Monetary Policy Statement[1]

March 2001

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

Contents

Appendices

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

ISSN 1170-4829

[1] Projections finalised on 22 February 2001. Policy assessment finalised on 13 March 2001.

1 Overview and policy assessment

After a considerable period during which the Official Cash Rate has remained stable at 6.5 per cent, the Reserve Bank has decided to reduce it to 6.25 per cent.

This was a finely balanced decision, with clear risks involved both in reducing the rate and in leaving it unchanged. There is on the one hand the risk that the increase in prices caused mainly by increased energy prices and the lower exchange rate will spill over into more widespread inflation, and on the other hand the risk that the world economy, and therefore eventually inflation pressures in the New Zealand economy, will turn out to be materially weaker than allowed for.

The first of these risks is heightened by the fact that significant parts of the economy are operating at close to capacity. To be sure, the construction sector is going through a slow period, and retail sales are subdued. But fuelled by a still-stimulatory exchange rate and relatively buoyant commodity prices, many companies are stretched. Tourism is experiencing very strong growth. Indicators of business and consumer confidence are high. There are many anecdotes of companies finding considerable difficulty in finding staff, particularly in the South Island, and unemployment is at its lowest level for more than 12 years. Previous experience suggests that the tightness of the labour market we are seeing at present could result in inflationary increases in wages and salaries coming through next year. Thus, as discussed in Chapter 4, there are clearly risks that inflation will turn out to be more persistent than we currently project.

Taken on their own, these pressures would argue against any reduction in short-term interest rates, or indeed for some increase in rates of the sort envisaged in our last *Monetary Policy Statement*.

But there are several factors which have changed since that last *Statement*. Because of some one-off factors in the March quarter, it now seems likely that headline inflation will retreat from 4 per cent quite quickly, reducing the risk of a spill-over into wage- and price-setting behaviour. The exchange rate, while still clearly stimulatory, has appreciated somewhat since our last *Statement*, with the Trade-Weighted Index some 4 per cent higher (on 12 March) than we had projected for the first half of this year. Against the Australian dollar, a currency of particular relevance to the manufacturing sector, the New Zealand dollar has appreciated by more than 6 per cent since the last *Statement* was finalised.

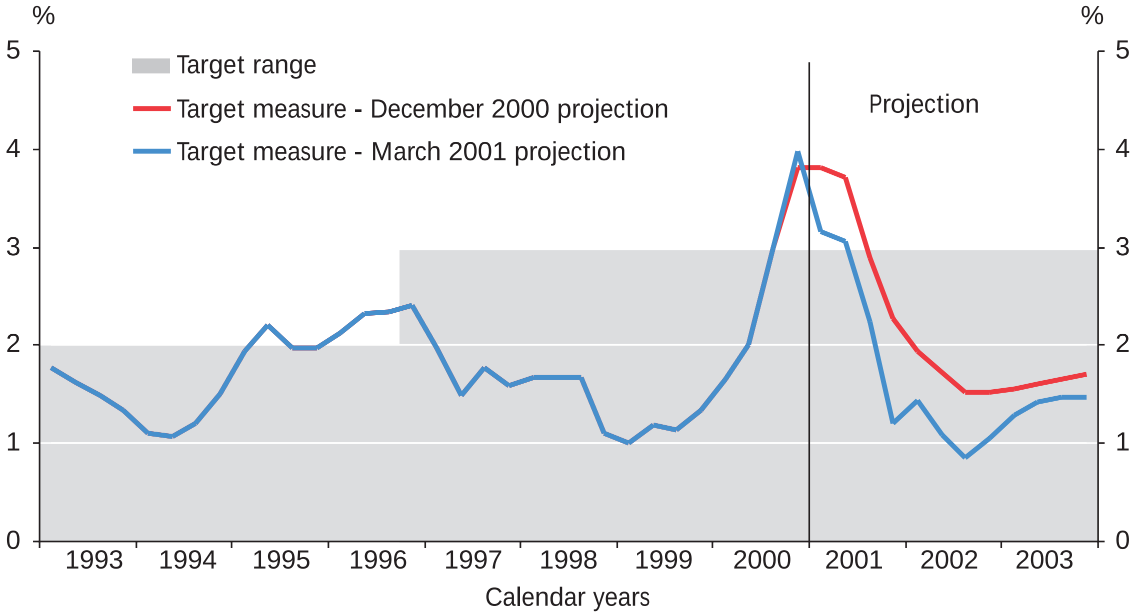
Perhaps most important of all, and highlighting the possibility that inflationary pressures will turn out to be weaker than we now expect, there is increasing uncertainty about how the international economy will evolve over the next year or so. Last November, most commentators projected a continuation of strong growth in the world economy. For the United States, for example, the average of *Consensus* forecasts was growth of 3.4 per cent in 2001; three months later, the average forecast was for growth of only 2.0 per cent. Some commentators are now even more pessimistic, talking about a recession in the United States in the first half of this year, followed by a period of slow growth. Were this to happen, it could have a seriously adverse effect on growth in our other trading partners.

At this stage, we do not know how severe the international slowdown may be, or how long it might last. Most international commentators, even the relatively pessimistic ones, expect the United States economy to recover fairly quickly from the current slowdown. Moreover, there are some special factors, particularly in markets for meat and dairy products, which suggest that New Zealand's export prices might hold up rather better than has been the case in previous periods of slow international growth. If the international slowdown turns out to be relatively brief, or if New Zealand's export prices hold up despite that slowdown, any substantial easing of monetary policy in New Zealand would be quite inappropriate.

But on the basis of emerging data, the risk that the world economy slows by more than assumed in our current projection – with a consequential material reduction in inflation pressures in the New Zealand economy – seems the marginally bigger risk. Today's reduction in the Official Cash Rate may be seen as an insurance premium against that risk. Clearly, if the world economy turns out to be significantly weaker than now seems likely, there may be a need to cut rates further, potentially by a significant margin. We are as keen to avoid inflation falling too far below the mid-part of our target range as we are to avoid its rising too far above it. But for the moment at least, the New Zealand economy is favourably "out of sync" with those of many of our trading partners. It is by no means inevitable that today's reduction in the Official Cash Rate will be quickly followed by further reductions.

Donald T. Brash
Governor

Figure 1
Consumer price inflation[2]
(annual percentage change)



[2] The target 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)

	Actuals	Projections			
March year	2000	2001	2002	2003	2004
Price measures					
CPI*	1.7	3	1 1/2	1 1/2	1 1/2
Wages	2.0	2 1/2	3 1/2	3	2 1/2
Import prices (in New Zealand dollars)	11.2	5	-4	1	1
Export prices (in New Zealand dollars)	9.6	8	-3 1/2	-1/2	0
Monetary conditions					
90-day bank bill rate (year average)	5.2	6 1/2	6 1/2	6 1/2	6 1/2
TWI (year average)	56.1	50 1/2	51 1/2	53	54 1/2
Output					
GDP (production, annual average % change)	4.4	2 1/2	3 1/2	3 1/2	3
GDP (production, March qtr to March qtr)	5.5	1	3 1/2	3	3
Output gap (% of potential GDP, year average)	-0.1	-1/2	0	0	0
Labour market					
Total employment (annual % change)	1.4	2 1/2	1 1/2	1 1/2	1 1/2
Unemployment rate (March qtr s.a.)	6.4	5 1/2	5 1/2	5 1/2	5 1/2
Labour productivity (annual average % change)	2.4	1	1	2	1 1/2
Key balances					
Government operating balance (% of GDP, year to June)	1.4	1	2	2 1/2	3
Current account balance (% of GDP, year to March)	-6.9	-4 1/2	-4	-4 1/2	-5
Terms of trade (annual average % change)	-0.1	1 1/2	0	-1	-1 1/2
Household savings rate (% of disposable income, year to March)	-4.1	-4	-4	-3 1/2	-3
World economy					
World GDP (annual average % change)	4.4	4	3	3 1/2	3 1/2
World CPI inflation	2.0	2 1/2	1 1/2	2	2

Quarterly projections	Jun-00	Sep-00	Dec-00	Mar-01	Jun-01
CPI (quarterly percentage change)	0.7	1.4	1.2	-0.1	0.6
CPI (annual percentage change)	2.0	3.0	4.0	3.2	3.0

e = estimate.
s.a. = seasonally adjusted

* This series is annual CPIX inflation until the June 1999 quarter, and annual CPI inflation thereafter (adjusted by SNZ 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 Recent developments and current economic situation

Our December *Statement* described an expanding economy beginning to show some, although not generalised, signs of pressure on resources. Prospects were for growth to continue at a pace slightly above that consistent with steady inflation, with a likelihood that core inflation pressures would need to be checked by some further tightening in policy over coming months. Mounting core inflation pressures were somewhat threatening in the context of inflation having already been boosted by non-core or temporary factors. Although the influence of such factors was expected to dissipate over time, the risk was that spillover into on-going inflation would occur at the same time that resource pressures came through.

Accordingly, the December *Statement* indicated a tightening path for policy – an increasing track for 90-day interest rates and a moderately appreciating exchange rate – notwithstanding the weakness in business and consumer confidence that had pervaded much of 2000. That a tighter policy was projected in such circumstances reflects the fact that the economy had been growing since the second half of 1998, that monetary policy needs to be forward-looking, and that our assessment of likely economic performance was, as always, derived from the fundamental drivers of economic activity.

What were the fundamental drivers? Broadly speaking, world demand had been very strong – as Asian economies had recovered from deep financial crisis, and as the United States continued its remarkable expansion – and our exchange rate had been low. Strong world demand progressively had raised the prices of most of the commodities that we export. At the same time, the fiscal stance had remained approximately neutral, while we had moved interest rates from strongly stimulatory to somewhere in the neutral-to-mildly-firm zone.

Given this combination of influences, it was not surprising that the economy had been expanding, as reflected in annual average growth over the last two years of around 3 per cent. What was surprising was that businesses and consumers were not in a better mood throughout 2000, that exports did not grow faster, and that the overall economy was not already at a more advanced stage of the growth cycle, where inflation pressures might be more evident.

This chapter attempts to assess at what stage in the cycle the economy is currently, while Chapter 3 looks forward and suggests some possible paths along which the fundamental drivers may take the New Zealand economy.

Current activity

We have discussed the theme of a two-part New Zealand economy in recent *Statements*, and it seems that this theme remains apt. Given the strong international economy and competitive exchange rate of the past year or more, the externally-focused sectors have continued to out-perform domestically-focused sectors, as is to be expected in such circumstances. Data received since December continue to depict an economy growing unevenly, with the export and import-substituting sectors showing most forward momentum.

