30
Factors limiting increased production
(labour and capital)



Source: NZIER.

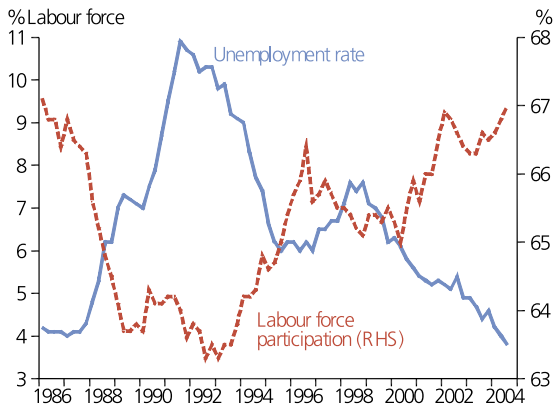
The labour market and wages

The tightness in labour resources is also reflected in the unemployment rate, which has fallen to 3.8 per cent – its lowest level in the history of the Household Labour Force Survey (figure 31, opposite). Low unemployment has encouraged more workers into the labour force – labour force participation is at an 18-year high.

An increasingly stretched labour market has meant that firms have had to pay increasingly higher wages to attract and retain staff. Annual growth in both the adjusted and the unadjusted Labour Cost Index (LCI) are at cyclically-high levels.⁴ Annual growth in average hourly earnings from the

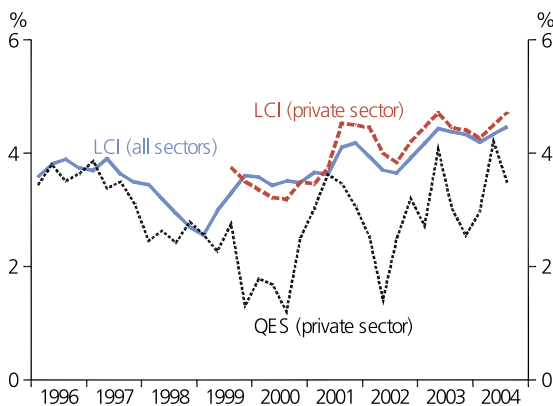
4 The adjusted LCI is a measure of salary and wage rates for a fixed quantity and quality of labour, while the unadjusted LCI is a measure that fixes the quantity of labour but not the quality.

Figure 31
Unemployment rate and labour force participation



Source: Statistics New Zealand.

Figure 32
Unadjusted LCI and QES hourly earnings (annual percentage change)



Source: Statistics New Zealand.

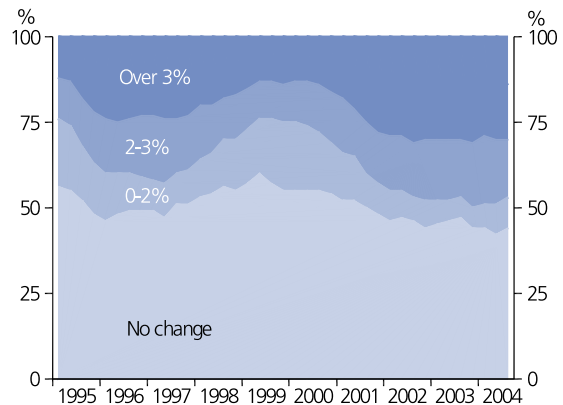
Quarterly Employment Survey (QES) has also remained high (figure 32). However, despite the tight labour market, wage adjustments, thus far, have remained relatively contained.

These observations are broadly supported by movements in the distribution of wage increases in the LCI. The proportion of all firms increasing salary and ordinary time wage rates in the September quarter remained at a high level (figure 33). Statistics New Zealand note that the main reasons given for wage increases in the September quarter were to reflect changes in the cost of living, to match market rates, and to retain staff, which are consistent with a high degree of stretch in the labour market.

Rising wage pressures, however, are not isolated to ordinary time salary and wage rates. The proportion of firms

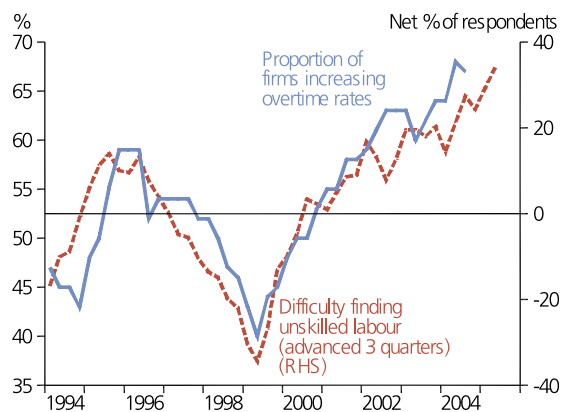
increasing overtime wage rates has also been trending up over the past few years (figure 34). This might suggest that firms have increasingly needed to coax existing staff to work longer hours through overtime wage increases.

Figure 33
Distribution of wage increases



Source: Statistics New Zealand.

Figure 34
Overtime wage increases and difficulty finding unskilled labour

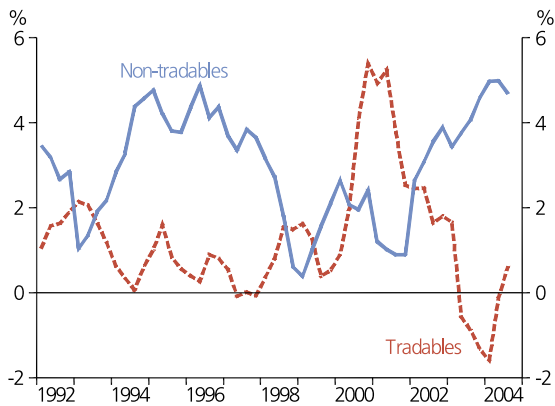


Source: Statistics New Zealand, NZIER.

Inflation pressures

Annual CPI inflation lifted to 2.5 per cent in the September quarter, remaining inside the target range. However, headline CPI continues to hide divergent trends in non-tradables and tradables inflation. Resource pressures in the economy have been reflected in non-tradables inflation, which has risen to a very high level (figure 35, overleaf). Conversely, inflation in the tradables sector has been low, reflecting the strength of the New Zealand dollar. More recently, however, tradables inflation has increased, as the currency has stabilised.

Figure 35
Tradables and non-tradables inflation
(annual rate)

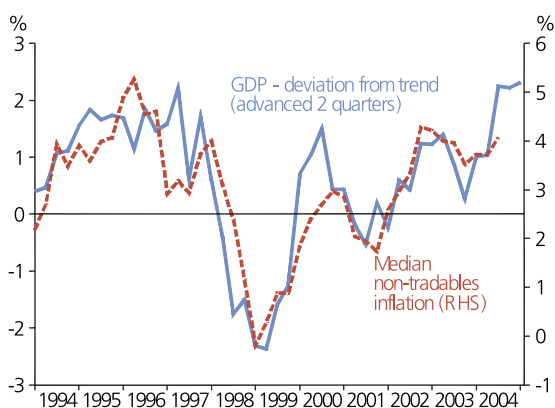


Source: RBNZ.

