March 1995 Economic Forecasts

Policy Implications of the March Forecasts

The Bank's latest *Forecasts* suggest that for the first three quarters of 1995 the underlying rate of inflation will be very close to the upper edge of the Bank's 0-2 percent target range, before beginning to ease back towards the centre of the target range.

Given the inevitable uncertainties associated with forecasting, this track for underlying inflation means there is a significant risk that underlying inflation may exceed the 2 percent upper edge of the target range in the March and June quarters. This assessment is an uncomfortable one for the Bank and demands a clear statement of the Bank's position.

In retrospect it is evident that the strength of the cyclical upswing in activity - with its implications for the build-up of inflation pressures - was stronger than estimated, particularly during 1994. An additional major factor, which has complicated the task of forecasting the general trend of inflation, has been the exceptional strength of building costs.

With the benefit of hindsight, the Bank acknowledges that had it pursued a firmer policy stance over the past year, the risks of underlying inflation moving outside the inflation target range this year would have been reduced.

The key issue for monetary policy at this point, of course, is not what the stance of policy ought to have been in the past but what it needs to be now in order to ensure that underlying inflation remains within the target range over the medium term.

The presence of long lags between monetary policy adjustments and their ultimate consequences for inflation has the important implication that even a very sharp firming of overall monetary conditions now - including substantial increases in interest rates and the exchange rate - would have only a marginal impact on the inflation outcomes in the June and September quarters of 1995.

The appropriate focus of current monetary policy actions must be on the period from late-1995 onwards, over which inflation outcomes are able to be significantly influenced by adjustments to the current stance of monetary policy.

The objective of current monetary policy is to put inflation on a path that brings it back to well within the target range. As shown in these *Forecasts*, it is the Bank's view that the significant firming of monetary conditions in the latter part of 1994 - if maintained - should work to bring inflation down towards the centre of the target range in 1996. Indeed, we are projecting the quarterly increases in underlying inflation to fall to 0.3 percent as early as the September quarter this year.

The *Forecasts* clearly indicate that there is absolutely no scope for easing of monetary conditions at present, since this would prolong the period over which inflation remained close to 2 percent, and accentuate the risk of inflation outcomes in excess of the target range. It should also be noted that the projections are based on the trade-weighted exchange rate index (TWI) averaging 59.8 in the March quarter, and 60.1 in the June quarter.

At the same time, it is also the Bank's assessment that a significant additional measure of firming in monetary conditions at this stage would be likely to push underlying inflation well into the lower part of the target range in 1996 and 1997, but would not significantly reduce the likelihood of underlying inflation outcomes above 2 percent in the immediate future.

As noted earlier, forecasts are inherently uncertain. Judgement has to be exercised in deciding whether to build certain potential developments into the central projection or to treat them simply as risks to the projection. In this set of projections, the Bank has continued to take the view that high headline inflation will have only a small spill-over into wages and prices. To date that view appears to have been warranted. The projections have similarly left out of the central scenario any impact from the potential implementation of tax cuts in 1996. In the current circumstances, it will be especially important for the Bank to monitor these and other risks to the central projection and stand ready to react if the risks threaten the prospect of maintaining price stability over the medium term.

Donald T Brash

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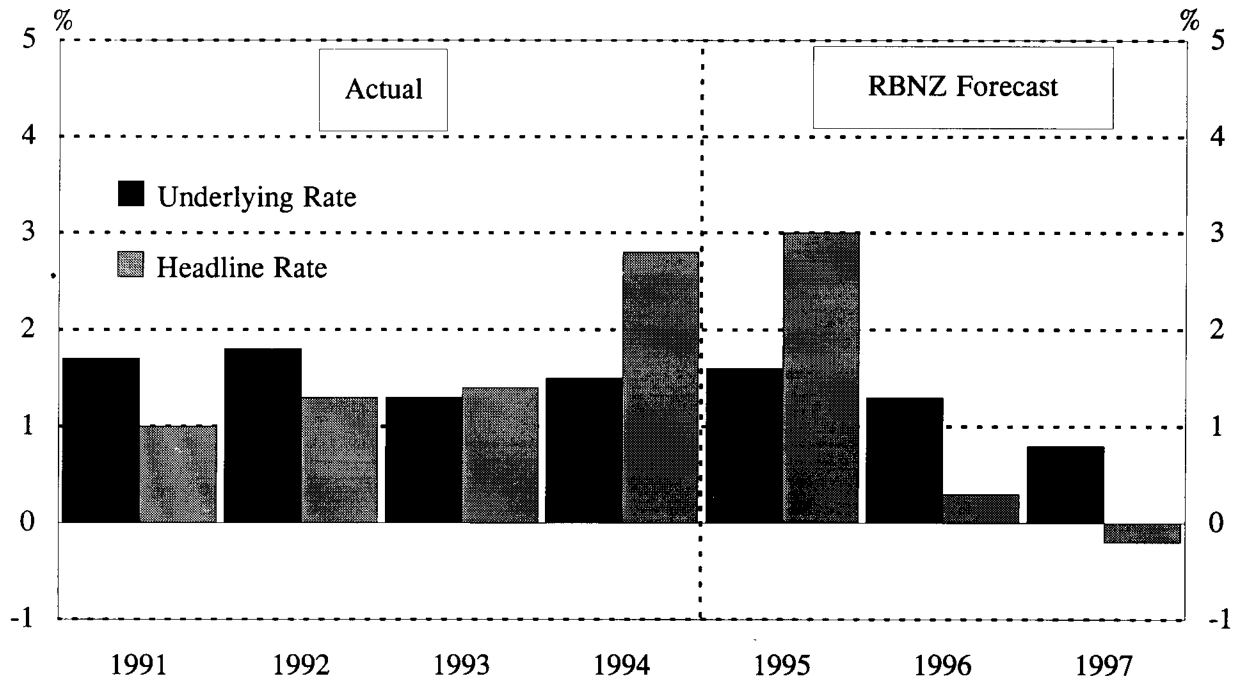
Governor