The export sector has been doing well because export prices, both on world markets and more particularly in New Zealand dollar terms, have been very strong. There are signs that the combination of a competitive exchange rate and good world prices are also encouraging growth in the volume of exports and services, in addition to boosting incomes earned from current volumes. This is most evident for services exports, especially tourism. Visitor arrivals and tourist expenditure (as evidenced by visitors' spending on credit cards) have continued their strong upward trend in the past few months (figures 2 and 3).

Figure 2
Monthly overseas visitor arrivals
(seasonally adjusted)

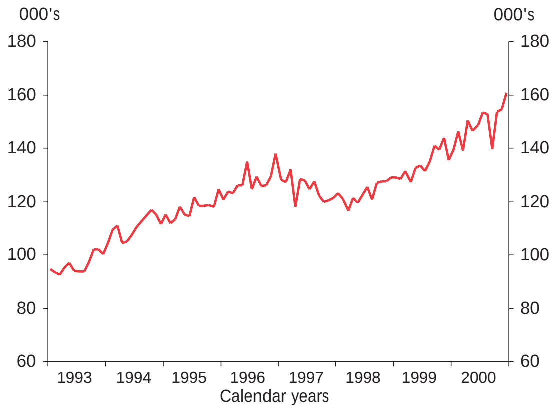
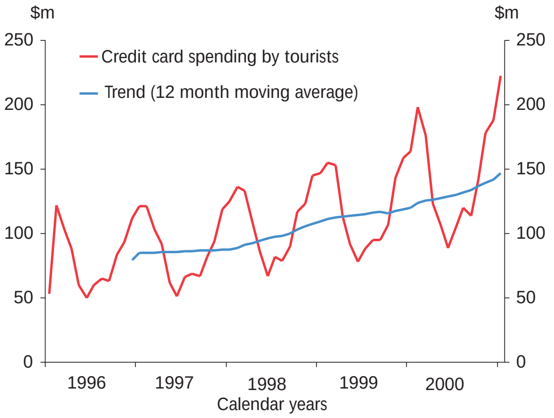


Figure 3
Monthly credit card spending by tourists



In addition to the favourable international environment for our exports, New Zealand has experienced generally favourable weather conditions over most of the growing season, with a few notable exceptions. This has led to a good supply of primary commodity exports at a time when prices have generally improved. To be sure, forestry prices are weak, as are prices for some of our horticultural products. But the key commodities of meat and dairy remain strong, with little immediate prospect of significant price declines. It may well be that market-specific factors, such as the BSE and foot and mouth outbreaks in Europe, are masking the impact on prices from broader economic factors – at least for meat.

About half of overall economic growth in the second half of last year is estimated to have been directly related to the primary sector, as shown in table 2. This table probably understates the total primary sector contribution to growth. Demand for other goods and services, such as transport, also increased with higher primary sector output, but these flow-on effects cannot be isolated in the aggregate statistics.

The improved export performance, combined with our assessment that imports of goods and services will have grown by only 3 per cent in the six months to March 2001, indicates that net exports will have made a sizeable contribution to GDP growth over recent months.

With short-term interest rates on hold since last May, and fiscal policy being broadly neutral for some time now, we might have expected the boost enjoyed by the external sector to have spilled over into stronger domestic demand. However, in the middle of last year there was a slump in business and consumer confidence. Concerns about the introduction of the Employment Relations Act, changes in the operation of ACC, the rapidly depreciating NZ dollar, and the increase in interest rates in the first half of 2000 combined to create substantial business nervousness that led to some deferral of new investment. Households also had to contend with reduced real disposable incomes following increases in petrol prices and the higher tax rate on earnings over $60,000 per annum.

This loss of confidence had a dampening effect on domestic demand for some time. Eventually, the fundamental forces of a strong world economy and a very stimulatory exchange rate overwhelmed the negative sentiment and induced a favourable reassessment of prospects. However, the improved confidence of consumers and businesses has not yet translated into rapid investment or consumption growth.

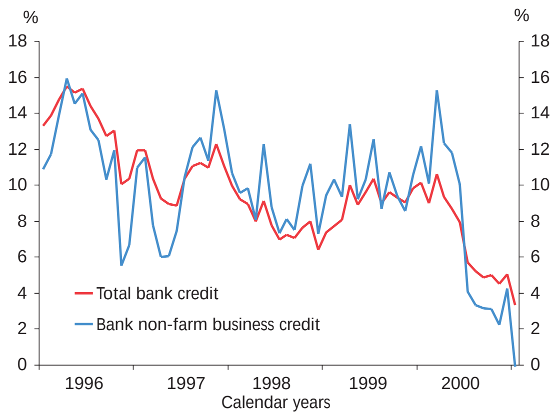
Business investment during the six months to March 2001 appears to have grown by about its historical average growth rate, if partial indicators and comments of business people are anything to go by. However, the pattern of investment is not uniform across sectors. For example, investment in the tourism industry has been strong, with increased hotel con-

Table 2
Primary sector contribution to GDP growth
(percentage point contribution to half-year percentage change)

	2000 Jan-Jun (actual)	2000 Jul-Dec (estimated)
Agriculture and hunting	-0.2	0.3
Primary food manufacturing	-0.2	0.4
Fishing, forestry and mining	0.0	0.0
Total primary	-0.4	0.7
Non-primary	0.7	0.6
Production GDP (half-year percentage change)	0.3	1.3

struction. In the primary sector, dairy conversions and indirect spin-offs from good agricultural conditions appear to have increased on-farm investment. By contrast, limited growth in non-farm business credit and total bank credit point to weak investment in other sectors (figure 4).

Figure 4
Non-farm business and total bank credit
(annual percentage change, seasonally adjusted)

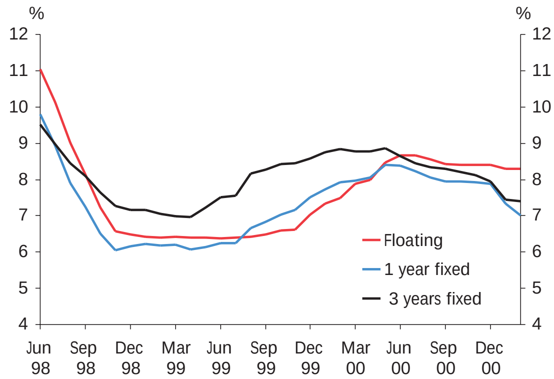


As to consumption trends, recent confidence gains have yet to overcome other factors.

Despite increased export sector incomes, price rises for petrol and other imported goods have been an offsetting influence on consumers' real disposable income. Also, some of the improved export income is being applied to retiring debt. The exchange-rate-related 'beat the price rise' advertising is also expected to have affected the pattern of consumption over the past few months. This disruption can be seen in the poor December quarter retail sales figure. In particular, retail spending on durable goods was very strong prior to the advertised price increases, but has subsequently dropped off.

Negative wealth effects from falling or at least flat house prices have similarly had a restraining influence on consumption. Declining house prices are due, in part, to the continued net migration outflows from New Zealand. The resulting reduction in demand for housing has meant that residential investment has been subdued – a drag on the domestic economy compared to its normal contribution. Quite recently there have been reports that activity in the housing market has improved relative to last year. Improved housing confidence surveys, anecdotal evidence of a small improvement in real estate turnover, and the fact that some fixed mortgage rates have recently been lowered (figure 5), suggest that the housing market may soon stabilise.

Figure 5
Household borrowing interest rates: fixed and floating

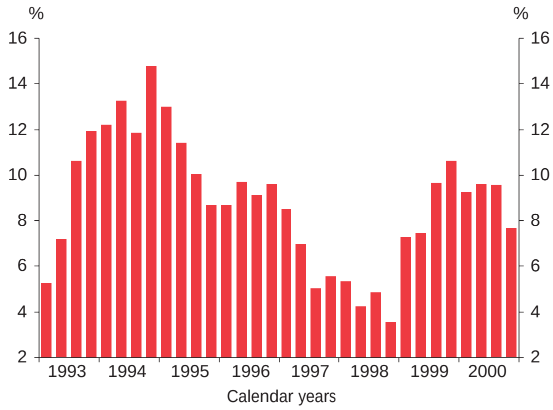


Resource stress in the economy

Our overall assessment is that consumption, investment, and net exports, taken together – that is, aggregate demand – is growing at a moderate pace. The ability of the economy to meet this demand depends on the availability of the resources, such as labour and capital, needed to produce goods and services. If these resources are utilised at a rate beyond what is sustainable in the long run, then production costs tend to rise and producers find it easier to increase their selling prices without losing sales. Watching for emerging stresses in the use of capital and labour may provide an early indication of future inflationary pressure.

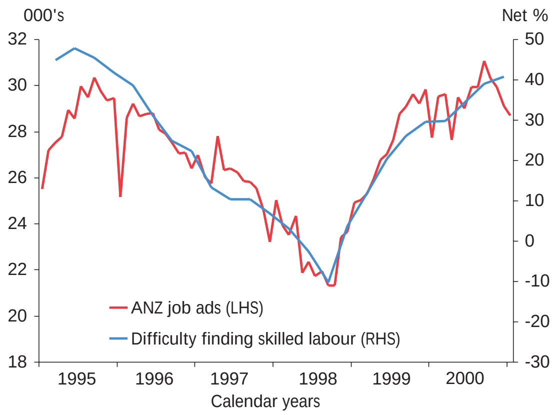
The extent of pressure on capital resources is difficult to gauge because of the lack of reliable capital stock data. However, indirect indicators are available and these suggest that there has been some under-utilised capital in the economy. For example, capacity utilisation surveys indicate that pressures have decreased from the peaks of a year ago and are now around long-run average levels. In addition, fewer companies have recently reported that capacity is a constraint to increasing output (figure 6). The existence of spare capital resources lowers the need for new investment in capital goods and is one reason why there appears to have been only moderate business investment over the last six months or so.

Figure 6
QSBO limiting factor – capacity[3]
(percentage of respondents noting capacity as their most limiting factor to increasing production)



A key gauge of conditions in the labour market is the Household Labour Force Survey, which in December showed the labour market becoming tighter. This tightening is corroborated by increases in the number of job advertisements and the reported lift in the incidence of employers finding it difficult to acquire skilled labour (figure 7).

Figure 7
Difficulty finding skilled labour and ANZ job ads[4]
(seasonally adjusted)



[3] Source: New Zealand Institute of Economic Research (NZIER).

[4] Source: NZIER and ANZ Banking Group.

Stronger demand for labour resulted in employment growth of 2 per cent over calendar year 2000. This growth in employment saw the unemployment rate fall to 5.6 per cent, the lowest level since mid-1988, together with some increase in participation in the labour force (by people not previously looking for employment).

