
Monetary Policy Statement¹

March 2004

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>).

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¹ Projections finalised on 27 February 2004. Policy assessment finalised on 10 March 2004.

1 Policy assessment

The Reserve Bank has decided to leave the Official Cash Rate unchanged at 5.25 percent.

New Zealand has continued to enjoy a period of sustained economic growth over recent years. Partly related to this, inflation pressures have been increasing in a number of domestic industries, including housing and construction. It is for this reason the Reserve Bank raised the OCR in January. Meanwhile, the overall CPI inflation rate has so far been offset by weak imported inflation due to the rising NZ dollar exchange rate.

In recent *Statements* we have projected a slowing in growth which would ease capacity and inflation pressures. This projected growth slowdown is due mainly to the lagged effects of the high New Zealand dollar and an expected slowdown in population growth. With tentative signs becoming more evident in recent weeks, it remains our view that this projected growth slowdown will occur and eventually will reduce the accumulated inflation pressures.

However, the latest activity indicators remain quite robust. This implies that, in the short-term, there are ongoing risks that the bottlenecks in the economy persist for some time yet. Any persistence in the current inflation pressures could see actual inflation nearing the top of the Bank's target range, raising policy risks. With this uncertainty, we judge it as appropriate at this stage to wait and watch the data, to see whether a further small increase in interest rates will be required this year.



Alan Bollard
Governor

2 Overview and key policy judgements

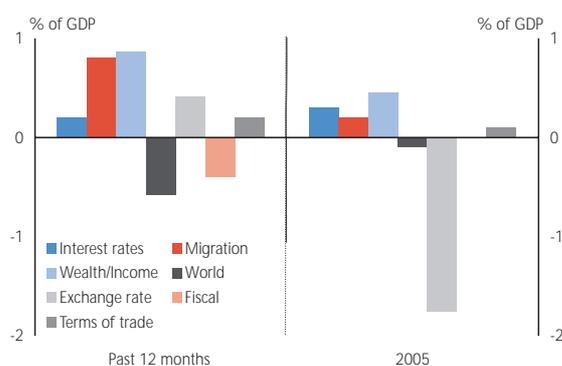
Introduction

The NZ economy continued its remarkable expansion through the second half of 2003 and early 2004, albeit with widening gaps between different sectors. As 2004 began to unfold, however, an increased number of precursors of a slowdown were becoming apparent.

The current growth phase began in 1999 – average growth over the five years to March 2004 will have been 3.7 per cent, noticeably ahead of New Zealand’s long-term average. Such above-par performance is remarkable for the fact that it has been achieved against the backdrop of a world economy that was growing below trend. The key reasons for the strength of economic activity since 1999 were the export income gains made in 2000 and 2001, when prices of our agricultural goods on world markets were high at the same time that the exchange rate was weak, and the burst of net immigration experienced through 2002 and 2003. These factors have led to strong domestic demand, with consumption and investment strength both important.

Even though exchange rate stimulus was reversed some time back, and net immigration has passed its peak, the time frames over which such forces influence economic activity are extended. Both influences have still been pushing growth forward over the last year. The effect of the turnaround in the exchange rate and the abatement in net immigration will be felt increasingly over the next year. The simultaneous existence of precursors of the associated slowdown (e.g. a slower pace of house sales) and signs of continued strength (e.g. above-trend growth in retail sales) has required careful consideration during our policy deliberations.

Figure 1
Relative cyclical drivers



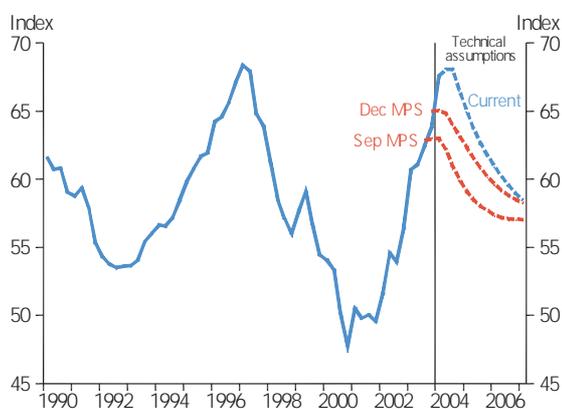
Source: RBNZ.

