
Monetary Policy Statement¹

November 2001

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

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¹ Projections finalised on 26 October 2001. Policy assessment finalised on 13 November 2001.

1 Overview and policy assessment

The Reserve Bank has decided to reduce the Official Cash Rate from 5.25 per cent to 4.75 per cent.

Clearly, a good deal has changed since our last assessment of the inflation outlook in August. At that time, we noted a number of factors which might have kept inflation at or above the top of our inflation target. In particular, we noted the possibility that there might have been more pressure on the economy's productive capacity than we had estimated. We suggested that there could well have been a case for an early increase in the Official Cash Rate were it not for the possibility that the world economy might turn out weaker than assumed at that time.

The international environment has indeed turned out to be much weaker than seemed likely in August. Even before the tragic events of 11 September, it is now clear that the world economy was slowing quite rapidly in July and August. The events of 11 September have exacerbated that slowdown by dealing a blow to business and consumer confidence around the world. The outlook for almost all of our major trading partners is now looking markedly weaker than it did three months ago. In response, most major central banks have eased monetary policy quite significantly. We too moved quickly to cut the Official Cash Rate, from 5.75 per cent to 5.25 per cent, on 19 September.

The slowdown in the international economy is already affecting the New Zealand economy and will continue to do so. For many months, we have been expecting the world prices of the commodities which New Zealand exports to decline and, with some notable exceptions, this has not happened. But export prices are now falling across a wide front, while nervousness about air travel is having an adverse impact on the growth of tourism. Business confidence has declined markedly, and we are expecting investment spending to slow. There can be little doubt that the New Zealand economy has already slowed quite sharply from the robust pace of the first half of the year, and is likely to continue growing rather slowly in the immediate future. This will exert downwards pressure on inflation in New Zealand.

At 4.75 per cent, our short-term interest rates are somewhat higher than those in many other developed countries. In large part that reflects the fact that New Zealand enters this period of slow international growth in a relatively strong position. Certainly, growth in the first half of the year was stronger than we had estimated in August, with the result that there was more pressure on the economy's productive capacity, and

therefore on inflation, than we had assumed.

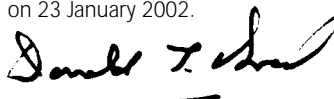
Moreover, since August many businesses have continued to prosper. The residential property market continues to trade well ahead of last year, helped by relatively low interest rates and a turn-around in migration flows. Export prices, though now declining, remain moderately strong for the most part, while the low New Zealand dollar provides additional support for export industries. Unemployment remains at its lowest level in 13 years. While inflation should be down to around 2 per cent in the year to December this year – a marked reduction from the 4 per cent for calendar 2000 – it looks likely to return to around 2½ per cent in the year to March 2002 as the artificially low inflation number in the March 2001 quarter drops out of the 12-monthly total.

In normal circumstances, this still relatively buoyant domestic economy might suggest the need for somewhat higher interest rates, not lower interest rates.

But these are clearly not normal circumstances. The international environment seems more threatening than at any time in more than a decade and, if things turn out even worse than we expect, we may well be faced with the need to reduce interest rates still further. At this stage, it is our assessment that monetary policy has now been set to accommodate quite a bit of additional weakening in the global environment. That reflects our judgement about the risks that lie ahead of us.

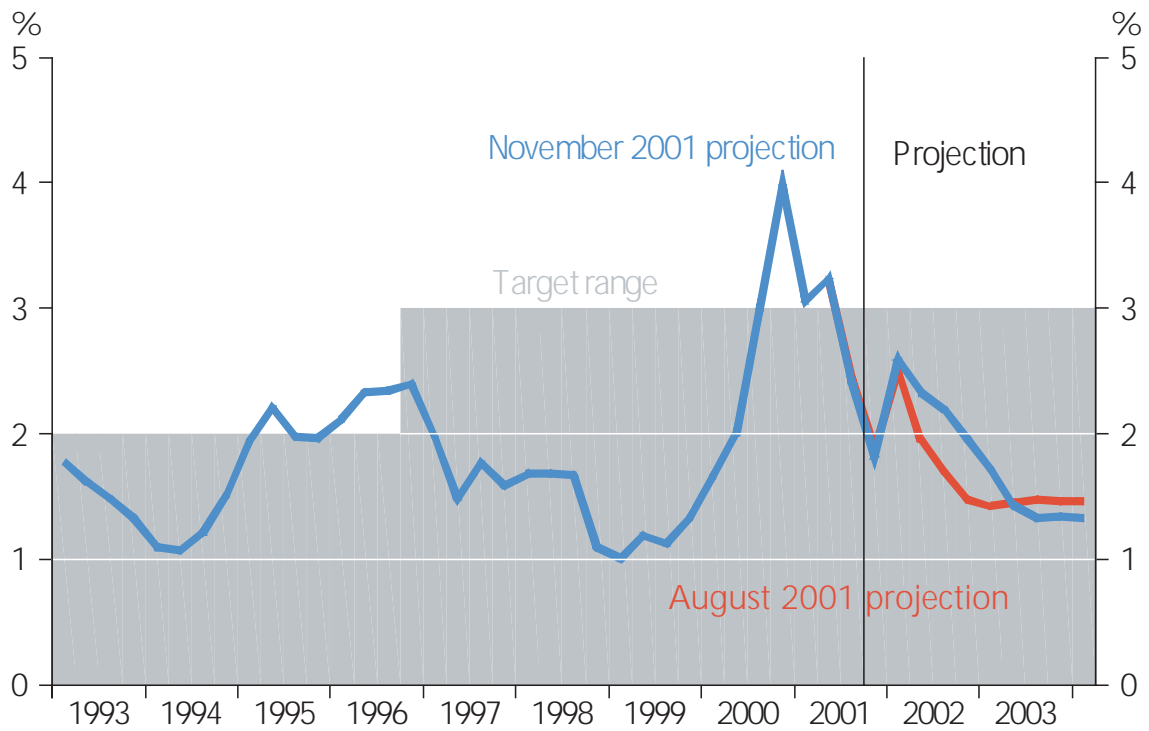
The uncertainty in the present situation is very considerable however. It is conceivable that the combination of a stronger underlying performance of the New Zealand economy and a global slowdown that blows over rather more quickly than now expected will require a reversal of recent interest rates cuts in the not-too-distant future. We will be monitoring all of the information as it becomes available, and will be constantly vigilant to the implications of that information for the outlook for inflation. The projection contained in Chapter 3 of this *Statement*, which shows interest rates slightly higher than those consistent with today's decision, is a good illustration of how easy it is to envisage quite different outcomes from those implicit in today's decision.

The Bank is next scheduled to review the Official Cash Rate on 23 January 2002.



Donald T. Brash
Governor

Figure 1
Consumer price inflation²
(annual percentage change)



² The measure shown is annual underlying inflation until the September quarter 1997, annual CPIX inflation from the December 1997 quarter until the June 1999 quarter, and annual CPI inflation thereafter (adjusted to exclude interest and section prices from the September 1999 quarter to the June 2000 quarter).

Table 1

Summary of economic projections

(Annual percentage change, unless specified otherwise)

March year	Actuals		Projections		
	2000	2001	2002	2003	2004
Price measures					
CPI*	1.7	3.1	2 ¹ / ₂	1 ³ / ₄	1 ¹ / ₂
Wages	1.9	3.1	4	3	2
Import prices (in New Zealand dollars)	11.2	7.4	- ¹ / ₂	-3 ¹ / ₂	0
Export prices (in New Zealand dollars)	9.6	20.1	-4 ¹ / ₂	-9 ¹ / ₂	1 ¹ / ₂
Monetary conditions					
90-day bank bill rate (year average)	5.2	6.6	5 ¹ / ₂	5 ¹ / ₄	5 ¹ / ₄
TWI (year average)	56.1	50.4	50	51	53
Output					
GDP (production, annual average % change)	4.6	2.6	3	1 ¹ / ₂	3
GDP (production, March qtr to March qtr)	5.5	1.1	3	2	3
Output gap (% of potential GDP, year average)	0.2	0.2	1	- ¹ / ₂	0
Labour market					
Total employment	1.4	2.3	1 ¹ / ₂	1 ¹ / ₂	2
Unemployment rate (March qtr, s.a.)	6.4	5.4	5	5 ¹ / ₂	5 ¹ / ₂
Labour productivity (annual average % change)	2.2	1.3	1	- ¹ / ₂	1
Key balances					
Government operating balance (% of GDP, year to June)	1.4	1.2	1 ¹ / ₂	2	2 ¹ / ₂
Current account balance (% of GDP, year to March)	-7.1	-4.9	-3	-5	-4 ¹ / ₂
Terms of trade (annual average % change)	-0.1	3.6	4 ¹ / ₂	-8 ¹ / ₂	0
Household savings rate (% of disposable income, year to March)	-4.2	-3	-1	-4	-3 ¹ / ₂
World economy					
World GDP (annual average % change)	4.4	3.4	1	2 ¹ / ₂	3 ¹ / ₂
World CPI inflation	2.0	2.4	1 ¹ / ₂	1 ¹ / ₂	2
Quarterly projections					
	Mar-01	Jun-01	Sep-01	Dec-01	Mar-02
CPI (quarterly percentage change)	-0.2	0.9	0.6	0.6	0.6
CPI (annual percentage change)	3.1	3.2	2.4	1.8	2.6

e = estimate.

s.a. = seasonally adjusted

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

Notes for this table are in Appendix 5.

2 The current economic situation

Introduction

Over 2001, our policy view has increasingly been driven by emerging weakness in the economies of most of our major trading partners. In response to that weakness, we cut the Official Cash Rate by a total of 75 basis points in three steps between March and May (to 5.75 per cent). Those moves reflected the view that inflation pressures over the next two years were likely to be weaker, in light of softening external demand.

On 19 September, in an unscheduled move, we cut the Official Cash Rate by a further 50 basis points to 5.25 per cent. We took the view that the 11 September terrorist attacks had significantly increased the downside risks to the already-weakening world economy. In these circumstances, the inflation outlook looked likely to be weaker than previously thought.

Looking backwards though, and despite the weakening external scene, the New Zealand economy appears to have held up well in the first half of 2001. In our August *Statement*, we noted the signs of increasing momentum in the economy in the early part of 2001 despite equally clear signs that the heat was coming out of the international economy. Data to hand since that *Statement* suggest that economic activity in the first half of 2001 was actually rather stronger than we expected at that stage, with GDP for the six months to June 2001 as a whole expanding by 2.3 per cent.³ This stronger level of activity implies that demand pressures on the economy's productive resources were increasing over this period.

On balance, we think economic activity also held up during the September quarter, with the economy growing at, or slightly below, its trend rate. The events of 11 September appear likely to have had only a marginal impact on activity levels for the quarter as a whole. However, business and consumer confidence indicators released since September show a sharp fall in confidence levels in the wake of the September attacks. As discussed in Chapter 3, this suggests a more pronounced negative impact in the December quarter.

Developments abroad

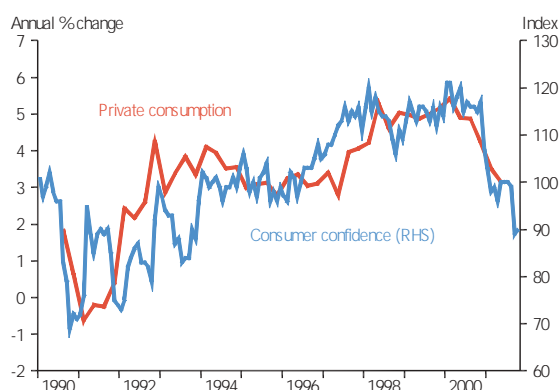
The economies of many of New Zealand's export trading partners have experienced slowing growth since the middle of 2000. Growth has slowed in all major regions of the global economy, including the United States, the European Union, Japan and most other Asian economies.

To some extent, the coincidence of the slowdown across various economies derives from the similar circumstances prevailing (for example, both the US and the European economies invested heavily in information technology and communications equipment over recent years). And to some extent the coincidence derives from the operation of global linkages through cross-border investment, centralised decision-making by multinational companies, and normal trade relationships. The sharp contraction of US corporate demand for IT and communications equipment – new orders for computers and electronic products in the US fell by a third in the year to May – has been transmitted quickly to several countries which have specialised in exporting such product to the US. Indeed, two-fifths of Asia's total GDP growth in 2000 is estimated to have come from exports of information technology products to the US.

Limiting the scale of the global slowdown, until recently, has been the remarkable robustness of US consumer confidence and the US consumer's willingness to continue spending. Notwithstanding substantial falls in equity prices (especially those associated with the technology sector) and the associated impact on household wealth, consumer spending expanded at a reasonable pace through much of 2001 (figure 2). Even so, by the middle of this year the US had already seen a collapse in its GDP growth rate of a magnitude typical of recession – a drop of around 4 percentage points over the last year. Now US industrial production is falling at an annual rate of around 5 per cent, a pace of contraction not seen since 1982, while the rate of job lay-offs has moved well into recession territory.

³ Statistics New Zealand's latest estimates suggest that the production-based GDP series grew by 2.0 per cent in the June quarter following a (revised) 0.3 per cent increase in the March quarter.

Figure 2
US consumer confidence and consumption⁴



Australia's economy also slowed during 2000, although domestic factors appear to have been the main drivers of that slowdown. More recently, the Australian economy has shown signs of picking up again, notwithstanding the weaker global economy. Like New Zealand, Australia has continued to benefit from a low exchange rate and has enjoyed relatively high commodity prices, at least until recently. Moreover, a number of 'domestic' influences are helping to support the economy. For example, subsidies offered for new home-buyers are lending support to residential construction. Some components of domestic demand have also been bouncing back following weakness after the introduction of GST last year, and in the period following the Olympics.

It is too early to observe the full effect of the events of 11 September on the world economy. Confidence surveys in the US and elsewhere have taken a sharp step down. But most of the data released since 11 September probably tells us more about the pace at which the world economy was weakening before 11 September than after.

