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# Monetary Policy Statement

March 2006<sup>1</sup>

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

## Contents

1.	Policy assessment	2
2.	Overview and key policy judgements	3
3.	The recent economic situation	8
4.	Financial market developments	18
5.	The macroeconomic outlook	22

## Appendices

A.	Summary tables	28
B.	Companies and organisations contacted during the projection round	33
C.	Reserve Bank statements on monetary policy	34
D.	The Official Cash Rate chronology	36
E.	Upcoming Reserve Bank <i>Monetary Policy Statement</i> and Official Cash Rate release dates	37
F.	Policy Targets Agreement	38

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ISSN 1770-4829

<sup>1</sup> Projections finalised on 28 February 2006. Policy assessment finalised on 8 March 2006.

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# 1 Policy assessment

The Official Cash Rate (OCR) will remain on hold at 7.25 per cent.

Recent data have confirmed our earlier view that economic growth is slowing. Business activity and confidence have been softening for some time. On the other hand, household spending has only recently started to wane. A key driver of strong household spending has been the buoyant housing market which, while showing signs of cooling, still remains very active. Over the next two years, we expect overall growth to remain subdued while a major rebalancing takes place, with a recovery in net exports as domestic demand weakens. A decline in the New Zealand dollar exchange rate is expected to play a role in this rebalancing.

Despite the slower growth, inflation and cost pressures remain persistent. Labour market and resource pressures have built up over many years of high growth and will take some time to dissipate. Labour costs in particular are growing strongly, at a time when firms are finding it difficult to lift sales and productivity. Realistic wage and price setting behaviour will be an important factor determining the severity of the downturn as inflation pressures are brought under control. The other key inflation risk over the next two years remains the housing market. We need to see this market continue to slow, so that consumption moderates and helps to reduce inflation pressures.

As long as these inflation risks remain under control, we do not expect to raise interest rates again in this cycle. However, given the time that it will take to bring inflation back towards the mid-point of the target band, we do not expect to be in a position to ease policy this year. Any earlier easing would require a more rapid reduction in domestic inflation pressures than the substantial slowing already assumed in our projections.

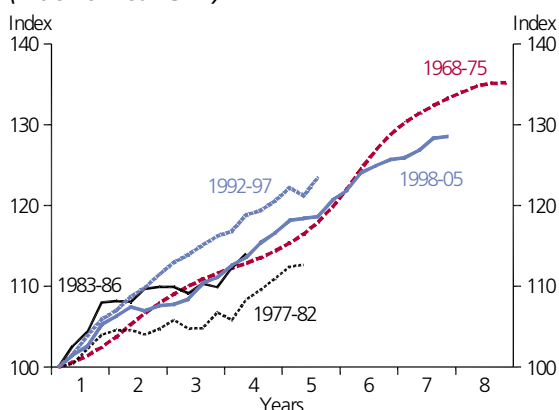


Alan Bollard  
Governor

## 2 Overview and key policy judgements

Economic indicators are now clearly signalling a slowdown, following New Zealand's longest economic expansion in 30 years. The economy is now around 30 per cent larger, in real terms, than it was in 1998. The expansion, which commenced in late 1998, has changed its character through time. The growth in domestic demand has increasingly outstripped growth in the economy's productive capacity over the most recent stage of the cycle, leading to increasing inflation pressures. Strong demand has also resulted in a widening trade and current account deficit. Annual non-tradables inflation has been running at or above 4 per cent over the last two years, and measures of medium-term inflation expectations have drifted higher and remain at uncomfortable levels.

**Figure 2.1**  
New Zealand economic expansions  
(Index of real GDP)



Source: Statistics New Zealand, RBNZ estimates.

Data since the second half of 2005 suggest that economic growth is slowing, particularly in those sectors exposed to the high exchange rate. More recent evidence suggests that domestic sectors have also begun to cool. Our projections are for further moderation in domestic activity over the rest of 2006. This, along with a decline in the exchange rate, is expected to relieve pressure on New Zealand's trade deficit, leading to an improvement in the current account balance. Slower growth in activity is projected to reduce inflation pressures over the next two years, with inflation gradually returning to more comfortable levels. However, in addition to a further moderation in domestic demand, this projected reduction in inflation

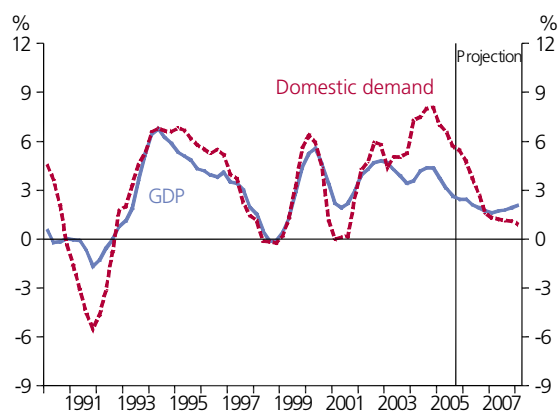
critically assumes a steady fall in inflation expectations, which have been on an upward trend in recent years.

In our policy deliberations we have had to contend with the uncertainties around the pace and composition of the slowdown in economic growth, the strength and persistence of medium-term inflation pressures, and the pace at which these pressures will moderate in the face of the economic slowdown. The lags between interest rate changes and inflation are an important factor in this regard.

### Recent developments

For the September quarter, GDP growth was weaker than expected. The data highlighted the continued divergence between domestic demand and domestic production, with growth in Gross National Expenditure (GNE) of 1.1 per cent against growth in Gross Domestic Product of 0.2 per cent. The ongoing divergence between GNE and GDP growth is unusually large in comparison to previous business cycles. Reflecting this excess demand, the current account deficit has widened to 8.5 per cent of GDP – levels not seen since the mid-1980s.

**Figure 2.2**  
Economic growth  
(annual average per cent change)<sup>1</sup>



Source: Statistics New Zealand, RBNZ Estimates.

However, the GDP data in the September quarter did portray a softening in the growth of 'non-traded' services-based industries. To date, weakness in economic activity has been confined mainly to the goods-producing, or 'traded'

<sup>1</sup> Domestic demand is calculated as GDP less net exports, and is similar to the National Accounts measure of Gross National Expenditure.

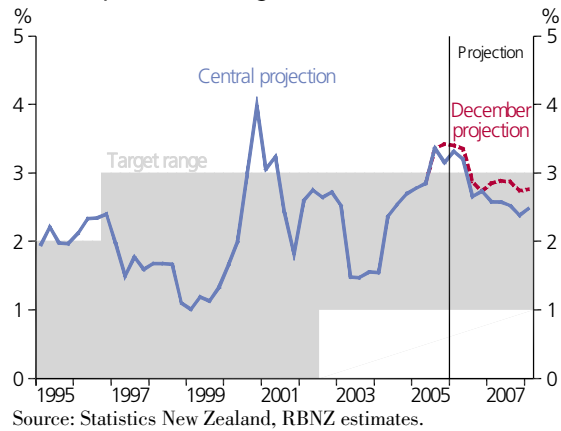
industries – industries that have been most exposed to the high exchange rate.

In addition, over recent months there has been a softening across a broader range of economic indicators than we had previously observed. These data are now more consistent with a slowing in domestic demand over the year ahead, and also continue to highlight the pressures being faced in the traded sector.

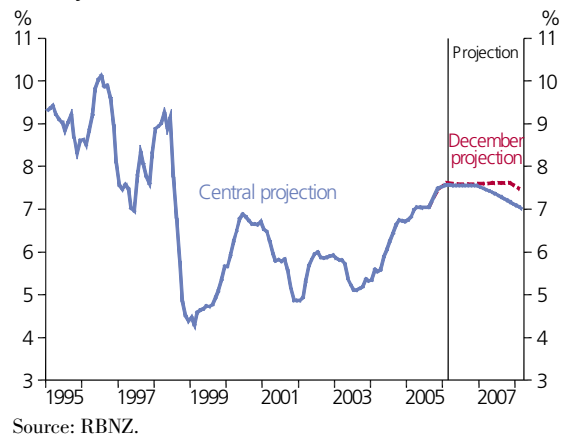
- Many of the activity indicators from business surveys have continued to weaken. It is still our assessment that the extent of the falls in business confidence overstate the degree to which overall economic activity is moderating. We note that business confidence indicators over recent years have been surprisingly soft amid this strong economic expansion. Nevertheless, this current degree of pessimism highlights the difficult trading environment being faced by many firms at this late stage of the business cycle.
- World prices for New Zealand's main export commodities have continued to ease from their previous high levels.
- While still buoyant, the labour market and employment outlook has shown signs of peaking. Employment levels in the December quarter remained static after a record surge in the September quarter. In addition, firms' employment intentions and their reported difficulty in finding labour have turned down.
- After remaining at elevated levels for most of 2005, consumer confidence has fallen back to levels that are consistent with slowing household spending growth.
- There have been signs that the momentum in house price inflation is slowing. In addition, the number of house sales has fallen significantly over recent months, while the median number of days to sell a house has inched higher. These data provide a degree of comfort that the house price inflation cycle should turn down over 2006. However, household credit growth has remained at high levels, still indicating a willingness by households to take on new debt.

Given the recent weaker GDP outturn, our projections incorporate a lower starting point for economic activity in comparison to our December *Statement*. This, in turn, implies a reduced outlook for medium-term inflation pressures compared to December. Nonetheless, these inflation pressures are expected to remain high for some time yet.

**Figure 2.3**  
CPI inflation  
(annual per cent change)



**Figure 2.4**  
90-day interest rates



Since early 2004, annual non-tradables inflation has been running at or above 4 per cent. While a significant contributor to non-tradables inflation has been the housing group, there have been signs of more broad-based domestic inflation pressure. Wage growth and unit labour costs have been rising and are expected to remain relatively high for some time. Firms are also facing a range of other significant cost pressures, such as rising energy and transportation costs. Consistent with a higher inflation environment, firms' pricing intentions are at high levels.

While inflation and cost pressures are expected to ease as economic activity softens, they will unwind only gradually. The economy has been operating above capacity for some time and the rebalancing between demand and supply will occur only after a period of below-trend growth. Another important dimension is the need to ensure that medium-term inflation expectations are anchored closer to the mid-

## Box 1

### Recent monetary policy decisions

The Bank has increased the Official Cash Rate (OCR) by a total of 225 basis points since early 2004. Part of this increase in the OCR has reflected the removal of the precautionary policy easing that occurred over the middle of 2003. Nevertheless, the extent of the policy tightening has been greater than expected by the Bank, its observers and financial markets.

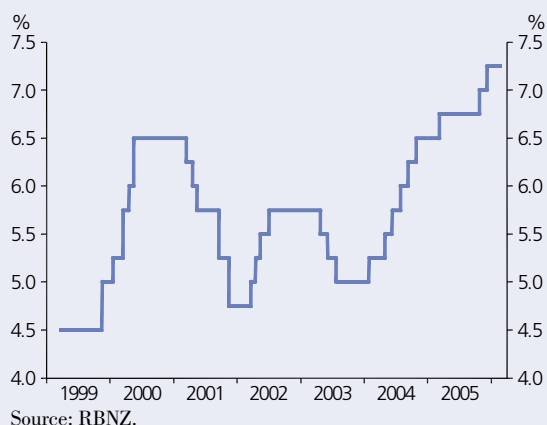
This extended tightening cycle has reflected the surprising strength in the domestic economy, which has resulted in productive resources becoming severely stretched and persistently high non-tradables inflation.

Some key economic drivers indicated a much earlier slowing in the domestic economy – most notably, the pronounced fall in net immigration over the past 24 months, a cooling in tradable sector activity associated with the rising exchange rate, and increases in the OCR itself. However, the slowdown in domestic activity has been limited to date. The marked increase in house prices, high job security coupled with robust income growth, the high terms of trade, and an increase in the lag between changes in the OCR and effective interest rates faced by households have all contributed to prolonging the domestic spending cycle.

At the time of the December 2005 *Statement*, the Bank raised the OCR by a further 25 basis points to 7.25 per cent. The *Statement* noted the ongoing strength in

domestic demand, which was continuing to fuel inflation and worsen economic imbalances. Labour and other business costs, and inflation expectations were also highlighted as key inflation risks. The *Statement* also noted the uncertainties around the future path of fiscal policy, which was expected to become more expansionary in the period ahead. The main downside risks highlighted were the prospects for a harder economic landing in the face of current imbalances, and the possibility of ongoing strength in the exchange rate. The Bank noted that whether further tightening would be needed would depend on the extent to which housing and demand pressures showed signs of easing. At the time of the January 2006 OCR review, the Bank assessed that recent economic data had been broadly consistent with the domestic slowdown projected in the December *Statement*, and the OCR was left unchanged at 7.25 per cent.

Figure 2.5  
Official Cash Rate



point of the target range. While medium-term inflation expectations are difficult to gauge, surveyed measures paint a consistent picture of inflation expectations having trended higher.

### Monetary policy judgements

Our monetary policy decisions over the past two years have been focused on reducing the inflation pressures that have built up following a period of sustained growth in the economy. The aim has been to ensure that inflation settles back comfortably within the 1 to 3 per cent target range over the medium term. During this period, we have had to

anticipate the significant lags that exist between changes in the OCR and the effective interest rates facing households and businesses, and the additional lags to economic activity and inflation. These lags mean that increases in the OCR undertaken during 2005 have yet to have their full effect on demand and inflation pressures.

Low global interest rates, strong competition in the domestic lending market and the preponderance of fixed-term lending have accentuated the lags between the OCR and interest rates facing borrowers over the past year. Nevertheless, as discussed further in Chapter 4, effective interest rates have continued to edge up gradually over this period, increasingly exerting a braking effect on demand.

Our projections of a further slowing in the rate of growth in domestic demand over 2006 are based on the view that the 'pipeline' effects of increases in the OCR will continue to play out over the remainder of this year. This was a key consideration behind our comment at the January OCR review that further policy tightening is not expected during the current cycle.

