Monetary Policy Statement[1]

June 2003

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).

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[1] Projections finalised on 23 May 2003. Policy assessment finalised on 4 June 2003.

1 Policy assessment

The Reserve Bank has decided to cut the Official Cash Rate by 25 basis points to 5.25 per cent.

Reducing the OCR is an appropriate response to a softening in inflation pressures and provides some protection for the economy against downside influences.

The evidence has become clearer that growth is beginning to slow following a period of strength. This slowdown mainly reflects the rapid appreciation of the exchange rate over the past 18 months, leaving the export sector more exposed to the soft world economy. We are projecting further slowing but expect domestic activity to remain reasonably robust with rapid growth in the population supporting demand. However, businesses are less assured about future trading prospects and confidence measures have fallen away. With confidence fragile, the impact of events such as SARS and dry weather on activity could be amplified.

The reformulated Policy Targets Agreement requires us to target inflation with a medium term focus and to avoid unnecessary instability in output, the exchange rate and interest rates. This OCR decision is intended to help prevent an unnecessarily sharp downturn, while delivering inflation that remains comfortably within the target range over the next few years. Influencing our decision is increased certainty that the economy has started to turn down, and the presence of downside risks – foreign and local – whose effects may be exaggerated by fragile confidence. In addition, CPI inflation is expected to receive extra downward pressure over the year ahead as a direct result of the higher exchange rate, but this effect will be temporary.

Our current projections of the economy incorporate a further modest reduction in the OCR. Any such further reduction will be contingent on further evidence that medium term CPI inflation pressures are abating as our projections assume. We will take our cues from the activity and inflation data as they come to hand.

Alan Bollard
Governor

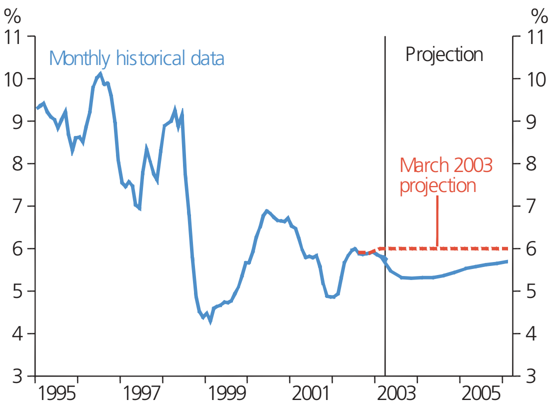
2 Overview and key policy judgements

Overview

New Zealand's economic growth has been strong and comparatively stable for an extended period, but it is now beginning to slow to a more modest pace. This growth progressively shifted the economy from under-utilising its available productive resources, to a much tighter resource situation. With the tightening came a noticeable build up in domestic inflation, which required a firmer monetary policy in New Zealand than typical elsewhere in the world. As growth eases, inflation pressures will also, allowing interest rates to be reduced (figure 1).

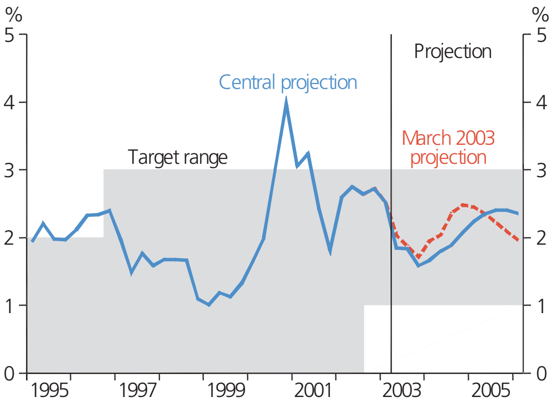
In line with the 2002 Policy Targets Agreement (PTA), we are aiming to ensure that the inflation trend eases back comfortably within the target range, while avoiding an unnecessary disruption to growth. In current circumstances, that implies a readiness to ease policy now to help maintain the economy on an even keel, consistent with its fundamentally sound position. Medium-term inflation could end up a little higher in the inflation target range than otherwise, but this would be in keeping with the PTA, especially if inflation remains comfortably within the target range – as we expect (figure 2).

Figure 1
90 day interest rates



Source: RBNZ.

Figure 2
Consumer price inflation



Source: RBNZ. See p 29 for series definition.

Much of the change in circumstance is due to the appreciation in the New Zealand dollar over the last 18 months. At the same time, the rest of the world has not become any friendlier in economic terms. These factors will continue to act over the next year or two to take the edge off New Zealand's growth, albeit while a continuing boost from strong immigration provides underlying support.

The slowdown may initially appear to be much faster than the true trend. Various events, including SARS and those related to dry weather, will probably cause growth to pause briefly before returning to a more normal rate. Simultaneously, the sharp fall in CPI inflation, which we expect to occur as import prices fall in response to the recent exchange rate appreciation, could create the impression of a more rapid slowdown in growth than is actually occurring. These events could have an out-sized effect on attitudes towards business and investment.

The recent economic cycle in context

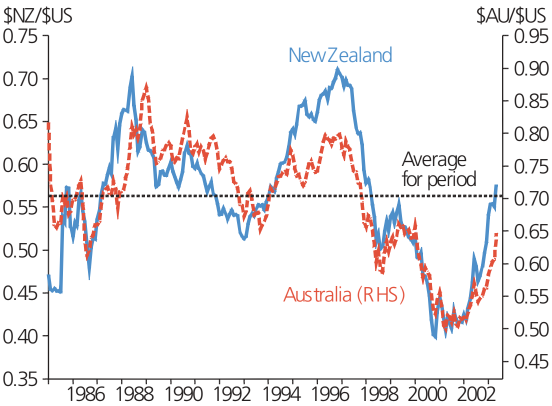
New Zealand's recent growth phase has been exceptionally strong by international standards. It is difficult for small open economies to avoid being swept along by developments in major countries. But in both New Zealand and Australia, temporarily depreciated exchange rates and other factors have provided a measure of independence from lacklustre global trends.

As usually happens eventually, strong economic performance has been followed by strengthening exchange rates, for both New Zealand and Australia (figure 3). Much of the antipodean protection from the current global weakness has consequently disappeared. US economic weakness has likewise started to become matched by US dollar weakness, which directly translates into New Zealand and

Australian dollar strength. A slip back in our growth rate from its recent above-trend pace has thus been inevitable.

Migration developments were also a major factor behind recent good growth. Migration swung sharply from a net outflow of over 10,000 people per annum to a net inflow of around 40,000 people per annum, essentially over the same period that our trading partners' growth started to slide. At that pace, fully 1 percent is added to the existing population each year. This influx has reflected our relatively good growth prospects, attracting New Zealanders to come home and new migrants to seek jobs here. Also, more people are on extended visits for education, and geo-political security concerns are keeping New Zealanders home.

Figure 3
Exchange rates with the United States



Source: Reuters.

Whatever the cause, the migration swing has boosted demand for New Zealand products - notably accommodation. The overall impulse to activity may have been more than 1 per cent in each of the last two years. Because non-working students have been a large part of the net immigration flow, the boost to the economy's productive capacity from immigration has been smaller than the boost to demand. This has placed net pressure on inflation, only partially alleviated by higher labour force participation by resident New Zealanders and additional investment in plant and machinery.

Helped also by favourable growing conditions, an Australian housing boom, and good commodity prices, the combination of a favourable exchange rate and strong net immigration more than compensated for weak world demand, up until the end of 2002 at least. This is shown by the accumulation of inflation pressure. More recently, the exchange rate has become unfavourable by comparison with its historical averages, but the positive impulse provided by strong net immigration is continuing. The boost from immigration is proving to be timely, helping sustain economic momentum at a time when conditions could otherwise become difficult. But this combination also means that divergences between parts of the local economy and export sectors are becoming sharper. At the same time that exporters to the US are finding conditions increasingly difficult, the construction industry in Auckland - the destination of much of the immigration - is clearly being stretched.

The economic cycle looking forward

As detailed in Chapter 3 of this Statement, growth seems to have remained robust through the first few months of this calendar year. But several indicators suggest that growth momentum has slowed, and will slow further. Employment growth (normally a lagging indicator) has eased back; tourist arrivals have fallen; export prices have weakened; and the latest retail sales numbers show smaller gains. Business confidence has been particularly hard hit, even if one sets aside the volatile and headline-sensitive general business confidence measures and focuses instead on expectations of prospects for individual businesses. The higher exchange rate, bad economic news globally, signs of an emerging electricity crisis and SARS have all contributed to the confidence setback.

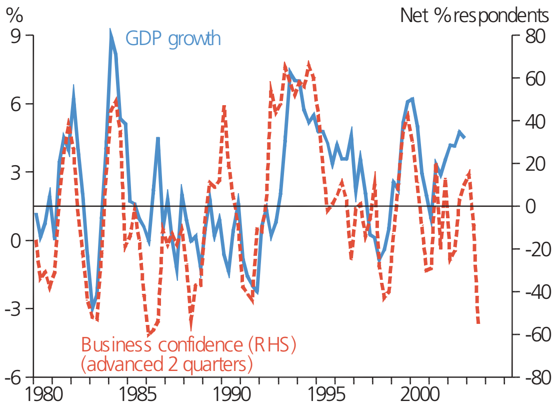
It therefore appears to us that the economy is turning from acceleration to deceleration, or is perhaps past that turning point. The rapidity of the exchange rate appreciation and global economic weakness might suggest that a drop in growth to low levels is in prospect. However, there are good reasons to expect something much less dramatic, given that:

- by historical standards, the exchange rate is only mildly contractionary, and the weakening Australian cross rate/ strengthening $US cross rate combination has some advantages for many manufacturing exporters;
- immigration continues apace;
- interest rates have not been high (by our historical standards) for some time, and have recently declined;
- the financial position of the corporate sector is generally very sound, and banks are well capitalised with low rates of bad and doubtful debt;

- order books remain full for many businesses, especially those associated with the construction sector; and
- past economic strength means that the "typical" wage earner is still experiencing real wage increases with solid employment prospects.

Business attitudes are important in such a situation. In this context, very weak general business confidence measures look worrying (figure 4). We think the drop in general business confidence (a volatile indicator at the best of times) has been exaggerated by concerns about the war in Iraq, a spreading SARS and early signs of power shortages. But in the period immediately ahead, these unusual factors could affect business attitudes through their effect on indicators of the state of the business cycle. Measured GDP will look weak in the second quarter. Most of that is a matter of timing (as detailed in Box 1 in Chapter 4) and therefore essentially misleading. The risk, however, is that the confidence rebound that ought to occur will be interrupted.

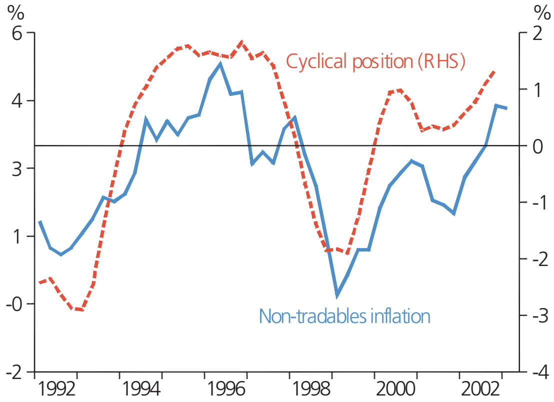
Figure 4
Business confidence and GDP growth



Source: Statistics New Zealand, New Zealand Institute of Economic Research.

Timing factors will also mask the underlying trend of inflation pressures over coming quarters. Recent economic strength has stretched the economy's productive resources, with relatively high domestically-sourced inflation resulting (figure 5). Once one allows for the temporary influences on GDP just discussed, the relaxation of inflation pressure will not be sharp. However, CPI inflation is expected to fall quite quickly, to an annual rate as low as 1 $^{1}/_{2}$ percent by the end of this year (figure 2).

Figure 5
Cyclical position and non-tradeables inflation



Source: RBNZ. The cyclical position is the difference between output and its trend (the output gap). Non-tradables inflation represented by the weighted median of annual changes.

The speed of the fall in CPI inflation is mostly due to a rapid reduction in inflation of internationally tradable goods and services prices, with non-tradables inflation taking longer to abate. Falling tradable inflation over 2003 is largely the product of exchange rate appreciation experienced over 2002, as well as the weakness of inflation globally.

Beyond the next few quarters, our ability to anticipate developments is reduced, as always. The central scenario depicted in the economic projections described in Chapter 4 involves a return to "normal" on most fronts. Consensus Forecasts of world economic activity, from which we source our assumptions for New Zealand's external trading environment, suggest such a picture. We assume, for want of a viable alternative, a return to long-term averages for the both the exchange rate and migration. Likewise, for lack of a good alternative, we assume a return to normal weather patterns with wholesale electricity prices and agricultural production reverting to more normal levels. As can be seen from the projections in Chapter 4, this assumed restoration of normalcy has important implications for the projected track of interest rates.

Policy response

The Policy Targets Agreement calls for policy to look forward at inflation in the medium-term. The reason is two-fold. Monetary policy cannot significantly affect inflation over the next few months – unless extreme policy actions were to be contemplated. Second, it is the trend of inflation that influences attitudes that people adopt towards price setting when making their economic decisions. If inflation trends seem likely to become material to outcomes, people devote time and effort to protecting themselves from the vagaries of inflation. If not, time and effort are able to be concentrated on the specifics of the business at hand.

