
Monetary Policy Statement

June 2004

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

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This document is available on the Reserve Bank's website (<http://www.rbnz.govt.nz>).

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1 Projections finalised on 28 May 2004. Policy assessment finalised on 9 June 2004.

1 Policy Assessment

The Reserve Bank has increased the Official Cash Rate to 5.75 per cent.

The New Zealand economy has enjoyed strong growth over an extended period. For some time, we have been expecting growth to slow due to a range of factors such as the high exchange rate and declining population growth. But activity has continued to prove stronger than expected, and stretched productive resources have caused inflation pressures to increase across a range of industries.

There remain compelling reasons to expect that momentum in the economy will slow. However, improvements in global demand, rising commodity export prices, and the recent fall in the exchange rate to a less contractionary level point to stronger activity than we projected in March. Moving interest rates higher is thus appropriate to ensure that medium-term inflation remains within the target range. At this stage, further increases in interest rates look likely to be needed over the year ahead, but to a modest degree by historical standards.

Although we expect medium-term inflation to remain consistent with the target range, the recent decline in the exchange rate and higher oil prices mean that we are now projecting annual inflation to rise temporarily above 3 per cent in 2005. This would not be a breach of the Policy Targets Agreement, as the Bank is now required to keep inflation between 1 and 3 per cent "on average over the medium term". Given that inflation is expected to fall in a reasonable time frame, it would not be appropriate to attempt to offset this short-term increase in inflation using monetary policy. However, we will need to remain alert to signs of more enduring effects that could arise if wage or price setting behaviour starts to change. Were that the case, additional monetary policy pressure might be required to keep medium-term inflation pressures in check.

We will continue to update our view of inflation pressures and the policy outlook, as new data come to hand.



Alan Bollard
Governor

2 Overview and key policy judgements

Introduction

New Zealand has enjoyed sustained economic growth over recent years, despite softer conditions in many of its trading partners. With spare labour and productive capacity becoming limited, inflation pressures have increased in a number of industries in the domestic sector. Monetary policy over the past year or so has been guided by a view that momentum in the economy will slow quite markedly going forward. Reasons have included the sharp rise in the New Zealand dollar since 2001 and the fading of some factors supporting strong activity, such as rapid population growth. The slowdown has been expected to place downward pressure on inflation, thus reducing the need for higher interest rates (see also box 1, overleaf).

However, anticipating the timing and extent of the slowdown has not been an easy task. Whereas our June 2003 Statement projected annual GDP growth to slow from 4½ per cent in the year to March 2003 to around 2 per cent in the year to March 2004, the actual growth rate now looks to have been closer to 3½ per cent. Non-tradables inflation – which relates to the prices of goods and services produced and consumed mainly in the domestic sector – has edged higher and currently sits at an annual rate of about 5 per cent.

Looking back over our projections, the main factor explaining this unexpected strength has been household spending, which has been fuelled by wealth effects associated with the rapid growth in population, a strong housing market, and ongoing growth in employment. Not only has the increase in housing wealth been considerably greater than we anticipated, the overall response of spending to the rise in wealth appears to have been more powerful. Relatedly, significant debt-financing of expenditures has occurred over the past 12 months following a period of only modest borrowing activity on the part of households.

As reflected in the updated projection in Chapter 4, there are still reasons to expect that momentum in the economy will start to slow and our central projection remains one where that occurs. Plausibly, that slowdown could eventually prove to be sharper than currently projected. However, the factors expected to drive a slowdown are being moderated by new developments, including the fall in the exchange rate since March, stronger global demand, and recent improvements in

export commodity prices. With the economy growing at a significantly faster pace over the past year than generally expected, our policy deliberations have had to consider the conditions under which activity could continue to surprise on the ‘upside’. Such an outcome raises the possibility of a somewhat stronger medium-term inflation outlook than in the projection in chapter 4 (and the need for greater policy action on our part).

What are the key judgements?

In discussing the policy outlook, we have had to confront and reach a view on a range of uncertainties regarding:

- the degree of inflation pressure already present in the economy (‘starting point uncertainty’);
- the future path of variables influencing the economy – such as the exchange rate, trading partner growth, commodity prices and population growth; and
- how the economy will behave in response to those variables (and to our monetary policy actions).

Starting point uncertainty

A starting point for our decision-making is determining the degree of inflationary pressure currently embedded in the economy. The greater the degree of ‘stretch’ in productive resources, the greater the propensity for the economy to generate stronger inflation pressures in the future (for any given growth path) and the more likely that countervailing action from monetary policy will be required.

As Chapter 3 notes, we look at a range of estimates and indicators of cyclical pressure, and there is considerable room for latitude when interpreting them. Viewed in comparison to historical norms, most of these indicators suggest a steady accumulation of inflation pressures over the past two years and, indeed, even greater stretch in the economy over the recent past.

However, we have had to contemplate whether the historical norms continue to provide a reliable guide when reading these indicators. It is entirely plausible that the economy’s capacity to sustain non-inflationary growth has increased in recent years, perhaps due to the infusion of the same technologies that appear to have driven substantial

Box 1

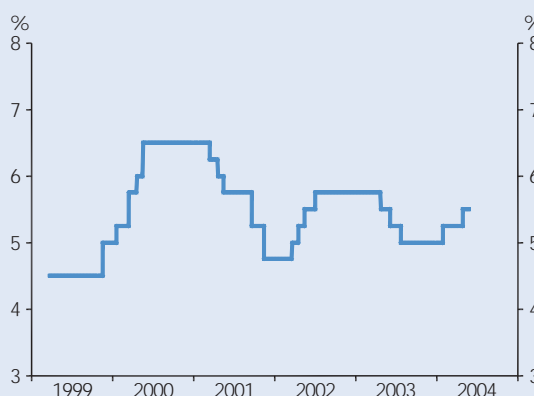
A review of recent monetary policy decisions

Around 12 months ago, we projected the New Zealand economy to slow sharply due to the strongly appreciating New Zealand dollar, the potentially dampening effects of the outbreak of the SARS virus, drought in some areas of New Zealand, and electricity shortages. This projected slowdown was expected to reduce inflation pressures that we observed in the economy. Hence, between April and July last year the OCR was reduced by 75 basis points.

By late last year it had become clear that activity was more resilient – and underlying inflation pressures more persistent – than we had initially expected. Hence, in the December *Monetary Policy Statement*, we signalled that small OCR increases were likely in the coming months in order to begin removing interest rate stimulus. Consistent with our December assessment, economic indicators over

the subsequent few months continued to suggest that overall economic activity remained robust. Accordingly, we increased the OCR in two 25 basis point steps – once in January and once in April of this year (figure 1).

Figure 1
Official Cash Rate



Source: RBNZ.

productivity improvements in other countries, such as the United States. Similarly, it is also possible that capacity utilisation in the business sector has shown a structural increase over the past decade, due to greater efficiencies in the use of capital by firms than in the past. Either possibility could mean we are inferring more inflationary pressure in the economy than is actually the case.

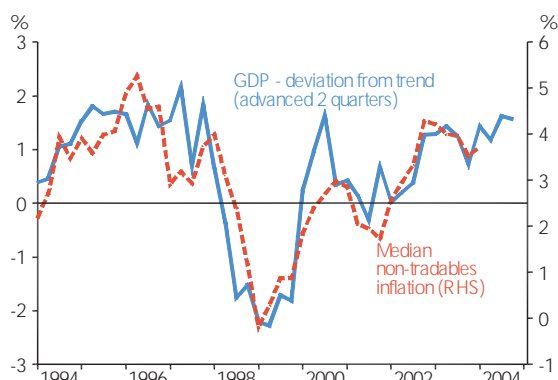
In addition to these structural questions, data on resource pressures in the economy are apt to be volatile. In recent quarters, measures of capacity utilisation and growth have been relatively noisy, adding further complexity to the question of whether pressures on resources might be abating or strengthening.

Since inflation outturns follow changes in resource pressures with a lag, considerable judgement is needed when setting monetary policy. That judgement is ongoing, but to date we feel that the relationships between the indicators of resource pressure and inflation remain broadly similar to those in previous economic cycles. As shown by figure 2, the correlation between non-tradables inflation and estimates of output relative to its trend recently appears to have held up

in much the same way as historical relationships would suggest. The overall view formed during our latest policy discussions thus remains one of an economy that is cyclically 'hot', with little evidence that the associated inflation pressures have started to unwind.

Another dimension to the starting point issue involves the current state of inflation expectations. Firms' and households' expectations for inflation over the medium term

Figure 2
Output and annual non-tradables inflation



Source: RBNZ estimates.

can have an important bearing on the actual medium-term path of inflation given the role those expectations play in the wage and price setting process. Strong inflation in some domestic industries, such as housing and construction, over quite a sustained period raises the question as to whether medium-term expectations have started to edge up. That possibility could affect the pace at which domestic inflation pressures ease in the future. It would also increase the risk that the temporary increase in inflation that we are projecting to occur over the coming year (due mainly to a fall in the exchange rate and higher oil prices) ends up having more enduring effects.

As with the measures of cyclical pressure, the various indicators of inflation expectations that we have are far from conclusive and provide very limited perspective on actual behaviours. Our on-balance judgement is that while near-term inflation expectations may well have edged up a little over recent times, reflecting the recent decline in the exchange rate and normal cyclical factors, the evidence is less clear regarding expectations about inflation over the longer haul. However, the grounds for complacency are limited, particularly given the prospect, discussed later, that the CPI inflation rate is likely to rise steadily over the next 12 months. If the experience of the past two years were to continue – with activity proving stronger than expected – the risks that expectations of inflation over the medium term drift to a point of inconsistency with the inflation target would be intensified. This conclusion has been an important conditioning factor when forming our policy view.

Uncertainty about the future path of variables influencing the economy

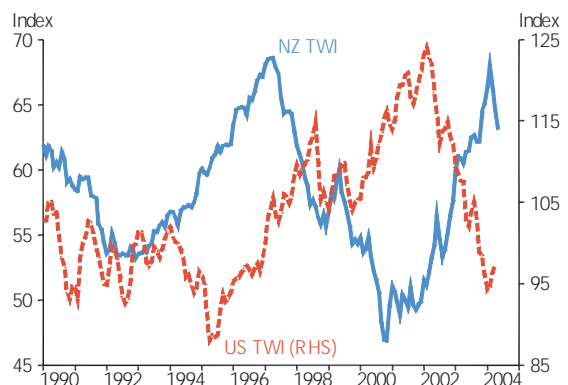
Our policy deliberations also have to consider the likely forward path for the economy. In part, that will depend on a range of variables, whose outlook is uncertain. Examples include the exchange rate, trading partner activity, oil prices, export commodity prices, and population growth.

Making assumptions about the future path of the exchange rate – as we must do to form a view of future economic conditions – has always been problematic. Not enough is known about the factors that drive the exchange rate over the short run to make reliable forecasts. Our normal approach is to assume that the exchange rate will revert

steadily towards its trend from wherever it is currently. This approach is broadly consistent with the historical behaviour of the exchange rate over a medium-term (3 to 4 year) horizon, but does not purport to capture its likely short-term path.

In practice, the actual path of the exchange rate can differ significantly from that assumed, as evidenced by the marked fall in the New Zealand dollar since early March. Much of that fall reflects a substantial turnaround in the US dollar following recent strong US data and growing expectations of an imminent policy tightening by the Federal Reserve (figure 3). The decline in New Zealand's trade weighted exchange rate index since our March *Statement* has left it some 6 per cent below the level we then assumed for the second half of 2004.

Figure 3
Trade weighted exchange rate indices



Source: RBNZ, Bank of England.

Looking ahead, the opinions of international forecasters are divided about the likely path of the US dollar over the next couple of years, highlighting uncertainty over prospects for the New Zealand dollar. One viewpoint is that current strength in the US dollar may be short-lived given the structural imbalances facing the US economy, including the historically large US current account deficit. An alternative view is that the drivers of US growth are becoming sufficiently robust as to overshadow the negative effects of such imbalances. These divergent opinions suggest that renewed appreciation or further depreciation of the New Zealand dollar are both quite plausible outcomes over the months ahead.

Reflecting our usual practice, we have assumed that the exchange rate remains at its recent lower level until the end of 2004, before gradually resuming its fall back towards its long-term average. The exchange rate is thus lower than in the March projection throughout the entire forecast horizon. Consequently, as discussed in Chapter 4, it has less of a braking effect on the growth rate of the economy than in earlier projections. Moreover, the assumption that the sharp decline over the past few months will be sustained leads us to project a larger near-term increase in CPI inflation than previously, as higher import prices wash through. Clearly, the possibility exists that the exchange rate assumption proves wide of the mark, implying rather different outcomes for the external sector and inflation than those presented in Chapter 4.

Until relatively recently, prospects for a recovery in the global economy of the pace typically seen during previous cycles appeared dubious. Demand conditions were weak in a number of regions and the overhang of a range of 'structural' issues (such as high household indebtedness and corporate balance sheet issues) looked likely to constrain a recovery in a number of countries.

Notwithstanding the continuation of these imbalances, the actual path of trading partner activity has evolved into what, to date, looks like a fairly conventional recovery by historical standards, implying a stronger external demand picture for the New Zealand economy than previously envisaged. Near-term *Consensus Forecasts* for most countries have also been revised up steadily over the past six months. But *Consensus* forecasters remain more circumspect about growth prospects in the medium term, with more subdued growth rates forecast for 2005. How much this reluctance to revise the medium-term outlook is simply normal conservatism on the part of forecasters and how much reflects uncertainty about the sustainability of the global recovery is difficult to tell. Our analysis has considered the possibility that global demand continues to out-perform *Consensus Forecasts*, which could in turn see New Zealand's own growth performance proving stronger than currently expected.

We are very mindful that monetary and fiscal policies remain stimulatory in many countries around the globe. Although much of that stimulus might be reversed as economic recoveries consolidate and inflation concerns re-emerge, the possibility exists that demand has already been

stimulated to such an extent that activity will lift more sharply than expected over the next 18 months or so – oil price rises notwithstanding.

The recovery in global demand (along with supply constraints in some markets) has been partly responsible for a sharp increase in New Zealand's terms of trade over the past year, with a significant increase in the world prices for some primary export products, including dairy, meat and forestry. To date these increases appear to have more than offset increases in import prices due to higher oil and industrial commodity prices (such as steel and copper and some plastics). When making projections over the past year, we have revised up our estimates of the terms of trade each time. In the current projection, we have assumed that some of the recent increases will unwind over the projection period, with higher oil prices and a recent softening in some industrial commodity markets limiting the upside for our export commodity prices. However, the potential clearly exists for stronger outturns than we are projecting, which would ultimately provide additional stimulus to the domestic economy.

However, not all the global risks are toward higher growth. The recent sharp rise in international oil prices is expected to place some upward pressure on New Zealand's CPI over the next few quarters given recent increases in domestic fuel prices. Our working assumption has been that the oil price spike will be relatively short-lived, with prices likely to ease back over the next 12 months. However, this is not a universally held view (see box 3, Chapter 3) and more sustained increases in oil prices would potentially damage the global recovery and growth prospects for New Zealand, whilst adding further upside to the nearer-term inflation outlook.

Another factor that will have an important bearing on the path of the economy over the next few years is population growth. Rapid population growth due to strong net immigration during 2002 and 2003 added to the effects on activity of the previously low exchange rate and strong commodity prices. Net immigration proved stronger and more sustained than generally envisaged, providing greater stimulus to the domestic economy in the process. In the past year, net immigration inflows have eased, but the extent of any further slowing that might occur remains uncertain. Projecting the forward path of net immigration requires numerous assumptions to be made about the various flows making up

the aggregate. Some of these flows are partly the result of policy decisions and administrative processes (such as the new criteria for assessing residency applications), some may reflect relative economic conditions (for example New Zealanders deciding whether to work locally or abroad), and others may be heavily related to previous migratory flows (such as New Zealanders returning from abroad). In practice, some of these flows can be quite volatile and are not readily amenable to modelling.

At this stage we have seen no new information that would lead us to change our assumption that net immigration slows to an annual inflow of about 10,000 persons per annum over the next few years. However, we will continue to watch the data and update our population projections accordingly. Such adjustments could well have a material impact on our projections of the economy and the policy outlook over the months ahead.