As evidence of a cooling in economic activity has increased over recent months, financial markets have increasingly begun to anticipate that the Bank may begin to reduce the OCR, perhaps as early as the middle of the year (see Box 2). At this point, however, an easing in monetary policy this calendar year seems unlikely and would run the risk of reigniting inflation pressures. In our view, a premature easing would quickly tend to negate the 'pipeline' effects of last year's policy tightening. This would risk a rebound in activity and prices in those areas of the economy that have driven much of the uplift in inflation over the past few years, such as the housing market. The risks around an early easing are accentuated by the relatively high level of inflation expectations on the part of businesses and households as borne out by a range of surveys. There is a material risk to these expectations should wage settlements exceed productivity growth over the medium term.

Our primary objective is to ensure inflation will settle comfortably within the 1 to 3 per cent range over the medium term. In making our policy assessment, we are conscious of the risk that unduly prolonged tight policy settings could potentially exacerbate the current slowing in economic activity, resulting in a 'hard landing'. Section 4(b) of the Policy Targets Agreement requires us to avoid unnecessary instability of this kind. Getting the right balance between

avoiding this risk, while ensuring continued downward pressure on inflation, involves a range of finely balanced judgements. The Bank will remain flexible in the face of any new data suggesting economic activity and inflation are evolving differently from our projections. We will continue to revise our policy outlook accordingly over the months ahead.

An additional consideration for monetary policy is the influence of the exchange rate on the activity and inflation outlook. There is little doubt that the high New Zealand dollar over the past two years has exerted a substantial braking effect on the export and import-substituting sectors of the economy, at a time when we would have preferred relatively greater moderation in domestic demand. The Bank has previously noted that the exchange rate has reached unsustainably high levels through this period. We have also stated that we would not seek to stand in the way of an eventual adjustment in the exchange rate back towards lower and more sustainable levels. We would endeavour to look through the short-term price effects of a falling exchange rate, provided we could have reasonable confidence that the medium-term path of inflation would be unaffected. To the extent that the decline in the exchange rate seen over recent weeks appears to be consistent with a cooling economy, we do not foresee a significant impact on medium-term inflation from the recent downward adjustment. Indeed, the recent decline in the exchange rate may go some way to shifting the balance of economic activity back toward the external sector of the economy, at a time when domestic spending is projected to cool significantly.

## Box 2

### The inflation and policy outlook

When discussing the uncertainties around the inflation outlook and the future path of monetary policy, it is useful to have a conceptual model of the inflation process in mind. The Bank considers a large amount of information in arriving at its inflation outlook. Some key assessments in our projections include:

- The balance between the level of output in the economy relative to its underlying productive capacity – sometimes referred to as the 'output gap';<sup>2</sup> and
- The level of inflation expectations held by households and firms.

2 The technical definition of the output gap is the percentage difference between real GDP and potential real GDP.

This approach to projecting inflation emphasises the inevitable lags between a change in the pace of growth in the economy and inflation pressures. A large output gap may be built up over a period of several years, leading to rising prices in product and labour markets. This gap will tend not to be eliminated immediately when growth starts to slow, but takes time to unwind. In addition, if inflation expectations are high, inflation may persist at a relatively high level even in the absence of a significant positive output gap, due to the influence of expectations on price and wage setting behaviour. Consequently, the pace at which inflation expectations adjust to a cooling economy will have a major bearing on the speed with which actual inflation falls.

A complicating factor when making projections is that neither the current output gap nor the level of inflation expectations are directly observable. A significant margin of error must be attached to any estimates. Our monetary policy deliberations involve continually re-assessing estimates of the output gap and inflation expectations using a variety of indicators and techniques.

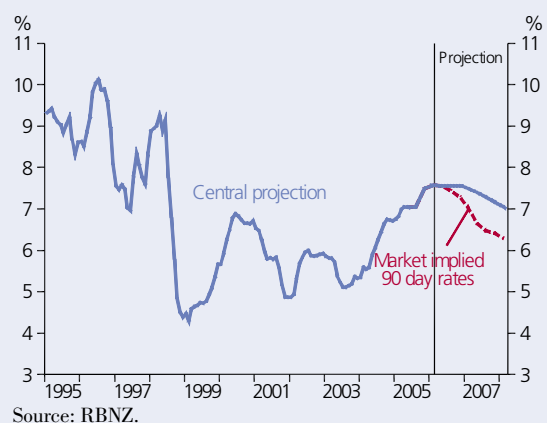
As outlined further in Chapters 3, significant inflation pressures have accumulated over recent years, reflected in a large positive output gap and high inflation expectations. Our assessment of a large positive output gap has been consistent with a tight labour market and high capacity utilisation in some sectors for an extended period. The rise in inflation expectations is borne out by a range of surveys as well as corroborative evidence, such as the relatively high level of wage inflation seen across many sectors. Our current assessment is that the output gap has begun to narrow and will be eliminated during 2006 given the significant projected slowdown in growth. Our projections also assume that inflation expectations edge down over the next two years given the weakening in activity, although this is likely to occur with something of a lag. Consequently, inflation (after allowing for the temporary effects of oil prices on the annual rate) is not projected to fall markedly in the near term.

Since our December *Statement*, the forward path of 90-day interest rates implicit in financial market prices has pointed to expectations of an earlier and more marked

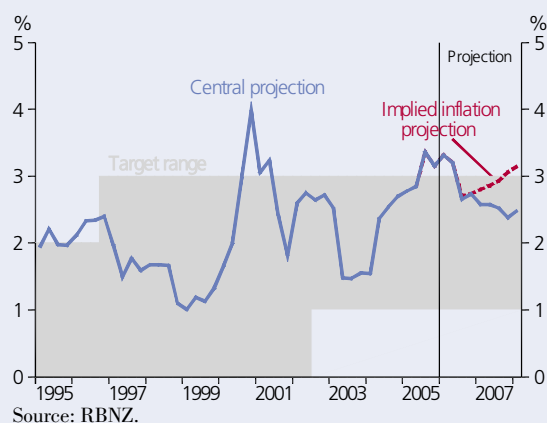
easing in monetary policy than is currently embodied in the Bank's own projections (figure 2.6). If the Bank's assessment of inflation pressure is adjusted to incorporate the financial market's forward interest rate path over the next two years, projected inflation over this period becomes uncomfortably high and would subsequently require tighter policy settings (figure 2.7). This underscores our view that an easing in monetary policy in the near future would appear to carry significant risks to the inflation outlook.

The Bank will continue to adjust its policy view as new information on the output gap and indicators of inflation expectations come to hand.

**Figure 2.6**  
Reserve Bank projection versus market implied 90-day rates



**Figure 2.7**  
Reserve Bank projection versus inflation projection using market implied 90-day rates

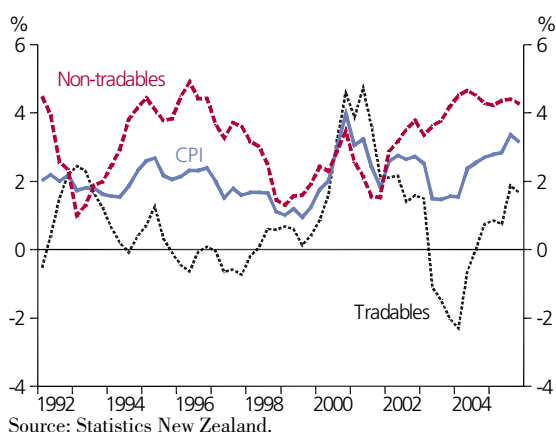


## 3 The recent economic situation

### Overview

Despite accumulating evidence of a slowing economy, the starting point is one where domestic demand (as proxied by Gross National Expenditure) has outstripped domestic supply for a number of years. Even with the softening in GDP growth to date, there remains considerable pressure on productive resources. This is evident in persistently high non-tradables inflation, which has been running above 4 per cent since 2004. Tradables inflation rose markedly over 2004 and 2005 as the rate of exchange rate appreciation moderated and oil prices rose sharply. Annual CPI inflation fell slightly to 3.2 per cent in the December quarter, but remains outside the Reserve Bank's 1 to 3 per cent target range (figure 3.1).

**Figure 3.1**  
**Tradables and non-tradables CPI inflation**  
*(annual per cent change)*



GDP growth slowed in the September quarter, recording just a 0.2 per cent quarterly increase, noticeably weaker than we had anticipated in our December *Statement*. While part of this weakness may be temporary, there were also signs of cooling activity outside the traded sectors of the economy. Evidence of this broader slowdown has become more apparent in a range of other indicators over recent months.

### Global economic developments

World growth has been firm over 2005, and appears to have retained momentum heading into 2006. Growth in our key trading partners has been supported by the resilient

US economy, continued strength across Asia, and improving prospects in the Eurozone. Internationally, inflation outturns have been dominated by higher energy prices. However, underlying inflation pressures appear under control.

In the US, GDP growth slowed sharply in the fourth quarter of 2005. However, the weaker-than-expected growth rate appeared to be partly the result of transitory factors. Continued strength across a range of indicators, suggests the US economy will continue to post solid growth over 2006. A healthy labour market will provide support for consumption going forward; however, a sharp cooling of the housing market remains a key risk. The US Federal Reserve has continued its gradual tightening of monetary policy in early 2006, raising interest rates to 4.5 per cent in January.

The Australian economy posted moderate growth in 2005. However, the outlook for 2006 is more favourable, with growth likely to be driven by an increasing contribution from the export sector. Despite high terms of trade, increases in export volumes have been slow to eventuate over 2005. Exports are likely to improve in 2006 as new mining projects come on line and transport infrastructure constraints ease. On the other hand, the outlook for consumer spending is more modest, with poor retail sales over the second half of 2005, a softening labour market and a consolidating housing market.

Positive developments in Japan during late 2005 have led to an improved outlook for activity. This is a significant change in outlook for an economy which has battled considerable structural problems for 15 years. GDP growth was stronger than expected in the fourth quarter, industrial production has gained momentum and the external sector continues to be supported by robust global demand. External sector strength has led to improved corporate profitability and, as a result, household sector incomes have also been rising modestly. Annual core CPI posted a marginal increase for the second consecutive month in December.

External sector strength has also been vital to growth in other countries across Asia. Annual Chinese GDP growth reached 9.9 per cent in the December quarter, extending a period of exceptionally strong expansion. Although considerable dependence on the export sector remains, there are preliminary signs of a re-balancing occurring in the

economy. Domestic demand rebounded and export growth eased over the second half of the year. There are tentative signs that domestic demand is improving across other Asian countries, which will support growth going forward. However, with Asia's ongoing dependence on exports, higher oil prices and a slowdown in US consumption remain key risks.

Signs of a patchy recovery are emerging from the Eurozone. To date, the pick-up has been mainly concentrated in industrial activity and any pass-through into household consumption remains muted. But with signs of improvement in the labour market, consumption growth may be boosted going forward. In the UK, GDP growth was stronger than expected in the fourth quarter; however, the outlook remains subdued.

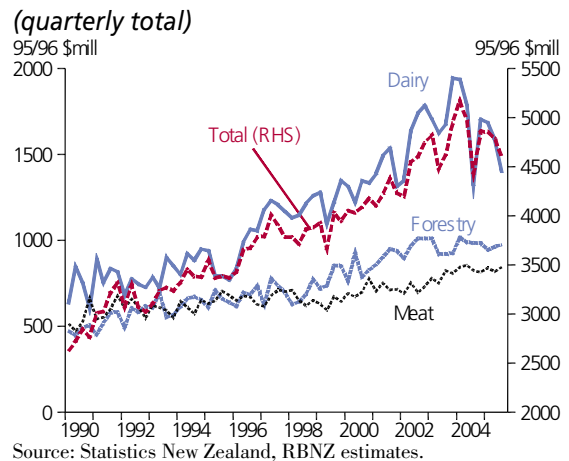
### Tradables sector activity

Tradables sector developments continue to be dominated by the strength of the New Zealand dollar. Domestic producers have faced stiff competition from relatively cheaper imported products, while some exporters have struggled to remain competitive in international markets. Consequently, while the volume of exports (as a share of real GDP) has remained relatively stable, the value of these exports (as a share of nominal GDP) has declined sharply (figure 3.2).

Export growth has slowed sharply over 2005, with much of this decline driven by a fall in exports of primary products – in particular, a sharp drop in exports of dairy products in the September quarter (figure 3.3). This fall mirrors the

September quarter of 2004 and is likely to reflect a change in the timing of exports. Dairy exports appear to have rebounded strongly in the December quarter.

**Figure 3.3**  
Commodity export volumes



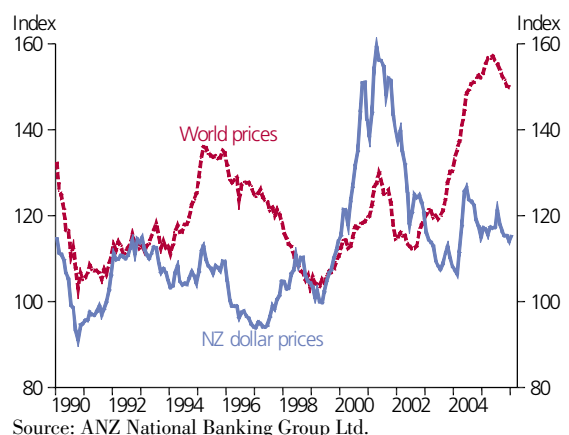
Meat exports were fairly soft over 2005 as farmers took the opportunity to rebuild herd levels. This follows a period of de-stocking where meat exports outpaced the natural increase in herds as farmers moved to take advantage of high international prices. The forestry sector continues to be weak, with few signs that an improvement is imminent. Slowing activity in the key Australian housing market, combined with low log prices, have offered few incentives for forestry exporters to boost harvest volumes.

An improvement in world commodity prices for many of New Zealand's key exports has provided a partial offset to the high New Zealand dollar. Recently, however, world prices for key commodities have begun to moderate (figure 3.4). The largest declines have been in prices of meat, skins

**Figure 3.2**  
Exports of goods as a percentage of GDP

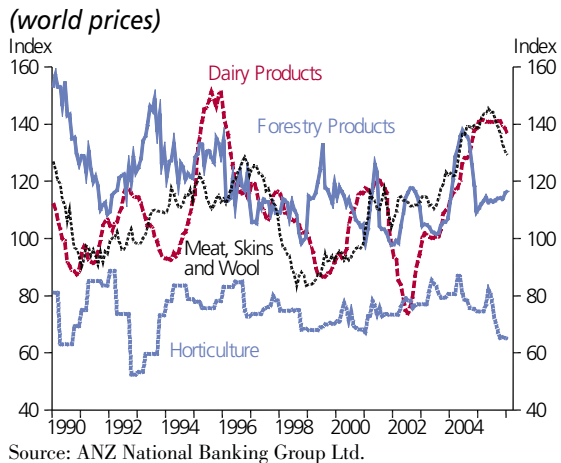


**Figure 3.4**  
ANZ commodity prices



and wool and horticultural products (including apples) while world prices for dairy and forestry commodities have tended to hold up near their 2005 levels (figure 3.5).