Our central view is that medium-term inflation pressures are benign. Inflation will rise once the temporary impact on tradable prices of exchange rate appreciation passes, but to a rate that is expected to be comfortably within the target range. Non-tradables inflation is expected to ease back over the period ahead, but this is not because economic slack is anticipated - capacity utilisation rates are expected to drop back to more normal levels, and the unemployment rate is expected to be fairly stable. Implicit in this outlook is a view about the behaviour of inflation expectations. We do not think that inflation expectations have been much affected if at all by the recent acceleration of non-tradables inflation. Meanwhile, the combination of a sharp fall in headline inflation and relatively weak business confidence will help keep inflation expectations consistent with ongoing achievement of the inflation target.

Against this background of easing inflation pressures and stable inflation expectations, some easing of policy would be warranted consistent with the objective of keeping inflation comfortably within the target band over the medium term. However, at the margin, bigger or smaller adjustments of interest rates than are warranted by reduced inflation pressure alone can also be consistent with the PTA inflation target. Whether one uses that margin depends on whether other policy considerations are relevant.

At this point in time, additional considerations are relevant for monetary policy. Supplementing the direction to focus on controlling medium-term inflation, the Policy Targets Agreement also calls for monetary policy to be conducted in a manner that minimises unnecessary instability in output, interest rates and the exchange rate. Avoiding unnecessary instability generally means ensuring that policy settings do not get well ahead of, or well behind, those required to keep medium-term inflation within the target range. With many business cycles, moving promptly can also help cushion real economic activity and employment (or help keep it from becoming over-stretched). Cutting interest rates in April, as soon as we became confident that inflation pressures were on their way down, is to be seen in this light.

From time to time, the nature of the risks and uncertainties present in the economic outlook also raise stability considerations. There is some asymmetry in the nature of three of the risks that we think are present in the current environment.

The first asymmetry relates to business and household attitudes towards the economic situation, and consequential spending decisions. At 18 year lows on some measures, general business confidence seems more in keeping with a hard landing than the soft one that we are projecting. As already noted, we don't think these confidence measures are a good reflection of the underlying economic situation, or indeed actual business attitudes. However, it is possible that the survey measures are more prescient than we are allowing. It is important that monetary policy does not unnecessarily contribute to that possibility by being excessively risk averse in terms of where inflation ends up within the target range. The risks of self-fulfilling nervousness about the future are somewhat increased because we are at a turning point, and because early readings on the scale of the change in direction are likely to be distorted by aforementioned timing factors.

The second asymmetric risk concerns the future path of the exchange rate. In our March *Statement*, we acknowledged that our technical assumptions of a reversion of the exchange rate to its long-term average might not be the most likely outcome. Foreign exchange market dynamics, interest rate and growth differentials, and the possible correction of an excessively elevated US dollar combined to make further appreciation more likely than depreciation.

As it happens, over the period since the March Statement, the exchange rate did not appreciate further. But many of these factors cited in March remain relevant to the current situation, with US dollar weakness being particularly noticeable. This again makes it quite possible that appreciation beyond that assumed in our projections will occur. At the same time, however, recent interest rate falls have narrowed the interest rate differential between New Zealand and overseas. Market expectations have also adjusted since March to narrow expected future interest rate differentials. It is very difficult indeed to judge how much this narrowing in differentials will affect future exchange rates.

And thirdly, we have for some time been emphasising the uncertainty that surrounds international economic developments. Some of the sources of that uncertainty have disappeared, with the quick cessation of hostilities in Iraq and with measures to control the spread of SARS starting to take effect. Other sources of uncertainty remain.

Chief amongst these is the ongoing tussle between two sets of influences. On one side, several factors are keeping US and European businesses from investing in new plant and equipment. On the other side, accumulated monetary and fiscal policy stimulus (particularly in the US) has been helping keep consumer spending alive despite substantial household debt accumulation.

The longer that weak business spending predominates, the greater the risk of slip towards recession. Key asset prices still anticipate a normal recovery, and without such a recovery, they are likely to be revised further down. A further significant drop in asset prices would almost surely generate a double-dip recession in the US. Likewise, household dis-saving cannot go on at the current pace indefinitely. If households run out of willingness to spend before businesses start reinvesting, recession could follow.

At the same time, US monetary and fiscal policy has been stimulatory enough for long enough to make a sharp recovery entirely plausible. Significant repairs to corporate balance sheets have been facilitated by low interest rates, and financial systems are awash with liquidity. There are signs that households in the US are taking renewed advantage of low interest rates to refinance mortgages and extract equity to finance additional spending. Financial markets are now pricing less risk into contracts. Both developments are consistent with this favourable alternative future.

However, less aggressive monetary and fiscal policy in Europe – which like the US is economically in a low altitude holding pattern – and ongoing weakness in Japan are not so consistent with a scenario of sharp acceleration. Weighing all these possibilities in the balance, we are inclined to the view that if things go differently from the path for the world economy assumed in our projections, the downside could be larger than the upside.[1]

Overall, for these reasons our projections allow for a slightly easier monetary policy stance than might otherwise be the case. The projected outcome for inflation over the two to three years ahead is accordingly above the middle of the inflation target range, but is still comfortably within that range. Taking that position is helped by our increased confidence that we are at, or past, the turning point for inflation pressure.

Two final issues are worth highlighting as potentially relevant to monetary policy developments over the next few years.

First, in our projections, the inflation pressures arising from current intense resource utilisation dissipate without requiring ongoing monetary policy firmness. Moreover, we are suggesting that this may have already started. In our projections, domestic inflation has already peaked, essentially coincident with the turning point in inflation pressures. It would be historically unusual for inflation to drop back this soon. But we think that a more benign inflation dynamic may be gradually emerging. Partly this relates to New Zealanders accumulating experience with an environment of price stability. And partly it relates to markets being increasingly competitive, especially in terms of openness to global competition which these days is a force for disinflation rather than inflation. It is also possible that part of an apparent lift in trend growth – average growth over the last decade was 3.5 percent, noticeably higher than the previous decade – is due to an edge upwards in productivity growth.

There is a risk that we are being overly optimistic. If that turns out to be the case, the degree to which monetary policy can be pre-emptive in seeking to forestall cyclical downswings might be constrained.

The second issue worth highlighting concerns the impact of fiscal developments on the economy and hence on monetary policy.

Fiscal policy has seen only a slow evolution of expenditure and tax structures over recent years, as shown in Box 2 on pages 26 to 27. Given incremental changes in discretionary elements of fiscal policy, our evaluation of monetary policy settings has not needed to devote much time to budgetary developments. The latest budget continued this pattern of incremental change to discretionary elements of spending and taxation. But it foreshadowed the possibility of more

[1] Though the probability of downside surprises may be no greater than the probability of upside surprises - hence our continued adoption of Consensus Forecasts in Chapter 4.

change in the future, depending on circumstances. Specifically, government expenditure could lift by under $^1/_2$ percent of GDP in each of the three years starting the next fiscal year, cumulating to under $1^1/_2$ per cent of GDP.

At less than $^1/_2$ per cent of GDP in any one year, the effects on the economy and hence monetary policy may not be particularly large. But without knowing the yet-to-be-determined details, it is difficult to evaluate the likely impact.

All of these potential sources of change in the environment facing monetary policy bear watching, as do many not discussed. It is fortunate that monetary policy settings are revisited every 6 weeks. It is unfortunate, in view of the lags with which policy operates, that the crystal ball examined every 6 weeks is inevitably murky.

3 Current economic situation

Overview

The New Zealand economy grew strongly in 2002 with GDP rising by a creditable 4.4 per cent in the year to December. The lion's share of that growth came from domestic expenditure – chiefly consumer spending and residential construction activity. A weak international environment and a rising New Zealand dollar dampened overall export sector performance and there was only modest growth in business investment. However, domestic demand was propelled by factors such as the rapid growth in the population together with the momentum created by the sharp increase in export earnings during 2000 and 2001. Strong domestic demand saw capacity utilisation sustained at relative highs through the year and was reflected in intense shortages of skills in some parts of the labour market. In turn, domestically-generated inflation pressures accelerated during the year, offsetting a sharp fall in imported inflation.

At this stage, we think the economy posted relatively solid growth in the first quarter of 2003, albeit partly due to the early slaughtering of stock in response to dry conditions in parts of the country. However, forward indicators of activity and our own discussions with businesses increasingly suggest a slowing in growth subsequently. Business confidence and firms' own assessment of their individual growth prospects have also declined sharply in recent months. That decline appears to be due to continued weakness in trading partner activity and the higher New Zealand dollar as well as specific events such as dry conditions in some agricultural regions, hydro-electricity generation shortages and the outbreak of SARS. The latter events are expected to add some volatility to the economic statistics over the coming months, although the extent to which they have an enduring impact on economic activity remains unclear at this point.

At our interim review in April, we reduced the Official Cash Rate (OCR) by 25 basis points from 5.75 to 5.50 per cent. Earlier in the year, we had noted that if the exchange rate continued to hold up following its sharp appreciation or continued to appreciate further, and if the evidence pointed to reduced pressures on resources and medium-term inflation, there might be scope for some easing in interest rates. Our April decision reflected a view that those conditions had been met. Not only had the exchange rate continued to move up, the latest indicators of activity had increased our confidence that inflation pressures would subside throughout the remainder of 2003.

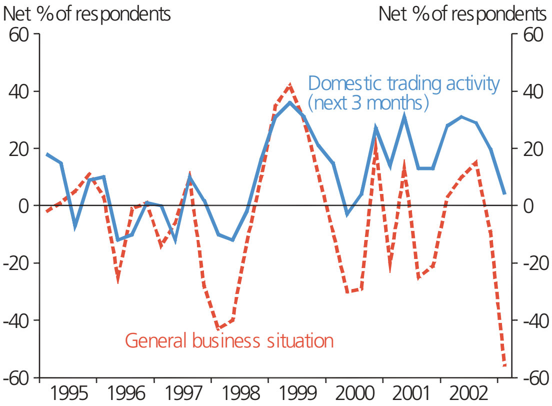
Since the April review, financial markets have continued to anticipate further reductions in interest rates. As at late May, financial markets were pricing a further reduction in the OCR of around 50 to 75 basis points by September.

Domestic demand

Domestic demand – especially consumer spending and residential investment – has been a major driver of recent economic growth. The strength in export sector incomes over 2000 and 2001 stimulated rural economies, with the boost in demand filtering through to urban areas with a lag. Export performance has since softened, and activity within the rural economies may be starting to cool, although this is not yet clearly evident in the statistics. Activity in many urban economies such as Auckland has continued to be sustained by the rapid growth in population brought about by high net immigration. Activity in sectors such as retailing, housing and residential construction has benefited from the stronger population growth, as has the education sector (through the provision of services for foreign students, whose numbers have expanded rapidly over the past two years).

The business sector appears to doubt that the strength in domestic demand will hold up, with headline measures of confidence about the general economy falling sharply in 2003. Firms' expectations for their own activity have also fallen quite sharply, including within sectors supplying mainly domestic markets (see figure 6). Although we are cautious in reading

Figure 6
Business confidence

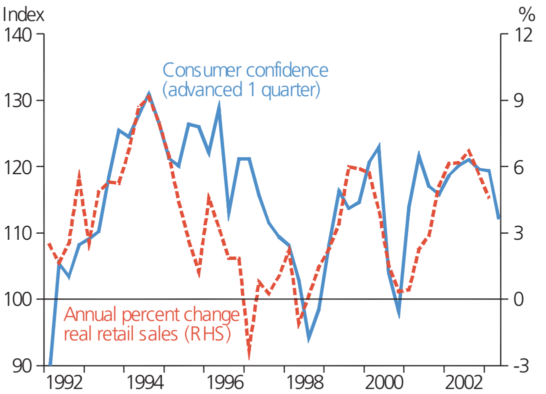


Source: New Zealand Institute of Economic Research.

too much into these measures, some of which can be volatile, the recent trends mirror a range of events such as the Iraqi conflict (and related oil price hikes), electricity shortages and SARS outbreaks.

Retail sales have shown strong growth over the past 12 months, with the growth spread across most store-types and regions. Motor vehicle retailing has been particularly strong in line with the fast-growing population, while strong residential investment activity may have also fed demand for some other large-ticket items. The employment gains created by the strong economy over the past two years will also have had a mutually reinforcing effect on consumer spending. While retail spending continued to show growth in the March 2003 quarter, there are signs that growth in demand may be about to wane (figure 7). Retail sales of some consumer durables, such as appliances and furnishings, have begun to cool, following an earlier period of strength.

Figure 7
Retail sales and consumer confidence



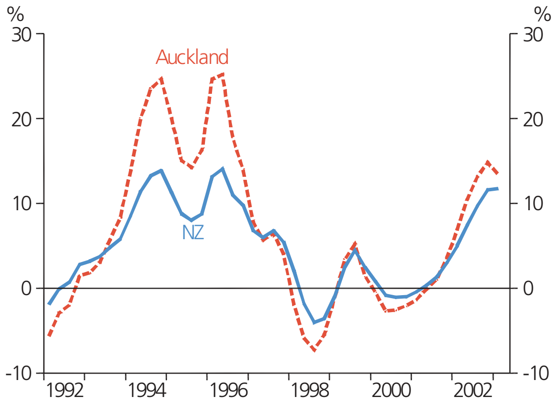
Source: Statistics New Zealand, Westpac Banking Corporation.

Retail sales in the South Island and non-urban areas of the North Island - regions that have shown strength in the past two years - have displayed some patchiness recently, consistent with a moderation in farming sector incomes, but there is not yet a clear downward trend in the statistics. However, a number of our business contacts note that their retail markets have softened recently, including within the rural areas, a point also noted by some large retailers in their public statements.

