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# Monetary Policy Statement<sup>1</sup>

March 2005

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

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This document is also available on [www.rbnz.govt.nz](http://www.rbnz.govt.nz)

ISSN 1770-4829

<sup>1</sup> Projections finalised on 1 March 2005. Policy assessment finalised on 9 March 2005.

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# 1 Policy assessment

The Reserve Bank has increased the Official Cash Rate (OCR) by 25 basis points to 6.75 per cent.

In our December and January reviews we emphasised that inflation was expected to remain toward the top of the 1 to 3 per cent target band over the medium term, providing little headroom to absorb additional inflation pressures. We also projected a near-term economic slowdown which was expected to constrain inflation consistent with the Policy Targets Agreement. With the economy remaining very strong and resources becoming increasingly stretched, we assess that a further tightening of policy is now necessary.

The momentum in today's economy is underlined by the continuing vigorous employment growth through December and by ongoing high levels of business and consumer confidence. Investment remains at record levels, our terms of trade remain very favourable and exports are generally holding up well despite the high exchange rate.

Our revised economic projections incorporate a stronger outlook for activity in the near-term with the projected slowing in growth now not occurring until later in 2005. World demand and export prices are projected to moderate through 2005. Net immigration has slowed appreciably. Housing activity continues to ease, but has been held up at least temporarily by last year's mortgage price war. The pipeline effects from last year's policy tightening will continue to raise average effective mortgage rates through this year but the impact will be gradual. The greater momentum in activity in the near term implies stronger underlying inflation pressures than we expected. The additional tightening today is required to contain these pressures.

Since we remain of the view that the economy is close to a turning point, we have to carefully confront the possibility that a further tightening in policy at this stage of the cycle might exacerbate an eventual slowing in activity. However, not responding to the prospect of stronger inflation pressures now would create a risk that inflation expectations and wage and price setting behaviour could change in a way that would make the task of containing inflation more difficult in the future, even if growth slows. Being prudent now reduces the prospect of a tighter monetary policy later on.

Whether there is any further tightening ahead will depend on how the risks play out over the coming period. Certainly, the current outlook offers little scope for an easing of policy in the foreseeable future.



Alan Bollard  
Governor

## 2 Overview and key policy judgements

The New Zealand economy has continued to grow strongly over the past year. Growth is expected to slow gradually as the high exchange rate, slower population growth and the lagged effects of last year's tightening in monetary policy increasingly constrain demand. However, to date, the domestic economy has shown more momentum than expected, placing further pressure on productive resources. The prospect of stronger inflation pressures has prompted some further tightening in monetary policy in order to ensure that inflation remains within the 1 to 3 per cent target band on average over the medium term. Looking forward, a further policy tightening cannot be ruled out. The outlook depends on how the various risks around the inflation outlook play out.

### Recent developments

Growth in GDP over the September 2004 quarter was weaker than expected, but this was due largely to timing issues related to the measurement of primary sector exports. Indicators of export activity suggest that the timing effect was reversed in the December quarter while a range of other data point to further strong growth in the domestic economy. Many of these indicators suggest that momentum in activity has been sustained in the opening months of 2005:

- Growth in employment and hours worked was much stronger than expected in the December quarter, providing a further boost to household incomes.
- Unemployment recorded a further significant fall in the December quarter while capacity utilisation has remained at record levels, despite further growth in business investment.
- World commodity prices for some of our key exports remain at near-record highs.
- Firms' expectations of their future activity remain at high levels across the main business surveys.
- Indicators of activity in the construction sector remain relatively strong, especially non-residential activity.
- While last year's mortgage war has made housing sector data difficult to interpret, the underlying level of house sales has proven a little stronger than we expected. Feedback from lending institutions suggests that borrowing for housing purposes remains robust. Recent

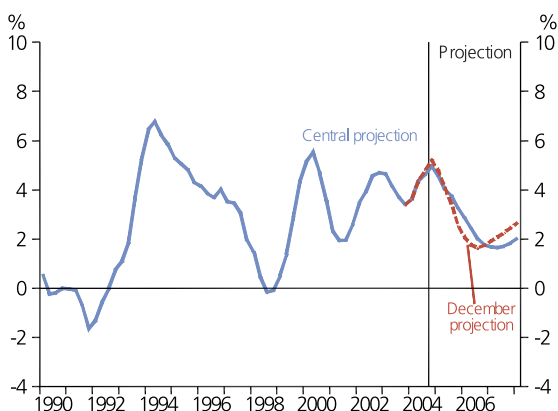
housing sector data have shown further rises in house prices in many parts of the country.

- Consumer confidence remains at very high levels. Although growth in retail sales moderated in the December quarter (possibly due to bad weather) anecdotal evidence indicates spending picked up again in January.

Against this backdrop of greater momentum in the economy, we have seen no evidence to suggest that inflation pressures are abating. CPI Inflation in the year to December was slightly stronger than anticipated – at 2.7 per cent – with inflation in the non-tradables sector continuing at a strong pace. The very tight labour market has been reflected in rising wage inflation with growth in the Labour Cost Index having moved up to a new high during 2004.

Our projections have been updated to incorporate a stronger outlook for activity in the near term and the projected slowing in growth is now pushed out to later in 2005 (figure 2.1). It remains our view that the ingredients for a slowdown are in place. The combined influence of the high New Zealand dollar, the ongoing decline in net immigration and the pipeline effects of last year's monetary policy tightening are expected to increasingly act as a brake on activity over the coming year. At the margin, however, greater momentum in activity in the near term implies stronger underlying inflation pressures than we previously expected with the economy drawing more heavily on its already stretched productive resources.

Figure 2.1  
GDP growth  
(annual average percentage change)



Source: Statistics New Zealand, RBNZ estimates.

## Box 1

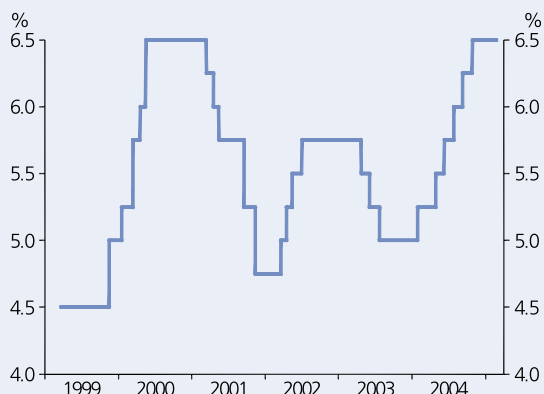
### Review of recent monetary policy decisions

Since the latter half of 2003, strong domestic activity, particularly in the housing and construction sectors, has increased pressures on both resources and domestic prices. While the rise of the New Zealand dollar was limiting import price inflation, overall CPI inflation was projected to rise and it was viewed as prudent to move monetary policy to less stimulatory levels. Between January and October 2004 the Official Cash Rate (OCR) was gradually increased from 5 per cent to 6.5 per cent.

In late 2004, the outlook for economic activity had remained strong and inflation pressures were persisting. The OCR was left on hold at the time of the December 2004 *Statement* and the interim review in January 2005, with the Bank indicating that pipeline effects from previous OCR increases and the high exchange rate would constrain the economy over the period ahead. However, the Bank

noted that inflation was expected to remain at the top of the 1 to 3 per cent target band, providing little headroom to absorb stronger than expected inflation pressures. If such pressures emerged, then a further policy tightening could not be ruled out.

Figure 2.2  
Official Cash Rate



Source: RBNZ.

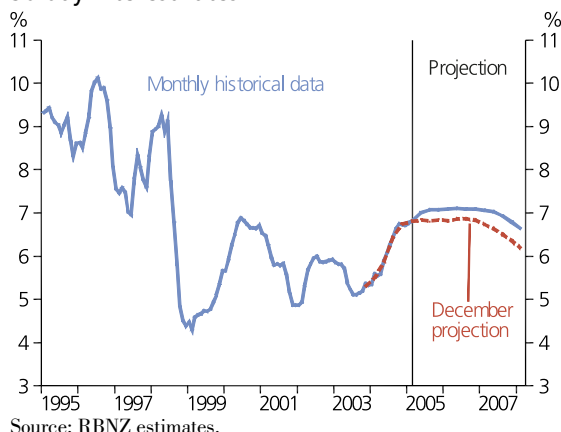
## Policy judgements

In the December 2004 *Statement*, our projections showed inflation settling near the top of the 1 to 3 per cent inflation target band over the next two years, based on no further change in monetary policy during 2005. The projected inflation path was consistent with meeting our obligations under section 2 of the Policy Targets Agreement (PTA), which requires us to keep inflation within the 1 to 3 per cent target band on average over the medium term. However, we noted that policy had little headroom to absorb any further upside surprises to the inflation outlook. We noted that policy was on hold for the time being but that a further tightening could not be ruled out if economic activity continued to surprise on the upside. The OCR was left unchanged at our interim review in January (see Box 1).

Reflecting the flow of stronger data since December 2004, we have revised up our assessment of underlying inflation pressures over the coming year. With the release of this *Statement*, we have undertaken a further firming in monetary policy in order to ensure that the projected path of inflation remains within the 1 to 3 per cent target band on

average over the medium term (see figures 2.3 and 2.4). In deciding to undertake this additional firming, we have made a number of judgements.

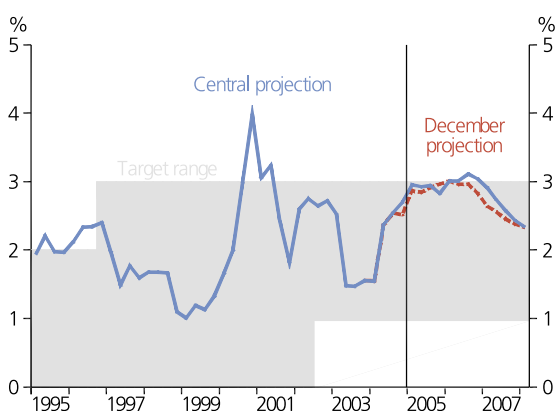
Figure 2.3  
90-day interest rates



Source: RBNZ estimates.

Section 4(b) of the PTA requires us to conduct monetary policy in a manner that avoids unnecessary instability in output, interest rates and the exchange rate. Since we remain of the view that the economy is close to a turning point, we have had to carefully assess the possibility that

**Figure 2.4**  
**Consumer price inflation**  
**(annual rate)**



Source: Statistics New Zealand, RBNZ estimates.

a further tightening in policy at this stage of the cycle might exacerbate an eventual slowdown in activity. The judgements here are difficult – monetary policy does have the potential to accentuate the economic cycle, particularly if we misread the strength or timing of the forces acting on the economy. However, not responding to the prospect of stronger inflation pressures creates a risk that inflation expectations and wage and price setting behaviour will change in a way that would make the task of containing inflation more difficult in the future, even if growth slows. In our assessment, not to adjust policy now could well require a more aggressive tightening in the future in order to re-establish medium-term inflation pressures at a level consistent with the PTA.

We have also paid particular attention to the likely consequences of our policy choices in circumstances where the economy evolves differently to our central projections. We have constructed a range of scenarios where inflation pressures over the coming year turn out to be stronger or weaker than we currently expect. Two such scenarios are described in Box 2. It must be emphasised that the scenarios presented here are intended purely to illustrate the sorts of risks facing monetary policy.

Scenario 1 considers the possibility that domestic demand maintains more momentum than in our central projection, creating additional inflation pressure. Scenario 2 considers a weaker outlook for the external sector, arising from a softer global economy and a stronger exchange rate.

Both scenarios represent plausible variations around the central projection presented in Chapter 5, broadly capturing our sense of the risks around our central track.

Under scenario 1, the outlook for inflation pressures is stronger than in our central projection, compounding the recent upside surprise. If the Bank had not responded to the recent stronger data and was then faced with an additional upside surprise, there is a risk of generating inflation outcomes well outside the target band. Monetary policy could, in this case, be forced to play 'catch-up' which would potentially increase volatility in interest rates, the exchange rate and output. This reflects the absence of any further headroom to absorb such upside surprises.

Under scenario 2, activity and inflation pressures are weaker than we currently expect. In that instance, a policy tightening undertaken now could potentially prove unnecessary. However, the possibility of generating inflation outcomes inconsistent with section 2 of the PTA would appear to be small given that our central projection is currently for inflation outcomes close to 3 per cent over the next two years.

The messages from scenario 2 in regard to section 4(b) of the PTA (avoiding unnecessary instability in interest rates, exchange rates and output) are less clear. Tightening now, followed by weaker than expected external demand conditions, could potentially exacerbate the economic slowdown and increase the pressures on particular parts of the economy, such as the export sector. However, the extent of such pressures could be reduced by an easing of policy as the signs of the downturn became apparent.