Figure 1
Consumer Price Inflation
(Percentage Change in Year to December)



Summary of Economic Forecasts

(Percentage changes of annual totals or averages)

March Years	Actual 1994	Forecasts 1995	1996	1997
Real Expenditures on GDP				
Final Consumption Expenditure				
- Private	3.0	5.8	3.2	2.9
(March qtr to March qtr)	(4.1)	(5.3)	(2.8)	(3.1)
- Public Authority	-2.6	-0.2	0.5	-0.4
Total	1.8	4.6	2.6	2.3
Gross Fixed Capital Formation				
- Market Sector				
- Residential	16.2	17.1	2.8	1.6
- Business	22.2	25.3	10.4	6.5
- Non-Market Government Sector	3.7	18.2	4.6	2.3
Total	18.9	23.1	8.5	5.3
Final Domestic Expenditure	5.9	9.5	4.4	3.2
Stockbuilding[1]	1.1	-0.4	0.0	0.0
Gross National Expenditure	6.8	8.9	4.3	3.1
Exports of Goods and Services	8.5	6.4	6.0	6.6
Imports of Goods and Services	12.0	17.0	6.5	6.3
GDP (PRODUCTION BASED)	5.5	6.4	3.4	2.9
(GDP (Production based) March qtr to March qtr)	(6.0)	(5.7)	(2.6)	(3.1)
Government Accounts[2]				
Operating Balance ($m.)	755	2,840	3,420	4,980
- (% of Nominal GDP)	(0.9)	(3.2)	(3.7)	(5.1)
External Accounts				
BOP Current Account Balance ($m.)	-1,644	-3,390	-2,570	-2,460
- (% of Nominal GDP)	(-2.0)	(-3.9)	(-2.8)	(-2.6)
Terms of Trade	1.5	-0.5	3.6	-0.3
Incomes[3]				
Real Household Disposable Incomes	1.7	3.9	3.3	3.5
Household Savings Rate (level)	6.0	4.3	4.5	5.0
Inflation[4]				
Consumer Price Inflation	1.3	4.0	2.0	0.1
Underlying Inflation	1.1	1.8	1.5	1.2
Labour Market				
Employment (000's)	1,532	1,604	1,633	1,666
Change in Employment[4]	3.9	4.7	1.8	2.1
Official Unemployment (000's)	161	134	132	128
Official Unemployment Rate (%)[5]	9.0	7.3	7.1	6.8

1 Percentage point contribution to growth rate of GDP.
2 June years.
3 Reserve Bank estimates.
4 March quarter to March quarter percentage changes.
5 Seasonally adjusted March quarter rate.

Overview

These forecasts update the September 1994 Economic Forecasts and the inflation projections published in the December 1994 Monetary Policy Statement. The forecasts of economic activity cover the period to March 1997, while the inflation outlook covers the period to March 1998. The summary table opposite details the key aggregates discussed in this release. The forecasts incorporate material available up to 7 March.

Our real economy and inflation 'forecasts' should be interpreted as 'projections', as they are strictly conditional on the exchange rate, interest rate and other assumptions.[1]

Underlying inflation to moderate over the second half of 1995

Underlying inflation is projected to peak at 2.0 percent in the year to June 1995, before moderating gradually to 1.5 percent in the year to March 1996, and to around 1 percent in the subsequent two years. The inflation profile largely reflects an expected slowdown in economic growth.

Following unsustainable growth, the expansion in GDP is projected to slow

Over the last two years, considerable slack in the economy has allowed activity to grow at historically high rates. However, rising rates of capacity utilisation, a growing shortage of skilled labour, emerging inflationary pressures in some sectors, and a significant deterioration in the current account, suggest that such growth rates are not sustainable. A slowing in economic growth is expected over the forecast period. After an estimated expansion of 6.4 percent over the year to March 1995, Gross Domestic Product (GDP) is projected to rise by 3.4 percent and 2.9 percent over the coming two years respectively.

These growth rates are expressed in terms of *annual averages* of GDP, which disguises the cyclical profile underlying the economic outlook. A comparison of levels of economic activity between March quarters shows a renewed rise in GDP growth towards the end of the forecast period.