World financial markets certainly seemed to move to anticipate lower short-term interest rates (than were expected at the time of our August *Statement*) before 11 September. Subsequently, interest rates expectations have fallen substantially further, with short-term rates now expected to be much lower and to stay low for longer. How much of the change in market perceptions can be attributed to the steady flow of negative economic indicators, and how much to the presumed economic consequences of the 11 September attack itself, is impossible to tell. The moves by many central banks to cut official interest rates quickly in response (see table 2) is also likely to have contributed to heightened expectations of even more easings.

Recent export performance

While the more encouraging performance from the Australian economy may be helping to buffer the effects of slower external demand for some New Zealand exporters, the global developments just discussed mean that overall external demand conditions softened considerably through 2000 and 2001 to date. Notwithstanding that softening, during the past 12 months, a combination of high international prices for key export commodities and the low New Zealand dollar has provided considerable insulation to the local economy in the face of slower trading partner growth. As a consequence, export earnings surged. Stronger export volumes contributed, although, not surprisingly, volume growth for some categories of exports has been relatively constrained (figure 3).

In recent *Statements*, we have discussed the remarkable strength in the world prices of many of New Zealand's key export commodities, given weaker external activity. Historical

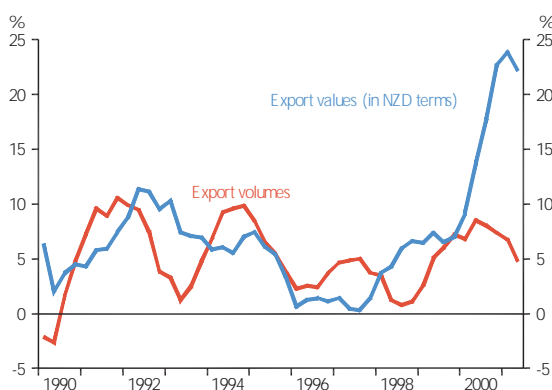
Table 2
Changes in official interest rates this year⁵

	Australia	Canada	Euroland	USA	UK	NZ
Rate at 1 January, 2001	6.25	5.75	4.75	6.50	6.00	6.50
Change 1 January - 11 September	-1.50	-1.75	-0.50	-3.00	-1.00	-0.75
Change 11 September - 9 November	-0.25	-1.25	-1.00	-1.50	-1.00	-0.50
Rate at 9 November, 2001	4.50	2.75	3.25	2.00	4.00	5.25

⁴ Source: University of Michigan, Datastream

⁵ Source: Bloomberg

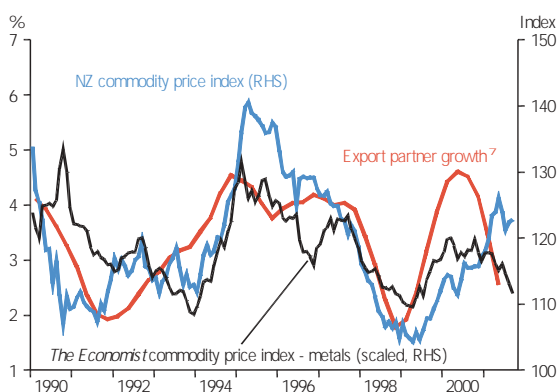
Figure 3
Exports
(annual average percentage change)



relationships between trading partner growth and world prices have led us to project falling commodity prices during 2001, falling export prices being a key channel through which softer global demand is transmitted to local activity (figure 4). For much of 2001, aggregate commodity prices have instead shown considerable resilience in the face of a deteriorating global outlook (figure 5).

A range of 'supply side' factors has operated. Climate-related shortages in US beef supplies help explain the recent strength in international beef prices. The BSE scare and the Foot and Mouth outbreak in the United Kingdom earlier this year have also been factors underpinning prices for New Zealand-

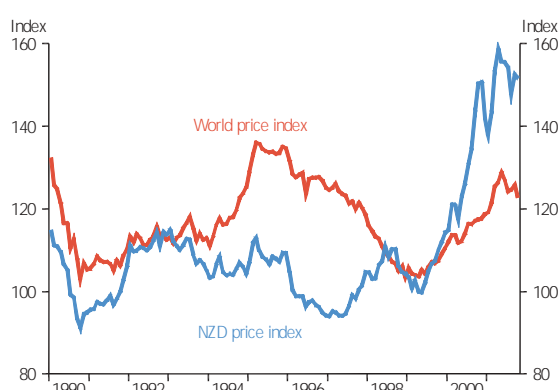
Figure 4
Export partner growth and commodity prices⁶
(commodity prices measured in USD)



⁶ Source: RBNZ, ANZ Banking Group Ltd, *The Economist*

⁷ 14 country export-weighted index of world GDP, annual average percentage changes.

Figure 5
Prices of New Zealand's commodity exports⁸



produced lamb and beef. In the case of dairy products, a reduction in subsidies within the EU dairy industry has been among the reasons cited as supporting dairy prices. Strong dairy and meat prices explain much of the strength in aggregate (trade-weighted) commodity prices.

However, evidence is now emerging that commodity prices are starting to soften. Prices for some products have eased since the middle of 2001, including those for some forestry products, aluminium and seafood. Over the past month, world prices of products such as wool, hides and skins, and even some dairy products have eased, consistent with an environment of slower external demand. Feedback from some commodity exporters indicates a view that commodity prices may continue to ease over the months ahead. The ANZ Commodity Price Index for October showed world prices for New Zealand's main export commodities falling by 2.4 per cent over the month, although they remained 4.6 per cent higher than a year earlier.

In terms of *volumes*, exports recorded further growth over the six months to June, with increases in dairy and meat exports (partly related to increased stock slaughtering due to dry climatic conditions). Export volumes of non-commodity manufactures also grew modestly over this six month period as a whole, although they fell during the June quarter. Meanwhile, the latest trade data hint toward a fall in merchandise export volumes in the September quarter.

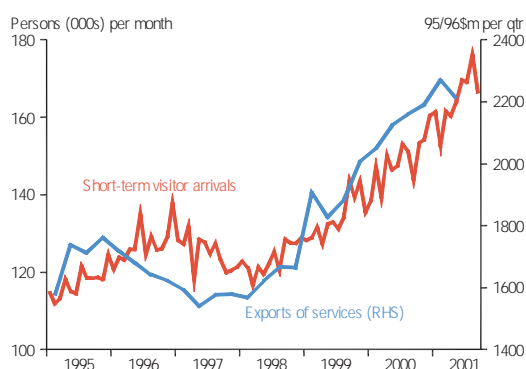
⁸ Source: ANZ Banking Group Ltd

Box 1 – The outlook for tourism

From New Zealand's perspective, the sector most likely to be affected by the 11 September terrorist attacks and their aftermath is tourism. Since the event, anecdotes from the tourism sector have been many and often conflicting, making it difficult to identify likely outcomes. Compounding the effects of the terrorist attacks are the other woes to hit the tourism industry recently, namely the collapse of Ansett Australia and Air New Zealand's afflictions, and a slowing world economy. What follows is a summary of possible influences on the tourism sector and a summary of the assumptions in our projections.

Visitor arrivals

Figure 6
Tourism exports
(seasonally adjusted)



In its broadest sense, New Zealand's tourism industry accounts for some 12 per cent of GDP, although domestic tourism accounts for more than half of this. The tourism industry's fear has been that the terrorist attacks would discourage foreigners – the Japanese and Americans in particular – from flying, significantly reducing visitors to New Zealand and hence tourism revenue. These fears are being realised, although perhaps not to the degree first anticipated immediately following 11 September.

The most recent Conference Board survey of American consumers shows a recovery in attitudes to travelling. On 19 September, 30 per cent of survey respondents said that the events of 11 September would cause them to cancel or postpone travel by plane. When the survey

was conducted a month later, this number reduced to 21 per cent. This recovery of nerve in the US has not been mirrored in Japan. The Japanese Government has cautioned its citizens against travelling at present, and the Japanese media are actively encouraging a very cautious consumer mentality.

In general, the negative influences on visitor arrivals over the coming months include:

- fear of flying;
- a weakening world economy (happening prior to 11 September); and
- a shortfall of internal air services in Australia due to Ansett Australia collapsing (many northern hemisphere travellers visit New Zealand and Australia on the same trip, and not being able to get around Australia puts them off coming down here at all).

Positive influences include:

- The perception that New Zealand is a safe place to visit. This should encourage travellers, particularly from the southern hemisphere, to adopt New Zealand as a preferred destination.
- The extraordinarily good value of New Zealand's currency, which should also continue to encourage visitors to our shores.

It is easy to imagine many scenarios for visitor arrivals depending on which different factors dominate. Out of the many plausible possibilities, the scenario implicit in this *Statement's* projections is one in which the perceived safety of New Zealand is not expected to be sufficient to offset the effects of lower disposable incomes in our trading partners and the general aversion to travelling. However, a recovery, albeit slow, is expected to get underway relatively promptly.

Visitor spending

The Tourism Action Group, a body specially set up after 11 September to monitor the situation, is forecasting a reduction in visitor numbers of 5 per cent over the coming

season (October to February). The bulk of this fall will be Japanese and US visitors. They tend to be big spenders: the Japanese and Americans spend around two and a half times per visit what the Australians spend. Thus, although Americans and Japanese accounted for 10 and 9 per cent respectively of visitor arrivals in the year to June, they each accounted for around 15 per cent of total expenditure. Compare this to Australians, who accounted for 32 per cent of visitor arrivals in the year to June but only 18 per cent of the total spend.

Tourism New Zealand published some indications of international forward bookings (as at 23 October), comparing

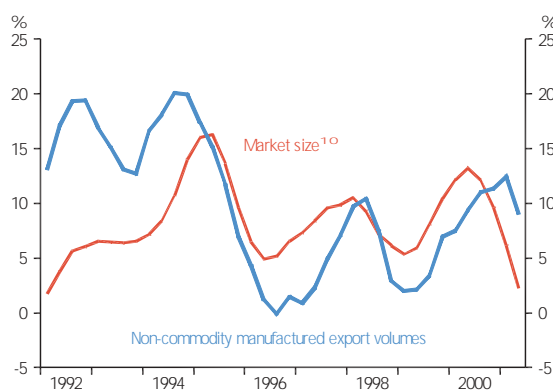
the coming season (October to February) with last year's season. Using these projections as the basis for some 'back-of-the-envelope' calculations implies an annual change in spending by international visitors over the coming holiday period of between 0 and -7 per cent. However, it is important to recall that this still leaves tourism spending at very high levels relative to history. In addition, a fall in spending by overseas visitors is likely to be offset a bit by increased domestic tourist spending, as world events compound the effects of the weak currency, resulting in a continuing trend towards holidaying at home.

Exports of services have in contrast grown strongly over the past year, mainly because of a strong tourism sector. Tourism, as represented by visitor arrivals, continued to grow strongly up until September, whereby arrivals fell 6 per cent for the month (seasonally adjusted). The main reason for this fall was the interruption of travel flows from the US following the 11 September attacks, with contributing factors being the collapse of Ansett Airlines and concerns over the future of Air New Zealand. It is hard to tell how much the latest developments in the tourist industry foreshadow something more lasting. These developments are discussed further in Box 1.

The exchange rate and the export sector response

An issue over recent times has been why exports of manufactured goods have not shown greater acceleration in the face of persistent weakness in the New Zealand dollar. Exports of non-commodity manufactures grew by around 9 per cent in the year to June 2001. In contrast, over the first half of the 1990s, growth rates of 15 to 20 per cent per annum were achieved (figure 7), and yet the New Zealand dollar has been widely perceived as more favourable for exporters than it was during that period. In addressing this issue, a range of possible explanations can be suggested.

Figure 7
Non-commodity manufactured export volumes⁹
(annual average percentage changes)



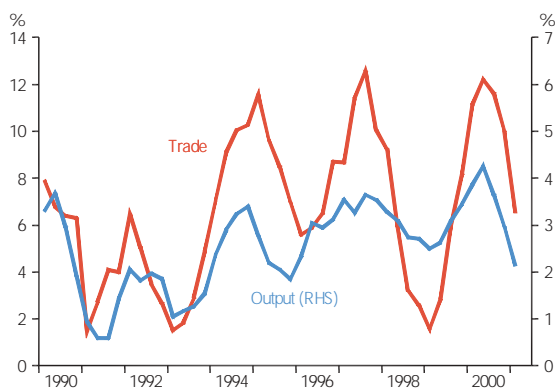
The first explanation takes into account the extent to which trading partner growth has slowed. As noted earlier, New Zealand exporters have been operating in increasingly weak external demand conditions over the past year. The World Trade Organisation has recently projected growth in world merchandise trade volumes for 2001 of just 2 per cent – compared with 12 per cent for 2000 – and has noted downside risks to that projection¹¹ (see also figure 8). Accordingly, the fact that New Zealand manufacturers have, in aggregate,

⁹ Source Statistics New Zealand, RBNZ.

¹⁰ Market size is calculated as a weighted average of the total imports of the US, Japan and Australia.

¹¹ Source: *International Trade Statistics 2001*, World Trade Organisation, October 2001.

Figure 8
World trade and output¹²
(annual average percentage changes of OECD aggregates)



continued to expand export volumes over this period may be more of an achievement than it first appears.

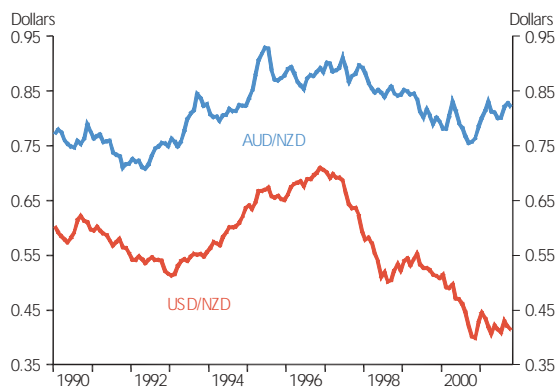
The second possibility, albeit one that loses its plausibility as time passes, is that there are lags between an exchange rate decline and a subsequent pick-up in export performance. While exchange rates may be 'favourable', exporters will take time to build markets and secure additional supply contracts. The use of hedging contracts may also delay the benefits of a falling exchange rate. Moreover, uncertainty over the path of the exchange rate may see exporters unwilling to commit to higher production volumes until there is evidence that the lower exchange rate is 'sticking'. This may be particularly true of some exporters who increased exports in response to the low exchange rate in the early 1990s, and were subsequently negatively impacted by the sharp rise in the exchange rate prior to 1997.

