
Monetary Policy Statement

December 2005

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 28 November 2005. Policy assessment finalised on 7 December 2005.

1 Policy assessment

The Official Cash Rate (OCR) will increase by 25 basis points to 7.25 per cent.

As emphasised in our September *MPS*, and again at the October OCR Review, we remain concerned about the tightness of resources and the persistence of inflation pressures. Exporters and other businesses exposed to the very high exchange rate are under considerable pressure and general business sector confidence is falling in the face of declining profit margins. However, overall demand continues to outstrip available capacity. The main driver of the strong demand is household spending, linked to a still-buoyant housing market. Increasing government spending and continued strong business investment are also boosting total demand. The resulting excess demand, reflected in a growing current account deficit, is continuing to fuel inflation.

Excluding one-off oil price effects, inflation has been trending upwards. Furthermore, while headline inflation is expected to return below the upper end of our target band by mid-2006, it is projected to remain high throughout the projection period. In addition, there is a risk that inflation could track higher. Mortgage credit growth and house prices have held up longer than anticipated; we are forecasting these to slow markedly in 2006, but continued strength remains a risk. The current high rates of increase in labour and other business costs present a further risk, particularly if inflation expectations become locked in at current high levels.

The main downside risk to our projections is the prospect of a faster-than-expected correction in domestic demand, leading to a harder landing for the economy and a more rapid easing of inflation pressures. A further downside risk arises if the current exchange rate strength persists, putting greater downward pressure on activity and medium-term inflation.

This outlook, combined with the lack of inflation headroom, has led us to increase the OCR today. Whether further tightening is needed will depend on the extent to which housing and demand pressures show signs of moderating over the months ahead. However, we do not yet see any prospect of a policy easing in the foreseeable future.



Alan Bollard
Governor

2 Overview and key policy judgements

Household and business demand in the New Zealand economy has been very strong in recent years, outstripping growth in the economy's productive capacity. Productive resources have become stretched and inflation pressures have increased. Abstracting from one-off oil price effects, actual inflation has been rising, as have measures of medium-term inflation expectations. Other symptoms of the excess demand have included a decline in the level of household savings and a rising current account deficit. Economic growth is now slowing, most notably in the export sector of the economy, which faces the pressure of a high New Zealand dollar. We are projecting that domestic demand will also cool over the months ahead. This will assist in reducing inflation pressures, although we expect that average annual inflation outcomes will remain close to 3 per cent over the next two years, providing policy with no headroom. In our policy deliberations we have had to confront uncertainties around the pace and composition of the slowdown, the lags between interest rate changes and inflation, and other risks to the future path of inflation.

Recent developments

The economy grew robustly over the June quarter, and at a marginally stronger pace than we anticipated in the *September Statement*. However, the composition of GDP growth continues to reflect the two-speed nature of the economy that has been evident over much of the past two years. Strong household consumption and business investment activity remain the primary drivers of growth, with activity in many parts of the tradable sector, including fishing, forestry, horticulture and manufacturing, under considerable pressure from the high exchange rate.

As discussed in Chapter 3, more recent indicators have suggested persistent strength in domestic demand:

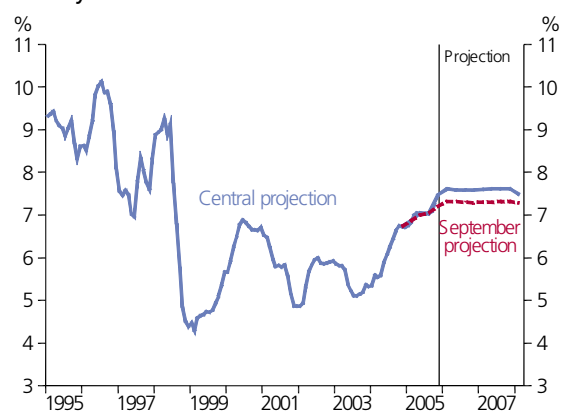
- The labour market has remained buoyant, as evidenced by very strong employment growth over the September quarter, which led to a further fall in the unemployment rate to a 20-year low of 3.4 per cent.
- Wage growth has continued to accelerate, which will fuel household incomes.

- Turnover and prices in the housing market, which have underpinned strong household demand, have remained buoyant.
- Housing lending data has remained strong, indicating a continued willingness on the part of the household sector to take on new debt.
- The survey measures of consumer confidence that have historically tracked consumer spending closely have remained at relatively high levels.

Conversely, some recent data has highlighted the continued downside pressure on tradable sector activity, the sector most exposed to the ongoing high exchange rate:

- The current account deficit continued to widen in the year to June, reflecting ongoing weakness in New Zealand's trade position against the rest of the world.
- World prices for export commodities, which have acted to cushion some parts of the export sector, have continued to ease over recent months.
- Merchandise trade statistics and visitor arrivals indicate limited growth in exports.
- Business expectations of future sales, investment and employment activity have weakened sharply, particularly in tradable industries such as manufacturing.

Figure 2.1
90-day interest rate



Source: RBNZ

Box 1

Review of monetary policy decisions

Since early 2004, monetary policy has been in a tightening phase with the Bank increasing the OCR by a total of 200 basis points from 5 per cent in January 2004 to 7 per cent by the end of October 2005.

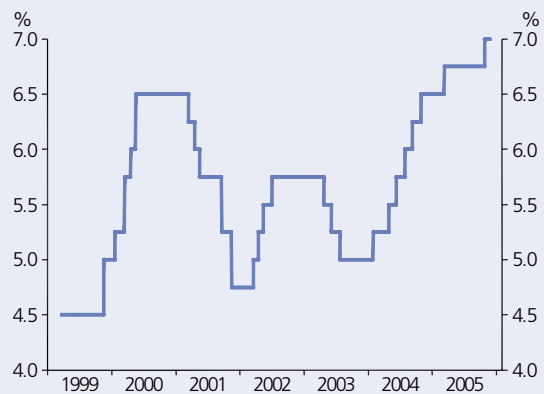
The extent of policy tightening has been greater than the Bank, its observers and the financial markets generally expected at the beginning of the cycle, and rather greater than in other countries over the same period. This largely reflects a prolonged period of strength in the domestic economy which has left productive resources severely stretched and led to a rise in non-tradables inflation. The domestic economy has been expected to slow for some time, particularly given a pronounced fall in net immigration and a cooling in tradable sector activity associated with a rising exchange rate. However, the slowdown in domestic spending has been deferred, with a marked rise in house prices and rapid growth in household borrowing continuing to fuel spending.

Our September *Statement* noted the ongoing strength in the domestic economy and highlighted the likelihood

Based on our analysis of these business surveys over recent history, it is likely that the extent of the falls in business confidence and expected activity overstates the degree to which activity is moderating. However, they are consistent with further moderation in activity going forward, particularly in the tradable sector.

The updated projection shown in Chapter 5 incorporates a starting point for the economy in which accumulated inflation pressures are stronger than we expected at the time of our September *Statement*, reflecting the recent strength in domestic demand. This in turn implies slightly stronger medium-term inflation pressures than in September. However, growth is still projected to moderate over the coming year, due to the cumulative effects of lower net immigration, the high exchange rate and the lagged effects of increases in the Official Cash Rate (OCR) over the past two years. Increasingly, the slowdown evident in

Figure 2.2
Official Cash Rate



Source: RBNZ

of a near-term spike in inflation due to a sharp rise in international oil prices. This was seen to pose a risk to ongoing wage and price inflation via its effect on inflation expectations. The *Statement* also noted the uncertainties around the future path of fiscal policy, which was expected to become more expansionary in the period ahead. These factors were emphasised again at the OCR Review in October, at which time the Bank increased the OCR by 25 basis points.

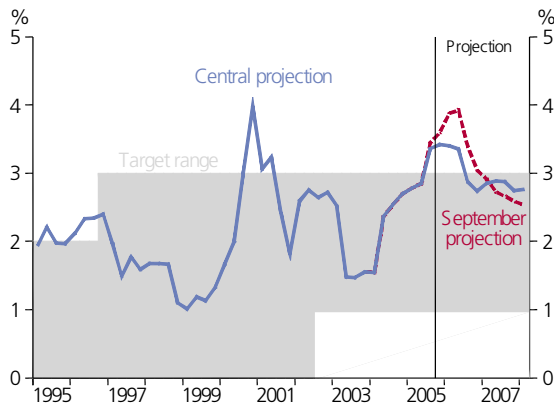
the tradable sector is expected to become reflected in the broader economy.

Our September *Statement* discussed the likelihood of a sharp rise in CPI inflation over the second half of 2005, due mainly to the sharp increases in international oil prices over the past year. Largely as projected, annual CPI inflation reached 3.4 per cent in the September quarter – above the medium term target range of 1 to 3 per cent. Of some concern, non-tradables inflation continues to remain high, with evidence that inflation pressures are becoming more widespread outside of the housing sector.

Developments in international oil prices have continued to prove volatile in the aftermath of Hurricane Katrina and Hurricane Rita in the US. Since the September quarter, oil prices have fallen more quickly than we assumed in our September projections, implying slightly lower 'headline' CPI inflation over the next few quarters, as the lower crude

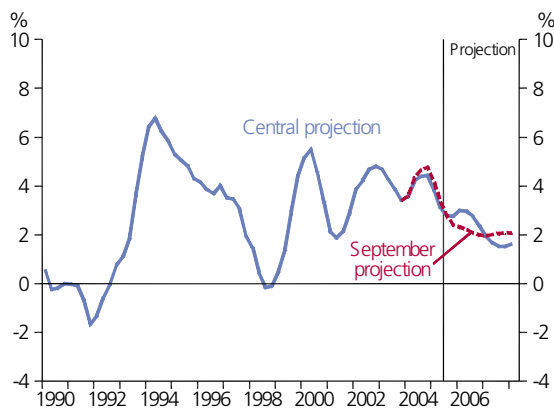
prices flow through to lower petrol prices at the pump. Consequently, we are now projecting that the CPI will remain at a peak of around 3.4 per cent over the next few quarters, compared with around 4 per cent in the September projections.

Figure 2.3
Consumer price inflation
(annual rate)



Source: Statistics New Zealand, RBNZ estimates

Figure 2.4
GDP growth
(annual average percentage change)



Source: Statistics New Zealand, RBNZ estimates

Monetary policy judgements

In September, we noted that the medium-term inflation outlook provided monetary policy with no headroom and identified a number of areas of risk to the inflation outlook. These included:

- Continued strength in housing and debt-financed household spending;
- The likelihood of a spike in CPI inflation caused by higher oil prices and the risk that this would lead to higher

medium-term inflation pressures via second round wage and price expectation effects; and

- The likelihood of more stimulatory fiscal policy following the October election.

The persistent strength of the domestic economy has been an ongoing issue for monetary policy over the past two years. In successive *Statements*, the Bank, in line with most other forecasters, has projected that domestic demand will cool. A range of factors, including a pronounced fall in net immigration and the cooling in tradable sector activity associated with the rising exchange rate, have provided solid grounds to believe that the slowdown will occur. The persistence of demand has largely reflected ongoing buoyancy in the housing market. By way of illustration, house prices in New Zealand are currently sitting around 15 per cent higher than the Bank envisaged this time last year, highlighting the difficulties inherent in forecasting asset price cycles and their influence on economic activity.

Indications of continuing strength in household spending, including rising house prices and rapid growth in mortgage lending, were an important consideration in our decision in October to increase the OCR to 7 per cent. As the Bank noted several times during October and November, strong household spending is preventing an easing of inflation pressures as well as contributing to a worsening current account deficit. We also noted that the longer adjustments in behaviour and asset prices are deferred, the more disruptive the eventual adjustment process is likely to be.

In our policy deliberations, we have continued to weigh the uncertainties around the ongoing strength of household demand and the eventual adjustment to more sustainable levels of spending. Unexpected strength in domestic demand and the associated imbalances have been features of the economy over the past two years and could persist for a while longer. The central projection described in Chapter 5 incorporates our expected adjustment path – one that is reasonably benign. Growth in household spending is projected to slow significantly over the next few years, associated with house prices levelling out at around current levels. Business investment activity also softens, although levels of investment remain relatively high. The moderation in household and business spending acts to

unwind inflation pressures. The reduction in demand, combined with a gradual depreciation of the exchange rate, also sees the current account deficit begin to narrow later in the projection horizon. A more pronounced adjustment than in the central projection is certainly possible, involving a steeper reduction in demand pressures and/or a sharper exchange rate adjustment. We will continue to re-assess the pace at which domestic demand, and the economy overall, are slowing and adjust policy settings accordingly.

There are significant lags between when increases in the OCR feed through to the interest rates faced by households and businesses. These lags mean that OCR increases undertaken since the beginning of last year are yet to fully feed through to 'effective' interest rates in the economy. The challenge here is to determine how much policy tightening remains in the pipeline and the extent to which additional tightening may be needed. If we mis-read the lags, there is a risk that policy tightening undertaken now will start to bite just at the point when domestic demand is already cooling. Conversely, avoiding policy tightening on the grounds that it may aggravate an eventual economic slowdown can allow inflation pressures to escalate to uncomfortable levels. Our recent decisions to increase the OCR reflected a view that pipeline effects from previous increases in the OCR were insufficient to stem the momentum in domestic demand.

During November, we released a terms of reference for a joint project with the Treasury to investigate whether there may be ancillary tools that the Bank could use to supplement the OCR. As noted in the terms of reference, such tools, if they exist, could potentially help to focus the impact of monetary policy on housing and reduce the pressure on the exchange rate associated with increases in the OCR. Some commentators interpreted this move as a sign that the Bank no longer has confidence in the OCR as a policy instrument. This is certainly not the case. While the OCR influences interest rates with a lag, it remains an effective lever over interest rates and is the primary instrument of monetary policy. As Chapter 4 explains, although low global interest rates have offset some of the effect of increases in the OCR over the past two years, effective interest rates have continued to edge up. Indeed, since September a rise in global interest rates has reinforced the rise in effective interest rates.

The risks to inflation expectations associated with several years of stretched productive resources, higher inflation outcomes during 2005, and recent rises in energy and labour costs continue to weigh heavily in our policy discussions. A range of surveys shows that inflation expectations have edged higher in recent months, in step with the rise in headline CPI. For example, surveyed expectations of inflation in the wider business sector appear to be hovering around 3 per cent or above, up from around 2½ per cent a year ago. These increases come at a time when the labour and product markets in many parts of the economy are stretched. From a monetary policy perspective, it would be unhelpful if higher rates of inflation expectations were to become embodied in household and business sector behaviour.

Although the recent declines in oil prices are a welcome development, there is no room for complacency around the near-term inflation outlook. There remains the possibility of upward pressure on medium-term inflation via inflation expectations. The exchange rate is expected eventually to decline in response to the large current account deficit. This will put further temporary pressure on headline inflation and could potentially affect inflation expectations.

On the fiscal front, we continue to expect fiscal policy to exert a more stimulatory effect on the economy over the next few years. Indeed, our updated projections incorporate marginally more fiscal stimulus than in September. With no inflation headroom at this point, further fiscal policy easing over and above what we have allowed for, could increase the degree of interest rate pressure required to ensure that medium-term inflation pressures are contained. We will need to assess any further initiatives carefully, taking into account the timing as well as the economic impact of changes.