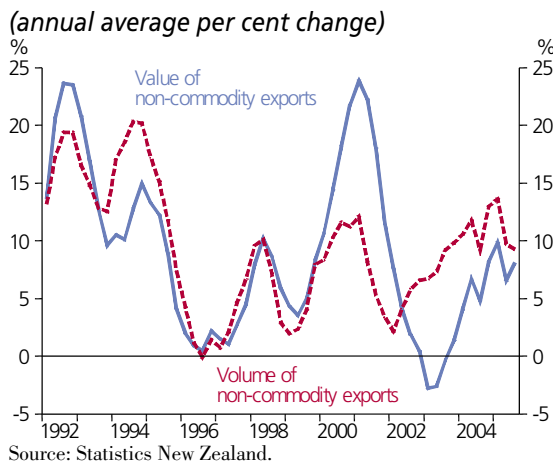
**Figure 3.5**  
ANZ commodity prices by sector



One of the most significant impacts on manufacturers from the high New Zealand dollar has been declining profitability. Growth in exporters' incomes has been significantly less than growth in manufactured export volumes over recent years (figure 3.6). Reduced New Zealand dollar revenue, combined with little pricing power in the face of international competition has eroded firms' profit margins. Domestically, manufacturers have faced increased competition from imported products.

Difficult trading conditions have been reinforced by manufacturers the Bank has spoken to during business visits over the past year. This despite evidence of more sophisticated

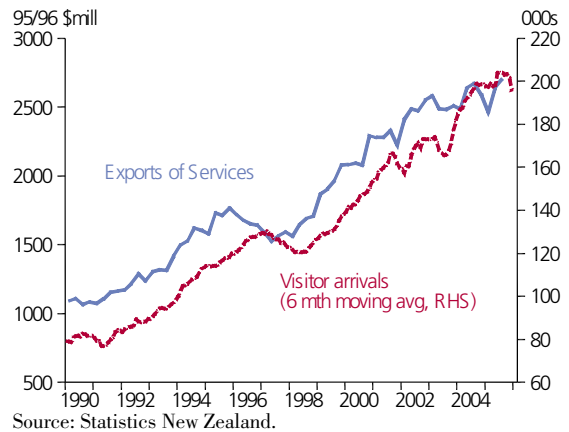
**Figure 3.6**  
Non-commodity manufactured exports volumes and values



currency hedging practices, and increasing imports of both inputs and finished products by manufacturers.

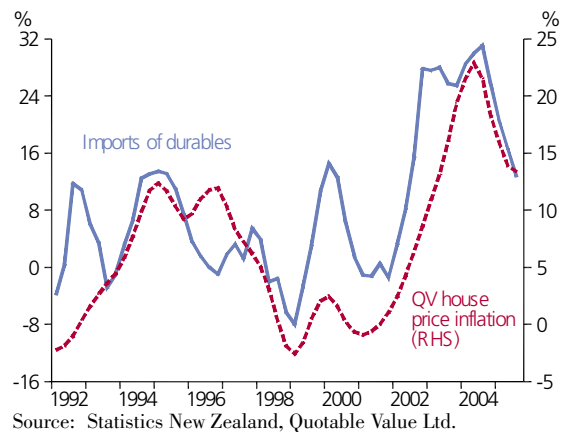
The strong New Zealand dollar has also impacted on exports of services, which are dominated by tourism (figure 3.7). Tourist flows have shown little growth as the relative price advantage of New Zealand has diminished compared to alternative destinations. Visitor arrivals and services exports were given a one-off boost in 2005 by the influx of Lions rugby tourists; however the outlook for services exports remains weak pending depreciation in the currency.

**Figure 3.7**  
Real exports of services and visitor arrivals

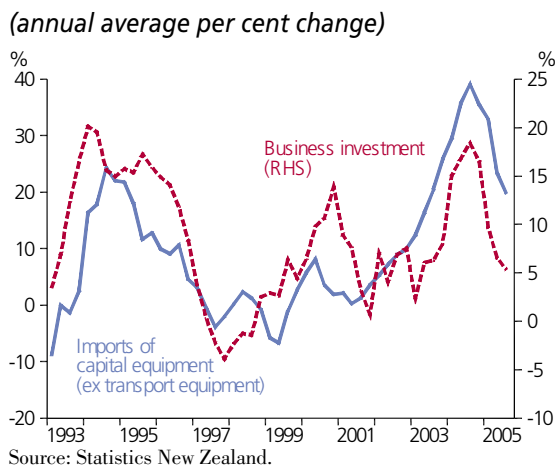


The combination of strong domestic demand, stretched productive capacity, and an appreciating New Zealand dollar led to accelerating import growth over 2004. While the rate of growth moderated over 2005, annual growth has remained above 10 per cent (figure 3.8). It is largely this

**Figure 3.8**  
House price inflation and imports of durables



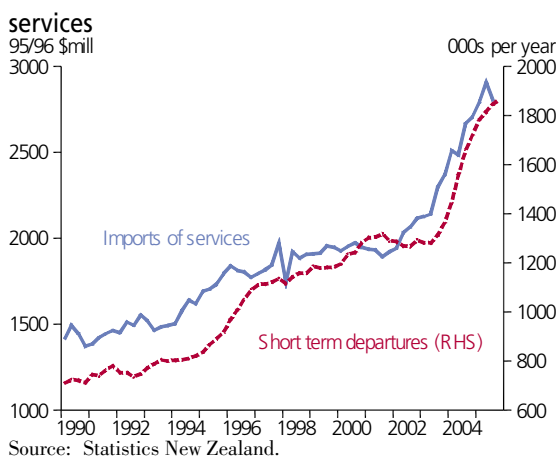
**Figure 3.9**  
Real business investment and imports of capital equipment  
(annual average per cent change)



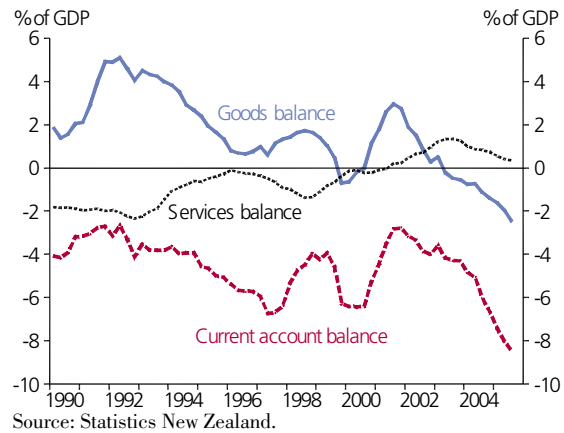
strength in imports (rather than weak exports) which has led to the rapid deterioration in New Zealand's net export position. Strong growth in the numbers of New Zealanders holidaying abroad has translated into solid growth in imports of services (figure 3.10). Overseas travel has been encouraged by factors such as robust income growth, cheap airfares and the high exchange rate. However, recent data suggest some slowing in imports of services.

Very strong imports and subdued exports, particularly in the traded goods sector, have been a major driver of the marked deterioration in the trade balance observed over the past two years (figure 3.11). This deterioration, combined with a declining services balance, has seen the current account deficit expand to 8.5 per cent of GDP.

**Figure 3.10**  
Short-term departures and real imports of services



**Figure 3.11**  
Annual current account, goods and services balances

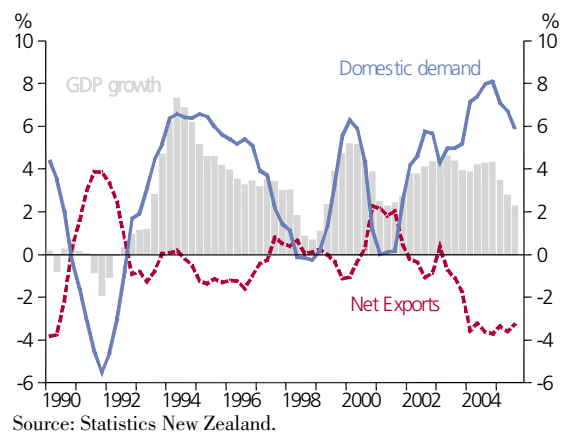


## Domestic demand

The softening in GDP growth over recent times has masked disparities between the performance of the tradables and non-tradables sectors of the economy. While the export sector remains weak, there has been only limited softening in domestic demand. However, there have been clearer indications over recent months that domestic demand is now slowing across a range of sectors.

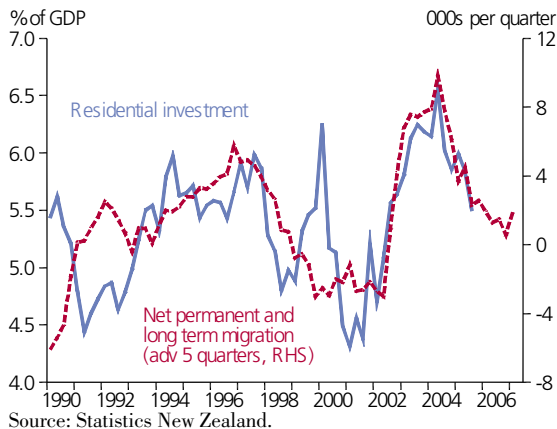
Strong housing market activity has been a key component of the strength in domestic demand strength, though recent housing data have been more mixed. After accelerating strongly following the rapid migration inflows of 2003, residential investment (as a proportion of GDP) peaked in the September quarter 2004. Since then, activity

**Figure 3.12**  
Contributions to GDP growth  
(annual per cent change)<sup>3</sup>



<sup>3</sup> Domestic demand is calculated as GDP less net exports.

**Figure 3.13**  
Residential investment and migration

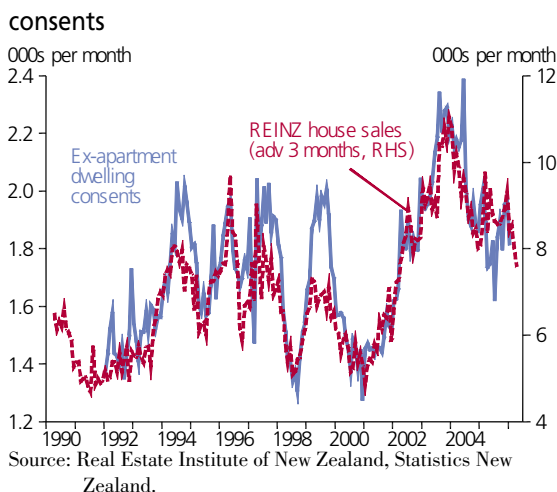


has cooled, broadly in line with falling net migration (figure 3.13).

There is the possibility of greater volatility in residential investment activity over the near term. The introduction of the new Building Act in March 2005 resulted in a sharp fall in consents issued over the middle of 2005, followed by an equally large rebound late in the year (figure 3.14). This pattern could subsequently be reflected in residential building activity. Nonetheless, the underlying trend is one where consent issuance and house sales are softening, and effective mortgage rates are rising – factors that are likely to dampen residential investment going forward.

The weakening in residential investment and housing turnover has yet to be fully reflected in house prices. While annual house price inflation fell from its peaks over the second half of 2003 and early 2004, it reaccelerated over

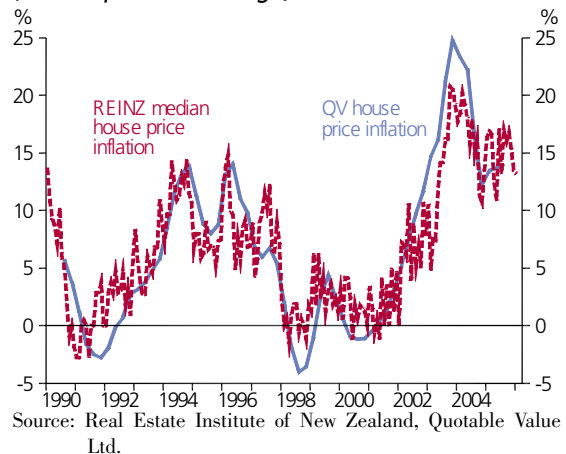
**Figure 3.14**  
REINZ house sales and ex-apartment dwelling consents



2005, with the Quotable Value measure of annual house price inflation reaching 14 per cent in the September quarter. So far, there are only tentative signs of softening in the monthly REINZ house price data (figure 3.15). However, the recent falls in the volume of house sales and a gradual rise in the median number of days to sell a house signals some moderation in house price inflation over 2006.

Facilitating ongoing housing market activity has been strong growth in credit. Household debt measured as a proportion of income has increased rapidly in recent years,

**Figure 3.15**  
REINZ and QV house price inflation (annual per cent change)

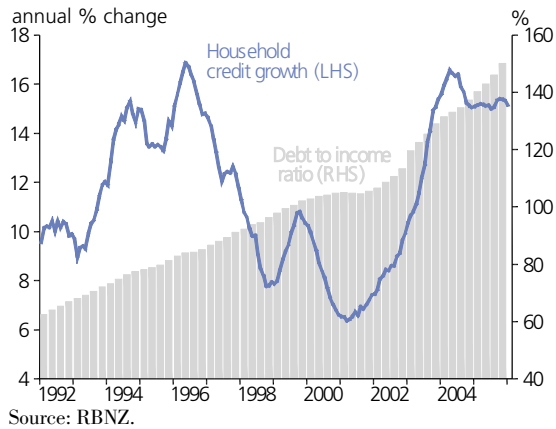


fuelled by strong house price inflation and relatively low mortgage rates. Yet despite recent interest rate increases and slower migration, household credit continues to grow around 15 per cent per annum (figure 3.16, opposite). If credit growth remains strong, this may point to housing market activity holding up for longer than expected.