A third explanation questions the degree to which New Zealand's exchange rate depreciation has resulted in competitiveness gains relative to the exporters of other countries against which New Zealand's exporters compete. In this regard, Australia and many Asian countries have also experienced sharp falls in their currencies over the past few years, to the advantage of their export sectors. This increase in 'third country' competition needs to be taken into account when assessing the competitive position of New Zealand exporters in the world market.

A fourth possibility, discussed in the August *Statement*, relates to differential movements in the New Zealand dollar against some key currencies. Many manufacturers buy inputs paid for in US dollars, against which the New Zealand dollar has fallen markedly over the last couple of years. Those selling to countries against which the exchange rate has moved down more modestly – such as Australia – will not necessarily have gained significant price advantages from currency movements and may, in some cases, have been disadvantaged.

New Zealand's exchange rate remains at levels that are likely – all these explanations considered – to provide some offset against weaker global activity (figure 9). That significant parts of the export sector have not responded to this low level of the exchange rate as much as previous episodes would have suggested probably has more to do with the weakness of external demand than anything else.

Figure 9
Key New Zealand dollar exchange rates¹³



Understanding why the exchange rate has remained at low levels during the past few months continues to be difficult. Fluctuations in the US dollar, both before and after the events of 11 September, have been an important factor, and have created some volatility for New Zealand's exchange rate. But US dollar developments are not the whole story: in the immediate aftermath of the 11 September attacks risk aversion was a dominant theme. As a result, the currencies of heavily-indebted countries like Australia and New Zealand fell against the US dollar, while those of creditor countries, espe-

¹² Source: Datastream

¹³ Source: RBNZ

cially Switzerland and Japan, rose markedly. As these initial effects waned, there appears to have been a tendency for international investors to continue to invest in the US markets, taking the view that lower short-term interest rates and more stimulatory fiscal policy will ultimately underwrite a recovery in growth and corporate earnings next year.

Domestic activity

Domestic economic activity gained some momentum over the first half of 2001, and by more than we thought at the time of the August *Statement*. Those parts of the export sector that enjoyed higher revenues over the past year or so – chiefly agricultural exports and tourism – were a key driver. Stronger incomes and expanding production levels in turn motivated growth in spending, incomes, profits and employment, thereby fuelling domestic activity. Encouragingly, there were increasing signs of stronger activity in the main urban areas of the country – areas less directly connected to the export sector.

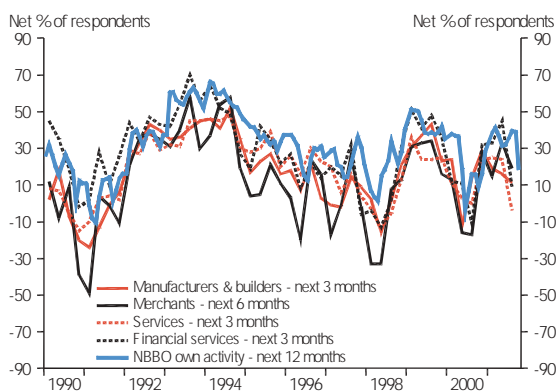
In general, information gleaned from our business contacts during late September also portrays an economy showing greater strength over recent times. Feedback from those operating in provincial economies (such as retailers and service sector businesses) was relatively upbeat while feedback from urban operators was mixed, but with a balance of businesses reporting better operating conditions over recent months. Most businesses expressed some trepidation about the impact of the 11 September terrorist attacks.

Another finding from our business discussions was that the vast majority of businesses were not significantly affected by the rise in wholesale electricity prices that occurred during winter. Many firms have been on contracts that have only recently expired or are yet to expire. However, many firms are expecting electricity costs to increase significantly when their contracts expire and this could have implications for output and inflation going forward.

Initial surveys of business confidence undertaken in the period following the terrorist attacks show firms quickly became more circumspect about their near-term growth prospects (figure 10). The September quarter QSBO showed a fall in business confidence, although firms' expectations of their own activity proved more resilient. The National Bank Business Outlook

(NBBO) for October also saw a sharp fall in firms' expectations for their own activity, investment and employment intentions. This follows the September NBBO survey, which did not include any responses received after 11 September, and which had shown only a small fall in the key activity indicators. The general message from the QSBO and NBBO surveys is that activity is likely to slow during the December quarter, perhaps quite sharply.

Figure 10
Expectations of economic activity¹⁴
(from the QSBO survey, unless otherwise specified)

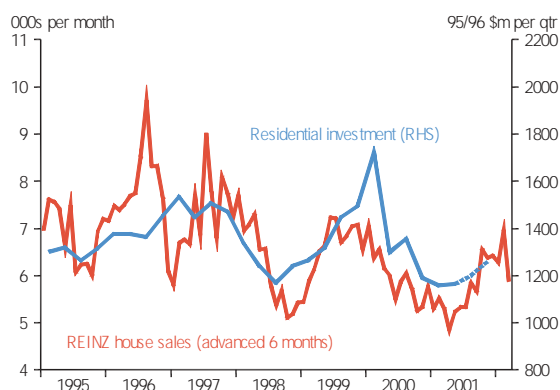


Business investment has been subject to considerable volatility over 2001, making trends difficult to read. However, for the six months to June as a whole, investment spending was stronger than in the same period in 2000, consistent with indicators showing the utilisation of existing capacity to have remained comparatively high through this period.

Residential building activity showed signs of bottoming in the first half of 2001 after sustained falls during 2000. Although the series has also been volatile of late, residential building consents have been on a rising trend since late 2000. Turnover in the existing home market has also picked up, although activity levels remain well below those evidenced during much of the 1990s (figure 11). Both consents and house sales fell sharply in the month of September. Market operators report a temporary pause in activity around the events of 11 September (the so-called 'CNN effect'), but note that activity levels have subsequently improved.

¹⁴ Source: New Zealand Institute of Economic Research, National Bank of New Zealand.

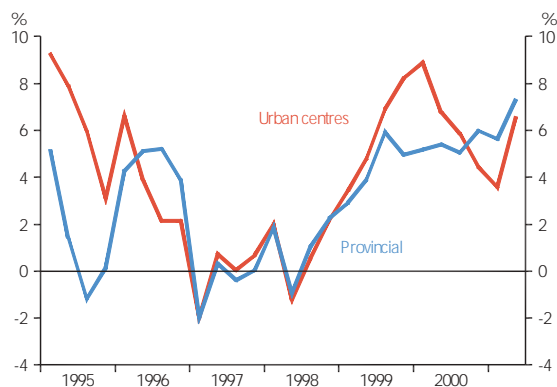
Figure 11
House sales and residential investment¹⁵



Strong employment growth and an historically low unemployment rate imply a boost to household sector incomes and a degree of job security that are likely to have been encouraging home-buyers into the market. In addition, the recent turnaround in migration flows to New Zealand's advantage implies that the demographic drivers of demand in the housing market may be strengthening. And recent reductions in interest rates following the series of cuts to the Official Cash Rate are also likely to have provided some support to this trend, as they have to household consumption.

Consumer spending showed solid growth over the first half of 2001, with monthly retail sales showing unbroken growth between February and July (figure 12). The retail sector has

Figure 12
Nominal retail sales¹⁶
(annual percentage change)

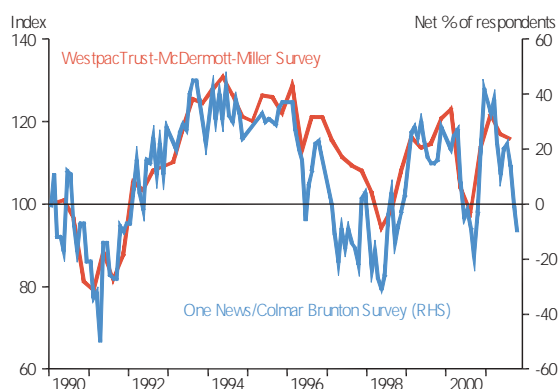


¹⁵ Source: Real Estate Institute of New Zealand, Statistics New Zealand.

¹⁶ Urban areas comprise Auckland, Wellington and Christchurch. Provincial areas comprise the rest of New Zealand.

continued to benefit from strong rural incomes and record levels of short-term international visitors. While little 'hard' data are available as yet, it appears likely that the growth trend in consumer spending has been interrupted in recent months, and especially following the terrorist attacks. Retail sales dipped in August, the first such decline in seven months. While that was not entirely unexpected, given the previous run of unbroken monthly growth, a dip in consumer confidence during September and October, as measured by the One News/Colmar-Brunton poll, suggests that retail sales may have continued to weaken into the December quarter. To some extent, a number of other events occurring in recent months, including the Air New Zealand/Ansett affair, and the constraints on hydro-electricity generation capacity during winter (discussed in our last *Statement*), may also have weighed on confidence levels (figure 13).

Figure 13
Consumer confidence¹⁷



Trends in credit data suggest that households, in the main, have been less inclined to finance expenditures through debt accumulation than has been the case over much of the past decade (figure 14). Over the year to September, total claims on the household sector rose by around 6½ per cent – more or less in line with estimates of the underlying growth in the sector's income. Reasons why households have been less enthusiastic in using credit to finance expenditures, despite lower servicing costs, are likely to include:

¹⁷ Source: WestpacTrust-McDermott-Miller, One News/Colmar Brunton.

- The fact that aggregate household debt levels have risen relatively sharply over the past 15 years to around international norms; and
- An absence of asset price inflation across most classes of household wealth, such as housing and equities (figure 15). This is likely to have dampened the attractiveness of debt-financing the purchase of such assets.

Figure 14
Household debt¹⁸
(household debt and interest costs are expressed as a ratio of disposable income)

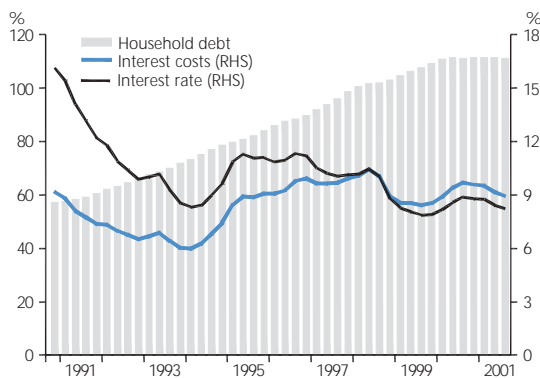
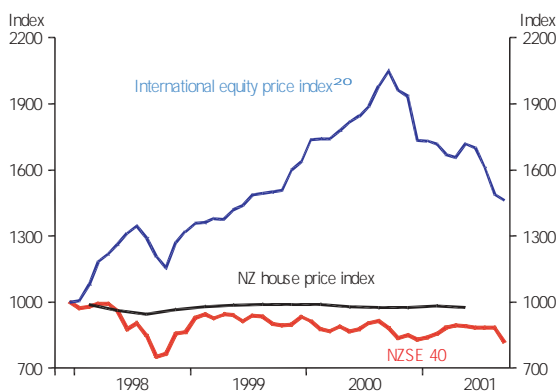


Figure 15
Housing and equity wealth measures¹⁹



¹⁸ Source: RBNZ

¹⁹ Source: New Zealand Stock Exchange, Morgan Stanley, Quotable Value New Zealand.

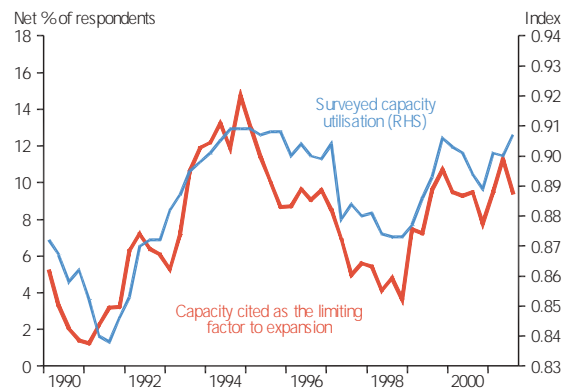
²⁰ International equity prices are measured by the Morgan Stanley Capital Index (in NZD terms).

The balance of pressure on resources

Our latest estimates of the 'output gap' suggest rather more pressure on resources than we thought in August, reflecting stronger activity levels over the first half of this year than we had anticipated. In our August *Statement*, we projected the output gap, obtained by comparing current output with its trend, to become slightly positive over the next 18 months. That was based on an outlook in which actual growth was projected to mildly exceed the potential growth rate. Our current assessment is that the gap was already in positive territory by the middle of this year.

A number of indicators corroborate the view that the balance of pressure on resources has been maintained in the September quarter (figure 16). Capacity utilisation measures, which were already high in the first half of 2001, remained at above average levels in the September quarter. For example, the QSBO showed firms' own assessment of their capacity utilisation to have lifted slightly in the September quarter, although expectations of future activity had deteriorated.

Figure 16
Indicators of spare capacity²¹
(from the QSBO survey, seasonally adjusted)



Although our latest estimates of the output gap are higher than our estimates in August, it bears emphasising that they remain lower than corresponding estimates for the period in the mid 1990s. During that time, economic activity was expanding very rapidly and the resulting pressure on resources

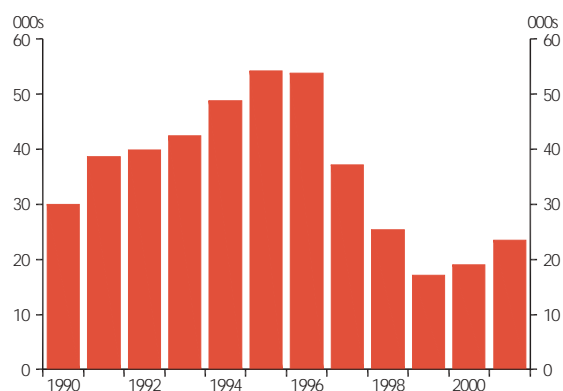
²¹ Source: New Zealand Institute of Economic Research

appears to have been more intense (and, by implication, more inflationary) than is implied by these estimates for 2001.