Momentum and lags

As noted, it takes time for changes in economic conditions to alter behaviour. Those lags can sometimes be long and variable, complicating economic analysis. Our assessment of the evolution of the forces driving the New Zealand economy is illustrative of the importance of taking time into account. That assessment is represented in figure 1, which shows the relative strength of the different forces expected to shape future growth, set against those shaping recent and current growth.

Strikingly, the exchange rate is shown to be a positive influence on current growth, some three years after it began to appreciate (figure 2). How can that be? For a start, it was not until late 2002 or early 2003 that the average exchange rate crossed over from being abnormally low to being abnormally high. Secondly, the decisions that lead to changes in the volume of exports and imports – the most important route through which economic growth is affected – take time to be made, and to implement. This is especially the case with exports that involve biologically-determined time frames, such as agricultural exports. To be sure, the incomes of exporters, and thus their spending will in principle be affected more rapidly than their production patterns. But there are offsetting influences. Hedging of export receipts against exchange rate changes can delay the effect on incomes. And as prices of imported goods fall, increased expenditure – on both imported and local production – becomes feasible at unchanged levels of income.

Figure 2
Exchange rate assumptions

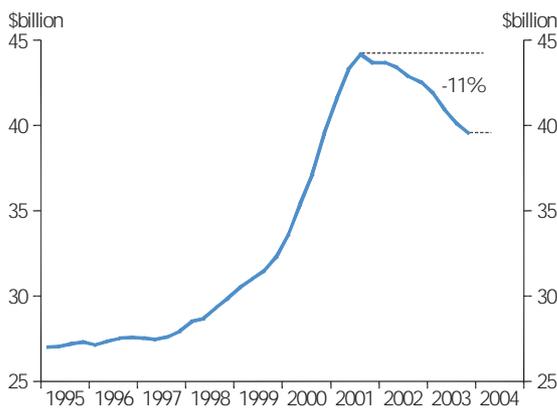


Source: RBNZ.

As figure 1 shows, in our assessment exchange rate appreciation to abnormally high levels will be a very strong contractionary influence on the economy over the period ahead, even if, as we assume, exchange rate appreciation has essentially finished and depreciation will follow. It is difficult to tell in advance the strength of the contractionary influence, and when it will reach its maximum effect. As the exchange rate has moved further away from its long-term trend, the likelihood of an abnormally quick and abnormally sharp reaction has increased.

The importance of lags and momentum when assessing the economic situation is also evident in relation to the economic force labelled "wealth/income" in figure 1. This composite force refers to the combination of influences arising from developments in household balance sheets. In 2000 and 2001 there was a dramatic improvement in the financial positions of households connected with the farming sector, with some \$7 billion of additional export earnings (measured relative to export earnings in 2000) boosting bank balances (figure 3). Only a portion of that boost was eroded in 2002 and 2003. Subsequently, the net wealth of real estate-owning households has increased sharply, as both rural land prices and residential property prices have moved up at historically rapid rates.

Figure 3
Export incomes

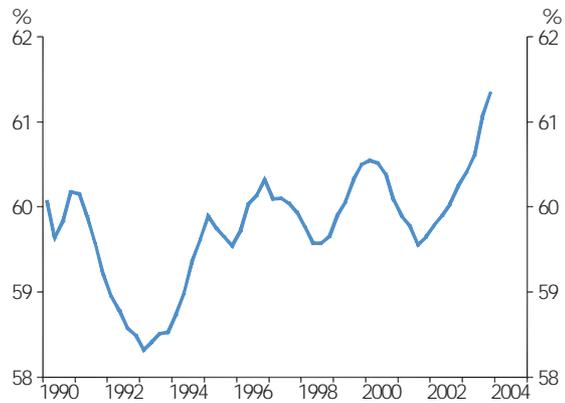


Source: Statistics New Zealand, RBNZ estimates.