Tighter labour market conditions, particularly over the second half of 2000, have not yet resulted in substantially higher wage pressure. This is not unduly surprising, as it typically takes one to two years before skill shortages are reflected in higher wage growth. Wage growth was around $2^1/_2$ per cent over 2000, slightly higher than the previous year but as expected in the December *Statement*. However, the relatively tight labour market in conjunction with the current CPI inflation spike, and new labour market legislation, suggests there is a risk that wage inflation could accelerate. If this occurs, it could be an important indicator of emerging inflation pressure.

A crude summary measure of overall stress and inflationary pressure in the economy is the estimated deviation of output from its long-run trend level. This deviation, known as the output gap, is an indicator of how overall demand for goods and services compares with the economy's capacity to produce those goods and services. At present, the output gap is thought to be slightly more negative (consistent with stable to declining inflationary pressure) than estimated at the time of the December *Statement* (figure 17, p.17).

As a supplement to looking at measures of the inputs to and the outputs from the production process for signs of stress in the economy, we can examine asset prices. Asset prices can contain valuable information about the level of demand for capital goods, although care is needed to also take account of the possibility that changing asset prices reflect changing market assessments of likely productivity growth. As discussed in box 1, New Zealand asset prices have been flat to moderate and do not indicate any excess demand pressure in the economy.

Box 1
Asset prices

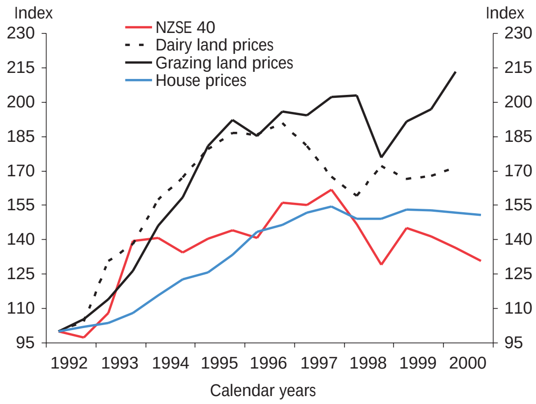
Asset prices are one of a variety of indicators the Reserve Bank monitors to gauge stresses in the economy. Historically, asset price cycles have been associated with movements in aggregate demand. One recent example of this is the spectacular performance of the US equity market alongside the strong growth the US experienced over the 1990s.

When an economy is doing well, or is expected to do well, asset prices tend to increase. Investors show a willingness to pay more for shares, for example, anticipating higher dividends, or house buyers trade up, partly because of confidence about their future prospects in a stronger economy. Asset price movements can also affect aggregate demand and economic activity through their effects on households' balance sheets. An increase in households' net worth may encourage them to increase borrowing and to spend more of their income now.

Traditionally, housing has been the largest asset on the balance sheets of New Zealand households. However, over the past five years especially, the share of equities in household net worth has increased to around 15 to 20 per cent, compared to nearly 50 per cent for housing.

Figure 8 shows the NZSE 40 index, and the Quotable Value New Zealand price indices for housing, dairy land, and grazing land. Equity prices, as measured by the NZSE 40, have been falling for the last three years, apart from a brief respite in the first half of 1999. House prices have been flat over the same period. Only dairy and grazing land prices have shown growth over the last two years. Some increase in rural property prices is to be expected, as the primary sector is prospering at present. Taken together, it is clear that there is currently no pressure on aggregate demand from asset prices.

Figure 8
New Zealand asset prices[5]
(1992 H1 = 100)



Developments in inflation

As anticipated in the December *Statement*, CPI inflation rose to 4 per cent in the year to the December 2000 quarter. It seems highly unlikely that the rise in inflation was caused by excessive pressure on resources, since the economy was not in a sustained period of excess demand over 1999 or 2000 – the period relevant to recent inflation developments.

Rather, the profile of CPI inflation has been dominated by three factors whose effects are expected to prove temporary. These three factors are: large rises in international oil prices that caused local petrol prices to jump during 2000; the increase in tobacco excises that impacted on tobacco prices in the June and September quarters; and the lengthy exchange rate depreciation that bottomed out in the last quarter of 2000. Their effects can be seen in the various measures of inflation set out in table 3, most clearly for the oil price and excise tax influences. Of the 2.7 percentage point jump in CPI inflation recorded over the four quarters to December 2000 (from 1.3 per cent in the year to December 1999 to 4.0 per cent in the year to December 2000), close to one-third was accounted for by these two factors.

Isolating the influence of the exchange rate depreciation is more difficult. The extent to which exchange rate changes pass through into local prices appears to have diminished over the last decade, not only in New Zealand but also in other small, open economies. As has been discussed in pre-

[5] Source: Quotable Value New Zealand Limited

Table 3
Annual percentage change in PPI, CPI, and derivative series

	1999	2000			
	q4	q1	q2	q3	q4
CPI	1.3	1.7	2.0	3.0	4.0
CPI ex petrol	0.9	1.2	1.3	2.1	3.3
CPI ex petrol and cigarettes	0.9	1.2	1.0	1.4	2.7
CPI non-tradables	2.1	2.6	2.1	2.0	2.4
CPI tradables	0.5	0.9	2.0	4.1	5.4
CPI weighted median	0.5	1.7	1.3	1.7	2.6
CPI 10% trimmed mean	0.9	1.2	1.8	2.3	3.4
Producer price index: inputs	2.8	4.9	5.5	8.0	10.2
Producer price index: outputs	2.0	3.3	3.9	5.6	6.8
Merchandise import prices (excluding petrol)	1.9	5.3	8.3	13.3	n.a.

Notes:

(i) CPI ex petrol and CPI ex petrol and cigarettes are calculated by excluding petrol and cigarettes from the regimen and re-weighting accordingly.

(ii) The CPI weighted median is calculated by taking the weighted median of the *annual percentage change* in the CPI components.

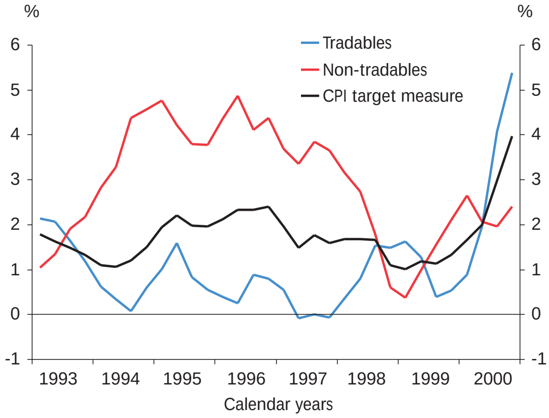
(iii) The CPI 10 per cent trimmed mean is calculated by removing the 5 per cent by weight of CPI items recording the largest positive annual percentage change, and the 5 per cent by weight of CPI items recording the largest negative annual percentage change. The weighted mean is then taken of what remains.

vious *Statements*, it appears that foreign exporters to New Zealand have been prepared to accept variations in their profit margins in order to limit the extent of repricing of their goods and services in New Zealand dollars. Likewise, importers and others in the distribution chain have absorbed some of the repricing that has occurred, also experiencing profit margin squeezes.

Absorbing price fluctuations in profit margins might make sense where the price fluctuations are expected to be temporary, or where there is no alternative, given fierce competition or no demand. But there are limits. Given the scale and duration of exchange rate depreciation since 1997, it would not be surprising to see progressively increasing pass-through. Indeed, without some pass-through there would be no adjustment of the relative prices that encourage resources within the economy to move in response to the changing environment.

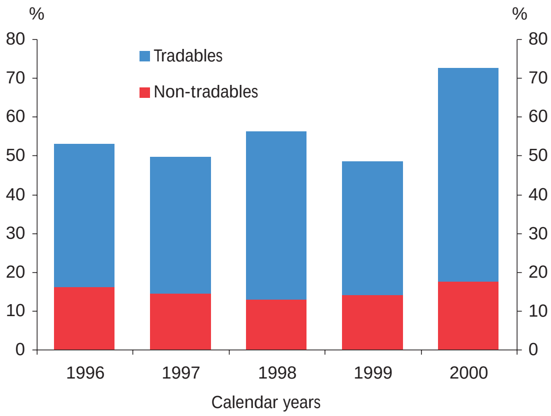
As table 3 shows, import prices and prices in the production sector started to rise rapidly over 2000, reflecting earlier and ongoing depreciation. Considerable absorption of the effect of the falling exchange rate is still evident. Import prices rose by 16 per cent (excluding petrol) from the end of 1997 to the third quarter of 2000, yet the exchange rate depreciated by 25 per cent over the same period. Substantial further absorption has taken place in the distribution chain. At the consumer level, tradables inflation, which <u>includes</u> the petrol and tobacco price hikes, accelerated by almost 5 percentage points over the four quarters to December 2000 – considerably less than the acceleration of import and producers' input prices (see also figure 9).

Figure 9
Tradables and non-tradables inflation
(annual percentage change)



Nonetheless, the effect of exchange rate depreciation is increasingly apparent in consumer prices. Different measures of inflation of 'typical' consumer goods and services, such as the median and trimmed mean, show clear signs of acceleration. Most recently, in the December quarter, most of the recorded inflation can be attributed to relatively small moves across many of the components, with about 70 per cent of items in the CPI regimen recording increases, up from the 50 per cent or so that has been typical in the past five years (figure 10). Most of the additional items recording price increases were tradables, reflecting the influence of exchange rate depreciation. But with the exchange rate appearing to have turned around, it is likely that the direct effects on consumer prices of past depreciation will wane through 2001. Chapter 3 describes the resulting time profile of inflation.

Figure 10
Items in the CPI basket whose price increased in the December quarter
(per cent of total number of items in the CPI basket)

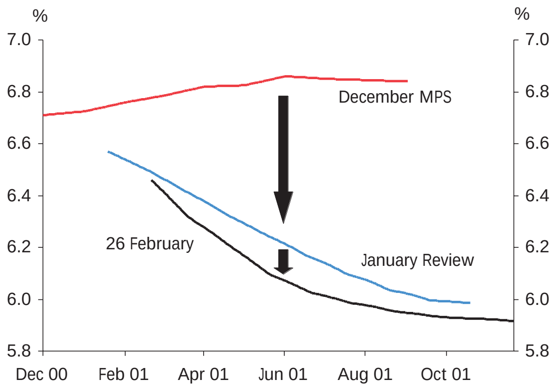


Note: Statistics New Zealand calculate the percentage of items in the CPI that increased at a higher level of disaggregation than the Reserve Bank. They reported that 64 per cent of items in the CPI increased in the December quarter as opposed to our 73 per cent. However, both measures show the same pattern.

Financial market developments

The data discussed so far in this chapter has been backward-looking in nature. Financial markets tend to look forward, so financial data reflects expectations of the future. As the outlook for global growth has evolved over recent months, so too has the collective view of financial market participants as to the future of New Zealand interest rates. The nature of this evolution can be seen in figure 11, which shows market expectations of future 90-day interest rates since the December *Statement*. (These expectations are extracted from prevailing rates for various maturities.)

