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# Monetary Policy Statement<sup>1</sup>

March 2003

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

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

ISSN 1170-4829

<sup>1</sup> Projections finalised on 25 February 2003. Policy assessment finalised on 5 March 2003.

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# 1 Policy assessment

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

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.



Alan Bollard  
Governor

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## 2 Overview and key policy judgements

For some time now, the NZ economy has been displaying strength out of keeping with the weak situation of most of our trading partners (Australia excepted). Because it is unusual for a small and relatively open economy to avoid the slings and arrows of others' misfortunes, we have for some time been expecting that strength to abate. That abatement has not materialised.

Over the past few months, this situation has not changed substantially. Economic activity onshore continues to proceed apace. Our trading partners' economic cycles are well past their lowest points, but their situation remains relatively weak and we continue to expect it soon to begin to act as a drag on us. That expectation is strengthened now that the exchange rate has appreciated to the point where it is no longer acting as an offset to offshore weakness. But for now, New Zealand economic strength remains the reality, and future weakness remains a prospect.

A period of slower growth is not inevitable, but it still seems likely. The "new economy" boom that had sustained the US, European and Asian economies and equity markets through much of the 1990s began to unwind from early 2000. It always seemed probable that this development, which was to undermine a significant engine of growth for the world economy, would substantially alter the external environment for New Zealand. Even though New Zealand is not a major supplier of goods and services to the world's technology users and consumers, the flow-on effect to global incomes and wealth more generally would normally affect demand for our products. And the scale of the global downturn now seems likely to be bigger than that experienced in the early 1990s. The early 1990s downturn was an event which carried significant adverse consequences for New Zealand.

Delaying the impact of the global slowdown on New Zealand has been a combination of good commodity prices, a depreciated exchange rate, relatively low interest rates by historical standards, and strong net immigration. The degree of support from the first three of these factors waned progressively over the course of the past 18 months or so. However, their earlier combined stimulatory effect continues to work its way through the economy. Also, although net immigration is expected to weaken in due course, it currently remains strong. All up, these supportive factors have been stronger than the weak influences coming from overseas.

Indeed, the balance has been such that the resource base of the New Zealand economy has been under pressure for the best part of a year.

### Determining the appropriate policy stance

Anticipating a hump-shaped profile for economic activity – strong now, more moderate later – has particular implications for monetary policy, which is ideally forward-looking. Monetary policy actions typically have very little immediate impact (except when a large surprise is involved). Usually, the dominant impact falls between one and two years ahead. Accordingly, even with some current heat in the economy, we have for some time been setting policy on the basis of an economy that is neither exceptionally hot nor exceptionally cold.

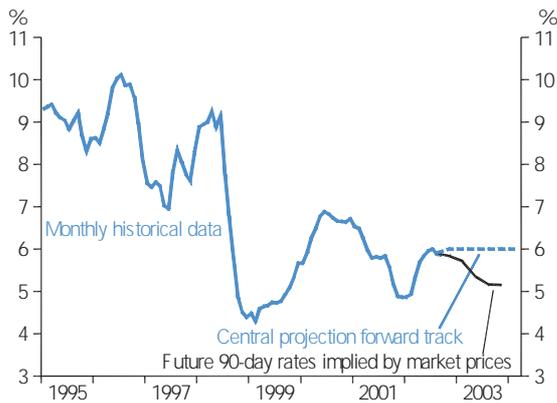
Despite the passage of time, the expected slowdown in the pace of economic activity that motivated these policy settings has still not arrived. Prices of our (non-technology) export commodities took some time to be affected by the global slowdown, and have since even rebounded noticeably. Net immigration has continued at a remarkable pace, pushing New Zealand's population growth towards 1½ per cent in the past year from about ½ per cent over the previous two years. Typically, migration inflows expand demand for goods and services faster than they expand the economy's capacity to produce those goods and services for quite some time, and the current net inflow appears to be no exception. Finally, the exchange rate remained weaker for longer than was assumed. Altogether, the pressure that these developments have put on available resources has pushed non-tradable inflation – that component of inflation that relates most closely to onshore developments – to over 4 per cent per annum.

Because we are still expecting economic activity to slow over the next year, and that slowing to reduce inflation pressures, we are leaving the Official Cash Rate (OCR) unchanged for now. Rapid exchange rate appreciation over the last six to nine months in particular influences this picture in two ways. Contributing to the expected slowing is the removal, and indeed reversal, of the protection from the effects of a weak world afforded by a depreciated exchange

rate. That will influence domestic inflation developments, not so much over the year ahead – since much of the path of inflation over the year ahead is determined by events that have already occurred – but further out. Secondly, exchange rate appreciation will directly affect tradables inflation, with the impact already beginning to become evident. Much of the latter component is less relevant to today's policy choice, since the direct effects of exchange rate changes on tradables inflation tend to be temporary and accordingly we substantially look through them. But some assurance that inflation expectations will remain well anchored is provided by the early reduction in headline inflation that results from exchange rate appreciation.

The projections described in Chapter 4 of this Statement illustrate these prospective developments. Given current policy settings and reasonable assumptions about the evolution of external influences, existing pressure on non-tradable inflation dissipates within the medium-term horizon that guides policy (figures 1 and 2). And allowing for the influence of the exchange rate on tradables inflation, overall CPI inflation is projected to fluctuate around the middle part of the 1 to 3 per cent target range established by the PTA. On average, given our assumptions, over the medium term ahead CPI inflation appears consistent with the target range.

Figure 1  
90 day interest rates

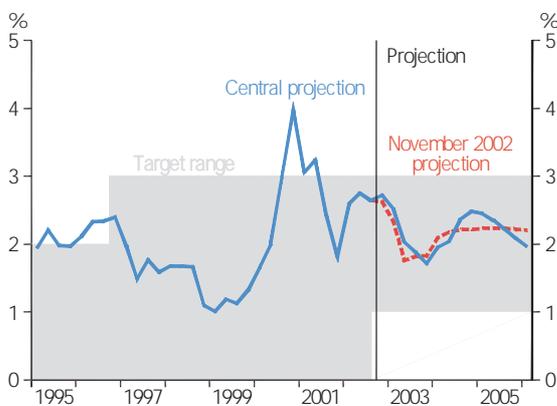


Source: RBNZ.

## Assessing policy risks – a cautionary tale

Clearly, the view that economic activity will slow over the year ahead is central to this policy judgement. What is the basis for continued reliance on this view? The global economy has been weak for some time, and the favourable combination of good commodity prices, a depreciated exchange rate and supportive interest rates disappeared some time ago. As time passes, the lagged effects of supportive forces wane and the lagged effects of the slowing forces start to dominate. The rapidity with which the exchange rate appreciated over the second half of 2002 is also relevant to this conclusion, as is the possibility that further appreciation will occur.

Figure 2  
Consumer price inflation  
(annual percentage change)



Source: RBNZ. See p 27 for series definition.

The speed and scale of exchange rate appreciation over the last 12 months has been substantial – it is the largest 12 month change since the exchange rate was floated in March 1985. It changes the balance of probabilities on whether the anticipated easing in the rate of growth will occur. It also raises the possibility of further appreciation. In the review of the Official Cash Rate that took place on 23 January, we indicated that should the exchange rate's appreciation persist or continue, and given evidence that an easing of inflation pressure was underway, it was likely that interest rates could be reduced later in the year. The current position is little different.

To many observers – especially those most exposed to the effects of exchange rate appreciation – such caution over

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the potential for a future policy easing is inconsistent with the extent and speed of the rise in the exchange rate. What is the explanation, especially in light of the fact that New Zealand's policy interest rates have for some time been considerably higher than those in most other parts of the world?

Three factors stand out.

The first, and most significant, is a direct consequence of the extended period of above-trend economic growth that we have been enjoying. Over the past three to four years, spare productive resources have increasingly been drawn back into activity. The unemployment rate has fallen, participation in the workforce has increased, and under-utilised plant and machinery has been brought on stream. Indeed, by many measures of the utilisation rate of available productive resources – both capital and labour – the degree of pressure is now on a par with, or has moved beyond, the levels reached in the mid-1990s.

Such pressure has already translated into rising inflation, with non-tradables inflation responding to the persistent pressure we have been experiencing, in a historically-normal way. It takes time for inflation to respond, and time for reduced pressure on resources to allow inflation to ease. In these circumstances, the policy mistake from which it would be harder to recover would be to allow a greater head of steam to build. This calls for caution in moving too quickly to adjust policy settings.

The second reason for caution is the fact that despite the speed and scale of recent exchange rate appreciation, the average exchange rate facing New Zealand exporters has only recently moved above its historical average. Looked at in isolation, the level of the exchange rate is now likely to be constraining for the "average" exporter. Of course the situation facing any one exporter may be quite different from the average, and for some producers – whether exporters or suppliers to the local market – exchange rate appreciation reduces the cost of the capital equipment that might be needed to alleviate some of the pressure on existing capacity, and directly reduces the cost of some components of production. In other words, time and offsetting factors are as relevant as the exchange rate appreciates as they were when the exchange rate depreciated.

Thirdly, as already explained, for a considerable period we have adopted monetary policy settings based on the

presumption that global weakness would translate into local weakness. In other words, current interest rate settings already anticipate a slowdown. For this reason, we need to be reasonably confident that the easing in growth rates that we think will happen over the coming year is at least as substantial as has already been allowed for.

## Where is the exchange rate headed?

One of the key uncertainties that we face in assessing the appropriate policy stance is the future path of the exchange rate. Exchange rate developments are often quite difficult to explain in retrospect. They are even harder to predict, which is the more relevant question for a forward-looking policy.

Amongst the components of the explanation we have ventured for the recent sharp rise in the exchange rate (see Box 1, and the Governor's January speech, 'Making Sense of a Rising Exchange Rate'<sup>1</sup>) are the comparative strength of the New Zealand economy, and the not-unrelated comparatively high level of New Zealand interest rates. There are potentially also factors related to momentum which can from time to time be highly relevant.

Broadly speaking, there does appear to be a relationship between exchange rate developments and international investors' assessment of the strength of different economies. Likewise, there does seem to be a relationship between the exchange rate and relative interest rates (partly because relative interest rates reflect relative economic strength). But there are many other things going on which mean that at times exchange rates are out of line with fundamentals – as for example seemed to be the case in 1999 through 2002 when both the New Zealand and Australian dollars were substantially more depreciated than could be explained by reference to relative growth and interest rates. When misaligned exchange rates start to move back into line with fundamentals, the adjustment can be rapid and go beyond the point that would be explained by closure of misalignments. Such "overshoots" display a pattern of changes reinforced by their own momentum.

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<sup>1</sup> <http://www.rbnz.govt.nz/speeches/0129542.html>

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It would be nice to be able to sidestep the complexities of the exchange rate when putting together projections, but we cannot. Our standard approach has been to assume that the exchange rate will eventually go back to its long-run trend level, with the speed of that reversion being affected by relative interest rates in only a small way. We have evaluated alternative approaches (such as assuming that the rate will remain unchanged, or assuming that change begets change), but none seem systematically better, and many have the problem of implicitly assuming that the exchange rate's behaviour is entirely divorced from other developments.

In the projections prepared for this Statement, we have essentially stayed with our standard approach, although we have amended that approach by not assuming an immediate depreciation in the direction of the long-term trend level. This is despite recognising that the combination of a further period of New Zealand out-performance of trading partners, the associated international interest rate differentials, and the effects of momentum, together mean further exchange rate appreciation is probably more likely than exchange rate depreciation.

To work through the implications of further exchange rate appreciation, we explored a number of scenarios and their likely impact on appropriate policy settings. The results can be summarised as follows. Were the exchange rate to continue to appreciate substantially further before subsequently reverting to current levels, *and were nothing*

*else to change* (apart from the consequential changes associated with the exchange rate), then monetary policy settings would need to become substantially easier. If policy settings did not ease substantially, the average inflation rate over the three or so years ahead would fall uncomfortably low. However, were the additional exchange rate appreciation to be accompanied and motivated by further out-performance of our trading partners, the situation would be different. In such circumstances, the net effect on the economy and on appropriate policy settings could even be negligible. As it happens, our previous research into this subject suggests that it is more typical for the big changes in the exchange rate to respond to and reflect some fundamental force than to move independently, but with wide variations in the degree of connection.