Annual non-tradables inflation reached a high of 5.0 per cent in the June quarter, falling slightly to 4.7 per cent in the September quarter. This high rate of non-tradables inflation is consistent with our view that the economy has been operating above its capacity for some time (figure 36). Inflation has been particularly high in the housing and construction markets, with the costs associated with the purchase and construction of new dwellings increasing by 9 per cent in the year to September. Strong inflationary pressures are also present in other sectors of the economy with prices for household goods and services, and for personal services rising sharply over the year.

Annual tradables inflation has turned around sharply in the past two quarters, as the lagged effects of the 2003 exchange rate appreciation have begun to wane, and higher oil prices have affected petrol prices.

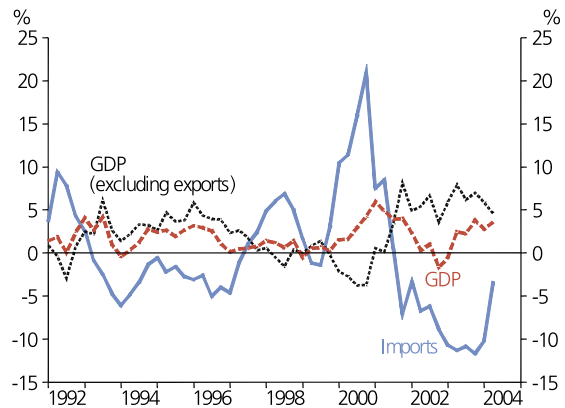
Figure 36
Cyclical pressures and annual non-tradables inflation



Source: RBNZ.

National Accounts-based indicators of inflation have reflected the divergence between non-tradables and tradables inflation. Annual growth in the GDP deflator has been increasing, but until recently has been subdued by falling New Zealand dollar export prices. Excluding export prices from the GDP deflator – producing a measure of domestically-sourced inflation similar to non-tradables inflation – reveals much higher inflation in recent years (figure 37). Meanwhile, the import price deflator from the National Accounts is significantly negative, but has recently increased from its lows.

Figure 37
National Accounts deflators
(annual percentage change)



Source: Statistics New Zealand.

The Producer Price Indexes (table 1, opposite) are showing the same trends that are driving consumer prices. Industries serving domestic-oriented sectors, such as construction and electricity, have experienced rising prices. Meanwhile, industries more exposed to international trading conditions, particularly forestry and logging, have experienced falling prices. However, rising commodity prices have caused prices in some parts of the export sector to increase.

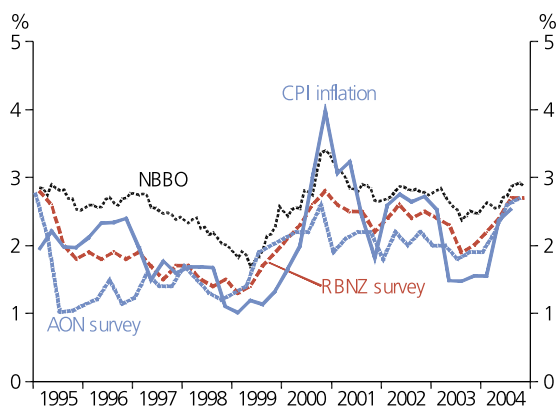
Inflation expectations

Price- and wage-setting decisions of households and firms are influenced by inflation expectations. Inflation expectations are guided, to a certain extent, by actual inflation outcomes. Therefore, temporary fluctuations in inflation can become ingrained into price and wage setting behaviour, and can affect inflation over the medium term. Although inflation

expectations are notoriously difficult to gauge (as they are not directly observable), surveyed expectations can provide some insight.

Survey measures of one-year-ahead inflation expectations tend to follow actual inflation relatively closely. Measures from the National Bank's Survey of Business Opinion (NBBO), the AON consulting survey (covering professional economists), and the RBNZ survey of expectations, have increased over the past 12 to 18 months, although inflation expectations in the RBNZ survey remained constant in the December 2004 quarter (figure 38). However, surveyed inflation expectations all remain below 3 per cent suggesting that any impact of inflation expectations on price- and wage-setting decisions will remain reasonably contained in the near term.

Figure 38
Inflation expectations (one-year-ahead) and CPI inflation
(annual rate)



Source: AON Consulting, National Bank of New Zealand, RBNZ, Statistics New Zealand.

Table 1
CPI and other inflation measures

	2003				2004		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep
CPI	2.5	1.5	1.5	1.6	1.5	2.4	2.5
Food	-0.2	0.0	0.3	0.2	0.5	1.1	0.5
Housing	4.0	4.7	5.9	6.6	7.0	7.1	6.7
Household operations	1.9	1.1	0.9	1.5	1.4	1.5	1.0
Apparel	0.8	-0.6	-1.1	-1.1	-1.0	-0.8	-0.4
Transportation	4.3	-1.7	-2.5	-3.9	-4.6	-0.6	1.5
Tobacco and alcohol	3.1	2.7	2.6	2.9	2.9	3.2	4.2
Personal and health	3.8	3.5	2.6	2.4	2.7	2.7	2.7
Recreation and education	2.7	2.1	1.7	1.6	2.0	1.4	1.5
Credit services	-2.0	0.7	-0.1	1.2	-0.9	0.8	-0.2
Derivatives and analytical series							
CPI ex food, petrol and government charges	2.7	1.9	1.3	1.2	1.2	1.4	2.3
CPI non-tradables	3.4	3.8	4.1	4.6	5.0	5.0	4.7
CPI tradables	1.7	-0.6	-0.9	-1.3	-1.6	-0.1	0.6
CPI weighted median (of annual price change)	3.7	2.6	2.3	1.9	2.1	2.6	2.6
CPI trimmed mean (of annual price change)	2.8	1.6	1.7	1.8	2.0	2.6	2.6
Merchandise import prices (excluding petrol)	-13.8	-12.5	-11.5	-12.0	-10.6	-5.9	n/a
PPI - Inputs	-1.3	-1.9	0.1	-0.1	-0.6	1.5	2.5
PPI - Outputs	-0.4	-0.6	0.7	1.1	0.9	2.0	2.4
Private consumption deflator	1.5	0.7	0.5	0.2	0.7	1.6	n/a
GDP deflator (derived from expenditure data)	-0.5	2.5	2.3	3.9	2.8	3.6	n/a
Retail trade deflator	1.4	-0.7	-0.7	-0.4	-0.6	0.8	0.5

Source: Statistics New Zealand, RBNZ estimates.

4 The macroeconomic outlook

Overview

This chapter describes our projections for economic activity, inflation, and interest rates over the coming years. The recent strong economic expansion appears to be continuing apace, underpinned by ongoing buoyancy in consumer spending. However, the turning point in the economic cycle is near. In 2005 economic growth is projected to slow markedly, as the effects of a cooling housing market, lower net immigration, and higher interest rates dampen household spending (see figure 3, Chapter 2). Furthermore, a moderation in the terms of trade from high levels and the lagged effects of the high exchange rate are expected to impact on the external sector.