That said, it is possible that the balance of supply and demand for skills in the labour market may be tighter than was the case in the mid 1990s. The unemployment rate has recently been at a 13 year low, and a range of surveys, such as the OSBO, continue to reveal that firms perceive difficulty in finding both skilled and unskilled labour. A continued high level of job advertisements is also suggestive of relative difficulty in filling jobs. Our business contacts likewise have continued to note difficulties in finding the right kinds of staff (especially in some rural areas), although in general they do not believe these difficulties to have placed undue pressure on wages.

Some alleviation of labour market 'tightness' may be occurring at present via the increasing shift toward net immigration, following several years during which New Zealand has been in a net emigration position. This will be providing a boost to the working age population, which has been growing relatively slowly in the past few years (figure 17). The recent terrorist attacks in the US, and the slowdown in trading partner growth, may reinforce the transition to a net immigration position in the near-term (see Box 3, Chapter 3).

Figure 17
Labour supply²²
(annual net additions to the working age population)



Inflation developments

The major development in inflation over the past 18 months was the pronounced spike in annual CPI inflation, which reached 4 per cent in the year to December 2000. Key drivers of the inflation 'spike' were higher fuel prices associated with the sharp increase in international oil prices, the rise in tobacco

Table 3
CPI, CPI derivative series and other price measures
(annual percentage change)

	Mar	2000			Mar	2001	
		Jun	Sep	Dec		Jun	Sep
CPI	1.7	2.0	3.0	4.0	3.1	3.2	2.4
CPI ex petrol	1.2	1.3	2.1	3.3	2.9	3.0	2.8
CPI ex cigarettes	1.8	1.7	2.4	3.4	2.4	2.8	2.4
CPI ex rents, petrol, and cigarettes	1.2	1.0	1.4	2.7	2.8	3.2	3.4
CPI non-tradables	2.6	2.1	2.0	2.4	1.2	1.0	0.9
CPI non-tradables ex rents	2.6	2.1	2.0	2.4	2.4	2.3	2.2
CPI tradables	0.9	2.0	4.1	5.4	4.9	5.2	3.8
CPI tradables ex petrol and tobacco	-0.4	-0.1	1.0	2.9	3.5	4.2	4.8
CPI weighted median (of annual price change)	1.7	1.3	1.7	2.6	2.8	2.5	3.0
CPI trimmed mean (of annual price change)	1.2	1.8	2.3	3.4	2.8	3.1	2.4
PPI: inputs	4.9	5.5	8.0	10.2	7.8	8.1	n/a
PPI: outputs	3.3	3.9	5.6	6.8	5.7	6.1	n/a
Merchandise import prices (excluding petrol)	5.3	8.3	13.2	16.7	5.6	5.6	n/a
Consumption deflator	1.0	1.2	2.3	3.3	2.3	2.6	n/a
GDP deflator (derived from expenditure data)	1.2	1.5	2.6	4.8	5.5	5.8	n/a

²² The contribution from the second half of 2001 is estimated by the RBNZ.

excise taxes prior to last year's Budget, and the flow-through effects on tradable prices from the earlier decline in the New Zealand dollar.

Headline CPI inflation has since fallen back within the 0 to 3 per cent target range. CPI inflation for the year to September 2001 was 2.4 per cent, in line with our projections in the August *Statement*. Part of the rapid fall in inflation from its spike can be attributed to special factors, including the move to income-related rentals for Housing New Zealand tenants in the March 2001 quarter (which reduced the CPI by around 0.6 per cent in that quarter).

As with the June quarter outturn, the 0.6 per cent increase in the September quarter CPI was driven principally by large increases in a few important items, partly offset by a couple of items showing a large fall in price. Milk and meat prices drove a large rise in the food component of the CPI, while the annual increase in excise taxes for alcoholic beverages also made a significant upwards contribution. Offsetting these increases to some extent, petrol prices and airfares dropped sharply.

Annual tradables inflation continues to run well ahead of non-tradables inflation at 3.8 per cent in the year to September, compared with 0.9 per cent for non-tradables inflation. Annual tradables inflation excluding petrol prices was considerably higher at 4.8 per cent, while non-tradables inflation excluding the downward adjustment to Housing New Zealand rentals earlier this year was 2.2 per cent.

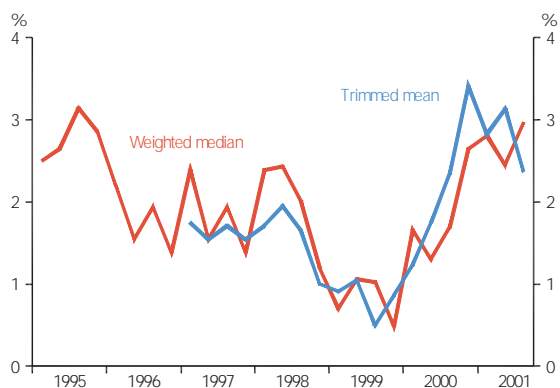
The considerably higher rate of tradables inflation reflects the influence of the fall in the New Zealand dollar during 2000 and high commodity prices, both of which have continued to drive up a range of domestic consumer prices over recent quarters.

However, with the non-tradables inflation series (excluding housing) having remained around the 2 to 2½ per cent mark for some time, there appear to be good reasons for believing that the spillover from higher tradables inflation to other domestic prices has been limited. Likewise, the stability in non-tradables inflation provides grounds for believing that the persistent component of inflation – that component influenced by expectations and the balance of supply of and demand for productive resources – remains well contained. Inflation in the non-tradables series (excluding housing) usually

exceeds tradables inflation, but has remained close to its long run average over recent times.

The influence of the exchange rate on tradable goods prices may have affected other measures of the central tendency of inflation, such as the weighted median and the trimmed mean. For example, weighted median inflation (calculated from the annual percentage change in CPI items) was 3.0 per cent in the year to September 2001, up from 1.7 per cent a year earlier (figure 18). It has to be acknowledged, however, that if these measures are instead picking up a genuine jump in domestic inflation, doubt would be cast on the low-spillover conclusion drawn from our estimates of non-tradables inflation.

Figure 18
CPI inflation measures²³
(annual percentage change)



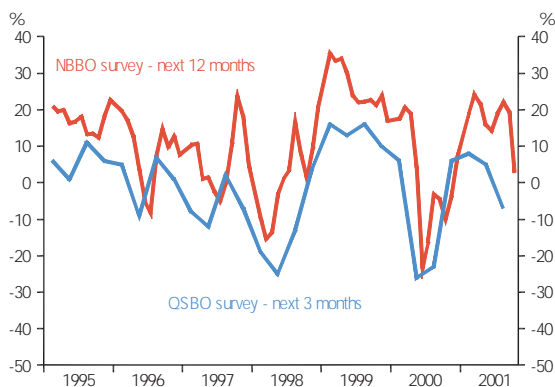
Just as these backward-looking indicators present a mixed picture, some forward indicators of persistent inflation have also provided contradictory signals recently. Some key indicators in this regard include those for profit margins, labour costs, pricing intentions and inflation expectations.

A possible insight into the behaviour of margins can be gleaned by looking at the GDP deflator, adjusted to exclude export prices. This measure, in principle, provides a broad measure of domestic sources of inflation; it rose 2 per cent over the year to June after falling during 2000. This is consistent with some element of re-building of profit margins over recent times, but not at a very rapid pace.

²³ Source: RBNZ

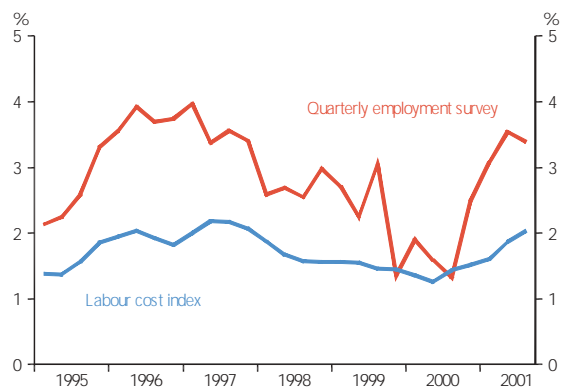
In contrast, the Producer Price Indices provide little evidence that margins have been increasing of late. In the year to June 2001, the index for input prices rose 8.1 per cent while the index for output prices rose 6.1 per cent, with input prices rising at a similar rate to output prices over the latest quarter. Survey results on expected profitability indicate that firms expect profitability to be under renewed pressure over the months ahead. This *may* imply constrained inflation pressures arising from firms' perceived inability to restore compressed margins through price rises. However, the expected reduction in profitability may instead be due to expectations of softer activity rather than lower unit profits (figure 19).

Figure 19
Expected profitability²⁴
(net per cent of respondents expecting an improvement)



Turning to labour costs, measures of private sector wages obtained from the Quarterly Employment Survey, together with the Labour Cost Index, have indicated some pickup in wage pressures over the past 12 months, consistent with the tighter labour market (figure 20). However, part of this acceleration may have reflected wage earners' attempts to recoup real income lost due to the spike in inflation over late 2000 and early 2001. It remains to be seen whether wage inflation continues to accelerate going forward. Encouragingly, our business contacts suggest that pressure on demand for labour so far has not been a major driving factor behind wage increases. At the same time, these contacts also suggest little capacity to pass on higher labour costs in increased prices.

Figure 20
Private sector wage growth
(annual percentage change)



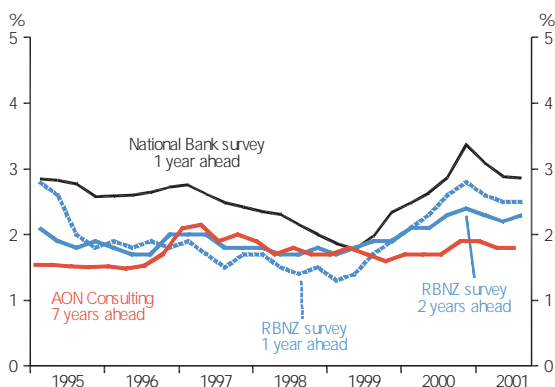
Pricing intentions (the net balance of firms planning to raise prices) have declined since peaking last year, although they remain at a reasonably high level. To some extent, upward pressures on inflation from the decline in the exchange rate are likely to be dissipating (given that the exchange rate has 'bottomed' over the past year or so). A small lift in pricing intentions in the September quarter QSBO appears to have been concentrated in the construction sector and is consistent with the recent lift in activity in the sector. More recently, the October NBBO suggests pricing pressures will fall over the next three months.

In general, inflation expectations have been fairly stable over the past six months. Year-ahead inflation expectations spiked during 2000, consistent with the spike in CPI inflation that was emerging. Encouragingly, most measures of inflation expectations that we monitor have edged down again (figure 21).

In summary, there seems to be only limited evidence of an increase in *persistent* inflation at a consumer level over recent times. The headline CPI continues to be driven mainly by large movements in a limited number of items, both up and down. Consistent with the evidence that demand pressure on productive resources was growing in the first half of this year, some of the forward indicators of persistent inflation have shown signs of increasing (most notably, higher labour costs). How those forward indicators resolve over the next two to three years is the central subject of the next chapter.

²⁴ Source: New Zealand Institute of Economic Research, National Bank of New Zealand.

Figure 21
Inflation expectations²⁵
(annual percentage change)



Monetary policy and the markets

Because it is well understood that we set the OCR with a view to affecting inflation outcomes in one to two years' time, new information bearing on the prospects for the economy tend to be quickly reflected in changes in private sector expectations of the OCR. Such changes can be seen by following the commentaries of financial market analysts, and by observing forward interest rates set by the collective actions of market participants.

Although the timing of our unscheduled 50 basis point reduction in the OCR on 19 September was something of a surprise to markets, expectations of a further cut to the OCR had been building ahead of the move. Market participants generally saw the move as being an appropriate reaction to the uncertainties created by the events of 11 September and the weakening global economy.

Following the move, markets were initially of the view that little in the way of further interest rate cuts was likely here, particularly in the short term. As a consequence, markets were not surprised that we chose not to adjust the OCR at the scheduled review point of 3 October.

Subsequently, expectations for the OCR have gradually shifted toward substantial further easings: a 50 basis point cut being expected in this *Statement*, and the possibility of a further cut in early 2002. The shift in view appears to have been

motivated by the combination of further weak economic data offshore, and the market's sense that recent New Zealand data indicated slowing domestic growth. Further weak international data have been taken as a signal of what is in store for the New Zealand economy via rapidly slowing demand for our exports of goods and services. And recent falls in domestic business and consumer confidence have been taken as confirming that New Zealand is unlikely to escape a period of economic weakness. With economic weakness probably implying lower inflation pressures, future OCR cuts are expected.

Financial markets are generally expecting that the OCR will have started to rise again, from a low of around 4.5 per cent, by the second half of 2002. This fits with the idea that a recovery of global growth will be underway by the middle of next year, a scenario that features in *Consensus* forecasts (see next chapter).

²⁵ Source: National Bank of New Zealand, RBNZ, AON Consulting New Zealand Ltd.

3 The macroeconomic outlook

Introduction

In August, we portrayed an economy that was in mid-cycle – neither too hot nor too cold – but with the likelihood of mild upward momentum. Mild upward momentum was in our view the (marginally) more likely outcome of the balancing of two forces: a weakening of global demand for our exports, and the lagged and ongoing effects of a weak real exchange rate coupled with reasonably good international prices for key commodities.

Since August, much has happened to amplify the power of both these forces in shaping our view of the future. As discussed in Chapter 2, it seems that the upward momentum of the domestic economy had been stronger than earlier estimated, to the extent that by mid-2001 the economy was experiencing some inflationary pressure on its capacity to produce. On the other side, it looks like global demand was already weakening by more than *Consensus* forecasts (our baseline for the world economy) allowed in August, even before the events of 11 September struck a substantial blow to confidence.

World growth is now expected to be well below trend, for a sustained period. A forecast based on *Consensus* forecasts (our regular practice) would reasonably project a sharp slowing in New Zealand growth but an early enough recovery to prevent the emergence of much slack in the economy. That, in a nutshell, is the projection presented in this chapter. In essence, this projection suggests that world events will remove a threat to future inflation that would at some stage have required higher interest rates, but not have such a big impact that deep cuts in New Zealand interest rates are required.

New Zealand, like Australia, is depicted as getting through this episode with positive growth throughout.