Together with relatively low interest rates and fairly buoyant consumer confidence – at least in respect of financial matters (fig 22 in Chapter 3) – this improvement in the financial position of households has already pushed consumption to a remarkably high level (figure 4). How much further and longer households will be prepared to spend at a

pace that outstrips income growth is an issue of real importance.

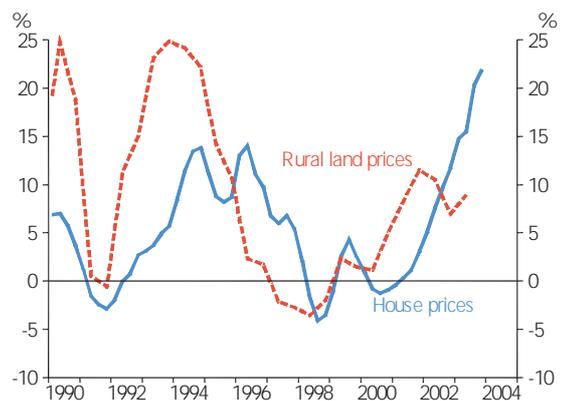
Figure 4
Consumption
(% of trend income)



Source: Statistics New Zealand, RBNZ estimates.

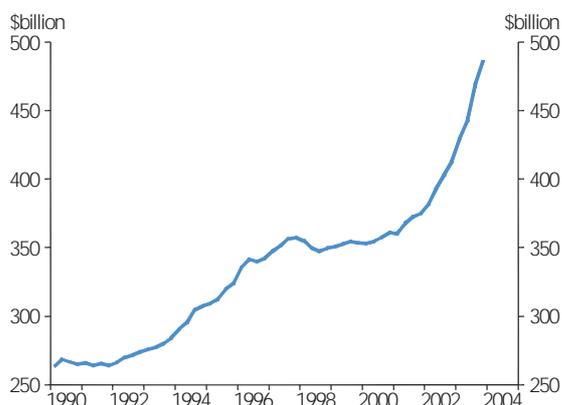
The lift in consumption that we have observed to date has driven the calculated household savings rate beyond -10 per cent of current disposable income. Such an extreme negative savings rate has, as far as we are aware, not been observed anywhere else. Responses of spending to changes in wealth are often gradual, as people take time to recognise and assess the permanence of such changes. With house price inflation still accelerating through 2003 and rural property price inflation still robust over the same period (figure 5), leading to continued improvements in the net wealth of households (figure 6), further exceptional consumption strength might be on the cards.

Figure 5
Property price inflation
(annual rate)



Source: Quotable Value New Zealand.

Figure 6
Net wealth of households¹



Source: RBNZ estimates based on Statistics New Zealand data.

This extremely unusual character of household savings developments raises the possibility of a sharper correction than we have allowed for in our projections. So too does the relationship between residential property prices and migration developments. The unexpected arrival over the past 2½ years of an additional 100,000 permanent residents, and of additional short-stay visitors, created serious pressure on the existing housing stock. The construction sector took time to respond. But by the end of 2003, construction sector employment had lifted by 26 per cent over its end-2001 level, and upwards of 50,000 new dwellings had been built in the same period. House building continues apace – over 2000 consents were granted to build new houses and apartments in January 2004 alone – which along with the slowing in net immigration will see the backlog of housing demand disappear at some point. It is quite likely that the downturn in property price inflation that will accompany this cross-over between supply and demand will be sharp, especially given the extent of speculative behaviour evident in recent months. A quick cessation or even partial reversal of wealth accumulation could impact noticeably on consumption behaviour. There is the potential for a faster and larger slowdown in activity growth than we currently project.