The somewhat greater probability of further appreciation than of depreciation lends support to our view that an easing of interest rates in the future is more likely than a tightening, as expressed at the time of our January OCR review. That balance of probability probably accounts for a substantial proportion of the gap between the flat interest rate track contained in our projections and financial market's collective expectation as expressed in market prices (see figure 1). But the uncertainty around this balance of probability, around the circumstances in which further appreciation might occur, and therefore around the consequences, highlights the conditionality that must be attached to this view.

## Box 1: The exchange rate and monetary policy

The New Zealand dollar has appreciated sharply since the start of last year – rising some 20 per cent on a TWI basis and around 15 and 30 per cent respectively versus the Australian and US dollars. Movements this large and fast in a key relative price potentially have important implications for the outlook for the economy, inflation and monetary policy.

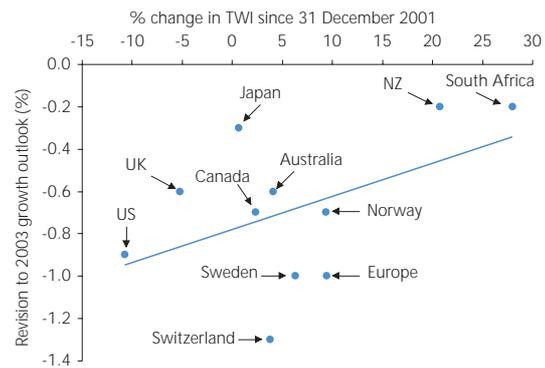
The significance of a change in the exchange rate for monetary policy depends on a couple of important considerations. Firstly, it matters why the movement in the exchange rate has occurred, and secondly it is important to understand whether the movement in the exchange rate will have a persistent effect on the economy and inflation pressures.

The factors that shape movements of exchange rates around their long-term trend often differ from those that determine the long-run trends themselves. The very long-run trends in the currency usually reflect the influence of factors that impinge on the underlying competitiveness of the economy, such as differences in the rate of productivity growth, or in inflation in New Zealand versus other countries. These long-run trend factors are typically very stable over long periods of time and explain relatively little of the year to year volatility of the exchange rate.

Most of the ebb and flow of the exchange rate cycle around its trend reflects changes in global investors' expectations of the relative rates of return of New Zealand dollar-denominated assets versus investments denominated in other currencies, taking into account their perception of the risks associated with the alternative investments. The factors that drive expectations of relative returns and risk generally fluctuate unpredictably, making exchange rates themselves hard to predict. And it is not just interest-bearing investments that are relevant. A few years ago expectations of the relative strength of equity markets appeared to dominate the thinking of global investors. The strongest currencies were those of countries with a preponderance of strongly growing technology sectors, such as the US, while the weakest currencies were those countries perceived as "old economy," like New Zealand.

More recently, investors' preferences appear to have shifted towards the currencies of countries which have grown surprisingly strongly and which have offered relatively high and stable fixed interest returns. The role of these two factors is illustrated in figures 3 and 4 contained in this Box. As shown in these figures, the New Zealand dollar appreciated significantly as our growth outlook and interest rate expectations remained reasonably stable over 2002 whereas the outlook soured in many other countries and interest rate expectations were revised down as the year wore on.

Figure 3  
Growth outlook revisions and exchange rate movements  
(percentage change in Consensus forecasts for 2003 GDP growth)



Source: Consensus Economics Inc, Bloomberg, South African Reserve Bank.

The Kiwi's rise against the US dollar was especially large as the US dollar itself depreciated alongside generally disappointing US growth and the associated historically low interest rates. The New Zealand dollar also gained significantly against the Australian dollar, partially reflecting the more uncertain growth outlook in Australia as the effects of the drought took hold in the second half of last year.

But these factors by no means explain all the relevant developments in exchange rates. To illustrate, although changes in the growth outlook and the level of short-term interest rates are consistent with New Zealand dollar strength vis-à-vis the Australian dollar, there are puzzles. The Australian dollar has also remained quite low by

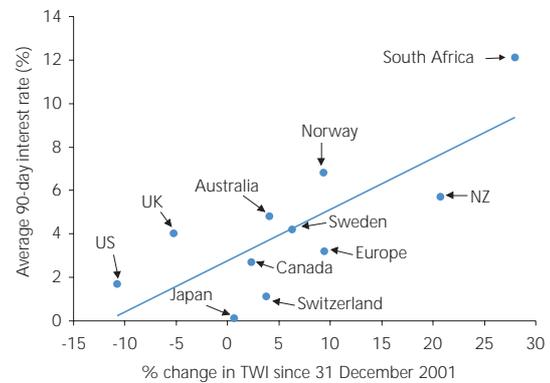
historical standards against trading partner currencies, notwithstanding solid growth and attractive interest rates by international standards.

All else equal, a rise in the New Zealand dollar implies a decline in our competitiveness and weaker medium-term growth and inflation pressures. However the exchange rate seldom rises without some underlying reason. Seldom if ever is all else equal. Considering the inflation consequences of a change in the exchange rate thus requires consideration of associated developments. As noted above, at least some of last year's rise in the exchange rate reflected our surprisingly strong growth performance that placed unexpected pressure on the economy's productive resources. Those developments changed the inflation outlook in a way that offset the effects on inflation of the exchange rate appreciation, in our judgement to an extent that implied that policy settings should remain broadly unchanged from the middle of last year.

When thinking about the policy implications, we focus on the more persistent implications of the exchange rate on the medium-term inflation outlook. In the short term, a change in the exchange rate has quite large effects on prices through changes in the New Zealand dollar price of imported goods. The local price of goods that we export are also affected quite directly – as was observed over the last several years with increases then decreases in the price of some food items as the exchange rate depreciated then appreciated. However these effects are relatively short-lived and only matter for policy if they influence inflation expectations and the longer-term trend in inflation. We typically assume that inflation expectations are quite well anchored which suggests we can safely “look through” the transitory impacts of the exchange rate on inflation.

The more important consideration for policy is the longer-lasting effect of the exchange rate on competitiveness and hence economic activity in New Zealand, as it is through this channel that persistent inflation developments tend to emerge. The most recent increase in the exchange rate has taken the TWI from more than 15 per cent below its long-run average to between 5 and 10 per cent above average levels. Taken by itself this change would significantly reduce activity in the export sector and hence substantially reduce the degree of pressure on the economy's productive resources. How much that change is offset by other developments, and how much is a correction from a previously unsustainable situation – and hence not acted upon by sceptical exporters – is difficult to tell.

**Figure 4**  
Short-term interest rates and exchange rate movements since 2002  
*(comparison across countries)*



Source: Bloomberg, South African Reserve Bank.

### 3 Current economic situation

#### Introduction

The economy continued to post solid growth in the second half of 2002 with GDP expanding by 1 per cent in the September quarter or 3.9 per cent for the year to September as a whole. Strong domestic spending has been the main engine of recent growth with a weaker contribution from exports than over the past two years. Some recent indicators hint toward a cooling in domestic demand, but the evidence is mixed. Business confidence has eased in early 2003, but indicators of firms' own activity remain reasonably robust.

The evolution of inflation pressures over the past year has been consistent with a fast-growing domestic economy. Strong demand, accompanied by only modest growth in business investment, has driven capacity utilisation to historically high levels. Skilled and unskilled labour is in short supply in many industries and regions throughout the country, despite accelerated growth in the workforce due to net immigration. Reflecting these pressures, inflation in the non-tradables sector of the economy (covering industries producing goods and services for domestic use with little direct competition from abroad) has lifted sharply and has not yet started to fall away. Weak world inflation and a higher exchange rate are producing an offsetting fall in tradables sector inflation, but annual CPI inflation for the year to December remained at 2.7 per cent – little changed from a year ago.

#### Domestic demand

Domestic demand gained considerable strength over 2002, and some of this momentum appears likely to have carried through into the New Year. The lift in primary sector incomes that occurred in 2000 and 2001 stimulated regional economies and activity levels remain relatively strong despite a softening in primary sector prospects during 2002. Fast population growth, brought about by net immigration, has provided considerable stimulus to urban economies (and to some provincial economies, such as those providing education services to foreign students). These initial stimuli have been reinforced by strong growth in employment that will have further supported domestic activity.

Within this picture, consumer spending has shown strength (figure 5), with a further solid increase in retail sales

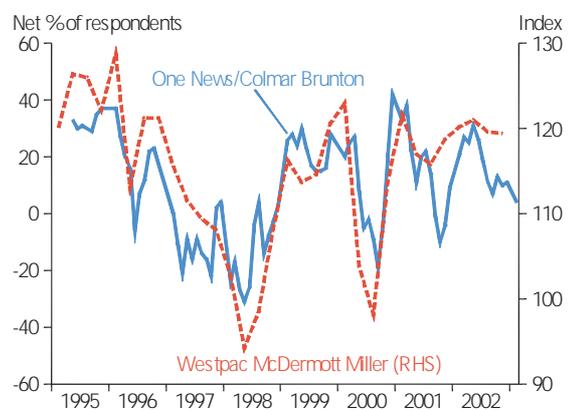
recorded across most regions and store-types during the December quarter. Sales of large ticket items like motor vehicles, appliances and furniture have been particularly strong consistent with the sharp rise in population and strong residential construction activity. However, total sales in the December month – as distinct from the quarter – showed little growth in seasonally adjusted terms, suggesting a possible slowing in consumer demand. Consumer confidence, as recorded by both the One News Colmar Brunton poll and the Westpac McDermott Miller surveys have been at healthy levels recently, indicating a readiness on the part of households to spend rather than save. However, the Colmar Brunton series has begun to fall in the New Year (figure 6).

Figure 5  
Nominal (ex-auto) retail sales  
(annual average percentage change)



Source: Statistics New Zealand.

Figure 6  
Consumer confidence



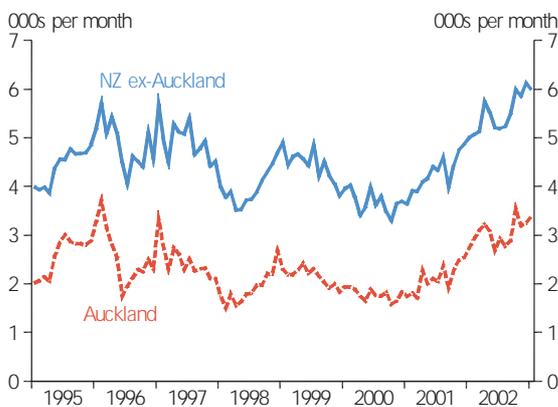
Source: One News/Colmar Brunton Poll, Westpac Banking Corporation.

Anecdotal reports of retail activity in the New Year have also been mixed, with some business contacts noting that

spending in rural areas has started to come under pressure as the prospect of weaker primary incomes takes hold. However, some indicators such as car registrations, continued to hold up well in January and reports of weaker sales have not been universal, especially in urban areas. Job ads in the regions have been softening in recent months, which is consistent with a more modest growth trend in provincial economies. Employment growth slowed in the second half of 2002, which may have limited the extra stimulus to demand.

Housing market activity has also been buoyant with the number of existing house sales recently at levels similar to those prevailing during the housing boom in the mid-1990s (figure 7). While a stronger Auckland market has received some media attention, the increase in house sales in other parts of New Zealand has actually been more marked, albeit with an uneven pattern of activity across individual regions. Real Estate Institute data confirm that the median days to sell houses have been relatively low, reflecting strong demand and some shortages of listings for sale.