Uncertainty over the response of the economy

Even if we could predict with greater accuracy the path of the key variables affecting the economy, such as the exchange rate or the terms of trade, determining the likely impact of these variables on activity and inflation pressures involves its own uncertainties. In practice, there are variable lags between changes in such factors and their impact on economic behaviour as well as uncertainty about the ultimate extent of their impacts.

Consideration of the lags is particularly relevant when assessing the exchange rate's impact on demand. Our best assessment is that, over the past year, the impact of the exchange rate on activity was still mildly positive despite the exchange rate having moved to an above-average level by about late 2002. In part, those lags can be traced to the biological drivers of agricultural export volumes, which mean that production changes in response to economic conditions occur with quite a long lag. Hedging against currency changes is likely to have slowed the impact of the rising dollar on many firms' revenues. Even when revenues begin to fall, exporters' spending activity in the local economy can take time to respond with previous improvements in balance sheets acting to buffer lower revenues.

The sharp rise in the exchange rate up until March had been expected to increasingly slow both export and domestic activity through 2004 and 2005. The recent fall in the

exchange rate to a position of more moderate over-valuation complicates the analysis of how the exchange rate will impact the economy over the next few years (leaving alone the related question of whether the exchange rate fall is actually sustained). The cash flows of some exporters may have been relatively unaffected by the spike in the exchange rate to around USD 0.70 given the rapidity of the appreciation, and subsequent depreciation back to current levels. However, this will not be the case for all exporters, particularly those who have locked in exchange rate hedges at higher rates.

Our discussions with businesses reveal that exchange rate policies (and instruments used to cover against exchange rate risk) can vary significantly across companies (and even within the same company over time). That, in turn, adds to the difficulty of assessing the likely implications of exchange rate movements on revenue streams and activity. Our judgement, based largely on our understanding of the exchange rate's influence on activity over history, is that the exchange rate will continue to exert a contractionary effect on the economy during the course of the projection, albeit to a lesser extent than in recent forecasts. At current levels, the exchange rate remains above trend, whilst the higher levels prevailing over much of the past year are likely to continue to have a dampening effect for some time. However, given the sharp movements in the exchange rate and our incomplete understanding of the relationships, the margins of error around the projections need to be recognised.

A related issue concerns the likely direct effects on inflation imparted by the recent exchange rate fall. Tradables inflation has fallen sharply over the past 12 months as the exchange rate has risen, but some importers and distributors look likely to have increased margins over this period (by not fully passing on lower import prices to the consumer). This might have been the case if, for example, the higher exchange rate was not expected to persist and/or as a result of buoyant demand conditions locally. Such a widening in margins could lead to a muted impact on tradables inflation from the recent fall in the exchange rate.

Our projections have assumed a slightly weaker price response to the exchange rate depreciation than we have seen during some historical episodes of exchange rate depreciation. That assumption appears to fit the data, which suggest tradables prices respond to exchange rate movements in a more muted fashion than they used to. However, a less

mutated response is certainly possible, particularly if domestic demand continues to remain more resilient than we expect. As noted earlier, such a response would increase the risks of a more enduring impact on the medium-term path of inflation.

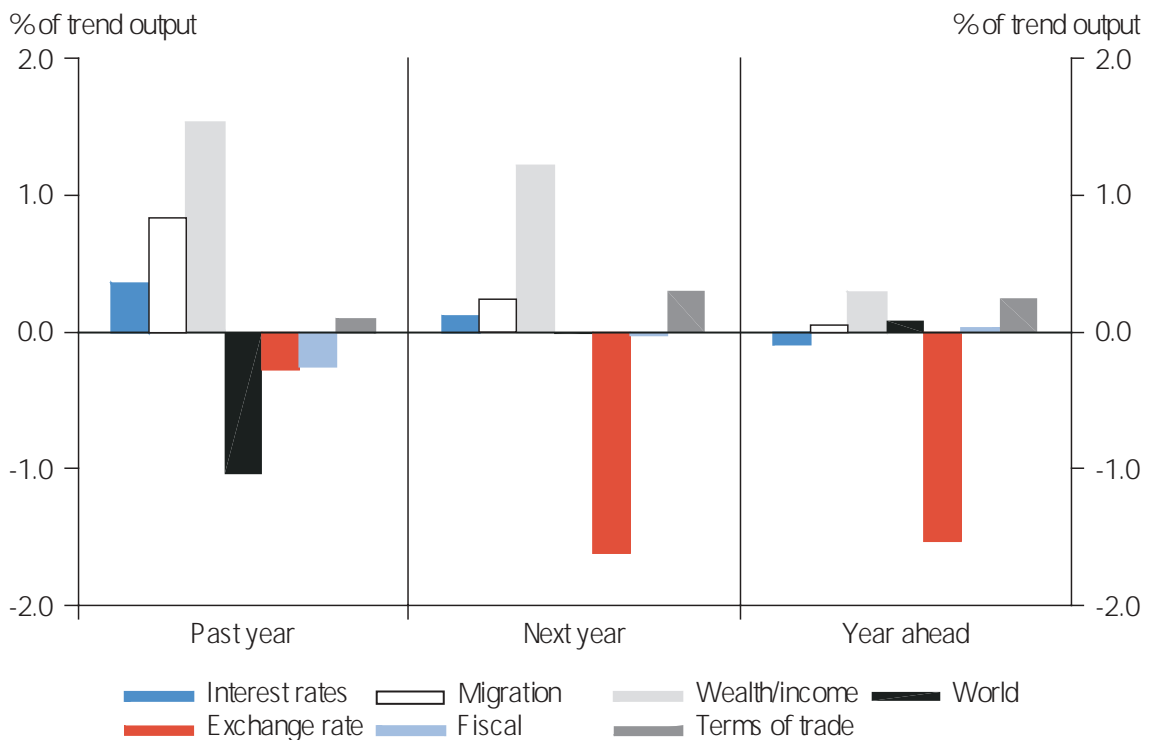
Consequently, much depends on the path of household spending going forward. As noted at the outset, the lift in household consumption over the past two years has been considerably stronger and more protracted than we had envisaged. Households have fuelled consumption spending through lower savings and increased reliance on debt, a trend that appears closely related to the sharp gains in housing wealth brought about by rapid increases in house prices (and indeed some other asset prices such as those for agricultural land). Having observed the strong spending to date, and the factors likely to lead to an eventual moderation – such as slowing population growth, we have continued to project a moderately-paced slowdown in spending.

But with few signs yet to hand of a cooling in demand, we cannot rule out the possibility that the spending cycle has rather longer to run. Indeed many of the traditional indicators – such as spending on durable goods – provide little reason to think that a significant slowdown is imminent. We are placing considerable weight on a cooling in housing market activity – already starting to become evident in the data – as a factor likely to moderate growth in spending over the next year or so, especially as debt-financed expenditure becomes less attractive. But as noted before, other channels, such as further strength in global demand, could well boost household incomes over this period, limiting the downside from weaker property price inflation.

Policy assessment

The Policy Targets Agreement (PTA) requires the Bank to focus on the future path of inflation, not the current inflation rate. The emphasis is on the trend in inflation – keeping inflation

Figure 4
Relative cyclical drivers¹



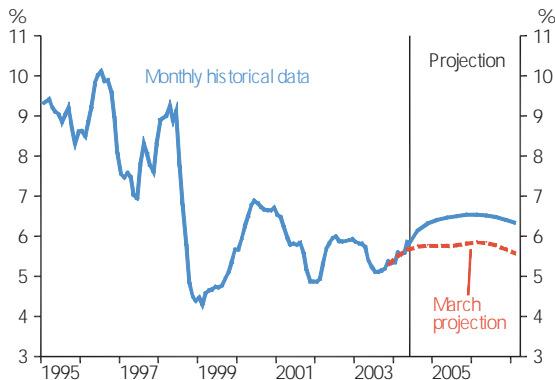
Source: RBNZ estimates.

¹ The vertical axis in figure 4 represents output relative to its trend – each bar provides an estimate of the contribution of each cyclical driver to the overall deviation of output from its trend. Note that 'terms of trade' represents only the effect of the terms of trade on export volumes. The income effects are captured by the wealth/income bar. Data are for June years, ie: the years to June 2004, June 2005, and June 2006 respectively.

within the 1 to 3 per cent target band on average over the medium term. Further, clause 4 of the PTA requires us to consider the implications of policy for the stability of the real economy, interest rates and the exchange rate. These considerations come to the fore in the current situation.

The New Zealand economy is expected to transit towards slower growth over the next two years as the lagged effects of exchange rate appreciation, slower population growth and dissipating wealth effects increasingly act to slow demand. Figure 4 summarises the main factors that will see growth slow from an above-trend position over the past 12 months to a below-trend position in two years' time. But whereas in our March projection these factors were expected to slow growth with little further adjustment to monetary policy, the latest projection incorporates a more pronounced rise in interest rates over the coming year (figure 5). The greater role for interest rate adjustment, compared to our March *Statement*, reflects a less contractionary effect from the exchange rate along with stronger external demand and stronger terms of trade.

Figure 5
90 day interest rates

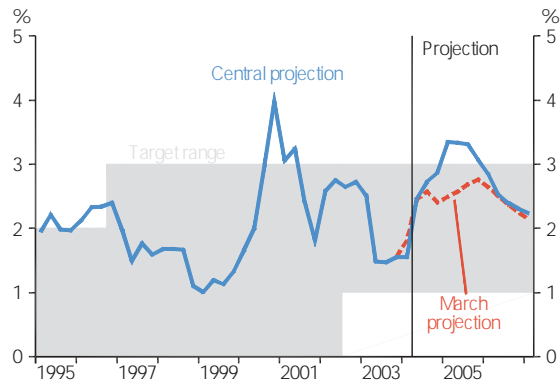


Source: RBNZ estimates.

As shown in figure 6, the projected rise in interest rates is sufficient to see inflation settle comfortably within the target band in the latter part of the projection horizon. In the near term, however, CPI inflation is projected to rise relatively sharply to just above the 3 per cent mark by early 2005, as the recent exchange rate depreciation and higher oil prices act to push up tradables sector inflation. Monetary policy cannot realistically attempt to counter this temporary near-term increase in inflation, as doing so would almost certainly require a very large and potentially destabilising adjustment

to interest rates (which would be apt to exaggerate the slowdown in activity further out).

Figure 6
Consumer price inflation
(annual rate)



Source: Statistics New Zealand, RBNZ estimates.

Instead, the PTA requires us to remain focussed on the medium-term path of inflation. We will need to remain particularly alert during the coming period to any evidence that the short-term boost to inflation is affecting inflation expectations in a manner that could disturb the medium-term path of inflation.

The policy path shown in figure 5 would be modest by historical standards. However, throughout this chapter, we have identified a number of factors that could combine to see activity and inflation pressures turning out to be stronger than in our updated projections, continuing the experience of the past 12 months. Stronger global demand, the recent lift in the terms of trade and the uncertain nature of the lags between the exchange rate, household wealth and activity create a risk that the medium-term path of inflation pushes into uncomfortable territory. Such a situation would ultimately require a more aggressive response from monetary policy than that shown here.

In March, the Bank announced that it had recommended to the Minister of Finance that it be given the capacity to intervene in the foreign exchange market with the aim of influencing the level of the exchange rate, in circumstances where it is exceptionally and unjustifiably high or low. At current levels of the exchange rate and with the current configuration of the economy, these criteria do not apply, but a summary of the proposals is provided in box 2.

Box 2

Foreign exchange intervention

On the 11th of March 2004 the Reserve Bank announced that we had recommended to the Minister of Finance that we be given the capacity to more actively intervene in the foreign exchange market.

The Bank has always had the capacity to intervene in the foreign exchange market, although our previous approach was to intervene only when it seemed that the basic functioning of the market was threatened.

The new additional approach is aimed at trying to influence the level of the exchange rate at times when intervention might help the Bank meet its obligations under the PTA – in particular the provisions that state that the Bank, while pursuing price stability, shall seek to avoid unnecessary instability in output, interest rates and the exchange rate.

The Bank has indicated four specific conditions that would need to be satisfied before intervention would take place:

- The exchange rate would need to be exceptionally high or low. This is likely to be when the New Zealand dollar is nearing cyclical extremes as has been seen in New Zealand over recent decades on a three to five year cycle (figure 7).
- The exchange rate would need to be unjustifiably high or low. That is, it would need to have moved far in excess of what may be warranted by economic fundamentals.
- Intervention would not be inconsistent with meeting the Bank's objectives under the Policy Targets Agreement.
- The opportunity is judged to exist in the foreign exchange market for a successful intervention. That is, the dynamics of the foreign exchange market need to be such that the Bank feels there is a material prospect of influencing the exchange rate.

It is expected that these conditions will coincide only rarely and therefore intervention will be considered only in reasonably infrequent circumstances.

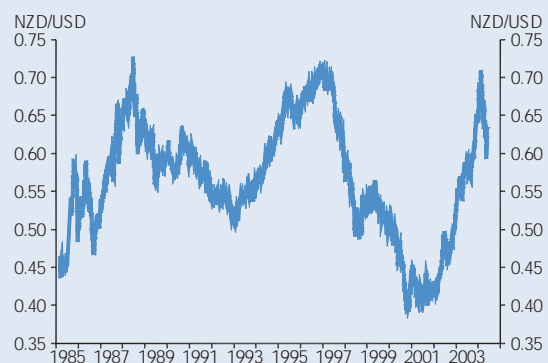
The Reserve Bank will implement our new intervention policy under the existing provisions in the Reserve Bank Act.

Under section 16 of the Act, the Bank has operational independence to intervene in the foreign exchange market.

While the Bank has always had the power to intervene in the foreign exchange market for monetary policy purposes, the Bank needed to approach the Finance Minister and Parliament for two reasons. A change in the Reserve Bank Funding Agreement was required to ensure that any mark-to-market losses incurred on open foreign exchange positions would not be treated as expenditure within the terms of this agreement. Second, additional capital was required to allow the Bank to weather short-term financial losses that might emanate from large open net foreign exchange positions. The necessary variation to the Reserve Bank Funding Agreement was ratified by Parliament on the 6th of April 2004 and the additional capital was appropriated in the recent Budget.

When the Bank intervenes we will be taking positions against the market trend, and in the short run mark-to-market losses are quite possible. However, in the longer run as long as the exchange rate continues to move cyclically and the Bank is not forced to exit positions prematurely, the strategy of "selling high" and "buying low" is likely to prove profitable – or at least not prove costly. The Bank will square up foreign exchange exposures from past interventions once the exchange rate reverts to more normal levels. This will mean that over the longer term, on average, the Bank will aim to have a net zero foreign exchange position.

Figure 7
New Zealand exchange rate against the US dollar



Source: RBNZ.

The Bank believes interventions of the type proposed can usefully influence the level of the exchange rate and help to reinforce perceptions among decision-makers that the exchange rate will revert to more normal levels over the medium term. It is not anticipated that intervention will have a large impact on the exchange rate, nor displace the need

for normal foreign exchange risk management on the part of those exposed to exchange rates. A significant amount of cyclical variability in the exchange rate will continue even if the new policy is successfully implemented.

Further information is available at <http://www.rbnz.govt.nz/>.

3 The current economic situation

Overview

The New Zealand economy has displayed strong growth over the past year, with GDP estimated to have grown by 3.5 per cent in the year to March. As has been the case over much of the past year or two, the expected economic slowdown has been delayed. While there are some signs of a slowdown in parts of the economy, many data remain surprisingly strong.

Reflecting continued strong economic growth, significant inflation pressures continue to build in the domestic economy. Indicators of resource pressures suggest that the economy entered 2004 with stretched capacity. Domestic inflation increased further in the early part of 2004 and now stands at 5 per cent – a level not reached since the early 1990s. In sharp contrast, the strong exchange rate has led to outright price falls for many imported goods and services. Overall, these two opposing forces – high domestic inflation and low imported inflation – have roughly offset each other to leave annual CPI inflation within the 1 to 3 per cent target band. In broad terms, the New Zealand economy is currently in a stronger position, and inflation pressures are more persistent, than we had envisaged when formulating our March projection.