Consistent with this picture, consumer confidence has moderated following a long period of buoyancy. The fall in confidence is unsurprising in light of trends in some factors impacting household income and wealth. For example, lower dairy payouts have received particular attention as part of an overall fall in export commodity prices. Particular negative events such as SARS, the electricity shortages and drought conditions in some rural areas may have also undermined confidence to a degree and may be creating a degree of caution in regard to spending plans.

Conversely, there is less evidence that activity in housing and residential construction is cooling appreciably. House sales during 2003 in many areas of the country have been at levels last seen in the mid-1990s and in some regions at record highs. In the last few months, sales have fallen slightly, including within the Auckland region, but levels remain high. The median number of days to sell houses remains very low and some real estate agents note a shortage of listings despite plenty of willing buyers. House prices have been rising (figure 8) and rents also appear to have drifted up (figure 9, opposite) with stronger demand for rented accommodation.

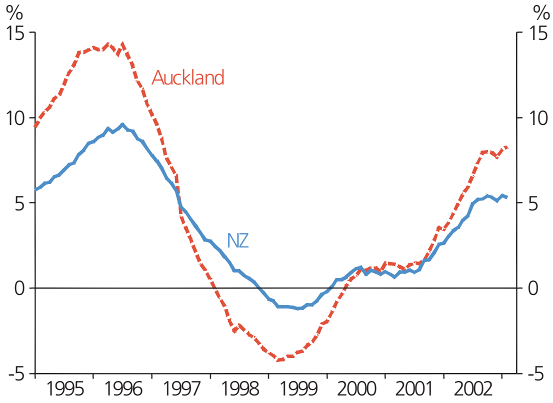
Figure 8
House prices
(annual percentage change)



Source: Quotable Value New Zealand.

Consents for building new dwellings have been strong over the past year, reaching cyclical peaks. As a result, residential construction activity has surged and remains strong. In recent months, there have continued to be significant numbers of consents for new apartments and houses although the growth appears to have peaked. Many builders report that they have a significant backlog of work in the pipeline and that labour shortages are hindering their ability to meet demand in a timely fashion. Nevertheless, surveys of expected future activity among construction companies, such as the Quarterly Survey of Business Opinion (QSBO) and National Bank Business Outlook (NBBO), indicate some

Figure 9
Average weekly rent
(annual average percentage change)



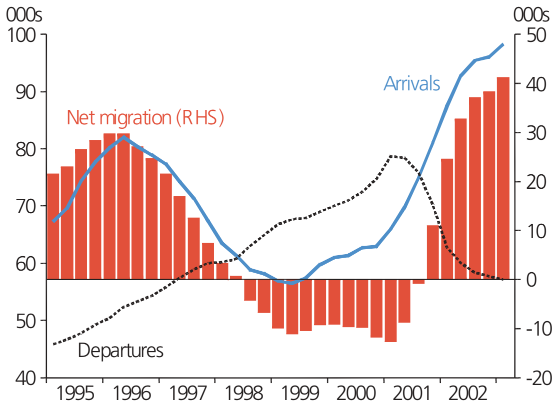
Source: Ministry of Housing.

trepidation about future activity levels, similar to that shown by other sectors.

Population growth through net immigration has contributed to the strength in domestic demand. There has been a net gain of permanent and long term immigrants (i.e the balance of those arriving or departing for periods of a year or longer) of more than 40,000 people over the period to April 2003 (figure 10). However, when the balance of persons staying for periods of less than a year is included (such as some students), the net boost to the population has been stronger still (figure 11). While other factors will have an important bearing on the outlook for consumer spending and residential investment, the path of net migration flows will continue to be important. Despite recent policy changes, which have reduced the eligibility for residency, significant numbers of applications remain in the pipeline under the old rules, which is likely to mean further strong arrivals of new residents over the coming months. Departures of New Zealanders, which fell sharply during 2001 and 2002, remained at low levels in 2003, contributing to ongoing high levels of net immigration.

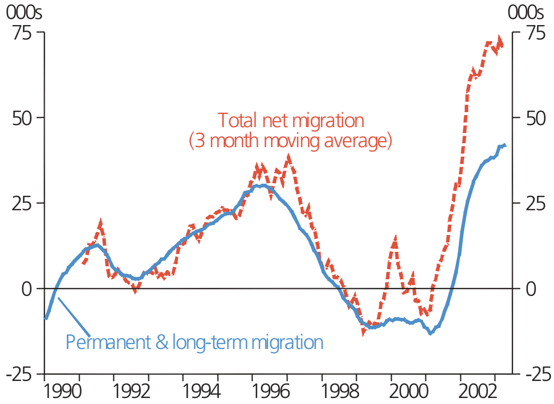
An important component of the migration story has been a significant increase in foreign students (mainly from China) in advance of the new academic year, which has provided a further boost to the population and is likely to have added to consumption demand. Many academic institutions are still planning for more foreign students in the future. Earnings from the provision of education services to foreign students have grown markedly over the past two years and have had a material impact on economic activity in some parts of the country. A marked change in the level or growth rate of foreign student numbers could therefore have quite significant impacts on regional economies. Anecdotal reports are that arrivals have been disrupted recently in the wake of SARS although it is not clear that there will be an enduring impact on the flows.

Figure 10
Net migration
(000s per year)



Source: Statistics New Zealand.

Figure 11
Migration flows
(000s per year)



Source: Statistics New Zealand.

External developments

New Zealand's main trading partners entered a recovery during 2002 following the sharp slowdown that occurred during 2001. However, by the second half of 2002, expectations of a 'normal' cyclical upswing had eroded and so far through 2003 the majority of near-term indicators of activity in most countries continue to raise questions about the durability and strength of the recovery. Throughout much of the past year the possibility of war in Iraq weighed on consumer, business and financial market confidence around most of the world. With hostilities having subsided, one potential hindrance to the global recovery has dissipated. But there are new uncertainties in the form of the recent SARS outbreak, which is adversely affecting a number of South East Asian economies. Moreover, there appear to remain a number of possible structural impediments to a recovery in a number of countries.

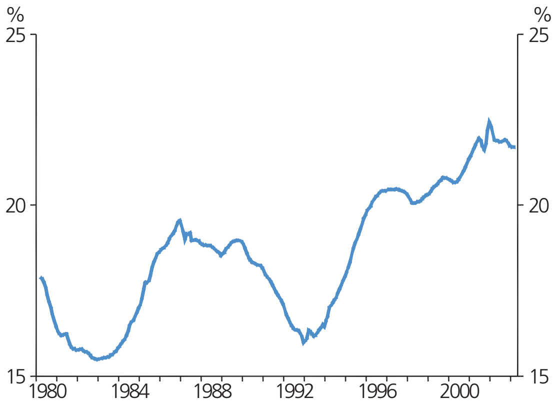
Interest rate markets remain sceptical about the prospects for the global economy. Long-term interest rates are at low levels and financial markets in most countries still expect further modest monetary policy easing over the course of 2003. However, equity markets have adopted a more optimistic tone, reflecting a number of factors. March quarter corporate earnings in the US proved surprisingly strong. The improvement in earnings follows efforts on the part of businesses to substantially trim costs, while balance sheet restructuring has also been significant. These developments place businesses in a better position for future growth, although some analysts have noted that revenues are yet to show a significant turnaround in most sectors. To a degree, the optimism in equity markets also reflects a reduction in uncertainty following the end of conflict in Iraq and greater willingness on the part of investors to hold riskier assets. Improved sentiment towards the corporate sector is likewise reflected in credit spreads, which have narrowed from the wide levels reached last year.

Despite these more promising signs, many indicators of economic activity within the US have continued to disappoint with indicators of manufacturing and industrial production having continued to decline following the conclusion of hostilities in Iraq. Most labour market indicators have also remained soft. The preliminary release of US GDP for the March quarter 2003 was below expectations at a 0.4 per cent quarterly movement. More positively, US consumer confidence measures have increased, though in large part this is likely to be simply a bounce back after the quick resolution of hostilities in Iraq. Non-durable goods orders have also provided some positive news.

Ongoing concerns about the US economic outlook in the context of a historically large current account deficit have seen a substantial fall in the US dollar over the past year. The dollar has fallen around 7 per cent over 2003 and is around 18 per cent lower than its 2000 peaks. The decline in the dollar has mechanically pushed up other currencies including the New Zealand dollar.

The US recession that began in March 2001 was fundamentally a business-led (rather than a household-led) recession. Consumer spending has continued largely unabated despite substantial declines in consumers' equity wealth, rises in unemployment and a downtrend in confidence that began in late 2000. There remains considerable debate as to whether the limits of this resilience may shortly be reached. Consumer debt-to-income ratios are at historically high levels with further aggressive debt accumulation through refinancing and new mortgages (figure 12). With economic recoveries in the US typically led by the consumer, any weakening in household sector activity could potentially hinder a recovery. However, falling oil prices, recent sharp increases in house prices in many areas of the US (acting as a counter to equity wealth losses) and some stimulus from President Bush's fiscal stimulus package could serve to support household spending.

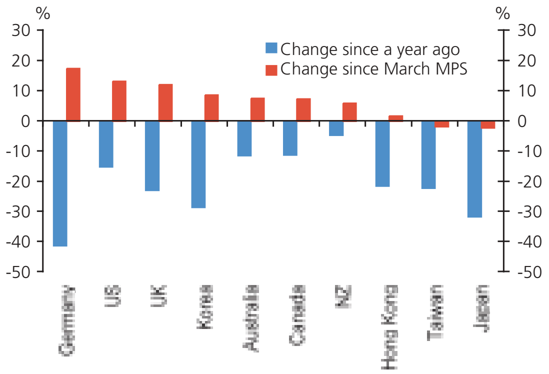
Figure 12
US consumer debt-to-income ratio
(moving average of consumer credit outstanding as a percentage of disposable personal income)



Source: Datastream.

While equity markets in Europe have also recently reflected some of the optimism shown elsewhere (figure 13), the economic data continues to be lacklustre, with the business outlook failing to rebound as expected. The IFO and INSEE surveys of German and French business confidence have generally continued a downward slide. Domestic demand remains stagnant and export demand also looks weak with an appreciating euro (mainly due to US dollar weakness) and a depressed world economic outlook. The ECB recently decided to leave interest rates unchanged stating that the current interest rate setting is consistent with price stability over the medium term.

Figure 13
World equity prices



Source: Bloomberg

Turning to Asia, recent data from Japan have begun to surprise on the downside, following more mixed data releases earlier in the year. High unemployment (which may also signify more people returning to the labour force, looking for work), falling retail sales and falling industrial production all contribute to the weaker outlook. Leading indicators for Japan have also begun to turn down sharply. Despite some recent measures by the Bank of Japan to ease monetary conditions, expectations for activity remain weak.

Meanwhile, the economic outlook for many Asian countries has been significantly adversely affected by the recent outbreak of SARS. Consensus Forecasts were quickly adjusted in April as individual forecasters revised down their projections of growth in the non-Japan Asian region. Hong Kong has been particularly badly affected with its reliance on tourism creating vulnerability. While recent economic growth in China has been rapid, the concentration of SARS in that country represents a major downside risk. If the disease persists, growth in China's crucial export markets will be dampened. Another concern is the possible impact that SARS may have on foreign direct investment flows in the region, which have helped to fuel growth.

The Australian economy continues to perform relatively well against a backdrop of a difficult global environment. Domestic demand is widely expected to slow over 2003 from the unsustainably high levels of 2002. In the housing market, building approvals data show a moderation in the overall downward trend. It appears that the housing market is set for a soft landing rather than a dramatic downturn. Although the unemployment rate continued to fall in April, most leading indicators of jobs growth have weakened a little in recent months. Australia's close geographical proximity to and strong trade ties with Asia also mean that SARS presents downside risk to that economy. SARS is likely to weaken international tourist flows, and some non-tourism related industries. These include seafood exports, and foreign student education.

Tradables sector activity

The tradables sector in 2003 is no longer providing the substantial stimulus to demand that it did over the past two years. Export revenues have declined over the past year with a sharp fall in export prices more than offsetting further growth in export volumes. That decline is continuing in 2003, largely as a result of the stronger New Zealand dollar. The corresponding drop in export revenues is in marked contrast to the significant expansion in incomes that occurred over the period from 2000 to late 2001 when prices received for exports were boosted by the fall in the New Zealand dollar and rising international prices for some commodity exports. As this largely price-driven rise in incomes was spent, other sectors of the economy benefited considerably. Some of that stimulus continues to be reflected in current levels of activity, but the impact is clearly waning.

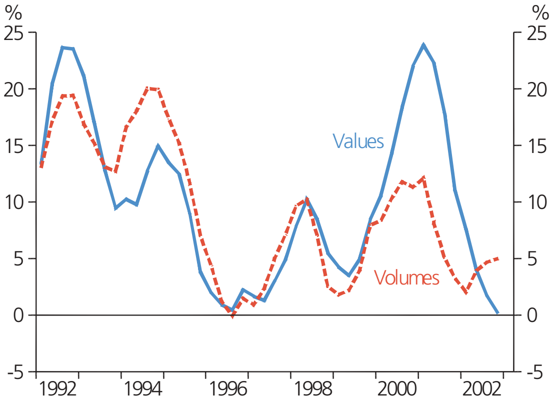
Export prices, measured in New Zealand dollar terms, fell substantially in 2002 in response to a sharp fall in commodity prices in world markets, particularly for dairy products and the rising New Zealand dollar. World market prices subsequently recovered much of their lost ground over the second half of 2002 and appear to have stabilised over the first half of 2003. World dairy price increases have flattened after their earlier recovery and current thinking is that they are likely to hold at current levels over the coming months with decreased supplies from NZ and Australia (due to drought) broadly offset by weaker demand from Asia and elsewhere given current economic conditions. World lamb prices are also expected to remain broadly stable over the next few months following some earlier increases. However, prices received by the exporter (abstracting from currency hedging and long term contracts) have continued to decline with further increases in the New Zealand dollar over 2003.