Whether a further tightening in monetary policy will be required over the months ahead will depend on how the upside and downside risks to inflation play out. Although domestic demand may again prove stronger than we currently expect, the possibility of weaker global demand conditions or a higher exchange rate is also quite plausible. Given that monetary policy has little scope to absorb further upside surprises to the inflation outlook, it would be imprudent to rule out further policy tightening.

## Box 2

### Alternative scenarios

Our central projection is always subject to risks that must be considered in policy judgements. The graphs on the right show two stylised scenarios that represent key risks to our current central projection. In each scenario, 90-day interest rates are assumed to follow the same path as in the central projection until early 2007 – at which time interest rates begin to respond more actively.<sup>1</sup>

#### Scenario 1: More momentum in the domestic economy

Under this ‘upside’ scenario, the expected slowdown in domestic activity occurs more gradually than assumed in our central projection. We assume a scenario where:

- consumption and investment are higher for longer;
- annual GDP growth over 2005 is around 0.8 percentage points higher than in the central projection.

Given these assumptions and the central policy track, inflation exceeds 3.5 per cent in late 2006 and early 2007 and remains above 3 per cent for an uncomfortable length of time. The slightly weaker path for the TWI is consistent with the assumption that stronger consumption would worsen the current account position.

#### Scenario 2: Fallout from further USD weakness

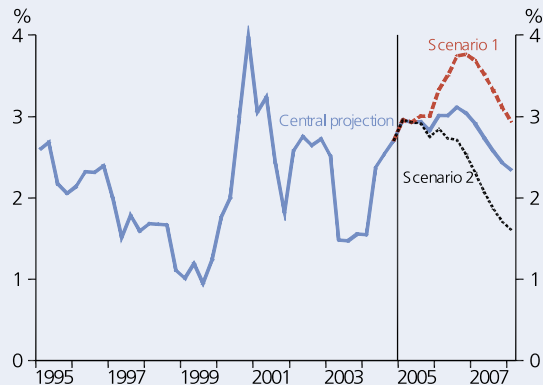
Under this ‘downside’ scenario, investor concerns surrounding the US current account deficit lead to a loss of confidence in the US dollar, with potentially adverse consequences for world economic activity. We assume:

- the TWI is 3 per cent higher than in the central projection by the end of 2006;
- international long-term bond rates peak 50 basis points above our central projection in 2007;
- annual average growth for our major trading partners is 0.2 per cent below the central projection in 2006.

<sup>1</sup> By ‘tuning in’ the same interest rate profile, we can illustrate the inflation consequences of each scenario. In reality it is likely that policy would respond sooner should either scenario eventuate, which could lead to quite different outcomes for economic activity and inflation.

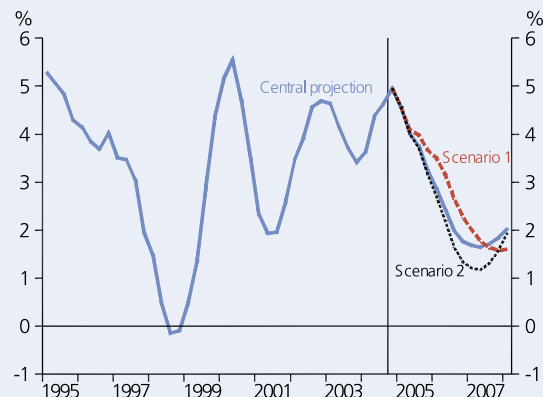
Under these assumptions, and if policy behaves as in the central projection, then annual CPI inflation remains comfortably within the target band, but annual average GDP growth falls to around 1 per cent in 2007.

Figure 2.5  
CPI inflation  
(annual rate)



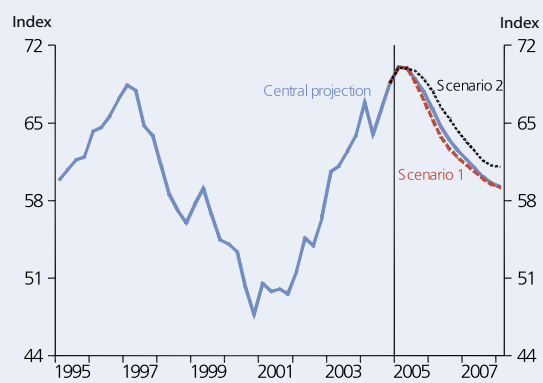
Source: Statistics New Zealand, RBNZ estimates.

Figure 2.6  
GDP growth  
(annual average percentage change)



Source: Statistics New Zealand, RBNZ estimates.

Figure 2.7  
Nominal TWI



Source: RBNZ estimates.

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## 3 The current economic situation

### Overview

The New Zealand economy has grown rapidly over the past year, with annual average GDP increasing by 4.6 per cent in the year to September 2004. The economy has been well supported by strength in the domestic sector with consumption, residential investment and business investment all growing significantly. There are few signs of an economic slowdown in the near term, with domestic data generally coming out stronger than expected. Consequently, GDP is estimated to have grown by 5.0 per cent, in annual average terms, in the year to December 2004.

Strength in the economy has meant that significant inflationary pressures have built up. Annual non-tradables inflation remained above 4 per cent over 2004, while over the same period tradables inflation accelerated sharply – reflecting a slowing in the pace of the exchange rate appreciation. Annual CPI inflation remains within the target band, and there continues to be a considerable imbalance between inflation in the tradable and non-tradable sectors of the economy.

### Global economic developments

In the US, GDP increased by an annualised 3.8 percent in the December quarter and forward looking indicators suggest a continuation of moderate rates of growth. There remain uncertainties over the future path of labour productivity growth and the evolution of economic imbalances. US core inflation measures have recently picked up, but remain well contained. Short-term interest rates have risen as the Federal Reserve continues with its ‘measured’ tightening of monetary policy.

Momentum in the Japanese economy has cooled as industrial production and export growth slows. Statistical revisions under the new chain linked methodology for Japan’s national accounts have also revealed falls in output over the final three quarters of 2004. Concerns over deflation remain and the Bank of Japan has reaffirmed current loose policy settings. Conversely, growth in China was 9.5 per cent in calendar 2004 – its strongest since 1996. Prospects for continued and more balanced growth remain favourable. The pace of export growth in other Asian countries has eased, although this is offset by stronger domestic demand.

In the Euro area, the pace of growth remains soft with GDP recording a 0.2 per cent increase in the December quarter. Despite modest tax cuts in some countries, consumer spending remains relatively subdued and growth remains highly reliant on export activity. Inflation has eased, although concerns over the strong growth in liquidity remain. After a soft patch, output in the UK economy expanded by 0.7 percent in the December quarter. UK inflation prospects have picked up, but risks are viewed more on the downside.

In Australia there has been a growing concern over capacity constraints and inflationary pressures. Output growth has been restrained by supply bottlenecks, while demand has been boosted by a high terms of trade. Despite recent weak economic data, the Reserve Bank of Australia has noted that domestic and global conditions are likely to continue to encourage spending growth in the period ahead. For the moment, measures of wage growth and core inflation remain moderate, although perceived risks are on the upside.

Oil prices have firmed recently but remain slightly below their late 2004 peaks. High prices reflect a combination of factors, including strong global demand for oil and tight capacity constraints.

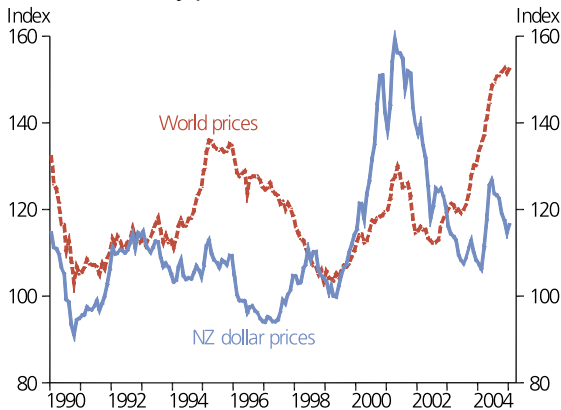
### Tradables sector activity

Over the past few years the key factors affecting the tradables sector have been the rising exchange rate, increasing prices for some of our key commodity exports, and strong demand for imports. In combination, these factors have meant that export incomes have remained relatively robust, while import volumes have grown significantly.

World prices for our commodity exports increased dramatically from late 2002 (figure 3.1). These price increases were driven by tight international supplies for some of our key commodities (such as beef, lamb and dairy products) and strong global demand. However, in recent months world prices have stabilised at high levels, due to some easing in international supply constraints. New Zealand dollar prices for our commodity exports have been more subdued than world prices because of the dampening effect of the high exchange rate. Nonetheless, New Zealand dollar commodity prices remain at above-average levels.

**Figure 3.1**

**ANZ commodity prices**



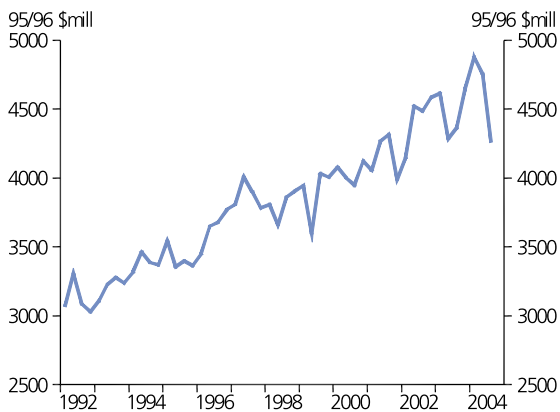
Source: ANZ National Bank Ltd.

To date, high commodity prices have limited the impact of the high currency on export volumes. Primary export volumes have continued to trend up over recent years (figure 3.2), supported by good international demand for dairy, beef and lamb. Dairy exports have been very volatile in recent quarters, with the volume of dairy exports falling sharply in the September quarter of 2004. However, this fall in dairy exports was a timing issue and will rebound in the December quarter.

**Figure 3.2**

**Primary export volumes**

*(quarterly total)*



Source: Statistics New Zealand.

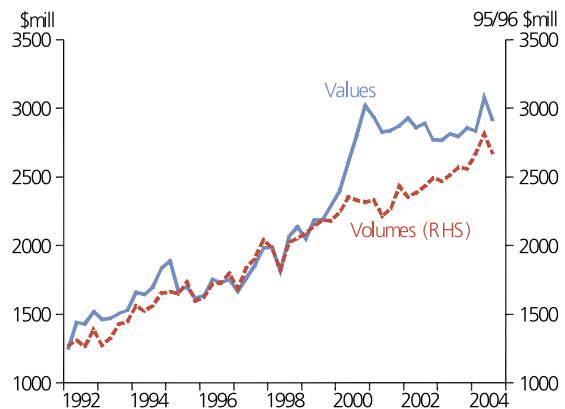
Non-commodity export volumes are up on 2003 levels (figure 3.3). However, this may be due to the lumpy nature of non-commodity exports. Recently, New Zealand has exported some manufacturing lines and large transport items, which can have a significant impact on the quarterly volumes of non-commodity exports. These large item exports

are partially masking a relatively subdued performance of non-commodity exports over the past few years. Non-commodity exports have, in general, been affected by the high TWI more than primary exports because they have not benefited from the high world prices generally seen by the primary sector.

**Figure 3.3**

**Non-commodity manufactured exports**

*(quarterly total)*

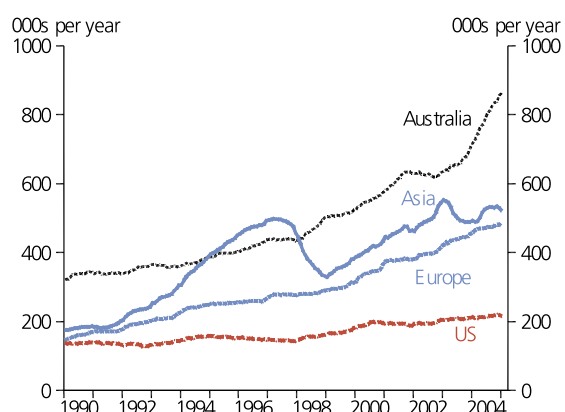


Source: Statistics New Zealand.

Exports of services rose reasonably sharply in 2004. The main component of service exports is spending by tourists. Tourist numbers recovered strongly from mid 2003, following the aftermath of SARS. Much of this increase was from greater numbers of Australian tourists, following increased capacity and airfare discounting on trans-Tasman routes (figure 3.4). However, tourist spending has increased by less than tourist numbers. Total tourist spend has been

**Figure 3.4**

**Overseas visitor arrivals**



Source: Statistics New Zealand.