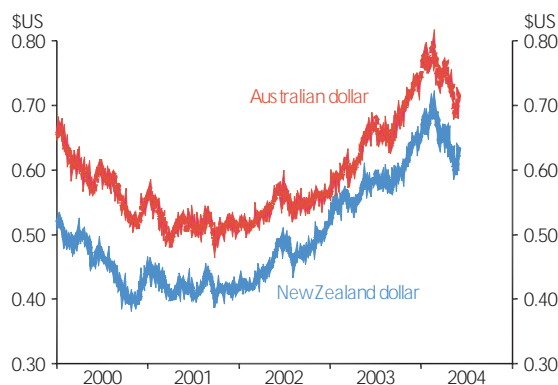
Global and financial market developments

The economies of New Zealand's main trading partners have slowly been gathering momentum, following a sharp downturn in 2001. Recent evidence suggests that the global recovery has continued to strengthen, and central banks around the world are beginning to move away from their accommodative policy settings. In some countries interest rates have already increased, while in others a tightening still seems some time away. Although the evidence still points to excess capacity in some economies, the risks of global deflation have dissipated.

A key theme in global financial markets more recently has been a significant recovery in the US dollar. The rise in the US dollar has been underpinned by increased optimism about a recovery in the US economy and by a rise in interest rate expectations. The 'high yield' currencies – including the New Zealand and Australian dollars – have depreciated particularly sharply against the US dollar as investors reposition themselves for an increase in US interest rates (figure

8). As has been the case over much of the past couple of years, future developments for the New Zealand dollar will continue to be heavily dependent on developments in the US.

Figure 8
Exchange rates against the US dollar



Source: RBNZ.

Recent data in the US have been positive. Activity continued to expand at a rapid rate in the March quarter. Spending for equipment and software is continuing to advance strongly, and corporate profitability is healthy. The labour picture has improved recently as well; in April, employment increased strongly and the unemployment rate edged down. Business sentiment surveys, such as the Institute for Supply Management (ISM) survey, continue to point to strong growth going forward, and consumer spending is expected to benefit from higher labour income growth. However, the boost received from other factors, such as the restructuring of household finances, tax cuts, and higher house and equity prices, is expected to fade.

Despite higher realised GDP growth, the Federal Reserve has kept interest rates on hold at 1 per cent – a very low level historically. Nevertheless, the prospects have increased for future interest rate rises, with the Fed stating that policy accommodation will be removed in a 'measured' fashion. Markets have responded and interest rate expectations have risen, underpinning the recent strength in the US dollar.

As with the US, the Japanese economy has recently shown some encouraging signs of growth. Industrial production and exports have continued to display surprising strength. Continued demand from China remains a key to Japanese export growth, while domestic demand prospects have been

improving, with a decline in the unemployment rate and an increase in consumer confidence.

Growth prospects have also improved in the other Asian economies, with *Consensus Forecasts* for a number of countries having recently been revised up. China continues to grow strongly, accounting for more than 15 per cent of global growth over the past year. Some analysts have expressed fears of a sharp slow-down in China. However, there are few signs that this will happen in the immediate future: the OECD remains reasonably upbeat about China's growth prospects, calling China a 'trump card' rather than a risk to the global recovery.

Growth in Europe has picked up recently, with Euro-area GDP for the March quarter making its largest quarterly advance in more than three years. Exports have been leading the way in Europe, despite an appreciation of the Euro, while domestic demand in some Euro area countries – most notably in Germany – remains subdued. Survey data for manufacturing have shown some improvement, suggesting that production will benefit from strong export growth, although consumer spending is expected to remain hampered by sluggish employment growth. The European Central Bank (ECB) has left interest rates on hold, and has recently highlighted particular concern over high oil prices.

In contrast, the Bank of England (BOE) recently increased interest rates. Growth in the United Kingdom is expected to remain above trend in the near term. However, uncertainty remains about rapidly rising house prices, with the BOE noting that recent rates of increase cannot be sustained – and that a sharp slow-down in house price growth is forecast over the next two years.

Australia has enjoyed a period of solid economic growth, concentrated mainly in the domestic sector. A strong housing market cycle and rapidly rising house prices have fuelled demand, which has more recently been supported by rising terms of trade and strong employment growth. There are now increasing signs that the housing market – and the strong growth in household borrowing that has accompanied it – is cooling. However, the depreciation of the exchange rate over recent months may help to underpin the Australian economy going forward. The Reserve Bank of Australia (RBA) has left interest rates unchanged at 5.25 per cent after increasing them by 25 basis points at both its November and December

meetings, and has indicated recently that inflation is likely to fall over the remainder of 2004.

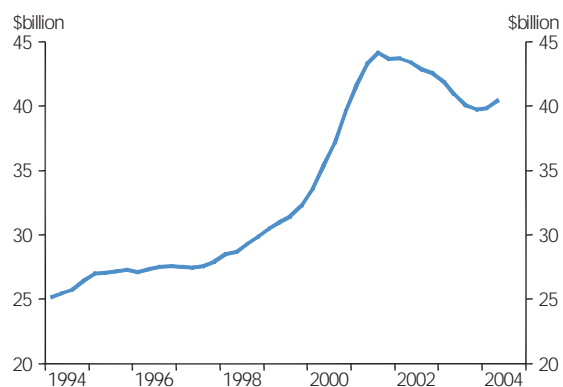
Overall, the prospects for a continued robust global recovery have improved. This has contributed to large increases in world oil prices (see box 3). But to the extent that some of the increase in the price of oil is due to terrorist threats in the Middle East and tight international supplies, high oil prices represent a risk to world growth.

Tradables sector activity

Between late 2000 and February of this year, the exchange rate appreciated by more than 40 per cent on a trade weighted basis. Although some exporters have been able to hedge the exchange rate – through forward cover or by pricing some costs in foreign currency – the high exchange rate will have reduced the profitability of exporters, undermining their international competitiveness. However, the world prices of many of New Zealand's primary exports have increased, offsetting some of the negative exchange rate impact.

Overall, export revenues in New Zealand dollar terms have fallen significantly since 2001 (figure 9). More recently, strong primary export volume growth and further gains in world prices have seen export incomes increase for the first time in two years, assisted by the recent decline in the value of the New Zealand dollar.

Figure 9
Export income

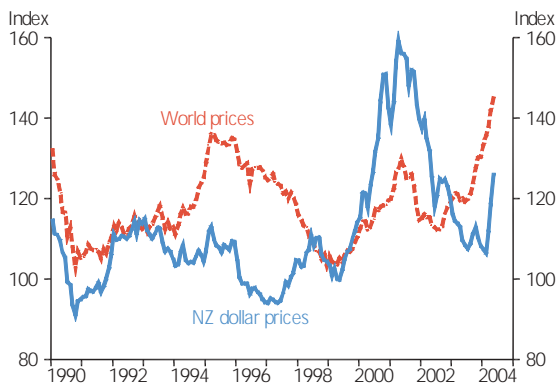


Source: Statistics New Zealand, RBNZ estimates.

World prices for our commodity exports have been improving strongly since late 2002, and currently stand at historical highs (figure 10, overleaf). This has occurred despite the level of foreign demand having been relatively weak over that period. Improving prospects for world demand and tight supply conditions for some of our key export products, such

as dairy and beef, have driven up world prices. The weak US dollar has also played a part, by lifting prices in markets where the US is a major market participant. Until recently, the benefits of rising world prices have been eroded by the rapidly rising exchange rate, and exporters' New Zealand dollar prices have declined. The recent fall of the currency, however, has meant that these prices have recovered over the past few months, providing a welcome boost to incomes in the export sector. Our discussions with companies and commercial banks suggest that a large number of exporters have been able to either delay or avoid the worst of the impact of the high exchange rate because they had increased their foreign exchange cover when the currency was at more favourable levels.

Figure 10
ANZ commodity prices



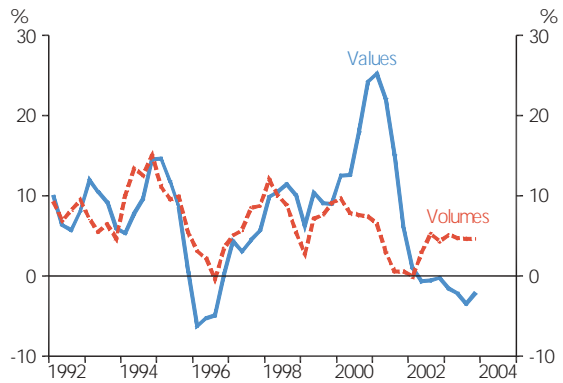
Source: ANZ Banking Group Ltd.

Despite the large decline in export incomes in the 2 years to the end of 2003, there has been little sign to date that overall activity in the export sector is easing in response to the high exchange rate. After falling in 2003, primary export volumes have recovered strongly. Dairy export volumes have shown particular strength, helped by productivity gains, good growing conditions and a run down in inventories. The forestry sector, however, remains under considerable pressure, facing low New Zealand dollar prices and rising shipping costs.

Non-commodity export volumes have been growing steadily since early 2002, despite a fall in overall income growth for exporters in that sector (figure 11). One reason that non-commodity export volumes have held up is that almost half of these are destined for Australia; the Australian economy has grown strongly in recent years and the New Zealand dollar did not appreciate as far against the Australian

dollar as it did against the currencies of our other major trading partners.

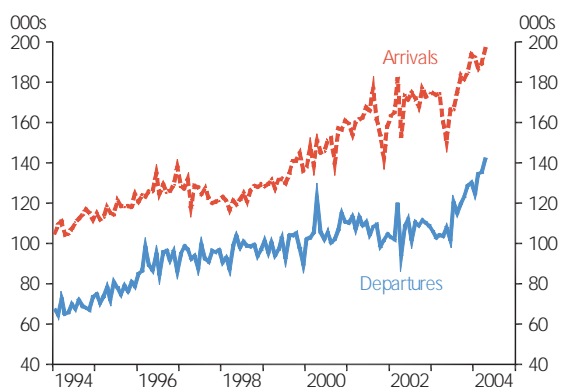
Figure 11
Non-commodity manufactured exports
(annual average percentage change)



Source: Statistics New Zealand.

Exports of tourism services came under considerable pressure during the first half of 2003, as the outbreak of SARS and the war in Iraq caused tourist numbers to drop significantly. A dramatic drop in visitors from Asia was a key factor behind this decline, but tourist numbers from that region have since begun to recover. Overall visitor arrivals have recovered, with the decline in Asian visitors more than offset by an increase in visitors from other regions (figure 12). Tourist arrivals from Australia have shown particularly strong growth, most likely as a result of airfare discounting and increased capacity on trans-Tasman travel routes. The per-person spend by overseas visitors has also recovered recently after dipping last year.

Figure 12
Departures of New Zealanders and overseas visitor arrivals
(monthly total)



Source: Statistics New Zealand.

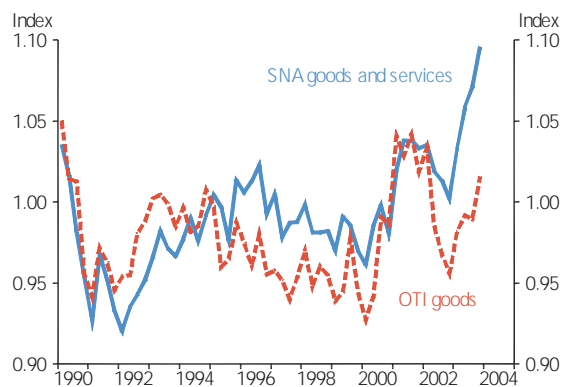
The appreciating exchange rate, and low inflation in many of our trading partners, has also reduced import prices over the past few years. But the downward pressure on these prices looks set to ease. Strong growth in China is drawing heavily on world supplies of some building materials, such as copper and steel, and placing upward pressure on prices. Oil prices have also been on the rise – up around 30 per cent since the March *Statement* (see box 3). Imports priced in New Zealand dollars are also likely to increase, owing to the recent depreciation of the exchange rate.

Import volume growth has been very strong over the past year or so. While some of the import growth is likely to reflect lower New Zealand dollar prices – making imported goods relatively attractive – the main reason for the strong imports has been the strong domestic economy. Imports of capital goods have been growing solidly, fuelled by high levels of capacity utilisation, low interest rates, and low import prices. Growth in imports of consumption goods has been robust, helped by last year's surge in net immigration and solid household income growth. New Zealanders have also taken advantage of discounted airfares, with short-term departures of New Zealand residents rising significantly, and imports of services growing strongly over the second half of 2003 (figure 12).

While the rapid rise in the exchange rate up until March has lowered both export and import prices in New Zealand dollar terms over the past few years, import prices have fallen by significantly more, and our terms of trade – the relative price of our exports – have risen to a historical high (figure 13). Rising terms of trade have the effect of increasing the economy's overall real income, by increasing the basket of imports that can be purchased with the income received from a given basket of exports.

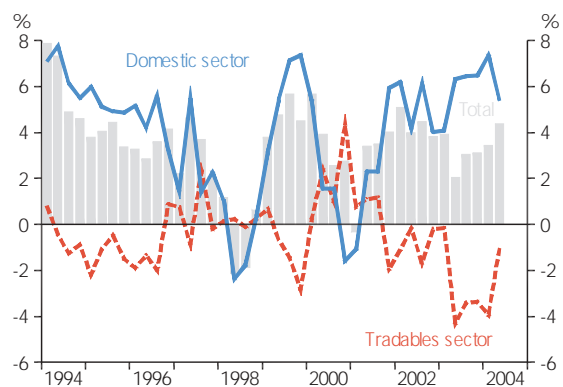
Our net exports position deteriorated between 2001 and the end of 2003, shifting from making a positive to a negative contribution to GDP growth (figure 14). Consequently, the current account deficit widened to around 4 per cent of GDP over the past year.

Figure 13
Terms of trade



Source: Statistics New Zealand.

Figure 14
Contributors to GDP²
(annual percentage change)



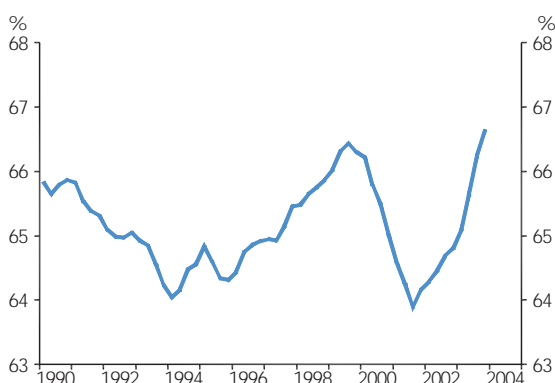
Source: Statistics New Zealand, RBNZ estimates.

Domestic Demand

The domestic economy has displayed strong growth over recent years, providing a powerful counter to weakness in the external sector. A sustained period of rapid population growth, brought about by a surge in net immigration, has fuelled consumer demand and a strong residential investment cycle. Employment has been growing rapidly and the unemployment rate is at a 16 year low. The rising terms of trade, moderate wage growth, and strong employment growth have helped to bolster incomes in spite of the high currency. This, along with low interest rates and large increases in house prices, has lifted household spending to very high levels (figure 15, overleaf).

² Here, domestic sector is GDP excluding net exports.

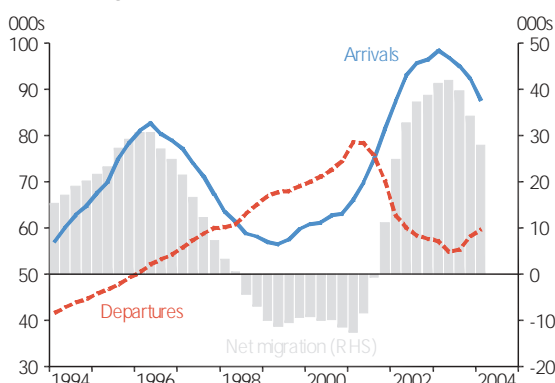
Figure 15
Household spending³
(% of GDP)



Source: Statistics New Zealand.

Population growth through net immigration has been a key contributor to the strength in the domestic economy over the past few years. Net permanent and long-term immigration added over 40,000 persons to the population in the year to March 2003, accounting for more than half of New Zealand's population gain over that period (figure 16). Net immigration began to slow in the middle of 2003, falling to below 30,000 persons in the year to March 2004. A decline in foreign language students – mainly from China – and an increase in departures of New Zealanders are amongst the drivers of the fall over the year.