Box 2 illustrates two scenarios that highlight the nature of the uncertainties policy currently faces. The first scenario describes a 'stronger for longer' domestic demand cycle, underpinned by ongoing strength in the housing market. As such, the projected slowing in domestic demand is deferred relative to the central projection. With the central projection showing no headroom around the medium-term inflation outlook, the additional inflation pressures created would require further monetary policy tightening. Accordingly, interest rates are higher than in the central projection.

Box 2

Alternative scenarios

There will always be a level of uncertainty or risk around our central projection. To illustrate this, we show two stylised scenarios, representing upside and downside risks which are seen as particularly pertinent.

Scenario 1

More momentum in the housing market and domestic demand

We expect momentum in the housing market to decline quite quickly, but see a risk of further rises in house prices before the market turns around. We nevertheless retain the view that house prices are likely to fall in real terms over the next few years; therefore any further rise would most likely be followed by a sharper correction.

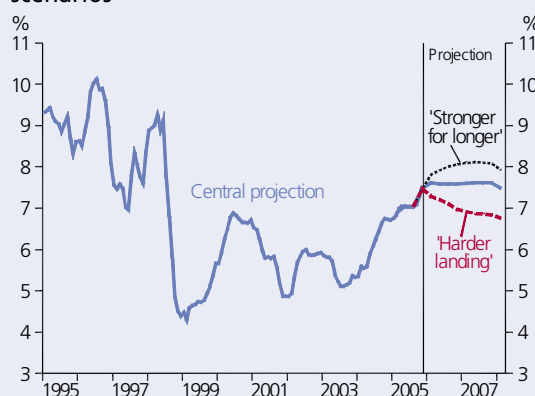
In this 'stronger for longer' scenario, house prices are assumed to be temporarily 10 per cent higher than in the central projection. Demand continues to remain strong over 2006 and most of 2007, bolstered by home owners converting increased housing wealth into consumption. This sees a further deterioration of the current account deficit. Medium-term inflation pressures are stronger and monetary policy responds by tightening further. However, the housing market eventually undergoes a sharper correction, resulting in a sharper slowdown in domestic spending. This sees the current account eventually begin to improve and inflation pressures wane.

Scenario 2

Sharper correction of economic imbalances

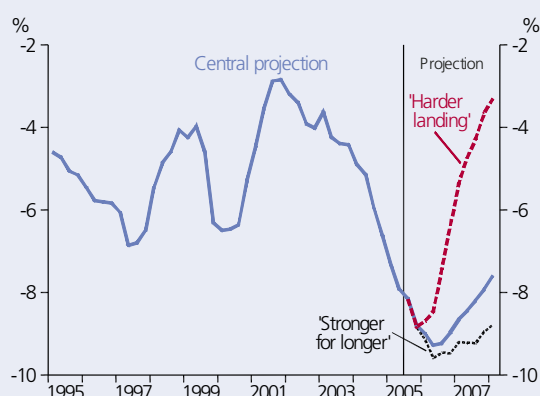
In our central projection, we have assumed a gradual decline in domestic spending and the New Zealand dollar. However, given the present economic imbalances, it is possible that a sharper correction could occur. The 'harder landing' scenario assumes a sharper fall in both the exchange rate and domestic spending. Relative to the central projection, medium-term inflation pressures would be weaker allowing for a lower interest rate profile. The current account position improves more markedly given the sharp decline in domestic spending.

Figure 2.5
90 day interest rates under alternative scenarios



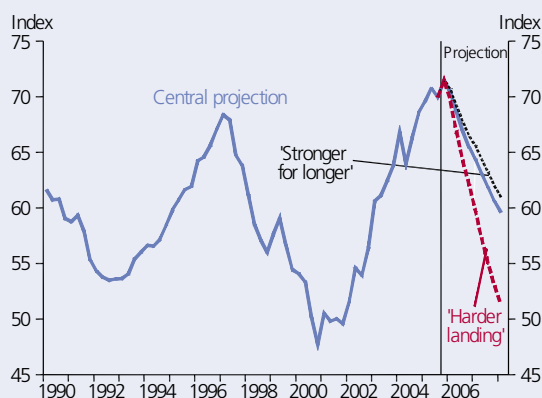
Source: RBNZ

Figure 2.6
Current account under alternative scenarios (per cent of nominal GDP)



Source: Statistics New Zealand, RBNZ estimates

Figure 2.7
TWI under alternative scenarios



Source: RBNZ

In the second scenario, we examine a faster adjustment to the current imbalances, under which household and business spending decline more quickly than in the central projection and the exchange rate falls away more abruptly. The reduction in spending works in favour of reducing domestic inflation pressures but the sharper exchange rate depreciation temporarily boosts tradables inflation. It is difficult to realistically prescribe a forward interest rate track

when assuming such abrupt changes in economic behaviour. Nevertheless, in this particular scenario, there would be scope for lower interest rates due to the weaker medium-term inflation pressures. Although monetary policy would endeavour to look through a temporary rise in tradables inflation due to a falling exchange rate, the extent it could do so would depend on whether inflation expectations remained well anchored.

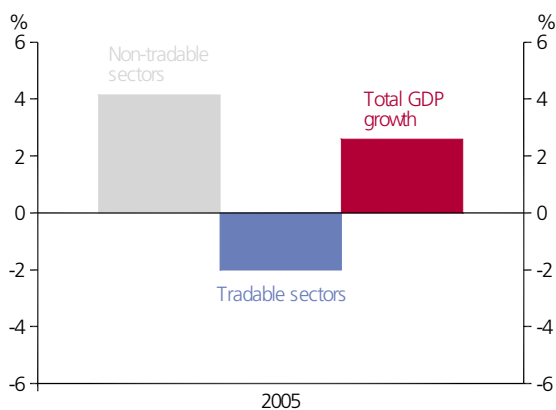
3 The recent economic situation

Overview

Domestic demand was again robust in the June quarter and continues to be the key source of economic growth and non-tradables inflation pressure in the New Zealand economy. The level of domestic demand continues to be greater than the economy's supply capacity. And although growth in domestic demand shows tentative signs of slowing, domestic productive resources have been highly stretched for some time. Consequently, part of this strong domestic demand has been met by imports. The high exchange rate has further encouraged import demand, while also contributing to the weakness in exports.

GDP growth was robust in the June quarter as the economy expanded 1.1 per cent. This continued the period of relatively robust growth the New Zealand economy has experienced in recent years. Growth in the June quarter was slightly stronger than we had anticipated in the September *Statement*, led by strong investment and consumption spending. However, import growth was again greater than export growth, with the June quarter being the ninth consecutive quarter that net exports have detracted from aggregate GDP growth.

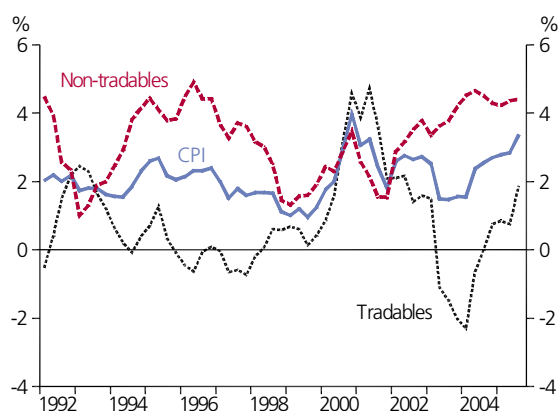
Figure 3.1
Tradable and non-tradable GDP growth
(annual per cent change year to June)¹



Source: Statistics New Zealand, RBNZ calculations

¹ Tradable sector GDP comprises agricultural production, manufacturing production and exports of services. Non-tradable sector GDP is defined as aggregate production GDP less tradable sector GDP.

Figure 3.2
Tradables and non-tradables CPI inflation
(annual per cent change)



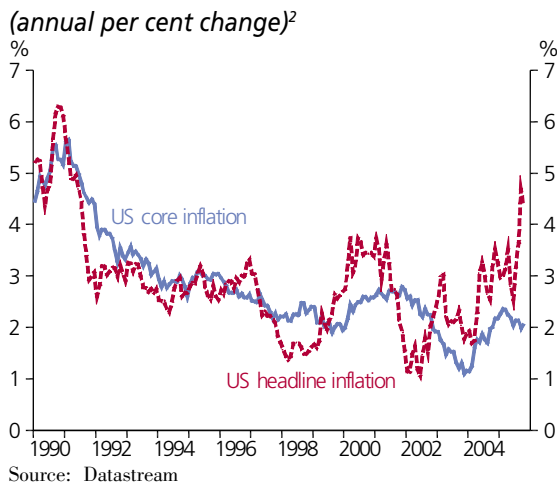
Source: RBNZ, Statistics New Zealand

Global economic developments

Growth in the economies of our key trading partners moderated over the last 12 months and is expected to remain around trend. Individual country developments vary widely. Prospects in Japan are improving, with the domestic demand-led recovery appearing more sustainable. Growth in China and other non-Japan Asian countries has continued to exceed expectations. Demand conditions appear to be improving from below-trend rates in the UK and in some regions of Europe. Australia's domestic demand slow-down continues, while strong growth in the US is expected to moderate as higher interest rates begin to slow activity.

US growth has been surprisingly robust – despite the disruption in activity caused by Hurricanes Katrina and Rita in the third quarter. GDP growth in the September quarter was driven by strong consumer and government spending. And while the effects of high oil prices (caused in part by the twin hurricanes) are evident in headline measures of inflation, they appear so far to have had only a limited impact on core inflation and consumer demand. This is despite headline inflation having remained above core CPI (excluding energy and food) for an extended period of time (figure 3.3, overleaf).

Figure 3.3
US Inflation



In Australia, domestic demand has continued to moderate. Softer labour market conditions, slowing house price inflation and higher energy prices have combined to slow household spending. Despite the rising energy prices, inflation appears to remain relatively contained. Third quarter CPI inflation rose less than expected and various measures of underlying inflation have remained relatively subdued.

Japan's recovery continued into the third quarter, underpinned by surprisingly strong consumer spending and business investment. Strong corporate profitability has supported a rise in business confidence, while there has also been a gradual improvement in consumer confidence. The export outlook for electrical machinery is also looking more upbeat with recent improvements in world IT demand.

Growth in China and other non-Japan-Asian countries continues to exceed expectations. Chinese annual GDP growth was 9.4 per cent in the third quarter, sustained by strength in net exports and investment. Other countries in Asia continue to benefit from ongoing strength in the Chinese economy, with export growth accelerating in most countries.

Tradable sector activity

Activity in the tradable sector over the last few years has been strongly influenced by the marked appreciation in the New

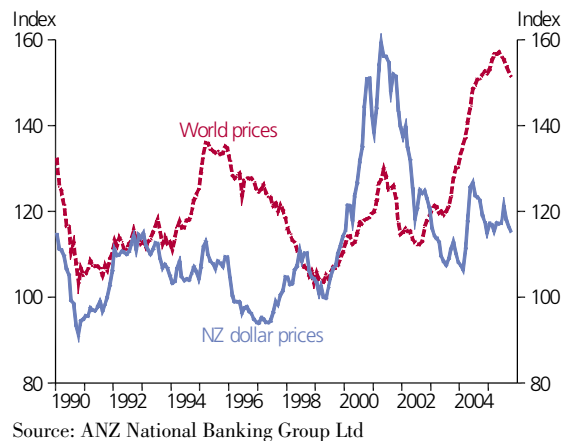
Zealand dollar. While this has obviously had a negative impact on exporters, the impact on some commodity exporters has been offset to a degree by high world commodity prices.

Figure 3.4
Exports of goods as a percentage of GDP



In response to strong global demand, world commodity prices increased strongly over 2004 and early 2005. Recently however, world commodity prices for key New Zealand exports have started to moderate. There has been a substantial decline in world prices for apple exports. The development of new apple varieties by international competitors has caused a collapse in the apple export market. International beef prices have eased as US production has increased. However, dairy prices have stabilised near their peaks for most of 2005, helping to keep aggregate commodity export prices high.

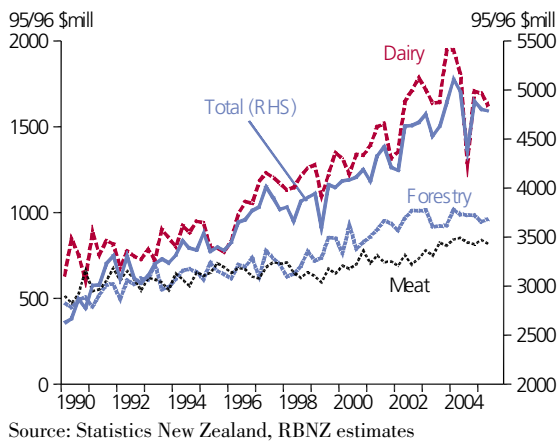
Figure 3.5
ANZ commodity prices



² Core measure of inflation excludes food and energy.

Despite solid world commodity prices, primary export volumes have been weak, particularly in late 2004 (figure 3.6). This reflects a poor dairy production season. Growth in meat exports also slowed considerably in 2004/2005 after two very good seasons where farmers took advantage of very high international prices. Forestry exports have been subdued as log exports have plummeted and exports of timber products (which are closely linked to the fortunes of the Australian housing market) have slowed.

Figure 3.6
Commodity export volumes
(quarterly total)



The effects of the sustained appreciation of the New Zealand dollar on the manufacturing sector have been twofold. While there has nonetheless been sustained volume growth in manufactured exports, the appreciation in the exchange rate has dampened exporters' incomes (figure 3.7). Domestically, the high TWI has encouraged import competition and therefore has reduced domestic production of manufactured goods (figure 3.8).

The strong New Zealand dollar has also been a key factor behind weak exports of services. Despite continued growth in tourist arrivals during 2005, exports of services fell sharply in the March quarter (figure 3.9). In addition to the negative impact from the high TWI, exports of services have also been dampened by the compositional shift towards a greater number of Australian tourists. These tourists typically stay for shorter periods and have a lower overall spend.

Exports of services recovered somewhat in the June quarter, and are likely to continue to recover in the

Figure 3.7
Non-commodity manufactured exports volumes and values
(annual average per cent change)

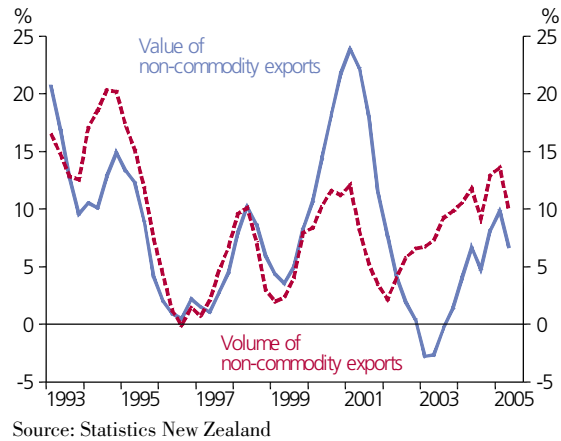


Figure 3.8
Manufactured production and exports
(annual average per cent change)

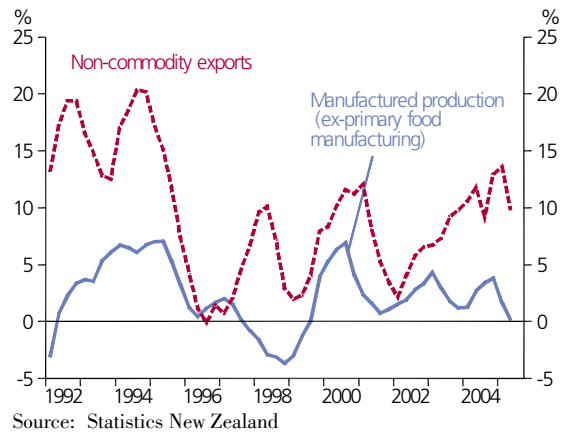
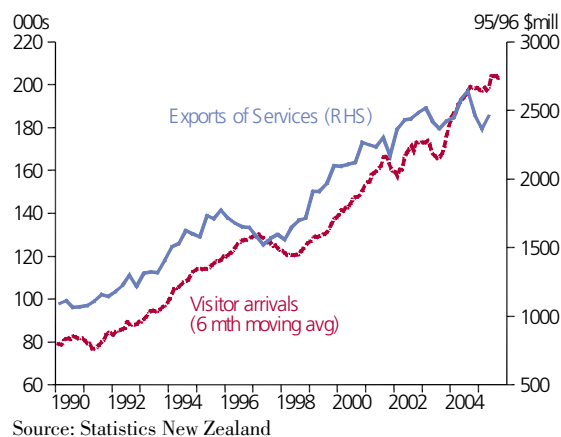


Figure 3.9
Exports of services



September quarter. This is a result of the large contingent of Lions rugby supporters, who arrived in New Zealand in late June and early July. Despite this one-off boost, the high level of the TWI is likely to continue to depress the average spend-per-tourist.