Figure 11
Market expectations for 90-day bank bill rates



At the time of the December *Statement*, market participants generally expected rates to rise over the course of 2001. They now expect rates to fall over this period. Expectations of firmer monetary policy over the year ahead, related to evidence of a rebound in domestic economic indicators and a December *Statement* that was perceived as 'hawkish', have given way to negative views about global growth prospects, particularly in those countries with which New Zealand has strong economic and financial market linkages. Combined with the Bank's more neutral tone at the January OCR review, this reversal of sentiment has consolidated market participants' expectations for lower rates.

A significant influence on interest rate expectations was the surprise move by the US Federal Reserve on 3 January to cut the Federal funds target interest rate by 50 basis points to 6 per cent, with a further 50 basis point adjustment a few weeks later, and the resulting round of interest rate cuts by other

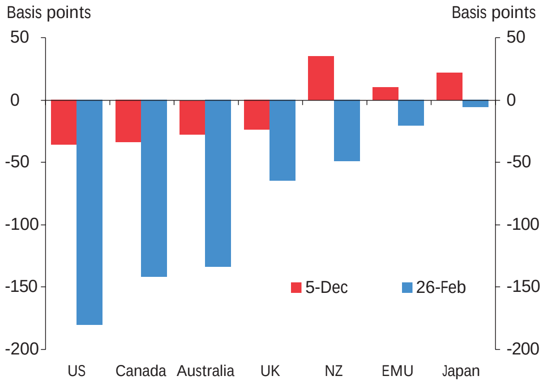
Table 4
Official interest rates

	Level as at 31 Dec 2000 (%)	Level as at 7 Mar 2001 (%)	Change (basis points)
United States	6.50	5.50	-100
Australia	6.25	5.50	-75
Canada	6.00	5.25	-75
United Kingdom	6.00	5.75	-25
Japan	0.25	0.15	-10
Euro area	4.75	4.75	0
Sweden	4.00	4.00	0
Norway	7.00	7.00	0
New Zealand	6.50	6.50	0

central banks in industrialised economies. However, some other central banks, notably the European Central Bank, have kept official rates steady (table 4).

In response to developments since December, financial markets internationally have moved to price in further easings. Interest rate expectations have been revised down in all major international markets (figure 12). The extent to which expectations have been revised down differs across countries, but the common trigger for the downward revision in rate expectations has been the weakening growth outlook in the United States and its potential effect on the rest of the world. This outlook is examined in more detail in Chapter 3.

Figure 12
Financial market expectations of official interest rate moves



Note: Total expected easing from December to June 2001, defined as the expected 90 day rates for June 2001 less the official cash rate in December 2000.

The New Zealand dollar has appreciated significantly since early December, much more so than was allowed for in the December *Statement*. As the projections were being prepared for the December *Statement*, the TWI was around its low of 46.2, while the New Zealand dollar was buying just $US 0.394. As the projections were being prepared for this statement, the TWI was around 50.3, and the US cross rate around $US 0.433, about 10 per cent higher in both cases.

Some of the rebound can probably be attributed to the gathering evidence of strength in the New Zealand economy, especially relative to indications of weakening growth in Australia and the United States. This is both because of the likely consequences for interest rates in each of these countries, and because to some extent currency markets associate exchange rate developments directly with growth.

However, it is difficult to be definitive about cause and effect in currency markets. As indicated in the December *Statement*, the extent of depreciation experienced over 2000 did not appear to have been justified by economic fundamentals, and it was therefore unlikely to be sustainable. The dominance of the US economy on investors' 'radar screens' and trend-following market dynamics seemed to have driven the US dollar beyond fundamental levels, leaving many other countries' exchange rates at abnormally low levels. Relatively small events can, in such circumstances, have surprisingly large consequences. Interestingly, however, movements in the NZD/AUD exchange rate over the last year or so – including the recent rise from around 75 cents in mid-October to about 83 cents now – appear to reflect actual and prospective interest rate differentials between New Zealand and Australia in fairly conventional fashion.

3 Medium-term macroeconomic outlook

This chapter presents the Bank's projections for the economy over the next two to three years. The projections incorporate a path for monetary conditions consistent with returning annual CPI inflation to close to the middle of the 0 to 3 per cent target range in the medium term.

Our December *Statement* described the principal issues then influencing our policy deliberations. Included among those issues were an expectation that business and consumer confidence would strengthen and the prospect that CPI inflation would rise to nearly 4 per cent (annual percentage change), and remain above the top of the 0 to 3 target band for at least three quarters. With the prospect of an improving domestic economy and resource pressure emanating from a strong external sector we noted that somewhat higher interest rates seemed likely over the coming year.

In addition, the December *Statement* outlined two important judgements that underpinned our projections, namely that:

- there would be a more muted response of economic activity (especially in exports and import substitutes) to the low exchange rate than had been observed historically; and
- price and wage setters would not adjust their behaviour to reflect the temporary spike in inflation.

These judgements left the risks to our central projection for inflation skewed distinctly to the upside.

Since December we have seen prospects for the global economy weaken sharply and a notable appreciation of the exchange rate. The change in the international environment has had a significant impact on our new projection. Below, we discuss developments in the international environment, their impact on the New Zealand economy, and the implications for New Zealand monetary conditions.

Judgements underpinning the projections

Even more than in December, our March projections are set against a backdrop of slowing trading-partner growth. The main issues we have had to wrestle with relate to:

- the uncertainty surrounding the world economic outlook;
- the extent to which a slowing in the world economy will reduce demand for New Zealand products and commodity prices;
- the degree of stimulus being provided by the still-low exchange rate; and
- the impact of the direct effects of the assumed further modest recovery in the exchange rate on CPI inflation.

As we discuss below, our judgements on these issues combine to produce a projection that is slightly weaker than that outlined in our December *Statement*. The key difference is that the current projection for export growth is lower from 2002 onwards, reflecting the prospect of slower world growth and to some extent a higher exchange rate.

The international environment

Developments in the international environment have been the dominant issue for our projections. In the December *Statement*, we noted that the future for global growth did not look as positive as it had the previous year. Since December, international economic conditions have weakened even further than was expected only a few months ago. The United States and Japan, in particular, appear to be now growing noticeably more slowly. Australian near-term growth prospects have also been revised down and there are growing concerns that a downturn in the United States and continued weakness in Japan could adversely affect growth rates in non-Japan Asia. In contrast, growth in the Euro area is projected to remain at around trend. This has prompted a broader reassessment of international economic prospects, with most observers revising down their expectations for near-term global growth.

Our medium-term projections for growth in New Zealand's main trading partners are based on *Consensus* forecasts as surveyed in early February (table 5). An alternative scenario, with weaker trading partner growth, is examined later in this chapter.

Table 5
Trading partner growth projections
(calendar year, annual average percentage change)

	Calendar years			
Country	1999	2000e	2001f	2002f
Australia	4.7	4.2	2.9	3.8
United States	4.2	5.0	2.0	3.5
Japan	0.8	1.7	1.4	1.8
Europe-4*	2.0	3.1	2.6	2.7
Asia ex-Japan**	6.1	8.1	5.0	5.7
14 country index	3.7	4.5	2.9	3.7

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

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

Implicit in the *Consensus* forecast track is a view that, after a temporary slowdown, growth in the United States' economy will pick up later this year. The mean *Consensus* forecast for the United States in February depicts a 'V-shaped' path for output growth over 2001. This projection is consistent with market expectations that the current slowdown is the result of an excessive accumulation of inventories of consumer and capital goods. It assumes that moderately strong growth will resume in the second half of 2001 once stock-levels are reduced. The scenario of a V-shaped recovery rests heavily on the assumption that "rapid and forceful" easings by the Federal Reserve, together with planned tax cuts, will trigger a quick rebound in business and consumer confidence, which will then generate an improvement in activity more generally.

While *Consensus* forecasts represent the views of research houses that devote considerable resources to economic forecasting and analysis, some of the forecasters surveyed may not always have completely up-to-date projections. At times when the economic outlook is changing rapidly, such as now, *Consensus* forecasts may be slow to reflect the new information.

Therefore, although the *Consensus* forecasts imply that global growth will slow this year, to around the reasonably robust rate recorded over the past three decades, downside risks dominate the outlook. In particular, substantial uncertainty remains about the near-term prospects for the United States and Japanese economies.

In the US, some easing in the pace of growth was inevitable after a prolonged period of exceptional strength. But many financial market analysts in the United States are now concerned that the slowdown could be sharper and more protracted than that currently projected in *Consensus* forecasts. These analysts argue that over-investment during the recent boom years caused two structural imbalances. First, businesses and households have become constrained by the *high debt levels* they built up in the process of upgrading tech-related capital and consumer durables. Second, firms have *excess capacity* as the result of strong previous capital spending and the weaker demand environment. If such imbalances are significantly impacting household and corporate decisions, then as demand weakens in the United States, we might expect to see some of the following indicators suggesting a more protracted 'U-shaped' adjustment:

- investment declining even more sharply, in the face of falling earnings;
- cut-backs on labour hours worked;
- inventory levels taking longer to work off;
- equity prices declining as expected earnings are revised down; and
- further erosion of business and consumer confidence, in response to deteriorating share prices and firms' cost-cutting strategies (for example, further job layoffs).

If this pessimistic scenario were to materialise, then it is unlikely that looser monetary policy alone would be effective in reviving confidence, at least within a short timeframe. In this case, the US economy would only return to its potential growth rate once the underlying imbalances themselves are resolved.

In Japan, the downside risks to the mean *Consensus* view also seem significant. The fledgling economic recovery observed in the first half of 2000 has faltered, with negative GDP growth recorded for the September quarter, and zero growth estimated for the December quarter. In January, industrial production contracted by 3.9 per cent and exports weakened. Business sentiment remains weak.

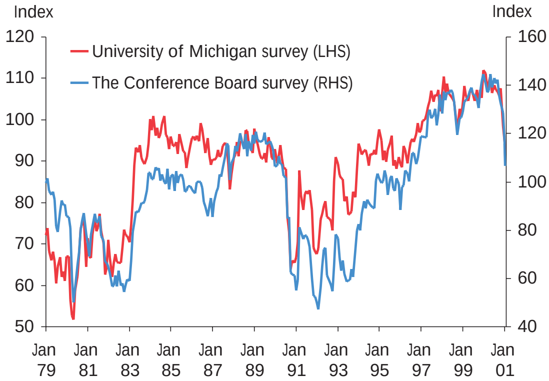
In addition, the recent sharp decline in the Japanese stock market to 15-year lows poses a risk to confidence. The prospects for renewed economic growth in 2001 are limited and this assessment is probably yet to be fully reflected in *Consensus* forecasts for growth in 2001.