While exporters have faced lower prices and challenging international conditions over the past year, growth in export volumes was rather stronger than is often acknowledged. Primary export volumes expanded quite rapidly last year with increases in production across many categories, including dairy products and some forest products. Dairy export volumes appear to have eased in the March quarter as dry conditions affected production in some parts of the country and demand for forest products is waning as construction activity abroad softens. In the near term, this weakness appears to have been masked in the aggregate statistics by strong export volumes of beef and lamb, with farmers adopting an early slaughter pattern as a result of the dry farm conditions. This temporary timing-related boost to export volumes will be followed by weakness over the coming months.

The activity picture for non-primary exporters has been rather mixed. The relatively robust performance of the Australian economy has been beneficial for many exporters in that market, but the rise in the exchange rate against the Australian dollar over the past year has offset that advantage in some cases (especially for those exporters without some form of hedging in place). Many of our business contacts have recently noted that export conditions are becoming more challenging in light of the rising exchange rate and are expecting activity to weaken. On the supply side, the hydro-electricity shortages have affected export production for some firms and are beginning to add an extra degree of volatility to the export statistics.

During the strong export expansion that occurred in the early 1990s, non-commodity manufactured exports showed rapid growth and were a key driver of overall export sector performance. Despite the sharp fall in the exchange rate in 1999 and 2000, performance in recent years was rather more subdued (figure 14). There have been some notable exceptions. Exports of carpets and textiles to Australia and the UK have increased substantially over the past two years, in line with strong housing markets in these regions. Impressive gains in the processed foods group were seen over 1999/2000. Moreover, the US has been one of the stand-out growth markets for non-commodity manufactured exports over recent years with significant gains in penetration into that market. Over the past year, non-commodity manufactured exports have shown moderate growth. Apart from the rising exchange rate, the soft global economy is likely to be a constraining factor, while intense competition from other suppliers (such as those in Asia) may also be affecting local exporters.

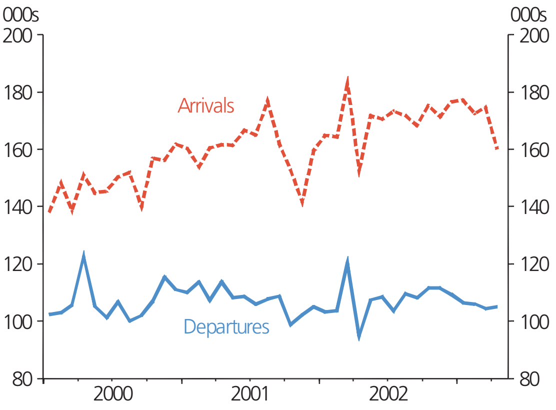
Figure 14
Non commodity exports
(annual average percentage change)



Source: Statistics New Zealand.

Over the past 12 months, visitor arrivals have shown solid growth, contributing to strong growth in exports of services. Growth in arrivals has been seen mainly from Europe and the UK. Arrivals received a further boost over the March quarter, no doubt helped by the America's Cup. More recently, SARS has resulted in a sharp fall in visitor arrivals from Asia but arrivals from Australia and the UK are up (perhaps as tourists from these countries choose to visit New Zealand instead of Asia). Visitor arrivals for April and May have fallen by more than would normally be expected at this time of the year (a seasonal low point for tourism) in the wake of the SARS outbreak (figure 15). That fall points to a likely sharp drop in exports of services during the June quarter. Departures of New Zealanders for overseas have also dropped over this period, implying some offset in the form of lower imports of services.

Figure 15
Short term arrivals and departures
(seasonally adjusted)



Source: Statistics New Zealand. Departures series is for NZ residents only.

Imports of consumption goods slowed in the final quarter of 2002, but were up nearly 30 per cent for the year as a whole. More recent data suggest some cooling in imports of consumer goods, which is consistent with reports of some slowing in demand in 2003. Conversely, aside from transport equipment, there is little indication of sustained, strong growth in imports of capital goods over the past year. This trend is consistent with the observed investment cycle: investment remains at cyclically high levels as a share of GDP but has shown only moderate growth over this period.

Like export prices, import prices have also dropped sharply in response to the higher exchange rate and weak global conditions, though not to the extent that export prices have. Upward pressure on oil prices occurred in anticipation of the Iraq war, although prices did not increase by as much as many expected during the war. Oil prices declined from an average of about US$28.50 (Dubai) during the war to around US$23 during April. As a result, the rise in fuel prices, which affected the March quarter CPI and other inflation indicators, appeared to unwind relatively rapidly. However, during May, oil prices began to edge up again as renewed fears of unrest in the Middle East emerged following several terrorist attacks.

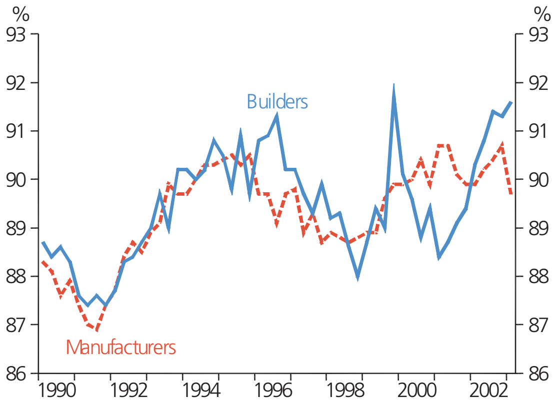
Cyclical position of the economy

Our Statements over the past two years have continued to note high rates of capacity utilisation experienced by firms throughout the economy, consistent with the strong expansion in activity that has occurred over this period. Whilst not necessarily the case in all industries - or for all firms within a particular industry - many companies have reported limited scope to increase production without incurring increases in unit costs. This upward pressure on costs may have come about through the need to use overtime, run extra shifts, hire more expensive labour or increase maintenance on plant and equipment that has been used more intensively.

Although many firms are likely to have absorbed increases in costs in the form of lower margins, or sought to add new machinery to keep production costs down, high rates of capacity utilisation have been a source of inflationary pressure. Indeed, the acceleration in non-tradables inflation over the past year has broadly followed the increase in capacity utilisation in a fashion similar to previous cycles in the economy.

Capacity utilisation measured by the NZIER's QSBO declined relatively sharply in the March quarter consistent with a range of indicators pointing to some slowing in momentum in the economy. Further analysis of this result shows that the decline in capacity utilisation was centred in the manufacturing sector with the building sector's capacity utilisation continuing to increase, reaching an all time high during the quarter as residential building activity remained frenetic (figure 16).

Figure 16
Capacity utilisation
(seasonally adjusted)

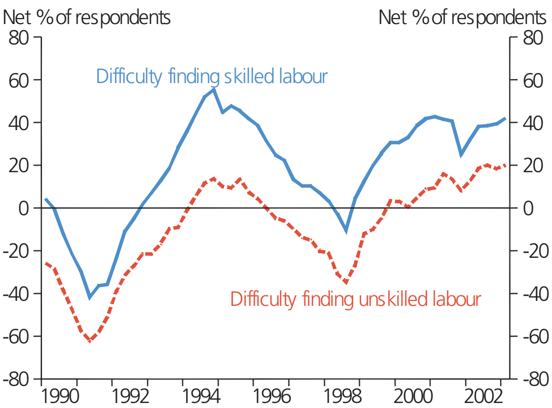


Source: Reserve Bank estimates based on NZIER's Quarterly Survey of Business Opinion data.

However, a range of other indicators of intensity of resource use from the QSBO - which cover sectors in addition to just building and manufacturing - generally suggest some easing in pressure on productive resources during the quarter. These trends are suggestive of an economy in which growth is beginning to slow, although most of the measures remain relatively high.

Conversely, there is as yet little evidence that shortages of suitable skilled and unskilled labour are abating to any great extent (figure 17). The percentage of firms citing labour as the limiting factor to expansion edged down slightly in the March quarter, but remains at levels last seen in 1974. A majority of firms in the QSBO continue to note increased difficulty in finding appropriately skilled labour, a feature almost universally mentioned by companies during our business talks. Industries facing intense labour shortages include the construction sector with many construction companies reporting that a lack of labour has hindered their capacity to undertake work and/or slowed building delivery times.

Figure 17
Difficulty finding labour



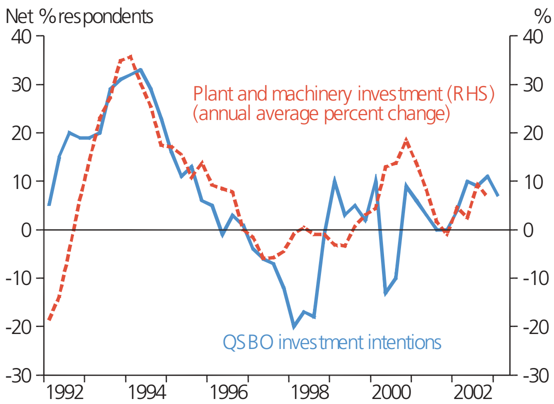
Source: New Zealand Institute of Economic Research.

The March quarter Household Labour Force Survey also supports the contention that the labour market remains tight. Despite a slight increase in the unemployment rate from 4.9 to 5 per cent of the labour force, it remains around its lowest level in 14 years. Of note, hours worked have been growing faster than employment, and measures of 'under-employment' (capturing part-time workers who would like more hours if offered) have dropped, suggesting that employers may be offering some existing part time staff more hours to help alleviate labour shortages.

Business investment spending has not shown the double-digit growth rates that it did during the upswing of the mid-1990s or that many other countries experienced during their strong growth conditions up until about 2001. But after climbing during the 1990s, business investment activity has remained high as a percentage of GDP (although the share has flattened after its earlier rise - see figure 32 Chapter 4). On that score, relative to the historical experience, recent investment activity does not really appear to be particularly subdued. However, given a sustained period of high capacity utilisation and a tight labour market, it might have been reasonable to have expected the share of investment spending in GDP to have continued to increase (producing stronger growth rates).

Reasons why this hasn't been the case may include the challenging international conditions prevailing over the past couple of years. Residual uncertainty over the path of the exchange rate may have dissuaded some firms from investing more heavily. Some companies have claimed that the low exchange rate until recently has led them to defer investment spending due to the high costs of imported plant. The rise in the exchange rate over the past year could potentially see some firms reconsider previously shelved investment plans.

Figure 18
Investment intentions and plant and machinery investment



Source: Statistics New Zealand, New Zealand Institute of Economic Research.

The correlation between investment intentions and actual investment has not been overly close in recent years with surveyed intentions having been rather volatile (figure 18). Investment intentions lifted a little in 2002 but have fallen again in 2003 as business confidence has declined, suggesting little prospect of a sustained acceleration in investment spending in the near future.

Inflation developments

In setting monetary policy, our prime interest is in the trend component of inflation over time rather than any particular inflation outcome. Monetary policy is set with a view to achieving future inflation outcomes within the 1 to 3 per cent target range on average over the medium term as required under the Policy Targets Agreement. In determining the appropriate settings for monetary policy, we need to take into account signs that inflation is moving up or down over time (or sitting at a level that is uncomfortably high or low relative to the target).

Annual CPI inflation was relatively stable over 2002, with outcomes averaging around $2^3/_4$ per cent. During this period we observed rising non-tradables or domestic inflation, consistent with an economy showing high rates of capacity utilisation and a tight labour market. The rise in non-tradables inflation would otherwise have led to a pronounced rise in CPI inflation were it not for a sharp fall in tradables inflation in response to weak global demand conditions, falling international commodity prices and the rising exchange rate.