The current strength in economic activity comes at a time of significant strain on the economy's productive resources, and is placing upward pressure on domestic inflation. In the near term, the high exchange rate is providing an effective offset to domestic inflationary pressure by keeping tradables inflation low. In the years ahead, the cooling economy is expected to moderate domestic inflationary pressure, while tradables inflation is set to rise. Taking these factors together, we project overall CPI inflation to rise to around 3 per cent, before easing back in the latter half of 2006 (see figure 8, Chapter 2).

Interest rates

We project 90-day rates to remain around current levels for the foreseeable future (see figure 9, Chapter 2). While

domestic demand is currently strong, in our assessment the high exchange rate, combined with likely increases in long-term interest rates, is likely to provide sufficient policy restraint to keep inflation consistent with the PTA.

Overall interest rate pressures are set to firm, even though 90-day rates are projected to remain roughly constant. Recent increases in the OCR are yet to fully work their way through to effective mortgage interest rates – that is, the interest rates actually being paid by households. This is especially true for fixed one- to two-year mortgage rates. We expect effective mortgage rates to increase next year, as existing fixed mortgages are refinanced at higher rates, as margins between wholesale and retail interest rates return to more normal levels, and as overseas interest rates rise (see box 2, Chapter 2).

The world economy

Our view on the outlook for New Zealand's main trading partners is largely based on *Consensus Forecasts*, a structured survey of the main forecasters in our trading-partner economies. There are signs that the recent strong global economic expansion may begin to ease next year. Global growth is expected to slow to around average levels by 2005 (figure 39, opposite). This represents a slight deterioration in the global outlook since the September *Statement*, largely reflecting a weaker growth outlook in Japan, and the effects of high oil prices.

Table 2

Forecasts of export partner GDP growth*

(calendar year, annual average percentage change)

Country	2001	2002	2003	2004f	2005f	2006f
Australia	2.5	3.9	3.0	3.5	3.4	3.4
United States	0.8	1.9	3.0	4.4	3.4	3.4
Japan	0.4	-0.3	2.5	4.0	1.6	1.8
Canada	1.8	3.4	2.0	3.0	3.3	3.0
Eurozone**	1.6	0.8	0.5	1.9	1.9	2.0
United Kingdom	2.3	1.8	2.2	3.2	2.6	2.0
Asia ex-Japan***	2.0	5.1	4.9	7.1	5.6	5.9
12 Country Index	1.6	2.6	3.0	4.2	3.4	3.5

* Source: Consensus Economics Inc.

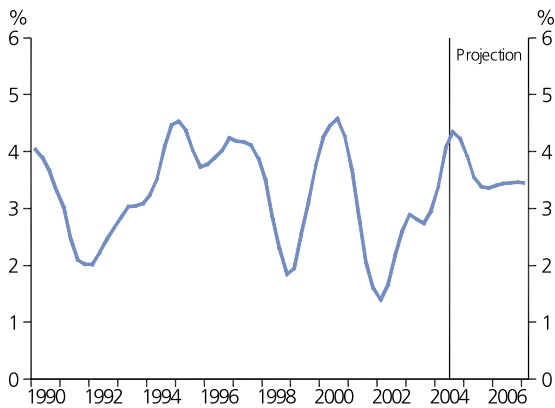
** Includes Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain.

*** Includes China, Hong Kong, Malaysia, Singapore, South Korea and Taiwan.

Figure 39

Trading partner GDP

(annual average percentage change)



Source: Consensus Economics Inc., RBNZ estimates.

World inflation is expected to increase a little in the coming year. However, this is likely to be temporary, mostly reflecting recent increases in energy and commodity prices.

High oil prices present an ongoing risk to the world growth outlook. At present, we have adopted the *Consensus* assumption that oil prices will gradually moderate from their current highs toward their long-run average. If oil prices remain higher for longer then global growth would moderate and global inflation would increase, with knock-on effects for New Zealand.

Large current account and fiscal deficits in the US present a further downside risk to the global growth outlook. A rapid correction in these imbalances could slow the pace of the US economic recovery, with potential for sharp adjustments to world-wide interest rates and exchange rates.

The tradables sector

Export prices

World prices of New Zealand's exports have risen very strongly over the past year, mainly due to strong international demand and tight international supply conditions for some of our key commodity exports. Indications are that these factors will remain in place for some months, continuing to support world export prices. Further ahead, we expect a gradual moderation in world export prices as international supply of some primary products increases. However, the projected impact of this fall in world export prices is more than offset by an assumed depreciation in the exchange

rate, so that New Zealand dollar returns to exporters are projected to rise during 2006.

Import prices

World import prices have risen recently, but we expect this trend to reverse going forward. Our expectation for mild falls in import prices mostly reflects the assumption that oil prices will fall. Given the uncertainties around oil prices, the future direction of import prices remains a significant source of uncertainty.

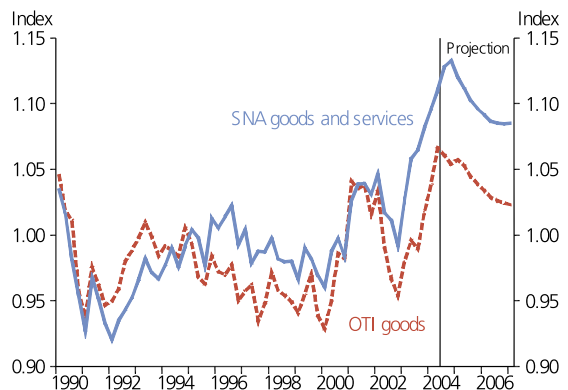
The projected depreciation of the exchange rate outweighs expected falls in world import prices in the later years of the projection, implying that imports will tend to become more expensive relative to domestic goods and services.

Terms of trade

Strong gains in world export prices have driven New Zealand's goods and services terms of trade to high levels recently. The terms of trade have continued to improve since the September *Statement*. The terms of trade are expected to fall next year as export prices fall more sharply than import prices (figure 40).

Figure 40

Terms of Trade



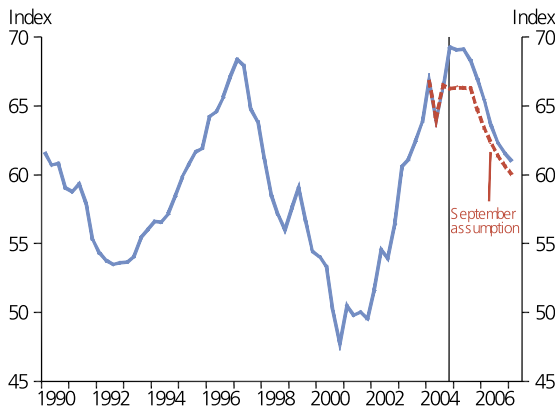
Source: Statistics New Zealand, RBNZ estimates.

Exchange rate

The exchange rate has risen in recent months, leaving the TWI around 4.5 per cent higher than the level assumed in the September *Statement*. Our technical assumption is for the trade-weighted exchange rate to remain around its current

level for some months yet, before gradually reverting towards its long-term average level (figure 41). Commodity prices and interest rate differentials have influenced movements in the New Zealand dollar in the past. The current projection for the TWI is consistent with falling world export prices and a narrowing in the interest rate differential between New Zealand and the rest of the world.