A deeper slowdown in the United States, and a slower recovery, would imply a larger impact on the rest of the world than is projected in the *Consensus* forecasts. The risks seem quite significant for our Asian trading partners. Some tech-exporting countries (e g Malaysia, South Korea, Taiwan and Thailand) are particularly vulnerable through their high trade exposure to the United States. Very slow structural reform of corporates in many Asian countries, including Japan, also increases their vulnerability to economic downturn.

While our central projections are based on the V-shaped recovery scenario embodied in *Consensus* forecasts, we acknowledge that the risks to this scenario are biased to the downside. While there have been prompt and forceful responses from the Federal Reserve and other central banks, there is a limit to how effective monetary policy can be in cushioning the impact of a sharp slump in sentiment or clearing a build-up in surplus capacity.

Certainly, consumer confidence has not responded positively to lower interest rates so far – instead it continues to fall (figure 13). Also, for the moment the US exchange rate remains strong, suggesting little stimulus to US export and import-competing sectors from that source.

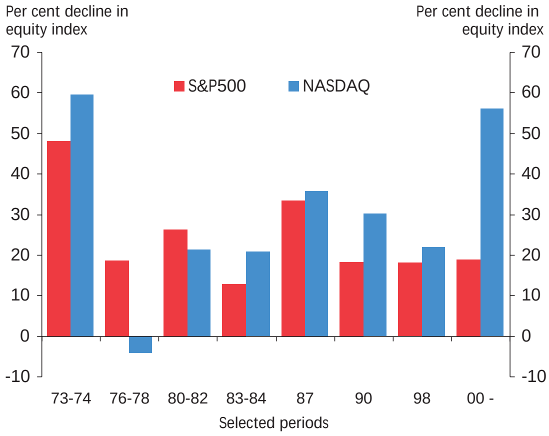
Figure 13
US consumer confidence



There is also a possibility that the supportive influence of lower interest rates on borrowing costs in the United States may be muted by other influences. For example, while borrowing costs have fallen, credit constraints have become more restrictive, making it more difficult for US firms to fulfil their business plans. The tighter credit conditions reflect the deterioration of credit quality in non-financial US corporations. For example, the already-downward trend in the ratio of credit upgrades to downgrades for industrial firms dipped sharply in the fourth quarter of 2000 and early 2001. Looking forward, the expected slowdown in corporate earnings growth will probably limit any improvement in credit-worthiness in the near future.

Finally, US equity prices have fallen significantly because of the prospects of slower US growth. In fact, US equity market falls (particularly in the technology-based NASDAQ) since their peak in 2000 have been as large as any downturn over the past three decades (figure 14).

Figure 14
Significant US equity market declines since 1970



Not only have equity prices had an adverse impact on households, but they have also hit firms, particularly high-tech firms, hard. While the market was rising, it was easy for firms to raise finance from equity markets rather than banks and so the interest rate increases undertaken by the Federal Reserve throughout the first half of 2000 had a muted impact on investment. However, the interest rate increases certainly had an impact on consumers. As soon as consumption and profits started to fall, equity markets reacted by raising the effective cost of capital sharply.

Immediately after the surprise move by the Federal Reserve in early January, equity prices rose, implicitly supporting the idea of a V-shaped recovery. However, subsequent equity price falls suggest that the expectation of a strong bounce-back in US growth may be waning.

The monetary policy implications of a more pessimistic scenario – encompassing a more protracted U-shaped slowdown in the United States, and the flow-on effects to our trading partners – are commented on at the end of this chapter.

Medium-term outlook

The weaker international outlook will influence New Zealand's medium-term outlook via the demand for our goods and services by foreigners and the level of the exchange rate. As in the December projection, we are again projecting a weaker net export response to the still-stimulatory level of the exchange rate than we might have projected in the past. In the December projection, we dampened the response of net exports to the exchange rate to reflect the less than spectacular net export growth reported to date, despite the exchange rate having been well below equilibrium for a long period of time. Reasons for the lack of a more positive net export projection included:

- an expectation by exporters and those in import-competing industries that the exchange rate was unsustainably low and would appreciate in the near term;
- tougher trading conditions in export markets associated with increasing globalisation of economic activity;
- weak margin growth as imported costs had increased and as buyers of some New Zealand products had demanded discounts; and
- the inability to substitute away from many imported goods (including oil).

In the current projections we have maintained the same judgements. Together with the more subdued outlook for the world economy and a stronger NZ dollar, this implies weaker net export growth relative to the December projection. However, because of lags between changes in both foreign demand and the exchange rate and the resulting export growth, the downward revision to our export projection affects exports predominantly from 2002 onwards. Ongoing strength in export growth through 2001 reflects exchange rate weakness and the strength of demand and commodity prices through 2000.

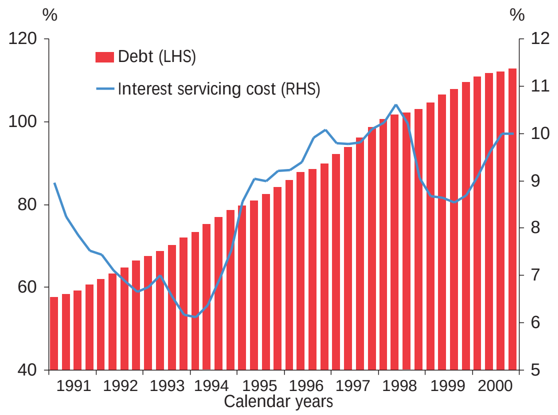
We expect that the low exchange rate will still encourage steady growth in exports, particularly exports of elaborately transformed manufactured goods. We do not think the rebound of the NZ dollar from its historic lows in late 2000 will undermine this prospect. On the contrary, stabilisation of the exchange rate may well have helped reverse the fall in sentiment seen in 2000, which in turn might help exporters become more confident about the medium-term outlook.

Domestic demand is expected to grow at similar rates to those projected in December. As explained below, we expect a weaker near-term outlook for consumption and residential investment, but this is offset by stronger business investment over 2001. As business investment growth declines, consumption and residential investment are forecast to increase over 2002/03.

We expect relatively weak private consumption growth in 2001 due to squeezed household disposable incomes and subdued asset prices. This may be partly offset by the likelihood of a temporary boost to consumption spurred on by the record pay-out to dairy farmers, and disbursements to Auckland electricity consumers.

Further out, we expect high returns in the external sector, improved consumer confidence, and stronger household income growth to lead to increased domestic demand and consumption growth. However, it should be noted that our projection for consumption does not allow very much for a structural adjustment that leads to a lower dependence on foreign savings. It is possible that consumption growth may be more restrained in response to the build-up of high levels of household indebtedness (figure 15). If the debt constraint starts to bite then we would expect to see relatively weak domestic consumption continuing for some time and the current account balance steadily improving.

Figure 15
Household debt and interest servicing costs
(as a ratio of disposable income)

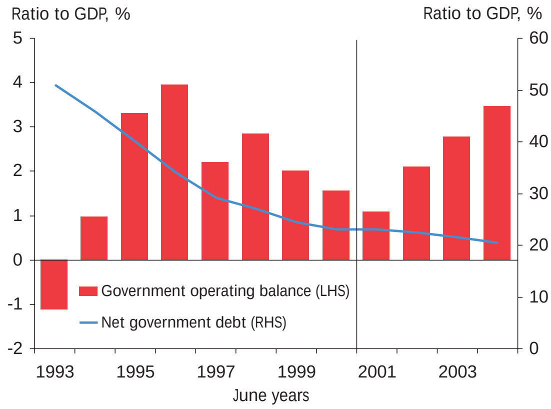


Residential investment has been held down by significant net emigration. Recent shifts in immigration policies increase the prospect of the migration flows reversing more than is assumed in the current projection. Moreover, the increasing difficulty local firms are facing in finding skilled labour increases the prospect that immigrants will be used to fill vacancies. Should this occur, then residential investment, and thus domestic demand, could be significantly stronger than presented in our projection.

As in the December projections, business investment growth over the next year or so is expected to be robust, although not spectacular. In part, this reflects anecdotal evidence that suggests enhancing efficiency rather than expanding capacity is the driving force behind most of the current investment activity. This is to be expected since the bulk of investment activity is for replacement purposes. But of course, not all investment is solely for replacement. The dairy and telecommunications industries, for example, appear to be areas where new, rather than replacement, investment is taking place.

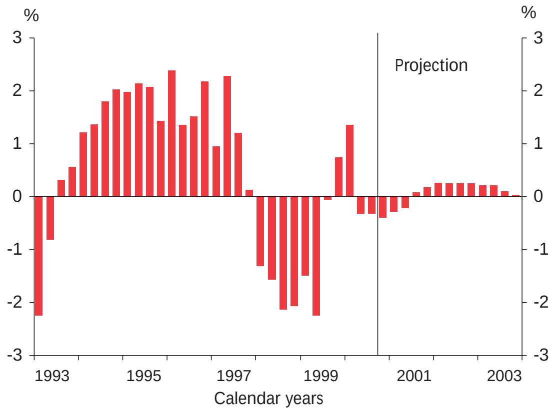
The fiscal position is not expected to greatly affect the shape of the business cycle over the forecast period. Based on the Treasury's forecasts prepared for the *December Economic and Fiscal Update*, fiscal policy is expected to have a broadly neutral effect on domestic demand growth. Rises in the government operating balance as a proportion of GDP are projected over the medium term (figure 16).

Figure 16
Fiscal projections[6]



Drawing the foregoing points together, these projections add up to a growth profile that is a little weaker – around 0.3 percentage points per annum – over the next three years than that forecast in December. Weaker GDP growth yields an output gap that remains close to zero over the next three years (figure 17).

Figure 17
Output gap
(per cent of potential GDP)



Inflationary prospects

Three separate influences shape the path of inflation over the next three years. First, with available resources broadly in balance with the growth in demand, and with interest rates remaining at broadly neutral levels, then other things equal, core inflation should tend to remain stable at current levels,

[6] Historical source: The Treasury. Adjusted by the RBNZ over the projection period.

which we judge to be close to the mid-point of the 0 to 3 per cent target band.

Second, there will be upward pressure on headline inflation in the near term as the exchange rate depreciation over 2000 feeds through into tradables prices. Later on, there will be downward pressure on inflation as landed prices of imports, in NZ dollar terms, are expected to hold steady or fall slightly in line with our assumption that the exchange rate gradually appreciates. As this happens, headline inflation should gradually return to the target band. However, as one of our judgements is that importers (or their suppliers) accepted tighter pricing margins as the exchange rate depreciated, we expect that they will look to recover margins as the exchange rate appreciates. As a result, the retail prices of imported items may be slow to show the benefit from an exchange rate appreciation.