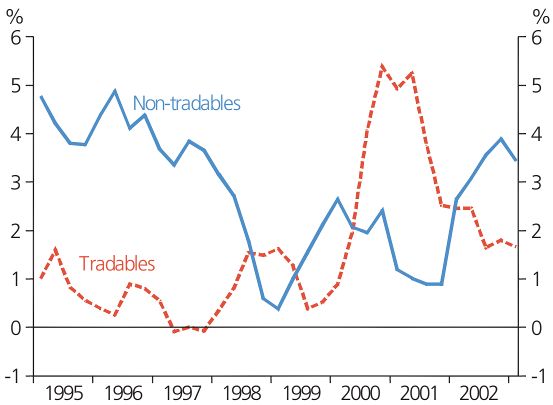
With the release of the March 2003 quarter CPI, there have been some encouraging signs that the rise in domestic inflation may be abating. CPI inflation fell to 2.5 per cent in

Table 1
CPI and other price measures
Annual percentage changes

	2001		2002				2003
	Sep	Dec	Mar	Jun	Sep	Dec	Mar
CPI	**2.4**	**1.8**	**2.6**	**2.8**	**2.6**	**2.7**	**2.5**
Food	6.6	6.7	5.3	4.1	2.3	0.9	-0.2
Housing	-0.6	-0.7	2.3	2.8	3.0	4.0	4.0
Household operations	2.5	1.4	1.5	2.7	2.9	2.7	1.9
Apparel	2.1	2.0	1.2	1.7	1.2	0.7	0.8
Transportation	1.0	-1.4	0.6	0.9	1.2	3.3	4.3
Tobacco and alcohol	3.7	3.5	3.3	3.8	3.6	3.6	3.1
Personal and health	4.5	4.3	3.7	4.1	4.5	4.2	3.8
Recreation and education	2.2	1.5	2.1	2.5	2.3	2.5	2.7
Credit services	-7.7	-8.5	-5.9	0.0	2.3	1.9	-2.0
Derivatives and analytical series							
CPI ex food, petrol and government charges	2.9	2.6	2.4	2.7	2.7	2.8	2.7
CPI non-tradables	0.9	0.9	2.6	3.1	3.6	3.9	3.4
CPI tradables	3.8	2.5	2.5	2.5	1.6	1.8	1.7
CPI weighted median (of annual price change)	3.0	2.7	2.6	3.0	3.0	3.1	3.2
CPI trimmed mean (of annual price change)	2.4	1.9	2.5	2.9	2.6	2.8	2.5
PPI - Inputs	6.2	1.8	2.8	1.5	-2.1	-1.4	-1.3
PPI - Outputs	4.8	2.6	3.1	2.3	-0.1	-0.1	-0.4
Private consumption deflator	1.9	1.1	1.9	1.5	1.3	1.0	n/a
GDP deflator (derived from expenditure data)	3.8	3.4	2.6	-0.3	0.5	-1.6	n/a

the year to March 2003 following a 0.4 per cent quarterly increase.[2] That drop followed a fall in the annual rates of both non-tradables and tradables inflation (figure 19). While a further decline in tradables inflation was expected, given the recent path of the exchange rate, the decline in non-tradables inflation at this point was a little surprising considering the normal lagged relationship between changes in capacity utilisation and domestic inflation. We had expected to see the first signs of a decline in non-tradables inflation later in 2003, when the projected slowing in growth was a little more advanced. Accordingly, we view these indicators as suggestive of a turning point in domestic inflation at this point, rather than definitive.

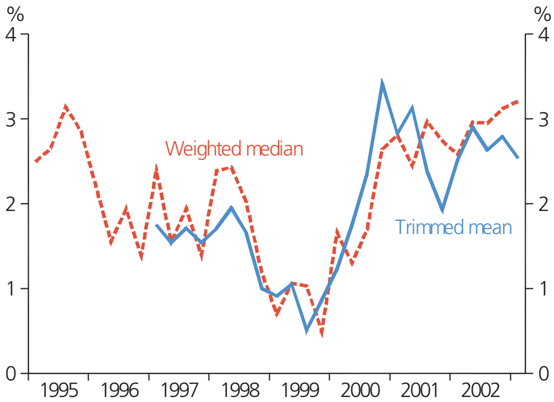
Figure 19
Sectoral inflation measures
(annual percentage change)



Source: RBNZ.

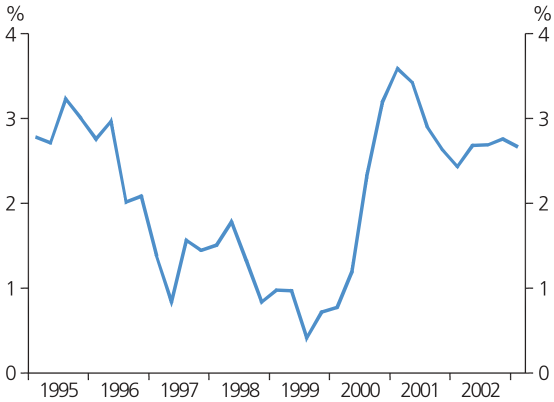
Encouragingly, some of the other indicators that we use to assess the trend or persistent component of CPI inflation have also edged down in the March quarter, presumably reflecting less pressure from non-tradables inflation. Simple mechanical calculations of the 'central tendency' of inflation include the weighted median of annual changes and the trimmed mean of annual changes (figure 20). An alternative measure, which excludes known volatile items in the CPI not amenable to monetary policy, is the CPI excluding food, petrol and administered charges (figure 21). All three of these measures moved up during 2002. During the March 2003 quarter, the trimmed mean, and the CPI excluding food, energy, and administered charges fell slightly.[3] Along with the decline in non-tradables inflation, these provide further

Figure 20
Indicators of core inflation
(calculated from annual percentage changes)



Source: RBNZ.

Figure 21
CPI ex food, petrol and administered charges
(annual percentage change)



Source: RBNZ.

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2 The rise in the March quarter CPI was primarily driven by price increases in the housing group - chiefly the purchase and construction of new dwellings. Rising petrol prices also contributed significantly to the quarter's rise. There was some evidence of direct exchange rate pass-through into consumers' prices in March (a reduction in the prices of household appliances and furnishings, for example). At this stage, we are expecting inflation for the year to June to decline further to 1.8 per cent based on a 0.4 per cent June quarter movement. We expect the housing group to continue to be the most significant source of inflation in the June quarter. Inflation during the quarter is likely to be reduced by falling petrol prices. We also expect recent strength in the exchange rate to continue to suppress tradables inflation in the quarter.

3 In contrast there was a further rise in the weighted median of annual changes.

possible evidence that the persistent component of inflation (and the domestic inflation pressures driving it) may have peaked.

Some of the non-CPI inflation indicators also point to weaker inflation pressures in the economy, including the GDP deflator and the private consumption deflator. The GDP deflator - conceptually one of the broadest measures of prices in the economy – fell by 1.6 per cent over the period from December 2001 to December 2002 (figure 22). However, this outright decline in prices appears to have been heavily influenced by a sharp fall in export prices that occurred over this period, and masks stronger rates of increase in prices in other sectors.

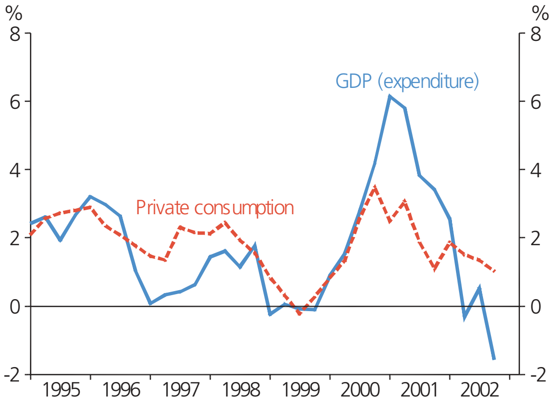
Another national accounts deflator – the private consumption deflator - measures prices for a broadly similar basket of goods and services as the CPI and rose by just 1 per cent over the same period. The rate of increase in the private consumption deflator has fallen steadily over the past 18 months and it has been increasing at a slower rate than the CPI though this period. The reasons for the lower rates of increase are not entirely clear and are currently being investigated by Statistics New Zealand.[4]

Producer prices have also shown little increase - indeed PPI output prices fell 0.4 per cent in the year to March 2003 while producers' input prices fell 1.3 per cent over the same period. However, as with the CPI, a sectoral analysis of the PPI continues to reveal relatively stronger rates of inflation within the domestic (non-tradables) sectors included in the PPI.

A key factor impacting the trend in inflation over time is the evolution of inflation expectations. Expectations have a bearing on wage, price and cost setting behaviour of firms and wage earners and may also affect their willingness to consume or invest. A rise in inflation expectations, if sustained, can make inflation harder to contain while a fall in expectations can assist in keeping inflation low with less pressure required on the part of monetary policy. As our primary interest is in the trend of inflation over time, temporary fluctuations in inflation may be of concern if they affect, and especially if they become ingrained in, inflation expectations and begin to affect behaviour.

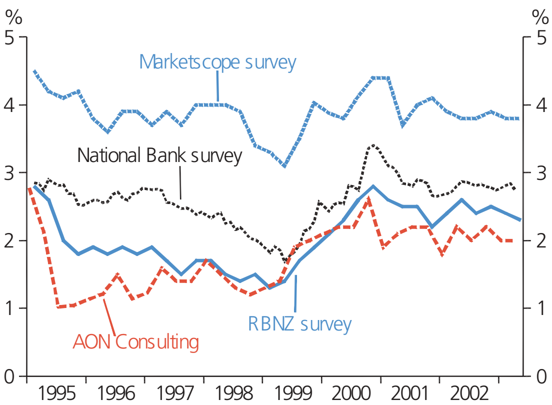
Most of the measures of inflation expectations, including the Marketscope survey (covering households), the RBNZ survey of expectations, and the National Bank survey of pricing intentions and AON Consulting survey (all covering business or professional audiences) have remained unchanged or edged down recently (figure 23). The Westpac McDermott Miller survey (covering households) remained steady at 4 per cent in the March quarter. The recent drop in expectations shown by some of these surveys may reflect the recent sharp rise in the New Zealand dollar and a view that inflation may fall away over the coming year. But each of these measures remains high relative to the lows experienced in 1999,

Figure 22
National accounts deflators
(annual percentage change)



Source: Statistics New Zealand.

Figure 23
Expected inflation
(one year ahead)



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

4 Statistics New Zealand have acknowledged the divergence between the consumption deflator and the CPI, have identified some problems with the deflator and note that methodological improvements are in the pipeline. In the interim, we are reluctant to place too much emphasis on the differences.

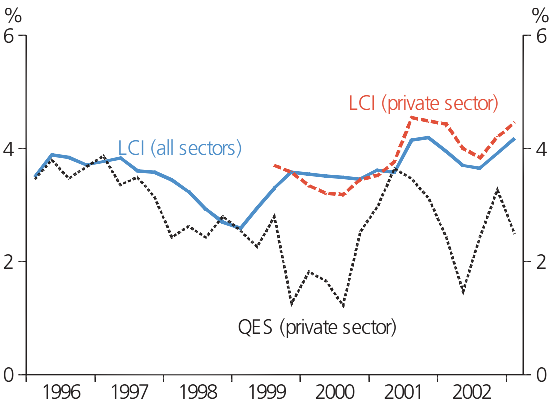
following which inflation picked up in response to the exchange rate depreciation that had occurred.

Another dimension to the inflation picture is the evolution of labour costs. Our assessment is that labour costs have not been a key driver of inflation over recent years, tending to follow rather than lead developments in prices. But higher increases in labour costs have been observed over the past couple of years and the potential exists for higher wage costs to exert pressure on inflation at some point via increased production costs. Unfortunately, drawing conclusions about the behaviour of labour costs is complicated by marked differences in the coverage and approach of the various measures available.

The Labour Cost Index (LCI) for the private sector, which measures salary and wage rates for a fixed quantity and quality of labour displays limited variance over the economic cycle (due to the exclusion of wage movements attributable to productivity movements). However, annual increases in the series have continued to edge up over the past 12 months, a trend consistent with reports of skill shortages throughout the economy. Statistics New Zealand are now making available the LCI prior to adjustments for productivity, a series that shows considerably more variance over the economic cycle than the published LCI.[5] The unadjusted series has picked up quite sharply over the past year, consistent with a relatively tight labour market and anecdotal reports of stronger wage movements (figure 24).

The other measure of wage movements is the Quarterly Employment Survey's average hourly earnings series for the private sector. Movements in this series were surprisingly subdued over most of the past two years in comparison to anecdotal reports of wage movements reflecting compositional changes in the labour force (new hires at below-average industry wages). Although the QES measure accelerated over the second half of 2002, a very weak March quarter result saw the annual increase drop from 3.3 to 2.5 per cent. We would be cautious about reading too much into that result, which is likely to reflect further compositional changes in the labour force.

Figure 24
Unadjusted LCI and hourly earnings
(annual percentage change, prior to productivity adjustments)



Source: Statistics New Zealand.

5 This series is available from Statistics New Zealand upon request.

4 The Macroeconomic Outlook

This chapter – and the accompanying tables of Appendix 1 – sets out a projection of economic conditions that has assisted the policy judgments described earlier in this document. As always, the economic outlook is subject to a range of uncertainties and is contingent on a number of key assumptions and judgements - some of which are not easily represented numerically. Chapter 2 provided the wider policy context by outlining some of the key issues that were considered during our policy deliberations. Contingent on our assumptions, the central scenario presented here is a useful way of establishing, in broad terms, how we think the major forces impacting on the economy might evolve over the next year or so, and what they might mean for monetary policy over that time.

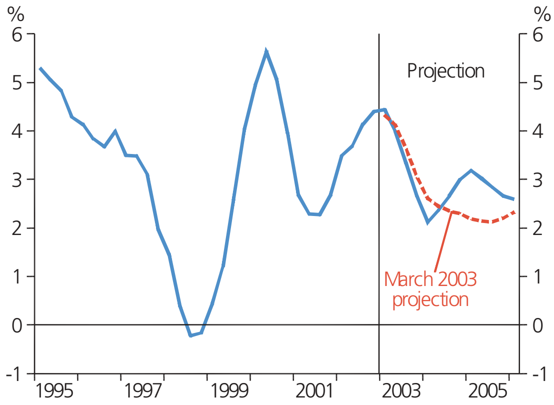
The overall picture is one in which the pace of economic growth and inflation pressures peaked towards the end of 2002. Economic growth is projected to slow over the coming year (figure 25). In broad terms the underlying drivers of this slowdown reflect the weak global demand cycle, the strong exchange rate, falling export revenues, and a reduction in the stimulus from net immigration. In addition, the effects from recent events such as the SARS virus outbreak, electricity shortages, and drought conditions are expected to disrupt economic activity over the coming year (see Box 1).