Central to the strong domestic demand observed over 2004/2005 has been very strong household consumption. Spending has been supported by a number of factors including rapid house price growth, robust employment and strong wage inflation. To date, while consumption growth has moderated from its 2004 peaks, annual growth remains firm at over 4 per cent in volume terms (figure 3.17, opposite).

Most recent retail trade data point to some moderation in consumption growth. Slowing in house price inflation is

**Figure 3.16**  
**Household debt and annual credit growth**  
*(annual per cent change)*

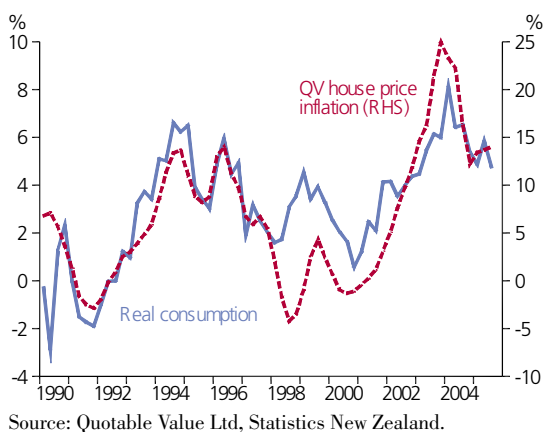


likely to dampen household consumption, given the degree to which the two have been correlated in recent years (figure 3.17). Furthermore, consumer confidence measures have recently fallen from their peaks, suggesting households are now less optimistic about the outlook and are therefore less likely to increase consumption spending at such a rapid pace.

Solid investment growth has also been a feature of the strong domestic economy in recent years. Encouraged by robust consumption, high levels of capacity utilisation and a high exchange rate, business investment has grown rapidly across a broad range of categories.

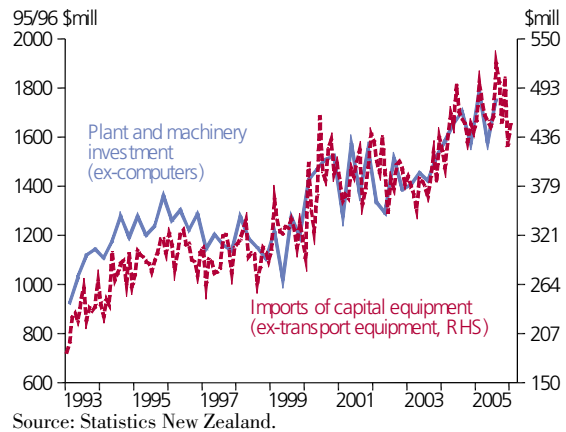
But there are recent signs that business investment is set to slow. Imports of capital goods have fallen in recent months, signalling lower plant and machinery investment

**Figure 3.17**  
**House price inflation and real consumption growth**  
*(annual per cent change)*



in the December quarter (figure 3.18). Business confidence has deteriorated markedly over recent months. This more pessimistic outlook for both the broader economy and for respondents' own activity has been evident in both the *National Bank Business Outlook* and *Quarterly Survey of Business Optimism* surveys. Sharp falls have also been recorded in measures such as investment intentions and expected profitability. This more pessimistic outlook for the economy was mirrored in the Bank's recent talks with businesses, and is likely to lead to reduced investment going forward.

**Figure 3.18**  
**Plant and machinery investment and imports of capital equipment**



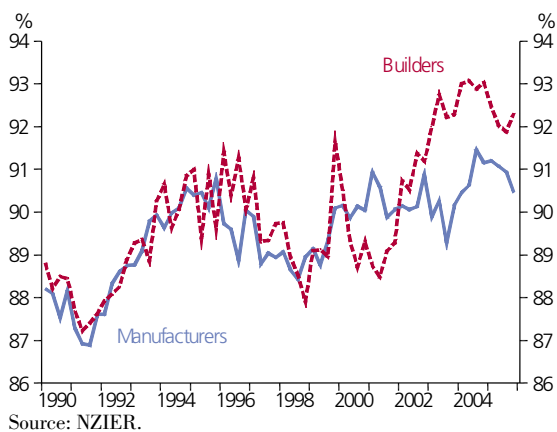
## Fiscal policy

The Treasury most recently updated its outlook for the economy in the December *Half-Yearly Economic and Fiscal Update*. As has been signalled since the build-up to the September elections, government spending is set to expand in the coming years as various initiatives, including the Working for Families programme and the removal of interest on student loans, are introduced. Moreover, a run of unexpectedly strong tax revenue appears to have come to an end. Consequently, after being a net contractionary influence on the economy in recent years, fiscal policy is set to become an expansionary influence.

## Productive capacity

The recent slower growth in activity has begun to ease pressure on productive resources. However, despite this easing, capacity remains tight according to a variety of measures. Unemployment remains at a near 20-year low, while capacity utilisation remains near historic highs (figures 3.19, 3.20). Our assessment is that the economy continues to operate under tight resource constraints.

**Figure 3.19**  
Measures of capacity utilisation



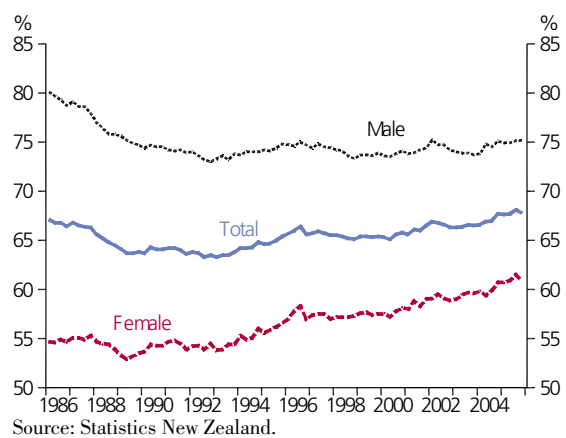
**Figure 3.20**  
Unemployment rate



## The labour market and wages

In conjunction with the buoyant domestic economy, both the demand for and supply of labour has steadily increased in recent years. The unemployment rate has fallen to historic lows as increases in employment have outstripped the strong growth in participation. Particularly strong trend increases have been observed in participation of both females and older cohorts (figure 3.21).

**Figure 3.21**  
Labour force participation by gender



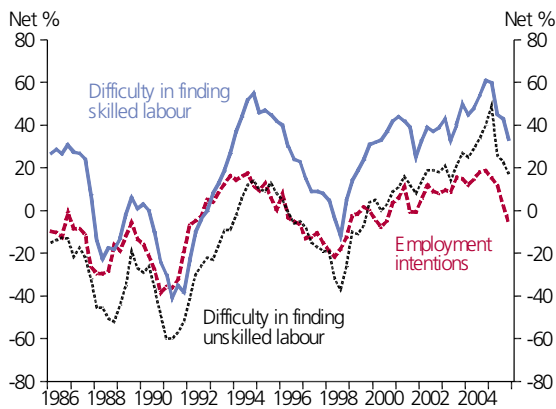
December quarter data showed that while the labour market remains tight, growth in employment may be starting to cool across a variety of industries. Overall, the number of people employed remained steady in the December quarter. However, there was a shift in the composition toward a greater number of part-time jobs, reflected in a fall in hours worked. In addition, firms' employment intentions and measures of difficulty finding labour have continued to moderate (figure 3.22, opposite).

Despite these initial signs of an easing in labour market conditions, very strong demand for labour over the past couple of years has put strong upward pressure on wages and salaries, which shows few signs of abating. Solid income growth has been further fuelled by skill shortages which have been particularly acute in some sectors.

Recently, the unadjusted labour cost index (LCI), for all sectors, recorded the largest annual increase in the 12-year history of the survey, climbing 5.4 per cent in the year to December. The adjusted labour cost index (a proxy for unit labour costs) was also up a strong 0.8 per cent in the quarter

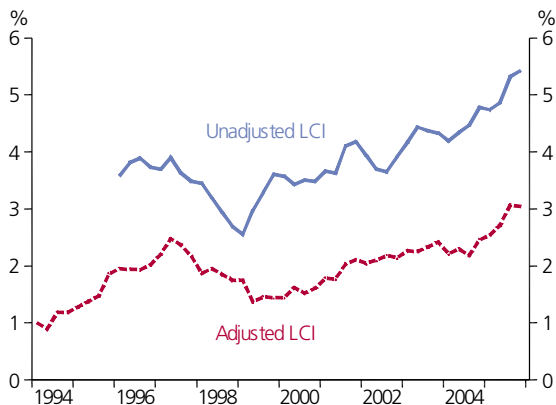
(3 per cent annually). Wage growth has also been strong in the public sector where wages and salaries climbed 3.9 per cent in the year to December on an adjusted LCI basis.

**Figure 3.22**  
Difficulty finding skilled and unskilled labour and employment intentions



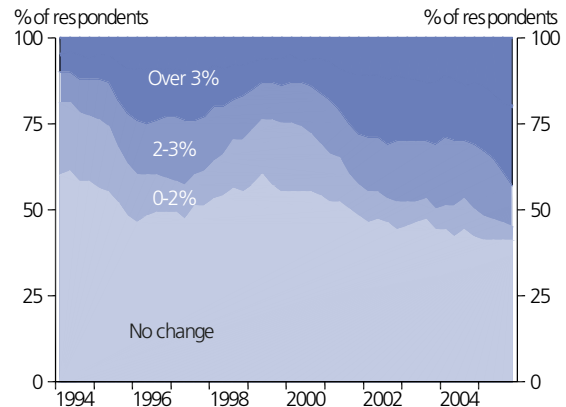
Source: NZIER.

**Figure 3.23**  
Adjusted and unadjusted Labour Cost Index (all sectors, annual per cent change)



Source: Statistics New Zealand.

**Figure 3.24**  
Distribution of annual wage increases



Source: Statistics New Zealand.

### Inflation pressures

Annual CPI inflation remained outside the Bank's 1 to 3 per cent target range for the second consecutive quarter in December, despite moderating slightly to 3.2 per cent. Non-tradables inflation remained strong, increasing 1 per cent in the quarter, leaving the annual figure above 4 per cent. The December quarter increase reflected ongoing increases in the purchase and construction cost of new dwellings, but also persistent pressures in non-housing non-tradable components. Tradables inflation increased only 0.5 per cent in the quarter as petrol prices eased from their peaks. Annual tradables inflation stood at 2 per cent in the December quarter.

Tradables inflation has been the more volatile of the two components of the CPI as it is significantly affected by volatile factors, such as oil prices and the exchange rate. In contrast, non-tradables inflation tends to be more persistent, and perhaps a more appropriate indicator of domestic capacity pressures. Recent increases in alternative measures of non-tradables inflation, including the trimmed mean and weighted median series, tend to suggest ongoing domestic inflationary pressures. Despite small declines, these measures remained at high levels in the December quarter. In particular, there are indications that recent large wage increases are feeding through into the non-housing components of non-tradables inflation (figure 3.25, overleaf). Electricity and energy prices more generally also remain a persistent source of inflation.

Figure 3.25  
Non-tradables inflation excluding housing  
and adjusted Labour Cost Index  
(annual per cent change)

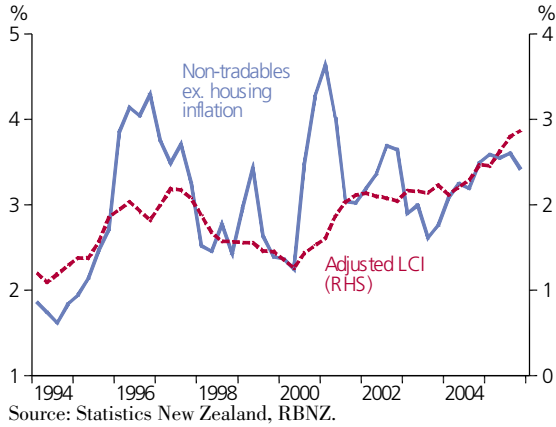


Figure 3.26  
Trimmed mean and weighted median non-tradables inflation  
(annual per cent change)

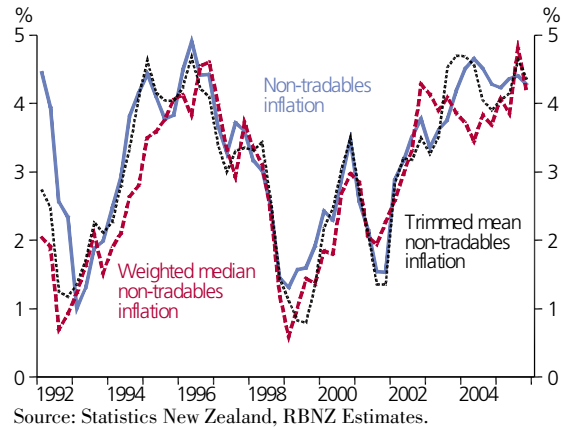


Table 3.1  
CPI and other price measures  
(annual per cent change)

	2004				2005		
	Jun	Sep	Dec	Mar	Jun	Sep	Dec
<b>CPI</b>	2.4	2.5	2.7	2.8	2.8	3.4	3.2
Food	1.1	0.5	1.2	1.5	1.1	1.6	1.5
Housing	7.1	6.7	5.6	5.4	5.7	5.7	5.8
Household operations	1.5	1.0	1.4	1.9	1.8	1.8	1.1
Apparel	-0.8	-0.4	-0.3	-0.6	-0.3	0.0	-0.1
Transportation	-0.6	1.5	3.3	1.9	2.6	5.8	5.0
Tobacco and alcohol	3.2	4.2	3.7	4.2	4.0	2.2	2.2
Personal and health	2.7	2.7	2.6	2.7	2.7	3.0	3.1
Recreation and education	1.4	1.5	1.8	2.3	2.3	2.4	2.4
Credit services	0.8	-0.2	-4.9	4.4	0.8	3.0	9.8
<b>Derivatives and analytical series</b>							
CPI ex food, petrol and government charges	1.4	2.3	2.5	2.6	3.0	2.8	2.6
CPI ex energy and fuel	1.6	2.0	2.1	2.3	2.5	2.5	2.6
CPI non-tradables	4.7	4.5	4.3	4.2	4.4	4.4	4.3
CPI tradables	-0.7	0.0	0.8	0.8	0.7	1.9	1.7
CPI weighted median (of annual price change)	2.6	2.6	2.9	3.3	3.1	3.2	3.2
CPI trimmed mean (of annual price change)	2.6	2.6	2.9	3.0	2.9	3.2	3.0
Merchandise import prices (excluding petrol)	-5.9	-5.8	-4.8	-1.5	-5.2	-2.7	n/a
PPI - Inputs	1.5	2.5	3.4	4.2	4.7	6.1	6.5
PPI - Outputs	1.9	2.4	2.6	3.2	3.0	4.1	3.9
Private consumption deflator	1.4	0.8	1.3	1.4	0.8	1.9	n/a
GDP deflator (derived from expenditure data)	4.7	3.8	3.4	2.7	2.6	2.0	n/a
Retail trade deflator	0.8	0.5	0.7	1.4	1.0	2.4	2.1

## Inflation expectations

Having CPI inflation above the Reserve Bank's 1 to 3 per cent target range for a short period does not in itself constitute a breach of the Policy Targets Agreement. The Bank is required to target inflation outcomes of 1 to 3 per cent on average over the medium term. However, very high (or low) inflation outturns may be of concern if they feed through into higher inflation expectations and lead to changes in households' and firms' wage and price setting behaviours. Over history it appears that higher inflation outturns have been at least in part reflected in higher inflation expectations. It is also apparent that surveyed measures of medium-term inflation expectations tend to move relatively slowly (figure 3.28)

In recent years, nearly all surveyed measures of inflation expectations have risen significantly and remain at uncomfortably high levels.