Figure 41
Nominal TWI technical assumption



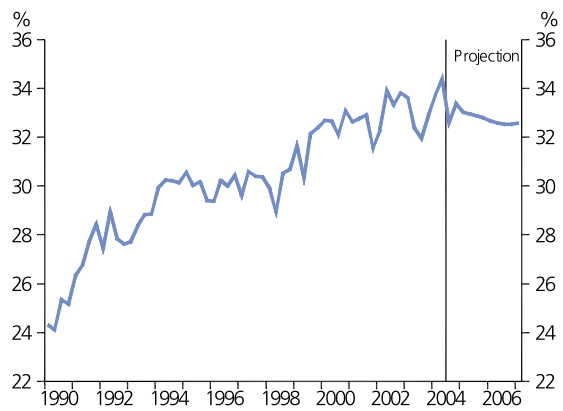
Source: RBNZ estimates.

Export volumes

Export volumes have been strong in recent years, but we expect the lagged effect of the high exchange rate to have an impact on exports in 2005. Overall, export volumes are expected to underperform GDP growth, although the outlook varies by sector:

- While non-primary manufacturing has experienced very strong growth recently, the lagged effect of the high exchange rate – in particular the NZD/AUD exchange rate – should be felt next year. Annual growth is expected to slow from 10 per cent currently to around 2 per cent by 2006.
- Agricultural exports are projected to grow at around 3.5 per cent per annum throughout the projection period.
- Log exports are projected to remain weak. Poor returns resulting from low world prices, the high exchange rate, and high shipping costs will continue to discourage forest owners from felling.
- Exports of services, although currently strong, are expected to weaken due to the lagged effects of the high New Zealand dollar.

Figure 42
Export volumes
(per cent of trend output)

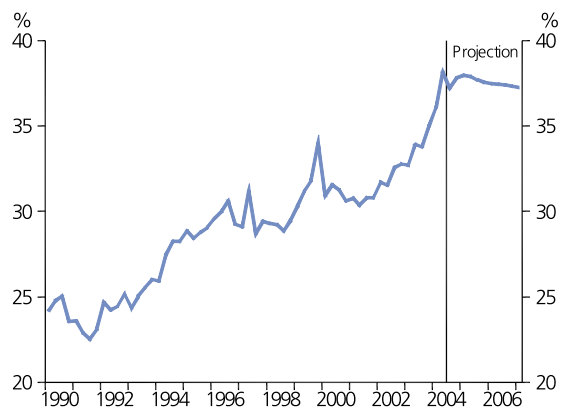


Source: Statistics New Zealand, RBNZ estimates.

Import volumes

The past year has seen a significant increase in the growth of import volumes, reflecting continued strength in the domestic economy. In addition, the high exchange rate has seen consumers and businesses alike take advantage of the higher purchasing power of the New Zealand dollar. We project that imports of capital goods will continue to underpin strong import volumes as firms continue to invest in labour saving capital and expand their productive capacity. Further ahead, import volume growth is projected to moderate as the pace of the domestic economy slows and the expected depreciation of the exchange rate raises the cost of imported goods and services (figure 43).

Figure 43
Import volumes
(per cent of trend output)



Source: Statistics New Zealand, RBNZ estimates.

Current account balance

The total value of imports is projected to grow faster than exports for some time. In line with the projected fall in the terms of trade, the current account deficit is projected to expand to a peak of around 6.5 per cent of GDP in late 2006.

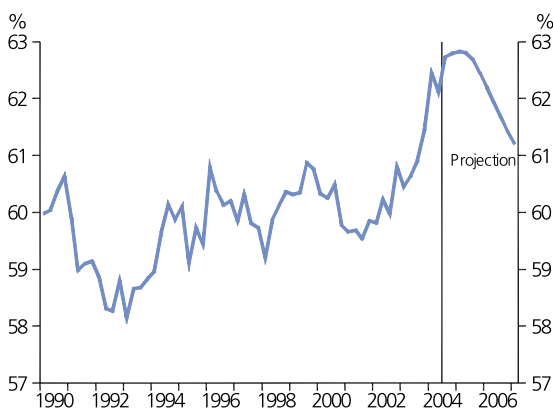
Household spending

Consumption spending

Recent economic indicators suggest continued strength in household consumption for the remainder of 2004. However, we are projecting growth in household consumption to slow markedly next year (figure 44). This view is based on a range of macroeconomic factors, such as lower net immigration, lower house price inflation, lower export sector incomes, and higher interest rates.

While a consumption slowdown is our central expectation, we are mindful of the risk that household consumption growth could remain high for longer, especially since there are very few immediate indicators of an imminent slowdown (for example, we would normally expect a fall in consumer confidence to foreshadow falling consumption growth, but we have seen no such fall to date). One particular area of uncertainty surrounds households' willingness to take on more debt. We have assumed that the rate of debt accumulation will slow from next year. If households instead continue to accumulate debt, consumption could grow more quickly than projected next year.

Figure 44
Real household consumption
(per cent of trend output)

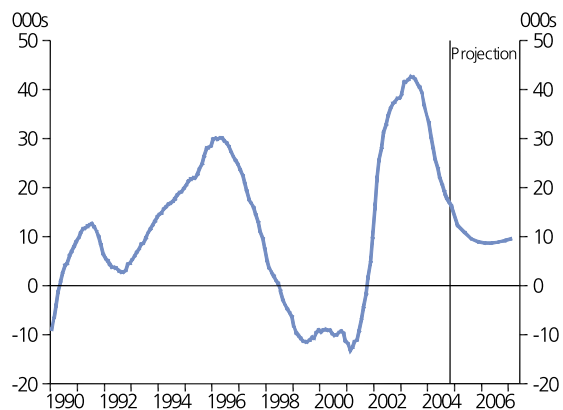


Source: Statistics New Zealand, RBNZ estimates.

Population and housing

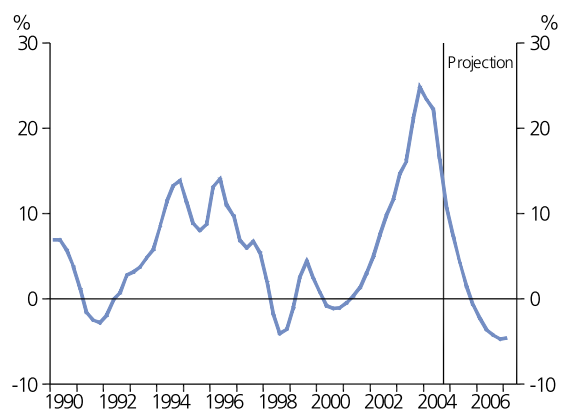
The very strong house price inflation cycle now appears to be past its peak, partly as a result of slowing net immigration, which we expect will continue to fall before stabilising a little below its average level for the past decade (figure 45). With lower net immigration and increasing effective mortgage rates, we project that house price inflation will slow markedly next year (figure 46).

Figure 45
Net immigration
(annual total)



Source: Statistics New Zealand, RBNZ estimates.