Consistent with a turning point in the profile for economic growth, inflation pressures also appear to have peaked. To some extent, these factors may be reflected in the recent drop in measured capacity utilisation rates and the relatively benign outcome for CPI inflation in the March quarter (see Chapter 3). And together with an assessment of slower growth, moderating inflation pressures, and other policy considerations that are relevant in the current economic environment, these projections allow for a more accommodating monetary policy stance with 90 day rates projected to fall to a little over 5 per cent by year end.

Based on all the factors that make up these projections, we expect CPI inflation to remain comfortably within the 1 to 3 per cent target range over the medium term. Initially, CPI inflation is expected to fall rapidly from current levels as the strong exchange rate and recent petrol price reductions exert downwards pressure on tradables sector inflation. Further out, as the pace of economic growth slows over 2003, domestic inflation pressures should also ease. In the outer years of our projections, growth is expected to pick up as the impact from short-term disruptions dissipates, world growth recovers, and the effects of easier monetary policy take hold.

What are the main differences in our economic outlook as compared to our projections presented in the March *Monetary Policy Statement*? We are now more confident in our assessment of a turning point in economic activity and inflation pressures, while the exchange rate has remained strong. Furthermore, economic developments since the formulation of our March projections suggest that the pace of economic growth may be lower over the coming year than previously anticipated. Together, these developments provide scope for lower nominal 90 day rates and a more accommodating monetary policy stance.

Figure 25
GDP growth
(annual average percentage change)



Source: Statistics New Zealand, RBNZ calculations.

The world economy

In establishing the outlook for New Zealand's main trading partners, we make recourse to a range of external forecasts and analyses of individual country prospects. Consensus Forecasts are often used as the benchmark for detailing the growth outlook for New Zealand's 14 main trading partners. However, our main focus is placed on understanding the channels through which the international economy is expected to influence activity and prices in New Zealand.

Despite being a source of significant international financial market volatility, the hostilities in Iraq have receded and with the majority of events panning out largely as expected, oil prices have fallen back to lower levels. The end of hostilities

(continued on p 23)

Box 1
The outlook for GDP over 2003

As noted throughout this document, we expect the underlying pace of economic growth to slow during 2003 as a range of factors, including the soft global economy and higher exchange rate constrain demand. However, we have also noted that this trend is likely to be clouded by several, high-profile disturbances that have recently occurred (or are in the process of unfolding as we prepare our projections).

Estimating the impact on economic activity from events such as SARS, the effect of dry weather on agricultural and export production and the flow-on effects of the electricity shortages is extremely difficult, although history provides some guidance. For illustrative purposes, the following table details the working assumptions that we have used when constructing our projections for the evolution of GDP in 2003.

As shown by the table and figure 26, we expect March quarter GDP to have been boosted slightly by the effects of higher livestock slaughtering in response to dry conditions (albeit with some offset from the onset of the hydro-shortages).

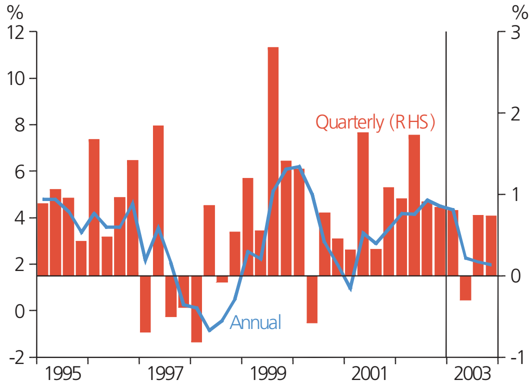
In the June quarter, a corresponding reduction in slaughtering, the switch away from hydro-production, some loss of export production due to the power price rises, and a SARS related reduction in export revenues will all have a negative impact on GDP. Indeed, as shown by Figure 26, we think it is quite plausible (though by no means certain) that GDP will contract during the quarter.

By the September quarter, some of these negative influences may unwind. However, we have allowed for some residual negative effects on output over this quarter, partly to reflect the sharp drop in confidence that has occurred over recent months.

Table 2 comes with an important caveat: the estimates here are indicative only and are based on some important assumptions. We have assumed, for example, that there are no electricity blackouts over the coming months and that the hydro-shortages abate relatively quickly. We have also assumed that international travel flows return to normal by the end of the year. These are reasonable assumptions, but things could quite plausibly evolve differently.

Even if our assumptions prove broadly correct, experience shows that correctly anticipating the resulting volatility in GDP statistics is difficult. It will be important to look beyond the short-term fluctuations in GDP – and in particular, a negative June quarter GDP outturn if it occurs – to try to gauge the underlying trend in activity.

Figure 26
GDP growth
(percentage change)



Source: Statistics New Zealand, RBNZ calculations.

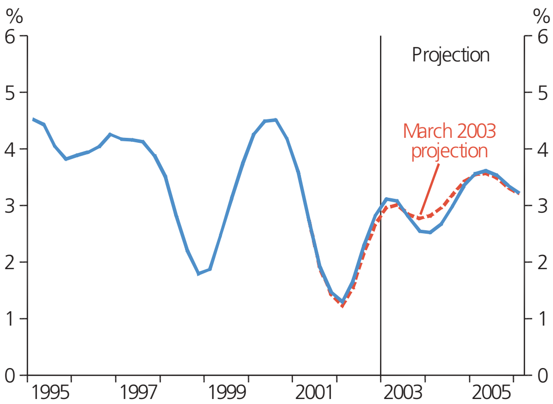
Table 2
Estimated impact of key events on GDP growth
(percentage point contribution to quarterly growth rate of GDP)

	Mar	Jun	Sep	Dec
Indicative estimates:				
Livestock slaughtering	+0.2	-0.4	+0.1	0.0
Electricity-related effects	-0.1	-0.3	+0.4	0.0
SARS	0.0	-0.2	0.0	+0.2
Confidence and residual effects	0.0	-0.1	-0.3	+0.1
Total contribution to quarterly GDP growth	+0.1	-1.0	+0.2	+0.3

in Iraq was met with initial optimism about global growth prospects, reflected in a jump in US consumer and business confidence. However, the subsequent flow of weaker-than-expected data has dampened hopes for a quick recovery in the US.

Against this backdrop, the outbreak of the SARS virus has eroded confidence and economic prospects in the Asian region. Accordingly, the latest Consensus Forecasts for 2003 growth have been steadily revised down to reflect these latest developments, and have provided a sense that the global economic growth malaise will now be more widespread than previously thought. There are risks on both sides, but on balance, we feel the latest Consensus is a reasonable central assessment of the global economic outlook, and have adopted such a profile in producing the projections here (figure 27, table 3).

Figure 27
Forecast of export partner growth
(annual average percentage change in real GDP of NZ's main trading partners)

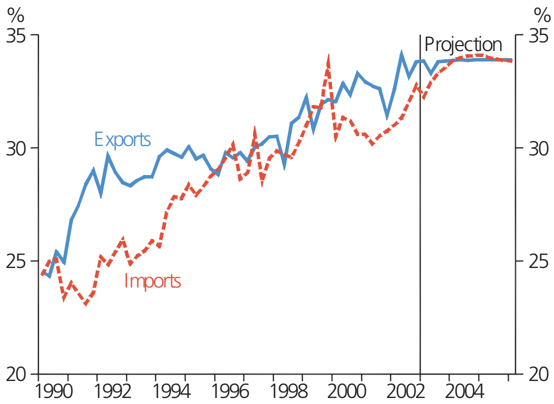


Source: Consensus Economics Inc, RBNZ calculations.

Tradables sector activity and prices

After having been a significant source of stimulus to the economy over the past few years, the contribution from net exports to overall economic activity is expected to fall significantly over the period ahead. Exports as a share of GDP are projected to remain flat, while the import share is projected to show some further increase (figure 28). In broad terms, developments in the tradables sector reflect the weak state of the global demand cycle and the impact from a stronger exchange rate on export incomes.

Figure 28
Exports and imports
(as a percentage of GDP)



Source: Statistics New Zealand, RBNZ calculations.

Figure 29 shows our projections for export volumes. Recent events such as drought conditions, the SARS virus outbreak, and the electricity shortages are expected to further disrupt export growth over the coming year. Growth in exports of services is projected to fall away significantly over

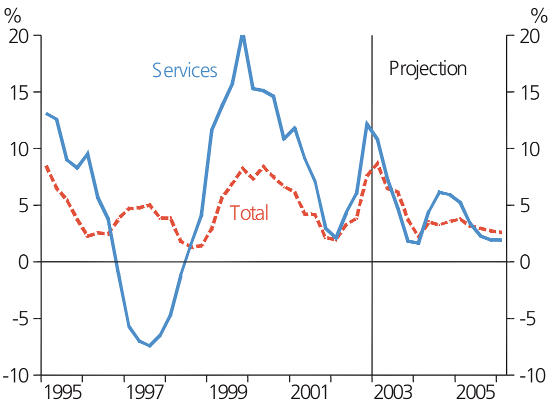
Table 3
Forecasts of export partner growth*
(calendar year, annual average percentage change)

Country	2001	2002	2003f	2004f
Australia	2.7	3.8	3.0	3.6
United States	0.3	2.4	2.3	3.6
Japan	0.4	0.3	0.8	0.8
Canada	1.5	3.4	2.7	3.3
Europe-4**	1.7	1.1	1.4	2.1
Asia ex-Japan***	1.8	5.0	4.2	5.5
14 country index	1.5	2.8	2.5	3.3

* Source: Consensus Economics Inc.
** Includes Germany, France, Italy, and the United Kingdom.
*** Includes China, Hong Kong, Malaysia, Singapore, South Korea and Taiwan.

the near term as tourism inflows from SARS-affected countries decline. Our projections have allowed for a gradual recovery in tourism flows over the second half of 2003 with visitor arrivals returning to more normal levels by the end of the year. There is little historical experience with disease-related disruptions to international travel so there is uncertainty over the extent to which tourism flows will recover. While we have allowed for only a gradual recovery in visitor arrivals, the rebound in tourism flows could be much sharper and occur more quickly – as witnessed in the aftermath of September 11.

Figure 29
Export volume growth
(annual average percentage change)



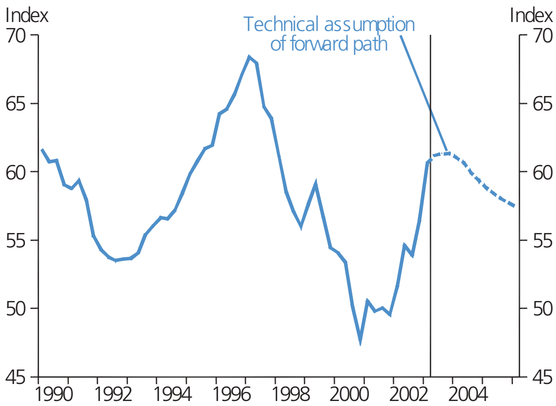
Source: Statistics New Zealand, RBNZ calculations.

The current episode of electricity shortages is also expected to impact on growth in exports of manufactured goods over the near term. These projections have allowed for a short-term reduction in the supply of manufactured goods - reflecting the recent publicised production cutbacks by several large manufacturing firms. Further out, however, growth in manufactured exports is projected to pick up in line with the expected return to normal for electricity prices and a recovery in trading partner activity.

As for primary sector exports, we rely heavily on the advice of primary sector agencies and companies. Their views on primary sector prospects take into account detailed factors like climatic conditions, stocks and productivity, as well as particular market conditions. The early slaughtering of stock in response to recent dry farming conditions is likely to disrupt the timing of primary export production and exports - with higher growth over the March quarter, followed by weakness in subsequent quarters.

The developments in the tradables sector should result in a gradual widening of the current account deficit. We do not envisage the current account cycle as posing a major risk given that the main factors behind the widening in the deficit - namely weak global demand and lower export prices - are expected to be temporary.

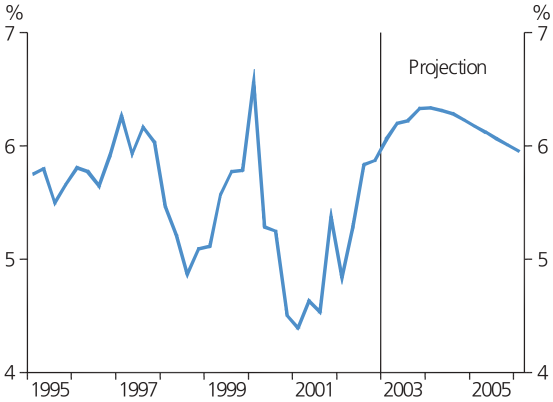
Figure 30
Nominal TWI exchange rate



Source: RBNZ.

Our projections embody a technical assumption for the exchange rate. Our standard approach has been to assume that the exchange rate will eventually return to some notion of long-run equilibrium, which in current circumstances, would project a depreciation from current levels. As discussed in Chapter 2, however, our assessment of the balance of risks given the current economic environment is that it is more likely for the exchange rate to appreciate than depreciate. We have evaluated alternative approaches (such as assuming that the exchange rate will remain unchanged throughout, or the possibility of 'overshooting'), but none seem systematically better. In these projections, we have essentially stayed with our standard approach. We have, however, made an allowance for our risk assessment by adopting an illustrative path that assumes the exchange rate will remain around current levels for the remainder of the year before gradually returning to its long-term equilibrium (figure 30).