The lags inherent in the labour market and wage developments must also be borne in mind when making projections. By most measures, the labour market has been

tight over the past three years. Wage growth has drifted upwards over this period – the proportion of employees receiving annual wage increases over 3 per cent is now higher than in the mid-1990s (figure 38, Chapter 3). However, this upwards drift has occurred with a substantial lag to the tightening in labour market conditions. Moreover, there are signs that the employer-based surveys have not been picking up the full story in terms of wage drift. The slowness with which labour market pressures have pushed wage growth up suggests the likelihood of only a slow easing in pressures.

Fiscal policy may also be a source of continued cyclical momentum over the period ahead. Having been surprised by the lift in tax revenue over the past few years, and 2003 in particular, the Government has announced an intention to edge up real expenditure growth rates over the three years from 2005. As indicated in figure 1, the tax revenue surprise is thought to have acted as a mild braking influence on the economy. But looking forward, changed spending plans will provide a small boost to economic activity. That pattern of fiscal adjustment will act to carry forward into the future some of the recent growth momentum, thus acting as a stabiliser for the economy.

The monetary policy issue

For monetary policy, these developments have added further complexity. Imported inflation has been very weak, primarily on account of sharp exchange rate appreciation. This has left headline inflation – the formal focus for monetary policy – in the bottom part of the inflation target range.

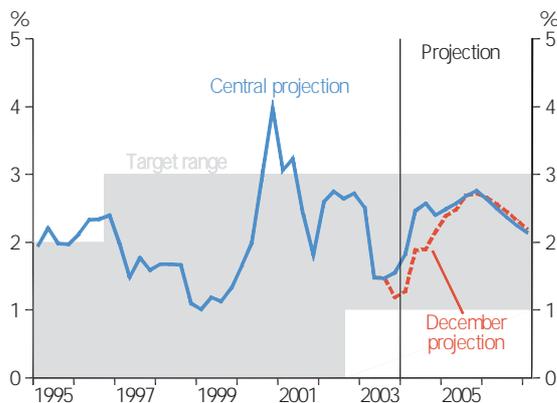
Were the exchange rate to stop appreciating, imported inflation would fairly quickly return to positive territory. Subsequent depreciation would push in the same direction. Such a scenario has been painted in recent *Monetary Policy Statement* projections, and is again in the current projection, albeit at successively higher levels of the exchange rate (figure 2). This scenario has headline inflation rising from its current comfortable level towards the top of the inflation target range (figure 7).

The rise happens as an elevated pace of domestic inflation is progressively unmasked by a return of imported inflation to positive territory. As the strength of the domestic economy has continued to surprise, so too has the level of domestic

¹ Net wealth is the sum of housing and financial wealth. Financial wealth is created using a top-down approach, which adds holdings of government stock and the business capital stock, and subtracts net foreign liabilities.

inflation. Considered alone, at around 5 per cent per annum, the current rate of domestic inflation is uncomfortably high. Continuation of inflation at this pace over an extended period, and especially a further acceleration, would be of considerable concern. The normal operation of lags between inflation pressures building and actual inflation resulting implies a continuation of high domestic inflation for some months to come.

Figure 7
Consumer price inflation
(annual rate)



Source: Statistics New Zealand, RBNZ.

In terms of the *Policy Targets Agreement (PTA)*, it is the *future* track of inflation that is the issue, not the current rate of inflation. Thus the fact that headline inflation is currently low on account of negative imported inflation is of less relevance than the prospect that headline inflation could rise to an uncomfortably high level further out.