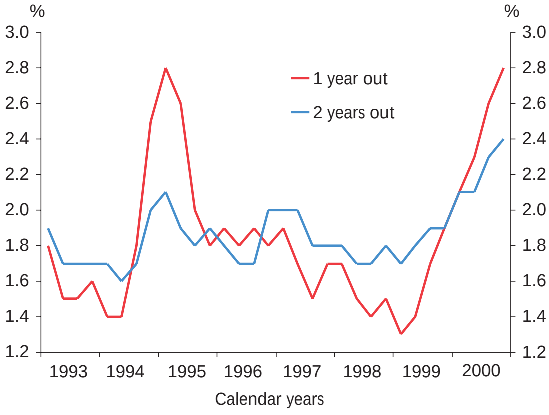
Third, overlaid on these trends are some special factors. The rise in petrol prices and increase in cigarette taxes that caused a large jump in the CPI inflation figure in the September quarter of last year will drop out of the annual numbers in September this year. The arithmetic of these calculations means that CPI inflation returns to target as these special factors drop off. Moreover, the return of inflation toward the target band will be faster than we projected in December. It now appears that the introduction of income-related rents by Housing New Zealand will result in larger reductions in state housing rents than we had previously expected.

This information, combined with the $7^{1}/_{2}$ per cent appreciation of the exchange rate since our December forecast was finalised, has lowered our near-term inflation forecast relative to that projected in the December *Statement*. Our forecasts for quarter-on-quarter CPI inflation are -0.1 per cent and 0.6 per cent for the March and June quarters respectively. These estimates translate to 3.2 per cent and 3 per cent inflation for the years to March and June 2001 respectively. But by September, CPI inflation is expected to be well within the target band and is projected to remain close to the mid-point of this band in the period beyond.

There are a number of major uncertainties in the outlook for inflation and most of the domestically-sourced uncertainties present upside risk to inflation. First, the relatively tight labour market, combined with the CPI spike from petrol, cigarette, and exchange rate-related price increases, could still result in increased wage demands. To date, wage growth has been moderate, although it typically takes about one to two years before labour costs respond to skilled labour shortages. If wage growth starts to accelerate sharply ahead of productivity growth, it would increase pressure on inflation and on monetary policy, relative to the benign outlook portrayed in this *Statement*.

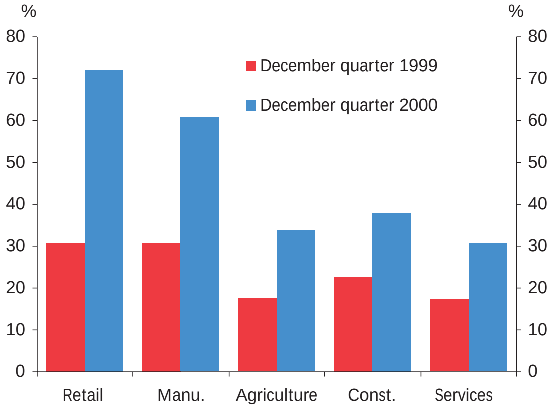
Second, the tighter labour market and CPI spike could also unhinge inflationary expectations. Indeed, measures of one-year ahead and two-year ahead inflation expectations have been rising for nearly two years now (figure 18), although this is probably more a reaction to the CPI spike than an indicator of people's expectations of ongoing higher inflation. In contrast, private sector long term forecasts of inflation (out as far as ten years) remain close to the mid-point of the Bank's target band. We expect that the short-horizon surveyed inflation expectations will fall once the temporary spike in inflation drops out of the annual CPI statistics. But if inflation expectations were to remain high, then inflationary pressures would probably become more persistent.

Figure 18
RBNZ survey of inflation expectations
(annual percentage change)



Third, increased costs from higher import prices have, to some extent, been absorbed by firms. The resulting lower margins will not be sustainable in all cases, and some margin recovery is likely. December pricing intentions data indicate that, relative to the December quarter of 1999, it is predominantly manufacturers and merchants who are looking to increase their prices (figure 19). This is probably due to these sectors facing a higher proportion of exchange-rate-related costs relative to other sectors.

Figure 19
Pricing intentions[7]
(net balance expecting to raise prices)

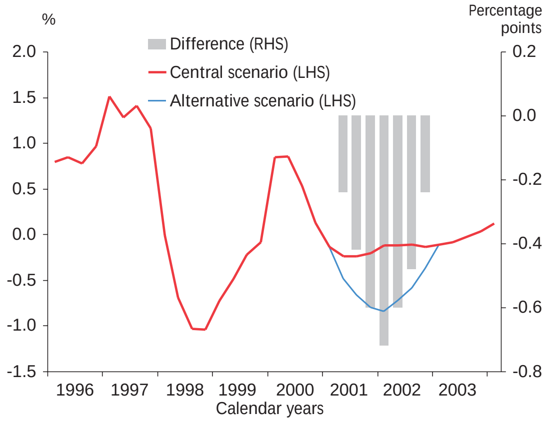


Risks aside, the projected lack of inflationary pressures over the next few years, and the projected return of CPI inflation towards the middle of the target band, implies a steady interest rate track for the period ahead. This projection has 90-day interest rates remaining at around current levels for the foreseeable future. This interest rate track is somewhat lower than the track presented in the December *Statement* (which portrayed a tightening of about 100 basis points over the forecast period). Monetary conditions, however, do tighten in the sense that the exchange rate appreciates over the forecast horizon. The assumed rate of appreciation is similar to that assumed in December, although from a higher starting point. The TWI exchange rate is assumed to be near 55 by the second half of 2003.

This projection critically relies on our assumption that the world undergoes only a mild slowdown. However, as discussed above, there is substantial uncertainty about how the international economy will evolve over the next year or so. If a more protracted slowdown in global growth were to eventuate, with subsequent falls in commodity prices, what would be the implications for monetary policy? We now briefly examine this question.

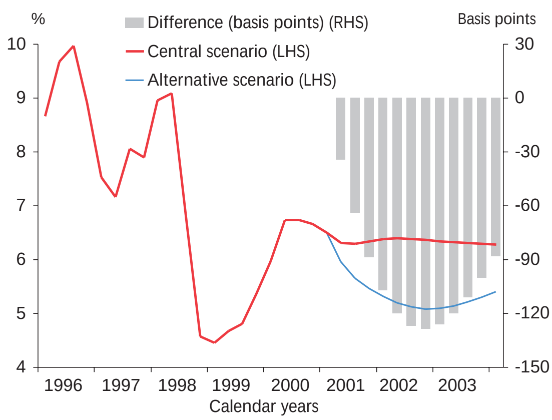
While in the main projection world economic growth is assumed to slow to a rate that is in line with historical averages, in an alternative scenario, we assume slower growth such that the level of world demand is about 1 per cent below trend by early 2002 (figure 20). This slowdown in global growth in turn lowers world prices for New Zealand's commodities and further slows export volumes. As before, the depressing effect on the New Zealand economy is mitigated by the already-low NZ dollar, which is assumed to depreciate mildly in response to the deeper trough in external demand before resuming its trend appreciation.

Figure 20
World output gap
(per cent of world potential output)



The overall outcome in this alternative scenario is reduced demand for New Zealand resources and lower inflationary pressure throughout the projection period. A more accommodating monetary policy stance is therefore required, with 90-day interest rates at the trough being around 125 basis points lower than in the central scenario (figure 21).

Figure 21
Nominal 90-day interest rates



7 Source: National Bank of New Zealand.

4 Policy issues

Earlier chapters have described how the New Zealand economy has evolved broadly in line with our expectations of late last year. The divergent performances of the domestic and external sectors, apparent for some time, have been maintained, although since December there has been a further lift in the general level of business and consumer confidence from the doldrums of the middle of 2000.

But despite those positives, asset markets have been subdued, the demand for credit has been uncharacteristically sluggish, company profitability, especially for those selling mainly to the domestic market, has been mixed but with a distinctly weak tone overall, and retail sales have been flat.

In terms of inflation pressures, the underlying trends at this point are also difficult to read. To date, there have been few signs that the transitory influences that have pushed headline CPI inflation to 4 per cent are spilling over into more generalised inflation. But the labour market has tightened and, coupled with expected continued migration outflows, this might induce upward pressure on salaries and wages in excess of productivity growth. Also, in those circumstances, there would be a greater likelihood of exchange-rate-related price increases – which have been increasingly evident – spilling over into rising domestic costs and prices.

Had nothing changed since December, the greater inflation risks associated with the tightening labour market could well have been reason to be increasing interest rates at this point – at least as much as foreshadowed in December. But there has been a notable change, that being in the state of the international economy and the stance of other central banks in response to that change. In December, we noted that the performance of the international economy over the previous year had been unusually favourable. While the consensus of major forecasters pointed to some softening in the international growth performance in 2001, that was off an exceptionally strong base. We did note, however, that the balance of risks in the international economy seemed well to the downside. Indeed, that was one important factor convincing us to defer any tightening in monetary policy at that time, despite a sense that inflationary pressures would probably build through 2001 in the absence of some offsetting influence.

A reasonably substantial slowing in the world economy now seems more likely to materialise, and that prospect has been a particular focus in our preparation of this *Statement.* Key questions have been:

- Whether, given the importance of external influences, monetary policy in New Zealand should be taking its cue from other central banks that have moved into an easing phase.
- Whether we are prone to be too cautious in easing policy in the face of world slowdowns. Are there lessons to be learned from how we responded to the previous global slowdown (the Asian crisis), when policy was eased later than turned out to be warranted?

Also, of course, the fact that annual CPI inflation is well outside the 0 to 3 per cent target range, and is expected to remain there until September of this year, remains an important issue in terms of what constitutes an appropriate current policy stance.

Responding to international developments

Since December, there has been a significant shift in the stance of monetary policy internationally. A sharp weakening of indicators in the United States has prompted two easings by the Federal Reserve Board's Open Market Committee and brought forth a flurry of responses by other central banks in the same direction (see table 4, chapter 2). Private sector analysts have similarly reassessed their expectations for the international economy. As discussed in chapter 3, while the V-shaped recovery envisaged in the *Consensus* is certainly plausible and consistent with a short term inventory correction, the balance of risks seems skewed in the direction of a more protracted slowdown.

So what does this mean for New Zealand? In particular, how should monetary policy best respond in such an environment? Does the fact that other central banks have begun easing suggest that New Zealand should automatically move to an easing phase?

The answers to these questions lie in judgements surrounding the current state of underlying inflation pressures in New Zealand relative to those evident in other countries, and the linkages between developments in our major trading partners and demand pressures in New Zealand.