**Figure 7**  
House sales  
(seasonally adjusted)

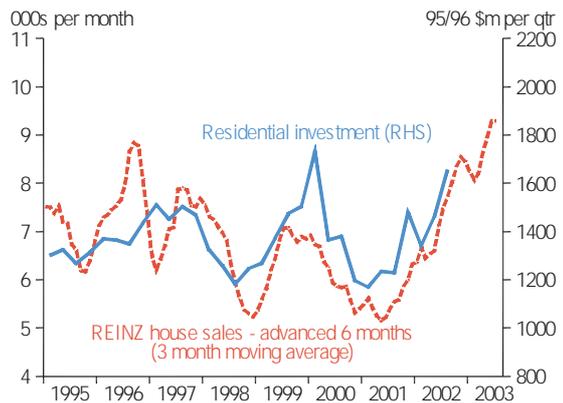


Source: Real Estate Institute of New Zealand.

Consistent with stronger sales activity, residential construction has accelerated over the past year (figure 8), with the September quarter GDP results confirming another sharp increase in activity during the quarter. There is little evidence of a near-term slowdown in activity with dwelling consents over recent months having remained high. Consents for new apartments – especially in Auckland – have been particularly strong. Given the normal lags between new consents and activity, it is likely that this building work will be

undertaken throughout the coming year. Many builders report that they have work booked for a considerable period into the future, a trend consistent with current high readings for that sector's capacity utilisation.

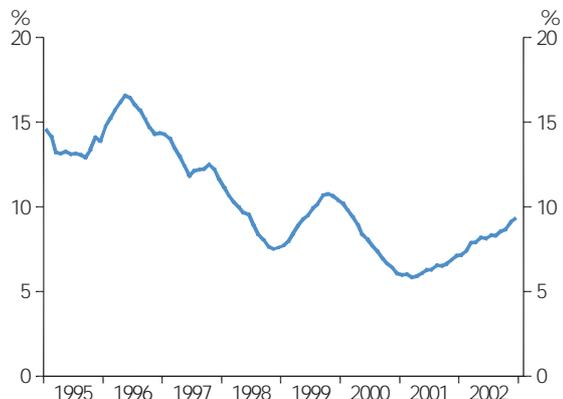
**Figure 8**  
Residential investment and house sales  
(seasonally adjusted)



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

To date, the increase in residential activity has differed from the episode in the mid-1990s in a number of important respects. First, household credit growth has been relatively muted, although lending for housing has begun to pick up recently (figure 9). Households appear to have been more reluctant to increase debt-to-income ratios than in the past, with the rise in activity financed largely from stronger incomes

**Figure 9**  
Household credit growth  
(annual percentage change)



Source: RBNZ.

(continued on p. 13)

## Box 2: The housing market and monetary policy

A box in the Bank's May 2002 Statement addressed the significance of the housing market for monetary policy. With housing market activity continuing to strengthen since that time, it is useful to recap the issues.

Housing-related items in New Zealand's CPI include dwelling rentals, the purchase and construction cost of new dwellings and expense of dwelling purchase. These make up nearly a fifth of the CPI regimen. Measured increases in these items have picked up over the past few quarters in line with the stronger housing market. Contrary to popular belief, the CPI no longer includes existing house and section prices.

The indirect effects of housing market trends are also significant for monetary policy. Trends in the housing market may be symptomatic of, or an influence on, more generalised inflation pressures in the economy. Periods of buoyant residential market activity often represent adjustment in the economy to factors such as faster population growth. Strong demand for housing may produce rising house prices and rentals before triggering a corresponding supply response. In the process, demand may be stimulated in a range of related industries.

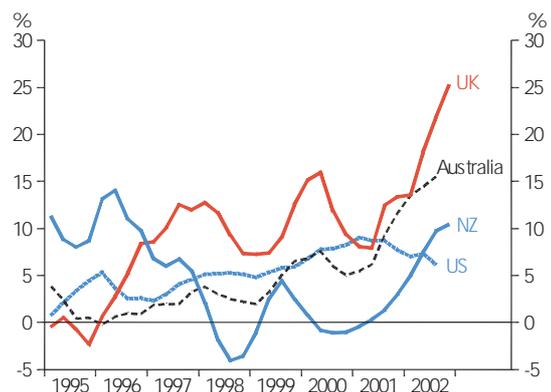
In principle, monetary policy could look through a period of housing market strength that reflected an adjustment to stronger underlying demand for housing on the grounds that the adjustment ultimately needs to occur. In practice, the choice of policy response is rarely this easy. Re-attaining balance between supply and demand for housing is a process that can be relatively protracted – perhaps lasting several years. Strong activity emanating in the housing market can impact aggregate demand through a variety of diffuse channels. On occasion, residential investment activity and house prices may increase out of proportion to the adjustment required as people attempt to benefit from higher house prices and speculative activity occurs. That, in turn, may add further pressure to demand.

How then should monetary policy respond to a strong housing market? Most economists believe it is appropriate for the demand effects of rising house prices to be factored into monetary policy decisions. Certainly we do take residential investment and household spending into account, along with all the other factors affecting spending and the cyclical position of the New Zealand economy.

Some economists have gone further and suggested that monetary policy should also respond to asset price movements that appear out of line with economic fundamentals. Because falling asset prices can lead to financial distress, these economists argue that it is appropriate to "lean against" asset price inflation before a bubble develops. They also note that nominal asset prices may rise (relative to real fundamentals) because inflation expectations have increased, which would merit monetary policy attention. Whether monetary policy could be actively used in this fashion without causing harm elsewhere in the economy is a matter of debate.

As shown in Figure 10, house prices have risen relatively sharply in New Zealand over the past year, albeit not to the extent of those in some countries overseas.

Figure 10  
House prices  
(annual percentage change)



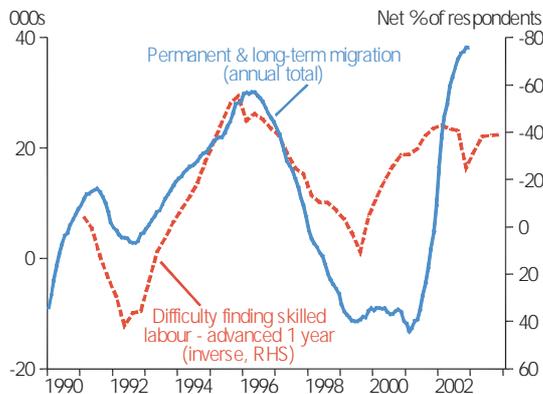
Source: Datastream, Quotable Value New Zealand.

### Box 3: Migration

A sharp turnaround in migration flows has been a factor contributing to strong demand in the economy over the past year. For over a year now, New Zealand has had substantially more people arriving on a permanent and long-term<sup>2</sup> (PLT) basis than leaving. The shift to a situation of net PLT immigration has reflected both a gradual increase in arrivals and a sharp fall in departures that occurred in late 2001 and has since been sustained.

The factors driving these changes are various, reflecting the many reasons why people choose to migrate from one country to another. To some extent these flows – in both directions – have reflected strong economic growth and good employment prospects in New Zealand, as reflected in falling unemployment rates and shortages of certain skills (figure 11). To some extent they probably reflect geopolitical tensions and security concerns. And to some extent they reflect a surge in students arriving to study for periods of a year or longer.

Figure 11  
Net migration and skill shortages



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

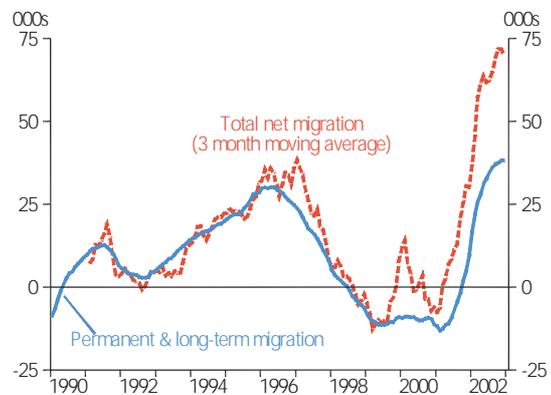
As dramatic as the surge in the net PLT numbers have been, they do not tell the full story. Unlike the situation in many other countries, visitors already in New Zealand can apply for residency without having to leave. As a result, additions to the long-term resident population can occur without new flows across the border, which is where the

<sup>2</sup> A year or longer.

PLT statistics are captured. Moreover, there has also been a sharp increase in people coming to New Zealand for significant periods but less than a year, such as some students and work permit holders.

Total net immigration (all arrivals less all departures) may provide a better sense of the overall boost to the numbers of people in NZ with economic needs to fill. As shown by figure 12, the overall boost may have been much greater than suggested by the PLT statistics.

Figure 12  
Net migration  
(annual total)



Source: Statistics New Zealand.

This is an important issue for monetary policy. As discussed in previous Statements, the significance of net immigration for monetary policy relates to the balance of its impact on supply and demand conditions in the economy. Many migrants add directly to the country's workforce and hence productive capacity. But the effect of a sharp rise in net immigration is likely initially to boost demand by more than supply. All newcomers, whether entering the workforce or not, require housing or other accommodation, and there is associated 'set-up' expenditure which adds to consumption. There will also be extra pressure on infrastructure that will prompt additional investment if the pressure is large and sustained enough.

The time profile of changes in migration flows is clearly highly relevant to the evolution of pressures on the economy and hence how monetary policy should react. But migration flows are notoriously difficult to forecast. For a start,

departures are not directly determined by policy and may hinge as much on specific conditions (economic, social and geopolitical) abroad as in New Zealand. These things are unpredictable, and in the current circumstances could easily swing either way. A complicating factor is the extent to which departures may be deferred when conditions for moving abroad are unfavourable, leading to a possible surge in outflows at some later date.

In terms of inflows, large numbers of people living abroad (non-resident New Zealanders in particular) have the right to enter at will. And even immigration that requires specific approval is not closely controllable. Changes to immigration policy late last year do not apply to those with applications already registered, and there is a large backlog of applications awaiting processing. Administrative factors, which are in part responsible for the backlog, will also influence the pace with which the changes in policy affect the inflow, as will variations in the lag between approvals and arrivals. And for all inflows, whether requiring specific

approval or not, there is just as complex a set of factors operating to influence potential migrants' decisions as is the case for outflows.

Consistent with our view that the New Zealand economy will begin to weaken relative to the global economy, we are assuming that we will see weaker net immigration over the next two years. The projections presented in Chapter 4 assume that net permanent and long-term migration will decline from nearly 40,000 persons per annum at the end of 2002 to approximately 20,000 persons in the March 2004 year. The latest data tentatively suggest that net immigration may have peaked (see figure 12), with some decline in both permanent and long-term arrivals and those arriving for other purposes (other than tourism). To date, departures have shown little sign of accelerating from their current lower levels. Given their influence on domestic demand and supply conditions, we will continue carefully to monitor migration developments.

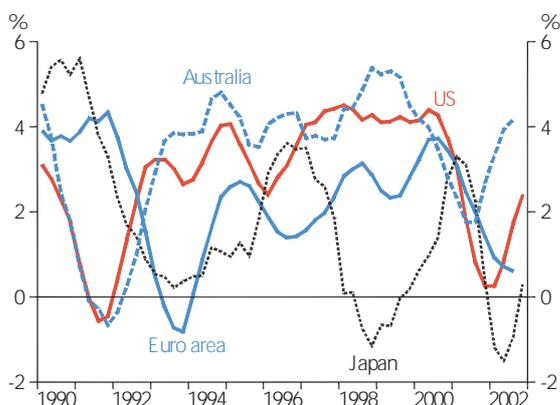
or migrants' transfers rather than debt. Second, although the CPI indicates a sharp increase in costs over the second half of 2002 as activity surged, construction costs have not risen as quickly as in the 1990s. However, existing house prices have been rising quite strongly over the past year, with rates of change approaching those seen during the 1990s. The box discusses the significance of the housing market to monetary policy in further detail.

Strong net immigration has been an important driver of residential activity over the past year. Stronger net inflows during 2002 partly reflected a gradual increase in arrivals – those approved for residency as well as those arriving on student visas and work permits – but was driven principally by a sharp fall in departures in the second half of 2001. As discussed further in the box, there are signs that net immigration may have peaked, but it remains unclear how quickly it may fall away going forward.