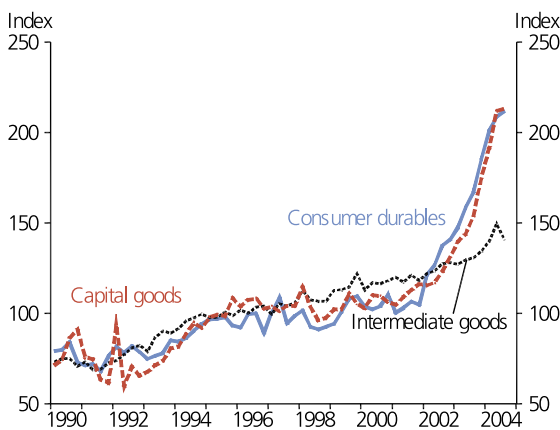
affected by a compositional increase in Australian tourists (who traditionally spend less per person than visitors from other major tourist markets) and by the high New Zealand dollar.

The rapid rise of the exchange rate and low inflation amongst our trading partners dramatically reduced import prices over recent years. However, this downward pressure on import prices is starting to ease. Although the exchange rate remains strong, high oil prices and continuing strong global demand (particularly in Asia) are placing upward pressure on some import prices. Strong global demand is also placing strain on the world's shipping resources, pushing up freight costs.

Growth in import volumes, particularly for both consumer durables and capital goods, was very strong in the past two years (figure 3.5). Strength in consumer durable imports was driven by favourable consumer import prices, a buoyant housing market, and rising household incomes and wealth. However, growth in consumer durable imports has moderated recently as the housing market has begun to slow. Capacity constraints and a high exchange rate have helped drive up imports of capital goods.

Imports of intermediate goods have also been relatively strong as firms have taken advantage of the high exchange rate. Exporters may also be importing more inputs and forming a natural hedge against exchange rate appreciation.

**Figure 3.5**  
**Import volumes**

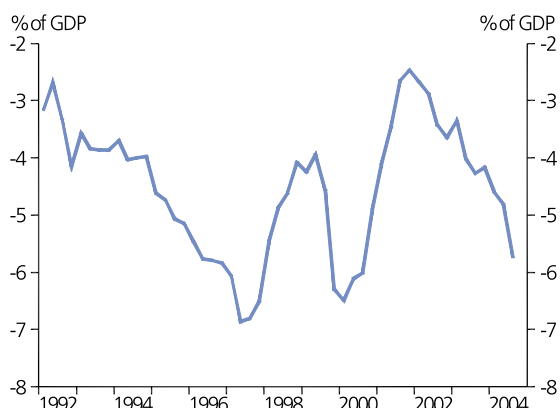


Source: Statistics New Zealand.

The number of short-term departures from New Zealand has been high over 2004, with the strong exchange rate and low airfares making overseas travel more attractive. This has been reflected in imports of services, which increased by 13 per cent in the year to September.

Since early 2002, our current account balance has deteriorated significantly (figure 3.6). In itself, this is more of a reflection of the domestic sector drawing imports into the economy at a rapid rate, rather than our exports being weak. More recently, in the September quarter of 2004 our international investment income deficit widened due to the increased profitability of foreign-owned New Zealand firms.

**Figure 3.6**  
**Annual current account balance**



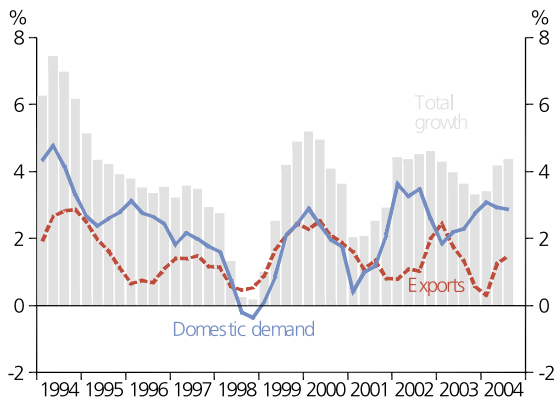
Source: Statistics New Zealand.

## Domestic demand

The domestic economy has contributed significantly to GDP growth over 2003 and 2004 (figure 3.7, overleaf). The strength of the domestic economy has been driven by strong population growth from net migration inflows, increased household wealth from house price inflation, and increased income from high terms of trade and rising labour incomes.

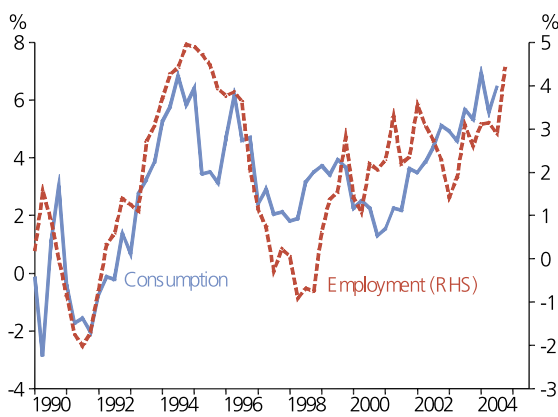
Consumption growth has been strong in recent years. To start with, this growth was driven by strong net immigration and high house price inflation. However, since mid 2003, net migration inflows have reduced significantly, and labour market developments have become an increasingly important driver of consumption growth (figure 3.8, overleaf). Employment has grown strongly over the past year and household incomes have been boosted by strong wage growth.

**Figure 3.7**  
**Contributors to GDP growth<sup>1</sup>**  
*(annual average percentage change)*



Source: Statistics New Zealand.

**Figure 3.8**  
**Employment growth and consumption growth**  
*(annual percentage change)*



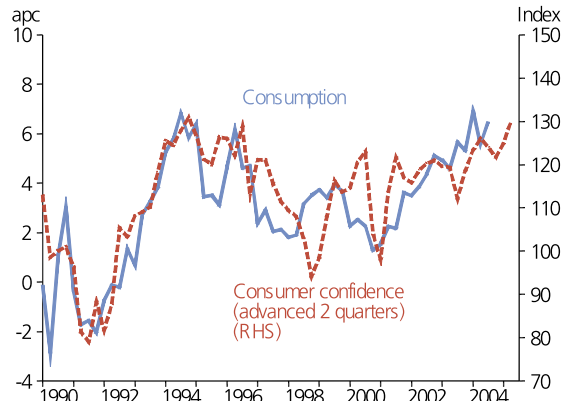
Source: Statistics New Zealand.

Well supported labour incomes and low prices in the retail sector (from the high exchange rate) have kept consumers buoyant. Consumer confidence has risen significantly since mid 2003 to a near record level (figure 3.9). Strong consumer confidence in the second half of 2004 suggests that consumer spending will remain strong into early 2005.

Since reaching a peak in April 2004, the annual growth rate of total household credit has slowed, but remains at historically high rates (figure 3.10). Growth in consumer credit has slowed over the past two years, but may reflect a switch towards mortgages due to the lower rate of

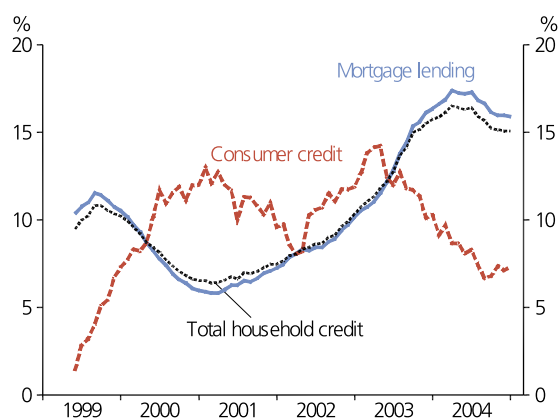
finance. Mortgages account for around 91 per cent of total household credit, and mortgage growth has been driven by the strength of the housing market, taking household debt ratios to historical highs.

**Figure 3.9**  
**Consumption growth and consumer confidence**



Source: Statistics New Zealand, Westpac McDermott Miller.

**Figure 3.10**  
**Household credit growth**  
*(annual percentage change)*



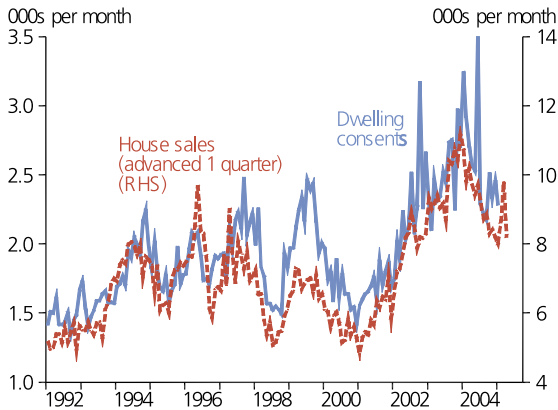
Source: RBNZ.

Over the past 12 months the housing market has come off the highs reached in late 2003/early 2004. However, the housing market appears to have stabilised somewhat in recent months with the number of dwelling consents issued staying steady and house sales ticking up (figure 3.11, opposite). Some of this increase in house sales is a reflection of low mortgage rates offered by banks in November and December. Nonetheless, house sales still remain above October levels.

<sup>1</sup> Domestic demand is calculated as GDP excluding exports.

Figure 3.11

House sales and dwelling consents

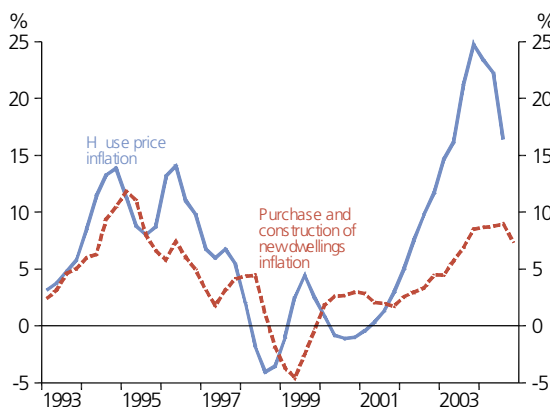


Source: Statistics New Zealand, Real Estate Institute of New Zealand.

House price inflation peaked at 24.8 per cent at the end of 2003, and has slowed since then, although it still remains high. Residential building costs have also increased sharply over the past few years, but at a slower rate than house price inflation (figure 3.12). This increase in house prices relative to the cost of building is likely to have encouraged people to build new houses and carry out additions and alterations to their current homes, thus supporting the high levels of residential investment seen over the past two years (figure 3.13).

Figure 3.12

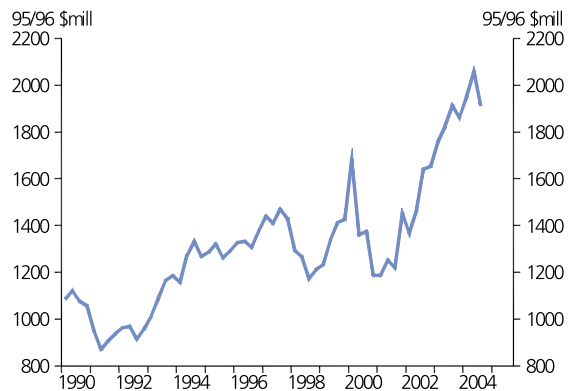
House price inflation and purchase and construction of new dwellings inflation (annual percentage change)



Source: Quotable Value Limited, Statistics New Zealand.

Figure 3.13

Residential investment (quarterly total)

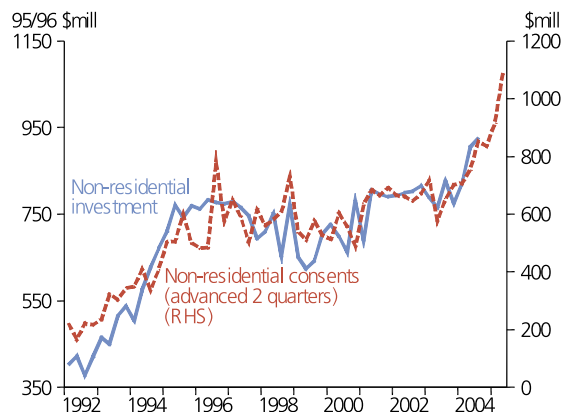


Source: Statistics New Zealand.

In recent years, non-residential construction has been subdued relative to residential construction. However, non-residential investment has increased strongly over 2004 and non-residential consents in late 2004 suggest that non-residential investment will be even stronger over early 2005 (figure 3.14). This will prolong pressures in the already resource-constrained construction sector.