On the first question, of where New Zealand sits in its current cycle relative to the position of our trading partners, it seems reasonably clear that we are not moving in parallel. Despite the negative developments in the US and Australia, business and consumer confidence in New Zealand has continued to lift and is now at quite buoyant levels. In figure 17, we can see that output fell below trend in New Zealand in the middle of 2000. But since then the economy has stabilised and the current outlook is for the economy to track around trend, or perhaps a little better than that. By contrast, figure 20 shows that the comparable adjustment in our main trading partners has been more recent, and there is correspondingly more uncertainty about whether the adjustment is yet complete. In this sense, the New Zealand economic cycle seems 'out of sync' with those of our trading partners. While, of course, the world slowdown will have an influence on the shape of the New Zealand economic cycle going forward, it nonetheless appears that New Zealand is facing that slowdown from a different cyclical starting point than are some of our trading partners.

Should this generally optimistic assessment be qualified with a "so far"? In other words, is it simply a question of waiting for the lags to play out, in which case monetary policy should be moving now to head off the inevitable downturn in commodity prices and export volumes as we get caught up in the international slowdown?

The answer to that lies crucially in the shape of the international slowdown. We have chosen to base our projections on the *Consensus* view of the international economy. As outlined earlier, this embodies a V-shaped recovery, with a short term inventory correction playing out during the course of this year. This envisages growth returning quickly to a pace well up with longer-term averages. In that environment, it is entirely plausible that commodity prices would 'smooth through' the downturn and that the New Zealand economy could proceed through the international dip with its own output track relatively undisturbed.

A re-run of the Asian crisis?

We are conscious that the current situation has some parallels with what we saw in 1997. Evidence of the unfolding Asian crisis is much clearer in hindsight than it was during the latter part of 1997. At that stage, too, we were quite aware of the emerging Asian difficulties, and policy was assisted by our knowledge of those events, but, in retrospect, it was insufficiently influenced. That, to some degree, was a consequence of US and European prospects remaining strong, and hence a concern that we should not overreact to what appeared to be a regional difficulty.

Against this background, we have asked ourselves whether we may again be erring on the optimistic side in our assessment of the world outlook. That questioning has resulted in a heightened awareness of how world developments can impact on the New Zealand economy. For instance, the world prices of the commodities New Zealand exports are currently under particularly close monitoring for any early signs of the world slowdown impacting on the New Zealand economy via that channel. And in Chapter 3 we sketch the alternative possibility of a deeper and more prolonged international slowdown. While we are not yet basing our policy stance on an expectation that this more negative pattern will emerge, we are certainly not discounting that possibility.

But we should also recognise that there are factors that differentiate the current circumstances from those of late 1997. While there has been a rapid reassessment of prospects, there is no 'crisis' about us at this point. A feature of the Asian crisis was that substantial amounts of trade were brought to a very abrupt halt, owing to the financial character of the crisis. Trade payment arrangements with trading partners in the East-Asia region were severely disrupted, with the result that goods already destined for export sat on the wharves for a period, pending payment uncertainties being resolved. Also, there were massive collapses of wealth in the region and massive exchange rate depreciations. One result was that the flow of tourists to New Zealand from the region also came to an abrupt halt.

The current world slowdown, even if it turns out to be deeper and more prolonged than presently envisaged, is not expected to be associated with the same degree of financial stress and crisis – though we are nonetheless mindful that such a slowdown could expose remaining financial vulnerabilities in some emerging market economies (and in Japan).

It is also the case that we enter this period of uncertain international economic prospects with an exchange rate already near historic lows, whereas in 1997 it was depreciating from historically very high levels, with the tradables sector then quite fragile as a consequence. In effect, the support that the exchange rate can usefully provide via the tradables sector during an external downturn is already in place. As a consequence, the tradables sector is in better shape to cope with any weakening of conditions abroad than was the case in 1997.

Another channel by which an international downturn might be transmitted to New Zealand is via financial markets. As the US, Australian and other central banks of relevance to us have eased policy over the past couple of months, the margin between New Zealand and international interest rates has widened. Expectations of the future path of interest rates here have also shifted from a near unanimous view that rates would be increasing through 2001 to a widespread (but not unanimous) view that the next moves in New Zealand will be to lower interest rates. Even without the Reserve Bank moving, borrowers have already seen lower borrowing rates as a consequence, particularly in fixed interest rate contracts. In other words, some part of the international easing has already been transmitted to New Zealand borrowers and savers.

In sum, the possibility that the slowdown in the world economy might be sharper and deeper than generally expected puts policy 'on alert.' Whether policy should move to take insurance against this possibility depends on the overall balance of risks, considered within the context of the factors that the PTA states should determine policy.

Interpreting the PTA

A key issue for the Bank as it contemplates its policy stance is the appropriate interpretation of the Policy Targets Agreement (PTA). The centre-piece of the PTA, of course, is the 0 to 3 per cent target range for annual increases in the CPI. But the PTA also provides that:

- 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.
- 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, and significant government policy changes that directly affect prices.

Taken together, these provisions indicate that monetary policy should be directed to keeping underlying, or persistent, inflation pressures within the target range over a medium-term horizon of, say, one to two years, while allowing shocks to be absorbed through the price mechanism in the shorter run. Importantly, that involves making judgements about the extent to which specific price shocks will spill over into other price and cost structures, that is, into general inflation on a persistent basis. Where there are grounds for judging that spillover will not happen, or will not be substantial, then it is reasonable to 'look through' the price shocks in question. But if it seems more probable that spillover will occur, then to look through them would be a policy mistake.

In this context, the present situation is not entirely clear-cut. It seems clear that the large movements in petrol prices, tobacco prices, and State House rentals, of themselves, are not part of a persistent inflation dynamic. And it is quite possible that the exchange-rate-related increases in prices we are seeing are a reflection more of New Zealand adjusting to a lower real exchange rate than they are of an emerging inflation dynamic.

This assessment is conditional on sufficient restraint being maintained to prevent spillover into domestic costs and prices. The spike in CPI inflation that these particular price adjustments have contributed to comes at a time when some pressures in the economy are emerging. In particular, labour market conditions have tightened appreciably and, given what history suggests about the link between labour market pressures and wage inflation, there is a risk that the spike in the cost of living will flow through to wage and salary increases to some extent. This risk needs to be weighed against concerns that trading partner demand will turn out noticeably weaker than our projections allow.

Appendix 1
Chronology

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

2000

6 December:	The Reserve Bank released its twenty-eighth *Monetary Policy Statement*, leaving the Official Cash Rate unchanged at 6.5 per cent. The news release accompanying the *Statement* is reproduced in Appendix 3.
21 December:	Production GDP figures were released showing that the New Zealand economy expanded 0.7 per cent in the September quarter.

2001

17 January:	CPI statistics were released for the December quarter showing that the CPI increased by 1.2 per cent over the quarter, and by 4.0 per cent for the year to December 2000.
24 January:	At the intra-quarter review, the Reserve Bank left the Official Cash Rate unchanged at 6.5 per cent. The accompanying news release is reproduced in Appendix 3.
28 February:	The Government released the Independent Review of the Operation of Monetary Policy in New Zealand prepared by Professor Svensson. The Reserve Bank's accompanying news release is contained in Appendix 3.

Appendix 2
Companies and organisations contacted by RBNZ staff in the last week of January 2001

Barfoot & Thompson Limited

Briscoes (New Zealand) Limited

Canterbury Manufacturers Association Incorporated

Carter Holt Harvey Limited

Centra Auckland

Christchurch International Airport Limited

Click Clack Limited

Fisher & Paykel Industries Limited

FMS Chartered Accountants

H. W. Richardson Group Limited

Interlock Industries Group Limited

Kiwi Co-operative Dairies Limited

Landbase Trading Society Limited

LV Martin & Son Limited

Macpac Wilderness Equipment Limited

Mainzeal Property and Construction Limited

Mercer Stainless Limited

Napier City Council

New Zealand Council of Trade Unions

New Zealand Wool Board

Port of Napier Limited

Ports of Auckland Limited

Prepared Foods Limited

PricewaterhouseCoopers

Registered Master Builders Federation of New Zealand Incorporated

Restaurant Brands New Zealand Limited

Reid Farmers Limited

Southland Times Co Limited

Sunbeam Corporation Limited

The Warehouse Limited

Tourism New Zealand Limited

Vita New Zealand Limited

— plus a number of registered banks, government departments, economic research agencies and industry organisations.

Appendix 3
Reserve Bank statements on monetary policy

The following are reports or texts of official statements on monetary policy issues made by the Bank during the period under review in this *Monetary Policy Statement*.

OCR unchanged at 6.5 per cent
6 December 2000

The Reserve Bank has again decided to leave the Official Cash Rate unchanged at 6.5 per cent, but also signalled that some increase in interest rates is likely, possibly early next year.

That's come with the release of the Reserve Bank's December *Monetary Policy Statement.*

Reserve Bank Governor Don Brash commented: "We believe that business confidence is set to strengthen, consistent with economic activity having picked up in recent months and being noticeably stronger in the second half of the year. Even with some exchange rate appreciation and slowing in world growth, exporters and those competing with imports will continue to benefit from exceptionally good trading conditions for some time. And the reality is that there is not much spare capacity in those sectors.

"We believe that the pressure on resources associated with the resurgence in growth can be kept in check with a gradual and - by historical standards - rather small firming of interest rates next year.

"It is also clear that, in the short-term, annual CPI inflation will exceed the top of the target band for the next several quarters. Even so, stripped of the transient effects of international oil prices and cigarette taxes, CPI inflation will remain well within the target range. In accordance with our longstanding agreement with Government, the Bank will continue to focus on the persistent elements of inflation and therefore ignore the transient elements.

"Inevitably, our confidence that the temporary inflation spike will not become persistent is affected by the wider situation, including the degree of pressure on the nation's resources. While there are clearly some risks that inflationary pressures will turn out to be stronger than now expected, at this stage we believe that a small firming of interest rates next year should be sufficient to ensure that the current spike in inflation will prove transitory.

"In summary, somewhat higher interest rates are likely to be needed, but not quite yet. The extent of the increase will depend very much on how the world economy evolves, on how the economy responds to the stimulus provided by the low exchange rate, and on the response of price and wage setters to the near-term increase in the inflation rate," Dr Brash concluded.

OCR unchanged at 6.5 per cent
24 January 2001

The Reserve Bank today announced that the Official Cash Rate (OCR) would remain at 6.5 per cent in the meantime.

Commenting on the announcement, Reserve Bank Governor Don Brash said "In our December *Monetary Policy Statement*, we noted that the New Zealand economy appeared to be regaining momentum after a mid-year pause, with both consumer and business confidence measures having rebounded strongly. Faced with a very low and stimulatory exchange rate, and a consensus outlook on the world economy that remained robust, it appeared likely that a gradual further rise in the OCR would be needed this year.