The flip side to a high New Zealand dollar and declining export performance has been strong import growth. Import volume growth accelerated rapidly over 2004 as domestic demand picked up and the exchange rate appreciated.

Imports of both capital and consumer goods have been strong. Demand for imported consumer goods, particularly durable goods, has in part been fuelled by strong activity in the housing market (figure 3.10). Similarly, strong investment

Figure 3.10
House price inflation and imports of durables
(annual average per cent change)

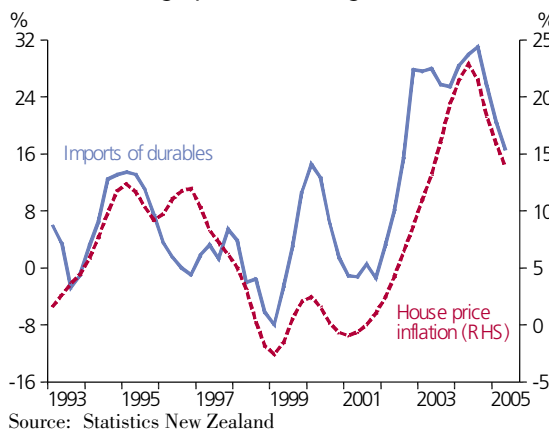
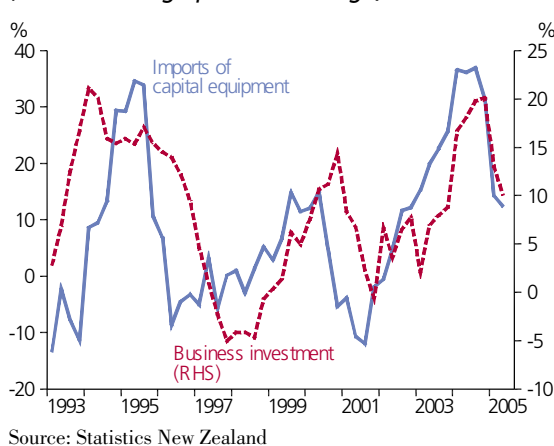


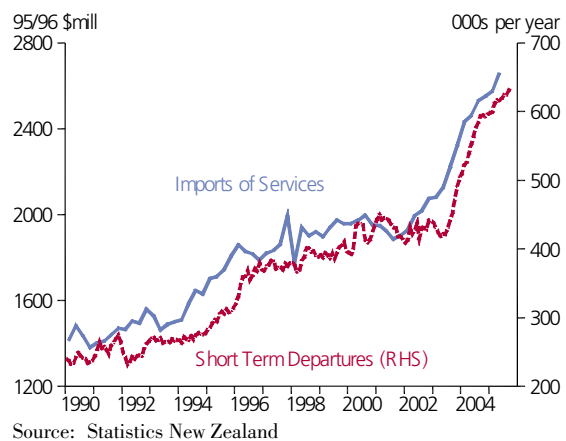
Figure 3.11
Business investment and imports of capital equipment
(annual average per cent change)



spending by firms over this period has lifted imports of capital goods (figure 3.11).

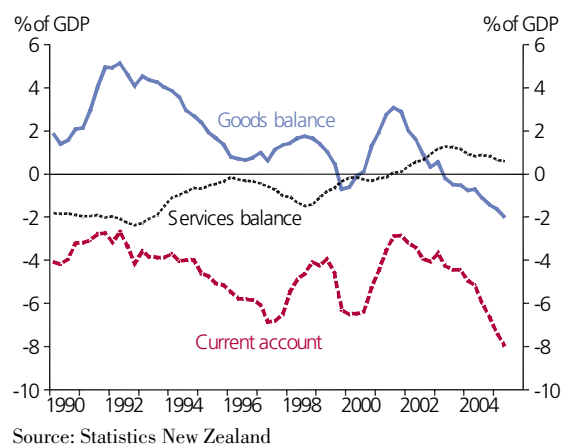
Imports of services have also grown strongly over the past 18 months, due largely to more New Zealanders holidaying abroad (figure 3.12). This trend has been encouraged by factors such as the high exchange rate, cheap trans-Tasman airfares and strong employment and labour income growth.

Figure 3.12
Short-term departures and imports of services



With very strong imports and weak exports, New Zealand's trade balance has deteriorated considerably since 2002, contributing to an expanding current account deficit. In the June quarter, the current account deficit reached 8 per cent of GDP.

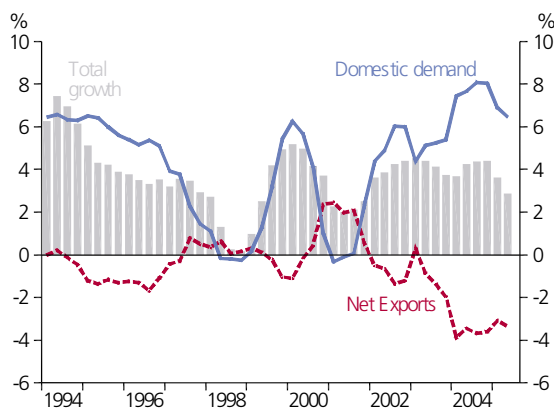
Figure 3.13
Annual current account, goods and services balances



Domestic demand

Recent GDP outturns have emphasised the dichotomy between the non-tradable and tradable sectors. Growth in the export sector has been weak, while domestic demand has remained the key driver of aggregate growth (figure 3.14). Strong domestic demand has been due to a combination of factors. A buoyant housing market and strong employment and wage growth have supported domestic consumption. In turn, business investment has been strong, supported by rising domestic demand, strong profit growth, a tight labour market, high capacity utilisation and a favourable exchange rate for importing capital equipment.

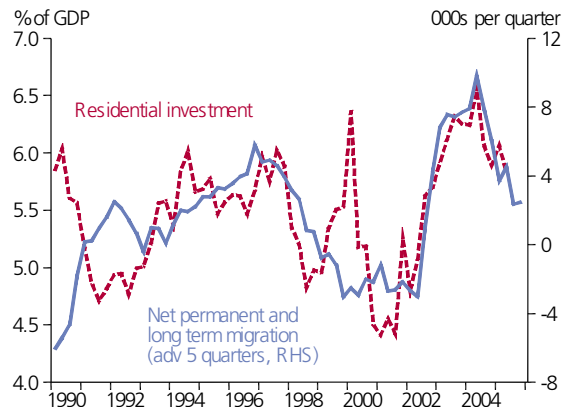
Figure 3.14
Contributions to GDP growth
(annual per cent change)³



Following strong migration inflows over 2003, residential investment rose, reaching a cyclical peak in mid-2004 (figure 3.15). But since then, residential investment has cooled. A spike in residential investment in the March quarter this year appears to have been temporary and forward indicators, such as house sales and building consents, have eased from their peaks.

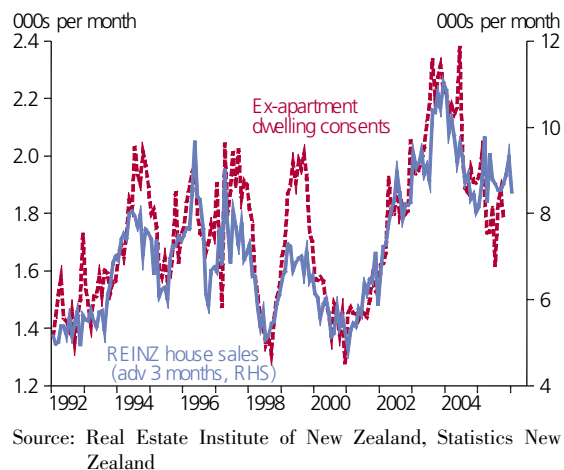
Despite this easing, during 2005 there has been a divergence between two forward indicators for residential investment (figure 3.16). Dwelling consents, affected significantly by the introduction of the new Building Act, have fallen much more sharply than the volume of house sales, which has trended sideways over 2005. However, the most recent data shows this gap between consents and

Figure 3.15
Residential investment and migration



Source: Statistics New Zealand

Figure 3.16
REINZ house sales and ex-apartment dwelling consents



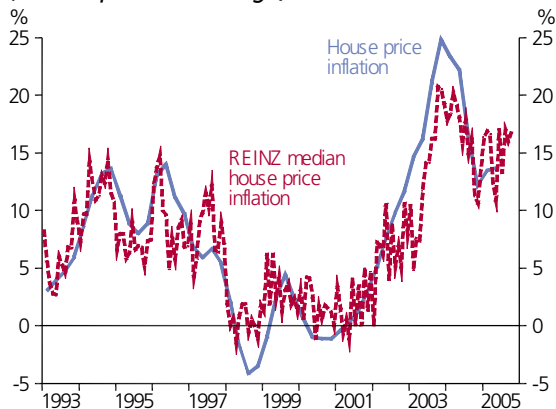
Source: Real Estate Institute of New Zealand, Statistics New Zealand

house sales closing – from both sides. Dwelling consents have rebounded from their lows and house sales have moderated somewhat.

In step with strong residential investment, house price inflation accelerated over 2003 and the first half of 2004, before moderating over late 2004. However, in early 2005 house price inflation picked up again – at least partly in response to the lower mortgage rates being offered by banks at the time. Since then, REINZ median house prices and the QV provisional monthly house price series have shown surprising resilience, with these measures of house price inflation remaining at high levels (figure 3.17, overleaf).

³ Domestic demand is calculated as GDP less net exports.

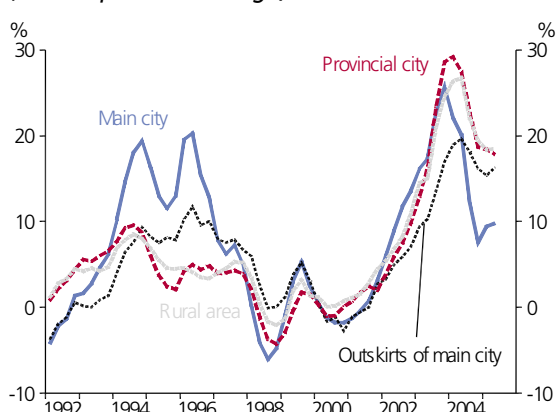
Figure 3.17
REINZ and QV house prices
(annual per cent change)



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

This persistence in house price inflation may in part reflect the geographically broad-based nature of the current house price cycle. Strong house price increases are being recorded in provincial cities and rural areas and not just in the main cities (figure 3.18). Indeed, the contrast between the current and mid-1990s cycle has been the extent to which house prices have increased outside the main urban regions.

Figure 3.18
Regional house price inflation
(annual per cent change)

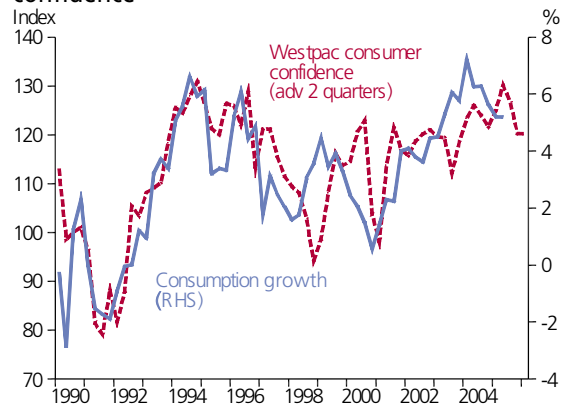


Source: Quotable Value New Zealand, RBNZ calculations

Combined with robust consumer confidence, low unemployment and strong wage growth, housing-based wealth gains have supported consumption growth over 2004 and the first half of 2005. Over much of this period, annual growth rates of consumption have been above 5 per cent. Although the rate of growth has slowed a little in the first half of 2005, it remains high historically.

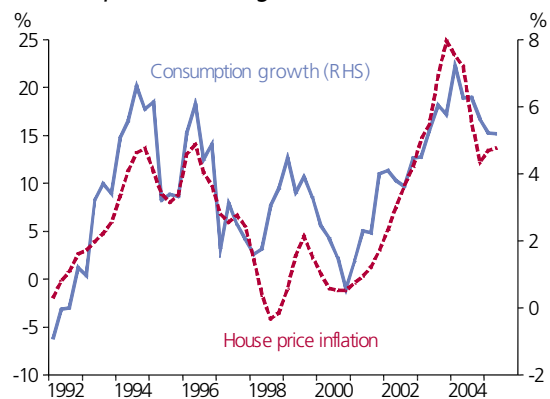
The recent sharp fall in the monthly Colmar-Brunton measure of consumer confidence indicates some downside risk to consumption growth going forward. However, historically this series has not correlated as closely to consumption growth as confidence measures from the quarterly Westpac McDermott Miller survey, and the more recent fortnightly Roy Morgan Survey. These measures of consumer confidence have not fallen as sharply as the Colmar-Brunton measure.

Figure 3.19
Annual consumption growth and consumer confidence



Source: Westpac McDermott Miller, Statistics New Zealand

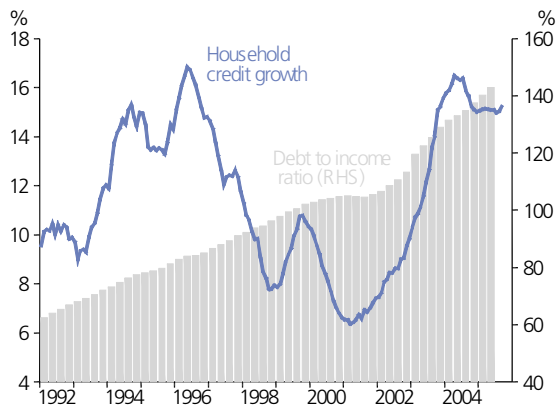
Figure 3.20
Consumption growth and house price inflation
(annual per cent change)



Source: Statistics New Zealand, Quotable Value New Zealand

As well as solid income growth, consumption has been supported by households' willingness to take on more debt. The debt-to-income ratio has continued to climb and in 2005 reached over 140 per cent of disposable income. Annual credit growth has slowed from its 2004 peaks but remains at a high level (figure 3.21).