But the projection presented in this chapter is only one of many possible paths that the economy might take. It is easy to envisage both stronger and weaker outcomes, each featuring quite different but plausible responses of the international economy to an unusual configuration of events. Chapter 4 discusses alternative potential outcomes, making the point that the projection presented in this chapter probably does not have a significantly greater probability of coming to pass than outcomes on either side.

The world economy

Recent developments in the world economy were discussed extensively in Chapter 2. The key features of those developments are reflected in the latest *Consensus* forecasts (table 4). A period of very weak growth and a slow recovery are depicted; a profile that is similar to that experienced in the early 1990s. US weakness dominates the profile (though the forecasts for Japan remain the worst of all of the major economies), and Australia's relative strength is recognised.

The extent of the downward revision to *Consensus* forecasts between August and now – shown in figure 22 – is historically very large. It is not easy to differentiate how much of this downward revision is associated with the undoubted blow to confidence that has followed the terrorist attacks, and how much was already in the pipeline. It is our sense that both are significant components.

Table 4
Forecasts of export partner growth²⁶
(calendar year, annual average percentage change)

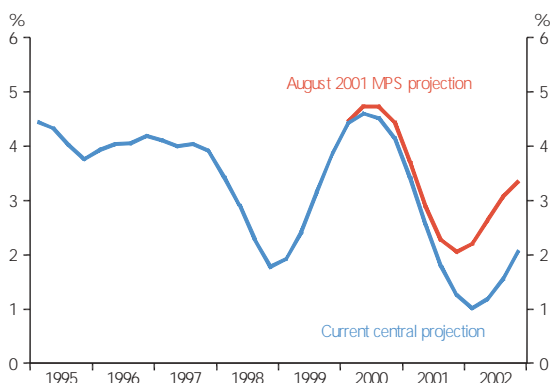
Country	1999	2000	2001f	2002f
Australia	4.7	3.3	2.1	3.4
United States	4.1	4.1	1.0	1.2
Japan	0.8	1.5	-0.5	-0.4
Canada	5.1	4.4	1.4	1.7
Europe-4 ²⁷	2.1	3.1	1.8	1.8
Asia ex-Japan ²⁸	6.7	8.6	1.5	3.6
14 country index	3.9	4.2	1.2	2.1

²⁶ Source: Consensus Economics Inc.

²⁸ Includes China, Hong Kong, Malaysia, Singapore, South Korea and Taiwan.

²⁷ Includes Germany, France, Italy, and the United Kingdom.

Figure 22
Consensus forecasts of export partner growth²⁹
(annual average percentage change)



How well the group of forecasters surveyed by *Consensus* has been able to sift through the implications of 11 September is yet to be seen. The same can be said for how well the group has assessed the effect of the quick policy responses already seen, and promised to come. A further tricky issue is judging the extent to which lower oil prices will continue to hold down the cost of running the world's industrial machine and transport system, offsetting the additional security-related costs of doing business and distributing product. There are no hard-and-fast rules that forecasters can use to assess how economies react to these confidence-breaking events. Box 2 suggests that the best rule of thumb is that there are no rules of thumb.

Recognising that considerable uncertainties exist, the projection reported in this chapter proceeds on the basis of the *Consensus* forecast numbers.

Box 2
A comparative analysis of US historical shocks

The events of 11 September have already had devastating consequences on people's lives. However, it is difficult to gauge what the consequences for the New Zealand economy will be. In this box, we look for clues from history, by examining the aftermath of other shocks – while noting that the causes, prevailing conditions and outcomes of each shock are different.

Our approach was simple. We took a range of shocks in which the US figured prominently, and summarised their economic implications by examining the behaviour of US and New Zealand GDP over four time periods: one year prior to the shock; the six months following the shock; the year following the shock; and the second year following the shock. We graphed the GDP outcomes as departures from their historical average, scaled by their standard deviations. We then looked for recurring patterns.

It is important to note that it is difficult to identify and isolate the effects of shocks in aggregate GDP data. The effects may be offset or reinforced by other shocks hitting the economy, by the varying duration of different shocks,

by the state of the business cycle, and by economic policies both at the time of, and in response to, the shocks.

Figures 23 and 24 graph the GDP growth outcomes for the US and New Zealand following a subset of the shocks included in our analysis. The list below provides a key for the shocks graphed in these figures.

1. June 1950: Outbreak of the Korean war
2. October 1962: Cuban missile crisis
3. November 1963: Assassination of President Kennedy
4. Early 1974: First oil shock (The dating is approximate here; this shock occurred over 1973/1974.)
5. April 1975: Fall of Saigon
6. Early 1979: Second oil shock
7. December 1979: Soviet invasion of Afghanistan
8. October 1987: Stock market crash
9. January 1991: Gulf war
10. October 1997: Asian financial crisis
11. September 1998: Collapse of Long Term Capital Management (LTCM)

²⁹ Source: Statistics New Zealand, Consensus Economics Inc.

We hazard a small number of lessons that we think we can draw from this relatively simple analysis:

- 1 Each shock is different. We have struggled to find repeat patterns – there are few, if any, of sufficient strength to warrant their use in a predictive manner.
- 2 One corollary of the lack of strong repeat patterns is that one cannot conclude that shocks of great importance at their moment of impact will have lasting adverse consequences on economic activity. To illustrate, out of eleven shocks that one might have presumed would raise fear and anxiety, US GDP growth was **above** average one year later on more than **half** of the occasions.
- 3 The stronger the US economy was leading up to a shock, the less negative was the initial impact of the shock. However, the prevailing conditions leading into the shock do not appear to help in identifying the economic impact at longer horizons.
- 4 However, the initial impact of a shock may indicate the probable medium term consequences. For US GDP, there were four occasions where the initial impact was to drop GDP growth below average. On all of these occasions, GDP growth was below average one and two years later.
- 5 Although many of the shocks examined in this paper have led to impacts of more than one standard deviation for the US, few have similarly impacted New Zealand. This is perhaps not surprising given that the shocks considered here had a prominent US element. And it does suggest that New Zealand will not *necessarily* catch the flu if the US sneezes.

Although New Zealand GDP growth displays more volatility than US GDP growth, it does not appear to be the case that these particular shocks have been responsible for this difference in volatility.

New Zealand GDP growth has been slightly below average in the second year following many of the shocks considered here – especially the later shocks. One reason

why this relationship did not prevail for the earlier shocks may be due to the fact that the New Zealand economy has become more integrated with the US economy over time.

Figure 23
United States GDP growth³⁰

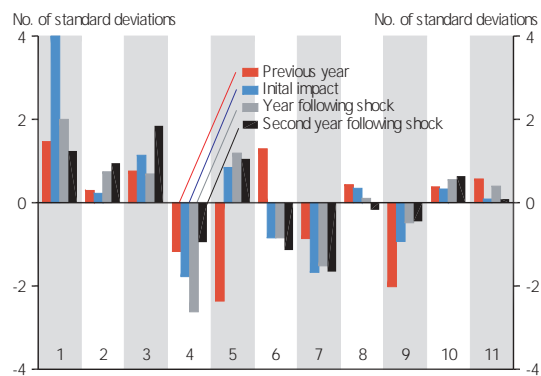
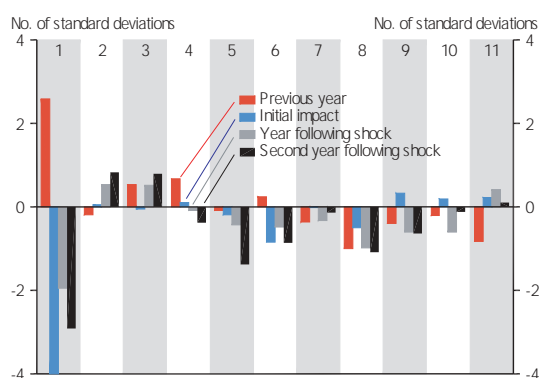


Figure 24
New Zealand GDP growth³¹



³⁰ Source: Datastream, Statistics New Zealand

³¹ Source: Datastream, Statistics New Zealand

Export activity and incomes

For some time we have been expecting export income growth to go into reverse, as slowing global demand means that fewer people buy our exports and that prices received on world markets for key exports subside. We have also been assuming – on a technical basis – that the exchange rate will gradually appreciate towards more normal levels. Such an appreciation would also reduce export incomes in New Zealand dollar terms.

The very latest indications suggest that prices are indeed beginning to fall back sharply. These indications, together with the deepening of the global slowdown (and the associated spreading from technology-focused industries to a wider range of activities), reinforce the idea that export incomes will soon shrink. We are therefore projecting export receipts in the year to March 2003 to be around 10 per cent lower than for the previous year, about twice the pace of decline that we projected in August.

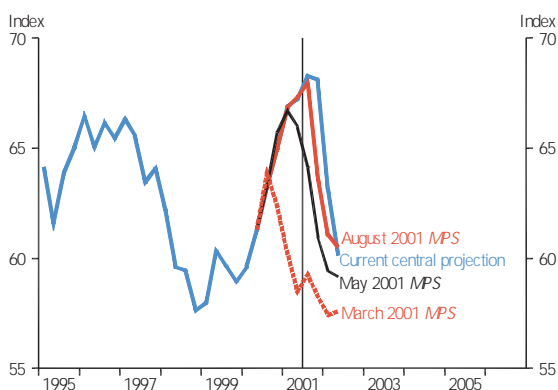
Weaker prices are the main factor behind the projected weakness in export income, although export *volume* growth is also projected to slide from around 5 per cent per annum at present, to about half of that pace over the coming year. At that modest pace, export volume growth will still be positive. That stands in sharp contrast to the recent experience of other countries more dependent on the US market and the specific vagaries of the technology sector (Taiwan's exports, for example, fell by 43 per cent over the latest year; Singa-

pore's non-oil exports were down 30 per cent in the month of August alone).

There are three reasons why New Zealand's export prospects are less affected. First, with such a low real exchange rate, we expect that New Zealand exporters will be able to at least sustain their share of the markets in which they compete, by adjusting prices. Price-competitiveness explains some of the recent volume growth for non-commodity exports (of both goods and services), notwithstanding slowing demand growth in increasingly tough export markets. Secondly, Australian growth is expected to remain robust by comparison with the rest of the world. Thirdly, the volume of primary exports is supply-determined – for the most part, we are able to sell the volumes that past production decisions and Mother Nature determine are available (albeit at prices that world markets dictate). Absent major climatic events,³³ ongoing growth in dairy and forestry production (in particular) is likely over the next few years.

Tourism is one area where swings in demand have the potential to be large and to impact quickly on volumes. In the circumstances of greatly increased nervousness about the safety of flying, we think that net exports of tourism will indeed slow early on. Having said that, there is some prospect that tourism exports will see a quick bounce back, if New Zealand comes to be viewed as a safe destination and as willingness to travel by air returns.

Figure 25
Export price forecasts³²
(from successive Monetary Policy Statements)



³² Source: RBNZ

Fiscal policy

As usual, we have based our projection of the fiscal position on the Treasury's latest forecasts (those prepared for the 2001 Budget), adjusted for recent out-turns and our updated macroeconomic outlook. The government's operating balance is expected to remain in surplus throughout the projection period, with those surpluses gradually increasing to reach around 2½ per cent of GDP by the March 2004 year. This

³³ Immediate concerns about dry conditions have receded somewhat over the past month following good rainfall in many parts of the country. However, aquifers are still low (reflecting the dry winter) and expected waterflows from the snow melt are expected to be below average and insufficient to fully recharge them. Experts advise that dry conditions could therefore potentially become a problem again over the summer months, but our projections are not *assuming* major effects on production.

track is essentially unchanged from that contained in our last projections, notwithstanding the significant cut-back to our growth forecast for the middle part of the projection period. Why? Because changes to the pace of activity tend to take some time to impact on government spending and revenue collections. With a stronger starting point for the economy, a period of weaker growth, then an early rebound, these lags smooth out the impact on the fiscal bottom line.

On the face of it, this tendency for the fiscal surplus to increase suggests a mildly contractionary influence on the macro economy. However, one should also allow for capital spending, which is not included in the operating balance. With allowance for capital expenditures that involve a claim on real productive resources, over the projection period fiscal policy will probably be roughly neutral as an influence on aggregate demand. In saying this, we make no allowance for any changes in the timing or scale of government capital expenditure relative to that already announced.

Domestic spending and activity

Data reviewed in Chapter 2 indicate that the strength and persistence of the boost to export incomes over the last two to three years had started to loosen the purse strings of the immediate beneficiaries – farmers, and other exporters selling into strong markets. Their spending was starting to impact on more and more of the economy, although there remained some (predominantly urban) areas that were yet to feel the benefit.

As previously explained, the slowing of global demand from around mid-2000 carried the seeds of a potential reversal of direction for export sector incomes. But with the real exchange rate remaining low, with Australia remaining strong, and with the lock-in effects of contract pricing and exchange rate hedging, that reversal still left incomes at relatively high levels. In other words, there was every reason to expect that exporters would continue to support domestic activity through their spending on investment and consumption goods, notwithstanding further global weakness.

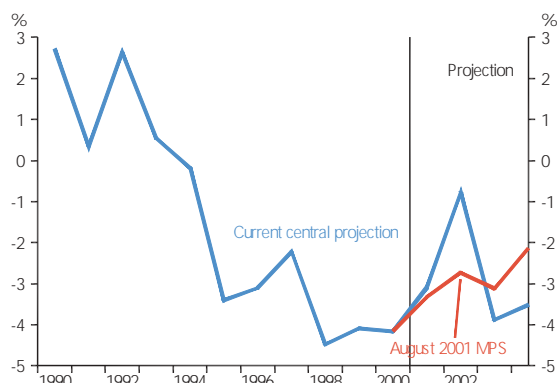
Since 11 September, the global slowdown is now more prominent in people's minds. A marked slowdown was on

the cards anyway, but there is little doubt that the terrorist attacks have hurt confidence – for consumers as well as businesses. Now, with the shock to confidence having significantly increased sensitivity to business and other risks, the constraining effect of declining global demand will be much greater. And confidence-related shocks to demand can have self-fulfilling properties, as we observed through the middle part of 2000.