Figure 3.14

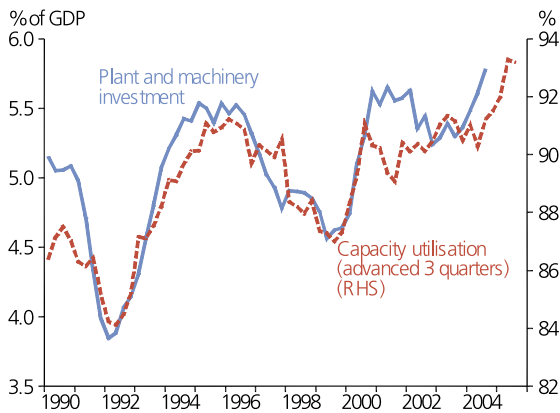
Non-residential investment and consents (quarterly total)



Source: Statistics New Zealand.

Other business investment also picked up strongly over 2004. Business investment has been encouraged by capacity constraints, strong domestic demand, and the high exchange rate (which has reduced the cost of imported capital goods). Despite this lift in investment, firms are still reporting high capacity utilisation. This suggests that plant and machinery investment will remain high over early 2005 (figure 3.15, overleaf).

**Figure 3.15**  
**Plant and machinery investment and capacity utilisation**



Source: Statistics New Zealand, NZIER.

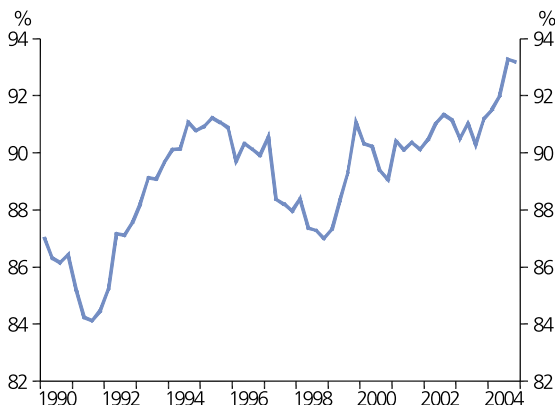
### Fiscal policy

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

### Productive capacity

The sustained period of above-average growth in recent years has stretched the economy's productive resources, particularly in the construction and services sectors. This is evident in the NZIER's Quarterly Survey of Business Opinion (QSBO) measure of capacity utilisation which increased significantly over 2004 and remains close to historical highs (figure 3.16).

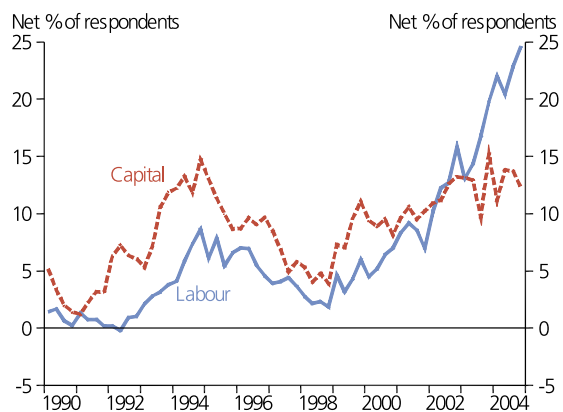
**Figure 3.16**  
**Capacity utilisation**



Source: NZIER.

Capacity constraints are also evident in the proportion of firms saying that capital and labour are factors limiting increased production (figure 3.17). An above-average proportion of firms say that capital is a factor limiting their ability to increase production, while firms have increasingly been citing labour as a limiting factor over the past few years.

**Figure 3.17**  
**Factors limiting increased production (labour and capital)**

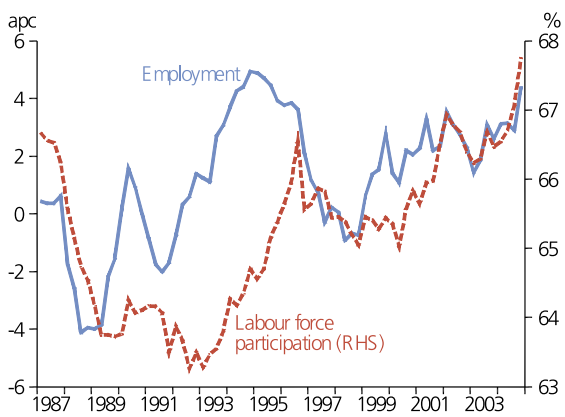


Source: NZIER.

### The labour market and wages

A strong economy over the past few years has increased firms' demand for labour resulting in strong employment growth (figure 3.18). This increased demand for labour has encouraged people to enter the labour force, with labour

**Figure 3.18**  
**Employment growth and labour force participation**

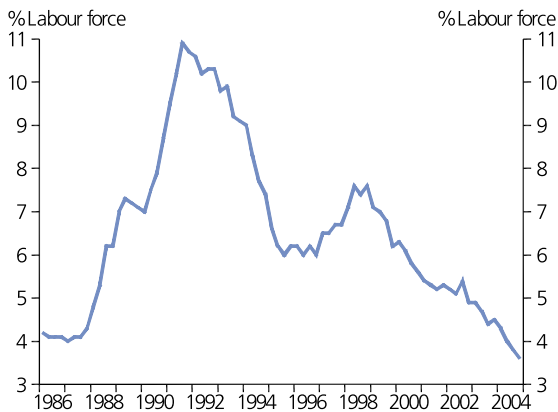


Source: Statistics New Zealand.

force participation increasing in the December quarter to its highest level in the history of the Household Labour Force Survey.

However, increases in the labour force over recent years have been more than offset by the growth in employment, resulting in consistent falls in the unemployment rate, which reached 3.6 per cent in the December quarter – an historical low and the lowest of all OECD countries (figure 3.19).

**Figure 3.19**  
**Unemployment rate**

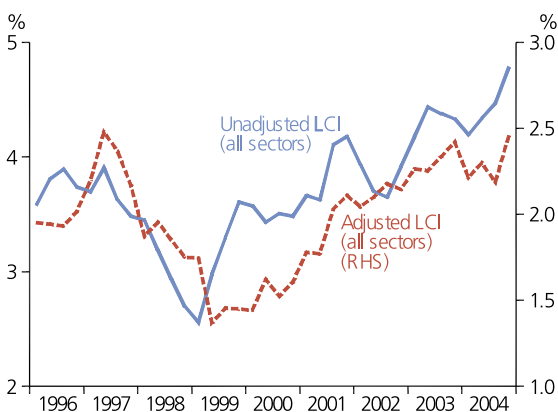


Source: Statistics New Zealand.

This stretch in the labour market has started to put pressure on wage settlements, with firms having to pay increasingly higher wages to attract and retain staff. Annual growth in both the adjusted and unadjusted Labour Cost Index (LCI) are at cyclically high levels (figure 3.20).

These observations are broadly supported by movements in the distribution of wage increases in the LCI. The proportion

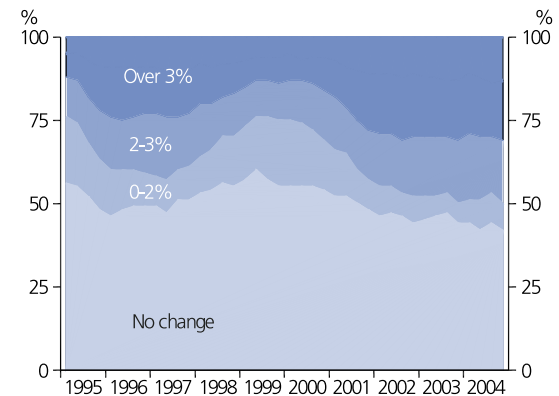
**Figure 3.20**  
**Adjusted and unadjusted LCI**  
*(annual percentage change)*



Source: Statistics New Zealand.

of firms increasing salary and ordinary time wage rates in the year to December was at an historical high (figure 3.21). Wage increases seem to be reflecting increasing CPI inflation and labour constraints – Statistics New Zealand note that the main reasons given for wage increases were to reflect changes in the cost of living, the need to match market rates and to retain staff.

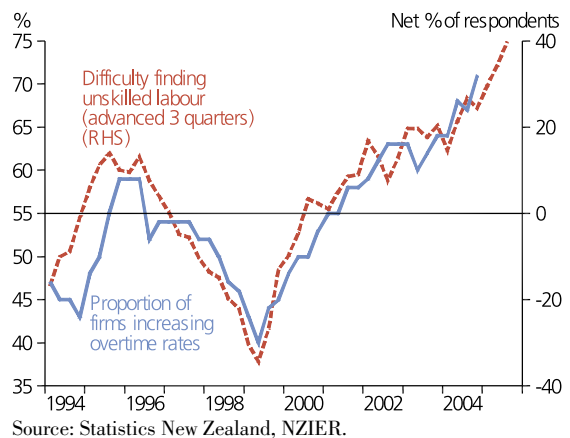
**Figure 3.21**  
**Distribution of annual wage increases**



Source: Statistics New Zealand.

Rising wage pressures, however, are not isolated to ordinary time salary and wage rates. The proportion of firms increasing overtime wage rates has also been trending up over the past few years (figure 3.22). This suggests that, given the tight labour market, firms have to pay higher overtime wages to existing staff.

**Figure 3.22**  
**Overtime wage increases and difficulty finding labour**

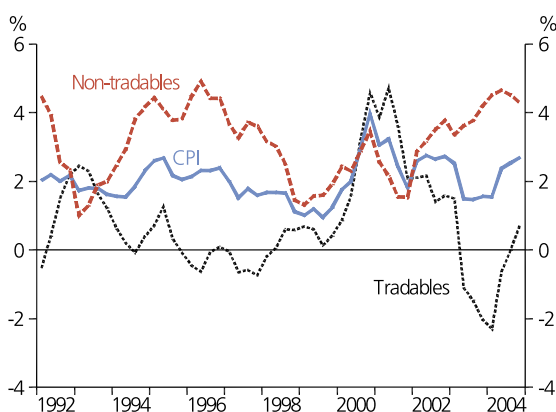


Source: Statistics New Zealand, NZIER.

## Inflation pressures

Annual CPI inflation increased steadily over 2004, reaching 2.7 per cent in the December quarter (figure 3.23). Although CPI inflation remained inside the target range, non-tradables inflation was above 4 per cent for all of 2004. This has been offset in the CPI by relatively low tradables inflation.

**Figure 3.23**  
CPI, non-tradables and tradables inflation  
(annual rate)



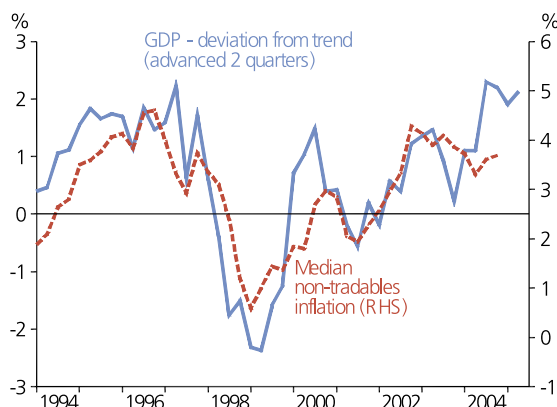
Source: Statistics New Zealand, RBNZ estimates.

Strong non-tradables inflation has reflected increasing resource pressures over the past three years, remaining above 3 per cent since early 2002. It is our view that the economy has been operating above its normal capacity for some time, putting pressure on non-tradables prices (figure 3.24). Inflation has been particularly high in the housing and construction markets, with the costs associated with the purchase and construction of new dwellings increasing by 7.3 per cent in the year to December. Strong inflationary pressures are also present in other sectors of the domestic economy with local authority rates, energy costs, and the cost of dwelling insurance (among others) rising sharply over the year.

Indicators of 'core' inflation also point to rising price pressures. The weighted median CPI and trimmed mean CPI have increased significantly over 2004, both reaching 2.9 per cent in the December quarter (figure 3.25). Furthermore, the GDP deflator excluding exports – conceptually, the broadest measure of economy-wide inflation – has been above 4 per cent for the past few years.

Conversely, tradables inflation has been low over the past three years, reflecting the appreciation of the exchange

**Figure 3.24**  
Cyclical pressures and non-tradable inflation

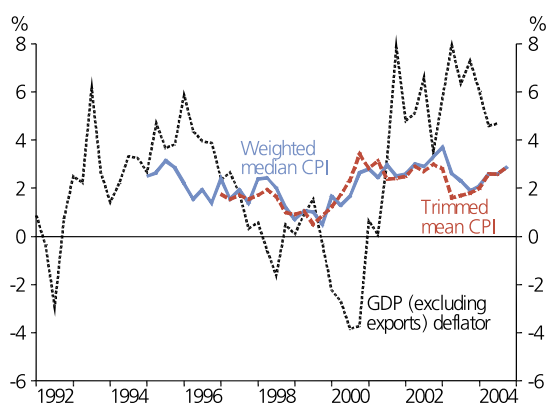


Source: RBNZ.

rate. However, tradables inflation has lifted over 2004, reflecting a less rapid rate of exchange rate appreciation, higher oil prices, stronger global demand pressures, and cost pressures such as higher labour costs.