The economy is projected to approach a sustainable growth path in the medium term

The projected moderation of growth is based on usual cyclical influences following a recovery phase, reinforced by firm fiscal and monetary policies. Early indications of a slowdown in demand growth have been provided by latest data on retail trade, imports, and dwelling permits, as well as a range of consumer and business confidence surveys.[2]

Following a significant appreciation over the last year, the outlook is based on a further modest rise in the real exchange rate. Monetary conditions are projected to ease gradually from the end of 1995, with domestic interest rates responding to a reduction in underlying inflation. Later on, this trend is expected to be supported by a projected decline in world interest rates. Such an easing in monetary policy is projected to facilitate the medium-term achievement of a sustainable GDP growth rate in the order of 3-4.5 percent per annum.

A re-balancing of contributions to growth is expected

A major contribution to the projected decline in GDP growth over coming years will result from the significant slowdown in investment activity. A further significant contribution is expected to arise from a halving of consumption growth rates. The reduction in growth of domestic demand will reduce the rate of increase in

1 The Government has specified conditions for the implementation of tax cuts during the period covered by these forecasts. Since no specific information has been released so far regarding the nature, the overall size, and the exact timing of the tax cuts, these projections do not incorporate such a change in fiscal policy. The latter should *not* be taken as an indication that the Reserve Bank regards the published outlook as inconsistent with the specified conditions.

2 As far as the interpretation of latest GDP data is concerned, it has become evident that Statistics New Zealand's seasonal adjustment methodology for Production GDP causes an over-estimation of activity in the September quarter, followed by an under-estimation in the December quarter. This has implications for interpreting the seasonally adjusted profile of Production GDP. As officially measured, on a seasonally adjusted basis Production GDP increased by 2.2 percent in the September quarter, which would suggest an acceleration of growth in that quarter. Our own calculations have attempted to rectify the seasonal adjustment problem. This has generated a smoother quarterly GDP track, which suggests that the properly seasonally-adjusted September quarter figure was around 1.7 percent.

imports. Given a continued strong export performance expected over the forecast period, this implies an improvement in the net external contribution to growth over coming years. However, with imports remaining relatively strong, a further declining merchandise trade surplus is projected. This is expected to cause a deterioration in the current account balance, before the improving investment income and services balances act to narrow the deficit.

The unemployment rate is projected to reduce gradually

On the basis of these real economy projections, we expect the unemployment rate to decline to 6.8 percent by March 1997. 77,000 more people are projected to be in employment by that date.

Firm monetary conditions improve the medium-term inflation outlook

In these projections, the TWI is assumed to rise by 2.0 percent per annum from a projected March quarter average of 59.8 to 63.5 by March 1998. This compares to an assumed March quarter level of 58.3 underlying the projections published in the December *Monetary Policy Statement.* The significant appreciation in the TWI since the forecast underlying that *Statement* was completed, will provide the primary downward influence on underlying inflation during the second half of 1995, following a projected peak of 2.0 percent in the year to June. Reduced rates of increase in unit labour costs, a stabilisation of profit margins, and a further marked decline in construction cost increases, are expected to prevent a rebound in underlying inflation over 1996 and beyond. Cost pressures from imported raw materials are also expected to abate.

Interest rates impact heavily on headline inflation

Headline inflation is expected to peak at 4.5 percent in the year to June 1995, largely as a result of recent mortgage rate increases. The remainder of the difference between projected headline and underlying inflation rates is due to lagged effects of oil price increases (March quarter 1995) and some significant changes to government charges (March quarter 1995 and year to March 1996). The projected decline in interest rates over 1996 is expected to reduce annual headline inflation below underlying inflation by mid-1996, and lead to negative headline inflation during 1997.

The balance of inflation risk is on the upside over 1995, but relatively even thereafter

The risks surrounding the real economy forecasts over the next year appear to be relatively balanced. While the momentum in the economy could lead to stronger growth rates than projected, the recent sharp firming in monetary conditions also implies a significant probability that the slowdown in growth could occur more sharply, with associated effects on inflation.

Assuming that the real economy evolves as projected, the most significant risk to the inflation outlook over 1995 is uncertainty surrounding the extent to which the recent exchange rate appreciation will pass through into retail prices. This pass-through is the main factor leading to the projected moderation in quarterly inflation rates over the second half of 1995. Potentially stronger than assumed international commodity price influences pose another risk to the outlook over the coming year.

The tax cuts foreshadowed by the Government imply some upside risk to the medium-term outlook for the real economy. This may pose a corresponding upside risk to the inflation outlook during the later part of the forecast period. However, the official criteria suggest that, if such risks were considered significant, the tax cut proposals would be modified accordingly.

Wage trends continue to be the main risk factor over the medium term, although latest wage outcomes suggest less inflation pressure than previously expected. Given that these projections incorporate a higher real wage outlook than before, more of the wage risk has been built into the central forecast track.

Overall, it is our assessment that the short- to medium-term risks surrounding the underlying inflation forecasts are now more balanced than previously. However, over 1995 the balance of risk continues to be on the upside.

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