Quite conservatively, in these projections we have allowed for exceptionally slow growth of consumption from around now until the middle of 2002. Why “quite conservatively”? Because it would be historically unusual for consumption growth to slow much in advance of tangible evidence of weaker employment or income growth prospects. Nonetheless, reports from retailers and other anecdotes suggest that such an unusual timing pattern is being seen. If we are correct, we will also see a long overdue rise in household savings relative to household income – although only temporarily, and still leaving household sector savings slightly negative (see figure 26).

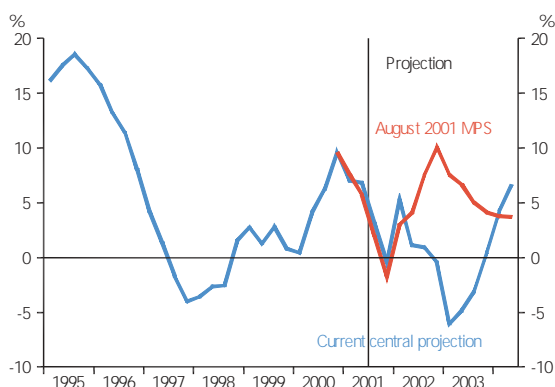
In contrast, investment spending probably won't immediately slow by much, as projects well advanced in the pipeline go forward. But a pause in commitments to new projects, as businesses wait to see how their particular markets will be affected, will produce a significant slowing in actual investment spending as we go further into 2002. Figure 27 compares the track for investment expenditure that is

Figure 26
Household savings rate³⁴
(per cent of disposable income, year to March)



³⁴ Source: RBNZ

Figure 27
Business investment³⁵
(annual average percentage change)



contained in this projection with that contained in the August *Statement*, revealing the large scale of the allowance that we have made for an adverse confidence shock.

In relation to both consumption and investment, we presume that confidence will recover through next year as uncertainty abates, as evidence of a global recovery emerges, and as it becomes clear that New Zealand's growth rate is remaining in positive territory. As confidence recovers, so too will spending.

Overall, growth slips from its current rate of around 3 to 4 per cent (abstracting from considerable quarterly volatility) to around 1½ per cent by the end of 2002, before recovering to a slightly above-average pace thereafter. The combined impact of shocks to global demand and to local confidence will be large but temporary.

The evolution of inflationary pressure

As recently as August, ongoing growth of output at least as fast as growth in productive capacity seemed likely to add progressively to medium-term inflation pressures, just as other developments were causing measured inflation to drop back. We judged that somewhat higher interest rates were probably going to be needed at some point to ensure that inflation's reversion to the middle of the target range would be sustained.

The situation now looks different. Whereas the previously-expected gradual accumulation of inflation pressure was estimated to start from a roughly neutral position, we now believe that productive resources were already somewhat stretched by mid-2001. (That possibility had been flagged in our August *Statement*, on the basis of partial indicators of the intensity of utilisation of resources.)

On the other hand, the forward growth profile is now much weaker, at least over the first half of the projection period. By the second half of 2002, the unemployment rate is projected to be rising (towards 5½ per cent by March 2003), and capacity utilisation is projected to have fallen back noticeably. Together, these developments will begin to put downward pressure on inflation, downward pressure that would be greater had interest rates not been cut on 19 September. Renewed growth through 2003 – the growth rate is projected to return to around 3 per cent by the end of that year – following a world recovery and supported by a real exchange rate that is still mildly stimulatory should mean that the downward pressure on inflation is short-lived.

Our view of the implications of this growth cycle for inflation pressure takes account of the recent sharp upswing in inward migration. However, the balance of inflation pressure is not assumed to change much as a result. As Box 3 discusses, the increase in demand (for housing, consumer durables, etc.) that will be associated with such a migration pattern will be offset by the addition to the labour supply that also comes with immigration. In contrast with our experience in the mid-1990s, in the years ahead we expect a closer balance between these two effects.

A drop in the annual rate of CPI inflation from close to the top of the inflation target band to nearer the middle will not happen immediately. With the lagged effects of past exchange rate depreciation still trickling through, and with the effects of strong international commodity prices still impacting on local prices for dairy and meat products, quarterly rates of inflation will remain above trend for a couple of quarters yet. As a consequence of the March 2001 quarter's negative inflation – associated with the reduction in Housing New Zealand rents – dropping out of the annual rate of change calculation, we expect that the March 2002 inflation rate will blip up from just under 2 per cent in the year to December 2001 to just over 2½ per cent.

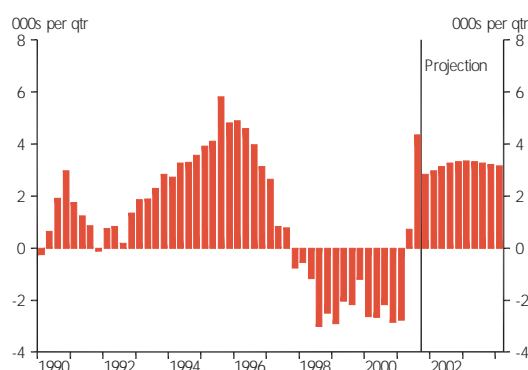
³⁵ Source: Statistics New Zealand, RBNZ

Box 3 – Net migration

A notable feature of recent economic developments has been the rapid turn-around in net migration (see figure 28). Although we expected to see migration turn from net outflows to net inflows as the New Zealand economy continued to perform relatively well, this turnaround has happened more rapidly than we were expecting.³⁶

The turn towards net migration inflows raises the question of whether this is likely to trigger a surge in demand and inflationary pressure similar to that which resulted from the migration boom of the mid-1990s. The answer to this question will depend on whether the recent migrants contribute more to overall demand for goods and services than to the economy's ability to supply these goods and

Figure 28
Net migration of persons of working age
(permanent and long term, seasonally adjusted)



services.

On the demand side, a net increase in the number of arrivals typically leads to an increase in overall demand, for both durable assets such as houses and cars, and for non-durable goods and services. However, if new migrants work in New

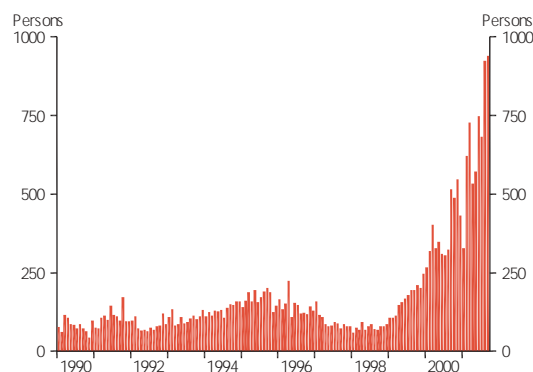
³⁶ A change in Australian immigration policy that led to departures being unusually high between December 2000 and February 2001 and unusually low in the months following has exaggerated the sharpness in this turnaround. From 26 February 2001, a policy change made it more difficult for New Zealanders to receive social security payments when living in Australia. This led some New Zealanders who would otherwise have departed for Australia after 26 February to bring their departures forward so as to arrive in Australia prior to the change.

Zealand, this adds to the supply of available workers in what is currently a tight labour market. If new migrants add to demand and supply in roughly equal measure, then there should not be any significant implications for inflationary pressure from an increase in net migration. However, if new arrivals are adding more to overall demand for goods and services than to the total supply of goods and services then inflationary pressure will result.

The relative contribution of migrants to demand and supply will depend heavily on the composition of migration flows. For example, the strong migration inflows of the mid-1990s were a source of inflationary pressure because many new arrivals at that time were relatively wealthy. A period of strong demand – particularly in the housing market as new arrivals purchased homes – resulted in inflationary pressure.

One notable feature of the composition of recent migration inflows is the sharp increase in the number of young Asian (particularly Chinese and Korean) students coming to study in New Zealand (see figure 29).³⁷ Although these students make up only around 10 per cent of total arrivals, their rapid growth accounts for about a quarter of

Figure 29
Monthly arrivals of North Asians aged 15-24 years
(permanent and long term, seasonally adjusted)



³⁷ It is not possible to get exact data on the number of long-term arrivals who have come to New Zealand for the purpose of study. Given that the recent surge in foreign students originates predominantly from China and Korea, we use long-term arrivals of persons aged between 15 and 24 from North Asia as our proxy for arrivals of foreign students.

total arrivals growth over the past 18 months. Because overseas students are unlikely to undertake paid work while in New Zealand but will be purchasing goods and services while here, they are likely to contribute more to overall demand than to supply. However, students are unlikely to be particularly large spenders, and so the scale of this asymmetry should be relatively small.

Leaving students aside, at this time we have no particular reason to believe that new arrivals to New Zealand will have asymmetric effects on total demand and supply. Thus although we are assuming continued net inflows of migrants

(see figure 28), our projections assume that migration inflows will boost total demand and the economy's productive capacity in roughly equal measure. Migration inflows are therefore not expected to be a key driver of inflationary pressure in the way they were in the mid-1990s.

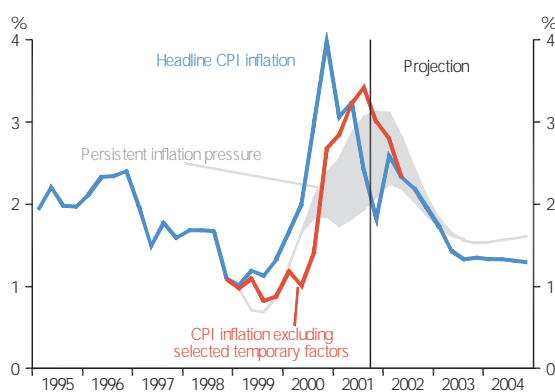
We are, however, mindful of the possibility that net inward migration could again have materially asymmetric impacts on demand and supply, resulting in more inflationary pressure than we are currently anticipating. As always, we will be reassessing the validity of our assumption as new information comes to hand.

The interaction of these factors is illustrated in figure 30. As explained in previous *Statements*, the grey shaded area in this chart depicts a range of alternative estimates of persistent inflation pressure. The upper part of the shaded area allows fully for the historically "normal" influence on price- and wage-setting behaviour of the degree of stress or slack in the economy. It also makes a substantial allowance for the possibility that that price- and wage-setting behaviour has

Overlaid on this synthetic depiction of persistent inflation pressures are our projections for headline CPI inflation (the blue line), and the headline measure adjusted for three specific factors³⁹ (the red line).

Figure 30 shows that the upper bound of the shaded area is now placed so that the peak occurs about two quarters later than we previously thought, and higher – just above 3 per cent. This is consistent with the idea that productive capacity was indeed becoming somewhat stretched in the first half of 2001, and with the idea that price- and wage-setting behaviour has been disturbed by the 4 per cent headline inflation rate recorded in the year to December 2000. Even if this upper bound were a reasonable representation of persistent inflation pressures, given its early reversion towards 1½ per cent, it remains quite a benign view of inflation developments. The quick reversion to the centre of the inflation target range occurs because that headline inflation spike is in the process of being reversed – so any disturbance to inflation expectations is short-lived – and because pressure on productive capacity is projected to abate quickly over the next few quarters.

Figure 30
Inflation and inflation pressure³⁸
(annual percentage change)



been strongly affected by the recent spike in headline inflation. The lower part of the shaded area makes no allowance for price- and wage-setting behaviour to have been disturbed by the recent spike.

As discussed in Chapter 2, our reading of the latest inflation indicators leads us to the view that there are few if any signs of persistent inflation pressures building. For this reason, there

³⁸ Source: RBNZ.

³⁹ Changes in petrol prices since early 1999, tobacco excise tax increases measured in the June and September quarters of 2000, and state house rental reductions measured in the March quarter of 2001.

is some possibility that the lower bound of this grey shaded area is at present a better representation of the fundamental drivers of the inflation process in New Zealand. This would imply that virtually all of the recent increase in measured inflation from the centre of the inflation target range has been associated with the combination of temporary special factors and pass-through of past exchange rate depreciation. Looking further ahead, as commodity prices fall back, and to the extent that the exchange rate begins to appreciate (as we assume), weak tradable sector inflation will begin to drag headline inflation down as 2002 progresses.

What of wage developments – wage growth potentially being an important indicator and indeed component of persistent inflation? Our wage growth assumption – that wage growth rises to a peak of just over 4 per cent in late 2001 before falling back to between 2 and 3 per cent per annum by late 2003) – roughly mirrors the profile of CPI inflation, but with a lag.

That wage growth would mirror CPI inflation should be unsurprising since, to some extent, one expects CPI inflation outcomes to affect wage bargaining. After all, ultimately people are bargaining over real wages. But peak wage growth is not expected to exceed peak CPI inflation by very much, reflecting that wage developments are heavily influenced by the product market conditions faced by employers.

Allowing for productivity growth and for relatively weak exchange rate pass-through into CPI prices, the modest growth of wages means that the nominal exchange rate's depreciation has been substantially preserved in real terms, making New Zealand more competitive on the world stage. That greater competitiveness should help New Zealand get through this world growth recession without itself going into recession, and with recent employment gains largely intact.

Monetary policy's response

Monetary policy in New Zealand is directed towards keeping inflation within the 0 to 3 per cent target range. The projections outlined above already incorporate the monetary policy responses necessary to achieve the target outcome. As it happens, *given the assumptions used to generate the projection*, re-convergence of inflation to the middle of the

target band occurs without significant changes to interest rates (from the level established on 19 September). Of course, actual policy decisions may differ from the projections, reflecting risk assessments and other judgement factors.

In contrast, reasonably significant interest rate changes are expected by financial markets. Forward interest rates and the commentaries of market analysts both suggest that short-term interest rates are likely to be further reduced over the next few months. The difference between the inflation-stabilising 90 day interest rate track in this projection, and the 90 day interest rate track that is implicit in current market interest rates, is shown in figure 31. This difference highlights that views of the current and likely future path of the economy can easily differ, especially in conditions of great uncertainty. Sources of difference often relate to the assumptions used.