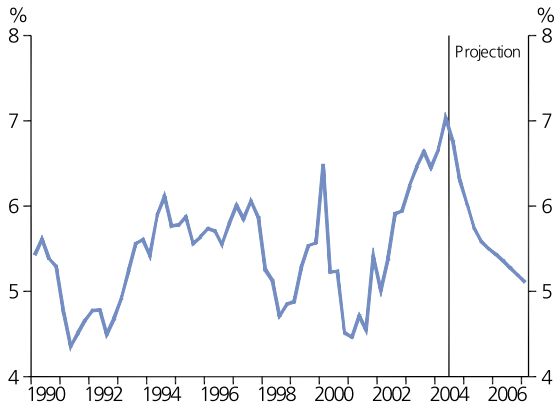
Figure 46
Annual house price inflation



Source: Quotable Value New Zealand, RBNZ estimates.

We are projecting a sharp decline in residential investment activity. Strong net immigration in recent years precipitated a flurry of residential construction activity, but this is almost certainly past its peak (figure 47, overleaf). This projection was formed on the basis of the typical relationship between residential investment and building consents issued. Given that the most recent housing cycle has been anything but

Figure 47
Residential investment
(per cent of trend output)



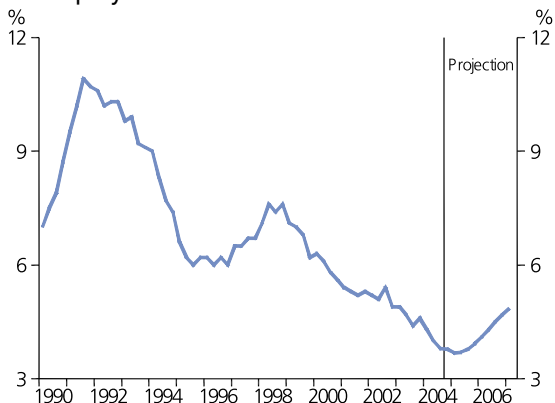
Source: Statistics New Zealand, RBNZ estimates.

typical, there may be some upside risk if there remains a significant backlog of building work. Furthermore, we expect that strong growth in non-residential construction activity will partially offset the fall in residential investment, meaning that the construction industry overall could remain stretched for some time.

Labour market

The strong economy has driven unemployment below 4 per cent and has encouraged increased labour market participation. With a higher proportion of adults now in paid employment than at any time since 1986, household incomes have received a considerable boost – a factor that may forestall falling consumption growth over the coming quarters. Looking ahead, we expect solid demand for labour to continue, keeping the unemployment rate very low until at least 2006 (figure 48).

Figure 48
Unemployment rate



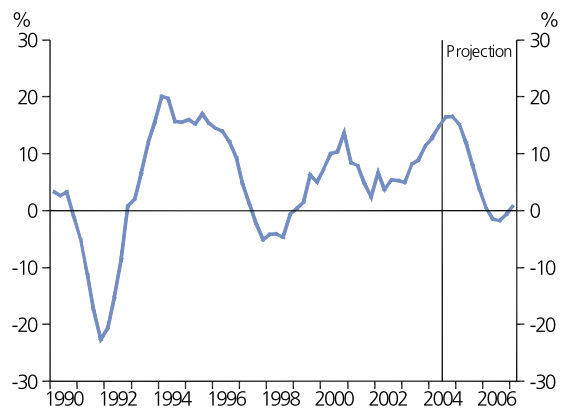
Source: Statistics New Zealand, RBNZ estimates.

While wage growth has reached cyclical highs, it remains lower than might have been expected given the current tightness of the labour market. We project larger wage increases in the coming years, partly due to increased labour productivity stemming from capital deepening, and partly in response to the increasing scarcity of labour.

Business investment

Robust demand at home and from abroad, coupled with lower capital goods prices from the high exchange rate, has encouraged strong business investment. We project further strong growth in business investment as firms face ongoing labour shortages at a time of strong demand. Business investment is projected to slow gradually from mid-2005, in line with the economic cycle (figure 49).

Figure 49
Business investment
(annual average percentage change)



Source: Statistics New Zealand, RBNZ estimates.

Fiscal policy

Our fiscal forecasts are largely based on the Treasury's *Budget Economic and Fiscal Update*. Government expenditure is expected to increase at around 6 per cent per annum in the coming years, representing an increase in expenditure as a proportion of GDP. This will be only partially offset by increasing tax revenues, which are set to grow at around 5 per cent per annum. As a result, the overall stance of fiscal policy is projected to move from being slightly contractionary at present, to slightly expansionary by 2006.

Inflation

CPI inflation is expected to rise to around 3 per cent before easing towards the end of 2006. However, this relatively flat profile masks distinctly different outlooks for tradables and non-tradables inflation (see figures 5 and 8, Chapter 2).

In our assessment, medium-term non-tradable inflation is projected to remain strong over the projection period due to the degree of strain on productive resources. While we are projecting a marked slowdown in economic growth, it may take some time for the strain on resources to fully dissipate. Furthermore, it may take time for reduced resource

strain to feed through to costs and, ultimately, prices. Consequently, non-tradables inflation is expected to remain high throughout 2005 before easing over 2006 – more than a year after the projected slowdown begins.

Tradables inflation, on the other hand, is likely to remain low in the near term, before increasing later. Tradables inflation is mainly influenced by the effect of the exchange rate on the price of imports and exportables. During 2005, the high exchange rate is expected to keep tradables inflation low. With the assumed depreciation beginning in late 2005, tradables inflation is expected to rise during 2006.

Appendix 1¹

Summary tables

Table A

CPI inflation, monetary conditions, and near-term GDP projections

(CPI and GDP are in percentage changes)

		CPI* quarterly	CPI** annual	TWI	90-day bank bill rate
1998	Sep.	0.7	1.7	57.1	6.8
	Dec.	-0.1	1.1	56.0	4.6
1999	Mar.	0.2	1.0	57.6	4.5
	Jun.	0.5	1.2	59.1	4.7
	Sep.	0.4	1.1	56.7	4.8
	Dec.	0.2	1.3	54.4	5.4
2000	Mar.	0.7	1.7	54.1	6.0
	Jun.	0.7	2.0	53.4	6.7
	Sep.	1.4	3.0	50.1	6.7
	Dec.	1.2	4.0	47.7	6.7
2001	Mar.	-0.2	3.1	50.5	6.4
	Jun.	0.9	3.2	49.8	5.9
	Sep.	0.6	2.4	50.0	5.7
	Dec.	0.6	1.8	49.6	5.0
2002	Mar.	0.6	2.6	51.6	5.0
	Jun.	1.0	2.8	54.6	5.8
	Sep.	0.5	2.6	53.9	5.9
	Dec.	0.6	2.7	56.4	5.9
2003	Mar.	0.4	2.5	60.6	5.8
	Jun.	0.0	1.5	61.1	5.4
	Sep.	0.5	1.5	62.4	5.1
	Dec.	0.7	1.6	63.9	5.3
2004	Mar.	0.4	1.5	66.9	5.5
	Jun.	0.8	2.4	64.0	5.9
	Second half average	$\frac{3}{4}$	$2\frac{1}{2}$	$67\frac{3}{4}$	$6\frac{1}{2}$
2005	First half average	$\frac{3}{4}$	$2\frac{3}{4}$	69	$6\frac{3}{4}$
	Second half average	$\frac{3}{4}$	3	$67\frac{3}{4}$	$6\frac{3}{4}$
2006	First half average	$\frac{3}{4}$	3	$64\frac{1}{2}$	$6\frac{3}{4}$
	Second half average	$\frac{3}{4}$	3	62	$6\frac{3}{4}$

Projections		CPI* quarterly	CPI** annual	GDP quarterly	GDP annual average
2003	Dec.	0.7	1.6	0.9	3.4
2004	Mar.	0.4	1.5	2.1	3.6
	Jun.	0.8	2.4	0.9	4.4
	Sep.	0.6	2.5	1.0	4.8
	Dec.	0.7	2.5	1.0	5.2
2005	Mar.	0.7	2.9		

¹ Notes for these tables follow on pages 27-28.