Figure 16
Net immigration



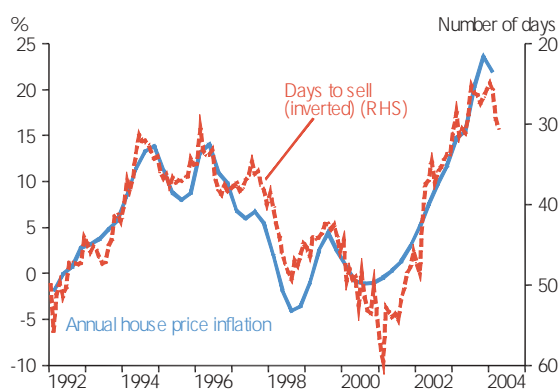
Source: Statistics New Zealand.

Consistent with the slowing in net immigration, there is growing evidence to suggest that the momentum in the housing market is slowing. Over the past few years strong demand for housing from both new immigrants and New

³ Household spending is the sum of private consumption and residential investment.

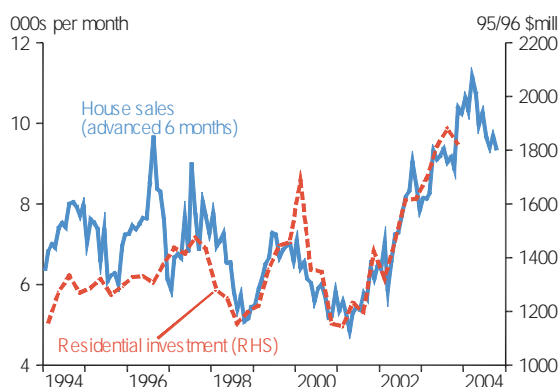
Zealand residents has resulted in a shortage of listings in many areas. Houses were selling at a record pace in 2003, placing upward pressure on house prices. According to Quotable Value New Zealand, house prices grew by more than 20 per cent per annum in the year to March 2004 (figure 17). However, the median number of days to sell a house has increased recently, and the number of house sales has been falling since late 2003, suggesting that the housing market might have peaked (figure 18).

Figure 17
House price inflation and days to sell



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

Figure 18
House sales and residential investment



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

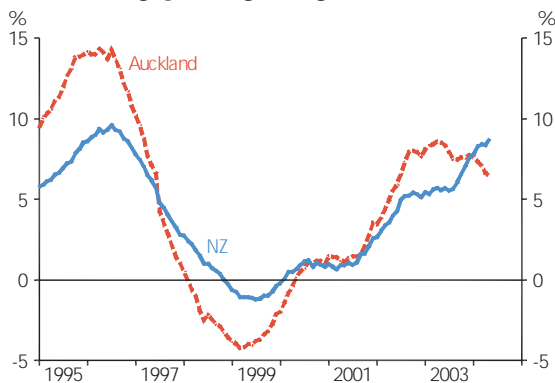
The rapidly growing population drew heavily on the economy's existing housing stock in 2003, putting pressure on resources and increasing prices and costs in the construction sector. Builders have reported long backlogs of work over the past year, causing delays in building new houses. This is despite nearly 40,000 more workers being added to

the construction sector since the beginning of 2001, and residential investment levels rising to historical highs. Strong issuance of dwelling consents around the beginning of 2004 suggests that building activity will remain strong – and likely grow further – in the early months of 2004. However, consents have declined in the past few months, providing an indication that residential investment might slow later in the year.

According to the REINZ, annual house price inflation has dipped slightly from its peak, consistent with the decline in house sales and the increase in the time to sell a house. The ASB's housing confidence survey also hints at easing house price inflation, showing in the first quarter of 2004 that a net 12 per cent of respondents thought that house prices would rise over the next year, compared with an average survey result of 50 per cent during 2003.

The increases in house prices have been much larger than the increases in rents over the past few years, reducing the rental yield on housing. According to Ministry of Housing rental data (based on information given on bond lodgement forms), growth in rents in the Auckland region has been easing over much of the past year (figure 19). This is consistent with anecdotes of an over-supply of housing in parts of the Auckland market – brought about by the fall in net immigration. As yet there are few signs that rental growth has begun to ease in the rest of the country, with rents in the CPI increasing sharply in the first quarter of 2004.

Figure 19
Average weekly rent
(annual average percentage change)

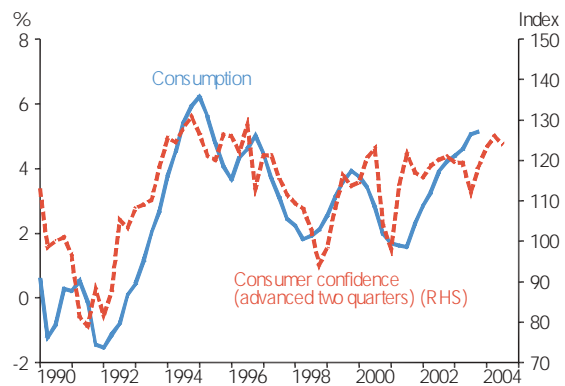


Source: Ministry of Housing.

As with residential investment, household consumption growth has been trending up since early 2001. 'Big-ticket' consumer durables, such as furniture and appliances, and motor vehicles, have been notable drivers of the growth. This

has been helped by strong competition in parts of the retail sector, exchange rate-induced discounting, and the booming housing market. According to the Westpac McDermott Miller survey, consumers have generally been in a buoyant mood over the past few years (figure 20). There were some tentative signs that consumption growth was beginning to moderate, with growth in consumer durables falling in the December quarter of 2003 for the first time since 2000, and Westpac McDermott Miller consumer confidence edging down in the March quarter. However, high retail sales growth suggests that consumption growth remained strong into the first quarter of this year.

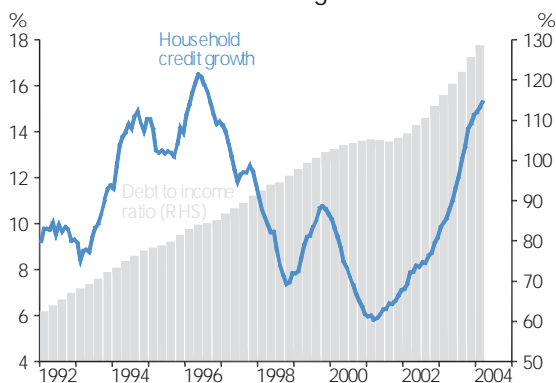
Figure 20
Consumption growth and consumer confidence



Source: Statistics New Zealand, Westpac McDermott Miller.

Despite strong employment growth, household income growth has not kept pace with spending growth, and the household debt to income ratio has increased to more than 125 per cent (figure 21, overleaf). Rising house prices have increased the perceived wealth of householders, and this, along with low interest rates, has encouraged them to become more leveraged by borrowing against the value of their house. An increase in the willingness of households to take on debt is also evidenced by rapidly rising household credit growth.

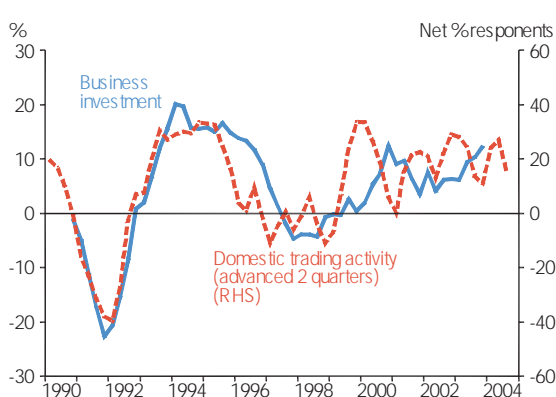
Figure 21
Household debt and credit growth



Source: RBNZ.

Business investment grew in excess of 10 per cent per annum over 2003. This growth reflected a combination of strong domestic demand, low interest rates, the high exchange rate (which reduced the New Zealand dollar cost of imported equipment), and a sustained period of high capacity utilisation. In addition, firms have generally been optimistic about the future, and the NZIER's domestic trading activity indicator – an indicator of firms' confidence about their own activity – has been sitting at above average levels (figure 22).

Figure 22
Business investment growth and business confidence



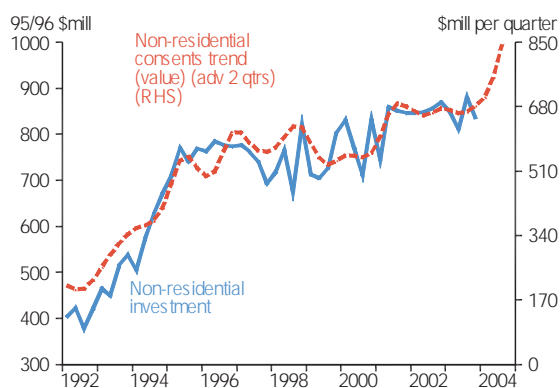
Source: Statistics New Zealand, NZIER.

While quite volatile historically, the plant and machinery component of business investment is currently growing at more than 20 per cent per annum. The expanding capital stock, however, has yet to ease the pressures on the domestic economy's productive capacity, and businesses continue to report pressures on their resources. Our business contacts have noted that difficulties finding labour have encouraged a

substitution towards labour-saving technologies, which has added to plant and machinery investment levels. The strength in plant and machinery investment has also been helped by low interest rates.

While the recent boom in construction activity has been dominated by residential construction, non-residential construction activity has been relatively subdued (relative to the economic cycle). The past few years have thus seen increasingly more resources diverted towards residential construction, away from the commercial construction sector. But this looks as though it might change. Non-residential building consents already lodged suggest that commercial construction activity will pick up over 2004 (figure 23). Businesses we have talked to suggest that there is some degree of substitutability of resources – particularly semi-skilled labour – between the commercial and residential construction sectors. With commercial construction expected to pick up and residential construction expected to slow, this could prolong the pressures that already exist in the construction sector as a whole.

Figure 23
Non-residential investment and consents



Source: Statistics New Zealand.

Cyclical pressures and inflation

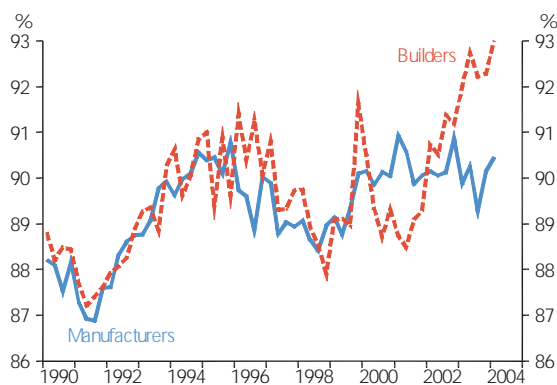
Productive capacity and the labour market

The sustained period of above-average economic growth has placed increasing pressure on productive resources. Indicators of resource use continue to paint a picture of an economy in which resources are being stretched – particularly in those industries servicing the domestic economy, such as the construction and services sectors.

We use a variety of indicators to determine the degree of spare capacity in the economy. Most of these indicators are

survey-based measures derived from the NZIER's Quarterly Survey of Business Opinion (QSBO). The capacity utilisation measure in the QSBO – a guide on the extent to which firms can increase their production without increasing costs – has been at very high levels over the past couple of years, driven in large part by an extremely high level of capacity utilisation in the building sector (figure 24). Although capacity utilisation has been particularly volatile recently, making it difficult to identify underlying trends, an increase in surveyed utilisation rates in the March quarter offers few signs of an easing of resource pressures. This comes despite the very high growth in plant and machinery investment over the past year.

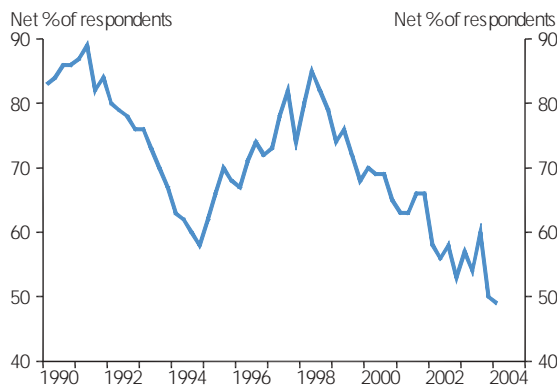
Figure 24
Capacity Utilisation



Source: RBNZ estimates based on NZIER's QSBO data.

Certainly, firms do not perceive a lack of demand as a key factor limiting increased production, with the proportion of firms citing a lack of forward orders as limiting their production falling steadily over the past few years (figure 25).

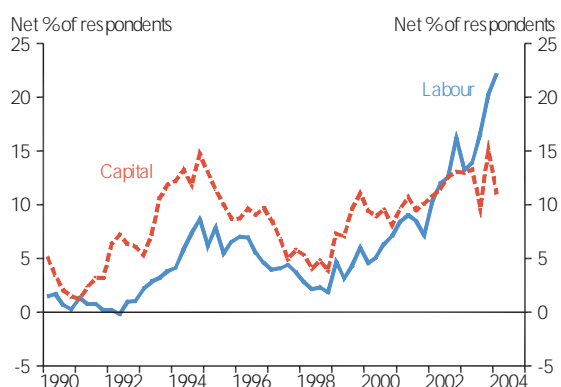
Figure 25
Factors limiting increased production (demand)



Source: NZIER.

Rather, it is more a lack of suitable labour and productive capacity that are the primary constraints on firms producing more. The proportion of firms citing labour as a constraint has been increasing recently, while the proportion of firms citing capital as a limiting factor fell slightly in the March quarter (figure 26).

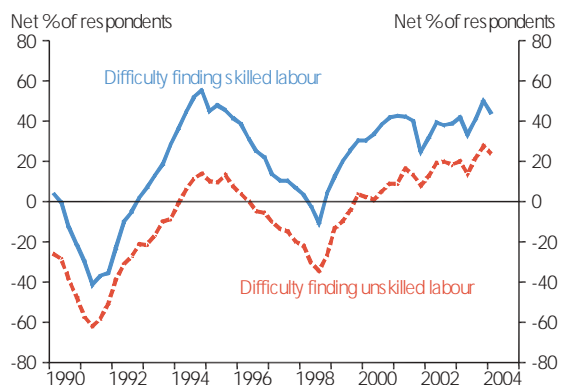
Figure 26
Factors limiting increased production (capital and labour)



Source: NZIER.

Employment has grown by almost 200,000 persons since the beginning of 2000, resulting in a sharp fall in unemployment and a continuation of labour shortages, as reported in the QSBO (figure 27). The unemployment rate has been trending down since 1998 and is currently at 4.3 per cent, the 4th lowest unemployment rate in the OECD.

Figure 27
Labour shortages

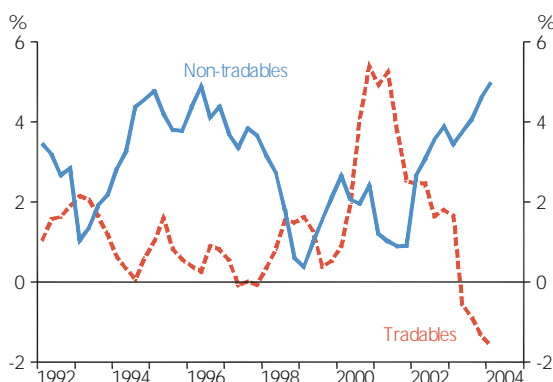


Source: RBNZ estimates based on NZIER's QSBO data.

Inflation pressures

Non-tradables inflation has increased steadily over the past couple of years to an annual rate of 5 per cent. Despite this, overall CPI inflation has fallen from 2½ per cent to 1½ per cent over the year to March 2004, masking considerable divergence in the behaviour of inflation in the tradables and non-tradables sectors (figure 28).

Figure 28
Tradables and non-tradables inflation
(annual rate)

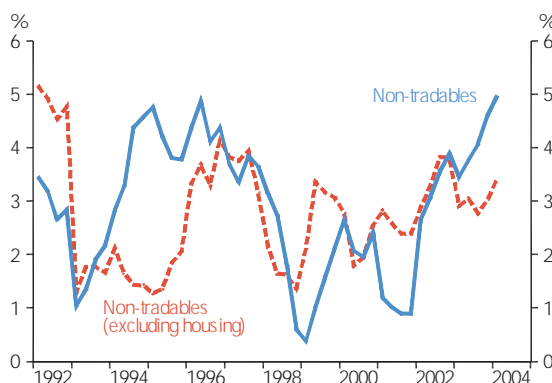


Source: RBNZ.