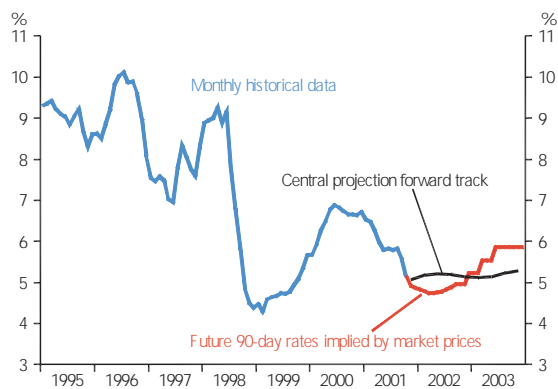
To illustrate:

- Current financial market prices, which are used to derive the market's implicit forecast of short-term interest rates in figure 31, may be embedding a more negative view of world prospects than is contained in the *Consensus* forecasts.
- The projection contained in this chapter starts from the position that by mid-2001 the economy's resources were already more than normally utilised. The accuracy of this assessment cannot be established definitively. Others have interpreted the degree of pressure on resources as being less. As a consequence, cuts to the growth rate would imply the emergence of more spare capacity than our projections have allowed, and thus more downward pressure on inflation than our projection contains.
- The intensity of utilisation of the economy's productive resources, and the direction of change in that intensity, are both relevant to the likely future development of inflation pressure and therefore of required policy settings. How much weight is given to the pace of growth, and how much is given to the output gap, may change one's view of inflation pressure. In the projection presented in this chapter, a sharp slowing of growth produces only a small negative output gap, because of the high starting point, and because a quick recovery is presumed. The small size of the negative output gap implies little downward pressure on inflation: a greater allowance for

the influence of sub-par growth would produce a weaker assessment of inflation pressure.

- More generally, setting interest rates requires allowance for policy risk management considerations. The projection presented here does not do this. The issue of risk management is a topic for the following chapter.

Figure 31
90-day interest rates⁴⁰



⁴⁰ Source: RBNZ

4 Policy Issues

In the world of monetary policy, the phrase “more than usual uncertainty” appears all too readily as central bankers struggle to make sense of new and conflicting data and to justify their latest decision. However, the phrase is hard to avoid at this time. While not wishing to over-emphasise the macroeconomic significance of the events of 11 September, there can be little doubt that they have had an impact on business and consumer confidence, as well as on the way companies and individuals around the world go about their daily business. What no one fully understands at this stage is how big that net impact will be over the longer term, or how those impacts might be distributed.

As discussed in Chapters 2 and 3, whatever the direct economic consequences of the events of 11 September, it is clear that they came at a time when the global economy was at a point of some fragility. The indirect consequences, for that reason, may be somewhat magnified. We had seen the *Consensus* forecasts for our trading partners’ growth rates progressively downgraded through the course of 2001. For a while before September there had been something of a debate amongst analysts on whether the US economy had found at least a temporary “bottom” to its cycle. Little of that sentiment was evident by the end of the month.

In this global context, Australia and New Zealand have been standout economies. The question for monetary policy has for some time been how well or for how long that relative out-performance can be maintained in a weak global setting.

From March of this year, the Bank has been reducing the OCR, driven primarily by the emerging evidence of slowing growth amongst our trading partners, and the expected future impact of that on domestic conditions. Throughout, we have been mindful of the support for activity provided by reasonably good commodity prices and the weak exchange rate – in effect offsetting the effects of the weakening world economy. Evidence of a slowdown in the pace of activity in New Zealand has to date not been overwhelming, suggesting that the commodity prices and the exchange rate have been an important buffer between us and the rest of the world.

We have also been very mindful that headline CPI was at or above target from September 2000 through until June 2001, and will likely return to be close to the top of the target range

in the year to March 2002. The longer that situation persists the greater the risk that inflationary expectations are encouraged to rise. With that comes a danger that we find ourselves, at some point, requiring a prolonged period of stringent monetary policy in order to bring those expectations back into accord with our inflation target range.

Our policy judgements through 2001 have, as a consequence, required a fairly delicate balancing of risks. Reducing the OCR has been a pre-emptive strategy, based on an assessment that offshore weakness will outweigh the buffers that have protected New Zealand thus far. But it is a strategy that has been cautiously applied, in view of the considerable uncertainties prevailing.

Where to from here? These considerable uncertainties have just been magnified, substantially.

Chapter 3 contains a projection based on a straight application of reasonable assumptions about how the global events will play out, and how the New Zealand economy will respond. It uses *Consensus* forecasts for its view of our trading partners’ prospects – a profile characterised by a sharp drop in growth from high levels earlier this year, and a reasonably rapid international recovery through the course of 2002. The outcome is a sharp but brief slowdown in New Zealand growth. Given a starting point which presumes some incipient inflation pressures with the domestic economy pushing against its output potential, this track embodies some easing of future inflation pressures, but does not produce a great deal of downward inflation pressure – hence the fairly flat forward interest rate path at around current levels. This outcome is at least supportive of our judgement that the 19 September cut to the OCR was of about the right magnitude.

Some allowance has been made within this projection for the additional impact of shocks to confidence, over and above the normal influences that come from abroad through changes in demand for our products and changes in the associated prices. But, inevitably, the allowance for the effect of abnormal circumstances will be incomplete.

That this is an abnormal circumstance is obvious. This is not just a slowdown in the US economy. What distinguishes the current situation from, for example, the 1997 Asian crisis, is the coincident slowdown in the US, Europe and Asia. Indeed,

in some respects, the situation in Asia now looks almost as problematic as in 1997. While it is not experiencing the same sort of high-visibility financial crises that characterised 1997, Asia is faced with the need for major structural reforms. It does not have the benefit that it enjoyed in 1997 of a rapidly growing US market for IT and related electronics goods to provide a cushion as that adjustment takes place.

Moreover, there seems little reason to expect an early recovery in the world's second largest economy, Japan. To complicate matters still further, Europe appears to be more tightly correlated with developments in the US than perhaps some of its policy-makers had expected. As with Asia, there is no obvious reason to expect that Europe will return to robust growth ahead of the US.

A more protracted period of sluggishness than the *Consensus* forecasts allow is therefore quite possible. The slower growth path could emerge as a consequence of such influences as brittle consumer and business confidence, equity-market-related wealth effects, an upgrading of estimates of the extent of previous over-investment, and dramatically higher costs of capital.

But greater sluggishness is not the only possibility. A rapid US recovery from perhaps the second quarter of 2002, fuelled by generous lashings of fiscal and monetary stimulus, is well within the range of reasonable outcomes.

Adding to the array of uncertainties, within New Zealand there have been important changes in the way the economy responds to events. In particular, inflation and inflationary expectations have remained well anchored despite a roughly 30 per cent decline in the exchange rate, on a TWI basis, over the past four years. That is a clear shift from the patterns we have seen in the past. The projection contained in Chapter 3 allows for some of this change in behaviour, but possibly not enough.

In circumstances such as we face currently, the projection outlined in Chapter 3 is best treated as a benchmark against which to consider the risks and uncertainties relevant to our policy call, rather than necessarily seeing it as the most likely outcome. On balance, we think that the downside risks to the world economy, relative to the *Consensus* forecasts view, are probably a little greater than the upside risks. And it is possible that the allowances made within the projections for

the dislocations associated with sharp drops in confidence underplay the likely effects.

On top of the balance of risks around the likely future course of inflation pressures, there is also a policy risk assessment to be undertaken. What policy mistake would be the worst to make?

In current circumstances, the policy risk assessment is quite difficult. Holding interest rates too high could exaggerate the existing confidence shock, and in these circumstances disproportionately amplify the downturn. On the other hand, given the recent track of headline inflation, the attendant risks to inflation expectations, and more particularly the long-term economic costs associated with allowing expectations to drift up, the risks attached to dropping interest rates too low are not trivial.

Given this considerable uncertainty, the temptation is to move cautiously and with a close eye on developments around us, and that indeed is what we have been doing through much of 2001. The cautious succession of OCR moves since March – backed by a progressive updating of our view as new data became available – has served us well. However, as the move on 19 September demonstrated, there may be occasions when even a cautious approach to changing circumstances will warrant a departure from standard practice. Prudence is not to be confused with inaction. As events unfold, we may again need to move quickly.

At the same time, we need to remain alert to the ease with which particular risks or developments can be exaggerated or double-counted. In this context, and as a useful illustration of the point, we need to keep firmly in mind that our benchmark track already encompasses a very sharp decline in export prices. Should it become apparent that the downturn in the international economy is having an impact on export prices over the next few months, the question to be asked is whether that impact is more or less than already projected. Evidence that export prices are indeed declining will not, of itself, provide a reason for further action on our part.

Finally, and perhaps most awkward, we need to remain alert to the possibility that there are structural or behavioural shifts underway in the economy. Our forecasting is drawn, inevitably, from a study of past relationships. Should it

transpire, for example, that the relationship between measures of capacity utilisation and future inflation pressures has shifted, or that New Zealanders have become less responsive to the influence of lower interest rates, we will need to be alert to those sorts of possibilities and draw them into our decision-making processes. These are not judgements that can be made quickly or lightly. We will continue to review and analyse recent data and adjust our thinking as analysis of the evidence warrants.

We are in unusual times. Monetary policy cannot insulate New Zealand from the ailments of the global economy. But by being alert to emerging information and being ready to respond in line with its familiar mandate, monetary policy can help to moderate the impact of an international chill. It can also help limit the risks associated with presuming the worst and finding subsequently that one's fears were – as fears are inclined to be – exaggerated.

Appendix 2

Companies and organisations contacted by RBNZ staff during the projection round

Advantage Group Limited	Lyttleton Engineering Ltd
Air New Zealand Limited	Lyttleton Port Co Ltd
Alliance Group Ltd	Meco Engineers
ANZ Banking Group (New Zealand) Limited	Meritec Ltd
Architecture Warren & Mahoney Ltd	Mobil Oil New Zealand Limited
ASB Bank Limited	NGD Pine Ltd
ABB Ltd	New Zealand Timber Industry Federation Inc.
Auckland Regional Chamber of Commerce and Industry	New Zealand Tourism Board
Bank of New Zealand	Otago Furniture Company
Bayleys Real Estate Ltd	Pacific Helmets (NZ) Ltd
Beca Carter Hollings & Ferner Limited	Polson Higgs & Co
Bissett Engineering	Ports of Auckland Ltd
BP Oil New Zealand Ltd	Port Otago Ltd
Bullock & Co Ltd	Powerco Ltd
Caltex New Zealand Ltd	PriceWaterhouseCoopers
Canterbury Meat Packers Ltd	Printlink
Capital Properties New Zealand Limited	Restaurant Brands New Zealand Ltd
Carter Group Ltd	Richardson, H.W. Group Ltd
Carter Holt Harvey Panels - MDF	Robinson Industries Ltd
Centreport Ltd	Sanford Ltd
Christchurch International Airport Limited	Sealy New Zealand Limited
Classic Manufacturing Ltd	Skellerup Industries Ltd
Compaq Computer New Zealand Limited	Southward Engineering Co Ltd
Designline Limited	Steel and Tube Holdings Ltd
Deutsche Bank, New Zealand Branch	Suzuki New Zealand Ltd
Doug Hood Ltd	Taranaki Newspapers Ltd
Federated Farmers of New Zealand Inc.	Taranaki Sawmills Ltd
Feltex Carpets Limited	The National Bank of New Zealand Limited
Foodstuffs (Wellington) Co-operative Society Ltd	The Southland Times Co Ltd
Frontline Finance Holdings Ltd	Ullrich Aluminium Ltd
Gallaway, Cook, Allan	Unisys New Zealand Limited
Globe Export Fisheries Ltd	Vodafone New Zealand Limited
Goulds Fine Foods	Wanganui Gas Ltd
Harcourts Group Limited	Wanganui Newspapers
Hayes and Sons Ltd	Westgate Transport Limited
Independent Newspapers Ltd	Westpac Banking Corporation (New Zealand Division)
Invercargill City Council	Wilson & Horton Ltd
Landbase Trading Society Ltd	WK Backhouse Ltd
Long Plastics Ltd, Christchurch	Woolworths (NZ) Ltd

Appendix 3

Reserve Bank statements on monetary policy

OCR unchanged

15 August 2001

The Reserve Bank today left the Official Cash Rate unchanged at 5.75 per cent.

Speaking at the release of the Reserve Bank's August *Monetary Policy Statement*, Dr Brash said " Reasonable estimates suggest that so far the 'underlying trend in prices' remains well within the target range and, on present assumptions, the CPI should track back to somewhere near the middle of our inflation target by mid next year.

" But, there are risks to that relatively benign assessment.

" Inflation could turn out to be more persistent than currently seems likely. There are an increasing number of indicators suggesting that the economy may be operating slightly above full capacity. Also, if headline inflation remains close to the top of the target range, the risk is that inflation expectations may go up, leading to adverse consequences for wage- and price-setting.

" Indeed, with businesses confident about the outlook for their own activity, rural sector incomes at their highest level in many years, employment intentions at near-record levels, and strong signs of a pick-up in both confidence and activity in residential construction - previously one of the most sluggish parts of the economy - we have no reason to date to regret the relatively cautious manner in which we have reduced the Official Cash Rate in recent months.

" The current situation would point to an early increase in the Official Cash Rate were it not for the risk that the international environment will turn out to be even weaker than assumed. The flow of economic indicators from the United States, Japan, non-Japan Asia and Europe makes a deeper and more prolonged slowdown seem quite likely. If the international environment were to turn out substantially weaker than our projections have allowed, there seems little doubt that the disinflationary pressures on New Zealand coming from overseas would intensify. As a result, inflation could fall into the bottom half of our target range and this would necessitate further easing of monetary policy.

" Given the balance of risks that the Bank faces, leaving the Official Cash Rate unchanged seems appropriate for the moment," Dr Brash concluded.

External monetary policy advisors appointed

6 September 2001

The Reserve Bank today announced the appointment of two part-time external monetary policy advisers.

The appointees are Dr Brent Layton and Ms Kerrin Vautier.

Both will participate in the preparation of analysis and advice ahead of the Reserve Bank's quarterly *Monetary Policy Statements*.

Dr Layton is a professional company director from Christchurch and is currently chair of Lyttelton Port Company Ltd and a number of other companies.

Ms Vautier is a consulting research economist from Auckland. She lectures part-time at Auckland University, holds a number of directorships and chairs the New Zealand Committee of the Pacific Economic Co-operation Council.