Figure 3.21
Household debt and annual credit growth

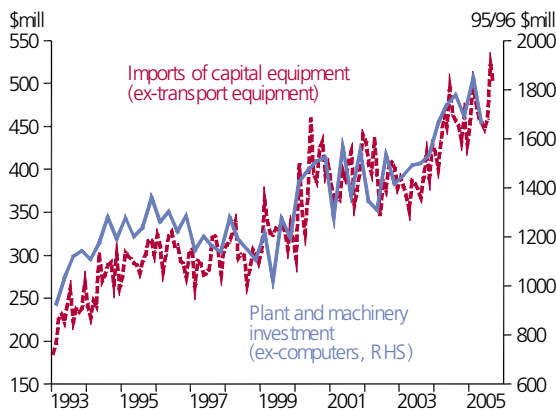


Source: RBNZ

The strong growth in the domestic economy over recent years has not been confined to just the household sector. Business investment has also grown strongly. Solid domestic demand, high levels of capacity utilisation and a tight labour market have all encouraged firms to undertake more investment. In addition, the high New Zealand dollar has made imported capital goods cheaper for New Zealand firms. And while investment growth has moderated from its peaks, the most recent import data shows capital imports surged again in the September quarter, indicating continued growth in plant and machinery investment in the September quarter (figure 3.22).

Non-residential investment has also escalated over 2004 and the first half of 2005, being boosted in the June quarter

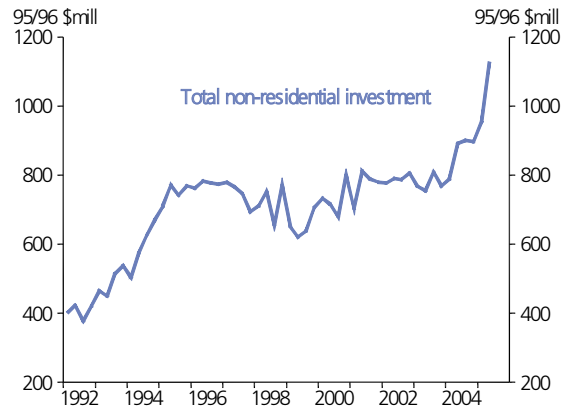
Figure 3.22
Market plant and machinery investment and imports of capital goods



Source: Statistics New Zealand

by a very large increase in non-market (mainly government) construction activity. Forward indicators, such as building consents and cement sales, suggest ongoing robust activity in this sector.

Figure 3.23
Total non-residential investment
(quarterly volume)



Source: Statistics New Zealand

While business investment to date has been strong, sharp falls in some measures of business confidence provide a downside risk to business investment growth going forward. Falling confidence is likely to reflect declining profitability, as well as increased uncertainty about the outlook for the economy.

Fiscal Policy

The most recent complete set of available Treasury forecasts is contained in the *Pre-Election Economic and Fiscal Update* (PREFU). These estimates were prepared prior to the September election. The *PREFU* indicated that fiscal policy was a contractionary force on the economy over the past year but would become a positive stimulus in the future. Since the election, new spending initiatives have been confirmed by the government, in particular the expansion of the Working for Families programme and the removal of interest on student loans.

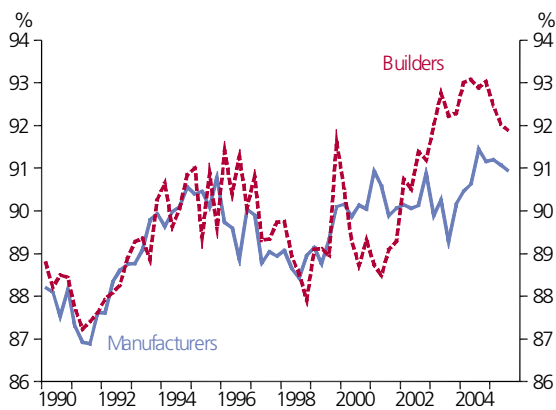
An estimate of the Working for Families impact has been included in these projections and all other new initiatives are assumed to be funded from existing Budget provisions. However, no allowance has been made for any increased uptake of student loans.

Productive capacity

A period of strong domestic demand growth has led to New Zealand's productive capacity becoming very stretched. However, there have been some signs in recent quarters that the degree of pressure on productive resources has eased marginally. Measures of capacity utilisation have retraced from their 2004 highs and survey measures have shown labour and capital becoming less limiting factors of production (figure 3.24 and 3.25). Overall, however, the economy continues to operate in a situation of excess demand.

Figure 3.24

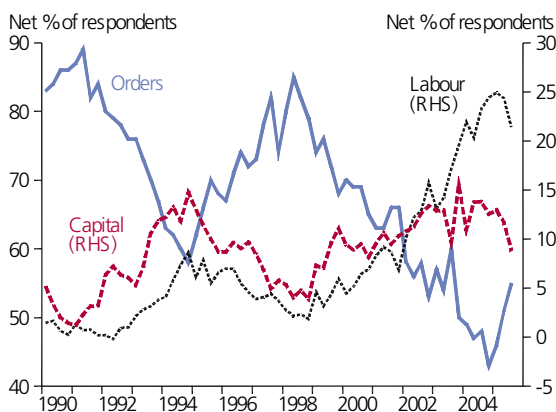
Capacity utilisation



Source: NZIER

Figure 3.25

Factors limiting increased production (labour, capital and orders)



Source: NZIER

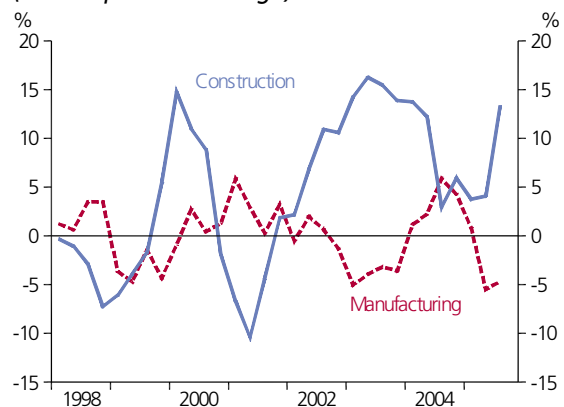
The labour market and wages

The labour market remains very tight and has shown continued strength in 2005. Demand for labour resources remains intense.

Most recent data for the September quarter showed very strong employment growth. Growth has been strongest in the services sector, and particularly in the construction sector. Conversely (and in contrast to aggregate employment trends), employment in the manufacturing sector has declined over 2005 (figure 3.26). This has mirrored the sectoral trends in the activity data.

Figure 3.26

Manufacturing and construction sector employment growth (annual per cent change)

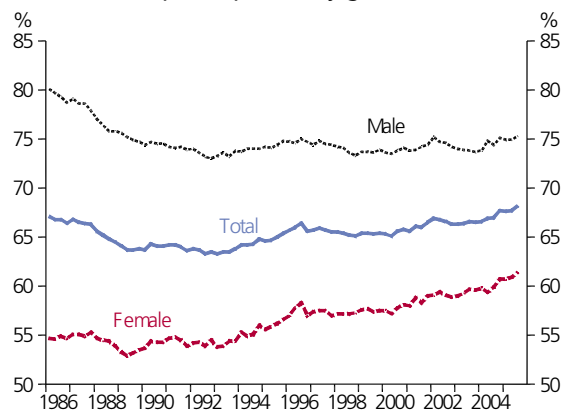


Source: Statistics New Zealand

Recent increases in employment growth have been accompanied by record high levels of labour force participation. Cyclical increases in labour force participation have occurred as favourable employment prospects and strong wage growth have enticed people into the labour force. Participation has been further boosted by ongoing structural changes, the most noticeable being increased participation by females and by older people (figure 3.27, 3.28).

Figure 3.27

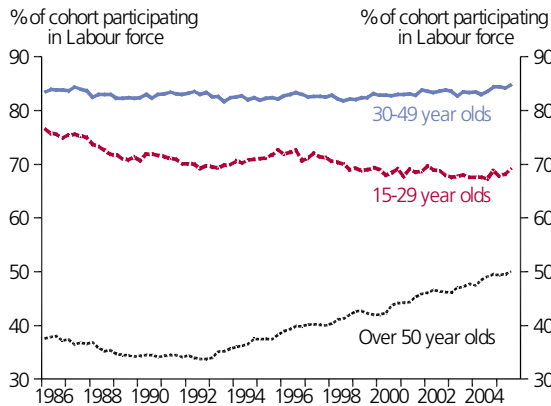
Labour force participation by gender



Source: Statistics New Zealand

Figure 3.28

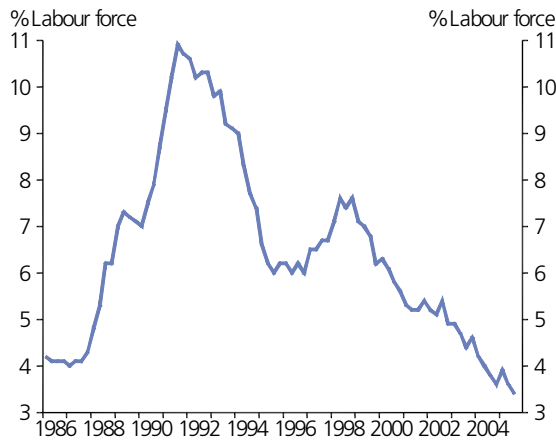
Labour force participation rate by age group



Source: Statistics New Zealand, RBNZ estimates

Figure 3.29

Unemployment rate



Source: Statistics New Zealand

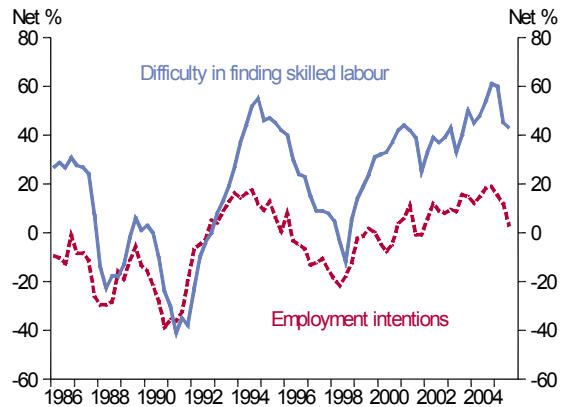
Despite these increases in the participation rate, the unemployment rate has fallen to a 20-year low as employment growth has outpaced participation growth (figure 3.29).

Looking forward, there are a few tentative signs of an easing trend in labour market pressure. In particular, employment intentions have fallen, the measure of firms' difficulty finding skilled and unskilled labour has reduced, and labour as a limiting factor has retreated from its record highs (figure 3.30).

The tight conditions in the labour market have led to rapid growth in wage inflation. The number of respondents in the Labour Cost Index survey reporting annual wage increases over 3 per cent has steadily increased, reaching a record high in the most recent September quarter (figure 3.32).

Figure 3.30

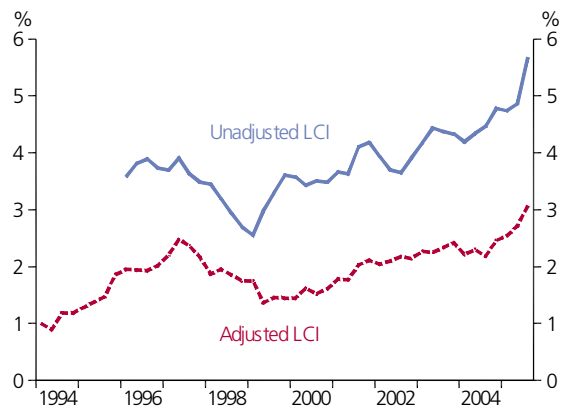
Difficulty finding skilled labour and employment intentions



Source: NZIER

Figure 3.31

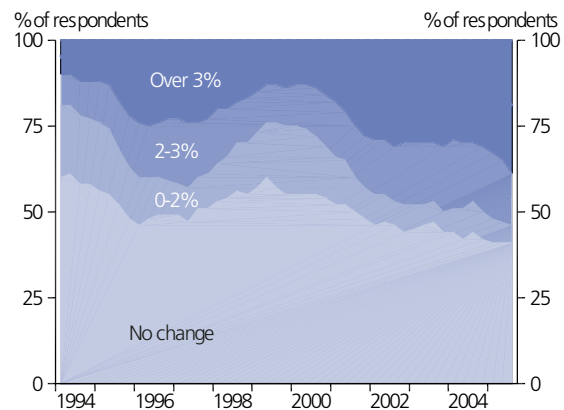
Adjusted and unadjusted Labour Cost Index (annual per cent change)



Source: Statistics New Zealand

Figure 3.32

Distribution of annual wage increases



Source: Statistics New Zealand

Box 3

Petrol and energy prices in the CPI

Despite having relatively low weights in the CPI, both energy and petrol costs have been significant contributors to recent increases in consumer prices. These prices have increased significantly over the past three years, rising at rates well above that of headline CPI inflation.

Increases in petrol prices have been large and volatile. As such, petrol price increases have at times had a significant impact on headline CPI inflation. For example, the increases in petrol prices in the wake of recent hurricanes off the Gulf coast of America caused a sharp rise in CPI inflation in the September quarter.

In contrast, increases in energy (electricity and gas) prices have been less dramatic but more persistent. Energy prices have been rising steadily and strongly for some time as New Zealand has become more dependent on higher-cost sources of electricity generation.

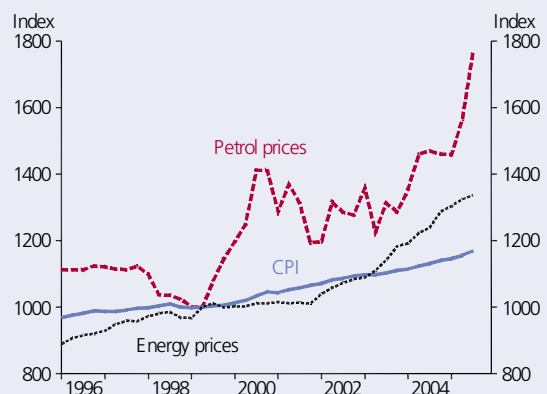
Looking ahead, there is likely to be a continuation of steadily rising electricity prices, given the shift towards higher costs of generation and distribution. On the other hand, international oil prices are expected to fall back to levels more consistent with estimates of the long-run marginal cost of oil production.

Some central banks look at consumer prices excluding volatile items such as petrol prices. This allows them to focus on underlying or persistent price pressures, rather than short-term contributors to inflation volatility. In New Zealand the Policy Targets Agreement (PTA) directs the Bank to focus on headline CPI on average over the medium term. This medium-term focus allows the Bank to effectively look through any short-term variation in inflation such as that caused by oil price spikes. Policy will respond to more persistent trends, such as the energy

price movements, although this will be offset to some extent by other negative price trends, such as in the price of computers.

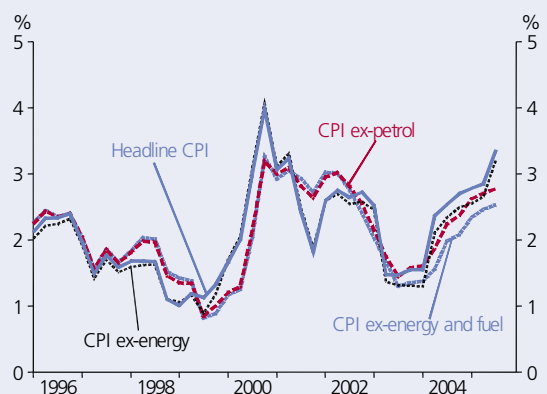
While petrol and energy price increases have been a significant contributor to higher CPI inflation, rising inflation pressure is also evident elsewhere. Even excluding electricity and fuel costs, inflation has been rising steadily over the past 18 months.