As was discussed in Chapter 2, the high level of non-tradables inflation is fully consistent with our view that the economy has been operating well above capacity for some time (see figure 2, Chapter 2). Inflation in the housing and construction markets has been particularly strong over the past year, with costs associated with the purchase and construction of new dwellings having risen by more than 8½ per cent in the year to March. Other housing-related components, such as dwelling rents and real estate agents' fees, have also shown strong growth over the year. Domestic inflationary pressures, however, are not isolated to the housing sector. Excluding the housing-related components, annual non-tradables inflation is currently sitting at around 3½ per cent (figure 29).

So far, these growing inflationary pressures in the non-tradables sector have been more than offset by falling inflation in the tradables sector. A combination of the appreciating exchange rate and strong competition in the retail sector has led to outright falls in the prices of many imported goods, such as used cars and electrical appliances. Combine this with other more transitory downward influences on inflation, such as heavy airfare discounting on the trans-Tasman travel routes,

Figure 29
Non-tradables inflation
(annual rate)

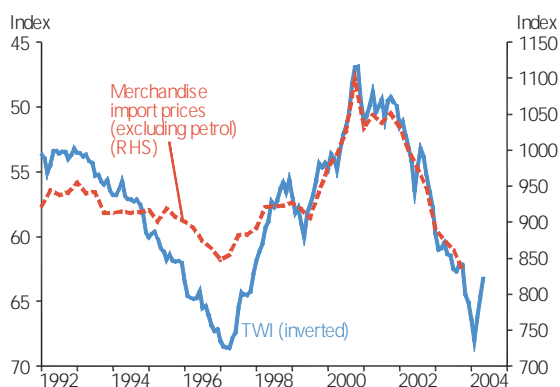


Source: RBNZ.

and annual tradables inflation was sitting at a very low -1.6 per cent in early 2004. The large drop in international airfares, in particular, has had a significant downward influence on tradables inflation – tradables prices excluding airfares fell by 0.4 per cent per annum in the year to March.

The fall in import prices seen so far in this exchange rate cycle is reasonably consistent with the magnitude of the exchange rate appreciation that occurred up until March this year (figure 30). This is in contrast to the the last exchange rate appreciation in the mid-1990s, when the impact of the exchange rate on import prices appeared somewhat muted, perhaps due to a widening of margins on the part of foreign suppliers.

Figure 30
Import prices and the TWI

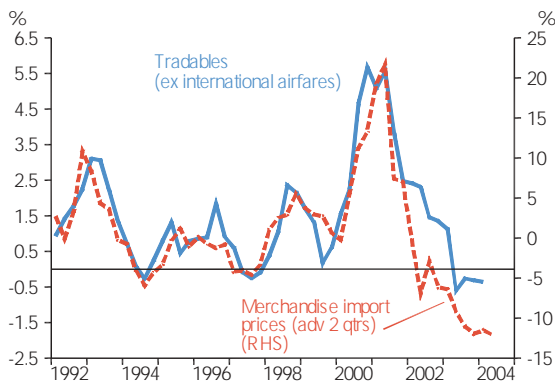


Source: Statistics New Zealand, RBNZ.

There is a hint, however, that consumer prices have not fallen by the extent implied by the fall in import prices (figure 31). This might reflect an attempt by importers, distributors and retailers to expand margins by more than is usual. Indeed,

strong domestic demand conditions may be giving sellers the capability to limit passing on exchange rate gains to customers. It could also be the case that costs, such as those associated with labour and transportation, have increased along the distribution chain, reducing the capability of sellers to pass on exchange rate gains.

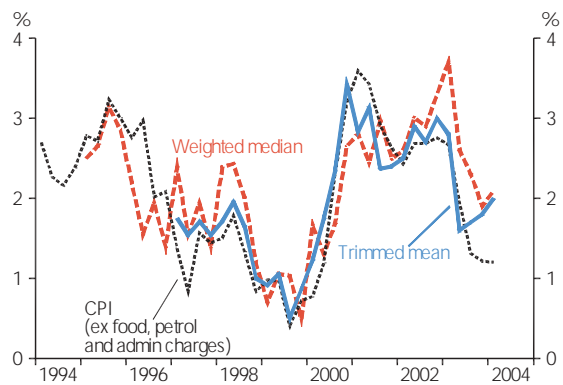
Figure 31
Import prices and tradables inflation
(annual rate)



Source: Statistics New Zealand, RBNZ.

A large divergence between tradables and non-tradables inflation makes it difficult to identify underlying trends in the CPI (figure 32). We monitor a variety of different indicators of 'trend' inflation, which attempt to remove the effects of temporary, one-off shocks to the CPI. Both the weighted median and the trimmed mean measures have been rising recently, and currently sit around 2 per cent. The CPI excluding food, petrol and administrative charges – an indicator that aims to remove known volatile items from the CPI not amenable to monetary policy – has stopped falling and currently stands at just over 1 per cent. While these underlying measures of inflation do a reasonably good job at removing the temporary effects of one-off shocks from the CPI, they are influenced by the exchange rate, whose impact on the prices of goods and services is far more pervasive. Thus, with the exchange rate moving sharply recently, we currently view non-tradables inflation as a better reflection of trend inflationary pressures.

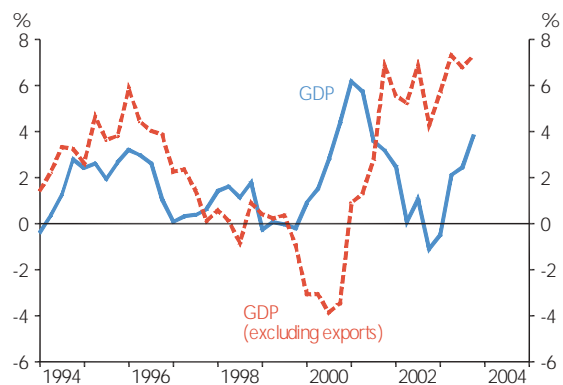
Figure 32
Indicators of core inflation
(annual rate)



Source: Statistics New Zealand, RBNZ.

Other, non-CPI-based, price measures provide mixed evidence on inflationary pressures at present. The annual growth in the GDP deflator, conceptually one of the broadest measures of prices, turned around in late 2002 and currently stands at just under 4 per cent (figure 33). However, the deflator has been subdued by falling export prices. The GDP deflator after excluding these prices – a measure of domestically-sourced inflationary pressures, similar to non-tradables inflation – has been growing at much higher rates, consistent with continued strength in the domestic economy. Annual inflation in the private consumption deflator has been falling over the past few years, reflecting the rising currency, and stood at just 0.1 per cent in the December quarter (table 1, overleaf). But Statistics New Zealand has identified problems with some of the methodologies used to compile the deflator, and it is currently under review.

Figure 33
National accounts deflators
(annual percentage change)



Source: Statistics New Zealand.

Table 1
CPI and other price measures
(annual percentage changes)

	2002			2003			2004
	Sep	Dec	Mar	Jun	Sep	Dec	Mar
CPI	2.6	2.7	2.5	1.5	1.5	1.6	1.5
Food	2.3	0.9	-0.2	0.0	0.3	0.2	0.5
Housing	3.0	4.0	4.0	4.7	5.9	6.6	7.0
Household operations	2.9	2.7	1.9	1.1	0.9	1.5	1.4
Apparel	1.2	0.7	0.8	-0.6	-1.1	-1.1	-1.0
Transportation	1.2	3.3	4.3	-1.7	-2.5	-3.9	-4.6
Tobacco and alcohol	3.6	3.6	3.1	2.7	2.6	2.9	2.9
Personal and health	4.5	4.2	3.8	3.5	2.6	2.4	2.7
Recreation and education	2.3	2.5	2.7	2.1	1.7	1.6	2.0
Credit services	2.3	1.9	-2.0	0.7	-0.1	1.2	-0.9
Derivatives and analytical series							
CPI ex food, petrol and government charges	2.7	2.8	2.7	1.9	1.3	1.2	1.2
CPI non-tradables	3.6	3.9	3.4	3.8	4.1	4.6	5.0
CPI tradables	1.6	1.8	1.7	-0.6	-0.9	-1.3	-1.6
CPI weighted median (of annual price change)	2.9	3.3	3.7	2.6	2.3	1.9	2.1
CPI trimmed mean (of annual price change)	2.7	3.0	2.8	1.6	1.7	1.8	2.0
Merchandise import prices (excluding petrol)	-6.2	-9.8	-13.8	-12.5	-11.4	-11.9	n/a
PPI - Inputs	-2.1	-1.4	-1.3	-1.9	0.1	-0.1	-0.6
PPI - Outputs	-0.1	-0.1	-0.4	-0.6	0.7	1.1	0.9
Private consumption deflator	2.0	1.7	1.2	0.4	0.4	0.1	n/a
GDP deflator (derived from expenditure data)	1.1	-1.1	-0.5	2.1	2.5	3.9	n/a
Retail trade deflator	1.1	1.0	1.4	-0.7	-0.7	-0.4	-0.6

Source: Statistics New Zealand, RBNZ estimates.

Annual growth in the Producers' Price Indexes (PPI), which are also broad measures of prices, has likewise been increasing (table 1). Generally speaking, the trends in producers' prices have been similar to those seen in consumers' prices over 2003. That is, the industries most exposed to international trading conditions, such as the retail and agricultural sectors, have experienced falling prices and domestically-oriented industries, such as the construction sector, have experienced rising prices.

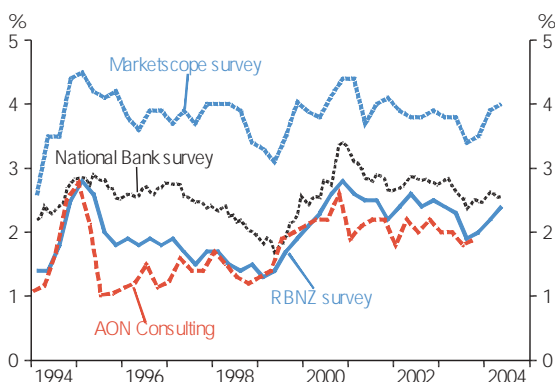
Inflation expectations and wages

Inflation expectations on the part of firms and workers guide price and wage setting decisions over the medium term, and they influence how businesses and households make their investment and consumption decisions. Fluctuations in the rate of CPI inflation can become ingrained in inflation expectations, and have the ability to affect the behaviour of firms and households. The inflation expectations of households and firms are not directly observable, but survey measures can provide some insight.

Most of the survey measures of one year ahead inflation expectations that we monitor, including the Marketscope

survey (covering households), the RBNZ survey of expectations, the National Bank's Survey of Business Opinion (NBBO), and the AON Consulting survey (covering professional economists), have edged up slightly after dipping briefly around the middle of 2003. Surveyed short-term inflation expectations have generally followed headline inflation rates (albeit with less volatility); a case in point being the large fall in expectations following the 1 per cent drop in annual CPI inflation around the middle of 2003 (figure 34). However, this pattern may not hold when inflation diverges considerably between the tradables and non-tradables sectors. As we have seen, headline CPI inflation has been relatively stable at around 1.5 per cent per annum since June 2003, yet, surveyed one year ahead inflation expectations have generally moved back up since that time. This may suggest that respondents expect the exchange rate-related fall in inflation to be temporary, and/or that the exchange rate will depreciate faster than non-tradables inflation will decline. Surveyed expectations of inflation further into the future have shown fewer signs of increasing, highlighting a tendency for these longer-term measures to 'look through' more temporary inflation fluctuations.

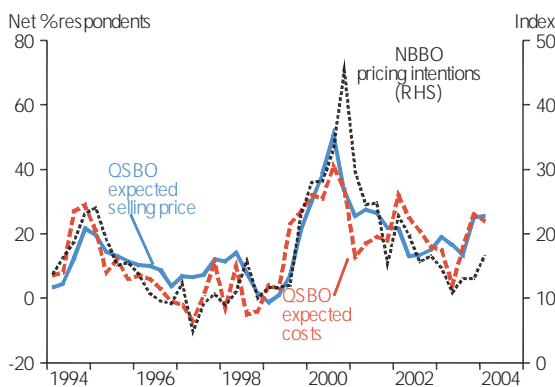
Figure 34
Annual inflation expectations
(one year ahead)



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

The pricing intentions of firms are another indicator of future inflationary developments. The firms surveyed by the NZIER and the National Bank have generally expected prices and costs to increase recently, also suggesting an increase in inflationary pressure going forward (figure 35).

Figure 35
Expected prices and costs



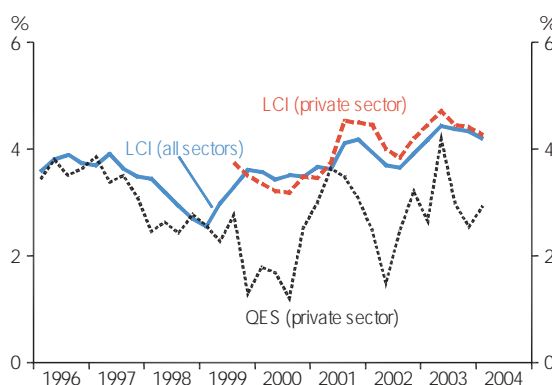
Source: NZIER, National Bank of New Zealand.

Although our assessment is that wages have not been a significant driver of inflation over recent history, wage data can provide a useful perspective on how our current economic environment is influencing pricing decisions.

While some measures of wage inflation can be quite volatile, the tight labour market over the past few years means that most measures currently sit above average levels (figure 36). Annual growth in the Labour Cost Index (LCI) for the private sector – a measure of salary and wage rates for a fixed quantity and quality of labour – has increased over the past few years, in line with continued reports of skill shortages.

Growth in the unadjusted LCI – which measures the wage for a fixed quantity, but not a fixed quality of labour – has also been trending up, but has edged down over recent quarters. Average hourly earnings growth from the Quarterly Employment Survey (QES), a relatively volatile wage measure, also appears to have been above average over recent years.

Figure 36
Unadjusted LCI and hourly earnings
(annual percentage change, the LCI series shown exclude productivity adjustments)



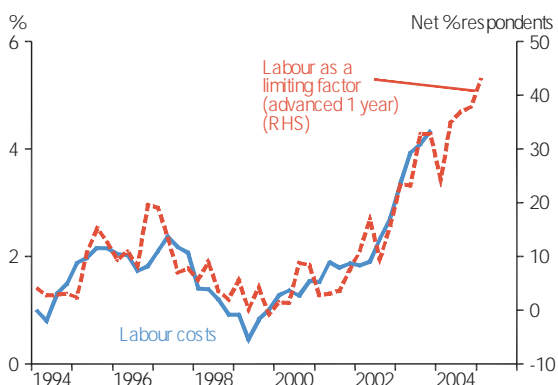
Source: Statistics New Zealand.

As mentioned in our March *Statement*, these measures of wage inflation seem quite subdued, given the degree of pressure on resources shown by some indicators, especially in areas such as the construction industry. A closer look at this industry, however, reveals pockets of very strong labour cost pressure. Labour costs for carpenters and joiners have increased particularly sharply recently, consistent with severe shortages of workers in that part of the labour force (figure 37, overleaf). Construction costs have been the largest positive contributor to annual CPI inflation over the past year and, according to Statistics New Zealand, 72 per cent of respondents cited rising labour costs as a reason behind increased costs in the March quarter.

So far, these strong wage pressures in the construction sector do not appear to have spilt over into wages in other parts of the economy. However, persistent intense wage pressure in the construction sector raises the risk of higher wage demands in other sectors going forward.

Our business contacts suggest that firms have needed to pay increasingly higher wages to attract new staff, particularly for skilled workers. Some firms have gone to the extent of searching outside New Zealand to help meet their labour

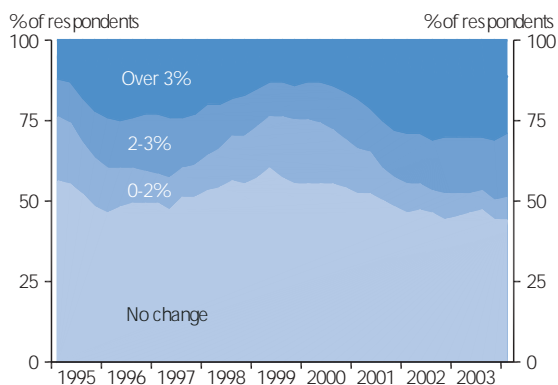
Figure 37
Carpenters' and joiners' labour costs and labour as a limiting factor in the building sector



Source: Statistics New Zealand, NZIER.

requirements. This is broadly corroborated by recent movements in the distribution of wage increases in the LCI (figure 38). The proportion of wage increases in excess of 2 per cent per annum has been steadily increasing since 1999, and currently stands at its highest level since the LCI began in 1992. And for the March quarter of 2004, Statistics New Zealand notes that of the annual increases in salaries and wages in excess of 5 per cent, 63 per cent were to match market rates, retain staff or attract staff, compared with 20 per cent for increases of up to 2 per cent.