Figure 31
Residential investment
(as a share of GDP)

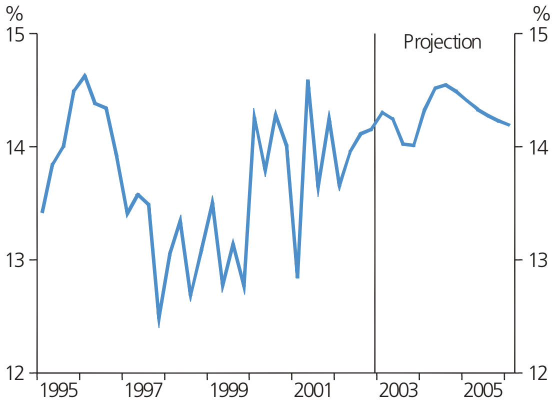


Source: Statistics New Zealand, RBNZ calculations.

Domestic spending

Domestic spending growth is projected to slow over the coming year. In broad terms, this reflects a combination of softer export incomes, reduced impetus from net immigration flows, and slower rates of growth in employment and household incomes. Furthermore, the knock-on effects to consumer and business confidence from SARS and electricity shortages are likely to cause some short-term disruptions to household and business spending plans. These recent developments suggest that the pace of economic growth over the coming year may be slower than previously anticipated. However, this is a marginal change - overall we are expecting a softening in activity over 2003, not a fall. Growth is expected to pick up over 2004 as the pace of global demand accelerates and the effects of easier monetary policy take hold.

Figure 32
Business investment
(as a share of GDP)



Source: Statistics New Zealand, RBNZ calculations.

Despite a slowing in other components of domestic spending, we expect activity in the residential investment market to remain robust, underpinned by net immigration flows. Reports suggest that capacity in the construction industry is already stretched, and this is leading to a backlog of work. Given this situation, the additional demand for housing from new immigrants could lead to a drawn out residential investment cycle (figure 31). While we may observe relatively mild growth rates in residential investment, levels of activity should remain high over a significant period of time as the backlog of work is cleared gradually.

In Chapter 3, we discussed various reasons why the share of investment spending has not moved higher recently despite a sustained period of high capacity utilisation and tight labour market conditions. These included the difficult international economic outlook and overall downturn in investment spending worldwide. Going forward, we project moderate business investment growth, reflecting an assessment that the share of investment spending in GDP will remain broadly unchanged, though at a relatively high level (figure 32). The international environment is likely to remain weak in the foreseeable future, with signs of a business-led recovery yet to appear in the US. Furthermore, recent domestic economic disruptions and uncertainty generated from SARS and electricity supply concerns are also expected to have a short-term impact on firms' spending plans.

Fiscal policy

Our projections of the fiscal position and the contributions of the government's fiscal operations to economic activity are based on Treasury's Budget Economic and Fiscal Update (BEFU). Treasury's BEFU continued to project a stable outlook for fiscal policy with little change in planned expenditure. Our assessment is that the fiscal position is likely to have a broadly neutral effect on the profile of economic growth over the projection period. Box 2 (overleaf) provides a more detailed discussion taking into account the possible changes to fiscal policy recently signalled by the Government.

(continued on p 27)

Box 2
The cyclical impact of fiscal policy

In making monetary policy decisions, policymakers need to take into account a wide range of factors that will impact on the balance between demand and supply, and hence on inflationary pressures in the economy. Among these factors, changes in fiscal policy can potentially have a significant effect on both demand and supply pressures. For example, changes in government spending can affect demand for goods and services directly, and changes in taxation can affect demand indirectly, by affecting how much of income is available to spend (or "disposable"). The large share of government activities in the economy means that even small percentage changes in government spending or revenue can have significant impacts.

Since 1994, successive governments in New Zealand have run operating surpluses. Although the operating surplus is an important indicator of the state of the government's finances, it does not tell us how government activities are impacting on the balance between demand and supply. Rather, we need to consider changes in the underlying spending and revenue streams, including investment expenditure, because these have the potential to affect net demand pressures.

Aggregate levels of government revenue and expenditure will tend to fluctuate with the economic cycle. For example, when economic conditions are strong, growing incomes will lead to higher tax receipts, while lower unemployment will reduce the government's unemployment expenditure. The opposite effect occurs when the economy weakens. These effects mean that fiscal policy will tend to exert a contractionary effect as the economy strengthens, and an expansionary effect as the economy weakens. These effects are known as "automatic fiscal stabilisers", which act to moderate the amplitude of cycles in private sector spending. Accordingly, automatic fiscal stabilisers tend to reduce the degree of work that has to be done by monetary policy to keep inflationary or deflationary forces in check.

Monetary policy must also take into account discretionary changes in fiscal policy to the extent that these are having a significant impact on net demand pressures. The impact of changes in discretionary fiscal policy on demand pressures is sometimes referred to as a fiscal "impulse" on the economy. The fiscal impulse may operate in a direction that is consistent with stabilising the economic cycle, in which case they will assist the automatic fiscal stabilisers in reducing the degree of any needed monetary policy adjustment. On the other hand, the fiscal impulse may work against the automatic stabilisers, in this case requiring a larger response from monetary policy.

Although it is difficult to measure the cyclical impulse, the change in the cyclically-adjusted general government primary balance is sometimes used as an indicator. In terms of this indicator, fiscal policy in New Zealand has been relatively stable over the last few years in comparison with fiscal policy changes that have occurred in some other countries (figure 33). This stability means that fiscal policy in New Zealand has not been a major shaping force on the macro economic cycle from year to year.

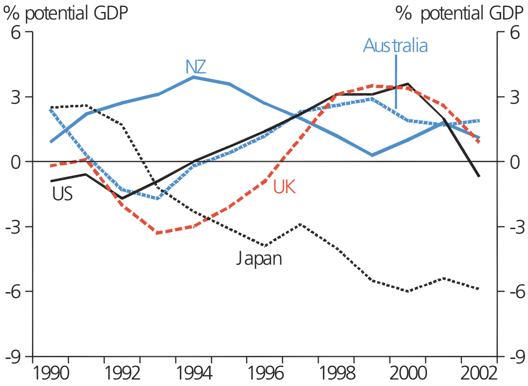
There have been occasions in the past when fiscal policy has had a relatively large cyclical impact. For example, the tax cuts introduced in the second half of the 1990s were large enough to have a detectable expansionary impact on the economy. When large fiscal policy changes are signalled in advance, monetary policy decisions can take into account the estimated cyclical impulse.[6]

In its May 2003 Budget, the Government signalled an intention to introduce fiscal policy adjustments of under $^1/_2$ per cent of GDP in each of the next three Budgets, conditional on the economic outlook evolving as expected. The degree of any cyclical impulse generated by these adjustments will depend on a number of factors, such as the composition of the adjustment, and the resulting behaviour of households and firms. A fiscal adjustment of

[6] Our interest in fiscal policy tends to be mainly around the short-term effects of fiscal policy on the economic cycle. However, fiscal policy can have other important effects - for example, on the long run structure of the economy and the distribution of incomes. While these are important issues, it is the cyclical effects that are of most interest for monetary policy.

this magnitude would be much smaller than the tax and spending package introduced in the second half of the 1990s. Nevertheless, depending on the composition of the adjustment, it may have a large enough impact on demand to have a material implication for monetary policy. We will need to assess the likely cyclical impulse generated by any fiscal policy adjustments once more details about the composition of the adjustments are available.

Figure 33
Cyclically-adjusted general government primary balances



Source OECD. These statistics are constructed using national accounts data and will not reconcile directly with the GAAP statistics published by the Treasury.

Inflation and monetary policy

As in March, our profile for CPI inflation has inflation falling significantly over the near term. A majority of this CPI fall reflects the effect of the strong exchange rate on prices for goods and services in the tradables sector. Furthermore, recent petrol price reductions should also be reflected in CPI inflation over the next few quarters.

Inflation in the non-tradables sector has accelerated to a high level, reflecting the strong expansion in domestic activity over 2002. However, the most recent inflation developments were in line with expectations and provided some initial evidence that inflation pressures may have peaked (see Chapter 3). And as the pace of economic activity slows over the coming year – and by slightly more than previously anticipated – inflation in the non-tradables sector is expected to ease – likewise by slightly more than previously anticipated.

Taking the outlook for tradables and non-tradables inflation together, the profile for CPI inflation is projected to remain comfortably inside the target band (figure 2, Chapter 2). Relative to our March projections, however, we assess that inflation pressures over the coming year will now be somewhat lower as the expected pace of economic growth slows by more than previously anticipated. This is the main reason why these projections have allowed for lower interest rates over the projection period. However, as discussed in Chapter 2, other policy considerations relevant in the current economic and inflation environment, have also influenced the decision to shift monetary policy towards a more accommodating stance over the period ahead.

Appendix 1[1]

Summary tables

Table A

CPI inflation projections and monetary conditions

(CPI is in percentage changes)

		CPI* Quarterly	CPI** Annual	TWI	90-day bank bill rate
1997	Mar.	0.2	2.0	68.4	7.5
	Jun.	0.3	1.5	68.0	7.2
	Sep.	0.6	1.8	64.8	8.1
	Dec.	0.5	1.6	63.9	7.9
1998	Mar.	0.3	1.7	61.2	9.0
	Jun.	0.3	1.7	58.5	9.1
	Sep.	0.6	1.7	57.1	6.8
	Dec.	-0.1	1.1	56.0	4.6
1999	Mar.	0.2	1.0	57.6	4.5
	Jun.	0.5	1.2	59.1	4.7
	Sep.	0.4	1.1	56.7	4.8
	Dec.	0.2	1.3	54.4	5.4
2000	Mar.	0.7	1.7	54.1	6.0
	Jun.	0.7	2.0	53.4	6.7
	Sep.	1.4	3.0	50.1	6.7
	Dec.	1.2	4.0	47.7	6.7
2001	Mar.	-0.2	3.1	50.5	6.4
	Jun.	0.9	3.2	49.8	5.9
	Sep.	0.6	2.4	50.0	5.7
	Dec.	0.6	1.8	49.6	5.0
2002	Mar.	0.6	2.6	51.6	5.0
	Jun.	1.0	2.8	54.6	5.8
	Sep.	0.5	2.6	53.9	5.9
	Dec.	0.6	2.7	56.4	5.9
2003	First Half Average	1/4	2 1/4	61	5 3/4
	Second Half Average	1/2	1 3/4	61 1/4	5 1/4
2004	First Half Average	1/2	1 3/4	60 3/4	5 1/4
	Second Half Average	1/2	2	59 3/4	5 1/2
2005	First Half Average	1/2	2 1/4	58 1/2	5 1/2
	Second Half Average	1/2	2 1/2	58	5 3/4
2006	First Half Average	1/2	2 1/4	57 1/4	5 3/4

Quarterly projections			
2002	Sep.	0.5	2.6
	Dec.	0.6	2.7
2003	Mar.	0.4	2.5
	Jun.	0.4	1.8
	Sep.	0.5	1.8

(1) Notes for these tables follow on page 32

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

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

Table B

Composition of real GDP growth

(Annual average percentage change, unless specified otherwise)

	Actuals						Projections			
March year	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Final consumption expenditure										
Private	4.5	2.2	2.5	3.8	1.7	2.8	4	2 3/4	3 1/2	3 1/4
Public authority	1.4	8.8	-2.2	7.3	-2.1	3.8	4 3/4	2 3/4	3/4	1 1/4
Total	3.8	3.7	1.4	4.6	0.8	3.0	4	2 3/4	2 3/4	2 3/4
Gross fixed capital formation										
Market sector:										
Residential	4.9	3.0	-14.0	22.8	-15.7	3.3	24 1/2	11 3/4	3 1/2	- 1/2
Business	3.1	-4.0	2.2	3.1	6.8	5.3	5	2 3/4	5 1/4	1
Non-market government sector	28.7	8.6	-15.9	10.6	-6.5	4.4	2 3/4	5 3/4	4 3/4	0
Total	5.7	-0.9	-4.1	8.6	-0.6	4.7	9 1/4	5 1/2	4 3/4	1/2
Final domestic expenditure	4.2	2.7	0.2	5.4	0.5	3.4	5 1/4	3 1/2	3 1/4	2 1/4
Stockbuilding [(1)]	-0.4	-0.1	-0.4	1.3	-0.4	0.1	- 1/4	- 1/4	1/4	1/4
Gross national expenditure	3.7	2.5	-0.2	6.7	0.1	3.5	4 3/4	3	3 1/2	2 1/2
Exports of goods and services	4.7	3.8	2.9	7.3	6.2	2.0	8 3/4	2 1/4	3 3/4	2 1/2
Imports of goods and services	6.5	2.6	2.0	11.4	-0.4	2.1	9 3/4	6 1/4	5	2
Expenditure on GDP	3.2	2.9	0.1	5.4	2.2	3.4	4 1/4	1 3/4	3	2 1/2
GDP (production)	3.5	1.5	0.4	5.0	2.7	3.5	4 1/2	2	3 1/4	2 1/2
GDP (production, March qtr to March qtr)	2.1	0.1	2.5	6.2	1.0	4.2	4 1/4	2 1/4	3	2 1/2
Potential output	3.6	2.9	2.5	2.6	2.8	3.2	3 1/2	3 1/2	3 1/4	3
Output gap (% of potential GDP, year average)	1.5	0.2	-1.8	0.4	0.3	0.6	1 1/2	1/4	1/4	0

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

Table C

Summary of economic projections

(Annual percentage change, unless specified otherwise)