* This series is quarterly CPI inflation, excluding credit services, until the June 1999 quarter, and quarterly CPI inflation thereafter.

** This series is annual CPI inflation, excluding credit services, until the June 1999 quarter, and annual CPI inflation thereafter (adjusted by Statistics New Zealand to exclude interest and section prices from the September 1999 quarter to the June 2000 quarter).

Table B**Composition of real GDP growth***(Annual average percentage change, unless specified otherwise)*

March year	Actuals										Projections				
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007					
Final consumption expenditure															
Private	2.2	3.1	3.3	1.9	2.7	4.8	5.3	5 ³ / ₄	3 ¹ / ₂	1 ³ / ₄					
Public authority	8.0	-0.2	5.2	-2.6	4.7	2.1	3.1	5 ³ / ₄	3 ¹ / ₂	4 ¹ / ₂					
Total	3.5	2.3	3.8	0.9	3.1	4.2	4.8	5 ³ / ₄	3 ¹ / ₂	2 ¹ / ₂					
Gross fixed capital formation															
Market sector:															
Residential	2.9	-13.0	19.5	-12.5	4.4	23.4	15.8	3 ¹ / ₄	-11 ¹ / ₂	-2 ³ / ₄					
Business	-4.2	0.3	7.2	8.8	6.5	5.0	12.7	15 ¹ / ₂	1 ¹ / ₂	3 ¹ / ₄					
Non-market government sector	11.0	-8.0	17.6	-19.2	17.9	1.6	5.4	8	10	2 ¹ / ₄					
Total	-0.9	-4.2	11.3	0.1	7.0	8.7	12.8	11 ¹ / ₂	-1 ³ / ₄	1 ¹ / ₄					
Final domestic expenditure	2.6	0.9	5.3	0.7	4.0	5.2	6.6	7	2 ¹ / ₄	1 ³ / ₄					
Stockbuilding ⁽¹⁾	-0.1	-0.3	1.2	-0.4	0.2	-0.5	0.2	0	1 ¹ / ₄	1 ¹ / ₄					
Gross national expenditure	2.4	0.6	6.5	0.3	4.1	4.7	6.8	7	2 ¹ / ₄	2					
Exports of goods and services	3.9	3.1	7.3	5.1	2.4	7.6	0.8	5 ³ / ₄	2	2 ¹ / ₂					
Imports of goods and services	2.6	1.9	11.5	-0.1	2.4	8.6	11.0	12 ³ / ₄	3 ¹ / ₄	2 ³ / ₄					
Expenditure on GDP	2.7	1.0	5.1	2.0	4.1	4.3	3.3	4 ³ / ₄	2	2					
GDP (production)	1.5	0.5	5.2	2.3	3.4	4.5	3.6	4 ³ / ₄	2	2					
GDP (production, March qtr to March qtr)	0.2	2.6	5.8	0.9	4.4	4.1	5.1	3 ¹ / ₂	1 ¹ / ₂	2 ¹ / ₄					
Potential output	2.9	2.5	2.6	2.8	3.2	3.6	3.7	3 ³ / ₄	3 ³ / ₄	3 ¹ / ₂					
Output gap (% of potential GDP, year average)	0.0	-1.9	0.5	0.0	0.2	1.2	1.1	2 ¹ / ₄	3 ¹ / ₄	-3 ¹ / ₄					

(1) Percentage point contribution to the growth rate of GDP.

Table C

Summary of economic projections

(Annual percentage change, unless specified otherwise)

March year	Actuals										Projections		
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007			
Price measures													
CPI*	1.7	1.0	1.7	3.1	2.6	2.5	1.5	2 ³ / ₄	3	2 ³ / ₄			
Labour costs	1.9	1.6	1.4	1.6	2.1	2.2	2.1	2 ¹ / ₂	2 ¹ / ₂	2 ¹ / ₂			
Import prices (in New Zealand dollars)	2.9	2.7	11.2	7.4	-2.9	-11.1	-10.5	-3 ³ / ₄	5	6 ¹ / ₂			
Export prices (in New Zealand dollars)	4.2	-0.6	9.9	20.6	-3.5	-15.5	-5.1	1	2 ³ / ₄	5 ¹ / ₂			
Monetary conditions													
90-day rate (year average)	8.0	6.2	5.2	6.6	5.4	5.9	5.3	6 ¹ / ₂	6 ³ / ₄	6 ³ / ₄			
TWI (year average)	64.4	57.3	56.1	50.4	50.3	56.4	63.6	67 ¹ / ₄	67 ¹ / ₄	62			
Output													
GDP (production, annual average % change)	1.5	0.5	5.2	2.3	3.4	4.5	3.6	4 ³ / ₄	2	2			
GDP (production, March qtr to March qtr)	0.2	2.6	5.8	0.9	4.4	4.1	5.1	3 ¹ / ₂	1 ¹ / ₂	2 ¹ / ₄			
Output gap (% of potential GDP, year average)	0.0	-1.9	0.5	0.0	0.2	1.2	1.1	2 ¹ / ₄	3 ³ / ₄	-3 ³ / ₄			
Labour market													
Total employment	0.1	0.7	1.5	2.3	3.5	1.5	3.0	2 ³ / ₄	1 ¹ / ₂	0			
Unemployment rate (March qtr, s.a.)	7.1	7.1	6.3	5.4	5.2	4.9	4.3	3 ³ / ₄	4	4 ³ / ₄			
Trend labour productivity (annual % change)	1.4	1.5	1.5	1.5	1.5	1.3	1.4	1 ¹ / ₂	1 ³ / ₄	2 ¹ / ₄			
Key balances													
Government operating balance (% of GDP, year to June)	2.5	1.7	1.3	1.2	1.9	1.5	4.3	4 ¹ / ₄	4	3 ³ / ₄			
Current account balance (% of GDP, year to March)	-5.5	-4.2	-6.5	-4.1	-2.2	-3.3	-4.4	-5 ¹ / ₂	-6	-6 ¹ / ₂			
Terms of trade (OTI measure, annual average % change)	-1.0	-0.4	-0.2	4.4	4.2	-5.7	3.9	5	-1 ³ / ₄	-1 ¹ / ₂			
Household savings rate (% of disposable income, year to March)	-4.1	-4.5	-1.4	-5.1	-3.1	-8.9	-9	-9	-11	-10 ¹ / ₄			
World economy													
World GDP (annual average % change)	3.5	2.0	4.2	3.7	1.4	2.9	3.4	4	3 ¹ / ₂	3 ¹ / ₂			
World CPI inflation	2.2	1.1	2.0	2.7	1.4	2.2	1.5	2	1 ³ / ₄	2 ¹ / ₄			

s.a. = seasonally adjusted

* This series is annual CPI inflation, excluding credit services, until the June 1999 quarter, and annual CPI inflation thereafter (adjusted by Statistics New Zealand to exclude interest and section prices from the September 1999 quarter to the June 2000 quarter).