## External developments

Following the slowdown in 2001, the economies of New Zealand's main trading partners began a recovery in 2002 (figure 13), but there are significant concerns about the durability and strength of the recovery. Near-term indicators of activity in the US, Japan, Europe and Australia have been disappointing, and expectations of growth prospects for 2003 have been revised down accordingly. With some exceptions, central banks in most countries – most notably Euroland – have adopted easier monetary policies over the past twelve months in response to soft demand conditions. In most cases, there is a widespread expectation that these easier policies will be sustained for an extended period. Although analysts are less convinced about the prospect of further rate cuts from this point, financial markets continue to price in the possibility of further interest rate reductions in some countries.

Figure 13  
Export partner growth  
(annual average percentage change)



Source: Datastream.

Strong consumer demand, especially for motor vehicles, has provided some support for the US economy recently, although confidence appears to be under pressure given current tensions around a possible conflict with Iraq. This trepidation could undermine spending in the near future. US businesses spent much of 2002 cutting back on excess capacity and cutting costs in an attempt to improve profits. As a result, investment has remained weak with few signs of improvement to date, incomes have been under pressure and the unemployment rate has climbed. Some leading indicators are pointing to an improvement in prospects over the months ahead, but others are less encouraging. President Bush's recently announced fiscal initiatives, which include tax relief over the next couple of years, may have some positive impact on the outlook assuming they pass through Congress. Expectations remain for a relatively shallow recovery.

European growth during 2002 was very subdued, with weak consumption and business investment in most countries, an appreciating euro and continued structural problems. Germany – historically the region's prime engine of growth – has been particularly weak, with sharp falls in equity prices and house prices both acting as a constraint on demand. Consequently, immediate prospects for recovery appear relatively limited.

A recent recorded rebound in GDP growth for Japan appears to be clouded by measurement issues and contrasts with an ongoing fall in industrial production. Business investment continues to decline and consumer spending

remains weak in the face of high unemployment. Non-Japan Asia grew moderately (by its standards) in 2002 with China, South Korea and Malaysia showing the strongest performance, while the more technology-dependent economies of Singapore and Hong Kong fared less well. Foreign investment in China's manufacturing sector has helped to sustain an expansion in exports in an otherwise weak global environment. However, the sustainability of that trend remains uncertain, especially if the US and European economies remain weak. Intra-regional trade among Asian countries has also helped to sustain activity in the region to a degree.

Like New Zealand, Australia's economic performance has been remarkably positive in the face of soft global demand. Over the past year, robust consumer spending, further expansion in housing, a firm labour market and some growth in business investment have produced relatively strong growth. However, drought conditions have undermined near-term growth prospects, with dry conditions already estimated to have shaved around  $\frac{1}{2}$  per cent off GDP growth in 2002. Moreover, there is some speculation that the housing boom may be peaking, which could weigh on growth prospects. Recent indicators may point to a softening in business conditions, including credit growth and job ads, but the most recent indicators of business investment have been encouraging.

International financial markets continue to reflect the indifferent global environment. Global equity markets, which fell sharply during 2002, have continued to edge down over the past few months, albeit not to the extent of the earlier falls. Ongoing profit concerns in the US and Europe and the tensions between the US and Iraq have seen some markets at multi-year lows and there is as yet little sign of an imminent recovery. Credit spreads in US and European markets remain higher than a year ago, reflecting increased risk aversion, but have fallen back considerably from their highs in the middle of 2002, even with the heightened possibility of war.

With the lack of alternative attractive investment alternatives around the world, and favourable perceptions of New Zealand's corporate environment given strong domestic demand, there has been strong demand for New Zealand investments over recent months. This increased demand has come from both local and foreign investors and has been

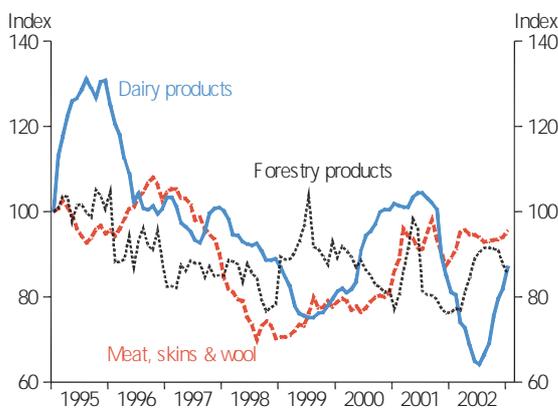
especially evident for Eurokiwis<sup>3</sup>. Reflecting the increased demand for investments, domestic swap spreads have narrowed, particularly for shorter-term maturities. More obviously, there has been a sharp increase in the exchange rate (discussed in Chapter 2).

## Tradables sector activity

In tracing the influence of the export sector on general economic activity, two key channels are relevant. The production of goods and services for export contributes directly to activity and represents an important claim on the economy's resources. However, fluctuations in the prices received for exports can also have a powerful effect on general activity via exporters' incomes. Over 2000 and 2001, export earnings were boosted considerably as commodity prices strengthened in world markets and the New Zealand dollar fell sharply against most currencies. The surge in export earnings acted to stimulate domestic activity.

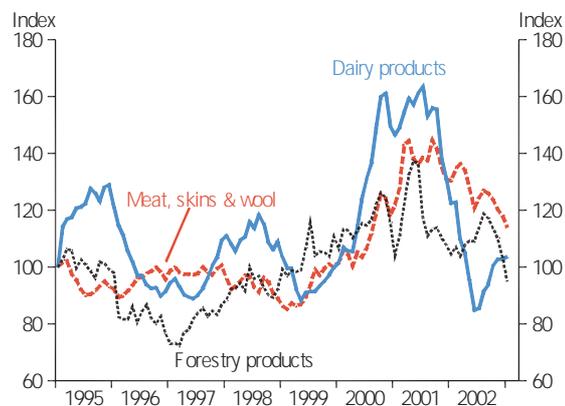
However, export earnings have declined modestly over the past year with further modest growth in volumes more than offset by a fall in prices received. To date, however, only a modest proportion of the growth in earnings that was attained in the previous two years has been unwound. After reaching a peak in mid 2001, prices received in world markets

Figure 14  
NZ commodity prices – world price terms  
(January 1995 = 100)



Source: ANZ Banking Group Ltd.

Figure 15  
NZ commodity prices – NZ dollar terms  
(January 1995 = 100)



Source: ANZ Banking Group Ltd.

for New Zealand's main export commodities eased relatively sharply, at least for some items such as dairy products (figure 14). In addition, the New Zealand dollar began strengthening during 2002, further eroding prices in local currency terms, albeit with a lag in some cases (figure 15).

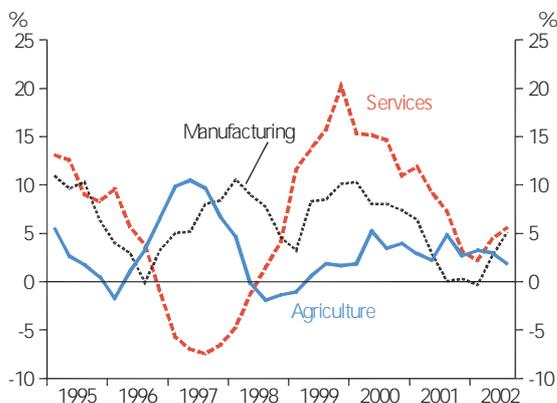
Dairy prices have now regained much of the ground lost during 2002, although the prospect of further gains is unclear. Milk powder prices have almost reached a level where unsubsidised US product will become competitive in world markets, which may increase global supplies and limit further price increases. Consumer demand in some markets – including the US – appears to be a little soft, which may also limit the scope for further increases. Prices for wool and beef have also made gains (partly reflecting tight supplies arising from the Australian drought). However, some commodity prices are under downward pressure, most notably for forest products, which are being affected by weak demand conditions, especially in the US. Consequently, a concerted further rise in aggregate export prices in world currency terms looks unlikely in the near term.

Reading the trend in export volumes (figure 16) over the past year has been complicated by a highly uneven pattern of agricultural exports. As export prices declined in late 2001, exporters appear to have accumulated stocks in the expectation that the price declines would be short-lived. Primary exports surged in the first half of 2002 as these stocks were sold, but volumes have since fallen back to lower levels. At the time of writing, dry conditions throughout many regions of the country were being reflected in lower

<sup>3</sup> For further information about Eurokiwis see Kelly Eckhold, *Developments in the Eurokiwi Bond Market*, Reserve Bank Bulletin, June 1998.

production in some areas of agriculture but higher in others (livestock slaughter numbers are purported to be very strong).

Figure 16: Export volumes by sector (annual average percentage change)



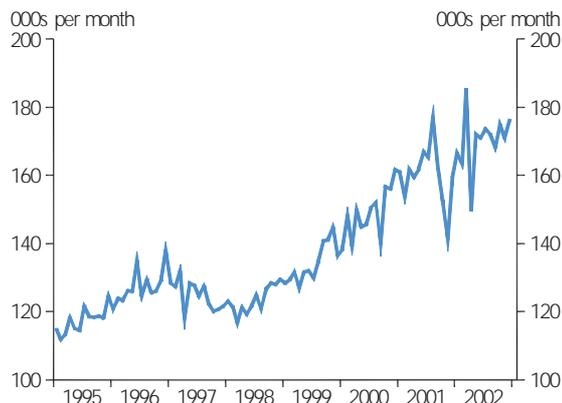
Source: Statistics New Zealand.

Abstracting from the recent volatility, the underlying growth in export volumes appears to have been relatively modest, consistent with soft global activity. Manufactured export volumes, which initially surged after the exchange rate fell in 2000, have settled on a more modest growth rate over the past year, although our discussions with businesses highlight considerable variance in the performance of individual exporters.

Following the fall in the exchange rate over 1998-2000, there was a sharp increase in the exports of services, with stronger activity in the tourism sector a key driver of that trend. The growth in tourism was temporarily interrupted following the terrorist attacks in 2001. Visitor arrivals rebounded quickly but subsequently appear to have flattened-off during the middle part of 2002 (figure 17), although higher on-shore expenditures by tourists assisted in boosting earnings. Arrivals picked up again in the latter part of 2002 and appear to have remained strong into the New Year.

Over the past few years, imports have shown only moderate growth in the face of stronger economic activity. A low exchange rate appears to have tipped the balance in favour of domestically-produced goods and services and encouraged some import-substituting production. In addition, investment activity – a significant proportion of which is met through imports – has shown little net growth, thereby limiting increases in capital imports. However, imports began to accelerate over 2002 with some fairly strong increases

Figure 17: Visitor arrivals (seasonally adjusted)



Source: Statistics New Zealand.

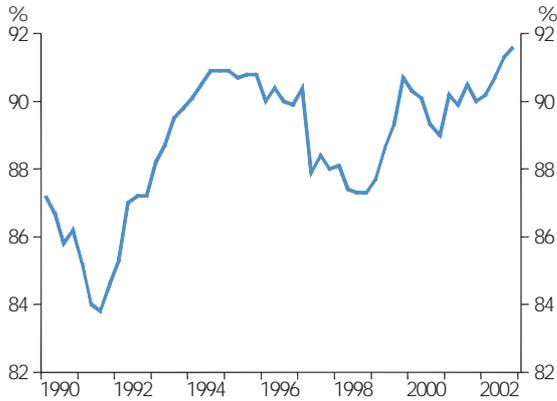
recorded during the year. Surging domestic demand has encouraged higher imports of consumer goods and intermediate materials, many of which may not be available locally. The rise in the New Zealand dollar over the past year may also be playing a role in promoting higher imports again, although the effects of the stronger exchange rate on imports may take longer to become apparent.