Inflation as measured by the Producers Price Indexes (table 3.1) has picked up over 2004. However, some industries have experienced more price pressure than others – prices in the construction sector have increased significantly over 2004, as have prices in metal manufacturing. Meanwhile, prices in textile and apparel manufacturing have been weak, reflecting the lagged effects of the appreciating TWI.

**Figure 3.25**  
Indicators of 'core' inflation  
(annual percentage change)



Source: Statistics New Zealand.

Table 3.1

## CPI and other price measures

	2003				2004		
	Jun	Sep	Dec	Mar	Jun	Sep	Dec
<b>CPI</b>	1.5	1.5	1.6	1.5	2.4	2.5	2.7
Food	0.0	0.3	0.2	0.5	1.1	0.5	1.2
Housing	4.7	5.9	6.6	7.0	7.1	6.7	5.6
Household operations	1.1	0.9	1.5	1.4	1.5	1.0	1.4
Apparel	-0.6	-1.1	-1.1	-1.0	-0.8	-0.4	-0.3
Transportation	-1.7	-2.5	-3.9	-4.6	-0.6	1.5	3.3
Tobacco and alcohol	2.7	2.6	2.9	2.9	3.2	4.2	3.7
Personal and health	3.5	2.6	2.4	2.7	2.7	2.7	2.6
Recreation and education	2.1	1.7	1.6	2.0	1.4	1.5	1.8
Credit services	0.7	-0.1	1.2	-0.9	0.8	-0.2	-4.9
<b>Derivatives and analytical series</b>							
CPI ex food, petrol and government charges	1.9	1.3	1.2	1.2	1.4	2.3	2.5
CPI non-tradables	3.6	3.8	4.2	4.5	4.7	4.5	4.3
CPI tradables	-1.1	-1.5	-2.0	-2.3	-0.7	0.0	0.7
CPI weighted median (of annual price change)	2.6	2.3	1.9	2.1	2.6	2.6	2.9
CPI trimmed mean (of annual price change)	1.6	1.7	1.8	2.0	2.6	2.6	2.9
Merchandise import prices (excluding petrol)	-12.5	-11.5	-12.0	-10.6	-5.9	-5.8	n/a
PPI - Inputs	-1.9	0.1	-0.1	-0.6	1.5	2.5	3.4
PPI - Outputs	-0.6	0.7	1.1	0.9	1.9	2.4	2.6
Private consumption deflator	0.5	0.3	0.0	0.5	1.4	0.8	n/a
GDP deflator (derived from expenditure data)	2.4	2.3	3.8	2.7	3.7	4.5	n/a
Retail trade deflator	-0.7	-0.7	-0.4	-0.6	0.8	0.5	0.7

Source: Statistics New Zealand, RBNZ estimates.

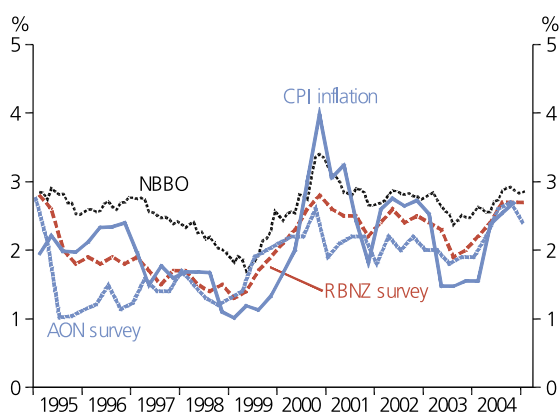
## Inflation expectations

Changes in inflation expectations can have a significant impact on the path of medium-term inflation. Temporary fluctuations in the rate of CPI inflation can become ingrained in inflation expectations, thus affecting the wage and price setting behaviour of firms and households. Although inflation expectations are notoriously difficult to gauge, surveyed expectations can provide some insights.

Survey measures of one-year-ahead inflation expectations tend to follow actual inflation relatively closely. Measures from the National Bank's Survey of Business Opinion (NBBO), the AON consulting survey (covering professional economists), and the RBNZ survey of expectations, have increased since mid 2003 (figure 3.26). However, inflation expectations all remain below 3 per cent suggesting that any impact of inflation expectations on price and wage setting decisions will remain reasonably contained in the near term.

Figure 3.26

## Inflation expectations (one-year-ahead) and annual CPI inflation



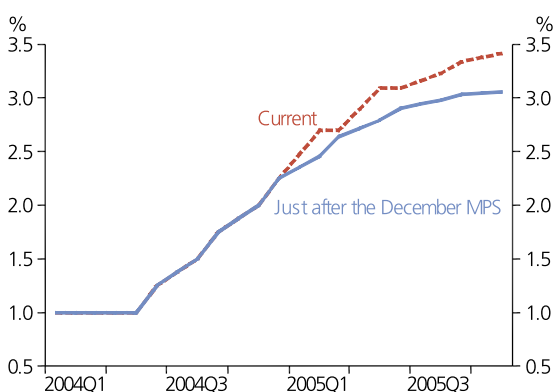
Source: AON Consulting, National Bank of New Zealand, RBNZ, Statistics New Zealand.

## 4 Financial market developments

### International interest rates

Short-term wholesale interest rates have risen in most of the world's major economies over the past three months. The increases have been most prominent in the US and Australia. As had been widely anticipated, the US Federal Reserve delivered another 25 basis point rate rise in February. This continues the 'measured' tightening programme, which has seen its policy rate rise from 1 per cent in May last year to 2.5 per cent currently. Spurred on by solid economic data and suggestions from various Fed officials that policy remains 'accommodative', market expectations regarding further US tightening have continued to intensify. Market pricing suggests the US policy rate is now expected to rise to 3.5 per cent by the end of 2005, rather than the 3 per cent expected at the time of the December *Statement* (figure 4.1).

**Figure 4.1**  
Financial market expectations of the Fed funds rate

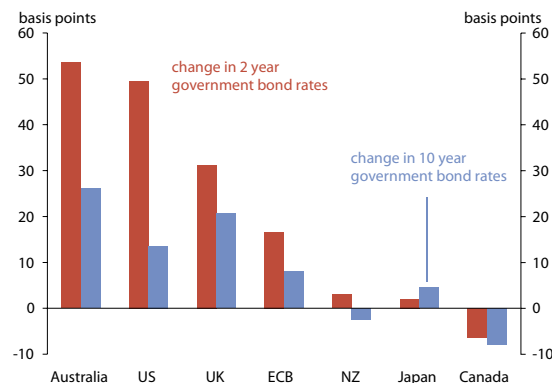


Source: Reuters, RBNZ estimates.

Short-term interest rates have risen to an even greater extent in Australia. After leaving rates on hold since late 2003, the Reserve Bank of Australia recently raised its policy rate by 25 basis points to 5.50 per cent and voiced concerns regarding capacity constraints and inflationary pressures. The market is pricing in a high probability of another rate rise at some stage over the next few months, despite the recent release of some relatively weak data (notably December quarter GDP).

In contrast, global longer-term interest rates have increased by considerably less than short-term rates. As a consequence, yield curves have flattened (figure 4.2).

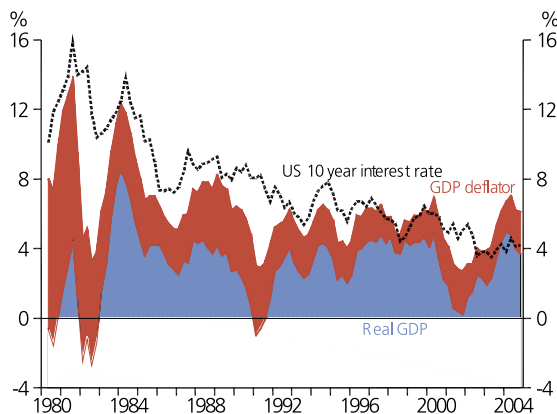
**Figure 4.2**  
Movements in global bond rates



Source: Bloomberg, RBNZ.

Although long-term global interest rates have risen, they are still low relative to current levels of economic growth and inflation, particularly in the case of the US – a situation US Federal Reserve Chairman Alan Greenspan recently described as a 'conundrum' (figure 4.3).

**Figure 4.3**  
US 10 year bond rates, economic growth and inflation



Source: Bloomberg.

There are a range of factors that have been identified as playing a role in maintaining relatively low long-term rates in the US. The so-called 'carry trade' has seen investors borrow money at relatively low short-term interest rates to invest in securities that pay a higher return. Not only has this been seen as putting downward pressure on longer-term government bond yields (as well as contributing to the flattening of yield curves), but it has created strong demand for corporate bonds and other more 'risky' assets. Other factors include pension funds buying long-term bonds to increase the duration of their portfolios and Asian central

banks buying US government bonds as part of their foreign exchange intervention programmes. However, there is no consensus on how important these various factors have been in contributing to the relatively low level of long-term interest rates.

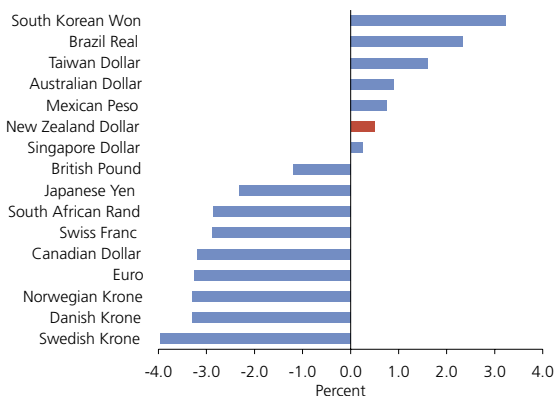
To the extent that current rates reflect expectations about the future, this could suggest the market's view of US economic growth and inflation prospects is considerably weaker than *Consensus'* forecasts. Alternatively, other factors such as the carry trade may be preventing interest rates from fully reflecting growth and inflation expectations. In the latter case, as the attractiveness of the carry trade wanes in the face of further US policy rate increases, then longer-term interest rates could rise considerably. Either way, the potential for US economic growth to prove weaker than *Consensus'* forecasts or for US longer-term interest rates to rise sharply represent downside risks to the New Zealand economic outlook (see scenario 2 in Box 2, Chapter 2).

## Exchange rates

After weakening through much of 2004, the US dollar has regained some ground since its lows in late December. The US dollar rebound appears to have been driven in part by a greater focus on interest rate differentials, with US short-term interest rates moving above those of Europe and Canada. Nevertheless, the potential for renewed US dollar weakness remains, given ongoing concerns regarding the US current account and fiscal deficits.

Figure 4.4

### Exchange rates against the US dollar



Source: RBNZ.

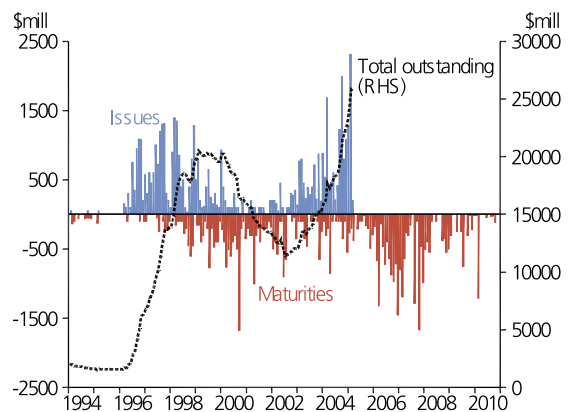
While the Euro has fallen from its late 2004 highs, a number of Asian currencies have actually strengthened against the US dollar over the same period (figure 4.4). This contrasts to the situation during much of the past three years, when Asian currencies appreciated far less than others against a weakening US dollar. The gains in these Asian currencies (particularly the South Korean Won and the Taiwan dollar) have partly reflected heightened speculation that China is planning to revalue and/or liberalise its fixed exchange rate.

The Bank's research into the determinants of exchange rate cycles suggests that trends in the New Zealand dollar broadly reflect New Zealand's relative cyclical position and its overseas terms of trade. The appreciation of the New Zealand dollar over the past two years has coincided with an increasing terms of trade brought about by rising commodity prices and a strong domestic economy, which has seen New Zealand's monetary policy tighten relative to many of its trading partners. New Zealand's bilateral exchange rates are also affected by foreign currency developments, with weakness in the US dollar pushing the New Zealand dollar higher over much of the past year.