Reserve Bank Governor Don Brash commented " These innovations follow on from suggestions that emerged as a result of Professor Svensson's *Independent Review of the Operation of Monetary Policy*. They are also part of the Bank's ongoing effort to be well-informed about developments in the New Zealand economy and to bring additional outside perspectives into our processes.

" For the same reason, in recent months the Bank has expanded its programme of visits to businesses and sector groups, and has invited senior central bankers from other countries to participate in the lead-up to *Monetary Policy Statements* and provide feedback on our processes. Our goal is to continue to achieve excellence in formulating monetary policy by actively challenging, reviewing and improving the way we work."

Dates for OCR announcements in 2002

11 September

The following is the Reserve Bank's schedule for the release of its quarterly *Monetary Policy Statements* and Official Cash Rate announcements for 2002. Each *Monetary Policy Statement* includes within it an OCR announcement, so in total, as usual there will be eight OCR announcements during 2002.

23 January OCR announcement

20 March *Monetary Policy Statement*

17 April OCR announcement

15 May *Monetary Policy Statement*

3 July OCR announcement

14 August *Monetary Policy Statement*

2 October OCR announcement

20 November *Monetary Policy Statement*

The Reserve Bank reserves the right to make changes to this schedule, if required due to unexpected developments. In that unlikely event, the markets and the media will be given as much warning as possible.

RBNZ cuts OCR to 5.25 per cent

19 September 2001

The Reserve Bank today cut the Official Cash Rate (OCR) by 50 basis points from 5.75 per cent to 5.25 per cent.

Reserve Bank Governor Don Brash said " We are making this unscheduled interest rate cut primarily because of recent tragic events in the United States.

" It seems more likely now that the current slowdown in the world economy will worsen. In these circumstances, New Zealand's short-term economic outlook would be adversely affected, although any downturn might well be relatively short-lived.

" New Zealand business and consumer confidence will be hurt by recent international and domestic developments, and today's move is a precaution in a period of heightened uncertainty.

" Our focus, as always, is to keep core inflation in check. Our present judgement is that interest rates do not need to be as high as previously to achieve this," Dr Brash concluded.

The next scheduled review of the OCR is on Wednesday 3 October.

OCR unchanged at 5.25 per cent

3 October 2001

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 5.25 per cent.

Reserve Bank Governor Don Brash said "The outlook for the world economy, and the likely impact on New Zealand's economy and inflation, remain highly uncertain. It is clear that the global economic outlook has deteriorated since the awful events of 11 September. We will inevitably feel some backwash from that, although our own economy appears to have been at least as robust before the attacks as we had previously expected.

"Our decision to cut the OCR by 50 basis points two weeks ago was a precautionary move that recognised the inevitable adverse effect and the likely impact on confidence. But how large those effects will be, and how long they will last, remains unclear. At this stage, it appears best to leave the OCR unchanged. We will have an opportunity for a fuller review of the outlook for economic activity and inflation, and the risks around that outlook, in our next *Monetary Policy Statement*, which will be released on 14 November," Dr Brash concluded.

Appendix 4¹

Summary tables

Table A
CPI inflation projections and monetary conditions
 (CPI is in percentage changes)

		CPI*	CPI**	TWI	90-day bank bill rate
		Quarterly	Annual		
1995	Mar.	0.5	1.9	59.8	9.4
	Jun.	0.6	2.2	60.8	9.1
	Sep.	0.3	2.0	61.7	9.0
	Dec.	0.6	2.0	61.9	8.5
1996	Mar.	0.6	2.1	64.2	8.7
	Jun.	0.8	2.3	64.6	9.7
	Sep.	0.3	2.3	65.6	10.0
	Dec.	0.6	2.4	67.1	8.9
1997	Mar.	0.2	2.0	68.4	7.5
	Jun.	0.3	1.5	68.0	7.2
	Sep.	0.6	1.8	64.8	8.1
	Dec.	0.5	1.6	63.9	7.9
1998	Mar.	0.3	1.7	61.2	9.0
	Jun.	0.3	1.7	58.5	9.1
	Sep.	0.6	1.7	57.1	6.8
	Dec.	-0.1	1.1	56.0	4.6
1999	Mar.	0.2	1.0	57.6	4.5
	Jun.	0.5	1.2	59.1	4.7
	Sep.	0.4	1.1	56.7	4.8
	Dec.	0.2	1.3	54.4	5.4
2000	Mar.	0.7	1.7	54.1	6.0
	Jun.	0.7	2.0	53.4	6.7
	Sep.	1.4	3.0	50.1	6.7
	Dec.	1.2	4.0	47.7	6.7
2001	Mar.	-0.2	3.1	50.5	6.4
	Jun.	0.9	3.2	49.8	5.9
	Second Half Average	$\frac{1}{2}$	$2\frac{1}{4}$	50	$5\frac{1}{2}$
2002	First Half Average	$\frac{1}{2}$	$2\frac{1}{2}$	50	$5\frac{1}{4}$
	Second Half Average	$\frac{1}{2}$	2	51	$5\frac{1}{4}$
2003	First Half Average	$\frac{1}{4}$	$1\frac{1}{2}$	52	$5\frac{1}{4}$
	Second Half Average	$\frac{1}{4}$	$1\frac{1}{4}$	53	$5\frac{1}{4}$

⁽¹⁾ Notes for these tables are in Appendix 5.

* This series is quarterly underlying inflation until the September quarter 1997, quarterly CPIX inflation from the December 1997 quarter until the June 1999 quarter, and quarterly CPI inflation thereafter.

** This series is annual underlying inflation until the September quarter 1997, annual CPIX inflation from the December 1997 quarter until the June 1999 quarter, and annual CPI inflation thereafter (adjusted by Statistics New Zealand to exclude interest and section prices from the September 1999 quarter to the June 2000 quarter).

Table B

Composition of real GDP growth

(Annual average percentage change, unless specified otherwise)

March year	Actuals						Projections			
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Final consumption expenditure										
Private	6.2	3.6	3.8	2.1	1.8	3.3	1.3	2	3	3
Public authority	0.9	4.9	1.7	8.4	0.0	4.9	-3.0	2	2	4
Total	5.0	3.9	3.3	3.5	1.4	3.7	0.3	2	3	3 1/2
Gross fixed capital formation										
Market sector:										
Residential	12.5	0.8	6.1	2.1	-15.1	21.8	-15.9	-1/2	22	6 1/2
Business	16.1	15.8	4.2	-3.6	2.8	0.4	7.0	5 1/2	-6	4
Non-market government sector	24.8	7.6	29.6	8.3	-14.3	6.7	-5.3	1 1/2	4 1/2	2
Total	15.8	10.8	6.8	-0.9	-3.9	6.1	-0.4	3 1/2	1	4 1/2
Final domestic expenditure	7.0	5.3	4.1	2.5	0.2	4.2	0.1	2 1/2	2 1/2	3 1/2
Stockbuilding ⁽¹⁾	-0.1	-0.1	-0.4	0.0	-0.6	1.3	-0.3	-1/2	0	0
Gross national expenditure	6.8	5.1	3.6	2.5	-0.3	5.5	-0.2	2	2 1/2	3 1/2
Exports of goods and services	8.5	2.3	4.6	3.5	2.5	6.8	6.8	5	2 1/2	3 1/2
Imports of goods and services	14.4	6.9	6.6	2.8	2.2	11.2	0.4	1/2	3 1/2	5 1/2
Expenditure on GDP	5.1	3.7	3.1	2.6	-0.2	4.2	1.8	3	2 1/2	3
GDP (production)	5.3	4.1	3.1	1.9	0.4	4.6	2.6	3	1 1/2	3
GDP (production, March qtr to March qtr)	4.7	4.1	1.7	0.6	2.6	5.5	1.1	3	2	3
Potential output	3.8	4.0	3.6	3.0	2.6	2.5	2.6	2 1/2	2 1/2	2 1/2
Output gap										
(% of potential GDP, year average)	1.7	1.9	1.4	0.3	-1.8	0.2	0.2	1	-1/2	0

e = estimate

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

Appendix 5

Notes to the tables

CPI	Consumers Price Index. Forecasts rounded to the nearest quarter per cent.
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. Forecasts rounded to the nearest whole number.
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. 14-country index, export weighted. Projections based on <i>Consensus Forecasts</i> . Seasonally adjusted.
World CPI inflation	RBNZ definition and estimate: TWI trading partners' CPI inflation (euro-zone proxied by Germany), weighted by TWI weights. Projections based on <i>Consensus Forecasts</i> .
Import prices	Domestic currency import prices. <i>Overseas Trade Indexes</i> .
Export prices	Domestic currency export prices. <i>Overseas Trade Indexes</i> .
Terms of trade	Constructed using domestic-currency export and import prices. <i>Overseas Trade Indexes</i> .
Private consumption	<i>System of National Accounts</i> .
Public authority consumption	<i>System of National Accounts</i> .
Residential investment	RBNZ definition: Private sector and government market sector residential investment. <i>System of National Accounts</i> .
Business investment	RBNZ definition: Total investment less the sum of non-market investment and residential investment. <i>System of National Accounts</i> .
Non-market investment	RBNZ definition: The <i>System of National Accounts</i> annual nominal government non-market/market investment ratio is interpolated into quarterly data. This ratio is used to split quarterly expenditure GDP Government Investment into market and non-market components.
Final domestic expenditure	RBNZ definition: The sum of total consumption and total investment. <i>System of National Accounts</i> .
Stockbuilding	Percentage point contribution to the growth of GDP by stocks. <i>System of National Accounts</i> .
Gross national expenditure	Final domestic expenditure plus stocks. <i>System of National Accounts</i> .
Exports of goods and services	<i>System of National Accounts</i> .
Imports of goods and services	<i>System of National Accounts</i> .
GDP (production)	<i>System of National Accounts</i> .
Potential output	RBNZ definition and estimate. Refer to: Conway, P. and B. Hunt, (1997), 'Estimating Potential Output: a semi-structural approach', <i>Reserve Bank of New Zealand Discussion Paper, G97/9</i> .
Output gap	RBNZ definition and estimate: The percentage difference between real GDP (production, seasonally adjusted) and potential output GDP.
Current account balance	<i>Balance of Payments</i> .

Total employment	<i>Household Labour Force Survey.</i>
Unemployment rate	<i>Household Labour Force Survey.</i>
Household savings rate	<i>Household Income and Outlay Accounts.</i>
Government operating balance	Historical source: The Treasury. Adjusted by the RBNZ over the projection period.
Labour productivity	Defined as GDP (production) divided by HLFS hours worked. This series is smoothed by taking a four-quarter moving average.
Wages	Private sector ordinary time average hourly earnings. <i>Quarterly Employment Survey.</i>
Quarterly percentage change	$(\text{Quarter}/\text{Quarter}_{-1} - 1) * 100$
Annual percentage change	$(\text{Quarter}/\text{Quarter}_{-4} - 1) * 100$
Annual average percentage change	$(\text{Year}/\text{Year}_{-1} - 1) * 100$

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

Rounding: Unless otherwise specified, all forecast data is rounded to the nearest half.

Appendix 6

The Official Cash Rate chronology

Date	Change in OCR (basis points)	OCR rate (per cent)
17 March 1999	OCR introduced	4.50
21 April 1999	No change	4.50
19 May 1999	No change	4.50
30 June 1999	No change	4.50
18 August 1999	No change	4.50
29 September 1999	No change	4.50
17 November 1999	+ 50	5.00
19 January 2000	+ 25	5.25
15 March 2000	+ 50	5.75
19 April 2000	+ 25	6.00
17 May 2000	+ 50	6.50
5 July 2000	No change	6.50
16 August 2000	No change	6.50
4 October 2000	No change	6.50
6 December 2000	No change	6.50
24 January 2001	No change	6.50
14 March 2001	- 25	6.25
19 April 2001	- 25	6.00
16 May 2001	- 25	5.75
4 July 2001	No change	5.75
15 August 2001	No change	5.75
19 September 2001	-50	5.25
3 October 2001	No change	5.25

Appendix 7

Policy Targets Agreement

This agreement between the Treasurer and the Governor of the Reserve Bank of New Zealand (the Bank) is made under sections 9 (1) and 9 (4) of the Reserve Bank of New Zealand Act 1989 (the Act), and shall apply for the balance of the Governor's present term, expiring on 31 August 2003. It replaces that signed on 15 December 1997.

In terms of section 9 of the Act, the Treasurer and the Governor agree as follows:

1. Price stability

Consistent with section 8 of the Act and with the provisions of this agreement, the Bank shall formulate and implement monetary policy with the intention of maintaining a stable general level of prices, so that monetary policy can make its maximum contribution to sustainable economic growth, employment and development opportunities within the New Zealand economy.

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 12-monthly increases in the CPI of between 0 and 3 per cent.¹

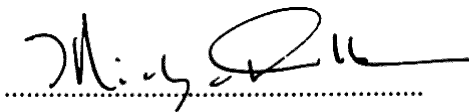
3. Unusual events

- a) There is a range of events that can have a significant temporary impact on inflation as measured by the CPI, and mask the underlying trend in prices which is the proper focus of monetary policy. These events may even lead to inflation outcomes outside the target range. Such disturbances 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 shall react in a manner which prevents general inflationary pressures emerging.

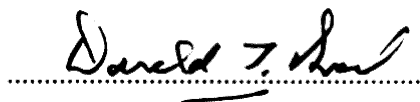
4. Implementation and accountability

- a) The Bank shall constantly and diligently strive to meet the policy target established by this agreement.
- b) It is acknowledged that, on occasions, there will be inflation outcomes outside the target range. On those occasions, 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 comes back within that range.

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- c) 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.
- d) The Bank shall be fully accountable for its judgments and actions in implementing monetary policy.



Hon Michael Cullen
Treasurer



Donald T Brash
Governor
Reserve Bank of New Zealand

DATED at Wellington, this 16th day of December 1999

¹ Statistics New Zealand introduced a revised CPI regime from the September quarter, 1999. Until the June quarter 2000, 12-monthly increases in the CPI will be calculated by comparing the new CPI series with the old CPI series adjusted by removing the impact of changes in interest rates and section prices. This adjustment is calculated by Statistics New Zealand. (Refer to the RBNZ's November 1999 *Monetary Policy Statement*, p 8, for details.)