Figure 38
Distribution of wage increases



Source: Statistics New Zealand.

Box 3

Oil prices and the New Zealand economy

US dollar oil prices have recently reached 13 year highs (US\$42 per barrel for the West Texas grade), roughly 60 per cent higher than 2002 levels.

International supply concerns and strong world demand have boosted oil prices over the past year. On the supply side, lower-than-expected production in Iraq, coupled with ongoing terrorism and geopolitical tensions in the Middle East, has helped to increase uncertainty about world oil production. Seasonally low oil stocks in the US have also added to the pressure on supply.

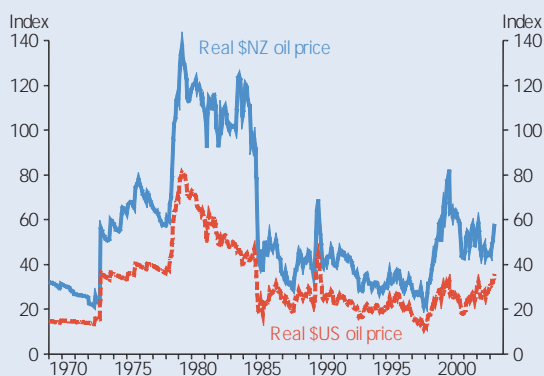
Saudi Arabian supply remains critical to the production picture, and speculative pricing, going forward. With other oil producing countries already running at near full capacity, extra Saudi production is needed in order to bring oil prices down in the face of current demand (production has been increasing strongly there, but heightened security concerns in that country have kept prices high to date).

On the demand side, world oil consumption has grown strongly over the past 12 months, led by high output growth in China and robust gasoline demand in the United States.

A rise in oil prices increases inflation directly through its effect on transport and petrochemical costs. Increases in inflation expectations and wage demands can potentially follow, leading to spill-over effects on wider inflation. After a while, higher petrol and diesel costs also act to reduce activity in the domestic economy, as consumers and businesses gradually cut back on other spending in the face of increasing transport costs.

The impact of this oil price rise on both New Zealand and international economies will depend on the level of the price increase. The recent level of nominal oil prices is high by historical standards. However, the real price is by no means unprecedented. In particular, the real US dollar price of crude oil is currently well below the price that prevailed at the start of the 1980's. The increase has also been much less compared to historical episodes when expressed in New Zealand dollars (figure 39).

Figure 39
Real West Texas Intermediate oil price



Source: Bloomberg, Datastream, Statistics New Zealand, RBNZ estimates.

Determining how long higher oil prices will be sustained is also an important factor in determining their likely economic effects. This is because producers and consumers feel less pressure to adjust their activities if they expect the price change to be temporary. According to studies by the IMF a permanent \$5 increase in oil prices is estimated to decrease OECD country growth by 0.2 to 0.4 per cent and raise CPI inflation by 0.1 to 0.5 per cent after 1 year. However, shorter-lived spikes in oil prices can be expected to result in a more modest reduction in output.

It is likely that, taken on its own, the effect of the recent oil price increase could be slightly greater for New Zealand than for larger industrialised countries. Unlike in the United States and Europe, in New Zealand there has been no significant long run decline in the consumption of oil relative to GDP. This pattern may reflect factors such as the decline in the price of vehicles in New Zealand, with motor vehicle tariff rates falling since the mid 1980's.

However, New Zealand remains less dependent on oil for domestic production than some developing Asian economies such as South Korea and China. Hence, further or prolonged oil price increases could well moderate the recent strong growth enjoyed within the Asian region. To the extent that higher oil prices have the potential to reduce activity worldwide, demand for New Zealand's commodity exports could also be expected to moderate (all else being equal).

Many oil analysts and commentators are expecting a decline in oil prices over the next 12 months, with oil prices heading down towards the \$US30 per barrel mark by May 2005. A possible moderation in Chinese demand for imported inputs is a frequently cited factor that could contribute to the price decline. An easing in gasoline demand from the United States as it moves out of its summer driving season, coupled with expectations of increased oil supply from OPEC and non-OPEC countries, could also contribute to some waning in oil price pressure. Strategically, oil producing countries have an incentive to keep prices at a competitive level given that a permanently higher level of oil prices could encourage the development of alternative energy sources, as well as more efficient energy conversion and production technologies.

The projection contained in this *Statement* allows for a decline in oil prices to around \$US30 per barrel by May 2005, broadly consistent with May 2004 *Consensus Forecasts*. The (assumed) temporary character of the peak in oil prices limits the extent to which oil price inflation spills over into wider price increases, and into reduced consumer and business spending. A more enduring oil price increase would result in lower-than-anticipated growth and more persistent price pressures.

4 The macroeconomic outlook

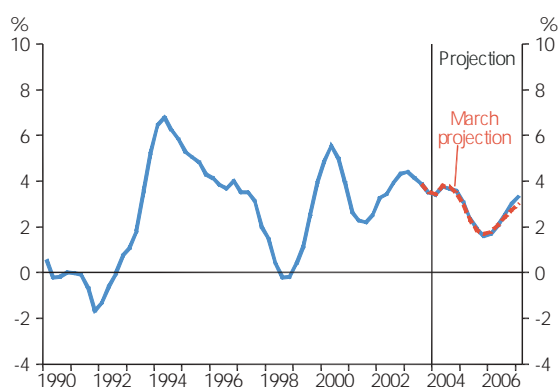
Overview

This chapter – and the accompanying tables in Appendix 1 – sets out the Bank's projection of economic conditions and the policy outlook. As always, the economic outlook is subject to a range of uncertainties and is contingent on a number of key assumptions and judgements, some of which were discussed in Chapter 2. With these uncertainties in mind, the projection presented here is a useful way of establishing, in broad terms, how we think the major forces impacting on the economy might evolve over the next two years or so, and what they might mean for monetary policy over that time.

This chapter describes a projection of GDP growth remaining around current high levels for most of 2004, before slowing through 2005, and then recovering towards average levels in the later years of the projection. Strong terms of trade and further increases in household income and wealth are expected to continue supporting household consumption during 2004. Beyond that, the lagged effects of declining net immigration and lower house price inflation are projected to combine to constrain household consumption growth. In addition, business investment growth is projected to remain strong this year before slowing next year, as capacity utilisation eases and expected profitability drops back. We assume that the exchange rate remains above its trend over the projection period, and this is expected to constrain net exports, notwithstanding improving world demand conditions.

Comparing this projection to our March *Statement*, the outlook for GDP growth is broadly unchanged (figure 40). What have changed since March are the drivers of the projected slowdown in GDP growth. We now expect stronger household income growth, primarily because of greater strength in the terms of trade and stronger labour incomes. This strength in household income is expected to provide a boost to consumer spending. In addition, a lower exchange rate assumption means that net exports are projected to be stronger. Accordingly, in order to keep the medium-term path of inflation within the target range, interest rates are projected to rise to a level that no longer acts as a stimulus to activity. Relative to March, therefore, we are projecting higher 90 day interest rates, which we expect to roughly offset the effect of stronger incomes on demand.

Figure 40
GDP
(annual average percentage change)



Source: Statistics New Zealand, RBNZ estimates.

While the overall projection for GDP growth is very similar to the March *Statement*, CPI inflation is expected to be quite a bit higher over 2005 (see figure 6, Chapter 2). This is primarily because the recent sudden fall in the exchange rate and sharp increases in international oil prices mean that tradables inflation is likely to increase more quickly than we assumed in March. Further ahead, our current projection for CPI inflation is broadly unchanged relative to March. We now expect annual CPI inflation to peak at around 3¼ per cent in the middle of 2005, before falling over 2006.

The world economy

Our outlook for New Zealand's main trading partners is largely based on forecasts and other analyses of individual country prospects made by forecasters in the countries in question. A useful benchmark for the growth outlook for our 12 main trading partners is *Consensus Forecasts*, a structured survey of the main forecasters in the various countries. Against this background, most of our focus is on understanding the channels through which the international economy is likely to influence activity and prices in New Zealand, the risks and uncertainties around the world growth outlook, and the key structural issues that may be affecting our trading partners.

On balance, the outlook for New Zealand's main trading partners has continued to improve, as outlined in table 2. The global economy is showing signs of a sustained and broad-based recovery. Recent strong GDP growth in the US is expected to continue, driven by strong growth in household consumption and capital investment. The Asian economies, especially China, are expecting further robust growth. Across

Table 2
Forecasts of export partner GDP*
(calendar year, annual average percentage change)

Country	2001	2002	2003	2004f	2005f	2006f
Australia	2.5	3.8	3.0	3.9	3.3	3.3
United States	0.5	2.2	3.1	4.6	3.8	3.6
Japan	0.4	-0.3	2.6	4.1	1.8	1.6
Canada	1.9	3.3	1.7	2.6	3.4	3.3
Eurozone**	1.6	0.9	0.4	1.6	2.0	2.3
United Kingdom	2.1	1.6	2.2	3.1	2.7	2.0
Asia ex-Japan***	2.0	5.1	4.8	6.6	5.9	5.9
12 Country Index	1.6	2.6	2.9	4.2	3.5	3.5

* Source: Consensus Economics Inc.

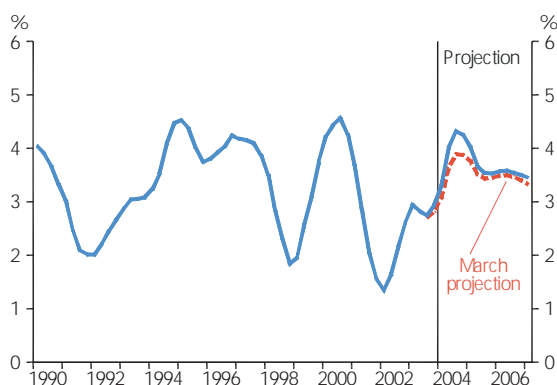
** Includes Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain.

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

the Tasman, Australian growth expectations remain at just above average rates.

Growth expectations for Europe are modest, but appear to have stabilised after recent downward revisions. Overall, these factors have been reflected in further small upward revisions to *Consensus Forecasts*. *Consensus Forecasts* for growth in our 12 main trading partners are now slightly above 4 per cent over 2004, and 3.5 per cent over 2005 (figure 41).

Figure 41
Trading partner GDP
(annual average percentage change)



Source: Consensus Economics Inc, RBNZ estimates.

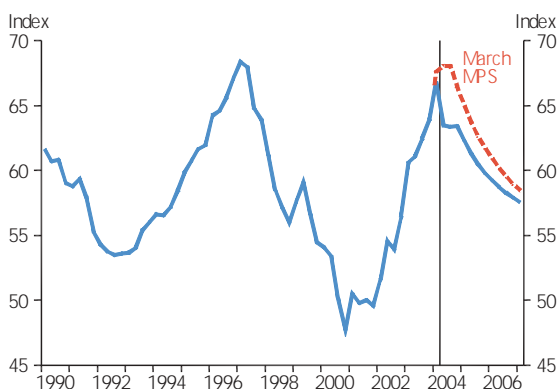
Consensus Forecasts for world inflation have also been revised up, but still remain at low levels. As noted in Chapter 2, we see some possible upside risks to the outlook for world inflation, and broadly balanced risks to the outlook for trading partner GDP.

Tradables sector prices and activity

The outlook for tradables sector prices and activity is for the current account deficit to widen as the high exchange rate squeezes the net export sector. We also expect the terms of trade to deteriorate from its very high level. However, as mentioned in Chapter 3, export incomes are now much healthier than we assumed in the *March Statement*, and we project this to persist over the next few years. We are now expecting terms of trade that are more favourable, and a smaller current account deficit than we projected in March.

The outlook for export prices measured in New Zealand dollar terms depends partly on the outlook for the exchange rate. For the purposes of this projection, we have assumed that the trade weighted exchange rate will remain around its current level (63½ on the TWI at the time this projection was finalised) until the end of 2004, before falling gradually towards its long-term average level (figure 42, overleaf).

Figure 42
Nominal TWI technical assumption



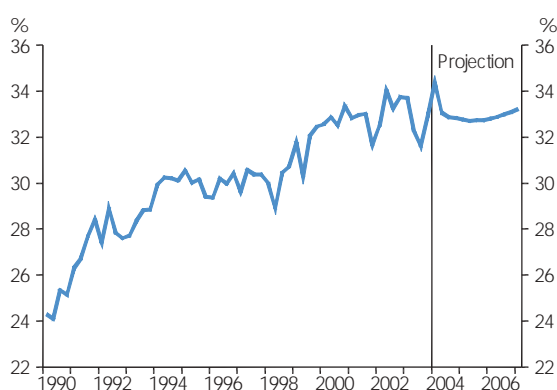
Source: RBNZ estimates.

The other factor that affects export prices in New Zealand is the world price of our goods and services. As noted in Chapter 3, world commodity prices stand at very high levels, and indicators suggest that this strength will continue in the near term. However, based on past relationships, current price levels are higher than can be explained by the current state of world demand. Over the coming months we expect the special supply factors that have supported the world price of our commodities to dissipate. Consequently, we are projecting world commodity prices to ease back over the second half of 2004, to a level more consistent with world demand.

This projected fall in world commodity prices underpins our expectation that domestic currency export prices will fall slightly in the second half of 2004. Further out, we expect a recovery in domestic currency export prices, as the currency is assumed to depreciate and world prices are projected to stabilise. Our current projection for New Zealand dollar export prices is around 7 per cent higher in 2004 than was projected in March.

Despite the near-term spike in export volumes that occurred as a result of a run down in dairy inventories, we continue to project that export volumes will under-perform overall GDP growth for most of the projection (figure 43). The main reason for this underperformance is the lagged effect of the high exchange rate, which is projected to constrain exports. Compared to March, however, we are now projecting a higher level of export volumes over the next few years, with a similar growth profile. Most of the improvement in the outlook for the level of export volumes since March has come in the exports of services, which we believe are relatively more sensitive to the exchange rate than other exports.

Figure 43
Export volumes
(% of trend output)



Source: Statistics New Zealand, RBNZ estimates.

The outlook for export volumes varies significantly across the main sectors. Beginning with primary exports, our forecasts rely heavily on the advice of various primary sector agencies and companies. Their views on the outlook for the primary sector take into account detailed factors like climatic conditions, stocks and productivity, and conditions in individual markets. Based on these views, we expect primary export volumes to fall toward more normal levels over this year, and to continue growing at normal rates further out. The recent strength in primary sector exports appears to be due to a rundown of stocks in the dairy export sector. As stocks stabilise, we project that the level of dairy exports will return to trend.

Forestry exports are projected to remain quite weak, consistent with a number of forest owners indicating that they intend increasing the average age of their forests before harvesting, due to poor New Zealand dollar returns and high shipping costs. However, the lower projected level of the exchange rate has prompted us to slightly revise up our projection for forestry exports relative to the March projection.

Export volumes of manufactured goods have continued to grow steadily, and we expect this to continue going forward. Many of our manufactured goods are exported to Australia, whereas the majority of our other exports are bound for more distant shores. The outlook for the Australian economy is for modest growth, rather than for accelerated recovery-based growth like in other parts of the world. Consequently, our projection is for continued modest growth in manufactured exports.

Exports of services are projected to remain steady at their current high levels, reflecting high tourist arrival numbers recently. The improved world outlook is expected to add further impetus to New Zealand's tourist industry. In addition, the assumed lower level of the exchange rate relative to March means that we do not expect the exchange rate to constrain exports of services to the same extent as we did in March. Compared to March, we are now projecting a significantly higher level of exports of services. In addition to the factors outlined above, part of the difference is due to a stronger projection for spending per tourist, which recent data show has recovered more quickly from last year's low than we assumed in March.