Figure 3.33
Petrol and energy price levels
(Index = 1000 at 1999)



Source: Statistics New Zealand

Figure 3.34
Headline inflation and measures excluding fuel and energy cost



Source: Statistics New Zealand

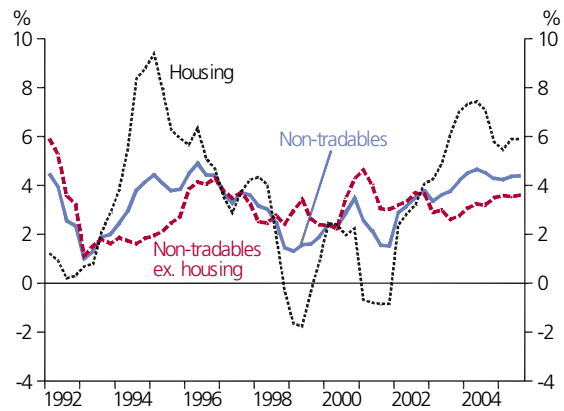
Inflation pressures

In the September quarter, annual CPI inflation rose above the top of the 1 to 3 per cent target band, reaching 3.4 per cent. One reason for this was a sharp rise in annual tradables inflation, which picked up to 1.9 per cent as a result of increases in petrol prices during the quarter. These increases brought the annual increase in the petrol component of the CPI to 20 per cent.

Also contributing to high headline inflation has been persistently high non-tradables inflation. With domestic productive capacity remaining stretched, annual non-tradables inflation has remained above 4 per cent since early 2004. While a significant component of non-tradables inflation has been related to the housing group in the past few years, non-tradables inflation excluding housing has also been steadily trending higher over 2004 and 2005 (figure 3.35). In addition, alternative measures of non-tradables

Figure 3.35

Non-tradables inflation excluding housing (annual per cent change)



Source: Statistics New Zealand, RBNZ

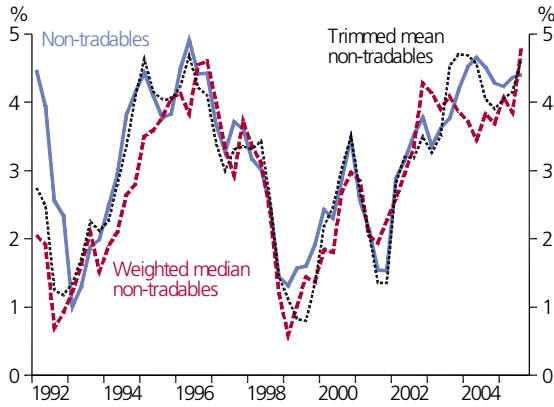
inflation, such as the trimmed mean and weighted median measures, have also risen recently – suggesting more broad-based non-tradables inflation pressure across the economy.

Table 3.1

CPI and other price measures (annual per cent change)

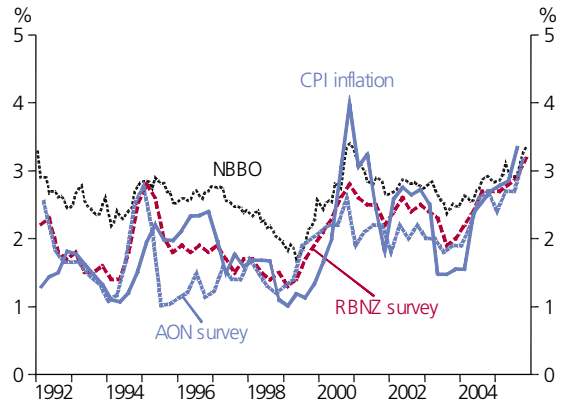
	2004				2005		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep
CPI	1.5	2.4	2.5	2.7	2.8	2.8	3.4
Food	0.5	1.1	0.5	1.2	1.5	1.1	1.6
Housing	7.0	7.1	6.7	5.6	5.4	5.7	5.7
Household operations	1.4	1.5	1.0	1.4	1.9	1.8	1.8
Apparel	-1.0	-0.8	-0.4	-0.3	-0.6	-0.3	0.0
Transportation	-4.6	-0.6	1.5	3.3	1.9	2.6	5.8
Tobacco and alcohol	2.9	3.2	4.2	3.7	4.2	4.0	2.2
Personal and health	2.7	2.7	2.7	2.6	2.7	2.7	3.0
Recreation and education	2.0	1.4	1.5	1.8	2.3	2.3	2.4
Credit services	-0.9	0.8	-0.2	-4.9	4.4	0.8	3.0
Derivatives and analytical series							
CPI ex food, petrol and government charges	1.2	1.4	2.3	2.5	2.6	3.0	2.8
CPI ex energy and fuel	1.4	1.6	2.0	2.1	2.3	2.5	2.5
CPI non-tradables	4.5	4.7	4.5	4.3	4.2	4.4	4.4
CPI tradables	-2.3	-0.7	0.0	0.7	0.8	0.7	1.9
CPI weighted median (of annual price change)	2.1	2.6	2.6	2.9	3.3	3.1	3.2
CPI trimmed mean (of annual price change)	2.0	2.6	2.6	2.9	3.0	2.9	3.2
Merchandise import prices (excluding petrol)	-10.6	-5.9	-5.8	-4.8	-1.5	-5.3	n/a
PPI - Inputs	-0.6	1.5	2.5	3.4	4.2	4.7	6.1
PPI - Outputs	0.9	1.9	2.4	2.6	3.2	3.0	4.1
Private consumption deflator	0.5	1.2	0.6	1.1	1.3	0.9	n/a
GDP deflator (derived from expenditure data)	2.7	3.7	4.4	4.0	3.1	2.8	n/a
Retail trade deflator	-0.6	0.8	0.5	0.7	1.4	1.0	2.4

Figure 3.36
Trimmed mean and weighted median non-tradables inflation
(annual per cent change)



Source: Statistics New Zealand, RBNZ estimates

Figure 3.37
One-year-ahead inflation expectations



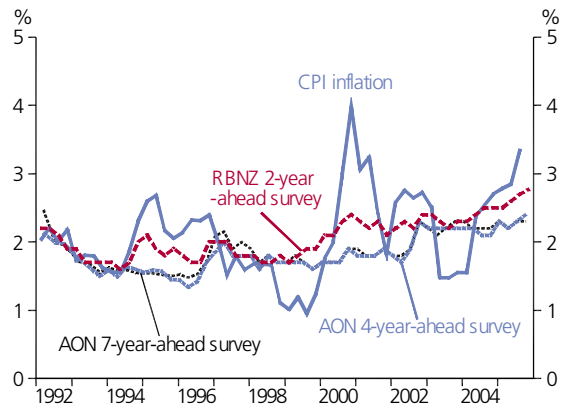
Source: National Bank of New Zealand, Statistics New Zealand, RBNZ, AON Consulting

Inflation expectations

A temporary increase in headline CPI inflation above 3 per cent does not constitute a breach of the PTA, as the Bank is required to keep inflation between 1 and 3 per cent on average over the medium term. However, rising headline inflation is of concern if it feeds through into households' and firms' everyday wage and price-setting behaviour. It is undesirable for people's expectations of medium-term inflation to settle near the top of the target range.

While medium-term inflation expectations are difficult to accurately gauge, surveyed measures of inflation expectations can provide some insight. Over 2005, one-year-ahead inflation expectations have drifted up as headline inflation has moved higher (figure 3.37). More recently, longer-term inflation expectations (two to seven years ahead) have also started to rise (figure 3.38). Some of these measures are now at their highest levels since the early 1990s.

Figure 3.38
Longer-term inflation expectations



Source: Statistics New Zealand, AON consulting, RBNZ

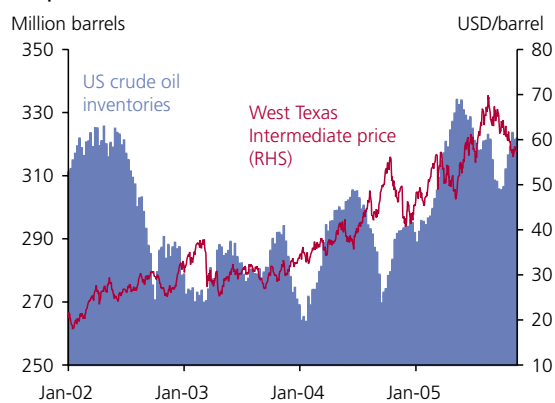
4 Financial market developments

International markets

The fears associated with high oil prices and US economic disruption from Hurricanes Katrina and Rita that were dominating global market attention in the lead up to the September Statement have dissipated. US economic activity has generally remained robust and the hurricane-related disruptions are increasingly being seen as temporary.

An important component of the increased global market confidence has been some retracement in oil prices from their highs in late August. This has reflected a range of developments, including a significant build-up in US oil inventories (figure 4.1) and better-than-expected weather at the start of the North American winter. Consequently, there has been some reduction in the 'supply risk premium' built into oil prices around the time of the hurricanes. However, with the global oil supply/demand balance remaining relatively tight, there is no guarantee that the recent downtrend in oil prices will continue.

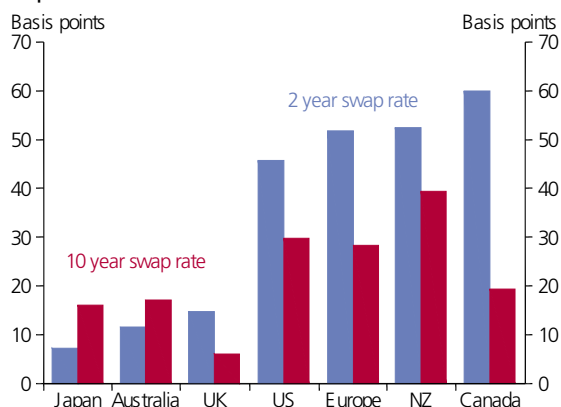
Figure 4.1
Oil prices and US crude oil inventories



Source: Bloomberg

Against this background, market interest rates have risen globally over the past couple of months (figure 4.2). Improved confidence in the economic outlook has been accompanied by heightened inflation fears. These fears have increased the prospects of monetary policy tightening in a range of major economies – underpinning shorter-term interest rates. In particular, the US Federal Reserve has continued to raise its policy rate and further increases are expected by the market over late 2005/early 2006. Longer-term interest rates have also risen, albeit to a more limited extent than shorter-term rates in most major economies.

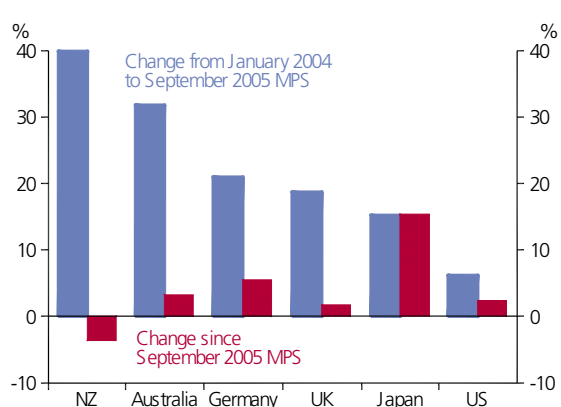
Figure 4.2
Movements in wholesale interest rates since the September Statement



Source: Bloomberg

Consistent with a sense of increased optimism surrounding the outlook for global growth, most major equity indices have risen since September (figure 4.3). Better-than-expected economic data, lower oil prices and generally solid US September quarter corporate earnings have overshadowed concerns about the potential impact of higher borrowing costs on corporate profitability. The Japanese sharemarket has gained the most ground over this period, reflecting increased confidence in a sustained Japanese recovery and progress on economic reform. In contrast, after being one of the strongest performers during the past two years, the New Zealand market has weakened over the past couple of months. While the NZSE50 is still around 10 per cent higher than at the start of the year, the market appears to be starting to factor in a period of slower growth ahead.

Figure 4.3
Movements in sharemarkets



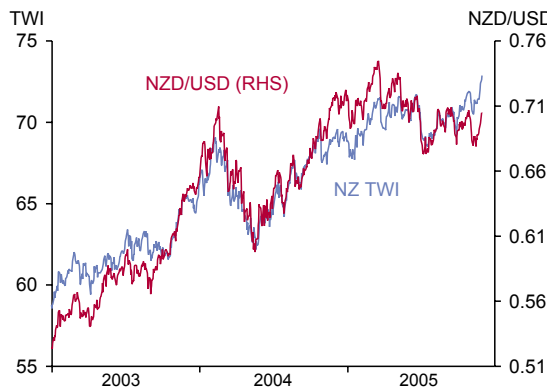
Source: Bloomberg

Exchange rates

Supported by US interest rates rising to a greater extent than those in the other major economies, the US dollar has risen since the September *Statement*. While this has put some downward pressure on the NZD/USD exchange rate, the New Zealand dollar Trade Weighted Index has remained strong (figure 4.4). Despite the growing imbalances reflected in the widening current account deficit, New Zealand's relatively high interest rates have continued to underpin the New Zealand dollar against a range of currencies.

Figure 4.4

NZ Trade Weighted Index and NZD/USD cross rate

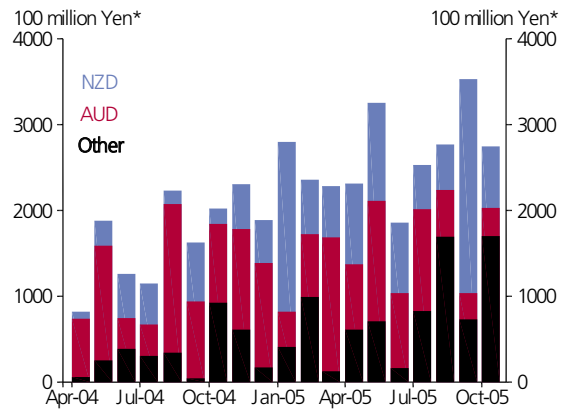


Source: Bloomberg

Issuance of New Zealand dollar-denominated securities in offshore markets has continued at a strong pace – particularly Uridashi bonds in the Japanese retail market. While these bonds constitute only one of many forms of Japanese foreign currency investment, more Uridashi bonds have been issued in the New Zealand dollar than in any other currency over the past few months (figure 4.5).

Figure 4.5

Non-Yen Uridashi issuance by currency



Source: Morgan Stanley, Bloomberg

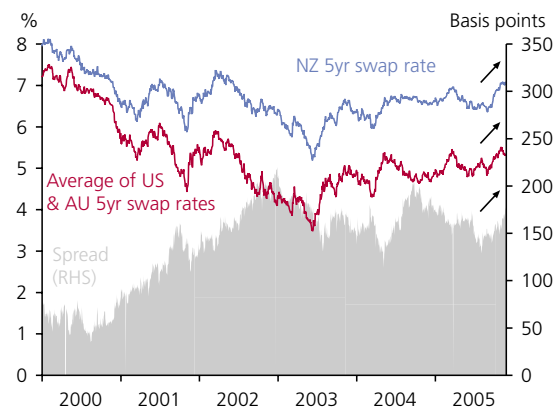
* 100 million yen is equivalent to approximately 1.2 million NZ dollars

Domestic markets

Locally, wholesale interest rates have risen across the yield curve during the past few months. For longer-term rates, this has partly reflected higher global rates (figure 4.6). But New Zealand longer-term rates have risen to a greater extent than those in most offshore markets. It appears that expectations of tighter monetary policy, clearly reflected in higher short-term rates, may also have played a role in the interest rate increases further out the yield curve.