	Actuals						Projections			
March year	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Price measures										
CPI*	2.0	1.7	1.0	1.7	3.1	2.6	2.5	1 3/4	2 1/4	2 1/4
Labour costs	2.0	1.9	1.6	1.4	1.6	2.1	2.2	2	2	2
Import prices (in New Zealand dollars)	-4.6	2.9	2.7	11.2	7.4	-2.9	-8 1/4	3/4	3 1/2	3 1/2
Export prices (in New Zealand dollars)	-6.3	4.2	-0.6	9.9	20.6	-3.5	-15	-3 1/4	3 3/4	4 3/4
Monetary conditions										
90-day rate (year average)	9.0	8.0	6.2	5.2	6.6	5.4	5.9	5 1/4	5 1/2	5 3/4
TWI (year average)	66.4	64.4	57.3	56.1	50.4	50.3	56.4	61 1/4	59 3/4	58
Output										
GDP (production, annual average % change)	3.5	1.5	0.4	5.0	2.7	3.5	4 1/2	2	3 1/4	2 1/2
GDP (production, March qtr to March qtr)	2.1	0.1	2.5	6.2	1.0	4.2	4 1/4	2 1/4	3	2 1/2
Output gap (% of potential GDP, year average)	1.5	0.2	-1.8	0.4	0.3	0.6	1 1/2	1/4	1/4	0
Labour market										
Total employment	1.2	0.0	0.6	1.4	2.3	3.5	1.5	1 3/4	2	1 1/2
Unemployment rate (March qtr, s.a.)	6.5	7.2	7.2	6.3	5.4	5.3	5.0	5	5	5
Trend labour productivity (annual % change)	1.0	1.3	1.5	1.5	1.5	1.5	1 1/4	1 1/4	1 1/4	1 1/4
Key balances										
Government operating balance (% of GDP, year to June)	1.9	2.5	1.7	1.3	1.2	1.9	1	2 3/4	3 1/2	3 3/4
Current account balance (% of GDP, year to March)	-6.1	-5.5	-4.1	-6.6	-4.6	-2.1	-3 3/4	-4 3/4	-5 3/4	-5
Terms of trade (annual average % change)	-0.8	-1.0	-0.4	-0.2	4.4	4.1	-6 3/4	-3	-1 3/4	1 1/2
Household savings rate (% of disposable income, year to March)	-3.0	-4.0	-4.8	-0.8	-4.4	-3.7	-4 1/4	-6 1/4	-6 1/4	-6
World economy										
World GDP (annual average % change)	4.2	3.5	1.9	4.3	3.6	1.3	3 1/4	2 1/2	3 3/4	3 1/4
World CPI inflation	2.2	2.4	0.9	2.0	2.8	1.2	1 3/4	1 3/4	2	2

s.a. = seasonally adjusted

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

Notes to the tables

CPI	Consumers Price Index. Quarterly projections rounded to 1 decimal place.
TWI	RBNZ. Nominal Trade Weighted Index of the exchange rate. Defined as a geometrically-weighted index of the New Zealand dollar bilateral exchange rates against the currencies of Australia, Japan, the United States, the United Kingdom, and the euro.
90-day bank bill rate	RBNZ. Defined as the interest yield on 90-day bank bills. Forecasts rounded to the nearest quarter per cent.
World GDP	Reserve Bank definition. 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.*
Exports 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	The series shown is the annual percentage change in a trend measure of labour productivity. Labour productivity is defined as GDP (production) divided by HLFS hours worked.
Wages	Private sector all salary and wage rates. *Labour Cost Index*.
Quarterly percentage change	$(\text{Quarter}/\text{Quarter}_{-1} - 1)*100$
Annual percentage change	$(\text{Quarter}/\text{Quarter}_{-4} - 1)*100$
Annual average percentage change	$(\text{Year}/\text{Year}_{-1} - 1)*100$

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

Rounding: Unless otherwise specified, all projection data are rounded to the nearest quarter per cent.

Appendix 2

Chronology

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

2003

6 March	The Reserve Bank released its thirty-seventh Monetary Policy Statement, leaving the Official Cash Rate unchanged at 5.75 per cent. The news release accompanying the Statement is reproduced in Appendix 4.
28 March	Production GDP figures were released showing that the New Zealand economy grew by 0.8 per cent in the December quarter of 2002.
15 April	CPI statistics were released for the March quarter of 2003, showing that the CPI increased by 0.4 per cent over the quarter, and by 2.5 per cent in the year to March 2003.
24 April	At the intra-quarter review, the Reserve Bank cut the Official Cash Rate from 5.75 per cent to 5.5 per cent. The accompanying news release is reproduced in Appendix 4.

Appendix 3

Companies and organisations contacted by RBNZ staff during the projection round

Ace Real Estate Ltd
Alliance Group Ltd
Amalgamated Builders 2001 Ltd
ASEA Brown Boveri Ltd
Auckland Chamber of Commerce
Auckland International Airport Ltd
Ballance Agri-Nutrients Ltd
Bay of Plenty Publishing Ltd
Bisset Engineering Ltd
Business New Zealand
Calder Stewart Industries Ltd
Canterbury Employers' Chamber of Commerce
Canterbury Meat Packers Ltd
Christchurch International Airport Ltd
Clive Wilson Ltd
Commerce Queenstown
Craig Printing Company Ltd
Criterion Group Ltd
Cruickshank Pryde
Destination Queenstown
Dunedin City, Marketing & Development
Ecolab Ltd
Electricity Ashburton Ltd
Energy Link Ltd
ENZA/Turners & Growers Ltd
Gabites, Sinclair & Partners Ltd
Gallagher Group Ltd
Gallaway, Cook, Allan
Grasshopper Properties Ltd
Greens Industries Ltd
Harcourts Group Ltd
Harvie Green Wyatt
Hayes International Ltd
La Grouw Corporation Ltd
Lichfield International Ltd
Mace Engineering Ltd
Mainzeal Property and Construction Ltd
M-Co Ltd
McDowell Real Estate Ltd
Morgan Furniture Ltd
New Zealand Council of Trade Unions
Ngai Tahu Fisheries Ltd
Orion New Zealand Ltd
Pacific Retail Group Ltd
PricewaterhouseCoopers
Priority One
Pyne Gould Corporation Ltd
Queenstown Lakes District Council
Radfords Ltd
Restaurant Brands NZ Ltd
Rotorua District Council
Satara Co-operative Group Ltd
Sealy New Zealand Ltd
Seeka Kiwifruit Industries Ltd
Shell New Zealand Ltd
Skyline Enterprises Ltd
Tachikawa Forest Products (NZ) Ltd
Tamahine Holdings Ltd
TelstraClear Ltd
Ullrich Aluminium Company Ltd
Vita New Zealand Ltd
Wilson & Horton Ltd
Wellington International Airport Ltd
Wellington Regional Chamber of Commerce

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

Appendix 4

Reserve Bank statements on monetary policy

RBNZ leaves OCR unchanged

6 March 2003

The Reserve Bank has decided to leave the Official Cash Rate at 5.75 per cent.

Speaking at the release of the Reserve Bank's March 2003 Monetary Policy Statement Reserve Bank Governor Alan Bollard said "On 23 January 2003, we stated that `If the exchange rate remains at around present levels or appreciates further, and if the evidence points to reduced pressures on resources and medium-term inflation, then there may be scope for a cut in the OCR later in the year.'

"Today's decision reflects that fact that the two-part criterion described above has not yet been fully met. The exchange rate has indeed appreciated further, but, so far, evidence of reduced inflation pressures has not been forthcoming.

"The domestic economy has been more robust than we thought. Rapid population growth, rising employment and the earlier strength in the export sector have fuelled strong household consumption and supported higher residential investment and housing market activity. Capacity utilisation is high and demand for labour is strong. Consequently, inflation in industries serving the domestic economy is relatively high at around 4 per cent.

"Thus the stronger currency and the stronger domestic economy continue to pull inflationary pressures in opposite directions. CPI inflation is projected to fall over the next few quarters, reflecting the impact of the exchange rate on import prices, and to settle comfortably within the target range over the medium term. However, we do not yet have sufficient certainty about this medium-term path of inflation to warrant a cut in interest rates now.

"This assessment could change over the months ahead and the Bank will be carefully watching economic developments. As we said earlier, when we see reduced pressure on resources and medium-term inflation, then there may be scope for a cut in the OCR later in the year," Dr Bollard concluded.

OCR reduced to 5.50 per cent

24 April 2003

The Reserve Bank today reduced the Official Cash Rate from 5.75 per cent to 5.50 per cent.

Reserve Bank Governor Alan Bollard commented "In January this year, we said that if the exchange rate remained unchanged or appreciated further, and if the evidence pointed to reduced pressures on resources and medium-term inflation, then there might be scope for a cut in the OCR later in the year. In our judgement, these conditions have now been met.

"The available data suggest that growth in the New Zealand economy is slowing as we projected in our March 2003 Monetary Policy Statement. A weak international economy is now being reflected in softer activity in New Zealand's tradable sector. The domestic economy remains relatively robust, especially in the housing market. However, the weaker tradable sector is expected to feed through into reduced domestic demand elsewhere in the economy, as exporters' incomes decline.

"With the passage of time, we are now more confident that inflationary pressures will ease, which is the basis of today's decision. This should not be interpreted as the Bank now having a more pessimistic view of the New Zealand economy, but rather as a consequence of our earlier expectations being confirmed.

"While the economy is progressing as expected, recent dry conditions in some parts of the country, potential electricity shortages and the SARS virus add additional downside risks to the economic outlook, though at this stage we do not expect a large enduring economic impact.

"The Policy Targets Agreement, signed in September last year, requires the Bank to avoid `unnecessary instability in output, interest rates and the exchange rate'. Based on this, we have been prepared to adjust interest rates a little faster in response to the unfolding evidence of a slowdown. However, any future easings will depend on the evidence still suggesting that inflation will settle comfortably within the target range over the medium term."

Appendix 5

The Official Cash Rate chronology

Date	Change in OCR (basis points)	OCR (per cent)
17 March 1999	OCR introduced	4.50
21 April 1999	No change	4.50
19 May 1999	No change	4.50
30 June 1999	No change	4.50
18 August 1999	No change	4.50
29 September 1999	No change	4.50
17 November 1999	+ 50	5.00
19 January 2000	+ 25	5.25
15 March 2000	+ 50	5.75
19 April 2000	+ 25	6.00
17 May 2000	+ 50	6.50
5 July 2000	No change	6.50
16 August 2000	No change	6.50
4 October 2000	No change	6.50
6 December 2000	No change	6.50
24 January 2001	No change	6.50
14 March 2001	- 25	6.25
19 April 2001	- 25	6.00
16 May 2001	- 25	5.75
4 July 2001	No change	5.75
15 August 2001	No change	5.75
19 September 2001	- 50	5.25
3 October 2001	No change	5.25
14 November 2001	- 50	4.75
23 January 2002	No change	4.75
20 March 2002	+ 25	5.00
17 April 2002	+ 25	5.25
15 May 2002	+ 25	5.50
3 July 2002	+ 25	5.75
14 August 2002	No change	5.75
2 October 2002	No change	5.75
20 November 2002	No change	5.75
23 January 2003	No change	5.75
6 March 2003	No change	5.75
24 April 2003	-25	5.50

Appendix 6

Policy Targets Agreement

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

1. Price stability

a) Under Section 8 of the Act the Reserve Bank is required to conduct monetary policy with the goal of maintaining a stable general level of prices

b) The objective of the Government's economic policy is to promote sustainable and balanced economic development in order to create full employment, higher real incomes and a more equitable distribution of incomes. Price stability plays an important part in supporting the achievement of wider economic and social objectives.

2. Policy target

a) In pursuing the objective of a stable general level of prices, the Bank shall monitor prices as measured by a range of price indices. The price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), as published by Statistics New Zealand.

b) For the purpose of this agreement, the policy target shall be to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term.

3. Inflation variations around target

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

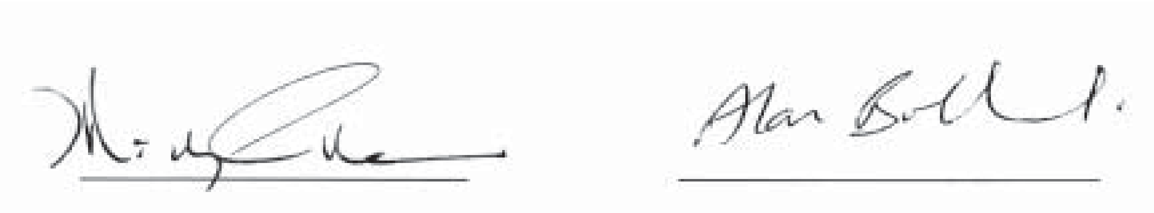
b) When disturbances of the kind described in clause 3(a) arise, the Bank will respond consistent with meeting its medium-term target.

4. Communication, implementation and accountability

a) On occasions when the annual rate of inflation is outside the medium-term target range, or when such occasions are projected, the Bank shall explain in Policy Statements made under section 15 of the Act why such outcomes have occurred, or are projected to occur, and what measures it has taken, or proposes to take, to ensure that inflation outcomes remain consistent with the medium-term target.

b) In pursuing its price stability objective, the Bank shall implement monetary policy in a sustainable, consistent and transparent manner and shall seek to avoid unnecessary instability in output, interest rates and the exchange rate.

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



Hon Dr Michael Cullen
Minister of Finance

Dr Alan E Bollard
Governor Designate
Reserve Bank of New Zealand

Dated at Wellington this 17th day of September 2002