"Since then, the exchange rate has strengthened. Perhaps even more important, expectations for global growth this year have slowed appreciably. This fall-off in expected growth has been most notable in the United States, but is also a feature of the outlook for Australia and for much of Asia.

"Although CPI inflation was marginally higher than we had expected in the December quarter, the main factors driving the spike in inflation were one-off in nature, as anticipated in the December *Monetary Policy Statement*. Other one-off factors now suggest that the peak in the CPI may be of rather shorter duration than we had earlier expected, with a commensurately reduced risk of spill-over from this spike into generalised wage and price setting behaviour.

"Given these factors, we feel we can prudently leave the OCR unchanged for the moment. We will have another opportunity to assess the situation when we issue our next *Monetary Policy Statement* on 14 March," Dr Brash concluded.

Brash outlines decision-making process

26 January 2001

Reserve Bank Governor Don Brash today outlined the processes employed in arriving at monetary policy decisions.

In a speech to the Canterbury Employers' Chamber of Commerce, Dr Brash said he was doing this to dispel criticism that the Reserve Bank "is insufficiently in touch with the `real world', or that it is excessively `ivory tower' or academic." Dr Brash also said he wanted to show that, while the Reserve Bank Act requires that he alone makes the Reserve Bank's monetary policy decisions, considerable care had been taken to create processes and structures to ensure that he receives comprehensive and balanced advice before decisions are taken.

Dr Brash told the gathering that an eight-week process is used in preparing the Bank's quarterly *Monetary Policy Statements* and making the interest rate decisions that go with that.

As the speech outlined:

- In weeks one and two, Reserve Bank economists typically visit or contact 40 to 50 businesses and sector groups to see first-hand how the economy is evolving.
- In weeks two and three, staff undertake intensive analysis of all available statistical data.
- In week four, the Bank reviews developments in the international data. Also in week four, Bank staff develop alternative interpretations of the current and prospective economic situation, testing the cases for both more and less aggressive monetary policy approaches.
- In week five, the Bank's Economics Department presents draft economic forecasts to the Bank's Monetary Policy Committee (MPC) for detailed consideration. These forecasts are adjusted and agreed, so that by that Friday a subset of the MPC advises Dr Brash on what the interest rate adjustment, if any, should be. Dr Brash makes a provisional decision, subject to revision later if required.
- In weeks six, seven and eight, the *Monetary Policy Statement* is drafted and published.

Dr Brash said that this framework had evolved over recent years, with improvements being constantly sought. For that reason, the Reserve Bank was looking forward to the results of the review of monetary policy being conducted by Professor Lars Svensson in order to identify what further improvements could be made.

RBNZ welcomes Svensson report

28 February 2001

The Reserve Bank today said it welcomed the judgement of Professor Lars Svensson that "Monetary policy in New Zealand is currently consistent with the best international practice of flexible inflation targeting."

This follows the release today of the Government's Independent Review of the Operation of Monetary Policy in New Zealand prepared by Professor Svensson.

Reserve Bank Governor Don Brash commented "Professor Svensson's review is thorough and extensive. I'm very pleased that Professor Svensson's research indicates that the Reserve Bank is following best practice in the way it delivers price stability, that being the Bank's primary function, as set by statute.

"The Reserve Bank is required, under the Policy Targets Agreement, to deliver price stability in such a manner as `to avoid unnecessary instability in output, interest rates and the exchange rate', and Professor Svensson's research indicates that the Bank is achieving this too.

"I also acknowledge that Professor Svensson's report is critical of some of the Reserve Bank's decisions and implementation procedures in the past, and in particular our use of a Monetary Conditions Index between mid-1997 and March 1999. The Reserve Bank itself indicated its concerns in this regard when we introduced the Official Cash Rate in March 1999.

"This performance assessment apart, the bulk of Professor Svensson's report, and the substance of its recommendations, are about governance and decision-making processes.

"Here I think no-one should rush to judgement. In terms of monetary policy decision making, internationally there are central banks using all the governance and decision-making models canvassed. The challenge is identifying the best option for the New Zealand context, remembering that New Zealand is already doing well in this regard.

"Financial market participants and the public can be confident that among New Zealand policy makers the importance of these issues, the on-going commitment to price stability, and the need for caution are well understood. I look forward to careful and productive discussions with the Government and its advisors in the weeks ahead."

Appendix 4
Summary Tables[1]

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

		CPI* Annual	TWI	90-day bank bill rate
1995	Mar.	1.9	59.8	9.4
	Jun.	2.2	60.8	9.1
	Sep.	2.0	61.7	9.0
	Dec.	2.0	61.9	8.5
1996	Mar.	2.1	64.2	8.7
	Jun.	2.3	64.6	9.7
	Sep.	2.3	65.6	10.0
	Dec.	2.4	67.1	8.9
1997	Mar.	2.0	68.4	7.5
	Jun.	1.5	68.0	7.2
	Sep.	1.8	64.8	8.1
	Dec.	1.6	63.9	7.9
1998	Mar.	1.7	61.2	9.0
	Jun.	1.7	58.5	9.1
	Sep.	1.7	57.1	6.8
	Dec.	1.1	56.0	4.6
1999	Mar.	1.0	57.6	4.5
	Jun.	1.2	59.1	4.7
	Sep.	1.1	56.7	4.8
	Dec.	1.3	54.4	5.4
2000	Mar.	1.7	54.1	6.0
	Jun.	2.0	53.4	6.7
	Sep.	3.0	50.1	6.7
	Dec.	4.0	47.7	6.7
2001	First Half Average	3	$50^1/_2$	$6^1/_2$
	Second Half Average	$1^1/_2$	$51^1/_2$	$6^1/_2$
2002	First Half Average	$1^1/_2$	$52^1/_2$	$6^1/_2$
	Second Half Average	1	$53^1/_2$	$6^1/_2$
2003	First Half Average	$1^1/_2$	54	$6^1/_2$
	Second Half Average	$1^1/_2$	$54^1/_2$	$6^1/_2$

1 Notes for these tables are in Appendix 5.

* 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 SNZ 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)

	Actuals						Projections			
March year	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Final consumption expenditure										
Private	6.0	4.1	3.7	3.0	1.3	2.6	$1\frac{1}{2}$	3	$3\frac{1}{2}$	$2\frac{1}{2}$
Public authority	-0.7	3.3	2.5	5.3	0.1	7.3	-4	$2\frac{1}{2}$	$1\frac{1}{2}$	$4\frac{1}{2}$
Total	4.6	3.9	3.5	3.4	1.1	3.5	$\frac{1}{2}$	3	3	3
Gross fixed capital formation										
Market sector:										
Residential	12.3	-0.1	4.0	1.8	1.8	22.0	$-15\frac{1}{2}$	$-3\frac{1}{2}$	9	$6\frac{1}{2}$
Business	18.5	14.2	4.9	1.0	4.4	6.7	11	7	$6\frac{1}{2}$	$4\frac{1}{2}$
Non-market government sector	21.8	2.0	31.8	12.4	-7.6	11.7	$-5\frac{1}{2}$	$4\frac{1}{2}$	8	12
Total	17.2	9.6	7.0	2.4	-1.1	10.1	4	5	7	$5\frac{1}{2}$
Final domestic expenditure	7.0	5.1	4.3	3.2	0.6	4.9	1	$3\frac{1}{2}$	4	$3\frac{1}{2}$
Stockbuilding [1]	-0.1	-0.3	0.0	0.1	-0.9	1.6	-1	$-\frac{1}{2}$	0	0
Gross national expenditure	6.8	4.7	4.2	3.2	-0.3	6.5	$\frac{1}{2}$	3	4	$3\frac{1}{2}$
Exports of goods and services	8.4	2.6	3.7	3.9	2.1	6.3	$9\frac{1}{2}$	8	$3\frac{1}{2}$	3
Imports of goods and services	14.3	7.4	7.2	4.8	3.3	11.2	3	$6\frac{1}{2}$	$5\frac{1}{2}$	$4\frac{1}{2}$
Expenditure on GDP	5.2	3.2	3.1	2.9	-0.7	4.7	$2\frac{1}{2}$	$3\frac{1}{2}$	3	3
GDP (production)	5.3	4.1	3.0	1.9	0.1	4.4	$2\frac{1}{2}$	$3\frac{1}{2}$	$3\frac{1}{2}$	3
GDP (production, March qtr to March qtr)	4.6	4.1	1.7	0.2	2.2	5.5	1	$3\frac{1}{2}$	3	3
Potential output	3.8	3.9	3.5	2.9	2.5	2.5	$2\frac{1}{2}$	3	3	3
Output gap (% of potential GDP, year average)	1.8	2.0	1.5	0.6	-1.8	-0.1	$-\frac{1}{2}$	0	0	0

e = estimate

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

Appendix 5
Notes to the tables

CPI	Consumers Price Index
TWI	RBNZ. Nominal Trade Weighted Index of the exchange rate. Defined as: A geometrically-weighted index of the New Zealand dollar bilateral exchange rates against the currencies of Australia, Japan, the United States, the United Kingdom, and the euro.
90-day bank bill rate	RBNZ. Defined as: The interest yield on 90-day bank bills.
World GDP	Reserve Bank definition. 14-country index, export weighted. Projections based on *Consensus Forecasts*. 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 *Consensus Forecasts*.
Import prices	Domestic currency import prices. *Overseas Trade Indexes.*
Export prices	Domestic currency export prices. *Overseas Trade Indexes*.
Terms of trade	Constructed using domestic-currency export and import prices. *Overseas Trade Indexes.*
Private consumption	*System of National Accounts.*
Public authority consumption	*System of National Accounts.*
Residential investment	RBNZ definition: Private sector and government market sector residential investment. *System of National Accounts.*
Business investment	RBNZ definition: Total investment less the sum of non-market investment and residential investment. *System of National Accounts.*
Non-market investment	RBNZ definition: The *System of National Accounts* 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. *System of National Accounts.*
Stockbuilding	Percentage point contribution to the growth of GDP by stocks. *System of National Accounts.*
Gross national expenditure	Final domestic expenditure plus stocks. *System of National Accounts.*
Export of goods and services	*System of National Accounts.*
Imports of goods and services	*System of National Accounts.*
GDP (production)	*System of National Accounts.*
Potential output	RBNZ definition and estimate. Refer to: Conway, P. and B. Hunt, (1997), 'Estimating Potential Output: a semi-structural approach', *Reserve Bank of New Zealand Discussion Paper*, G97/9.
Output gap	RBNZ definition and estimate: The percentage difference between real GDP (production, seasonally adjusted) and potential output GDP.
Current account balance	*Balance of Payments.*
Total employment	*Household Labour Force Survey.*
Unemployment rate	*Household Labour Force Survey.*

Household savings rate	*Household Income and Outlay Accounts.*
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. *Quarterly Employment Survey*.
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.