## Cyclical position of the economy

Gauging the cyclical position of the economy is a crucial step in assessing the degree of inflationary pressure present in the economy. Even in the midst of a cyclical upswing, relatively few firms are likely to face binding physical constraints on the ability to produce more. The use of overtime, extra shifts and hiring new labour are all ways of increasing production for the same level of plant and equipment. However, the issue is whether the extra production can be achieved without incurring additional unit costs and whether strong demand begins to facilitate a sustained increase in margins across the production and distribution chain. Upward pressure on costs and margins may intensify as available productive capacity is increasingly absorbed.

Our assessment of the New Zealand economy suggests that it has begun to run up against these kinds of cyclical pressures over the past couple of years. We examine a range of indicators of capacity utilisation to assess the degree of intensity with which plant and equipment are being used.

Figure 18: Capacity utilisation  
(seasonally adjusted)



Source: New Zealand Institute of Economic Research.

Nearly all these measures suggest productive capacity is relatively stretched. For example, the Quarterly Survey of Business Opinion's capacity utilisation measure has increased sharply over the past two years and in the December quarter reached its highest level since 1974 (figure 18). Further examination of this series – splitting the measure into a separate utilisation series for manufacturers and construction sector respondents - confirms that capacity utilisation is cyclically high in both sectors. Fewer firms in the same survey are reporting a lack of demand for their output as a constraint on production, a further sign that productive capacity is being used intensively (figures 19 and 20).

A factor that may have exacerbated the pressure on productive resources is the relatively muted business investment response to demand that has occurred during the cyclical upswing. Investment in some sectors – such as

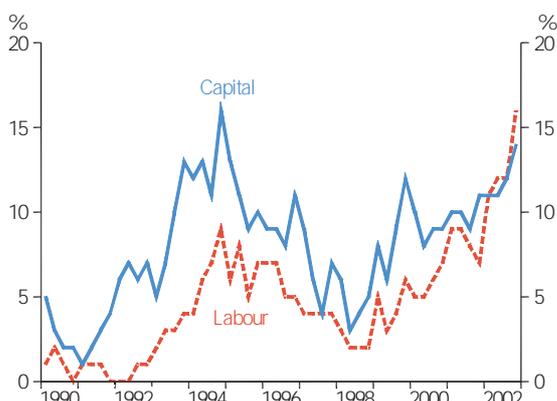
Figure 20: Demand pressures  
(percentage of QSBO respondents citing orders/sales as the main limiting factor to their expansion)



Source: New Zealand Institute of Economic Research.

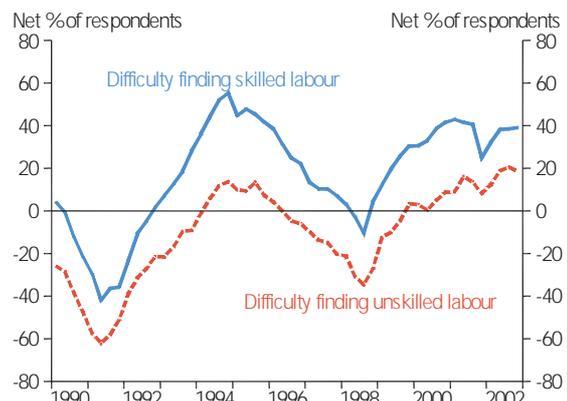
agriculture – has been relatively strong over the past two years, but in general the investment cycle has proven weaker than might otherwise be expected, including within sectors such as manufacturing. As noted in previous Statements, the reasons for this weaker response are not entirely clear, but may be partly related to the difficult international environment over the past couple of years and uncertainty among some exporters about whether the low New Zealand dollar would be sustained. Some companies have even suggested that the low exchange rate over the past few years has encouraged them to defer investment (due to the much higher cost of imported equipment). Of note, business investment was a little stronger in the September quarter and recent import data show a rise in imports of capital equipment.

Figure 19: Limiting factors to expansion  
(percentage of QSBO respondents citing labour and capital as the main limiting factor to their expansion)



Source: New Zealand Institute of Economic Research.

Figure 21: Difficulty finding labour  
(seasonally adjusted)



Source: New Zealand Institute of Economic Research.

Table 1  
CPI and other price measures  
*Annual percentage changes*

	2001				2002		
	Jun	Sep	Dec	Mar	Jun	Sep	Dec
CPI	3.2	2.4	1.8	2.6	2.8	2.6	2.7
Food	6.0	6.6	6.7	5.3	4.1	2.3	0.9
Housing	-0.6	-0.6	-0.7	2.3	2.8	3.0	4.0
Household operations	2.2	2.5	1.4	1.5	2.7	2.9	2.7
Apparel	1.5	2.1	2.0	1.2	1.7	1.2	0.7
Transportation	5.5	1.0	-1.4	0.6	0.9	1.2	3.3
Tobacco and alcohol	6.8	3.7	3.5	3.3	3.8	3.6	3.6
Personal and health	4.4	4.5	4.3	3.7	4.1	4.5	4.2
Recreation and education	2.0	2.2	1.5	2.1	2.5	2.3	2.5
Credit services	-6.9	-7.7	-8.5	-5.9	0.0	2.3	1.9
<b>Derivatives and analytical series</b>							
CPI ex food, petrol and government charges	3.4	2.9	2.6	2.4	2.7	2.7	2.8
CPI non-tradables	1.0	0.9	0.9	2.6	3.1	3.6	3.9
CPI tradables	5.2	3.8	2.5	2.5	2.5	1.6	1.8
CPI weighted median (of annual price change)	2.5	3.0	2.7	2.6	3.0	3.0	3.1
CPI trimmed mean (of annual price change)	3.1	2.4	1.9	2.5	2.9	2.6	2.8
Merchandise import prices (excluding petrol)	5.5	1.2	-4.4	0.1	-4.6	-5.0	n/a
Private consumption deflator	3.1	1.9	1.1	1.6	1.3	1.4	n/a
GDP deflator (derived from expenditure data)	5.8	3.8	3.4	2.5	-0.4	0.5	n/a

Turning to the labour market, most indicators suggest the market has been tight for an extended period and the latest data (figure 21) show little change in that picture. The expansion in activity has seen the unemployment rate decline over the past few years to levels not seen since the mid 1980s and firms have consistently reported ongoing difficulties finding suitable skilled and unskilled labour.

## Inflation developments

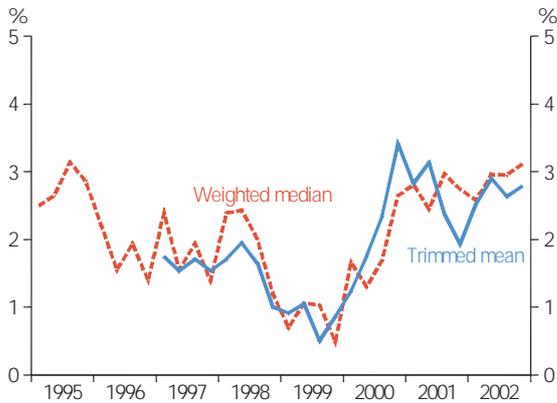
Recent inflation developments in New Zealand have been consistent with an economy that has undergone a strong cyclical upswing. Annual CPI inflation has been sitting above 2½ per cent over the past two years, but was widely picked to edge lower during 2002, partly in response to a rising exchange rate and weaker global demand. In the event, while these downward influences have been operating to some degree, the CPI rose by 2.7 per cent in the year to December 2002, similar to the increase a year earlier. During the

December quarter, the CPI increased 0.6 per cent, close to our expectations<sup>4</sup>.

In setting monetary policy our interest is not in any particular quarterly inflation outcome but rather with the trend in inflation over time. We have various approaches to assessing the trend or persistent component of inflation. The weighted median and trimmed mean of annual changes (figure 22) provide alternative measures of the 'central tendency' in inflation calculated in a simple mechanical fashion. An alternative measure, which excludes known volatile items and influences on the CPI not amenable to monetary policy influence, is the CPI excluding food, petrol and administered charges (figure 23). As at the December 2002 quarter, each of these measures was sitting between

<sup>4</sup> At this stage we envisage quarterly increases in the CPI of 0.4 and 0.5 per cent for the March and June quarters of 2003 respectively, producing an annual rate of increase of 2.5 per cent and 2 per cent. The higher exchange rate is expected to place downward pressure on a range of traded goods prices over these quarters, but some upward pressure is expected from the recent petrol price increases, and further solid increases in some domestic goods and service prices.

Figure 22  
Indicators of core inflation  
(annual percentage change)



Source: RBNZ.

2.8 to 3.1 per cent and each was higher than a year earlier. The conclusion to be drawn is that there is as yet little evidence that the persistent component of inflation is beginning to fall away.

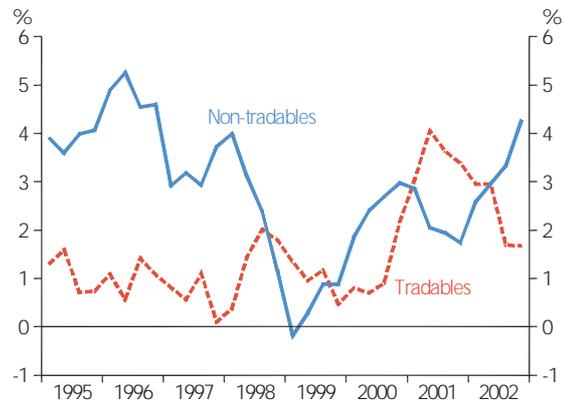
Some clues as to why persistent inflation has held up can be gleaned from a sectoral analysis of inflation (figure 24). Tradables price inflation (inflation for goods and services that are imported or for which there is significant foreign competition) has eased over the past year with soft global inflation and the rising exchange rate each having some influence. The effect of rising international oil prices has also been dampened to a degree by the stronger Kiwi dollar. But inflation for non-traded goods and services has accelerated sharply, consistent with the picture of strong domestic

Figure 23  
CPI excluding food, petrol and administered charges  
(annual percentage change)



Source: RBNZ.

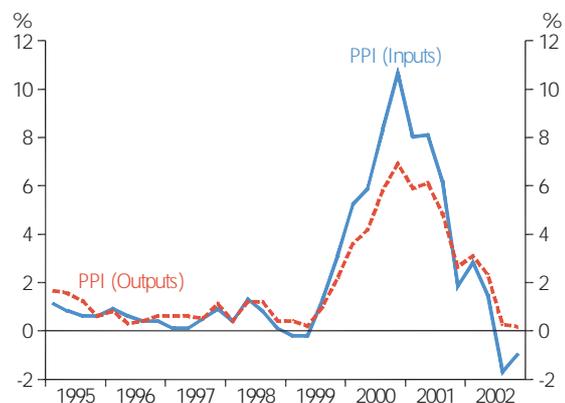
Figure 24  
Sectoral inflation measures  
(weighted median of annual percentage change)



Source: RBNZ.

demand. Non-tradables inflation continued to move up in the December quarter, with strong price rises evident across a broad range of product types, including the purchase and construction cost of new dwellings, electricity and a wide range of services.

Figure 25  
Producer prices  
(annual percentage change)



Source: Statistics New Zealand.

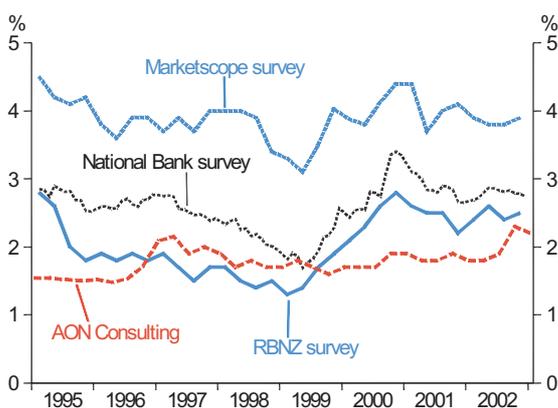
In general, broader measures of prices throughout the economy corroborate the picture evident in the components of the CPI. Rates of increase in producer prices (inputs and outputs) have slowed sharply over the past year, with the inputs index actually falling over the year to September (figure 25). Weaker inflation rates reflect the stronger exchange rate, weak world inflation and the fall in commodity prices from late 2001 (since partly reversed). However, rates of input and output inflation in a range of domestic industries such as

services and construction have been rather higher, consistent with stronger domestic activity.