Figure 3.28

## Longer-term inflation expectations

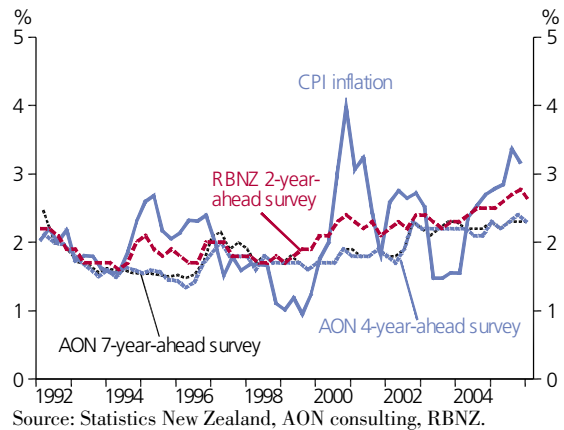
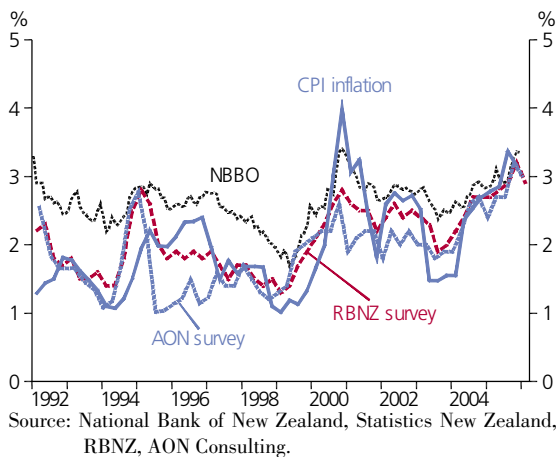


Figure 3.27

## One year ahead inflation expectations

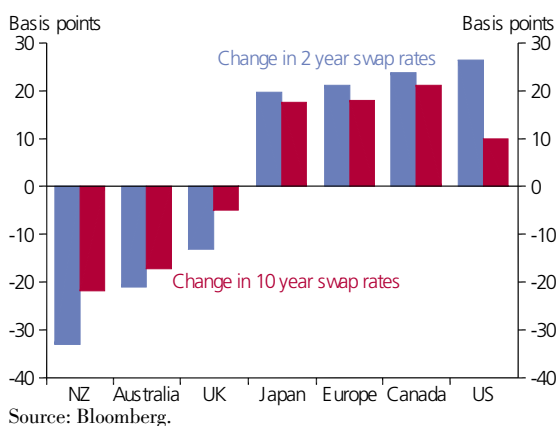


## 4 Financial market developments

### International markets

Both short- and long-term interest rates in the key economies of the US, Europe and Japan have risen since the December *Statement* (figure 4.1). This reflects increasing expectations of continued (or, in the case of Japan, the commencement of) policy firming, fuelled by generally stronger-than-expected economic developments. In the US, markets now expect the Federal Reserve to raise its policy rate to at least 5 per cent given signs of rising resource pressures and accompanying inflation risks. The European Central Bank is expected to follow up its recent rate rises with further increases over the months ahead. The Bank of Japan is expected to end its quantitative easing programme and, thereafter, the zero interest rate policy over 2006/07. Meanwhile, market pricing suggests the Australian policy rate is generally expected to remain on hold for the foreseeable future.

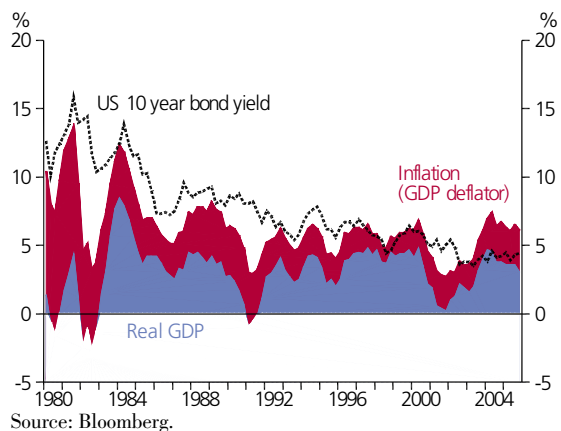
**Figure 4.1**  
Movements in wholesale interest rates since the December *Statement*



Despite increased policy rate expectations in the world's major economies, global longer-term interest rates – particularly in the US – remain low by historic standards and relative to their historic relationship with growth and inflation developments (figure 4.2). There remains considerable debate as to why this is the case. Various explanations include the impact of global excess savings and a reduction in risk premia associated with the maintenance of low inflation.

Oil prices have been volatile in recent months. Lingering fears regarding the supply outlook have maintained some upward pressure on prices, particularly given geopolitical

**Figure 4.2**  
US long term interest rates, growth and inflation

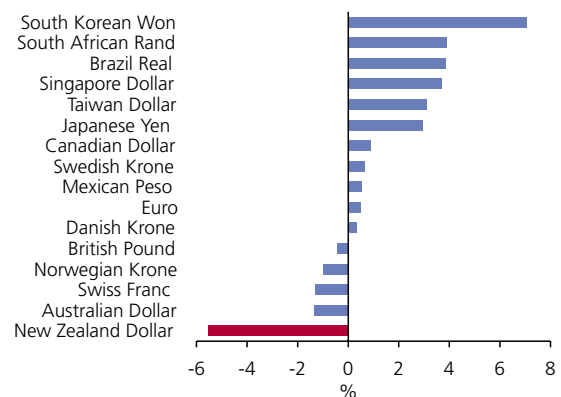


developments such as the ongoing standoff between the United Nations and Iran over its nuclear programme. However, with oil inventories remaining at relatively high levels, prices have retraced from their highs.

### Exchange rates

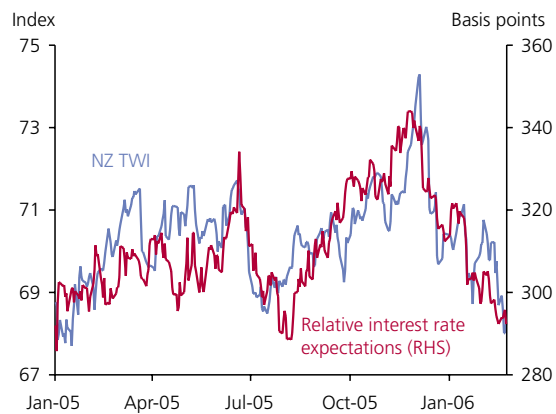
The US dollar has depreciated against the major currencies (the euro and Japanese yen) since the December *Statement*. However, the past month has seen the US dollar recover much of its lost ground as expectations of the extent of further US policy rate rises have increased. Although the US dollar has depreciated against most currencies, the NZD/USD exchange rate has fallen by more than 5 per cent since the December *Statement* – with the New Zealand dollar the weakest of the main currencies over the period (figure 4.3).

**Figure 4.3**  
Movements in currencies against the US dollar since the December *Statement*



Accordingly, the New Zealand dollar has fallen against all the major currencies since the December *Statement*. Over the past year in particular, the New Zealand dollar has waxed and waned in line with movements in relative interest rate expectations (figure 4.4). In this regard, the fall in the New Zealand dollar since the December *Statement* has occurred alongside rising interest rate expectations in key offshore markets (notably the US) and the market becoming increasingly confident that the New Zealand policy rate will fall over the coming year (as discussed in 'Domestic markets' below).

**Figure 4.4**  
The New Zealand dollar and relative interest rate expectations

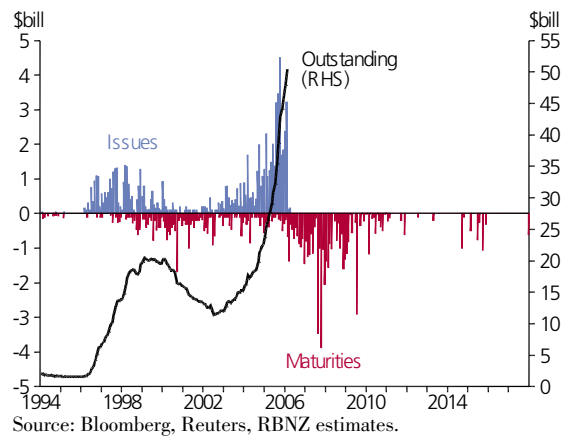


Source: Bloomberg, RBNZ estimates.

Note: This measure of relative interest rate expectations is the spread between bank bill futures rates in New Zealand and a TWI-weighted average of US, Europe, Australia, Japan and UK.

Nevertheless, investors have continued to display a strong appetite for Eurokiwi and Uridashi bonds. There has been a resurgence in issuance in the new year (figure 4.5), which has taken outstanding issuance of these bonds to more than \$50 billion – almost twice the amount of New Zealand government bonds outstanding. This suggests that investors still find the current level of New Zealand interest rates attractive and, as such, interest rates are still providing some support for the New Zealand dollar. Nevertheless, a significant maturity profile over the next few years represents an ongoing downside risk to the New Zealand dollar if current levels of issuance are not maintained.

**Figure 4.5**  
New Zealand dollar bond issuance in offshore markets

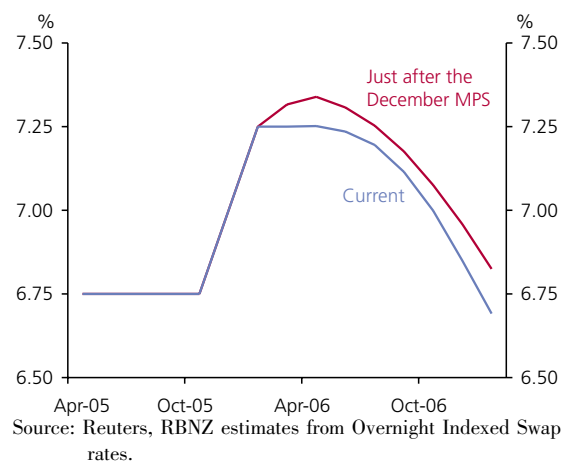


Source: Bloomberg, Reuters, RBNZ estimates.

## Domestic markets

Domestic interest rates have fallen since the December *Statement*. Recent economic developments have been seen by the market as pointing to growth and inflation pressures easing to a greater extent than projected by the Reserve Bank. Accordingly, short-term interest rates have fallen, with the market removing the small probability of a further OCR rise that had previously been priced in. Not only does the fall in short-term interest rates suggest the market has become more confident that the next move in the OCR will be down, pricing now suggests the market expects the OCR will be cut earlier and to a greater extent than anticipated at the time of the December *Statement* (figure 4.6).

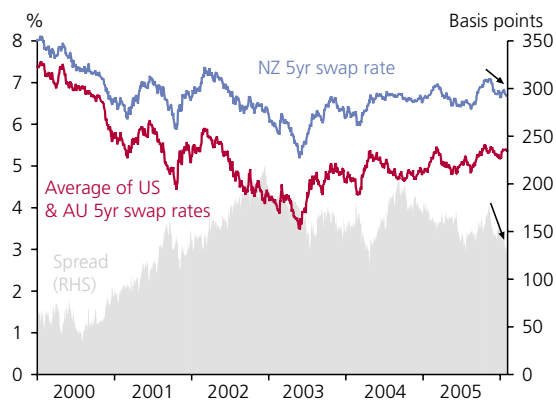
**Figure 4.6**  
Financial market expectations of the Official Cash Rate



Source: Reuters, RBNZ estimates from Overnight Indexed Swap rates.

Longer-term interest rates have also fallen since the December *Statement*. This period has seen largely offsetting movements in longer-term interest rates in key global markets, with US rates rising while Australian rates have fallen. Longer-term interest rates in New Zealand have fallen suggesting that the change in monetary policy expectations, evident in falling short-term interest rates, has also been an influence on the direction of longer-term interest rates (figure 4.7).

**Figure 4.7**  
Longer-term wholesale interest rates

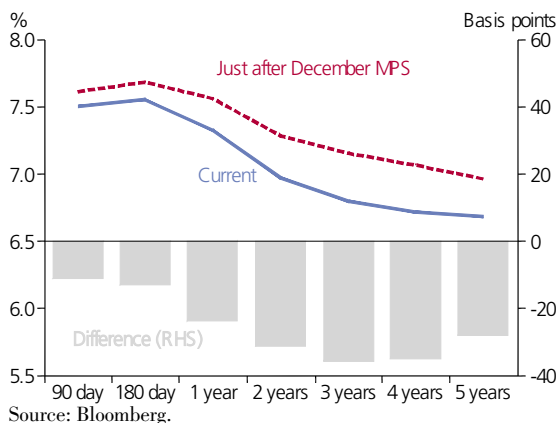


Source: Bloomberg.