At the same time, the PTA makes it clear that it is the *trend* of inflation – the average rate of inflation – in the future that is the proper focus of monetary policy. The scenarios that we have been painting in recent times have a *temporary* rise in inflation towards the top of the inflation target range, not persistence of inflation in the upper part of the range. This has been crucial to recent interest rate decision-making. We have maintained mildly stimulatory interest rate settings, notwithstanding clear inflationary pressure on the economy's resources, because the inflation trend has not been projected to continue in uncomfortable territory. But the risk that high inflation becomes entrenched is the reason why we nudged interest rates up in January, as pressures on domestic inflation surprised again with their strength and persistence.

Why have we presumed that the forthcoming rise in inflation will be temporary, rather than the beginning of a

rising trend? Essentially because the expected slowdown in the growth rate of economic activity will progressively take pressure out of the economy, in time bringing domestic inflation lower. Indeed, since December exchange rate appreciation has become more exaggerated, leaving the New Zealand dollar at a level that is even more clearly constraining the export sector. And the expected reduction of net immigration appears to be happening rather more quickly than we allowed for in our earlier projections. Together, these dampening forces are noticeably more powerful than was the case just a few weeks ago.

Thus at one and the same time, existing upward pressures on domestic inflation appear to have remained surprisingly strong, while the factors that promise to dampen those pressures have also strengthened. At some point there will be a cross-over. Whether that point is imminent, or still several months away, is a matter of momentum and lags – factors around which there is considerable uncertainty. But the location of that point is the crucial issue for whether interest rates will need to rise further in this cycle.

The exchange rate

The dramatic swing in the exchange rate from exceptional undervaluation to exceptional overvaluation over the past three years has been a key influence on New Zealand's current economic cycle. In analysing the likely effect on future economic growth of recent exchange rate appreciation, we have considered a number of issues.

One of those relates to the possibility that the exchange rate is not actually as high, relative to history, as it seems. A change in the method of calculating the trade weighted index in 1999 does indeed make a small difference in this direction. But the bigger issue is whether New Zealand exporters are nowadays structurally more productive, more profitable, in a way that means that current levels of the exchange rate are more sustainable than previously. Our analysis suggests that they are not. Although New Zealand's terms of trade are currently relatively high (see Chapters 3 and 4 for details), that appears to be more cyclical than structural. More generally, the long term deterioration of the balance of trade, of the current account of the balance of payments, and New Zealand's net financial position vis-à-vis the rest of the world, all point to the exchange rate being unsustainably appreciated

at current levels. The small lift in New Zealand's rate of investment over the past two years does not promise sufficient returns to cover the additional cost of the debt that the country has acquired, reinforcing the same point.

A second issue that we have considered is that the very high level of the exchange rate might cause rather sharper than normal responses in the export economy, especially if exporters expect the current level to persist. As past exchange rate hedges mature, or as the squeeze on exporters' profitability eats further into the reserves, it is quite likely that increasing numbers of exporters stop investing in additional export capacity, or even find it too difficult to continue. Two possible implications present themselves. To the extent that several exporters find themselves at the same decision point at the same time, estimates of the "normal" influence of the exchange rate on economic activity might be misleading. And to the extent such exporters would have been profitable over the longer term, if they had been able to hold on, some lasting damage to the economy may be done.

On the first of these possible implications, our research shows some, but not much, propensity for economic responses to the exchange rate to become sharper at the extremes of the exchange rate cycle. Moreover, it seems that large parts of the export sector – particularly that associated with farming – entered this exchange rate appreciation cycle with balance sheets in unusually good shape.

On the second of these possible implications, there is little doubt that exaggerated exchange rate cycles can do lasting damage to businesses in the internationally-exposed sector of the economy. Some of that damage comes in the form of preventing people from setting up businesses in that sector in the first place, given the variability and uncertainty of income flows that can be expected. Whether monetary or other economic policies can do anything to ameliorate this damage is a subject of ongoing and active research.