Notes to the tables

CPI	Consumers Price Index. Quarterly projections rounded to 1 decimal place.
TWI	RBNZ. Nominal Trade Weighted Index of the exchange rate. Defined as a geometrically-weighted index of the New Zealand dollar bilateral exchange rates against the currencies of Australia, Japan, the United States, the United Kingdom, and the euro.
90-day bank bill rate	RBNZ. Defined as the interest yield on 90-day bank bills. Forecasts rounded to the nearest quarter per cent.
World GDP	Reserve Bank definition. 12-country index, export weighted. Projections based on <i>Consensus Forecasts</i> . Seasonally adjusted.
World CPI inflation	RBNZ definition and estimate. TWI trading partners' CPI inflation (Eurozone proxied by Germany), weighted by TWI weights. Projections based on <i>Consensus Forecasts</i> .
Import prices	Domestic currency import prices. <i>Overseas Trade Indexes</i> .
Export prices	Domestic currency export prices. <i>Overseas Trade Indexes</i> .
Terms of trade	Constructed using domestic-currency export and import prices. <i>Overseas Trade Indexes</i> .
Private consumption	<i>System of National Accounts</i> .
Public authority consumption	<i>System of National Accounts</i> .
Residential investment	RBNZ definition. Private sector and government market sector residential investment. <i>System of National Accounts</i> .
Business investment	RBNZ definition. Total investment less the sum of non-market investment and residential investment. <i>System of National Accounts</i> .
Non-market investment	RBNZ definition. The <i>System of National Accounts</i> annual nominal government non-market/market investment ratio is interpolated into quarterly data. This ratio is used to split quarterly expenditure GDP government investment into market and non-market components.
Final domestic expenditure	RBNZ definition. The sum of total consumption and total investment. <i>System of National Accounts</i> .
Stockbuilding	Percentage point contribution to the growth of GDP by stocks. <i>System of National Accounts</i> .
Gross national expenditure	Final domestic expenditure plus stocks. <i>System of National Accounts</i> .
Exports of goods and services	<i>System of National Accounts</i> .
Imports of goods and services	<i>System of National Accounts</i> .
GDP (production)	<i>System of National Accounts</i> .
Potential output	RBNZ definition and estimate. Refer to Conway, P and B Hunt (1997), 'Estimating Potential Output: a semi-structural approach', <i>Reserve Bank of New Zealand Discussion Paper</i> , G97/9.
Output gap	RBNZ definition and estimate. The percentage difference between real GDP (production, seasonally adjusted) and potential output GDP.
Current account balance	<i>Balance of Payments</i> .
Total employment	<i>Household Labour Force Survey</i> .
Unemployment rate	<i>Household Labour Force Survey</i> .
Household savings rate	<i>Household Income and Outlay Accounts</i> .

Government operating balance	Historical source The Treasury. Adjusted by the RBNZ over the projection period.
Labour productivity	The series shown is the annual percentage change in a trend measure of labour productivity. Labour productivity is defined as GDP (production) divided by HLF5 hours worked.
Wages	Private sector all salary and wage rates. Labour Cost Index.
Quarterly percentage change	$(\text{Quarter}/\text{Quarter}_{-1} - 1) * 100$
Annual percentage change	$(\text{Quarter}/\text{Quarter}_{-4} - 1) * 100$
Annual average percentage change	$(\text{Year}/\text{Year}_{-1} - 1) * 100$

Source: Unless otherwise specified, all data conform to Statistics New Zealand definitions, and are not seasonally adjusted.
Rounding: Unless otherwise specified, all projection data are rounded to the nearest quarter per cent.

Appendix 2

Chronology

Listed below are recent events of particular relevance to monetary policy and inflation.

2004

- 9 September The Reserve Bank released its 43rd *Monetary Policy Statement*, increasing the Official Cash Rate from 6.0 per cent to 6.25 per cent. The news release accompanying the *Statement* is reproduced in Appendix 4.
- 24 September Production GDP figures were released showing that the New Zealand economy grew by 0.9 per cent in the June quarter of 2004.
- 15 October CPI statistics were released for the September quarter of 2004 showing that the CPI increased by 0.6 per cent over the quarter, and by 2.5 per cent in the year to September 2004.
- 28 October At the intra-quarter review, the Reserve Bank increased the Official Cash Rate from 6.25 per cent to 6.5 per cent. The accompanying news release is reproduced in Appendix 4.

Appendix 3

Companies and organisations contacted by RBNZ staff during the projection round

3M New Zealand Ltd

Air New Zealand Ltd

Alliance Textiles (NZ) Limited

Aoraki Development Trust

Barfoot & Thompson

BridgestoneNew Zealand Ltd

Bush Road Ltd

Canterbury Leather International

Chequer Corporation Ltd

Clorox New Zealand Limited

Criterion Group Limited

Dan Cosgrove Ltd

Deposit Bond (NZ) Limited

Deutsche Bank AG Ltd

Ecolab Ltd

Education New Zealand

F & P Whiteware Division

Foster Construction Ltd

GL Bowron & Co Ltd

Greenlea Premier Meats Ltd

J Ballantyne & Co Ltd

Lichfield International Ltd

LV Martin & Sons Ltd

Mainzeal Construction Ltd

Meat & Wool New Zealand

Menzies Group Ltd

Maunsell Ltd

McVicar Timber Group Ltd

Medallion Foods Limited

Mitek New Zealand Ltd

Moore Gallagher Ltd

Morgan Furniture Ltd

NZ Honey Producers Cooperative

NZ Timber Industry Federation

NZ Wood Moulding Company Limited

Norsewear of New Zealand Ltd

Optimation New Zealand Ltd

Orion New Zealand Limited

Otago Lumber Ltd

Primeport NZ Ltd

Port of Napier Ltd

Ports of Auckland Limited

Scott Technology

Skellerup Ltd

Steelbro (NZ) Ltd

Tait Electronics Ltd

The Warehouse Group Ltd

Tumu Timbers Ltd

Waikato Federated Farmers

Weldwell (NZ) Ltd

Williams & Kettle Limited

In addition to our formal meetings with the organisations listed above, contact was also made with other companies and organisations for feedback on business conditions and particular issues relevant to our policy deliberations.