The New Zealand and Australian dollars have appreciated since the time of the December *Statement*. Consistent with strong foreign demand for New Zealand and Australian investments, Uridashi and Eurokiwi bond issuance has continued at a rapid pace in early 2005. But recent issuance has built up a large volume of maturities from 2006 to 2008 (figure 4.5). Just as recent issuance has put upward pressure

Figure 4.5

### New Zealand dollar bond issuance in offshore markets



Source: RBNZ estimates.

on the New Zealand dollar, these maturities represent a downside risk to the New Zealand dollar in the future.

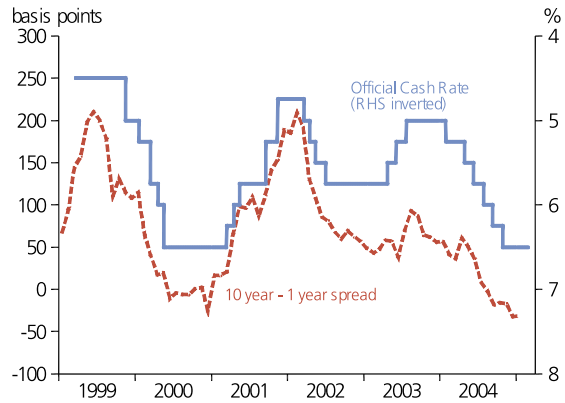
### Domestic interest rates

The New Zealand yield curve has become more negatively sloped (or 'inverted') since the December *Statement* (figure 4.6). Shorter-term interest rates have continued to rise in response to ongoing signs of robust economic growth, which have raised OCR expectations. Meanwhile, relatively low global interest rates have maintained downward pressure on longer-term interest rates. The inverted yield curve is consistent with expectations that the New Zealand economy will slow going forward as the full effects of the OCR increases over the last 12 months flow through to economic activity.

From mid December the mortgage rates offered to new borrowers rose, particularly for two year fixed mortgages. This reflected at least a temporary end to the period of intense competition between the major banks as well as the increase in wholesale rates noted above. It is unclear

at this stage whether this intense competition will resume. For the time being, the effective mortgage rate continues to rise gradually in line with estimates made in the December *Statement*.

**Figure 4.6**  
The OCR and the slope of the wholesale interest rate curve



Source: RBNZ.

## 5 The macroeconomic outlook

### Overview

This chapter describes our economic projections for economic activity, inflation and interest rates over the coming years. The economy is performing strongly, with growth expected to remain robust over the early half of 2005. Continued strength in activity is placing pressure on productive resources and, over the medium term, inflation pressures are projected to remain strong. CPI inflation is expected to rise to 3 per cent in 2005 and remain around that level for some time.

Economic activity is expected to slow from late 2005 onwards. The key factors for a slowdown remain in place – the combination of higher interest rates, lower net immigration, and a cooling housing market are expected to dampen household spending. Also, a moderation in the terms of trade and the lagged effects of the high exchange rate are expected to impact on the external sector.

The projected slowdown in economic activity will eventually moderate domestic inflation pressures and bring CPI inflation under 3 per cent in 2007. But relative to our December assessment, we judge that a firmer policy stance is required to achieve inflation outcomes that are consistent with the Bank's target range of 1 to 3 per cent on average over the medium term. 90-day interest rates are projected to remain around 7 per cent for some time (see figure 2.3, Chapter 2).

### World outlook

Our view on the outlook for New Zealand's main trading partners is largely based on *Consensus Forecasts*, a survey of the main forecasters in our trading partner-economies.

Global growth is expected to ease back over 2005 and 2006 (figure 5.1, overleaf). World inflation is expected to be a little higher over the same period. Consistent with this inflation outlook, global short-term interest rates are expected to rise.

While the global economic outlook conveys a relatively orderly picture, there is a risk of larger downward adjustments to global growth given the structural imbalances in the US economy.

### Tradables prices

Over recent months, world prices for New Zealand's exports have remained stable at high levels, underpinned by strong global demand and tight international supplies for some of our key commodity exports. While global demand is expected to remain robust, international supplies for some primary products are expected to increase, resulting in some moderation in world prices. New Zealand dollar returns are likely to be buffered to some extent due to the assumed depreciation of the TWI over the projection period.

World import prices are expected to moderate, largely based on an assumption that oil prices will gradually decline

**Table 5.1**  
**Forecasts of export partner GDP growth\***  
(calendar year, annual average percentage change)

Country	2001	2002	2003	2004f	2005f	2006f	2007f
Australia	2.5	4.0	3.3	3.4	3.1	3.4	3.5
United States	0.8	1.9	3.0	4.4	3.5	3.4	3.2
Japan	0.2	-0.3	1.4	2.6	0.9	1.5	1.2
Canada	1.8	3.4	2.0	2.7	2.8	3.0	2.9
Eurozone**	1.6	0.9	0.5	1.7	1.7	2.0	2.1
United Kingdom	2.3	1.8	2.2	3.1	2.5	2.4	2.0
Asia ex-Japan***	2.0	5.1	4.9	7.3	5.7	5.8	6.0
12 Country Index	1.5	2.6	2.9	4.0	3.2	3.4	3.3

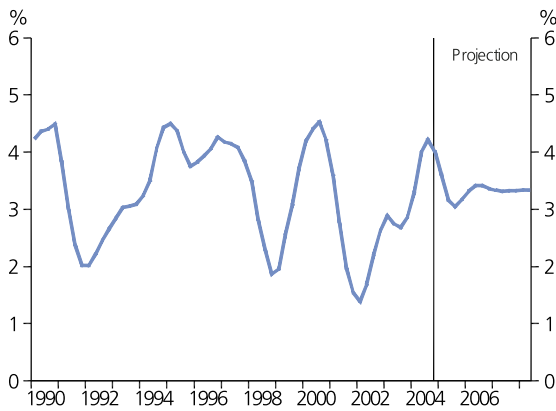
\* Source: Consensus Economics Inc., RBNZ estimates.

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

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

Figure 5.1

**Trading partner GDP**  
(annual average percentage change)



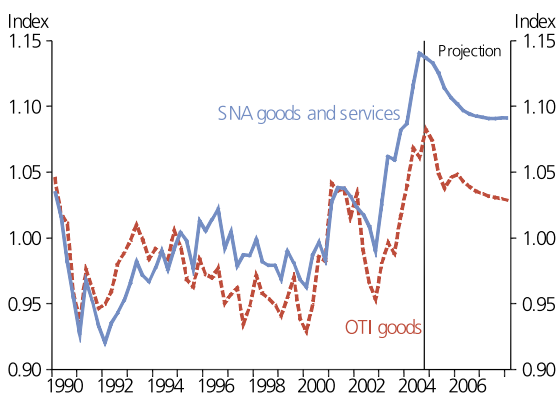
Source: Consensus Economics Inc., RBNZ estimates.

going forward. The outlook for oil prices remains a source of uncertainty.

The projected decline in world export prices outweigh the fall in import prices, resulting in a fall in the terms of trade over the coming years. However, the terms of trade are expected to remain at high levels by historical standards (figure 5.2).

Figure 5.2

**Terms of trade**



Source: Statistics New Zealand, RBNZ estimates.

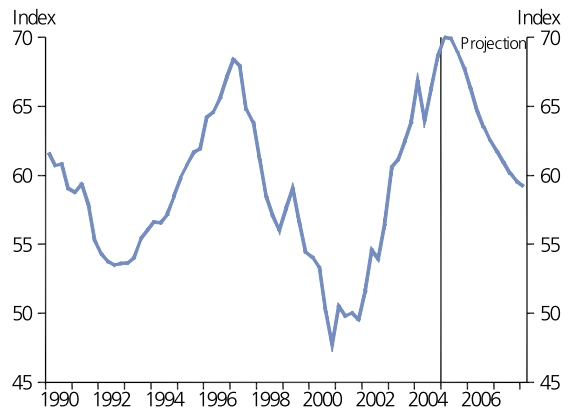
**Exchange rate**

The TWI is marginally higher than the level assumed in the December *Statement*. Our assumption is for the TWI to remain around current levels for some months before gradually reverting to its long-term average (figure 5.3). The profile of the TWI is modelled to be consistent with the projected decline in world export prices and a narrowing

in the short-term interest rate differential between New Zealand and the rest of the world.

Figure 5.3

**Nominal TWI assumption**



Source: RBNZ estimates.

**Export volumes**

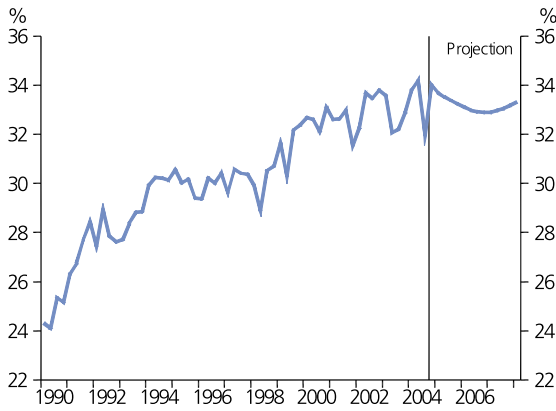
Export volume growth was strong over 2004. Only modest growth is expected over the period ahead reflecting the lagged effects of the high exchange rate. However, the outlook varies by sector:

- Non-commodity manufacturing has been surprisingly strong recently, and is projected to grow by around 10 per cent over calendar 2004. We expect annual growth in non-commodity manufactured exports to slow to 5 per cent in 2005, and 1 per cent in 2006, as the lagged effect of the high exchange rate takes hold.
- Agricultural exports are expected to rebound strongly in 2005, and to grow moderately thereafter.
- Forestry export volumes are projected to remain quite weak until 2006, as poor returns, due to low world prices and high shipping costs, discourage local suppliers from felling.
- Exports of services grew much more than expected in late 2004, but we are maintaining our view that growth in this sector will slow dramatically in the next two years, as the lagged effects of the high New Zealand dollar feed through.

Figure 5.4

**Export volumes**

(per cent of trend output)



Source: Statistics New Zealand, RBNZ estimates.

**Current account**

The current account deficit is projected to widen to around 7 per cent of GDP by 2007. The projected decline in the terms of trade and a deterioration in net exports due to the high exchange rate contribute to the widening of the current account deficit. At around 7 per cent of GDP, the projected current account deficit will be larger than levels reached in the mid to late 1990s and reflects unprecedented dissaving by households. These levels are not sustainable in the medium term and are consistent with our declining outlook for the New Zealand dollar. The projected TWI depreciation, together with slower rates of consumption growth are expected to gradually improve the current account position from the latter half of 2007.

**Import volumes**

Import volumes have increased significantly over recent years, underpinned by strong growth in consumption and business investment. At the same time, the rise in the exchange rate has lowered the relative cost of imports, fuelling households' and firms' appetite for imports. Import volume growth is expected to slow significantly in the period ahead, largely mirroring the projected slowdown in domestic spending and aggregate economic activity.

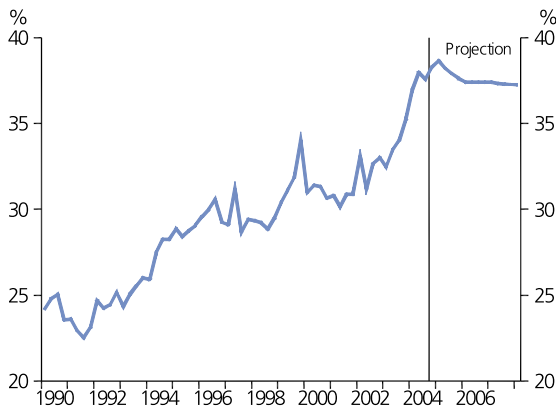
**Household consumption**

After experiencing strong consumption growth over the past few years, household spending is expected to slow over the period ahead. However, relative to our December projections, the timing of the slowdown has been pushed out to the second half of 2005. The strength in the labour market has improved household incomes, job security and consumer confidence. Momentum in household spending has also been supported by ongoing additions to household wealth.