Figure 4.6

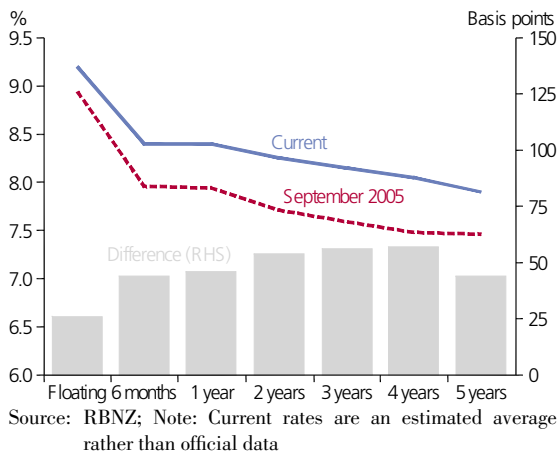
Longer term wholesale interest rates



Source: Bloomberg

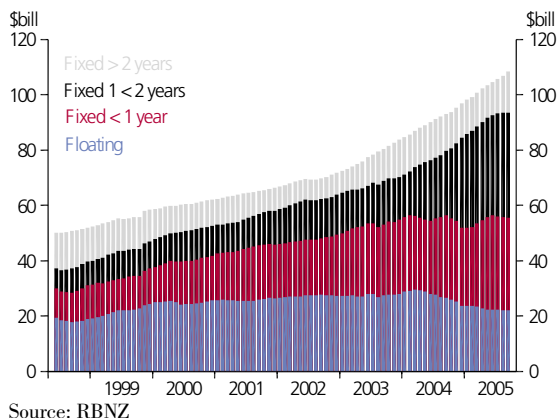
The rise in wholesale rates has pushed up mortgage rates across all maturities (figure 4.7). Indeed, the rise in fixed mortgage rates has been even greater than for floating. As a consequence, new borrowers (and those with maturing fixed terms) face rates that are around 25 to 50 basis points higher than was the case in September.

Figure 4.7
Mortgage rates offered to new borrowers



The inverted mortgage rate curve continues to see borrowers – both new and existing – opt for fixed rates. Fixed-rate borrowing now makes up almost 80 per cent of all mortgage debt compared to less than 60 per cent in 2000/01 (figure 4.8). Recent activity suggests borrowers are increasingly opting for fixed rates for periods that are longer than the one to two year terms that have been most popular during the last couple of years. However, fixed-rate mortgages with less than two years until they re-price still make up more than 65 per cent of all mortgage debt outstanding.

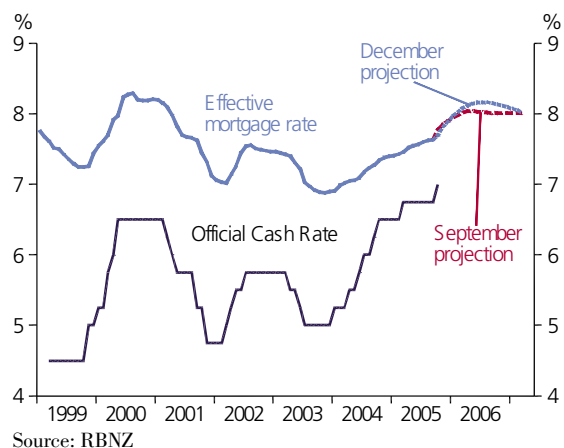
Figure 4.8
Maturity profile of mortgages



In terms of assessing pipeline interest rate pressures, the bow wave of fixed-rate mortgage re-pricing at higher rates, new fixed-rate borrowing at higher rates, and higher floating rates will have an important influence on effective

rates over the next six months. Looking at the year ahead, 40 per cent of existing fixed mortgage debt will re-price from an average existing rate of just over 7.2 per cent. On the basis of recent rate developments and the outlook for mortgage rates implied by our projections for short and long-term wholesale rates, these borrowers will face rates at least 60-70 basis points higher than they were previously paying. This suggests that the average interest rate paid on outstanding mortgage debt (the 'effective mortgage rate') will rise to a greater extent than projected at the time of the September Statement.

Figure 4.9
The OCR and the average interest rate paid on outstanding mortgage debt (the 'effective mortgage rate')



5 The macroeconomic outlook

Overview

Several years of strong economic growth have led to a build-up of medium-term inflation pressure. In recent quarters, growth in the externally-oriented sectors of the economy has slowed, but domestic demand has remained robust. The emergence of the 'two-speed economy' has worsened economic imbalances, with declines in the household savings rate and a further widening of the current account deficit. Over the coming years a period of slower growth in domestic expenditure is required to alleviate built-up inflation pressures and to correct imbalances in the economy.

We are projecting economic growth to slow to around 2 per cent per annum, while private consumption growth slows to around zero. This should be sufficient to allow inflation pressure to ease gradually, and will see the current account deficit gradually closing. Some macroeconomic factors are already aligned toward bringing about a slowdown – net immigration has slowed, the terms of trade are easing, and the exchange rate has been at high levels for some time. We also expect a sharp fall in house price inflation to contribute to the slowdown, although such a fall is yet to materialise.

In our assessment, these factors alone are not sufficient to bring about a slowdown and alleviate inflation pressure. Higher interest rates than projected in the September *Statement* are likely to be required to encourage increased saving and discourage unsustainable expenditure. We are projecting 90-day rates to remain at 7.6 per cent throughout

the projection period. This level of interest rates is roughly in line with current market rates.

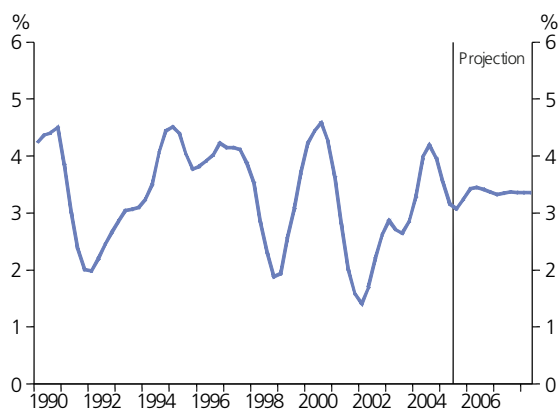
The remainder of this chapter details our economic projections for the coming years.

World outlook

Our view on the outlook for New Zealand's main trading partners is largely based on *Consensus Forecasts*, a survey of the main forecasters in our trading partner economies. After a period of slower growth in recent quarters, the outlook for world economic growth has picked up since September. World inflation has picked up recently, largely reflecting the effect of higher oil prices. Over the period ahead, however, inflation is expected to moderate.

Figure 5.1

Trading partner GDP
(annual average growth)



Source: Consensus Economics Inc., RBNZ estimates

Table 5.1

Forecasts of export partner GDP growth*
(calendar year, annual average growth)

Country	2001	2002	2003	2004	2005f	2006f	2007f
Australia	2.5	4.0	3.3	3.3	2.6	3.4	3.3
United States	0.8	1.6	2.7	4.2	3.6	3.3	3.2
Japan	0.2	-0.3	1.4	2.6	2.3	1.9	1.7
Canada	1.8	3.1	2.0	2.9	2.8	3.0	3.0
Eurozone**	1.8	0.9	0.7	1.8	1.3	1.7	1.9
United Kingdom	2.2	2.0	2.5	3.2	1.8	2.2	2.2
Asia ex-Japan***	2.0	5.2	4.9	7.3	6.0	5.8	5.9
12 Country Index	1.6	2.6	2.8	4.0	3.2	3.4	3.4

* Source: Consensus Economics Inc., RBNZ estimates

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

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

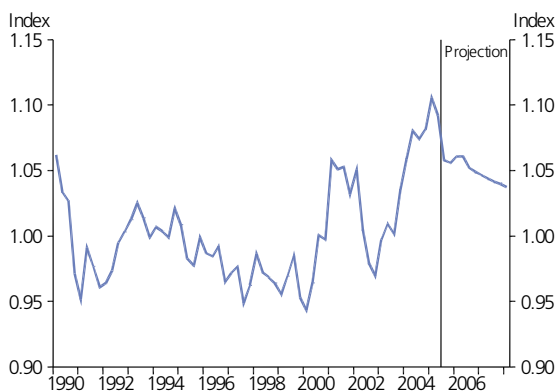
Tradables prices

Over recent years, world prices for many of New Zealand's exports have risen strongly. However, in recent months world prices of some agricultural goods have fallen. We expect this trend to continue, with export prices falling toward more normal levels over the coming years. New Zealand dollar returns to exporters are projected to be more positive, due to the assumed depreciation of the TWI exchange rate over the projection period.

World import prices have risen strongly in recent quarters, though not to the same extent as the increase in oil prices. The impact of oil prices has been moderated by international prices of manufactured goods, which have been falling for some time. More recently, world oil prices have fallen from their peak in September, and we project this trend to continue. The price of Dubai oil is assumed to fall to around USD40 per barrel by the end of 2007. We recognise this as a key source of uncertainty.

The outlook for the terms of trade is more negative than the September projection. Falls in export prices are expected to outweigh falls in oil prices, resulting in an overall fall in the terms of trade. However, the terms of trade are expected to remain high by historical standards throughout the projection period.

Figure 5.2
OTI terms of trade (goods)

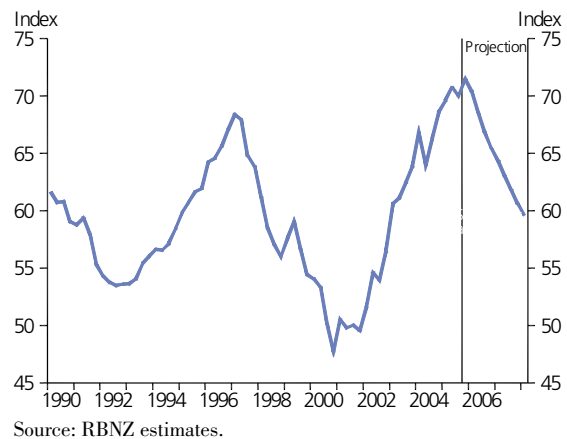


Exchange rate

The starting point for the TWI exchange rate in the December quarter, at 71.5, is higher than we assumed in the September *Statement*. Our assumption is for the TWI to depreciate

from here towards its long-term average. The profile of the TWI is modelled to be consistent with the projected decline in export prices and a narrowing in the short-term interest rate differential between New Zealand and the rest of the world. There are considerable uncertainties around our assumption for the TWI. For example, a very rapid correction in the current account deficit could be accompanied by a more rapid TWI depreciation than in the central projection.

Figure 5.3
Nominal TWI assumption



Export volumes

As noted in Chapter 3, many export industries have been experiencing low growth in recent quarters. We expect this weakness to persist for some months, before a modest export growth recovery begins in 2006. However, the outlook for exports varies by sector:

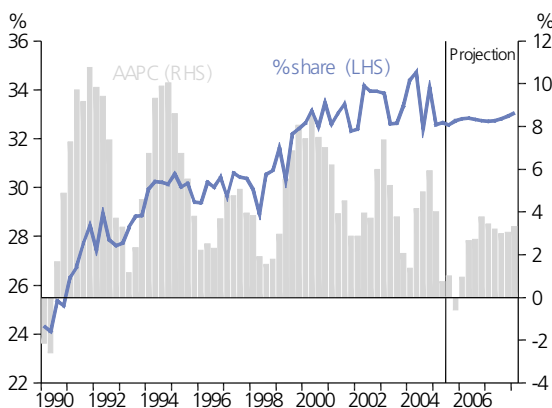
- **Non-commodity manufactured export** growth is expected to continue slowing, reflecting the lagged effect of the high exchange rate. From an annual average growth rate of 10 per cent in calendar 2004, growth in this sector is expected to fall to 1 per cent by 2007.
- **Agricultural export** growth has recently fallen to rates not seen in over a decade. Poor export volume growth over the past season has reflected weather-related disruption to dairy production, and temporarily lower meat production due to an element of herd rebuilding. Production levels are expected to recover gradually over the season ahead, resulting in improved agricultural export volume growth.

- **Forestry export volumes** are projected to remain quite weak due to a combination of low world prices, high shipping costs, and the high exchange rate.
- **Exports of services** growth has fallen sharply in recent quarters, notwithstanding the temporary boost from the recent Lions Tour. Growth in this sector is expected to remain soft over 2006 as the high exchange rate continues to dampen tourist spending. From 2007 onwards, growth is projected to recover strongly, although this is contingent on the assumed depreciation of the TWI.

Figure 5.4

Total export volumes

(per cent of trend output and annual average growth)



Source: Statistics New Zealand, RBNZ estimates.

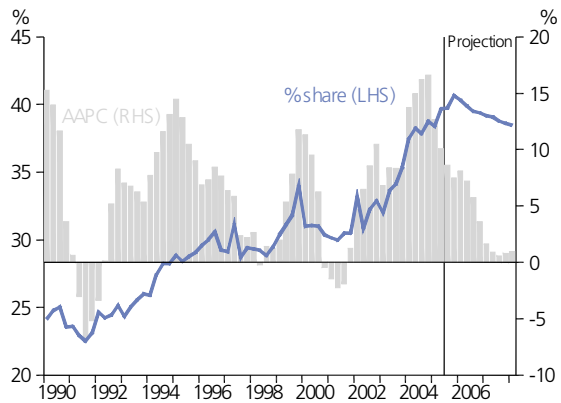
Import volumes

Import volumes have increased significantly over recent years, underpinned by strong growth in consumption and business investment. Imports have been further encouraged by the high exchange rate. Import penetration is expected to fall in the period ahead as the exchange rate falls. Combined with slower consumption and investment growth, import growth is expected to fall sharply.

Figure 5.5

Total import volumes

(per cent of trend output and annual average growth)



Source: Statistics New Zealand, RBNZ estimates.

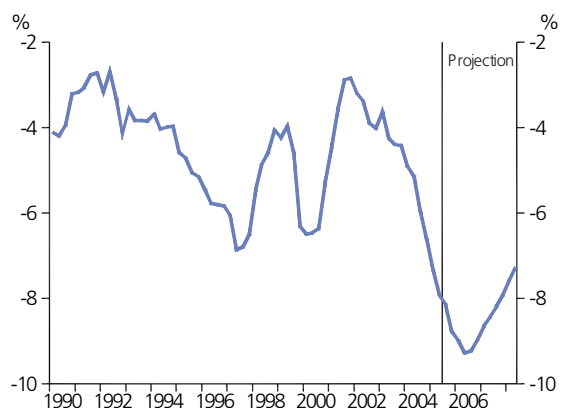
Current account

The current account deficit has widened by more than expected over recent months to around 8 per cent of GDP. By late 2006, the deficit is expected to peak at 9¼ per cent of GDP. This large current account deficit partly reflects strong investment in productive resources. However, it is also a reflection of unprecedented dissaving by households, which is not expected to be sustained in the medium term.