Policy assessment

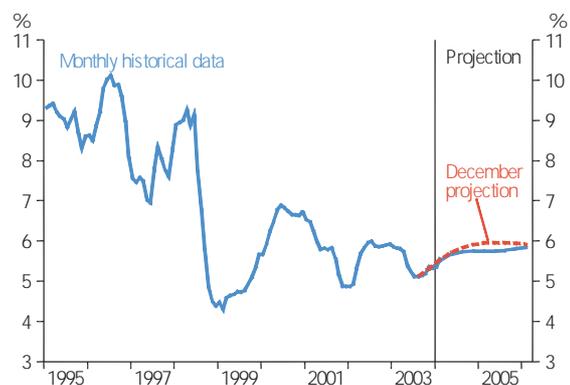
As figure 1 and the accompanying discussion argue, the New Zealand economy is en route for a crossover in the forces that have been driving its evolution, from predominantly accelerating to predominantly decelerating. Most of the influences related to that crossover have been in place for some time – exchange rate appreciation, a reduction in net

immigration, the income and wealth consequences of past strong activity, and the lingering effects of a period of sustained pressure on productive resources. The shift in balance from net expansionary to net contractionary forces will subsequently dampen existing domestic inflation pressure. Judging when that happens, and the degree of assurance required, is what monetary policy assessment is about.

The balancing act is difficult, especially in the context of interest rates continuing to add a mildly expansionary force to the economy. Given the degree of contractionary pressure resulting from exchange rate appreciation, there are good reasons not to have contractionary interest rate settings. But excessive risk aversion can have its costs, as the *Policy Targets Agreement* recognises. Clause 4 of the *PTA* requires us to consider the implications of policy for the stability of the real economy. In the context of the expected crossover in the economy's driving forces, moving interest rates up to virtually guarantee inflation control would almost certainly exaggerate the sharpness of the subsequent slowdown.

As figure 8 indicates, allowing for those forces that will increasingly slow New Zealand's economic growth rate, a reasonable central view is that a small further adjustment of interest rates towards more neutral settings would be warranted. Even with inflation likely to rise towards the top of the range, however, interest rates are likely to remain low by New Zealand's historical standards. As to the appropriate timing for a further adjustment of interest rates, in our view there are sufficient uncertainties around the outlook that we prefer, for the moment, to wait and see.

Figure 8
90 day interest rates



Source: RBNZ.

Box 1

Exchange rate developments

New Zealand's trade-weighted index (TWI) has appreciated strongly since early 2002 and is now around 15 per cent above its long-term average (figure 2). This follows a period where the TWI fell to very low levels by historical standards. The weakening US dollar and New Zealand's strong economic performance seem to have contributed to the TWI's appreciation in roughly equal measure.

Starting from a period where the US dollar was widely considered to be over-valued relative to its long-run trend, this depreciation has occurred as markets have re-evaluated the likely pace of US growth and have become concerned about the sustainability of that economy's large current account and fiscal deficits. The US TWI has fallen around 20 per cent from its early 2002 peaks (figure 9).

Figure 9
US trade weighted exchange rate



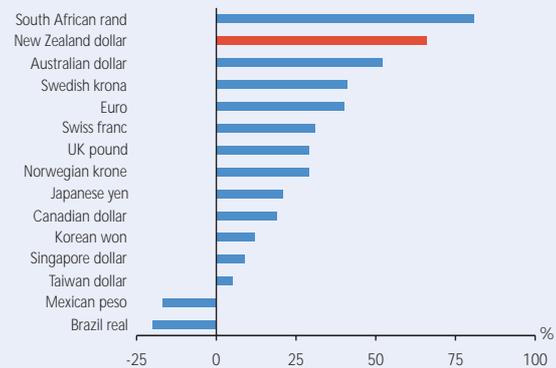
Source: IMF, Bank of England, RBNZ.

The flipside to the dollar's depreciation is that almost all currencies have appreciated strongly against the US dollar (figure 10).