Inflation expectations are highly relevant to the future path of inflation. Expectations influence price, wage and cost setting behaviour on the part of firms and wage earners and may also have a bearing on consumption and investment decisions. Temporary movements in inflation have the potential to become persistent if they become ingrained in inflation expectations.

The inflation expectations incorporated into the behaviour of households and firms are not directly observable, but survey measures may provide some insights (figure 26). A range of expectations surveys are conducted in New Zealand, including the RBNZ's Marketscope and Westpac McDermott Miller survey (which cover households' inflation expectations), the RBNZ's Survey of Expectations and National Bank Business Outlook surveys (covering mainly business expectations) and the AON consulting group survey (covering economists). Historically in New Zealand, surveyed expectations of inflation appear to have followed actual inflation relatively closely although perceptions of the level of inflation rates tend to vary across the different surveys and sectors (with the household sector in particular consistently reporting expectations well above the actual rate of inflation).

**Figure 26**  
Expected inflation  
(one year ahead)



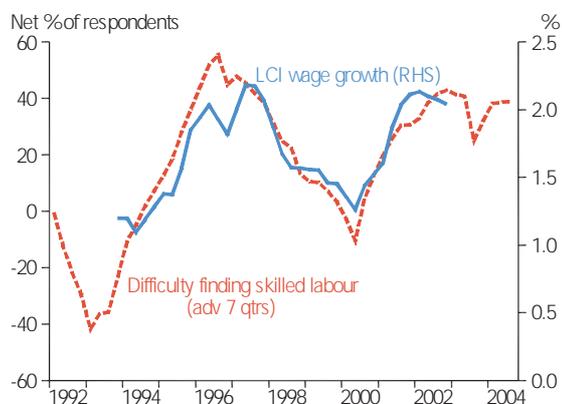
Source: AON Consulting, National Bank of New Zealand, RBNZ.

Inflation expectations from most surveys increased from about 1999 onwards as actual CPI inflation moved up in response to the exchange rate depreciation. Most series have

since edged down again, but not to their previous lows. There has been little change in household or business inflation expectations in the most recent surveys.

Another important factor to consider when assessing inflation prospects is developments in labour costs. Over most of the past decade, labour costs appear not to have been a major independent driver of inflation, tending to follow rather than lead changes in prices. But during a period of marked labour shortages, as have been experienced over the past two years, the potential exists for higher wage costs to exert upward pressure on inflation via higher production costs. Businesses may be able to allay these pressures to some extent, by adopting more efficient production techniques, or may choose to absorb any increases in labour costs through margins. But during a period of strong demand, there is a greater likelihood that increases in labour costs will contribute to price increases.

**Figure 27**  
Labour cost inflation  
(private sector all salary and wage rates)



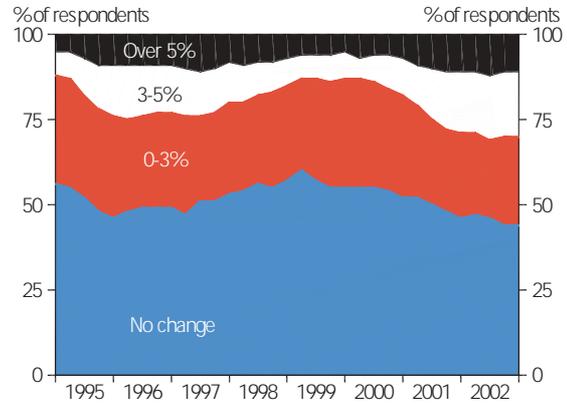
Source: Statistics New Zealand, New Zealand Institute of Economic Research.

The two main measures of labour costs in New Zealand are the Labour Cost Index and the Quarterly Employment Survey's average hourly earnings measure. 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 across the economic cycle (due to the exclusion of any wage movements that firms attribute to productivity improvements). However, annual increases in the series (figure 27) have picked up to over 2 per cent over the past year. That acceleration is consistent with the series'

previous cyclical peak in the mid-1990s when reported skill shortages were similarly intense. Data on the distribution of wage increases, compiled with the LCI, confirms that an increased proportion of wage earners has been receiving increases with a greater proportion of wage earners receiving larger increases than a year or more ago (figure 28).

On the other hand, the QES private sector average hourly earnings measure has been surprisingly subdued over the past year, possibly reflecting compositional changes in the labour force (such as new employment occurring at below-average industry wages). However, annual movements in this series edged up in the latest survey with average hourly earnings up around 3.3 per cent in the year to November 2002. This increase is more in line with the observed historical behaviour of wages during periods of strong activity and along with the LCI is consistent with somewhat strong wage increases recently. In some instances, higher labour costs may be a factor behind the stronger price increases observed in some parts of the economy lately.

**Figure 28**  
**Distribution of LCI salary and ordinary-time wages**  
*(% of respondents whose labour costs changed by a given amount since the same quarter of the previous year)*



Source: Statistics New Zealand.

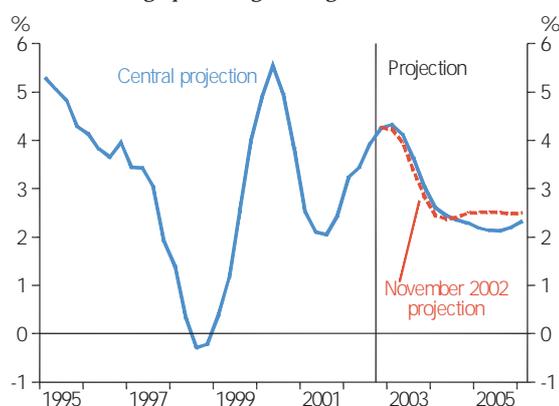
## 4 The macroeconomic outlook

This chapter – and the accompanying tables of Appendix 1 – set out a projection of economic conditions that has assisted the policy judgements 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 demand pressures accumulated to this point subside steadily over the next two years. Economic growth – while projected to have been strong again in the December quarter – is expected to slow gradually over the coming year and beyond. The combination of weak global demand and the higher exchange rate act as a brake on export sector revenues and production, eventually filtering down to domestic demand. Only a mild recovery in trading partner growth is assumed throughout the projection horizon. In addition, a reduction in the stimulus from strong population growth via net immigration is expected to moderate domestic spending growth – though the level of economic activity should remain robust.

These projections show a profile for 90 day interest rates that is flat at around 6 per cent over the period ahead. In combination with all of the factors that make up these projections, we expect CPI inflation to remain within the 1 to

Figure 29  
GDP growth  
(annual average percentage change)



Source: Statistics New Zealand, RBNZ calculations.

3 per cent target range over the medium term (figure 2, Chapter 2). Initially, we expect CPI inflation to fall rapidly from current levels as the recent sharp rise in the exchange rate exerts significant downward pressure on tradables sector inflation. However, this influence is partially offset by the recent rise in oil prices. Further out, the slowing in economic growth should moderate domestic demand pressures and have CPI inflation remaining within the target band.

What are the main differences in our economic outlook as compared to the projections presented in the November Monetary Policy Statement? As described in Chapter 3, economic activity is currently somewhat stronger than expected in the near term – most notably in the retail and residential construction sectors – reflecting more sustained momentum from recent stimulatory factors. But the offsetting influences include an assumption of a slower recovery in trading partner activity over 2003 and beyond, along with a

Table 2  
Forecasts of export partner growth\*  
(calendar year, annual average percentage change)

	2001	2002e	2003f	2004f
Country				
Australia	2.7	3.8	3.1	3.7
United States	0.3	2.4	2.6	3.6
Japan	0.3	-0.3	0.4	0.8
Canada	1.5	3.3	3.1	3.3
Europe-4**	1.6	1.0	1.6	2.3
Asia ex-Japan***	1.8	4.8	5.0	5.6
14 country index	1.4	2.7	2.8	3.4

\* Source: Consensus Economics Inc.

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

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

higher exchange rate. Taken together, the combination of these factors continues to suggest little change in short-term interest rates over the foreseeable future.

## 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. While we usually use Consensus Forecasts as the benchmark for detailing the growth outlook for New Zealand's 14 main trading partners, we nonetheless evaluate carefully the channels through which the international economy is expected to influence activity and prices in New Zealand.

In our November Statement, we adopted a trading partner outlook that was somewhat weaker than that portrayed by the latest available Consensus Forecasts – reflecting our assessment of the downside risks that were prevalent at the time. That approach was justified by the subsequent downward revisions to the Consensus forecast numbers. The overall profile was one portraying a steady recovery in global growth from its early 2002 trough.

Recent economic and geopolitical developments have cast some doubt on the expected pace of the recovery. Accordingly, the latest Consensus Forecasts are now showing a slightly weaker recovery profile for trading partner growth over 2003 than that anticipated in our November projections. We feel that the latest Consensus is a reasonable central

assessment of the global economic outlook, and have adopted such a profile in producing the projections here. However, there are still significant risks surrounding the expected speed of recovery, as already evident to some extent in current data (see Chapter 3 for more details).

Lastly, recent events have heightened the possibility of a war in Iraq with the likely consequences of further oil price rises and supply disruptions. These projections, however, assume no significant effect from these factors other than that incorporated in the current Consensus Forecast profiles. The Bank's recent analysis of previous wars and other major global events over the past few decades revealed little predictable impact on the medium-term path of the New Zealand economy despite the inevitable disruptions created in the short term<sup>5</sup>.

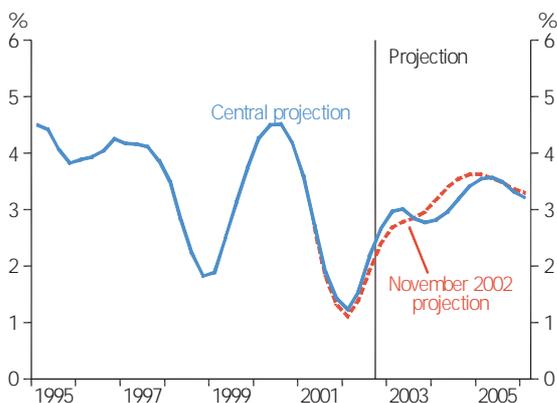
## Tradables sector activity and prices

Over the past few years the New Zealand economy has received significant stimulus from the combination of cyclically-high world export prices and a low exchange rate. However, export revenues began to falter over the latter half of 2002, as a weak world economy saw substantial falls in some export prices together with a strengthening New Zealand dollar.

Our November projections allowed for the stimulus from the export sector to dissipate over the period ahead. Since that time, the New Zealand dollar has strengthened further, on top of the perception for a slower recovery in global demand. Furthermore, increasingly adverse weather may significantly impact on export volumes over the coming year. As a partial offset, world export prices have been significantly higher recently – particularly for some commodities such as dairy and beef, reflecting market-specific factors (Chapter 3 provides more details). But overall, export incomes are projected to fall significantly over next twelve months, more so than we expected in November.

Export volume growth is expected to slow significantly over the next two years. In broad terms, this reflects the weak global demand cycle and the higher exchange rate.

Figure 30  
Forecast of export partner growth  
(annual average percentage change in real GDP of NZ's main trading partners)

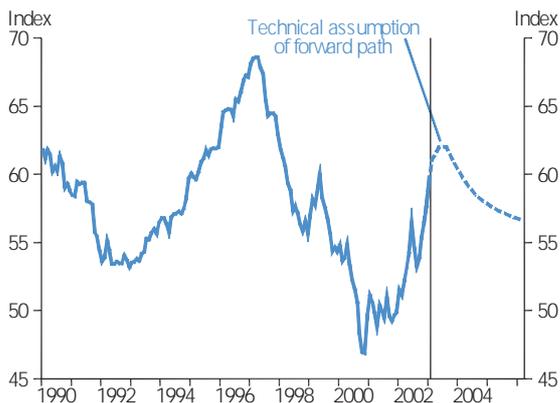


Source: Consensus Economics Inc, RBNZ calculations.