Figure 5.6

Current account balance

(per cent of nominal GDP)

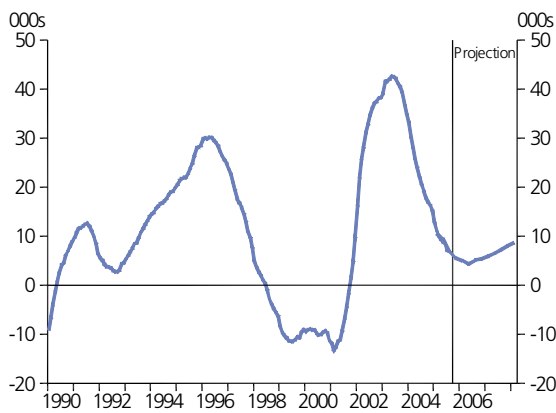


Source: Statistics New Zealand, RBNZ estimates.

Net immigration and residential investment

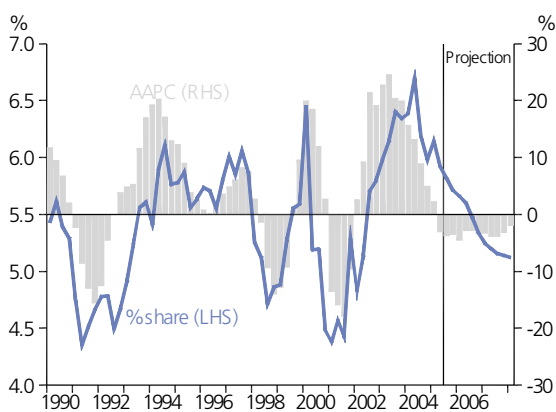
Net permanent and long-term immigration has fallen dramatically since 2004, and is assumed to remain low over the projection period. Consistent with the net immigration outlook, residential investment activity is projected to trend lower.

Figure 5.7
Net permanent and long-term immigration
(annual total)



Source: Statistics New Zealand, RBNZ estimates.

Figure 5.8
Residential investment
(per cent of trend output and annual average growth)



Source: Statistics New Zealand, RBNZ estimates.

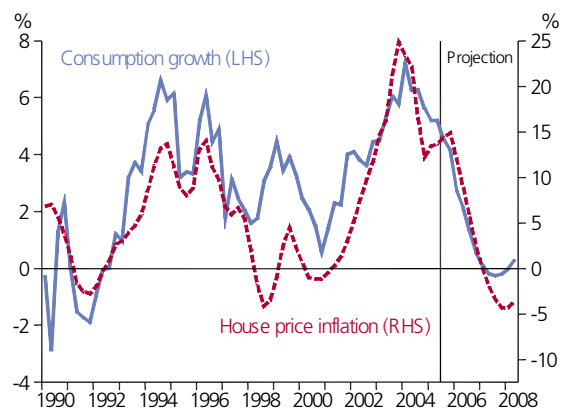
House prices

House price inflation has remained high for longer than we previously anticipated, and indications are that house price inflation will remain strong in the near term. With immigration having fallen dramatically, and with increasing signs that house prices are overvalued relative to incomes, we are projecting a sharp decline in house price inflation in the coming years. We project quarterly house price inflation to turn negative at the end of 2006.

Much of the strong consumption growth we have seen in recent years has been related to wealth effects from increasing house prices. In our projections, a significant slowdown in house price inflation is one of the key factors

expected to bring about a slowing in household consumption growth. Box 4 shows that in Australia and the UK, falls in house price inflation have been matched by sizable falls in consumption growth.

Figure 5.9
House price inflation and private consumption growth
(annual per cent change)

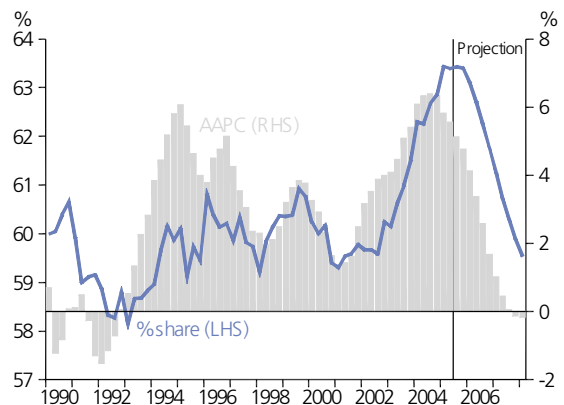


Source: Quotable Value New Zealand, Statistics New Zealand, RBNZ estimates.

Household consumption

After several years of strong consumption growth, the real consumption share of trend GDP has reached a record high. Consumption is expected to slow significantly in the coming years as lower net immigration, lower house price inflation, falling terms of trade and rising interest rates dampen household spending (figure 5.10). This fall in consumption growth is expected to play a key role in correcting imbalances between domestic demand and production.

Figure 5.10
Real household consumption
(per cent of trend output and annual average growth)



Source: Statistics New Zealand, RBNZ estimates.

Box 4

House prices and consumption

– international comparisons

Our projection for a sharp slowdown in consumption growth is largely dependent on lower house price inflation. To examine the plausibility of our consumption projection, we have examined Australia and the UK, two countries where there has already been a significant slowdown in house price inflation. Figure 5.11 shows that the slowdown in the Australian and UK housing markets has been quite dramatic. The magnitude of the projected slowdown in New Zealand house price inflation appears to be on par with what has already occurred in these two countries.

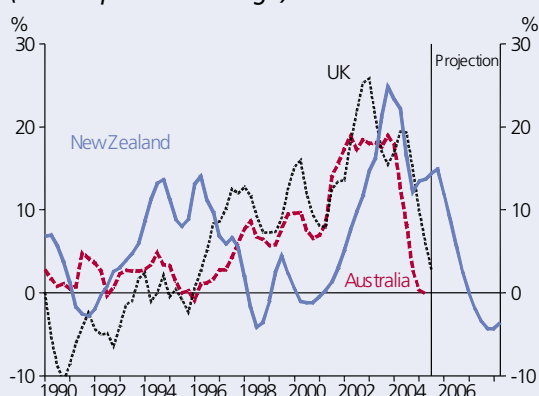
In both Australia and in the UK, slowing house price inflation has been quickly followed by slowing household

consumption growth (figure 5.12). In Australia, annual consumption growth has fallen from around 6 per cent to 3 per cent. In the UK, annual consumption growth has fallen from around 4 per cent to around 1 per cent.

We are forecasting a slightly larger fall for New Zealand, with consumption growth slowing from 5 per cent to zero. Our analysis suggests that house prices have a bigger influence on household spending in New Zealand than they do in Australia or the UK. New Zealanders have consumed more out of housing wealth gains than Australians or the British, so a fall in house price inflation can be expected to have a larger effect in New Zealand.

Figure 5.11

House prices – Australia, UK, New Zealand (annual per cent change)

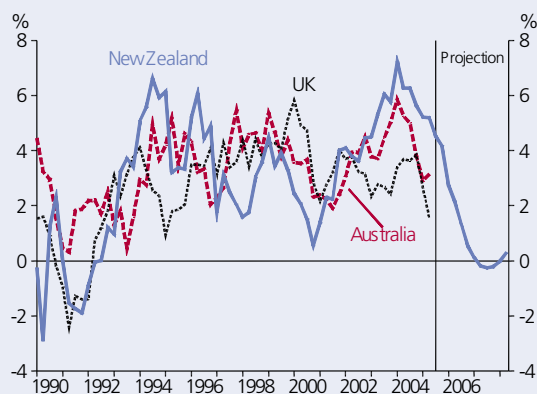


Source: Australian Bureau of Statistics, Nationwide Anglia Building Society, Quotable Value New Zealand, RBNZ estimates.

Figure 5.12

Household consumption – Australia, UK, New Zealand

(annual per cent change)



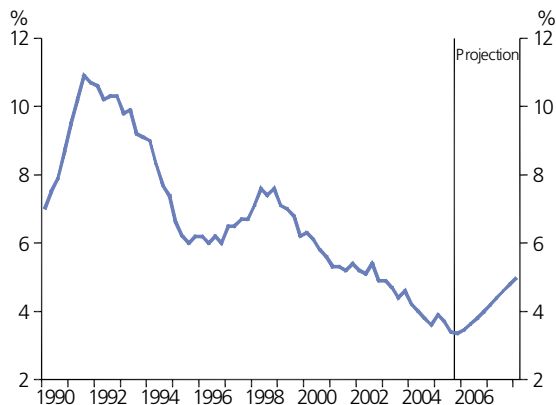
Source: Australian Bureau of Statistics, Office for National Statistics (UK), Statistics New Zealand, RBNZ estimates.

Over the past year we have been continually surprised by the strength of consumption, as households have proved willing to take on more debt than expected. A similar 'stronger-for-longer' surprise on consumption is clearly a risk to these projections (see Box 2 in Chapter 2 for an alternative scenario that features stronger domestic demand than in the central projection).

Labour market

The labour market remains very tight, as evidenced by the 20-year low unemployment rate of 3.4 per cent. The strong labour market is bringing an increasing number of people into paid work and lifting wage growth. We expect relatively high wage growth to continue, with only a modest increase in unemployment. The overall outlook for labour earnings is robust.

Figure 5.13
Unemployment rate

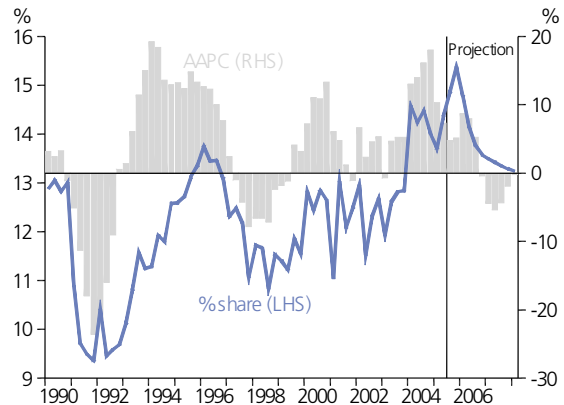


Source: Statistics New Zealand, RBNZ estimates.

Business investment

Robust demand from home and abroad, the increasing scarcity of labour, and the high exchange rate have encouraged strong investment in new capital. Over 2006, we expect the pace of business investment to weaken in line with the economic slowdown. However, investment is expected to remain high as a share of GDP. Strong investment is expected to result in an improvement in productivity growth over future years.

Figure 5.14
Business investment (excluding computers)
(per cent of trend output and annual average growth)



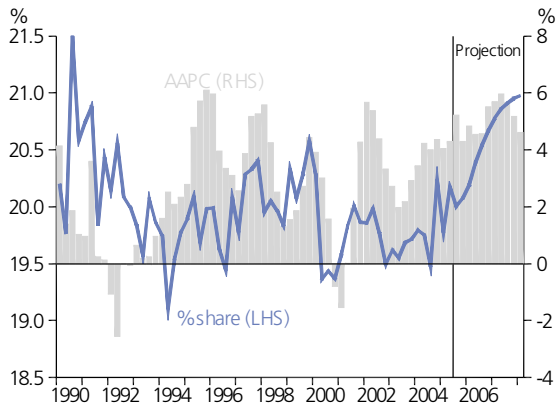
Source: Statistics New Zealand, RBNZ estimates.

Government

Our projections for fiscal policy use the Treasury's *Pre-Election Budget Economic and Fiscal Update 2005* (PREFU) as a baseline. Additional to this baseline, we have made adjustments to the government expenditure forecast to reflect new policy initiatives that have been announced since the election. These changes result in higher government expenditure forecasts than indicated in the *PREFU*, based on the following assumptions:

- Changes to the Working for Families package are assumed to add \$500 million per year to government expenditure from the 2006/2007 fiscal year onwards.
- All other recent initiatives are assumed to be funded from existing Budget provisions – this includes the reduction of interest payments arising from the removal of interest on student loans. However, we have assumed no additional uptake of student loans. To the extent that some additional uptake can be expected, there remains an upside risk to these fiscal projections.

Figure 5.15
Government consumption and non-market investment*
(per cent of trend output and annual average growth)



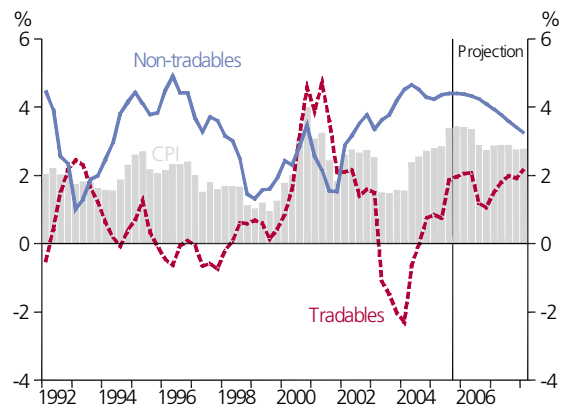
Source: Statistics New Zealand, RBNZ estimates.
 * Excluding frigates and other military spending.

Inflation

We expect inflation to remain around $3\frac{1}{2}$ per cent until June 2006. The impact of recent oil-related price increases will affect headline annual CPI inflation for one year, before dissipating in September 2006, when annual inflation is projected to fall to around $2\frac{3}{4}$ per cent. Further ahead, we expect CPI inflation to continue falling gradually.

While headline inflation is expected to ease gradually, we are projecting changes to the split between tradables and non-tradables inflation. The falling TWI is expected to pass through to increased import prices, and rising tradables inflation. Meanwhile, non-tradables inflation is expected to fall as the economy slows and resource pressures ease in key non-traded sectors such as construction.

Figure 5.16
CPI, tradables and non-tradables inflation
(annual per cent change)



Source: Statistics New Zealand, RBNZ estimates.

Appendix A¹

Summary tables

Table A

CPI inflation projections and monetary conditions

(CPI is in percentage changes)

		CPI Quarterly	CPI* Annual	TWI	90-day bank bill rate
2000	Sep.	0.4	1.1	56.7	4.8
	Dec.	0.2	1.3	54.4	5.4
	Mar.	0.7	1.7	54.1	6.0
	Jun.	0.7	2.0	53.4	6.7
2001	Sep.	1.4	3.0	50.1	6.7
	Dec.	1.2	4.0	47.7	6.7
	Mar.	-0.2	3.1	50.5	6.4
	Jun.	0.9	3.2	49.8	5.9
2002	Sep.	0.6	2.4	50.0	5.7
	Dec.	0.6	1.8	49.6	5.0
	Mar.	0.6	2.6	51.6	5.0
	Jun.	1.0	2.8	54.6	5.8
2003	Sep.	0.5	2.6	53.9	5.9
	Dec.	0.6	2.7	56.4	5.9
	Mar.	0.4	2.5	60.6	5.8
	Jun.	0.0	1.5	61.1	5.4
2004	Sep.	0.5	1.5	62.4	5.1
	Dec.	0.7	1.6	63.9	5.3
	Mar.	0.4	1.5	66.9	5.5
	Jun.	0.8	2.4	64.0	5.9
2005	Sep.	0.6	2.5	66.3	6.4
	Dec.	0.9	2.7	68.6	6.7
	Mar.	0.4	2.8	69.6	6.9
	Jun.	0.9	2.8	70.8	7.0
2006	Second Half Average	1	3 $\frac{1}{2}$	70 $\frac{3}{4}$	7 $\frac{1}{4}$
	First Half Average	1/2	3 $\frac{1}{2}$	69 $\frac{1}{2}$	7 $\frac{1}{2}$
	Second Half Average	3/4	2 $\frac{3}{4}$	66 $\frac{1}{4}$	7 $\frac{1}{2}$
2007	First Half Average	3/4	2 $\frac{3}{4}$	63 $\frac{3}{4}$	7 $\frac{1}{2}$
	Second Half Average	3/4	2 $\frac{3}{4}$	61 $\frac{1}{4}$	7 $\frac{1}{2}$

Quarterly projections

		CPI quarterly	CPI* annual	GDP quarterly	GDP annual average
2005	Mar.	0.4	2.8	0.7	3.8
	Jun.	0.9	2.8	1.1	3.1
	Sep.	1.1	3.4	0.8	2.8
	Dec.	0.9	3.4	0.7	2.7
2006	Mar.	0.4	3.4		

¹ Notes for these tables follow on pages 34-35.