Indeed, longer-term interest rates have fallen to a greater extent than short-term rates. Wholesale rates for terms of two years and beyond have fallen more than 30 basis points since the December *Statement* (figure 4.8). This has seen the yield curve become more negatively-sloped or inverted.

Fixed mortgage rates have fallen in response to lower wholesale rates. The widening gap between fixed and floating rates continues to see both new and existing borrowers elect to pay fixed rates. Fixed-rate borrowing

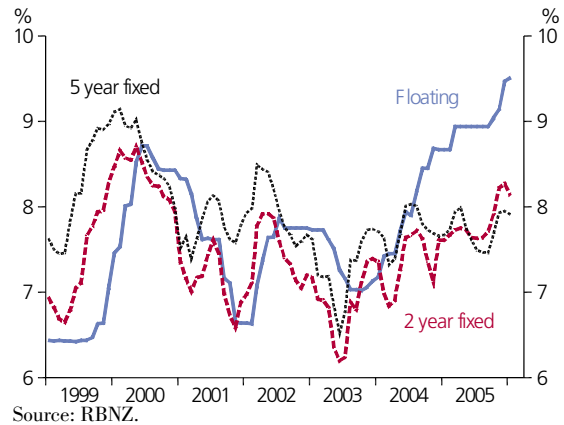
**Figure 4.8**  
The wholesale interest rate curve



Source: Bloomberg.

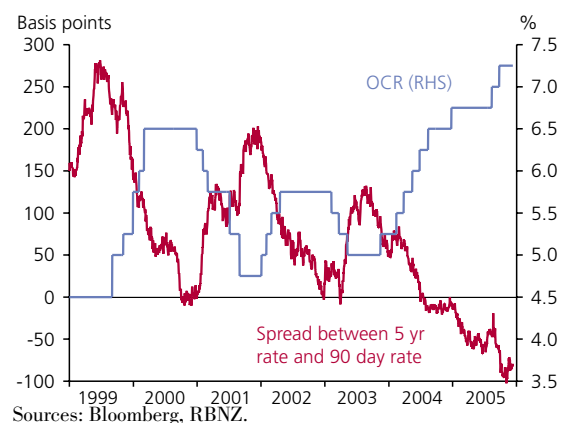
now makes up 80 per cent of all mortgage debt, compared to less than 60 per cent in 2000/01. The ongoing inversion of the yield curve has seen five-year fixed rates fall below two-year rates during the last six months (figure 4.9). In line with this development, movements in mortgage stocks during the last six months suggest borrowers are increasingly favouring longer-term fixed-rate mortgages.

**Figure 4.9**  
Mortgage rates offered to new borrowers



As we have discussed in previous *Statements*, the increased prevalence of fixed-rate borrowing has lengthened the lags involved from changes in the OCR to the actual interest rates being paid by borrowers. This, in turn, has reflected relatively low global long-term interest rates, which have been a factor in creating a more negatively sloped yield curve than generally seen in previous tightening cycles (figure 4.10) – thereby increasing the attractiveness of fixed-rate borrowing relative to floating.

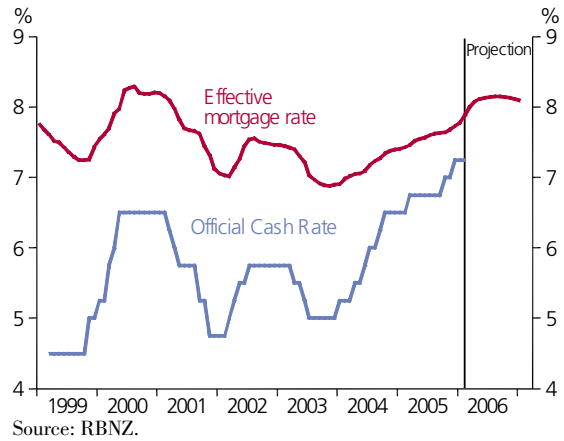
**Figure 4.10**  
The OCR and the slope of the wholesale interest rate curve



Sources: Bloomberg, RBNZ.

As a consequence, the rise in the average interest rate paid on outstanding mortgage debt – the ‘effective’ mortgage rate – has been slower than in previous tightening cycles. The effective mortgage rate is projected to continue rising over the year ahead. Alongside new borrowing, around 40 per cent of existing fixed-rate mortgage debt will re-price over the next 12 months from an average existing rate of just under 7.3 per cent. That said, the recent fall in fixed mortgage rates offered to new (and re-pricing) borrowers represents a downside risk to our effective mortgage rate projection (figure 4.11).

**Figure 4.11**  
The OCR and the effective mortgage rate



## 5 The macroeconomic outlook

### Overview

In recent years, domestic demand has outstripped production, leading to a widening current account deficit and mounting inflation pressure. We are projecting a rebalancing of the New Zealand economy. Private consumption and business investment are expected to slow sharply, while public demand expands and net exports stage a recovery. While this rebalancing should improve the balance of payments, we are expecting overall economic growth to remain weak for some time.

We are projecting 90-day rates to remain at around 7½ per cent until the end of 2006. This should be sufficient to see inflation fall to around 2½ per cent by the end of 2007.

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

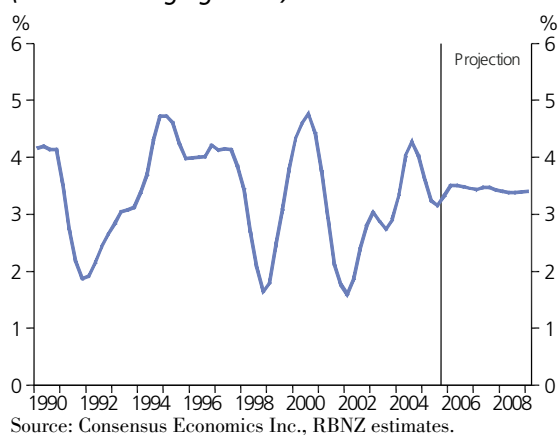
### World outlook

Our view on the outlook for New Zealand's main trading partners is largely based on *Consensus Forecasts*, a survey of the main forecasters in our trading partner economies. Over 2005, global economic activity generally proved more robust in the face of economic headwinds. We are projecting robust world economic growth of around 3½ per cent per annum for the foreseeable future, reducing the risk that external demand for our exports will falter.

A fall in world headline inflation is projected due to some retracement in oil prices from current high levels.

Figure 5.1

### Trading partner GDP (annual average growth)



### Tradables prices

World prices for New Zealand's exports reached high levels in 2005, but we are projecting lower export prices for 2006. The early months of the year have seen sharp falls in world prices for some agricultural products. World export price declines are expected to continue, albeit much more gradually, for the remainder of the projection period. However, recent falls in the exchange rate, combined with an expected further depreciation, will more than offset the fall in world export prices, implying a net improvement in New Zealand dollar returns for exporters.

World prices for New Zealand's imports are also projected to fall throughout the projection period. In the case of oil, we are assuming that the price of Dubai oil gradually falls to

Table 5.1

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

Country	2002	2003	2004	2005f	2006f	2007f	2008f
Australia	4.1	3.1	3.5	2.5	3.1	3.4	3.3
United States	1.6	2.7	4.2	3.5	3.2	3.0	3.2
Japan	0.1	1.8	2.3	2.5	2.3	2.2	1.3
Canada	3.1	2.0	2.9	2.9	3.0	2.7	2.9
Eurozone**	1.0	0.7	1.8	1.4	2.0	1.8	1.9
United Kingdom	2.0	2.5	3.2	1.8	2.1	2.4	2.2
Asia ex-Japan***	6.8	6.5	6.3	7.1	5.6	6.1	6.3
12 Country Index	2.8	2.9	4.0	3.3	3.5	3.4	3.4

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

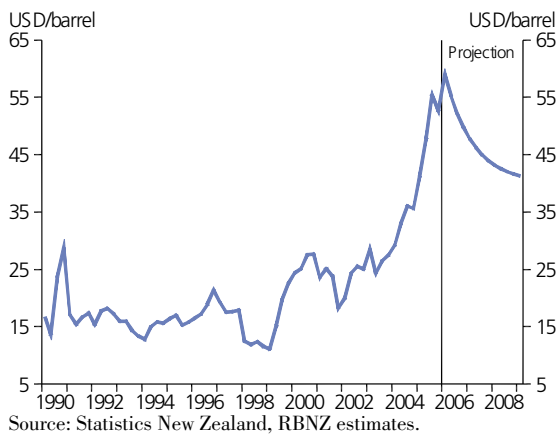
\*\* Includes Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

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

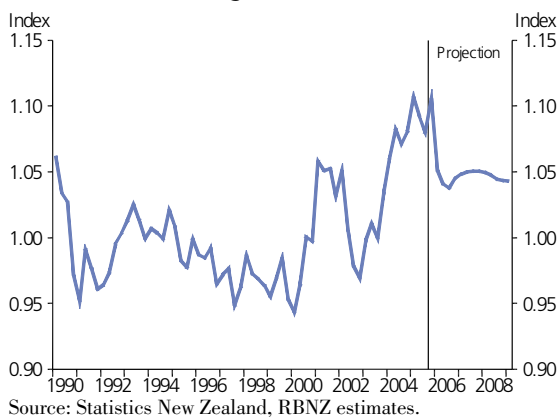
USD40 per barrel by the end of 2009. This assumed oil price track is higher than the December *Statement* assumption. Oil prices remain a key source of uncertainty.

Higher oil prices, coupled with the fall in export prices, imply a sharp fall in the terms of trade for the March quarter of 2006. Further ahead, the terms of trade are expected to remain broadly unchanged at this lower level, as falling export prices and falling import prices broadly offset one another. However, the terms of trade are expected to remain high by historical standards throughout the projection period.

**Figure 5.2**  
**Dubai oil prices**



**Figure 5.3**  
**OTI terms of trade (goods)**

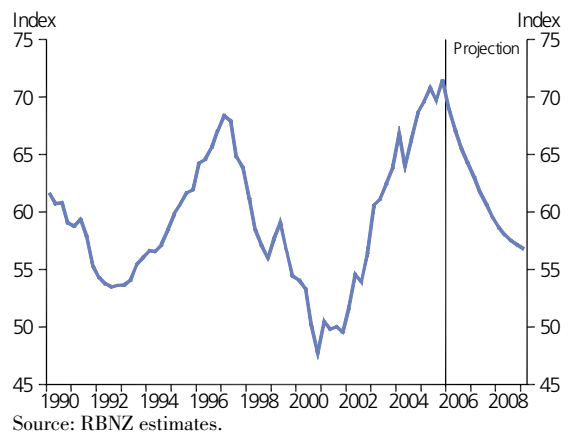


## Exchange rate

Following recent falls in the exchange rate, our TWI projection is now lower than it was in the December *Statement*. The TWI is projected to depreciate gradually from here towards its long-term average. The profile of the TWI is modelled

to be consistent with the projected decline in export prices and a narrowing in the short-term interest rate differential between New Zealand and the rest of the world. There are, of course, considerable uncertainties around our projection for the TWI. For example, a very rapid correction of the current account deficit could be accompanied by a more rapid exchange rate depreciation.

**Figure 5.4**  
**Nominal TWI assumption**



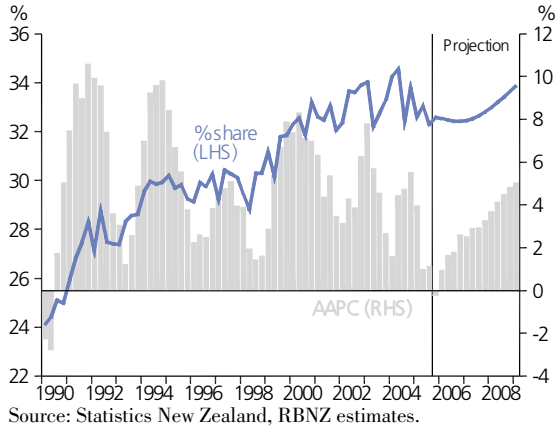
## Export volumes

Many export industries have been experiencing low growth in recent quarters. We expect this weakness to persist for some months, before a modest export recovery begins in 2007. However, the outlook for exports varies by sector:

- Non-commodity manufactured export growth is expected to continue slowing, reflecting the lagged effect of the high exchange rate.
- Agricultural export growth is expected to continue its gradual recovery from the low levels experienced in 2004/2005.
- Forestry export volumes are projected to remain quite weak in the near term, due to a combination of low world prices, high shipping costs, and the high exchange rate. Further ahead, a modest recovery is projected as the exchange rate falls.
- Exports of services are likely to be weighed down by the high exchange rate for some quarters yet. Growth is expected to recover in 2007.

Figure 5.5

**Total export volumes**  
(per cent of trend output and annual average growth)



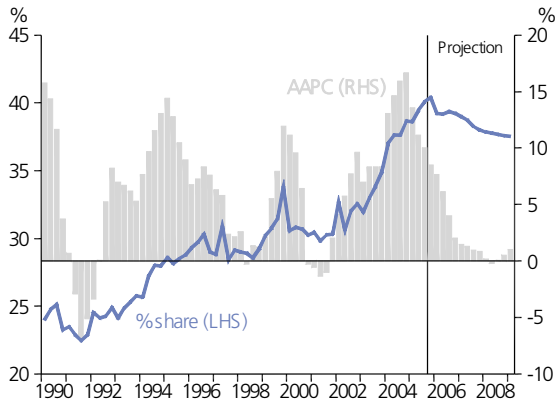
Source: Statistics New Zealand, RBNZ estimates.

### Import volumes

The surge in import volumes over recent years has been driven by strong business investment, strong household consumption, and the high exchange rate. The strong import cycle has also reflected limited domestic capacity to meet strong demand. However, all of these driving forces are expected to weaken markedly, giving low growth in imports going forward.

Figure 5.6

**Total import volumes**  
(per cent of trend output and annual average growth)



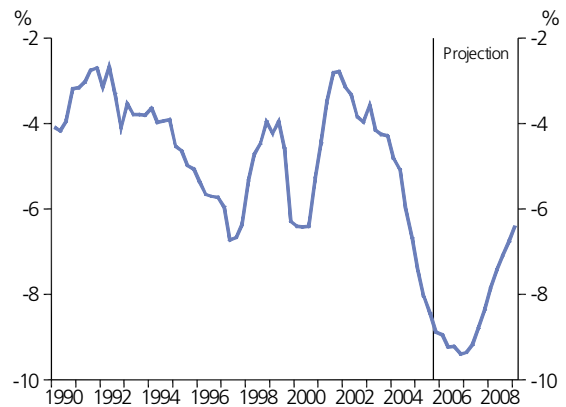
Source: Statistics New Zealand, RBNZ estimates.