New Zealand's strong economic performance over the past few years, and the relatively high interest rates that have accompanied it, has also contributed to the TWI's appreciation – causing it to gain more than most other currencies against the US dollar and to appreciate against

the currencies of our other major trading partners. However, it is important to remember that the New Zealand dollar started this appreciation from unusually low levels. As such, it is necessary to look at the level of the exchange rate relative to its long-term average, rather than simply the total amount that it has appreciated, when trying to assess how much restraint it is likely to place on the export sector.

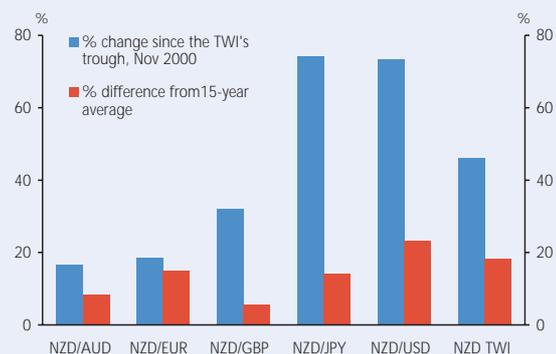
Figure 10
Exchange rates against the US dollar
(percentage change since 1 January 2002)



Source: Datastream.

Figure 11 shows movements in the bilateral exchange rates comprising the TWI since the TWI trough in November 2000.

Figure 11
Component exchange rates of the TWI



Source: Datastream.

3 The current economic situation

Overview

The New Zealand economy has recorded strong growth over the past year, with GDP in the year to December 2003 estimated to have grown by 3.5 per cent. Indicators to hand suggest that activity has remained strong in the opening months of 2004, although evidence is accumulating that a slowdown is becoming imminent. In particular, factors including the further rise in the New Zealand dollar and a sharp reduction in net immigration over recent months suggest growth will cool during 2004. Momentum in some areas, such as the housing market, appears to have slowed in recent months, although much of the evidence remains anecdotal at this stage.

Although growth may be starting to slow, significant inflation pressures have accumulated in parts of the domestic economy following sustained growth, and as yet these pressures show few signs of abating. Domestic inflation has continued to increase and stands at 4.6 per cent. In contrast, the strong exchange rate has led to outright falls in the price of many tradable goods. Overall, annual CPI inflation has remained comfortably within the 1 to 3 per cent target range.

In our December *Statement*, we signalled that small increases in the OCR could be required over the year ahead to ensure that inflation remains comfortably within the target range over the medium term. That outlook reflected a view that, notwithstanding some cooling in activity due to factors such as the higher exchange rate and slowing population growth, accumulated domestic inflation pressure was likely to produce a rise in inflation once the temporary direct price effects of the higher exchange rate started to abate. At our interim review in January, we increased the OCR by 25 basis points, in response to evidence of continued strong activity and inflation pressures in the domestic sector. Broadly speaking, this economic picture is much the same as it was in December.

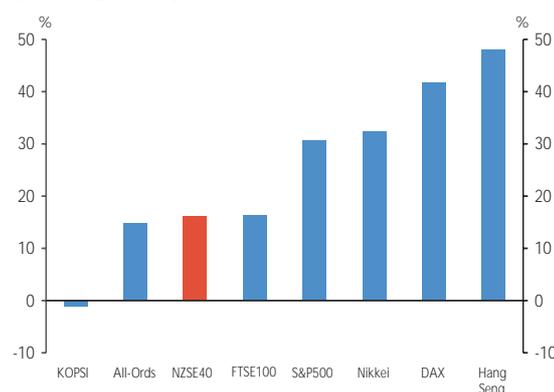
Global and financial market developments

Following a sharp slowdown in 2001, the economies of New Zealand's main trading partners began a tentative recovery in 2002, and this recovery has strengthened through 2003. The US economy remains the main driver of growth, although

recently there have also been some positive signs in other countries.