<sup>5</sup> See the November 2001 *Monetary Policy Statement*.

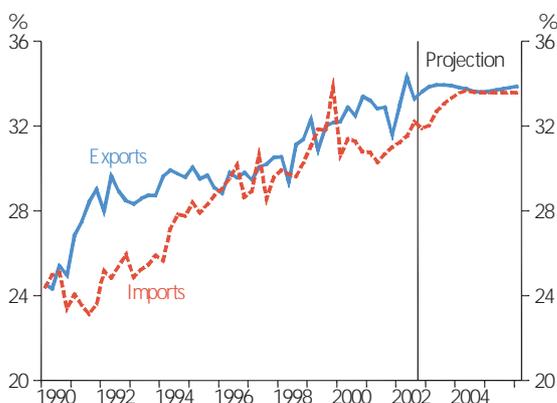
The stronger New Zealand dollar should further dampen the contribution from net exports to overall aggregate economic activity as domestic demand shifts towards lower-priced imported goods and away from domestic production of import substitutes.

**Figure 31**  
Nominal TWI exchange rate



Source: RBNZ.

**Figure 32**  
Exports and imports  
(as a percentage share of GDP)



Source: Statistics New Zealand, RBNZ calculations.

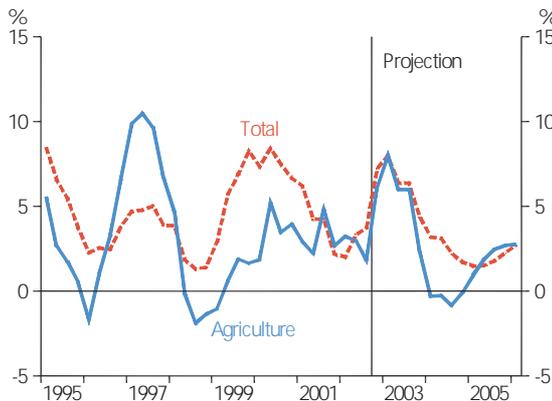
Within this projected aggregate export profile, growth in exports of manufactured goods is initially weak due to the effects of the higher exchange rate and slower trading partner growth – particularly in the Australian and US markets. Further out, however, growth in manufactured exports is expected to pick up in line with the projected recovery in trading partner activity.

As for primary sector exports, our forecasts 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. Recent dry conditions in many parts of the country have created some downside risks for primary export production over the next year or so and we have incorporated some of that risk into the export projections.

Growth in exports of services is expected to moderate, consistent with slower income growth in many of New Zealand's visitor-source countries, coupled with a higher exchange rate. Although there continues to be considerable uncertainty and debate about whether the fluctuating probability of conflict in the Middle East and other security concerns will promote or dampen tourism to countries such as New Zealand, these projections continue to assume no significant effect either way.

**Figure 33**  
Export volume growth  
(annual average percentage change)



Source: Statistics New Zealand, RBNZ calculations.

## Domestic spending

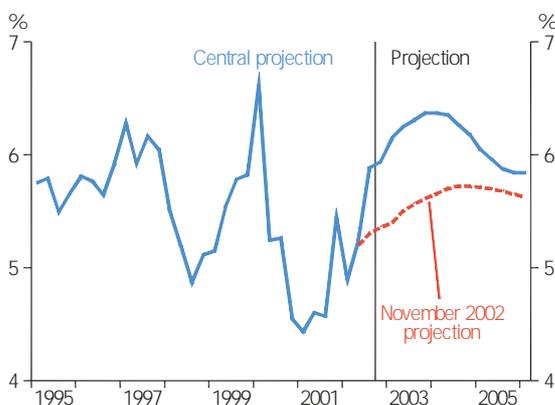
Domestic spending growth is also projected to slow over the projection period. Over the near term, however, growth will probably be marginally higher than assumed in our November projections. The momentum from earlier primary sector income growth, net immigration, and employment and wage gains has held up household confidence levels and boosted aggregate demand – most notably in the retail and residential housing market sectors. Accordingly, these projections begin with an economy that is slightly more stretched in its use of

productive resources – a view that is supported by the continued increase in measured capacity utilisation rates (to record high levels), and the cyclically low unemployment rate.

Household spending growth is expected to ease back towards more ‘normal’ rates. This moderation occurs as the softening in export incomes and reduced impetus from migration inflows exert a braking effect on domestic demand, reduced growth in employment and discretionary incomes and a lower appetite for business investment. But this is a softening, not a fall. While observed rates of growth will be lower, expenditure should hold up at high levels.

As highlighted in Chapter 3, a combination of continued strong immigration flows, and the recent sharp acceleration in new dwelling consents suggests that residential investment activity may be sustained at higher levels for some time. As a consequence, we have revised higher our profile for the residential investment cycle. Further out, residential investment is projected to moderate as net immigration flows fall back.

**Figure 34**  
Residential investment  
(as a share of GDP)



Source: Statistics New Zealand, RBNZ calculations.

Risks to the outlook for household spending lie in both directions. On the one hand, the possible wealth effects from greater or more prolonged strength in the residential investment market could sustain consumer confidence and household spending for even longer than allowed for in these projections. The outlook for net immigration is also subject to uncertainty (see Box 3).

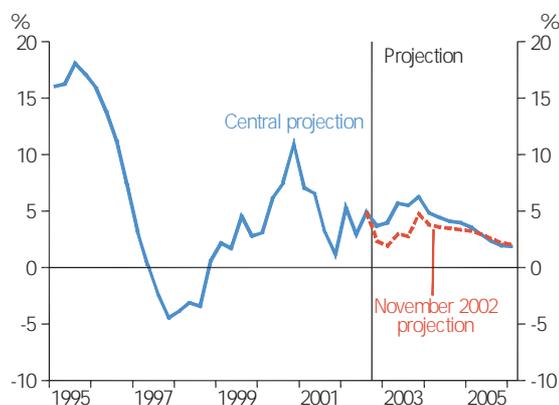
On the other hand, a much stronger exchange rate over the next few years is a distinct possibility, in the environment

of a relatively weak US dollar and a relatively robust New Zealand economy. On its own, a stronger exchange rate would accentuate the slowdown in export incomes, as well as its downstream effect of lower domestic spending.

Our profile for business investment growth is slightly stronger than that assumed in November. Recent stronger domestic demand and the associated further rise in reported capacity utilisation is expected to prompt slightly higher investment over the coming year – more so in some sectors than others. To some extent, the higher exchange rate may actually assist firms’ investment plans by lowering the cost of imported plant and machinery components.

While our updated investment profile is slightly higher than that assumed in November, the overall profile remains weak by historical standards. This continues to reflect our judgement that the expected slowdown in export sector activity, and the subdued global economic outlook, together with a downturn in investment spending worldwide, act as a brake on domestic capital expenditure.

**Figure 35**  
Business investment growth  
(annual average percentage change)



Source: Statistics New Zealand, RBNZ calculations.

## Fiscal policy

Our projections of the fiscal position and the contributions of the government’s fiscal operations on economic activity are based on Treasury’s December Economic and Fiscal Update. The December Update projected continued operating surpluses and falling government debt, in line with the Government’s long-term fiscal objectives.

Unlike other countries such as the US, where fiscal stimulus has been proposed to help support a weak economy,

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fiscal policy in New Zealand has been relatively stable, with a medium-term focus. That stability has been assisted by the relatively stable pattern of economic growth (by historical standards). Accordingly, while fluctuations in the fiscal position from year to year can have a significant impact on economic activity, the fiscal "impulse" has been modest in New Zealand for some time.

In keeping with this pattern, our assessment is that the projected gradual rise in the operating surplus (after taking into account the effect of the economic cycle), combined with projected capital spending, is likely to have a broadly neutral effect on the profile of economic growth over the projection period.

## Inflation and monetary policy

Our profile for CPI inflation (figure 2, Chapter 2) continues to incorporate the view that inflation in the tradables sector and in the non-tradables sector will continue to diverge for some time yet. Tradables inflation is expected to fall away sharply as a result of the recent strong appreciation in the New Zealand dollar. As noted in previous Statements, the degree to which prices are affected by the exchange rate is subject to

uncertainty. Strong domestic trading conditions, particularly in the retail sector, will continue to provide retailers and suppliers with scope to rebuild margins. Roughly balancing out this risk are competitive pressures in the tradables sector, which remain intense as firms face the prospect of having to compete against lower-priced imported goods.

As the economy continued to expand strongly over the second half of 2002 at least, putting further pressure on resources, we expect inflation in the non-tradables sector to remain high over most of 2003. However, further out, as the projected economic growth slowdown occurs over 2003 and beyond, inflationary pressures in the non-tradable sector should gradually fall away.

Taking the outlook for tradables and non-tradables inflation together, and given our projection of flat nominal short-term interest rates, the profile for CPI inflation is projected to remain comfortably inside the target range on average over the medium term. However, this CPI inflation profile continues to be crucially dependent on the assumption that the recent higher non-tradables inflation has not become ingrained in inflation expectations and pricing behaviour. Should that prove not to be the case, then monetary policy may well have additional work to do, even if the projected profile for economic activity turns out to be broadly correct.

# Appendix 1<sup>1</sup>

## Summary tables

Table A

### CPI inflation projections and monetary conditions

(CPI is in percentage changes)

		CPI*	CPI**	TWI	90-day bank bill rate
		Quarterly	Annual		
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	$\frac{1}{2}$	$2\frac{1}{4}$	$61\frac{1}{2}$	6
	Second Half Average	$\frac{1}{2}$	$1\frac{3}{4}$	$61\frac{1}{2}$	6
2004	First Half Average	$\frac{1}{2}$	2	$59\frac{1}{2}$	6
	Second Half Average	$\frac{1}{2}$	$2\frac{1}{2}$	$58\frac{1}{4}$	6
2005	First Half Average	$\frac{1}{2}$	$2\frac{1}{2}$	$57\frac{1}{2}$	6
	Second Half Average	$\frac{1}{2}$	$2\frac{1}{4}$	57	6

#### Quarterly projections

2002	Jun.	1.0	2.8
	Sep.	0.5	2.6
	Dec.	0.6	2.7
2003	Mar.	0.4	2.5
	Jun.	0.5	2.0

<sup>(1)</sup> Notes for these tables follow on page 30.

\* 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)

March year	Actuals					Projections				
	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	3 1/4	2 3/4	3	3 1/4
Public authority	1.4	8.8	-2.2	7.3	-2.1	3.8	4 1/2	3 1/4	0	0
Total	3.8	3.7	1.4	4.6	0.8	3.1	3 1/2	3	2 1/4	2 1/2
Gross fixed capital formation										
Market sector:										
Residential	4.9	3.0	-14.0	22.8	-15.7	3.3	24 1/4	12 1/2	1 1/4	-2 3/4
Business	3.1	-3.9	2.2	3.1	7.0	5.3	4	4 3/4	3 1/2	2
Non-market government sector	28.7	8.6	-15.9	10.5	-6.5	4.4	2	6 1/4	4 1/4	0
Total	5.7	-0.8	-4.2	8.6	-0.5	4.8	8 1/2	7	3	1/2
Final domestic expenditure	4.2	2.7	0.2	5.4	0.5	3.4	4 1/2	3 3/4	2 1/2	2
Stockbuilding <sup>(1)</sup>	-0.4	-0.1	-0.4	1.2	-0.4	0.1	0	- 1/2	1/4	1/4
Gross national expenditure	3.7	2.6	-0.2	6.6	0.1	3.5	4 1/2	3 1/4	2 3/4	2 1/4
Exports of goods and services	4.7	3.8	2.9	7.3	6.2	2.0	8	3 1/4	1 1/2	2 3/4
Imports of goods and services	6.5	2.6	2.0	11.4	-0.4	2.1	8 1/4	6 1/2	3 1/2	2 1/4
Expenditure on GDP	3.2	2.9	0.1	5.3	2.2	3.4	4 1/4	2 1/4	2 1/4	2 1/4
GDP (production)	3.4	1.4	0.4	4.9	2.5	3.2	4 1/4	2 1/2	2 1/4	2 1/4
GDP (production, March qtr to March qtr)	2.1	0.0	2.4	6.1	0.8	3.9	4 1/4	2 1/2	2	2 1/2
Potential output	3.6	2.8	2.4	2.5	2.7	3.0	3 1/4	3 1/4	3 1/4	3
Output gap (% of potential GDP, year average)	1.5	0.2	-1.8	0.4	0.3	0.5	1 1/2	3/4	0	- 3/4

<sup>(1)</sup> Percentage point contribution to the growth rate of GDP.