### Current account

Together with a decline in the exchange rate and lower profits accruing to foreign owners of New Zealand companies, the imports slowdown should allow a gradual improvement in the current account. The annual current account deficit is expected to peak at 9¼ per cent of GDP, before improving over the remainder of the projection.

Figure 5.7

**Current account balance**  
(per cent of nominal GDP)



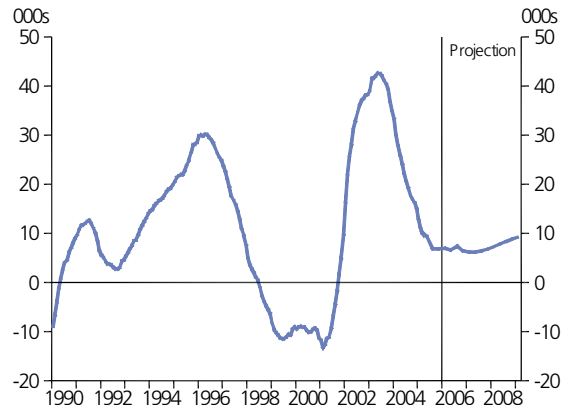
Source: Statistics New Zealand, RBNZ estimates.

### Net immigration

Recent data has shown that net immigration was stronger than expected in the last two months of 2005. However, we are treating this as temporary. We continue to project low (but positive) permanent and long-term net immigration over the projection period.

Figure 5.8

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



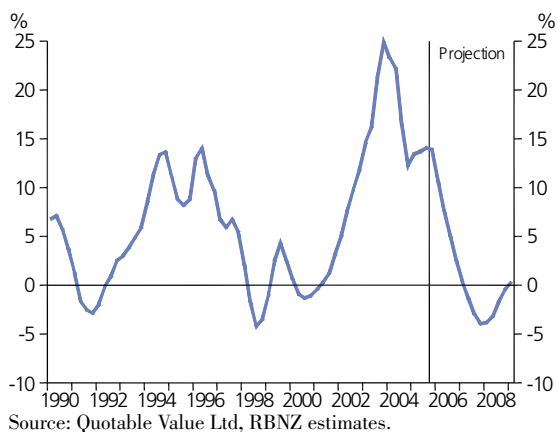
Source: Statistics New Zealand, RBNZ estimates.

## House prices

The recent strength in house price inflation has left house prices at very high levels relative to incomes. Part of the recent strength in house price inflation can be explained by strong net immigration over 2003 and 2004. However, the highs in net immigration have long since passed, and the economy is cooling, meaning that house prices may now be overvalued. We are projecting a sharp decline in house price inflation over the coming years, although there are considerable uncertainties around this projection. On the one hand, even the modest house price deflation that we are projecting would leave the ratio of house prices to income very high by historical standards. On the other hand, house prices have surprised us with their strength over recent years.

Figure 5.9

### House price inflation (annual per cent change)

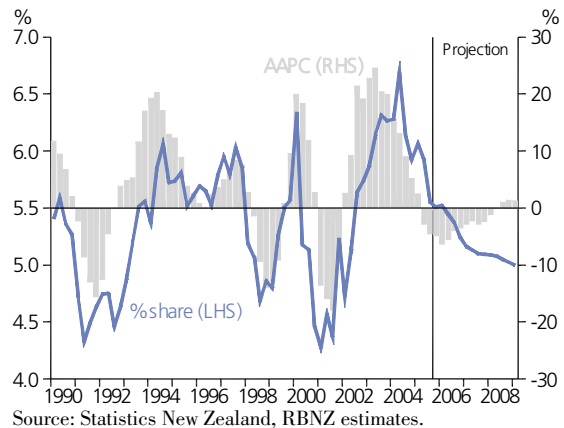


## Residential investment

The current downward trend in residential investment activity is expected to continue for some time. Low net immigration and rising effective mortgage rates will continue to weigh on residential investment. Furthermore, low rental yields may make property investment a much less attractive option once capital gains have slowed. However, the projected downturn in residential investment is reasonably muted by historical standards. Unlike previous cycles, net immigration is expected to remain positive, underpinning residential investment activity to some extent.

Figure 5.10

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

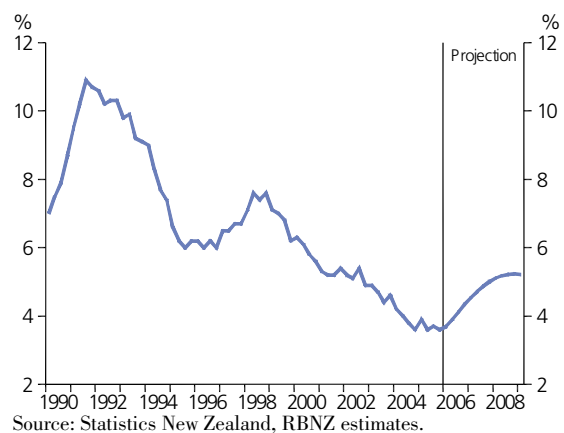


## Labour market

Due to the current tightness of the labour market, it will be some time before the cooling economy leads to a material easing in labour market pressures. The tight labour market has pushed wage growth to high levels, which are expected to remain for some time. Elevated wage inflation has the potential to create an unhelpful inflation dynamic if wage gains are not matched by similar improvements in productivity growth, and if the flow-through to inflation in turn holds up inflation expectations.

Figure 5.11

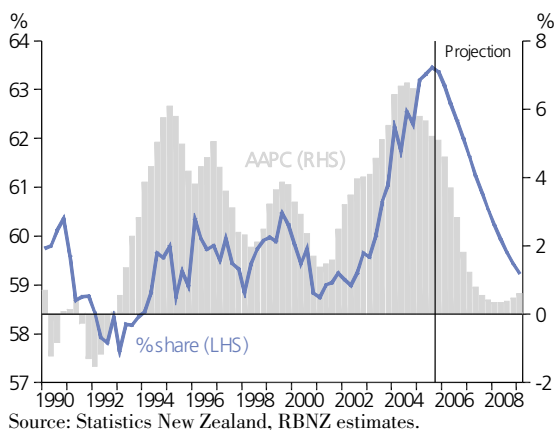
### Unemployment rate



## Household consumption

In recent years we have witnessed a sharp increase in household consumption that has outstripped income growth, creating household debt levels that appear unsustainable. We are expecting a substantial slowdown in consumption going forward. Indeed, the peak-to-trough fall in consumption growth is projected to be larger than any since 1990. This slowdown should see consumption return to a more normal proportion of GDP. The key drivers behind the slowdown in consumption are lower house price inflation, low migration, and the relatively high level of interest rates, although government transfers and strong labour earnings will provide a partial offset.

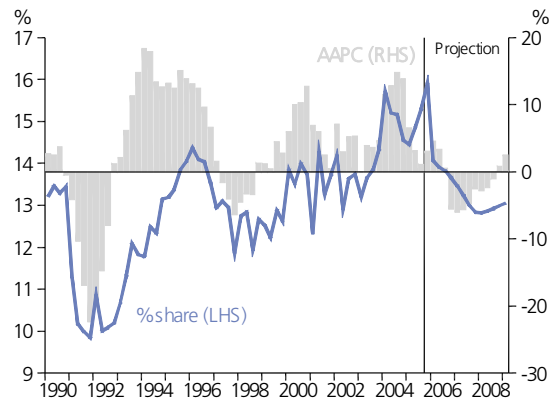
**Figure 5.12**  
Real household consumption  
(per cent of trend output and annual average growth)



## Business investment

Businesses have borne the brunt of the economic slowdown to date, with profits falling and confidence low. We have revised down the outlook for business investment since the December *Statement*. We now expect business investment to contract sharply in 2006, and to remain subdued for the remainder of the projection period. This contraction is expected to be concentrated mainly in plant and machinery investment, with non-residential construction expected to remain relatively robust. Our lower projection for business investment implies less scope for growth in labour productivity than we projected in December.

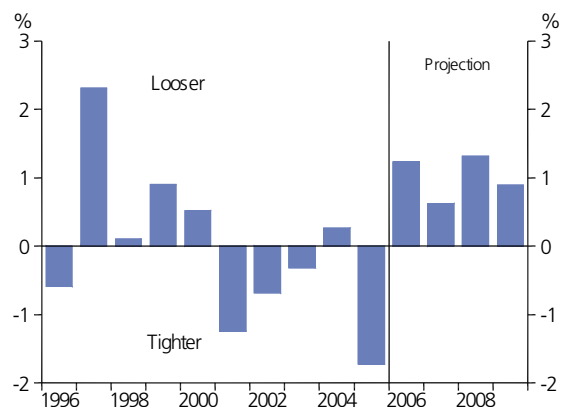
**Figure 5.13**  
Business investment (excluding computers)  
(per cent of trend output and annual average growth)



## Government

Our projections for fiscal policy are based on the Treasury's *Half-Year Economic and Fiscal Update 2005*. Fiscal policy is to become quite expansionary, adding to domestic demand. Government expenditure will provide some offset to reduced consumption and investment spending over the projection period. The Treasury's measure of fiscal impulse suggests that government activity is set to add around 4 per cent to GDP over the next four years, after having a net contractionary effect of around 3.5 per cent of GDP over the previous five years.

**Figure 5.14**  
Fiscal Impulse\*  
(per cent of trend output, June years)



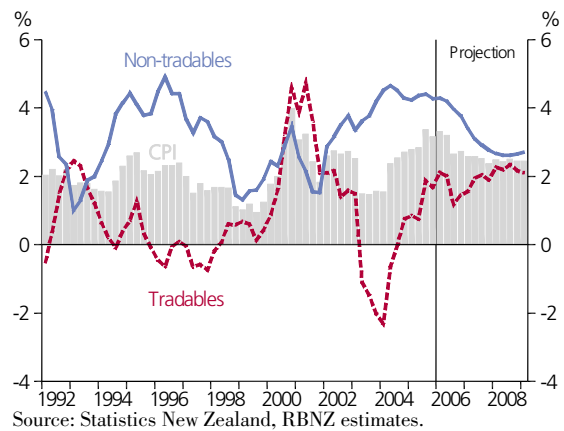
\* Fiscal impulse is a measure of the effect that discretionary fiscal policy has on GDP growth. It abstracts from changes to the fiscal balance that may occur over a business cycle. A positive number indicates a fiscal expansion.

## Inflation

We expect inflation to remain around  $3\frac{1}{4}$  per cent until the impact of recent oil-related price increases drops out of the annual figures in September 2006. Beyond September, inflation is expected to fall gradually toward the mid-point of the target range.

While headline inflation is expected to decline gradually, we expect significant changes to the split between tradables and non-tradables inflation. The falling exchange rate is expected to pass through to increased import prices, keeping tradables inflation relatively high. Meanwhile, non-tradables inflation is expected to fall as the economy slows and resource pressures ease. After a period of below-trend activity and weakening inflation pressure, inflation expectations are also expected to return closer to the mid-point of the target range.

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



# Appendix A<sup>1</sup>

## Summary tables

Table A

### CPI inflation projections and monetary conditions

(CPI is in percentage changes)

		CPI Quarterly	CPI Annual	TWI	90-day bank bill rate
2000	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
2002	Dec.	0.6	1.8	49.6	5.0
	Mar.	0.6	2.6	51.6	5.0
	Jun.	1.0	2.8	54.6	5.8
2003	Sep.	0.5	2.6	53.9	5.9
	Dec.	0.6	2.7	56.4	5.9
	Mar.	0.4	2.5	60.6	5.8
2004	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
2005	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
2006	Dec.	0.9	2.7	68.6	6.7
	Mar.	0.4	2.8	69.6	6.9
	Jun.	0.9	2.8	70.8	7.0
2007	Sep.	1.1	3.4	69.7	7.0
	Dec.	0.7	3.2	71.5	7.5
	First Half Average	$\frac{3}{4}$	$3\frac{1}{4}$	68	$7\frac{1}{2}$
2008	Second Half Average	$\frac{3}{4}$	$2\frac{3}{4}$	65	$7\frac{1}{2}$
	First Half Average	$\frac{1}{2}$	$2\frac{1}{2}$	$62\frac{1}{2}$	$7\frac{1}{4}$
2009	Second Half Average	$\frac{1}{2}$	$2\frac{1}{2}$	60	7
	First Half Average	$\frac{1}{2}$	$2\frac{1}{2}$	$58\frac{1}{4}$	7
2010	Second Half Average	$\frac{1}{2}$	$2\frac{1}{2}$	$57\frac{1}{4}$	$6\frac{3}{4}$

#### Quarterly projections

		CPI quarterly	CPI annual	GDP quarterly	GDP annual average
2005	Jun.	0.9	2.8	1.2	3.1
	Sep.	1.1	3.4	0.2	2.6
	Dec.	0.7	3.2	0.4	2.4
2006	Mar.	0.6	3.3	0.4	2.4
	Jun.	0.8	3.2		