* 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 C

Summary of economic projections

(Annual percentage change, unless specified otherwise)

March year	Actuals					Projections				
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Price measures										
CPI*	1.0	1.7	3.1	2.6	2.5	1.5	2.8	3 ¹ / ₂	2 ³ / ₄	2 ³ / ₄
Labour costs	1.6	1.4	1.6	2.1	2.2	2.1	2.5	3	3	2 ³ / ₄
Import prices (in New Zealand dollars)	2.7	11.2	7.4	-2.9	-11.1	-10.5	0.5	2	6 ¹ / ₄	6 ³ / ₄
Export prices (in New Zealand dollars)	-0.6	9.9	20.6	-3.5	-15.5	-5.1	4.9	-2 ¹ / ₄	4 ³ / ₄	5 ³ / ₄
Monetary conditions										
90-day rate (year average)	6.2	5.2	6.6	5.4	5.9	5.3	6.5	7 ¹ / ₄	7 ¹ / ₂	7 ¹ / ₂
TWI (year average)	57.3	56.1	50.4	50.3	56.4	63.6	67.1	70 ³ / ₄	66 ¹ / ₄	61 ¹ / ₄
Output										
GDP (production, annual average % change)	0.5	5.2	2.1	3.9	4.7	3.6	3.8	3	2	1 ¹ / ₂
GDP (production, March qtr to March qtr)	2.6	5.8	0.9	4.7	4.2	4.8	2.3	3 ¹ / ₄	1 ¹ / ₂	2
Output gap (% of potential GDP, year average)	-1.9	0.5	-0.2	0.4	1.4	1.4	1.8	1 ¹ / ₂	1 ¹ / ₄	-1
Labour market										
Total employment	0.7	1.5	2.3	3.5	1.5	3.1	3.4	2 ¹ / ₂	0	-1 ¹ / ₄
Unemployment rate (March qtr, s.a.)	7.1	6.3	5.3	5.2	4.9	4.2	3.9	3 ¹ / ₂	4 ¹ / ₄	5
Trend labour productivity (annual % change)	1.5	1.5	1.5	1.5	1.1	0.9	0.8	1	1 ¹ / ₄	1 ³ / ₄
Key balances										
Government operating balance (% of GDP, year to June)	1.7	1.4	1.2	1.9	1.5	5.3	3.9	4 ³ / ₄	4	2 ¹ / ₄
Current account balance (% of GDP, year to March)	-4.2	-6.5	-4.5	-3.2	-3.7	-4.9	-7.4	-9	-8 ³ / ₄	-7 ¹ / ₂
Terms of trade (OTI measure, annual average % change)	-0.4	-0.2	4.4	4.2	-5.7	3.9	5.8	-1 ³ / ₄	-1 ¹ / ₄	-1
Household savings rate	-4.6	-1.5	-4.9	-4.9	-11.1	-12.3	-12.7	-14	-13	-11 ¹ / ₄
(% of disposable income, year to March)										
World economy										
World GDP (annual average % change)	1.9	4.2	3.6	1.4	2.9	3.3	3.5	3 ¹ / ₂	3 ¹ / ₄	3 ¹ / ₄
World CPI inflation	1.1	2.0	2.7	1.4	2.2	1.5	2.0	2 ³ / ₄	1 ³ / ₄	2

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 B

Companies and organisations contacted by RBNZ staff during the projection round

Alto Plastics Ltd	Nissan New Zealand Limited
ANZ Banking Group (NZ) Limited	NZ Council of Trade Unions
ASB Bank Limited	NZ Trade and Enterprise
Barfoot & Thompson Ltd	NZ Venture Investment Fund Limited
Canterbury Leather International Ltd	Optimization New Zealand Ltd
Chubb New Zealand Limited	Orica New Zealand Ltd
Clelands Construction Ltd	Port of Taranaki Ltd
Clorox New Zealand Limited	Ports of Auckland Limited
Cocksedge & Co Ltd	Pumpkin Patch Ltd
Education New Zealand	Pyne Gould Corporation Ltd
Engineering, Printing and Manufacturers' Union	Rembrandt Ltd
ENZA/Turners and Growers Ltd	Skellerup Ltd
Export New Zealand	Sky City Group Ltd
Financial Services Federation	Smith City Group Ltd
Fisher & Paykel Industries Ltd	Solid Energy New Zealand Limited
Fletcher Building Ltd	Steelbro (NZ) Ltd
Freight & Bulk Transport Ltd	Tait Electronics Ltd
GL Bowron & Co Ltd	Taranaki Sawmills Ltd
Harcourts Ltd	Titan Plant Services Ltd
Hooker Bros Holdings Ltd	Transfield Worley Ltd
Jade Corporation Ltd	Tyco Electronics New Zealand Ltd
K-Mart Regional New Zealand Ltd	
Krone (NZ) Ltd	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.
LV Martin & Sons Ltd	
Mace Group Ltd	
McVicar Timber Group Ltd	
Meco Engineering Co Ltd	
New Zealand Tourism	

Appendix C

Reserve Bank statements on Monetary Policy

OCR unchanged at 6.75 per cent

9 June 2005

The Reserve Bank has left the Official Cash Rate (OCR) unchanged at 6.75 per cent.

Speaking at the release of the Reserve Bank's June 2005 Monetary Policy Statement, Reserve Bank Governor Alan Bollard said: "Our current review confirms what we said in the March Statement and again at the April OCR review. Activity remains strong across many parts of the economy and inflation pressures remain persistent. Several years of strong growth have led to productive resources becoming stretched, with capacity utilisation and measures of labour shortages remaining at or near record highs.

"However, there is sufficient evidence that the economy is slowing, and that past policy tightenings are yet to have their full effect, for us to leave policy on hold at this point.

"While many businesses see more difficult trading conditions ahead, activity and inflation pressures in some sectors are proving stronger than anticipated. Export prices for some commodities have edged up in recent months. Household spending and housing market activity have remained firmer than expected. Non-residential construction and business investment look likely to be sustained at high levels in the near-term.

"Overall, we assess that the balance of inflation risks remains on the upside. We base this view on the ongoing growth in debt-financed household spending; and on increases in costs – of labour, energy and freight – that are now putting considerable pressure on margins and prices.

"With inflation projected to remain around 3 per cent through most of this year and next, a firm policy stance will be required for some time. We will be watching closely to see if inflation pressures are contained, and further tightening in monetary policy would likely be required if there are upside surprises to the inflation outlook. Certainly, there is no scope for an easing in policy in the foreseeable future."

OCR unchanged at 6.75 per cent

28 July 2005

The Reserve Bank has left the Official Cash Rate (OCR) unchanged at 6.75 per cent.

Reserve Bank Governor Alan Bollard said: "The economy has recently shown signs of softening. GDP growth has continued to ease over recent quarters, particularly in sectors such as manufacturing that are exposed to the strong exchange rate. Indicators of business activity have been pointing downwards for some months and it now appears that household consumption growth is also beginning to weaken. However, residential housing market indicators remain firm, representing an upside risk for the future path of household spending and inflation. We view the overall easing in activity as broadly consistent with our June MPS economic outlook.

"Inflation pressures nevertheless remain present. Several years of strong growth have led to productive resources becoming stretched and the resulting inflation pressures will take some time to unwind. Moreover, additional short-term inflation pressures have recently emerged as a result of surging oil prices and the waning impact of the strength in the exchange rate over recent years. These short-term inflation pressures, which could easily be exacerbated, are now expected to push CPI inflation temporarily above 3 per cent over the coming quarters.

"Looking further ahead, we expect that current policy settings will be sufficient to achieve our objective of 1-3 per cent inflation on average over the medium term. However, in the current environment, monetary policy must remain vigilant. We remain vulnerable to upside inflation risks and monetary policy must continue to work at reducing the ongoing excess demand pressures. A firm policy stance is also necessary to prevent the expected short-term inflation pressures from becoming entrenched in inflation expectations. A further tightening of policy could not be ruled out in the event of a resurgence in medium-term inflation pressures. Certainly there remains no prospect of a policy easing in the foreseeable future."

OCR unchanged at 6.75 per cent

15 September 2005

The Reserve Bank has left the Official Cash Rate (OCR) at 6.75 per cent.

Reserve Bank Governor Alan Bollard said: "Since our June Monetary Policy Statement, economic indicators have broadly confirmed the slowdown in activity that commenced in the second half of 2004. The slowdown has been concentrated in sectors such as manufacturing and tourism that have been exposed to the high exchange rate. The non-traded sectors of the economy on the other hand, such as household and business services and construction, have maintained their high growth of recent years. The housing market in particular has remained strong, underpinning consumption growth. Reflecting the slow pullback in domestic demand, capacity and labour shortages are expected to persist well into 2006.

"New developments in oil prices have made the future more uncertain. Oil prices have surged in recent months and are now 20 per cent higher than projected in June, some 60 per cent up from the end of 2004. As a consequence, headline CPI inflation is now forecast to approach 4 per cent over the next few quarters before returning below 3 per cent by early 2007. Monetary policy will not attempt to offset the unavoidable first-round price effects of the oil price spike. However, it will be used to resist any flow-through to ongoing price and wage inflation. Further out, the higher oil prices are expected to have a dampening effect on both world and domestic economic activity, thus taking some pressure off monetary policy in the medium-term.

"Fiscal policy is also adding to uncertainty. The shape and economic impact of new post-election policies is not clear at this point. However, it does appear likely that fiscal policy will become more expansionary in the period ahead.

"Right now, it is too early to make a call on the relative strength of the emerging cross-currents and how these will translate into medium-term inflation pressures. It will be several months before the persistence and global impact of the oil shock become more apparent. A similar period could be needed for the fiscal outlook to be clarified. We are concerned, however, that the risk of higher medium-term inflation has increased. Consequently, further monetary policy tightening may still prove necessary to ensure inflation is kept within the 1 per cent to 3 per cent target band on

average over the medium-term. Certainly there remains no prospect of a cut in the OCR in the foreseeable future."

Reserve Bank increases OCR to 7.00 per cent

27 October 2005

The Reserve Bank has increased the Official Cash Rate (OCR) by 25 basis points to 7.00 per cent.

Reserve Bank Governor Alan Bollard said: "As noted in our September Monetary Policy Statement, medium term inflation risks remain strong. Persistently buoyant housing activity and related consumption, higher oil prices and the risk of flow-through into inflation expectations, and a more expansionary fiscal policy are all of concern. While there has been a noticeable slowing in economic activity, and a particular weakening in the export sector, we have seen ongoing momentum in domestic demand and persistently tight capacity constraints. Hence, we remain concerned that inflation pressures are not abating sufficiently to achieve our medium term target, prompting us to raise the OCR today.

"The most serious risk to medium term inflation is the continuing strength of household spending, supported by a relentless housing market and rapid growth in mortgage lending. Significant dis-saving by the household sector is showing through in a worsening current account deficit, now 8 per cent of GDP. Borrowers and lenders alike need to recognise that the current rate of debt accumulation is unsustainable. The correction of these imbalances and associated inflation pressures will require a slowdown in housing, credit growth and domestic spending. We also expect a significantly lower exchange rate. The longer these adjustments in behaviour and asset prices are deferred, the more disruptive they are likely to be.

"Today's increase in the OCR, combined with higher world interest rates and pipeline effects from the repricing of fixed rate mortgages, are expected to slow the housing market and household spending over the coming months. However, the prospect of further tightening may only be ruled out once a noticeable moderation in housing and consumer spending is observed. Certainly, we see no prospect of an easing in the foreseeable future if inflation is to be kept within the 1 per cent to 3 per cent target range on average over the medium term."

Terms of Reference for the Supplementary Stabilisation Instrument Project

10 November 2005

The strength and persistence of domestic demand, the scale of the accompanying external imbalances, and the key role being played by the current house price cycle, have prompted officials to explore whether ancillary instruments could be deployed to complement monetary policy in the task of managing inflation pressures. Such tools, if they exist, could enable less reliance to be placed on the OCR and, hence, reduce some of the pressure on the exchange rate.

There is a variety of policy factors which may have shaped New Zealanders' attitudes to housing and to savings-consumption choices. The longer-term policy issues, such as the tax treatment of capital gains, the extent of social safety nets and public sector savings programs are important but beyond the scope of the present review. The review will consider structural and cyclical policies that are amenable to implementation in the short term and which have a direct bearing on housing. In particular, the review will look at policies that may influence housing credit growth independently of changes to the OCR.

Two classes of options will be explored:

One-off measures, eg:

- The removal or restriction of structures that facilitate tax reduction through property investment, such as Loss Attributing Qualifying Companies (LAQCs)
- Factors that may be incorporated into the prudential framework which could reduce the amplitude of housing credit cycles

Discretionary stabilisation measures, eg:

- A limit on loan-to-value ratios for mortgages, that could be managed by the Reserve Bank as a macro-stabilisation instrument
- Other direct interventions that might be used by the Reserve Bank to influence the quantity and or price of mortgage lending

Factors that will be considered include:

- The nature of the problem being addressed
- Likely effectiveness of the measures using real industry data
- Likely signalling and reputation effects
- Long-term enforcement and disintermediation risks
- Consistency between cycle-management objectives and longer term financial stability objectives
- Efficiency costs
- Distributional implications
- Options for implementation and their timing
- Legal powers (including whether, and in what form, legislation would be required).
- International precedents and practices.

The work will be conducted jointly by staff of the Reserve Bank and the Treasury, and the Inland Revenue Department will be consulted on tax specific matters. An initial report will be provided to the Governor and Secretary of the Treasury by 31 January 2006, and a report to the Minister of Finance shortly thereafter.

Appendix D

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	9 December 2004	6.50
24 January 2001	6.50	27 January 2005	6.50
14 March 2001	6.25	10 March 2005	6.75
19 April 2001	6.00	28 April 2005	6.75
16 May 2001	5.75	9 June 2005	6.75
4 July 2001	5.75	28 July 2005	6.75
15 August 2001	5.75	15 September 2005	6.75
19 September 2001	5.25	27 October 2005	7.00
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 E

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 2006.

Thursday 26 January 2006	OCR announcement
Thursday 9 March 2006	<i>Monetary Policy Statement</i>
Thursday 27 April 2006	OCR announcement
Thursday 8 June 2006	<i>Monetary Policy Statement</i>
Thursday 27 July 2006	OCR announcement
Thursday 14 September 2006	<i>Monetary Policy Statement</i>
Thursday 26 October 2006	OCR announcement
Thursday 7 December 2006	<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 F

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