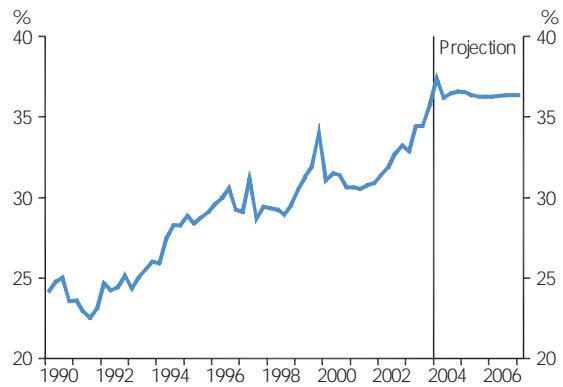
Combining our projections for export prices and volumes gives a picture of exporters' incomes that are significantly stronger than we projected in March, although they remain low relative to their 2001/2002 peak. This more optimistic outlook for export incomes implies that they will be less of a brake on domestic activity than we allowed for in the *March Statement*.

Improving world demand has also been causing increases in world prices for some of the goods and services that New Zealand imports. One example is the world price of oil, which has received a high degree of media attention recently, hitting record highs in nominal terms. We are adopting the view of most commentators that the world price of oil will decline towards more normal levels over the next year (see box 3). We expect the world price of non-oil imports to rise modestly over the projection, mostly due to world demand continuing to drive industrial commodity prices upwards. The outlook for oil prices in New Zealand dollar terms is for the projected decline in world oil prices to be offset by the assumed depreciation of the New Zealand dollar. New Zealand dollar prices of other imports are projected to rise as the exchange rate depreciates.

The past year has seen a significant increase in the growth of import volumes, as retailers, consumers, and businesses took advantage of the relatively high purchasing power of the New Zealand dollar. Looking ahead, we expect the falling exchange rate and the slowing domestic economy to limit import growth. Broadly speaking, increasing imports of investment goods will be offset by falling growth in consumption imports, so that overall, imports are projected

to remain a constant share of GDP over the projection horizon (figure 44).

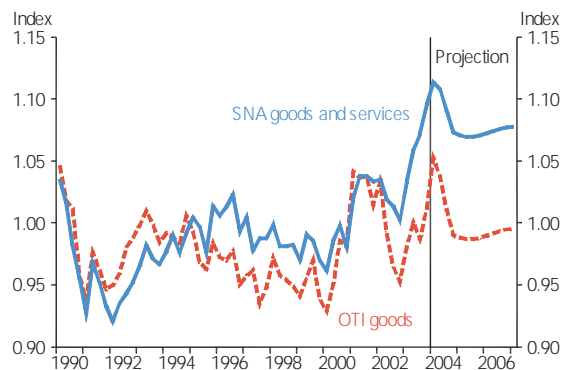
Figure 44
Import volumes
(% of trend output)



Source: Statistics New Zealand, RBNZ estimates.

As mentioned in Chapter 3, New Zealand's terms of trade have improved considerably over the past year, as falls in New Zealand dollar import prices have outstripped falls in New Zealand dollar export prices. In line with the import and export price projections discussed above, we expect the terms of trade to fall over the next year, before stabilising (figure 45). This projection for the terms of trade is considerably higher than we assumed in the *March Statement*. The fact that the projected terms of trade are higher than in March, despite the large increase in world oil prices, highlights the size of the increase seen in the world price of our commodity exports.

Figure 45
Terms of trade



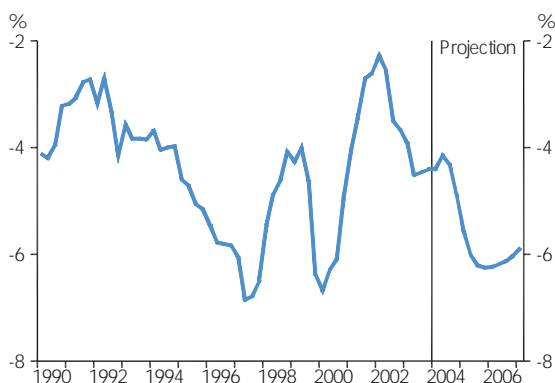
Source: Statistics New Zealand, RBNZ estimates.

Better terms of trade translate directly into higher real incomes for New Zealanders. The stronger incomes that exporters are expected to receive over the projection is one of the major positive influences on consumption spending in

this projection. Higher prices for imported goods, including oil, are expected to only partially offset the effect of improved export prices. On balance, the external sector is providing less of a constraint to consumption spending in this projection than we expected in the March *Statement*.

Our outlook for export and import activity is consistent with a widening in New Zealand's current account deficit over the coming two years to peak at around 6 per cent of GDP in late 2005, before beginning to improve (figure 46). The deterioration in the current account is a consequence of growth in import volumes outpacing that of exports, as well as the effect of the falling terms of trade.

Figure 46
Current account balance
(% of nominal output)



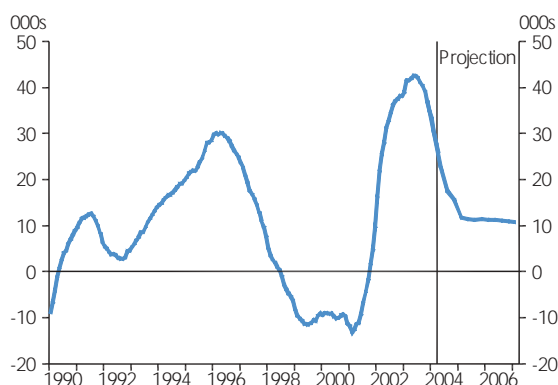
Source: Statistics New Zealand, RBNZ estimates.

Domestic spending

Domestic expenditure has grown very strongly over the past few years. Looking ahead, we expect growth in domestic expenditure to slow over 2005, before returning to more normal growth rates in 2006.

The very strong net immigration during 2002 and 2003 began to slow late last year, and we expect this trend to continue. We expect the number of departures to continue to increase – as overseas job markets improve – and the number of arrivals to remain around current levels across the projection. However, permanent and long-term net immigration is projected to remain positive, and will therefore continue to add positively to the level of consumption (figure 47).

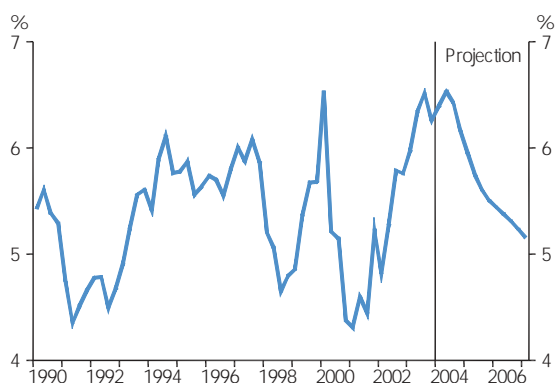
Figure 47
Net immigration
(annual total)



Source: Statistics New Zealand, RBNZ estimates.

We believe that there is currently still excess demand for housing as a result of the strong net immigration over 2002 and 2003, suggesting further residential investment growth in the near term. However, consistent with declining net immigration and the decline in house sales and building consents discussed in Chapter 3, residential investment is projected to decline from its current high level towards the end of the year (figure 48).

Figure 48
Residential investment
(% of trend output)



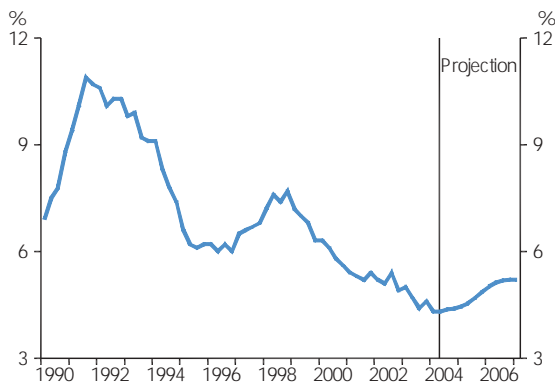
Source: Statistics New Zealand, RBNZ estimates.

The house price inflation associated with the strong housing market cycle over the past two years has improved household wealth, and provided a significant boost to household consumption. Consistent with declining population growth and the associated 'cooling-down' of the residential property market, we project house price inflation to fall quite sharply, possibly turning mildly negative in 2005. As a result,

we expect household wealth to grow more slowly over the projection horizon.

Favourable domestic employment conditions are continuing to support household incomes. As noted in Chapter 3, employment and hours worked have exhibited considerable strength recently, with unemployment hitting a 16 year low. Indications are that the labour market will remain very tight throughout 2004, with unemployment remaining at current low levels until the second half of 2005 (figure 49). This labour market tightness is likely to cause real wage rates to rise a little faster than usual in the coming years.

Figure 49
Unemployment rate

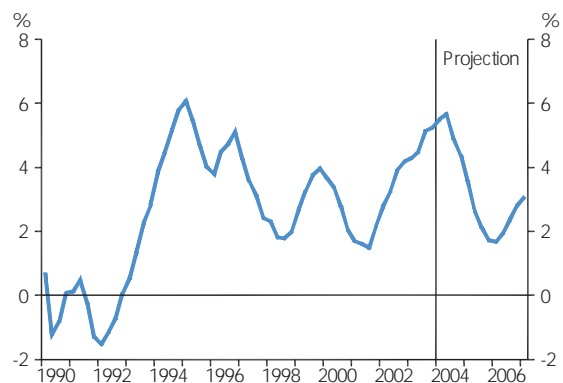


Source: Statistics New Zealand, RBNZ estimates.

Higher wage rates, higher hours worked, and strong employment all translate into higher incomes for New Zealanders. Strong incomes coupled with strong wealth effects from the recent house price inflation lead us to expect further robust growth in consumer spending for the rest of 2004, albeit at lower growth rates than we have seen recently. Further ahead, we expect that falling house price inflation, falling population growth, and the removal of monetary policy stimulus will slow the rate of growth in consumer spending to around 1½ per cent per annum, before it accelerates again to a more normal pace (figure 50).

As with household consumption, business investment has been growing very strongly in recent times, and indicators such as capacity utilisation, firms' investment intentions, overtime worked, and the value of non-residential construction consents suggest that this strength will continue. As mentioned in Chapter 3, tightness in the labour market has increased firms' labour costs, providing an incentive for firms to invest in labour-saving capital. This is supported by

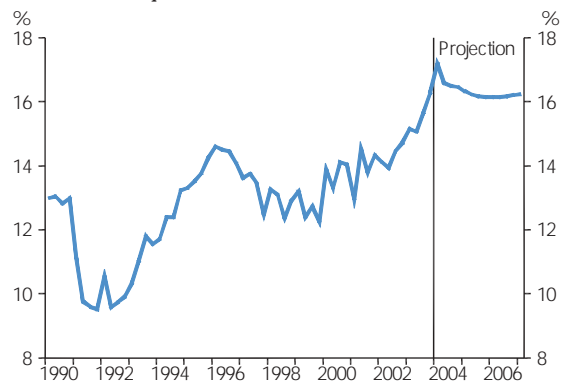
Figure 50
Real household consumption
(annual average percentage change)



Source: Statistics New Zealand, RBNZ estimates.

discussions with our business contacts, with most firms reporting an intention to continue investing at around current levels. As a result, we project further strong investment growth over the next few quarters, before growth slows to a rate that keeps investment constant as a share of GDP (figure 51).

Figure 51
Business investment
(% of trend output)



Source: Statistics New Zealand, RBNZ estimates.

Our projections of the fiscal position and the contributions of the government's fiscal operations to economic activity are largely based on the Treasury's Budget Economic and Fiscal Update (BEFU). The government has signalled a significant increase in expenditure over the next 4 years, which will provide some stimulus to the domestic economy in the later years of the projection. We expect some offsetting contractionary influence to come from increasing tax revenues, as a result of higher nominal GDP. On balance, we expect the increased government spending to provide marginally more stimulus to the economy than the increased revenues will

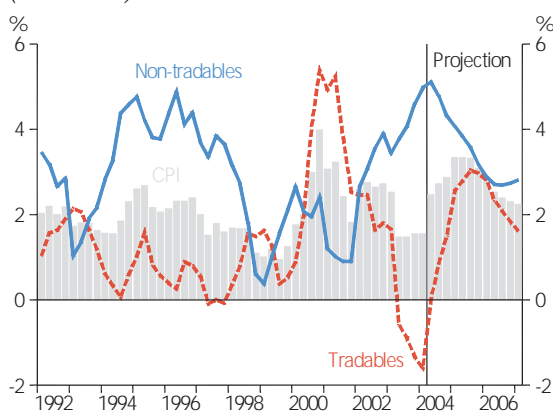
offset. Relative to the March *Statement*, we have not materially changed our view on the degree of fiscal stimulus over the projection.

Our overall projection for domestic activity has not changed significantly since the March *Statement*, but the drivers of the projected slowdown have changed. In the March *Statement*, we expected the very high exchange rate to dampen export incomes, which in turn would lead to slower domestic activity. At the same time, we projected interest rates to remain mildly stimulatory over the projection. Our current exchange rate assumption is well below the March assumption, and our projection for the terms of trade is much higher, leading us to project real export incomes to have less of a negative impact on domestic activity. Offsetting this, we are projecting the removal of the remaining interest rate stimulus implicit in our March projection. The balance of these two changes since the March *Statement* is roughly equal, leaving the overall projection for domestic activity broadly unchanged.

Inflation and monetary policy

We are projecting CPI inflation to peak at around 3¼ per cent during 2005, before gradually declining across the projection. This view is based on non-tradables inflation slowly declining from high levels, and tradables inflation rising sharply, largely due to the recent depreciation in the exchange rate (figure 52). This situation of rising tradables inflation during a period of high non-tradables inflation is unusual, at least in terms of recent history, and warrants more detailed comment.

Figure 52
Tradables and non-tradables inflation
(annual rate)



Source: Statistics New Zealand, RBNZ estimates.

Our projection for tradables inflation represents a change in view since the March *Statement*, driven largely by the lower-than-expected exchange rate, and to some extent by higher oil prices. The exchange rate depreciation since March is likely to lead to higher prices of imported consumption goods. However, we expect some of the effect of the lower exchange rate to be absorbed by importers shrinking their margins. This effect is likely to be a little less than usual, given our view that effects of the previous appreciation have not fully passed through to consumer prices. In addition, the recent 30 per cent increase in oil prices has fed quickly through to higher petrol prices and placed upward pressure on tradables inflation, as will the petrol tax increases that have been announced for April 2005. We project these influences will cause tradables inflation to turn positive in the second half of this year, peaking at around 3 per cent in the second half of 2005.

The economy has been growing robustly over the past 4 years, creating significant strain on productive resources such as labour and capital, and leading to upward pressure on consumer prices – the stretched construction sector and the flow-on effects to house prices is but one example. We expect the lagged effect of these pricing pressures to continue feeding into non-tradables inflation for some time to come. Our projection is for non-tradables inflation to remain high, falling only slowly to around 3 per cent per annum in late 2005, a little stronger than we projected in the March *Statement*. This is not caused by a change in our view of economic activity going forward. Rather, we are projecting the sharp rise in overall CPI inflation over the coming 12 months to cause inflation expectations to edge up slightly. Inflation expectations are self-fulfilling, meaning that if inflation expectations do increase, this would put further upward pressure on non-tradables inflation relative to the March *Statement*.

Combining all of these factors, we are now projecting further modest increases in interest rates in order to contain the inflationary pressures that we see developing. We project 90 day interest rates to rise toward a peak of around 6½ per cent in early 2005 (see figure 5, Chapter 2).