Figure 5.5

**Import volumes**

(per cent of trend output)

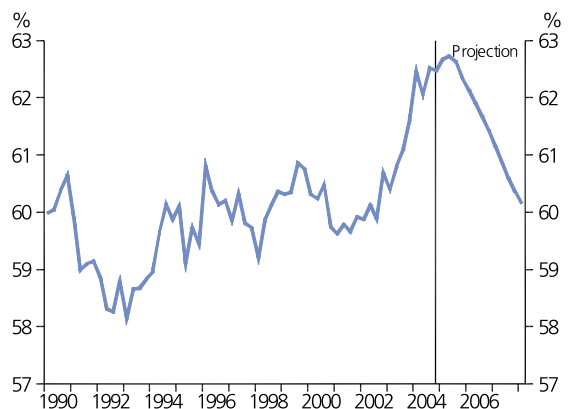


Source: Statistics New Zealand, RBNZ estimates.

Figure 5.6

**Real household consumption**

(per cent of trend output)



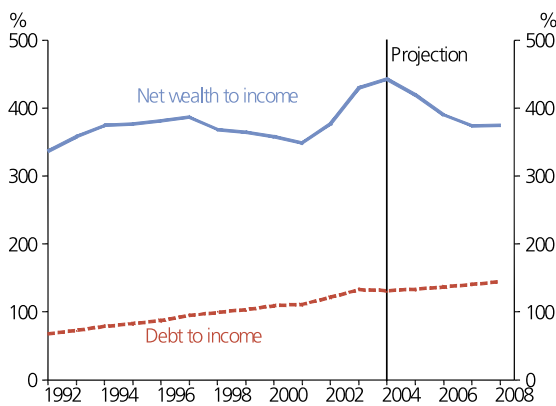
Source: Statistics New Zealand, RBNZ estimates.

## Household balance sheet

Household savings, measured as a cash flow – the difference between current income and current expenditure – has been negative and declining over recent years (this measure is called financial savings). As households have essentially borrowed to fund current consumption, the debt-to-income ratio has risen steadily.

However, the increase in the household debt-to-income ratio has been more than offset by increases in the ratio of household assets-to-income. As a result, the net wealth-to-income ratio has increased from around 350 per cent in 2001 to around 450 per cent in 2004 (figure 5.7). The majority of the increase in net wealth is due to increases in house prices.

**Figure 5.7**  
Net wealth-to-income ratio and debt-to-income ratio



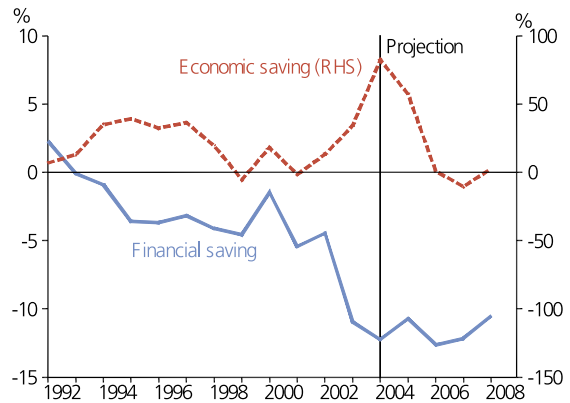
Source: RBNZ estimates.

Thus, if savings is measured as the change in accumulated net wealth – the difference from one year to the next in assets less liabilities, i.e. economic savings – then it has been rising, in contrast to financial savings (figure 5.8).

## Housing market

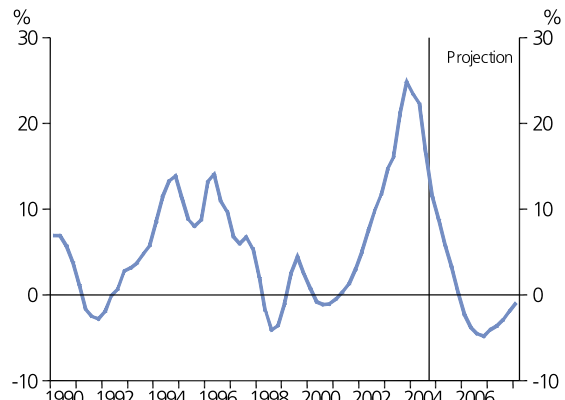
Quantifying the wealth effect is difficult, but increases in wealth from rising house prices have underpinned momentum in household spending. We project that house price inflation will slow markedly over the coming years, reflecting lower net immigration and higher interest rates. The combination of these factors will eventually act to constrain household spending and slow domestic economic activity.

**Figure 5.8**  
Financial savings rate and economic savings rate



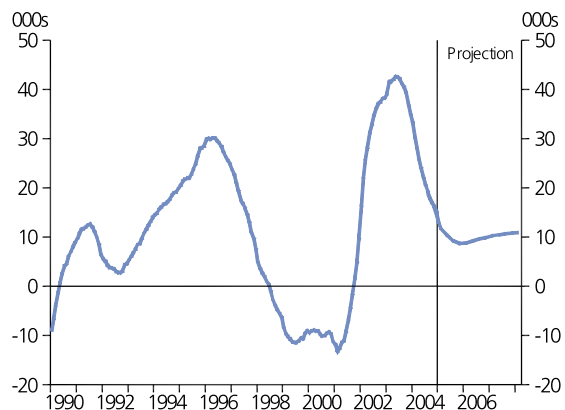
Source: Statistics New Zealand, RBNZ estimates.

**Figure 5.9**  
Annual house price inflation



Source: Quotable Value New Zealand, RBNZ estimates.

**Figure 5.10**  
Net permanent and long-term immigration  
(annual total)



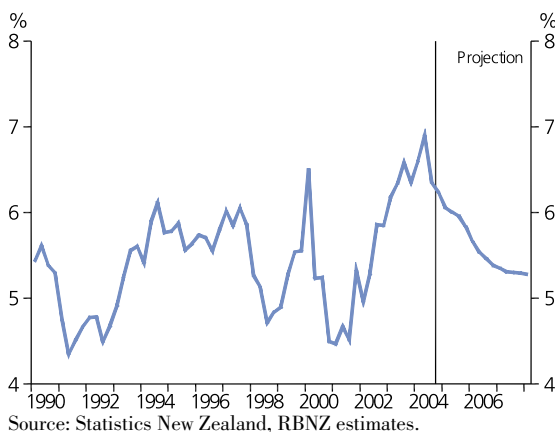
Source: Statistics New Zealand, RBNZ estimates.

## Residential investment

The residential investment cycle is past its peak and is expected to slow significantly over 2005. The projected residential investment cycle is based on the typical relationship with residential building consents issued. However, there remains an upside risk to this profile if there remains a significant backlog of building work. Further, activity in the construction sector overall is likely to remain strong given the surge in non-residential building consents and significant infrastructure investment.

Figure 5.11

### Residential investment (per cent of trend output)



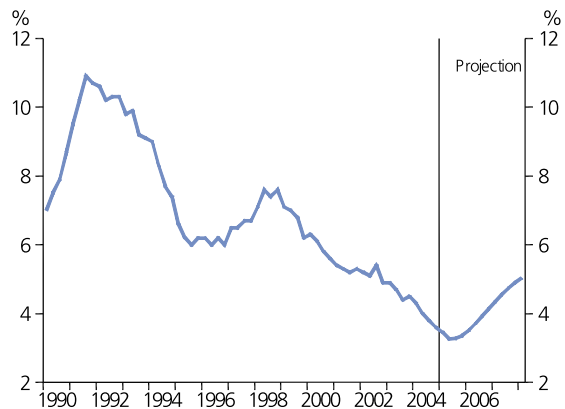
## Labour market

The labour market is very tight, with strong employment growth driving the unemployment rate to a record low, despite a record high labour force participation rate (figure 5.12). The demand for labour is likely to remain strong for some time, which is expected to keep the unemployment rate below 4 per cent over the coming years. Consistent with a tight labour market, wage growth has increased over 2004. The strong labour market is also affording greater job security and higher levels of consumer confidence, which should underpin robust domestic spending in the near term.

Looking ahead, wage growth is expected to remain around current rates for some time. However, given the degree of reported labour shortages, there is a risk of higher generalised wage inflation. Where this is not matched by productivity increases, it could have unhelpful consequences for pricing behaviour and inflation expectations.

Figure 5.12

### Unemployment rate



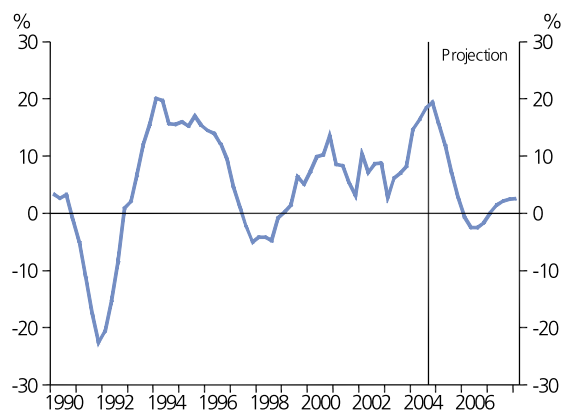
Source: Statistics New Zealand, RBNZ estimates.

## Business investment

Robust demand from home and abroad, coupled with the high exchange rate, has encouraged strong investment in new capital. We project further strong growth in business investment over early 2005 as ongoing labour shortages encourage investment in labour-saving capital. Further ahead, plant and machinery investment is projected to slow in line with the economic cycle (figure 5.13). Similarly, we are expecting the recent surge in non-residential construction activity to continue apace into early 2005 before slowing thereafter.

Figure 5.13

### Business investment (annual average percentage change)



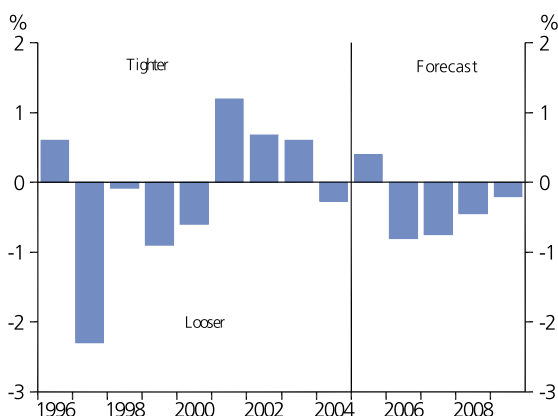
Source: Statistics New Zealand, RBNZ estimates.

## Government

Our fiscal projections are largely based on The Treasury's December *Economic and Fiscal Update*. Government expenditure is projected to rise strongly in the coming years, becoming an increasing proportion of GDP. The key increases will be on health spending, government transfers (the Working for Families package), and infrastructure investment. At present, we expect the increases in spending to be partially offset by rising taxation as nominal incomes rise. Fiscal policy in 2005 is expected to be contractionary, but is expected to become increasingly stimulatory in later years (figure 5.14).

The balance of risks around the projected fiscal impulse lie to the upside. In addition to the inherent uncertainty of the election later this year, the Working for Families package could have a larger than expected impact if the families receiving the transfers have a relatively high propensity to consume. Similarly, the infrastructure investment could place further pressures on the capacity-constrained construction sector.

**Figure 5.14**  
Estimated fiscal impulse  
(per cent of GDP)



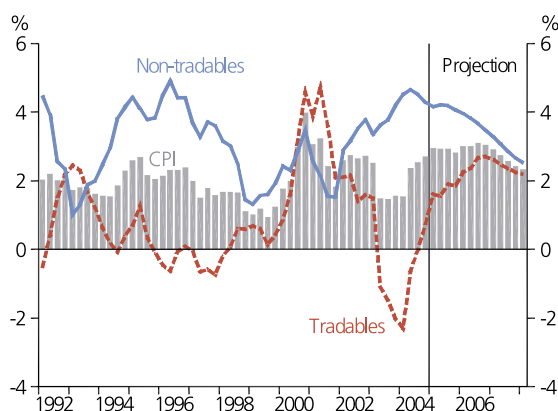
Source: The Treasury.

## Inflation

Relative to our December assessment, medium-term inflation pressures have increased given our view of stronger economic activity over 2005. CPI inflation is expected to peak slightly above 3 per cent in 2006, before easing over 2007 (see figure 2.4, Chapter 2).

The stronger outlook for CPI inflation is based on high non-tradables inflation (figure 5.15). Given the current degree of stretch on resources, non-tradables inflation is projected to remain above 4 per cent before the full effects of monetary policy tightening act to dampen domestic inflation pressures over 2006. High non-tradables inflation has been masked thus far by low inflation in the tradables sector. But with the exchange rate assumed to be depreciating from current levels, tradables inflation is projected to rise over the period ahead.

**Figure 5.15**  
CPI, tradables and non-tradables inflation  
(annual rate)



Source: Statistics New Zealand, RBNZ estimates.