<sup>1</sup> Notes for these tables follow on pages 31-32

**Table B**

**Composition of real GDP growth**

*(Annual average per cent change, unless specified otherwise)*

March year	Actuals										Projections				
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009					
Final consumption expenditure															
Private	3.3	1.4	3.2	4.3	6.3	5.8	4 <sup>1</sup> / <sub>2</sub>	1 <sup>1</sup> / <sub>4</sub>	1 <sup>1</sup> / <sub>4</sub>	1 <sup>1</sup> / <sub>2</sub>					
Public authority	5.7	-2.0	4.6	2.1	3.1	5.2	3 <sup>1</sup> / <sub>2</sub>	6 <sup>3</sup> / <sub>4</sub>	3 <sup>1</sup> / <sub>2</sub>	3 <sup>1</sup> / <sub>2</sub>					
Total	3.9	0.6	3.5	3.8	5.6	5.7	4 <sup>1</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>4</sub>	1	1 <sup>1</sup> / <sub>4</sub>					
Gross fixed capital formation															
Market sector:															
Residential	19.5	-13.3	2.4	22.5	15.8	2.3	-6	-2 <sup>3</sup> / <sub>4</sub>	-1	1 <sup>1</sup> / <sub>4</sub>					
Business	6.4	9.2	6.7	2.6	14.8	9.9	7 <sup>1</sup> / <sub>2</sub>	-2 <sup>1</sup> / <sub>2</sub>	-1 <sup>1</sup> / <sub>2</sub>	3					
Non-market government sector	18.4	-18.1	12.7	9.9	15.1	7.2	14 <sup>3</sup> / <sub>4</sub>	-2 <sup>3</sup> / <sub>4</sub>	7 <sup>1</sup> / <sub>2</sub>	3 <sup>3</sup> / <sub>4</sub>					
Total	10.6	0.7	6.3	7.4	15.1	7.8	5 <sup>1</sup> / <sub>4</sub>	-2 <sup>3</sup> / <sub>4</sub>	0	2 <sup>3</sup> / <sub>4</sub>					
Final domestic expenditure	5.3	0.6	4.1	4.6	7.8	6.2	4 <sup>1</sup> / <sub>2</sub>	1	3 <sup>1</sup> / <sub>4</sub>	1 <sup>1</sup> / <sub>2</sub>					
Stockbuilding (1)	1.2	-0.3	0.1	-0.3	0.2	0.3	1 <sup>1</sup> / <sub>4</sub>	-1 <sup>1</sup> / <sub>2</sub>	0	0					
<b>Gross national expenditure</b>	<b>6.3</b>	<b>0.3</b>	<b>4.2</b>	<b>4.2</b>	<b>8.0</b>	<b>6.5</b>	<b>4<sup>3</sup>/<sub>4</sub></b>	<b>3<sup>3</sup>/<sub>4</sub></b>	<b>1</b>	<b>1<sup>1</sup>/<sub>2</sub></b>					
Exports of goods and services	7.4	6.3	3.0	7.8	1.6	3.9	3 <sup>1</sup> / <sub>4</sub>	2 <sup>3</sup> / <sub>4</sub>	3 <sup>3</sup> / <sub>4</sub>	5					
Imports of goods and services	11.3	-0.7	4.0	7.2	12.9	13.7	8	1 <sup>3</sup> / <sub>4</sub>	1 <sup>1</sup> / <sub>4</sub>	1					
Expenditure on GDP	5.2	2.5	3.8	4.5	3.9	3.5	2	1 <sup>1</sup> / <sub>4</sub>	2	3					
<b>GDP (production)</b>	<b>5.3</b>	<b>2.1</b>	<b>3.9</b>	<b>4.7</b>	<b>3.6</b>	<b>3.7</b>	<b>2<sup>1</sup>/<sub>2</sub></b>	<b>1<sup>1</sup>/<sub>2</sub></b>	<b>2</b>	<b>3</b>					
GDP (production, March qtr to March qtr)	5.8	0.9	4.8	4.2	4.8	2.3	2 <sup>1</sup> / <sub>4</sub>	1 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>	3					
Potential output	2.7	3.0	3.4	3.6	3.6	3.3	3 <sup>1</sup> / <sub>4</sub>	3	2 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>					
Output gap (% of potential GDP, year average)	0.4	-0.3	0.2	1.2	1.2	1.6	3 <sup>1</sup> / <sub>4</sub>	-1 <sup>1</sup> / <sub>2</sub>	-1 <sup>1</sup> / <sub>4</sub>	-3 <sup>1</sup> / <sub>4</sub>					

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

Table C

## Summary of economic projections

(Annual per cent change, unless specified otherwise)

March year	Actuals					Projections				
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
<b>Price measures</b>										
CPI	1.7	3.1	2.6	2.5	1.5	2.8	3 <sup>1</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>2</sub>
Labour costs	1.4	1.6	2.1	2.2	2.1	2.5	3	2 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>4</sub>
Import prices (in New Zealand dollars)	11.2	7.4	-2.9	-11.1	-10.5	0.5	5 <sup>3</sup> / <sub>4</sub>	5 <sup>3</sup> / <sub>4</sub>	5 <sup>1</sup> / <sub>2</sub>	3 <sup>3</sup> / <sub>4</sub>
Export prices (in New Zealand dollars)	9.9	20.6	-3.5	-15.5	-5.1	4.9	1 <sup>1</sup> / <sub>4</sub>	5 <sup>1</sup> / <sub>2</sub>	5 <sup>3</sup> / <sub>4</sub>	3
<b>Monetary conditions</b>										
90-day rate (year average)	5.2	6.6	5.4	5.9	5.3	6.5	7 <sup>1</sup> / <sub>4</sub>	7 <sup>1</sup> / <sub>2</sub>	7 <sup>1</sup> / <sub>4</sub>	6 <sup>3</sup> / <sub>4</sub>
TWI (year average)	56.1	50.4	50.3	56.4	63.6	67.1	70 <sup>1</sup> / <sub>4</sub>	65	60 <sup>1</sup> / <sub>4</sub>	57 <sup>1</sup> / <sub>4</sub>
<b>Output</b>										
GDP (production, annual average % change)	5.3	2.1	3.9	4.7	3.6	3.7	2 <sup>1</sup> / <sub>2</sub>	1 <sup>1</sup> / <sub>2</sub>	2	3
GDP (production, March qtr to March qtr)	5.8	0.9	4.8	4.2	4.8	2.3	2 <sup>1</sup> / <sub>4</sub>	1 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>	3
Output gap (% of potential GDP, year average)	0.4	-0.3	0.2	1.2	1.2	1.6	3 <sup>1</sup> / <sub>4</sub>	-1 <sup>1</sup> / <sub>2</sub>	-1 <sup>1</sup> / <sub>4</sub>	-3 <sup>1</sup> / <sub>4</sub>
<b>Labour market</b>										
Total employment	1.5	2.3	3.5	1.5	3.1	3.4	1 <sup>3</sup> / <sub>4</sub>	1 <sup>1</sup> / <sub>4</sub>	1 <sup>1</sup> / <sub>4</sub>	1
Unemployment rate (March qtr, s.a.)	6.3	5.3	5.2	4.9	4.2	3.9	3 <sup>3</sup> / <sub>4</sub>	4 <sup>1</sup> / <sub>2</sub>	5	5 <sup>1</sup> / <sub>4</sub>
Trend labour productivity (annual % change)	1.5	1.6	1.5	1.2	0.9	0.8	1	1 <sup>1</sup> / <sub>4</sub>	1 <sup>1</sup> / <sub>2</sub>	1 <sup>3</sup> / <sub>4</sub>
<b>Key balances</b>										
Government operating balance (% of GDP, year to June)	1.4	1.1	1.9	1.5	5.2	4.1	3 <sup>1</sup> / <sub>2</sub>	3 <sup>3</sup> / <sub>4</sub>	2 <sup>3</sup> / <sub>4</sub>	2
Current account balance (% of GDP, year to March)	-6.4	-4.4	-3.1	-3.6	-4.8	-7.4	-9	-9 <sup>1</sup> / <sub>4</sub>	-7 <sup>3</sup> / <sub>4</sub>	-6 <sup>1</sup> / <sub>2</sub>
Terms of trade (OTI measure, annual average % change)	-0.2	4.4	4.2	-5.7	3.9	5.8	-1 <sup>1</sup> / <sub>4</sub>	-3 <sup>3</sup> / <sub>4</sub>	3 <sup>1</sup> / <sub>4</sub>	-1 <sup>1</sup> / <sub>2</sub>
Household savings rate (% of disposable income, year to March)	-1.7	-5.2	-5.2	-10.8	-11.4	-13.8	-14 <sup>1</sup> / <sub>2</sub>	-14	-11 <sup>3</sup> / <sub>4</sub>	-9 <sup>3</sup> / <sub>4</sub>
<b>World economy</b>										
World GDP (annual average % change)	4.3	3.7	1.5	3.0	3.3	3.6	3 <sup>1</sup> / <sub>2</sub>	3 <sup>1</sup> / <sub>2</sub>	3 <sup>1</sup> / <sub>2</sub>	3 <sup>1</sup> / <sub>2</sub>
World CPI inflation	2.0	2.7	1.4	2.2	1.5	2.0	2 <sup>1</sup> / <sub>2</sub>	1 <sup>3</sup> / <sub>4</sub>	2	2

s.a. = seasonally adjusted

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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, 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>Labour cost</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

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

Affco Ltd

Contact Energy Ltd

Criterion Group Ltd

Farmers Ltd

Federated Farmers (Waikato)

Fonterra

Foodstuffs (SI) Ltd

H & J Smith Holdings Ltd

J Ballantynes Ltd

Mainzeal Construction Ltd

Mitre 10 Ltd

Orion New Zealand Ltd

Port of Tauranga Ltd

Ports of Auckland Ltd

Real Estate Institute of New Zealand

Skyline Enterprises Ltd

Steel Tube Ltd

The Warehouse 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 C

### Reserve Bank statements on Monetary Policy

#### OCR unchanged at 6.75 per cent

*15 September 2005*

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

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

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

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

"Right now, it is too early to make a call on the relative strength of the emerging cross-currents and how these will translate into medium-term inflation pressures. It will be several months before the persistence and global impact of the oil shock become more apparent. A similar period could be needed for the fiscal outlook to be clarified. We are concerned, however, that the risk of higher medium-term

inflation has increased. Consequently, further monetary policy tightening may still prove necessary to ensure inflation is kept within the 1 per cent to 3 per cent target band on average over the medium-term. Certainly there remains no prospect of a cut in the OCR in the foreseeable future."

#### Reserve Bank increases OCR to 7.00 per cent

*27 October 2005*

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

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

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

"Today's increase in the OCR, combined with higher world interest rates and pipeline effects from the repricing of fixed rate mortgages, are expected to slow the housing market and household spending over the coming months. However, the prospect of further tightening may only

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be ruled out once a noticeable moderation in housing and consumer spending is observed. Certainly, we see no prospect of an easing in the foreseeable future if inflation is to be kept within the 1 per cent to 3 per cent target range on average over the medium term.”

## Terms of Reference for the Supplementary Stabilisation Instrument Project

*10 November 2005*

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

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

Two classes of options will be explored:

One-off measures, eg:

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

Discretionary stabilisation measures, eg:

- A limit on loan-to-value ratios for mortgages, that could be managed by the Reserve Bank as a macro-stabilisation instrument

- Other direct interventions that might be used by the Reserve Bank to influence the quantity and or price of mortgage lending

Factors that will be considered include:

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

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

## Reserve Bank increases OCR to 7.25 per cent

*8 December 2005*

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

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

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a growing current account deficit, is continuing to fuel inflation.

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

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

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

## **OCR unchanged at 7.25 per cent**

**26 January 2006**

The Official Cash Rate (OCR) will remain unchanged at 7.25 per cent.

Reserve Bank Governor Alan Bollard said: "The economy has continued to slow in recent months, broadly in line with the outlook contained in our December Monetary Policy Statement. GDP growth slowed in the third quarter of 2005, due to the impact of the high exchange rate on the export and import-competing sectors, and a fall in construction. Looking to 2006, while there are some early indications, we are yet to see hard evidence of a sustained slowdown

in domestic demand. To date, strong domestic demand has been fuelled by strong employment, wage growth, rising house prices, and growth in Government spending. Overall, total spending continues to outstrip growth in production, contributing to an unsustainably large current account deficit.

"Over recent years, considerable pressures have built up on resources, leading to the current high level of inflation. While capacity and resource constraints appear now to be easing, inflation pressures remain of concern. Annual CPI inflation stands at 3.2 per cent, and our forecasts point to inflation remaining toward the upper end of the target band over the next couple of years. Continuing increases in wages, energy prices and other business costs suggest that inflation pressures will not subside quickly. Of particular concern, inflation expectations remain uncomfortably high.

"Given this situation, we do not expect to raise the OCR further in this cycle; however, this possibility cannot be ruled out until we see clear evidence of a sustained weakening in domestic demand. Certainly we see no prospect of an OCR easing, given the relatively high medium-term inflation outlook. An early decline in interest rates, as expected by some in the financial markets, would risk reigniting spending and hence inflation pressures."

## Appendix D

### The Official Cash Rate chronology

Date	OCR (per cent)	Date	OCR (per cent)
17 March 1999	4.50	6 March 2003	5.75
21 April 1999	4.50	24 April 2003	5.50
19 May 1999	4.50	5 June 2003	5.25
30 June 1999	4.50	24 July 2003	5.00
18 August 1999	4.50	4 September 2003	5.00
29 September 1999	4.50	23 October 2003	5.00
17 November 1999	5.00	4 December 2003	5.00
19 January 2000	5.25	29 January 2004	5.25
15 March 2000	5.75	11 March 2004	5.25
19 April 2000	6.00	29 April 2004	5.50
17 May 2000	6.50	10 June 2004	5.75
5 July 2000	6.50	29 July 2004	6.00
16 August 2000	6.50	9 September 2004	6.25
4 October 2000	6.50	28 October 2004	6.50
6 December 2000	6.50	9 December 2004	6.50
24 January 2001	6.50	27 January 2005	6.50
14 March 2001	6.25	10 March 2005	6.75
19 April 2001	6.00	28 April 2005	6.75
16 May 2001	5.75	9 June 2005	6.75
4 July 2001	5.75	28 July 2005	6.75
15 August 2001	5.75	15 September 2005	6.75
19 September 2001	5.25	27 October 2005	7.00
3 October 2001	5.25	8 December 2005	7.25
14 November 2001	4.75	26 January 2006	7.25
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 E

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

The following is the Reserve Bank's schedule for the release of *Monetary Policy Statements* and Official Cash Rate announcements for 2006.

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

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

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# Appendix F

## Policy Targets Agreement

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

### 1. Price stability

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

### 2. Policy target

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

### 3. Inflation variations around target

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

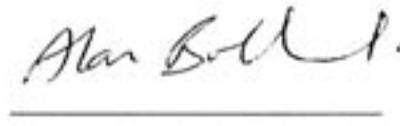
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#### 4. Communication, implementation and accountability

- 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