Appendix 1¹

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
1998	Jun.	0.3	1.7	58.5	9.1
	Sep.	0.6	1.7	57.1	6.8
	Dec.	0.5	1.1	56.0	4.6
1999	Mar.	0.3	1.0	57.6	4.5
	Jun.	0.3	1.2	59.1	4.7
	Sep.	0.6	1.1	56.7	4.8
2000	Dec.	-0.1	1.3	54.4	5.4
	Mar.	0.2	1.7	54.1	6.0
	Jun.	0.5	2.0	53.4	6.7
2001	Sep.	0.4	3.0	50.1	6.7
	Dec.	0.2	4.0	47.7	6.7
	Mar.	0.7	3.1	50.5	6.4
2002	Jun.	0.7	3.2	49.8	5.9
	Sep.	1.4	2.4	50.0	5.7
	Dec.	1.2	1.8	49.6	5.0
2003	Mar.	0.6	2.6	51.6	5.0
	Jun.	1.0	2.8	54.6	5.8
	Sep.	0.5	2.6	53.9	5.9
2004	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
2005	Sep.	0.5	1.5	62.4	5.1
	Dec.	0.7	1.6	63.9	5.3
2006	First Half Average	$\frac{3}{4}$	2	$65\frac{1}{4}$	$5\frac{3}{4}$
	Second Half Average	$\frac{3}{4}$	$2\frac{3}{4}$	$63\frac{1}{2}$	$6\frac{1}{4}$
2007	First Half Average	$\frac{3}{4}$	$3\frac{1}{4}$	$61\frac{3}{4}$	$6\frac{1}{2}$
	Second Half Average	$\frac{3}{4}$	$3\frac{1}{4}$	60	$6\frac{1}{2}$
2008	First Half Average	$\frac{1}{2}$	$2\frac{3}{4}$	59	$6\frac{1}{2}$
	Second Half Average	$\frac{1}{2}$	$2\frac{1}{4}$	58	$6\frac{1}{2}$

Quarterly projections

2003	Sep.	0.5	1.5		
	Dec.	0.7	1.6		
2004	Mar.	0.4	1.5		
	Jun.	0.9	2.5		
	Sep.	0.7	2.7		

(1) Notes for these tables follow on pages 36.

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

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

Table B

Composition of real GDP growth

(Annual average percentage change, unless specified otherwise)

March year	Actuals					Projections				
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Final consumption expenditure										
Private	2.2	2.5	3.7	1.7	2.8	4.4	5 1/2	3 1/2	1 1/2	3
Public authority	8.8	-2.1	7.3	-2.1	4.6	2.3	3	4	3 1/2	4 1/2
Total	3.7	1.4	4.6	0.8	3.2	3.9	5	3 1/2	2	3 1/2
Gross fixed capital formation										
Market sector:										
Residential	3.0	-14.0	22.8	-15.7	3.4	23.4	16	1 1/2	-8 1/4	-2 1/4
Business	-4.0	-0.3	1.8	9.5	7.3	6.1	15	5 1/2	1 1/4	3 1/2
Non-market government sector	8.5	-1.6	16.2	-16.8	4.7	2.0	9	7	8 3/4	1 1/4
Total	-0.9	-4.1	8.6	-0.6	6.1	9.6	14 3/4	4 3/4	-1 1/4	2
Final domestic expenditure	2.7	0.2	5.4	0.5	3.8	5.1	7	3 3/4	1 1/2	3
Stockbuilding (1)	-0.1	-0.5	1.2	-0.4	0.3	-0.3	0	0	1/4	0
Gross national expenditure	2.5	-0.2	6.6	0.1	4.1	4.7	7	3 3/4	1 3/4	3
Exports of goods and services	3.9	3.1	7.0	6.1	2.0	7.0	1	3 3/4	3	4 1/4
Imports of goods and services	2.6	2.1	11.5	-0.4	2.4	9.4	12 1/2	6	3	3 1/2
Expenditure on GDP	2.9	0.1	5.2	2.2	3.9	4.0	3	3	1 3/4	3 1/4
GDP (production)	1.5	0.4	4.9	2.7	3.3	4.4	3 1/2	3	1 3/4	3 1/4
GDP (production, March qtr to March qtr)	0.1	2.4	6.1	0.9	3.9	4.3	3 3/4	2	2 1/4	3 1/2
Potential output	2.9	2.5	2.6	2.8	3.1	3.4	3 1/2	3 1/2	3 1/2	3 1/4
Output gap (% of potential GDP, year average)	0.1	-1.9	0.3	0.1	0.3	1.3	1 1/4	1	-3/4	-3/4

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

Table C

Summary of economic projections

(Annual percentage change, unless specified otherwise)

March year	Actuals					Projections				
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Price measures										
CPI*	1.7	1.0	1.7	3.1	2.6	2.5	1.5	3 1/4	2 3/4	2 1/4
Labour costs	1.9	1.6	1.4	1.6	2.1	2.2	2.1	2 1/4	2 1/4	2
Import prices (in New Zealand dollars)	2.9	2.7	11.2	7.4	-2.9	-11.1	-10 1/4	11 1/2	5	3
Export prices (in New Zealand dollars)	4.2	-0.6	9.9	20.6	-3.5	-15.5	-3 3/4	4 3/4	5 1/4	3 3/4
Monetary conditions										
90-day rate (year average)	8.0	6.2	5.2	6.6	5.4	5.9	5.3	6 1/4	6 1/2	6 1/2
TWI (year average)	64.4	57.3	56.1	50.4	50.3	56.4	63.6	63 1/4	60 1/4	58
Output										
GDP (production, annual average % change)	1.5	0.4	4.9	2.7	3.3	4.4	3 1/4	3	1 3/4	3 1/4
GDP (production, March qtr to March qtr)	0.1	2.4	6.1	0.9	3.9	4.3	3 3/4	2	2 1/4	3 1/2
Output gap (% of potential GDP, year average)	0.1	-1.9	0.3	0.1	0.3	1.3	1 1/4	1	- 3/4	- 3/4
Labour market										
Total employment	0.0	0.6	1.4	2.3	3.5	1.5	3.2	1	1/2	1
Unemployment rate (March qtr, s.a.)	7.2	7.2	6.3	5.4	5.2	5.0	4.3	4 1/2	5	5 1/4
Trend labour productivity (annual % change)	1.3	1.5	1.5	1.4	1.4	1.2	1 1/4	1 1/2	1 3/4	2
Key balances										
Government operating balance (% of GDP, year to June)	2.5	1.7	1.3	1.2	1.9	1.5	4 3/4	4 3/4	3 3/4	3 3/4
Current account balance (% of GDP, year to March)	-5.5	-4.3	-6.7	-4.1	-2.3	-3.9	-4 1/2	-5 3/4	-6 1/4	-5 3/4
Terms of trade (OTI goods, annual average % change)	-1.0	-0.4	-0.2	4.4	4.2	-5.7	4	- 3/4	-1 3/4	1/2
Household savings rate	-4.0	-4.8	-0.8	-4.4	-3.0	-8.2	-9 1/2	-11	-9 1/2	-9
(% of disposable income, year to March)										
World economy										
World GDP (annual average % change)	3.5	2.0	4.2	3.7	1.3	2.9	3 1/4	4	3 1/2	3 1/2
World CPI inflation	2.2	1.1	2.0	2.7	1.4	2.2	1 1/2	1 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 (euro-zone 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, G97/9</i> .
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 HLFS hours worked.
Wages	Private sector all salary and wage rates. <i>Labour Cost Index.</i>
Quarterly percentage change	$(\text{Quarter}/\text{Quarter}_{-1} - 1) * 100$
Annual percentage change	$(\text{Quarter}/\text{Quarter}_{-4} - 1) * 100$
Annual average percentage change	$(\text{Year}/\text{Year}_{-1} - 1) * 100$

Source: Unless otherwise specified, all data conform to Statistics New Zealand definitions, and are not seasonally adjusted.

Rounding: Unless otherwise specified, all projection data are rounded to the nearest quarter per cent.

Appendix 2

Chronology

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

2004

- 11 March The Reserve Bank released its forty-first *Monetary Policy Statement*, leaving the Official Cash Rate unchanged at 5.25 per cent. The news release accompanying the *Statement* is reproduced in Appendix 4.
- 11 March The Reserve Bank announced that it had provided advice to the Minister of Finance recommending that, as one of its monetary policy implementation tools, it should have the capacity to intervene in the foreign exchange market to influence the level of the exchange rate. The accompanying news release is reproduced in Appendix 4.
- 26 March Production GDP figures were released showing that the New Zealand economy grew by 0.6 per cent in the December quarter of 2003.
- 30 March The Government announced that it supported the Reserve Bank's proposal to broaden its foreign exchange intervention capacity.
- 6 April An amendment in the Reserve Bank's Funding Agreement to broaden the Reserve Bank's foreign exchange intervention capacity was ratified by the House of Representatives.
- 19 April CPI statistics were released for the March quarter of 2004 showing that the CPI increased by 0.4 per cent over the quarter, and by 1.5 per cent in the year to March 2004.
- 29 April At the intra-quarter review, the Reserve Bank increased the Official Cash Rate from 5.25 per cent to 5.5 per cent. The accompanying news release is reproduced in Appendix 4.
- 27 May The 2004 Budget included an appropriation for a capital injection into the Reserve Bank to allow it the capacity to weather any short term financial losses that might be associated with the Bank's new foreign exchange intervention policy.

Appendix 3

Companies and organisations contacted by RBNZ staff during the projection round

Affco New Zealand Ltd	NZ Council of Trade Union
Alliance Group Ltd	NZ Sugar Company Limited
Allied Telesyn Research Ltd	Paper Plus New Zealand Ltd
Auckland International Airport Ltd	Ports of Auckland Ltd
Balance Agri-Nutrients Ltd	PPCS Ltd
Calder Stewart Industries Ltd	Pricewaterhousecoopers
Carter Holt Harvey Limited	Progressive Enterprises Ltd
City Forest Ltd	Pukepines Sawmills (1998) Ltd
Clive Wilson Ltd	Pyne Gould Corporation Ltd
Cocksedge & Co Ltd (BJC Ltd)	Rotorua District Council
Colliers Jardine NZ Ltd	Ryan Group Ltd
CWF Hamilton Co Ltd	Satara Co-operative Group Limited
Financial Services Federation	Seeka Kiwifruit Industries Ltd
Fisher & Paykel Industries Ltd	Skope Industries Ltd
Foodstuffs (Auckland) Limited	Solid Energy New Zealand Ltd
Foodstuffs (South Island) Ltd	Tachikawa Forest Products (NZ) Ltd
FOSROC Ltd	Tait Electronics Ltd
Glengarry Hancocks Ltd	Tamahine Holdings Ltd
Glovers Food Processing Limited	Tecpac Industries Ltd
Goughs Ltd	Titan Plant Services Ltd
Greens Industries Ltd	Topsco International Ltd
H & J Smith Ltd	Villa Maria Estate Limited
Hayes International Ltd	Waikato Federated Farmers
Hubbards Foods Ltd	
Hume Pine (NZ) Ltd	In addition to our formal meetings with the organisations
Jade Software Corporation Ltd	listed above, contact was also made with major registered
Jasol New Zealand Ltd	banks and other companies and organisations for
Krone (NZ) Technique Limited	feedback on business conditions and particular issues
La Grouw Corporation Ltd	relevant to our policy deliberations.
Landmark Homes Ltd	
Long Plastics Ltd	
Market Gardeners Ltd	
Mastertrade Ltd	
Mitre 10 Ltd	
Naylor Love Properties Ltd	

Appendix 4

Reserve Bank Statements on Monetary Policy

Official Cash Rate unchanged at 5.25 percent

11 March 2004

The Reserve Bank has decided to leave the Official Cash Rate unchanged at 5.25 percent.

Speaking at the release of the Reserve Bank's March 2004 *Monetary Policy Statement*, Reserve Bank Governor Alan Bollard said "New Zealand has continued to enjoy a period of sustained economic growth over recent years. Partly related to this, inflation pressures have been increasing in a number of domestic industries, including housing and construction. It is for this reason the Reserve Bank raised the OCR in January. Meanwhile, the overall CPI inflation rate has so far been offset by weak imported inflation due to the rising NZ dollar exchange rate.

"In recent *Statements* we have projected a slowing in growth which would ease capacity and inflation pressures. This projected growth slowdown is due mainly to the lagged effects of the high New Zealand dollar and an expected slowdown in population growth. With tentative signs becoming more evident in recent weeks, it remains our view that this projected growth slowdown will occur and eventually will reduce the accumulated inflation pressures.

"However, the latest activity indicators remain quite robust. This implies that, in the short-term, there are ongoing risks that the bottlenecks in the economy persist for some time yet. Any persistence in the current inflation pressures could see actual inflation nearing the top of the Bank's target range, raising policy risks. With this uncertainty, we judge it as appropriate at this stage to wait and watch the data, to see whether a further small increase in interest rates will be required this year."

Capacity to intervene in foreign exchange market proposed

11 March 2004

The Reserve Bank has provided advice to the Minister of Finance recommending that, as one of its monetary policy implementation tools, it should have the capacity to intervene in the foreign exchange market to influence the level of the exchange rate.

The Reserve Bank's current stance is to use its foreign exchange reserves to intervene only if the foreign exchange market became "disorderly".

Reserve Bank Governor Alan Bollard said "We have recommended that when the New Zealand dollar is exceptionally and unjustifiably high, the Reserve Bank would be able to use New Zealand dollars to buy foreign exchange, which would put downward pressure on the exchange rate. And, when the exchange rate is exceptionally and unjustifiably low, we would be able to sell foreign exchange to buy New Zealand dollars, putting upwards pressure on the exchange rate. By unjustifiable, we mean when the exchange rate has moved to a level in excess of that readily explained by the relevant economic fundamentals, which occurs only infrequently. This process is similar to that used for some years by the Reserve Bank of Australia.

"By having this intervention tool, we would generally aim to influence the exchange rate in a direction consistent with maintaining our price stability goal. The addition of intervention as an instrument of monetary policy would also better enable the Bank to meet its Policy Targets Agreement clause 4B commitment, which stipulates that "In pursuing its price stability objective, the Bank ... shall seek to avoid unnecessary instability in output, interest rates and the exchange rate." That is, at extreme levels of the exchange rate, intervention may be chosen to supplement monetary policy.

"Importantly, such foreign exchange intervention would not be trying to permanently change the long-run exchange rate. And, the New Zealand dollar exchange rate cycle would not be eliminated. At best, we can influence the exchange rate only

by small amounts at the extremes of its cycle when it is a long way from economic fundamentals. In doing this there could be financial risks to the Bank, requiring very careful management.

“In recent days we have put these ideas to the Minister of Finance. There is more work and consultation to be done before final decisions can be made or the setting of operational procedures and capacities,” Dr Bollard concluded.

OCR increased to 5.5 per cent

29 April 2004

The Reserve Bank today increased the Official Cash Rate from 5.25 per cent to 5.5 per cent.

Commenting on the decision, Reserve Bank Governor Alan Bollard said “The New Zealand economy continues to perform strongly and this is being supported by further improvements in the global economy. However, domestic inflation pressures remain strong and annual CPI inflation looks set to rise over the year ahead, as we projected in our March *Monetary Policy Statement*. Moving interest rates to less stimulatory levels appears prudent to ensure inflation remains within the target range over the medium term.

“Looking forward, the Reserve Bank will continue to monitor the data to see what it implies for medium-term inflation. At this stage, it remains unclear whether the fall in the exchange rate over recent weeks will be sustained and thus what its impact on activity and inflation pressures will be. Within parts of the domestic sector, such as housing and construction, some data suggest a cooling in activity, but the evidence is mixed and pricing pressures remain strong. Given these uncertainties, a further adjustment to monetary policy cannot yet be ruled out.

“However, as noted in March, a number of factors are likely to have a dampening effect on inflation pressures over the next year or so, reducing the need for policy action. Two such factors would include a further fall in net immigration and the delayed effects of the recent high exchange rate on activity in the export sector.

“The Reserve Bank’s next Official Cash Rate announcement will come with the release of a *Monetary Policy Statement* on 10 June 2004.”

Appendix 5

The Official Cash Rate chronology

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

Appendix 6

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

The following is the Reserve Bank's schedule for the release of *Monetary Policy Statements* and Official Cash Rate announcements for the remainder of 2004.

Thursday 29 July 2004	OCR announcement
Thursday 9 September 2004	<i>Monetary Policy Statement</i>
Thursday 28 October 2004	OCR announcement
Thursday 9 December 2004	<i>Monetary Policy Statement</i>

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

Appendix 7

Policy Targets Agreement

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

1. Price stability

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

2. Policy target

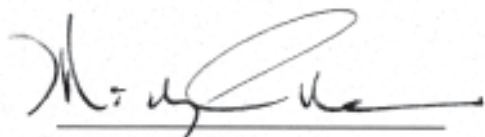
- a) In pursuing the objective of a stable general level of prices, the Bank shall monitor prices as measured by a range of price indices. The price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), as published by Statistics New Zealand.
- b) For the purpose of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

3. Inflation variations around target


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

4. Communication, implementation and accountability

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



Hon Dr Michael Cullen
Minister of Finance



Dr Alan E Bollard
Governor Designate
Reserve Bank of New Zealand

Dated at Wellington this 17th day of September 2002