# Appendix A <sup>1</sup>

## Summary tables

Table A

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

(CPI and GDP are in percentage changes)

		CPI*	CPI**	TWI	90-day bank bill rate
		Quarterly	Annual		
1999	Jun.	0.5	1.2	59.1	4.7
	Sep.	0.4	1.1	56.7	4.8
	Dec.	0.2	1.3	54.4	5.4
2000	Mar.	0.7	1.7	54.1	6.0
	Jun.	0.7	2.0	53.4	6.7
	Sep.	1.4	3.0	50.1	6.7
	Dec.	1.2	4.0	47.7	6.7
2001	Mar.	-0.2	3.1	50.5	6.4
	Jun.	0.9	3.2	49.8	5.9
	Sep.	0.6	2.4	50.0	5.7
	Dec.	0.6	1.8	49.6	5.0
2002	Mar.	0.6	2.6	51.6	5.0
	Jun.	1.0	2.8	54.6	5.8
	Sep.	0.5	2.6	53.9	5.9
	Dec.	0.6	2.7	56.4	5.9
2003	Mar.	0.4	2.5	60.6	5.8
	Jun.	0.0	1.5	61.1	5.4
	Sep.	0.5	1.5	62.4	5.1
	Dec.	0.7	1.6	63.9	5.3
2004	Mar.	0.4	1.5	66.9	5.5
	Jun.	0.8	2.4	64.0	5.9
	Sep.	0.6	2.5	66.3	6.4
	Dec.	0.9	2.7	68.6	6.7
2005	First Half Average	$\frac{3}{4}$	3	70	7
	Second Half Average	$\frac{3}{4}$	3	68 $\frac{1}{4}$	7
2006	First Half Average	$\frac{3}{4}$	3	65 $\frac{1}{2}$	7
	Second Half Average	$\frac{3}{4}$	3	63	7
2007	First Half Average	$\frac{3}{4}$	2 $\frac{3}{4}$	61 $\frac{1}{4}$	7
	Second Half Average	$\frac{1}{2}$	2 $\frac{1}{2}$	59 $\frac{3}{4}$	6 $\frac{3}{4}$

		CPI*	CPI**	GDP	GDP
		quarterly	annual	quarterly	annual average
2004	Mar.	0.4	1.5	2.1	3.6
	Jun.	0.8	2.4	0.8	4.4
	Sep.	0.6	2.5	0.6	4.6
	Dec.	0.9	2.7	1.1	5.0
2005	Mar.	0.6	3.0	1.0	4.6
	Jun.	0.8	2.9		

<sup>1</sup> Notes for these tables follow on pages 28-29.

\* 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 C

## Summary of economic projections

*(Annual percentage change, unless specified otherwise)*

March year	Actuals					Projections				
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
<b>Price measures</b>										
CPI*	1.0	1.7	3.1	2.6	2.5	1.5	3	3	3	2 <sup>1</sup> / <sub>4</sub>
Labour costs	1.6	1.4	1.6	2.1	2.2	2.1	2 <sup>3</sup> / <sub>4</sub>	2 <sup>3</sup> / <sub>4</sub>	2 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>
Import prices (in New Zealand dollars)	2.7	11.2	7.4	-2.9	-11.1	-10.5	-2 <sup>1</sup> / <sub>4</sub>	4 <sup>1</sup> / <sub>2</sub>	7 <sup>1</sup> / <sub>4</sub>	5
Export prices (in New Zealand dollars)	-0.6	9.9	20.6	-3.5	-15.5	-5.1	1	2	5 <sup>3</sup> / <sub>4</sub>	4 <sup>1</sup> / <sub>2</sub>
<b>Monetary conditions</b>										
90-day rate (year average)	6.2	5.2	6.6	5.4	5.9	5.3	6 <sup>1</sup> / <sub>2</sub>	7	7	6 <sup>3</sup> / <sub>4</sub>
TWI (year average)	57.3	56.1	50.4	50.3	56.4	63.6	67 <sup>1</sup> / <sub>4</sub>	68 <sup>1</sup> / <sub>4</sub>	63	60
<b>Output</b>										
GDP (production, annual average % change)	0.5	5.2	2.3	3.5	4.6	3.6	4 <sup>1</sup> / <sub>2</sub>	3	1 <sup>3</sup> / <sub>4</sub>	2
GDP (production, March qtr to March qtr)	2.6	5.8	0.9	4.4	4.2	5.1	3 <sup>1</sup> / <sub>2</sub>	2	1 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>
Output gap (% of potential GDP, year average)	-1.9	0.5	0.0	0.2	1.2	1.2	2	1 <sup>1</sup> / <sub>2</sub>	0	-1
<b>Labour market</b>										
Total employment	0.7	1.5	2.3	3.5	1.5	3.1	3 <sup>1</sup> / <sub>2</sub>	1	0	1 <sup>1</sup> / <sub>4</sub>
Unemployment rate (March qtr, s.a.)	7.1	6.3	5.4	5.2	4.9	4.3	3 <sup>1</sup> / <sub>2</sub>	3 <sup>1</sup> / <sub>2</sub>	4 <sup>1</sup> / <sub>4</sub>	5
Trend labour productivity (annual % change)	0.6	2.7	0.9	1.6	1.6	1.4	1 <sup>1</sup> / <sub>2</sub>	1 <sup>1</sup> / <sub>2</sub>	1 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>4</sub>
<b>Key balances</b>										
Government operating balance (% of GDP, year to June)	1.7	1.3	1.2	1.9	1.5	5.3	3 <sup>3</sup> / <sub>4</sub>	4 <sup>1</sup> / <sub>4</sub>	3 <sup>1</sup> / <sub>2</sub>	3
Current account balance (% of GDP, year to March)	-4.2	-6.5	-4.1	-2.7	-3.4	-4.6	-6 <sup>1</sup> / <sub>2</sub>	-6 <sup>1</sup> / <sub>2</sub>	-6 <sup>3</sup> / <sub>4</sub>	-6 <sup>1</sup> / <sub>2</sub>
Terms of trade (OTI measure, annual average % change)	-0.4	-0.2	4.4	4.2	-5.7	3.9	6	-2 <sup>1</sup> / <sub>2</sub>	-3 <sup>1</sup> / <sub>4</sub>	-3 <sup>1</sup> / <sub>4</sub>
Household savings rate	-4.6	-1.5	-5.4	-4.5	-11.0	-12.2	-10 <sup>3</sup> / <sub>4</sub>	-12 <sup>3</sup> / <sub>4</sub>	-12 <sup>1</sup> / <sub>4</sub>	-10 <sup>1</sup> / <sub>2</sub>
(% of disposable income, year to March)										
<b>World economy</b>										
World GDP (annual average % change)	2.0	4.2	3.6	1.4	2.9	3.3	3 <sup>1</sup> / <sub>2</sub>	3 <sup>1</sup> / <sub>4</sub>	3 <sup>1</sup> / <sub>4</sub>	3 <sup>1</sup> / <sub>4</sub>
World CPI inflation	1.1	2.0	2.7	1.4	2.2	1.5	2 <sup>1</sup> / <sub>4</sub>	1 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>4</sub>

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).

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## Notes to the tables

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

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

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.

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## Appendix B

### Chronology

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

#### 2004

- 9 December The Reserve Bank released its forty-fourth *Monetary Policy Statement*, leaving the Official Cash Rate unchanged at 6.50 per cent. The news release accompanying the *Statement* is reproduced in Appendix 4.
- 22 December Production GDP figures were released showing that the New Zealand economy grew by 0.6 per cent in the September quarter of 2004.

#### 2005

- 19 January CPI statistics were released for the December quarter of 2004 showing that the CPI increased by 0.9 per cent over the quarter, and by 2.7 per cent in the year to December 2004.
- 27 January At the intra-quarter review, the Reserve Bank left the Official Cash Rate unchanged at 6.5 per cent. The accompanying news release is reproduced in Appendix 4.

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## Appendix C

### Companies and organisations contacted by RBNZ during the projection round

Alliance Group Ltd

Auckland International Airport Ltd

Council of Trade Unions

Employers & Manufacturers Association

Energy Link Ltd

Engineers Printers and Manufacturer Union

Fletcher Building Limited

Hospitality Association New Zealand

Jade Software Corporation

Kirkaldie & Stains Ltd

Ministry of Agriculture & Fisheries

Mitre 10 Ltd

Nelson Regional Economic Development

NZ Tourism Board

Port of Auckland Ltd

Port of Tauranga Ltd

Real Estate Institute of New Zealand

Retail Merchants Association

Skyline Enterprises Ltd

Wenita Forest Ltd

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

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## Appendix D

### Reserve Bank statements on monetary policy

#### OCR increased to 6.25 per cent

*9 September 2004*

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

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

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

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

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

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

#### Reserve Bank increases OCR to 6.50 per cent

*28 October 2004*

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

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

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

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

#### OCR unchanged at 6.50 per cent

*9 December 2004*

The Reserve Bank has left the OCR unchanged at 6.50 per cent.

Speaking at the release of the Reserve Bank's December 2004 *Monetary Policy Statement*, Reserve Bank Governor Alan Bollard said "As indicated in our October Review, we continue to expect that the current policy position will achieve inflation between 1 and 3 per cent on average over the medium term. This outlook assumes that significant pipeline effects from past interest and exchange rate increases will eventuate and act to further constrain the economy over the period ahead.

"Since the last review, overall economic indicators have continued to surprise on the upside. As a result, we have revised upwards our GDP estimates for the second half of 2004 and pushed out our expected timing of the economic slowdown. But the slowdown is still expected in 2005. The easing in house sales, residential building consents and

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net immigration remain in line with our earlier projections. Reinforcing this outlook is a weakening exports picture, based on softer world growth and the constraining effects of the strong NZ dollar.

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

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

3 per cent and is expected to remain around this level before easing back later in 2006. On the upside there is clearly a risk that the current momentum in household demand will hold up longer than expected. Rising wage and salary pressures also present an upside inflation risk given persistent labour market tightness. On the downside there is the possibility of more exaggerated movements in the US dollar and US interest rates, leading to a stronger New Zealand TWI, weaker exports and less inflation pressure.

“The tightening in monetary policy over the past year currently looks sufficient to keep medium term inflation pressures in check. However, with inflation expected to remain toward the top of the 1 to 3 per cent target band over the medium term, there is little headroom to absorb stronger than expected inflation pressures. If such pressures emerge, a further policy tightening cannot be ruled out. Further, the current outlook offers little scope for an easing in policy in the foreseeable future. We will review the situation at the March *Monetary Policy Statement*.”

## **OCR unchanged at 6.50 per cent**

**27 January 2005**

The Reserve Bank has left the OCR unchanged at 6.50 per cent.

Reserve Bank Governor Alan Bollard said “As indicated in our last *Monetary Policy Statement*, we continue to expect that the current policy position will achieve inflation between 1 and 3 per cent on average over the medium term. This outlook assumes that significant pipeline effects from past interest and exchange rate increases will eventuate and act to further constrain the economy over the period ahead.

“Economic developments are generally proving at least as strong as we anticipated, although a slowdown is still expected over the year ahead. Inflation has risen to close to

## Appendix E

### The Official Cash Rate chronology

Date	OCR (per cent)	Date	OCR (per cent)
17 March 1999	4.50	6 March 2003	5.75
21 April 1999	4.50	24 April 2003	5.50
19 May 1999	4.50	5 June 2003	5.25
30 June 1999	4.50	24 July 2003	5.00
18 August 1999	4.50	4 September 2003	5.00
29 September 1999	4.50	23 October 2003	5.00
17 November 1999	5.00	4 December 2003	5.00
19 January 2000	5.25	29 January 2004	5.25
15 March 2000	5.75	11 March 2004	5.25
19 April 2000	6.00	29 April 2004	5.50
17 May 2000	6.50	10 June 2004	5.75
5 July 2000	6.50	29 July 2004	6.00
16 August 2000	6.50	9 September 2004	6.25
4 October 2000	6.50	28 October 2004	6.50
6 December 2000	6.50	9 December 2004	6.50
24 January 2001	6.50	27 January 2005	6.50
14 March 2001	6.25		
19 April 2001	6.00		
16 May 2001	5.75		
4 July 2001	5.75		
15 August 2001	5.75		
19 September 2001	5.25		
3 October 2001	5.25		
14 November 2001	4.75		
23 January 2002	4.75		
20 March 2002	5.00		
17 April 2002	5.25		
15 May 2002	5.50		
3 July 2002	5.75		
14 August 2002	5.75		
2 October 2002	5.75		
20 November 2002	5.75		
23 January 2003	5.75		

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## Appendix F

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

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

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

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

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## Appendix G

# 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.

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#### 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

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