Appendix 4

Reserve Bank statements on monetary policy

OCR increased to 6.25 per cent

9 September 2004

The Reserve Bank has increased the Official Cash Rate from 6.00 per cent to 6.25 per cent. The Bank has also stated that further tightening of monetary policy is likely to be required.

Speaking at the release of the Reserve Bank's September 2004 *Monetary Policy Statement*, Reserve Bank Governor Alan Bollard said "The New Zealand economy is performing very strongly. On balance, the recent economic data has delivered positive surprises. Economic growth is near its peak, but resources will remain stretched for some time, and inflation pressures remain strong.

"In terms of the economic outlook, there are risks to consider. The consensus view in our projections is that global economic activity is expanding at a reasonable pace. However, high world oil prices and softer growth in the US could slow global economic growth. Further, if the TWI continues to rise, or if commodity prices fall sharply, our growth prospects would be weaker.

"Domestically, the economy is heavily influenced by housing activity, which we expect to continue to slow over coming months. However, if that weakening is delayed, then household spending would continue to expand at a rapid rate, fuelling inflation pressures. This could be compounded by continuing strength in the labour market.

"So far, inflation has been kept in check by the rising New Zealand dollar, which has pushed import prices lower. We expect domestic inflation to remain strong due to tight production capacity. Assuming the exchange rate is near a peak, import prices are unlikely to continue falling. As a result, even though economic growth is likely to be slowing next year, inflation is projected to increase.

"The Reserve Bank is required to keep inflation between 1 and 3 per cent 'on average over the medium term'. Also, section 4(b) of the Policy Targets Agreement requires us to minimise unnecessary instability, hence monetary policy must always be a balancing act. We are using this flexibility to the full. However, looking ahead we do not have much inflation headroom, which is why we are continuing our incremental tightening of monetary policy."

Reserve Bank increases OCR to 6.50 per cent

28 October 2004

The Reserve Bank has increased the Official Cash Rate from 6.25 per cent to 6.50 per cent.

Reserve Bank Governor Alan Bollard said "New Zealand's economy is still performing strongly and recent domestic economic data has delivered positive surprises. Resources will remain stretched for some time yet, and there are still inflation pressures.

"However, the recent monetary policy tightenings still have to work their way through the economy, and the high exchange rate will also have its effect. Given this, we believe that the current settings of monetary policy are now doing enough to ensure price stability as defined in the Reserve Bank's Policy Targets Agreement.

"The Reserve Bank will continue to monitor events as they unfold. The release of the Bank's next *Monetary Policy Statement* is scheduled for Thursday 9 December 2004.

Appendix 5

The Official Cash Rate chronology

Date	OCR (per cent)	Date	OCR (per cent)
17 March 1999	4.50	6 March 2003	5.75
21 April 1999	4.50	24 April 2003	5.50
19 May 1999	4.50	5 June 2003	5.25
30 June 1999	4.50	24 July 2003	5.00
18 August 1999	4.50	4 September 2003	5.00
29 September 1999	4.50	23 October 2003	5.00
17 November 1999	5.00	4 December 2003	5.00
19 January 2000	5.25	29 January 2004	5.25
15 March 2000	5.75	11 March 2004	5.25
19 April 2000	6.00	29 April 2004	5.50
17 May 2000	6.50	10 June 2004	5.75
5 July 2000	6.50	29 July 2004	6.00
16 August 2000	6.50	9 September 2004	6.25
4 October 2000	6.50	28 October 2004	6.50
6 December 2000	6.50		
24 January 2001	6.50		
14 March 2001	6.25		
19 April 2001	6.00		
16 May 2001	5.75		
4 July 2001	5.75		
15 August 2001	5.75		
19 September 2001	5.25		
3 October 2001	5.25		
14 November 2001	4.75		
23 January 2002	4.75		
20 March 2002	5.00		
17 April 2002	5.25		
15 May 2002	5.50		
3 July 2002	5.75		
14 August 2002	5.75		
2 October 2002	5.75		
20 November 2002	5.75		
23 January 2003	5.75		

Appendix 6

Upcoming Reserve Bank *Monetary Policy Statements* and Official Cash Rate release dates

The following is the Reserve Bank's schedule for the release of *Monetary Policy Statements* and Official Cash Rate announcements for 2005.

Thursday 27 January 2005	OCR announcement
Thursday 10 March 2005	<i>Monetary Policy Statement</i>
Thursday 28 April 2005	OCR announcement
Thursday 9 June 2005	<i>Monetary Policy Statement</i>
Thursday 28 July 2005	OCR announcement
Thursday 15 September 2005	<i>Monetary Policy Statement</i>
Thursday 27 October 2005	OCR announcement
Thursday 8 December 2005	<i>Monetary Policy Statement</i>

The announcement will be made at 9:00am on the day concerned. Please note that the Reserve Bank reserves the right to make changes, if required due to unexpected developments. In that unlikely event, the markets and the media would be given as much warning as possible.

Appendix 7

Policy Targets Agreement

This agreement between the Minister of Finance and the Governor of the Reserve Bank of New Zealand (the Bank) is made under section 9 of the Reserve Bank of New Zealand Act 1989 (the Act). The Minister and the Governor agree as follows:

1. Price stability

- a) Under Section 8 of the Act the Reserve Bank is required to conduct monetary policy with the goal of maintaining a stable general level of prices
- b) The objective of the Government's economic policy is to promote sustainable and balanced economic development in order to create full employment, higher real incomes and a more equitable distribution of incomes. Price stability plays an important part in supporting the achievement of wider economic and social objectives.

2. Policy target

- a) In pursuing the objective of a stable general level of prices, the Bank shall monitor prices as measured by a range of price indices. The price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), as published by Statistics New Zealand.
- b) For the purpose of this agreement, the policy target shall be to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term.

3. Inflation variations around target

- a) For a variety of reasons, the actual annual rate of CPI inflation will vary around the medium-term trend of inflation, which is the focus of the policy target. Amongst these reasons, there is a range of events whose impact would normally be temporary. Such events include, for example, shifts in the aggregate price level as a result of exceptional movements in the prices of commodities traded in world markets, changes in indirect taxes, significant government policy changes that directly affect prices, or a natural disaster affecting a major part of the economy.
- b) When disturbances of the kind described in clause 3(a) arise, the Bank will respond consistent with meeting its medium-term target.

4. Communication, implementation and accountability

- a) On occasions when the annual rate of inflation is outside the medium-term target range, or when such occasions are projected, the Bank shall explain in Policy Statements made under section 15 of the Act why such outcomes have occurred, or are projected to occur, and what measures it has taken, or proposes to take, to ensure that inflation outcomes remain consistent with the medium-term target.
- b) In pursuing its price stability objective, the Bank shall implement monetary policy in a sustainable, consistent and transparent manner and shall seek to avoid unnecessary instability in output, interest rates and the exchange rate.
- c) The Bank shall be fully accountable for its judgements and actions in implementing monetary policy.



Hon Dr Michael Cullen
Minister of Finance



Dr Alan E Bollard
Governor Designate
Reserve Bank of New Zealand

Dated at Wellington this 17th day of September 2002