**Table C**  
**Summary of economic projections**

(Annual percentage change, unless specified otherwise)

March year	Actuals					Projections				
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
<b>Price measures</b>										
CPI*	2.0	1.7	1.0	1.7	3.1	2.6	2 1/2	2	2 1/2	2
Labour costs	2.0	1.9	1.6	1.4	1.6	2.1	2	2	2	2
Import prices (in New Zealand dollars)	-4.6	2.9	2.7	11.2	7.4	-2.9	-8 3/4	2	4 3/4	3
Export prices (in New Zealand dollars)	-6.3	4.2	-0.6	9.9	20.6	-3.5	-14 1/4	-2 3/4	5 1/4	3 3/4
<b>Monetary conditions</b>										
90-day rate (year average)	9.0	8.0	6.2	5.2	6.6	5.4	6	6	6	6
TWI (year average)	66.4	64.4	57.3	56.1	50.4	50.3	56 1/2	61 1/4	58 1/4	57
<b>Output</b>										
GDP (production, annual average % change)	3.4	1.4	0.4	4.9	2.5	3.2	4 1/4	2 1/2	2 1/4	2 1/4
GDP (production, March qtr to March qtr)	2.1	0.0	2.4	6.1	0.8	3.9	4 1/4	2 1/2	2	2 1/2
Output gap (% of potential GDP, year average)	1.5	0.2	-1.8	0.4	0.3	0.5	1 1/2	3/4	0	- 3/4
<b>Labour market</b>										
Total employment	1.2	0.0	0.6	1.4	2.3	3.5	1 1/2	1 3/4	1 1/2	1 1/4
Unemployment rate (March qtr, s.a.)	6.5	7.2	7.2	6.3	5.4	5.3	5 1/4	5	5	5 1/4
Trend labour productivity (annual % change)	1.0	1.3	1.5	1.4	1.4	1.4	1 1/4	1 1/4	1 1/4	1 1/4
<b>Key balances</b>										
Government operating balance (% of GDP, year to June)	1.9	2.5	1.7	1.3	1.2	1.9	2	2 3/4	3 1/4	3 1/2
Current account balance (% of GDP, year to March)	-6.1	-5.5	-4.1	-6.6	-4.6	-2.1	-4	-5	-5 1/4	-4 1/2
Terms of trade (annual average % change)	-0.8	-1.0	-0.4	-0.2	4.4	4.1	-5 1/2	-4 1/4	- 1/4	1
Household savings rate	-3.0	-4.0	-4.8	-0.8	-4.4	-3.7	-5 1/4	-6	-5 1/2	-5 1/2
(% of disposable income, year to March)										
<b>World economy</b>										
World GDP (annual average % change)	4.2	3.5	1.9	4.3	3.5	1.1	3	2 3/4	3 1/2	3 1/4
World CPI inflation	2.2	2.4	0.9	2.0	2.8	1.2	1 3/4	1 1/2	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).

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## Notes to the tables

CPI	Consumers Price Index. Quarterly projections rounded to 1 decimal place.
TWI	RBNZ. Nominal Trade Weighted Index of the exchange rate. Defined as a geometrically-weighted index of the New Zealand dollar bilateral exchange rates against the currencies of Australia, Japan, the United States, the United Kingdom, and the euro.
90-day bank bill rate	RBNZ. Defined as the interest yield on 90-day bank bills. Forecasts rounded to the nearest quarter per cent.
World GDP	Reserve Bank definition. 14-country index, export weighted. Projections based on <i>Consensus Forecasts</i> . Seasonally adjusted.
World CPI inflation	RBNZ definition and estimate. TWI trading partners' CPI inflation (euro-zone proxied by Germany), weighted by TWI weights. Projections based on <i>Consensus Forecasts</i> .
Import prices	Domestic currency import prices. <i>Overseas Trade Indexes</i> .
Export prices	Domestic currency export prices. <i>Overseas Trade Indexes</i> .
Terms of trade	Constructed using domestic-currency export and import prices. <i>Overseas Trade Indexes</i> .
Private consumption	<i>System of National Accounts</i> .
Public authority consumption	<i>System of National Accounts</i> .
Residential investment	RBNZ definition. Private sector and government market sector residential investment. <i>System of National Accounts</i> .
Business investment	RBNZ definition. Total investment less the sum of non-market investment and residential investment. <i>System of National Accounts</i> .
Non-market investment	RBNZ definition. The <i>System of National Accounts</i> annual nominal government non-market/market investment ratio is interpolated into quarterly data. This ratio is used to split quarterly expenditure GDP government investment into market and non-market components.
Final domestic expenditure	RBNZ definition. The sum of total consumption and total investment. <i>System of National Accounts</i> .
Stockbuilding	Percentage point contribution to the growth of GDP by stocks. <i>System of National Accounts</i> .
Gross national expenditure	Final domestic expenditure plus stocks. <i>System of National Accounts</i> .
Exports of goods and services	<i>System of National Accounts</i> .
Imports of goods and services	<i>System of National Accounts</i> .
GDP (production)	<i>System of National Accounts</i> .
Potential output	RBNZ definition and estimate. Refer to Conway, P. and B. Hunt, (1997), 'Estimating Potential Output: a semi-structural approach', <i>Reserve Bank of New Zealand Discussion Paper, G97/9</i> .
Output gap	RBNZ definition and estimate. The percentage difference between real GDP (production, seasonally adjusted) and potential output GDP.
Current account balance	<i>Balance of Payments</i> .

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Total employment	<i>Household Labour Force Survey.</i>
Unemployment rate	<i>Household Labour Force Survey.</i>
Household savings rate	<i>Household Income and Outlay Accounts.</i>
Government operating balance	Historical source The Treasury. Adjusted by the RBNZ over the projection period.
Labour productivity	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. <i>Labour Cost Index.</i>
Quarterly percentage change	$(\text{Quarter}/\text{Quarter}_{-1} - 1) * 100$
Annual percentage change	$(\text{Quarter}/\text{Quarter}_{-4} - 1) * 100$
Annual average percentage change	$(\text{Year}/\text{Year}_{-1} - 1) * 100$

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

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

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## Appendix 2

### Chronology

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

#### 2002

- 20 November The Reserve Bank released its thirty-sixth *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.
- 20 December Production GDP figures were released showing that the New Zealand economy grew by 1.0 per cent in the September quarter of 2002.

#### 2003

- 17 January CPI statistics were released for the December quarter of 2002 showing that the CPI increased by 0.6 per cent over the quarter, and by 2.7 per cent in the year to December 2002.
- 23 January At the intra-quarter review, the Reserve bank left the Official Cash Rate unchanged at 5.75 per cent. The accompanying news release is reproduced in Appendix 4.

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## Appendix 3

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

Ace Real Estate Ltd

Air New Zealand Limited

Barfoot and Thompson Limited

Benchmark Building Supplies Ltd

Comalco

Employers and Manufacturers Association (Northern)

Export Institute Of New Zealand

Fletcher Building Limited

Fisher & Paykel Limited (Whiteware Division)

Interlock Group Limited

Kirkaldie & Stains Ltd

LV Martin & Son Ltd

Mainzeal Property and Construction Ltd

Mobil Oil New Zealand

Motor Trade Finances Ltd

NZ Meat & Wool

NZ Tourism Board

Ports of Auckland (Axis Intermodal)

Port of Tauranga Ltd

Progressive Enterprises Limited

Real Estate Institute of New Zealand

Retailers and Merchants Association

The Warehouse Ltd

Wenita Forest Products Ltd

Wrightson Limited

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

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## Appendix 4

### Reserve Bank statements on monetary policy

#### OCR unchanged

*20 November 2002*

The Reserve Bank has decided to leave the Official Cash Rate unchanged at 5.75 per cent. In addition, the Bank's projections show no change in short-term interest rates over the period ahead - reflecting the Bank's sense that the risks for the future direction of the OCR are evenly balanced.

Speaking at the release of the Reserve Bank's Monetary Policy Statement Reserve Bank Governor Alan Bollard said " The new Policy Targets Agreement directs the Bank to target future CPI inflation outcomes of 1 to 3 per cent on average over the medium term. Looking ahead, current policy settings appear consistent with that objective. In essence, strong domestic demand is expected to be offset by offshore developments, keeping inflation pressures in check.

" Unlike most trading partners, the New Zealand economy has performed well in 2002. Activity has continued to benefit from the surge in export earnings over the past two years and from the recent rapid population growth. To date, weak global conditions have not had as large an impact on the local economy as we might have expected.

" Strong activity has left businesses with limited scope to meet increases in demand without incurring extra costs and firms have been reporting ongoing difficulties in finding skilled and unskilled labour. These pressures are contributing to higher prices in some domestic-based industries, such as services.

" However, the soft international economy, falls in some commodity prices and the path of the exchange rate have produced a fall in the inflation rate for tradable items. These offsetting factors have seen annual CPI inflation remain steady at a relatively high level.

" Economic growth is likely to slow over the coming year, to a little below its average, reflecting international market conditions and a moderating of the demand pressures associated with strong population growth. The rise in the exchange rate over recent months, if sustained, will also put downward pressure on inflation over the next few quarters and exert some braking effect on activity and inflation further out. From a starting point of some considerable pressure on resources, inflation pressures evident in some parts of the economy are likely to subside somewhat, although perhaps not immediately.

" The new PTA provides monetary policy with a little more flexibility in the way it responds to changing economic conditions. Our intention is to operate policy in a flexible manner in order to meet our obligations under the PTA. We will continue to reassess economic developments and respond appropriately," Dr Bollard concluded.

#### OCR unchanged at 5.75 per cent

*23 January 2003*

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

Governor Alan Bollard said " A key development since November has been a further sharp rise in the New Zealand dollar against all major currencies. If sustained, we expect the higher exchange rate to dampen future economic activity and, hence, medium-term inflation pressures.

" However, current domestic economic activity appears to be more robust than we anticipated, as reflected in indicators of household spending and construction sector activity. The latest estimates suggest that domestic inflationary pressure has continued, offsetting a fall in imported inflation. As expected, overall CPI inflation has remained towards the upper end of the 1 to 3 per cent target band for inflation on average over the medium term.

" For the moment, it is appropriate to leave the OCR unchanged, reflecting the strong growth in the New Zealand economy. However, the balance of risks around the future path of interest rates has shifted. 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," Dr Bollard concluded.

The next OCR announcement comes with the release of the Monetary Policy Statement on 6 March 2003.

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## 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

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# 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.

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4. Communication, implementation and accountability

- a) On occasions when the annual rate of inflation is outside the medium-term target range, or when such occasions are projected, the Bank shall explain in Policy Statements made under section 15 of the Act why such outcomes have occurred, or are projected to occur, and what measures it has taken, or proposes to take, to ensure that inflation outcomes remain consistent with the medium-term target.
- b) In pursuing its price stability objective, the Bank shall implement monetary policy in a sustainable, consistent and transparent manner and shall seek to avoid unnecessary instability in output, interest rates and the exchange rate.
- c) The Bank shall be fully accountable for its judgements and actions in implementing monetary policy.



Hon Dr Michael Cullen  
Minister of Finance



Dr Alan E Bollard  
Governor Designate  
Reserve Bank of New Zealand

Dated at Wellington this 17<sup>th</sup> day of September 2002