The US economy recorded strong GDP growth over the second half of 2003. Household spending was particularly strong, supported by tax cuts and low interest rates. Business investment also picked up over 2003, with investment in equipment and software showing strong growth. The pick up in business investment could reflect an improvement in after-tax profits, due to tax cuts and sustained historically low interest rates, which have helped firms restructure their balance sheets. The continued recovery in equity prices and narrowing of credit spreads are consistent with the more optimistic outlook for the corporate sector (figure 12).

Figure 12
Equity prices
(percentage change since 1 January 2003)



Source: Datastream, RBNZ.

Despite the rapid increase in activity, there has not been a significant increase in employment in the US. Rapid growth in productivity has allowed firms to increase production without additional labour. Despite strong growth in the second half of 2003, the Federal Reserve has kept interest rates on hold, reflecting a subdued outlook for inflation, and still weak employment growth. Global interest rates have typically fallen over the period since the December *Statement*, as comments from the Federal Reserve indicating no urgency to tighten, along with continued weak employment growth, have led markets to move out the timing of expected tightening in the US. New Zealand long rates have followed US long rates lower, and the continued appreciation of the New Zealand dollar has also prompted New Zealand short-term interest rates to track lower.

The historically high US current account deficit is cited as a reason for the decline in the US dollar over the past year (figure 13). The US dollar has declined by around 12 per cent on a trade-weighted basis since the beginning of 2003 (see box 1, Chapter 2).

Figure 13
US current account deficit
(% of GDP)



Source: Datastream.

The flipside of the weakening US dollar has been a strengthening of many other currencies. The Euro has recorded a large appreciation, as have the New Zealand and Australian dollars, and the Yen to a lesser extent.

The appreciation of the Euro appears to have taken some time to have an effect on European exports. Although overall GDP growth in the Eurozone has been below trend, a significant contribution to growth in the third quarter of 2003 came from exports. This may be because the stronger world economy has provided support to export growth, offsetting the effect of the stronger Euro. However, more recent indicators suggest exports may be beginning to slow.

Domestic demand in many European countries has remained weak. Although there have been some signs of a gradual recovery, such as improving sentiment surveys, this has yet to materialise into stronger activity. There has also been an improvement in some employment indicators, although these remain at relatively low levels and the unemployment rate has remained unchanged at 8.8 per cent since March 2003.

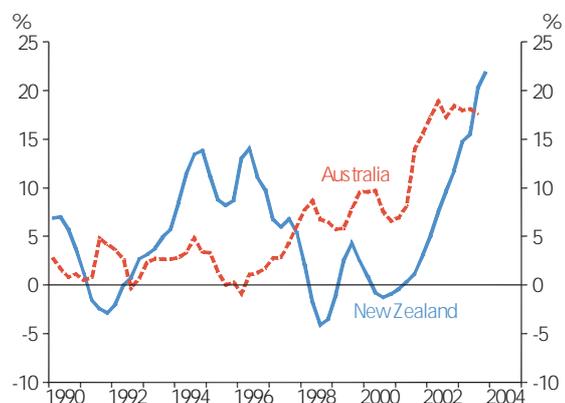
In contrast to the weak situation in many other European countries, the UK has experienced relatively strong growth in the second half of 2003. Household spending growth has

been strong, supported in part by rising house prices, and momentum in household spending looks to have continued into early 2004. Business investment intentions and profitability have also picked up. However, increases in the British pound against the US dollar are likely to limit growth in the external sector. On balance, the strong growth outlook has prompted the Bank of England to raise interest rates by 25 basis points in both November and February.

The Reserve Bank of Australia (RBA) has also increased interest rates, raising rates by 25 basis points at both the November and December meetings. Growth in Australia has picked up, driven by strong growth in domestic spending. At the same time, the stronger global economy and a rebound in farm exports following the drought are leading to an improvement in exports, although net exports are still detracting from GDP. The RBA cited strong domestic spending and the improving global economy as the key factors behind the move to a less expansionary interest rate setting.

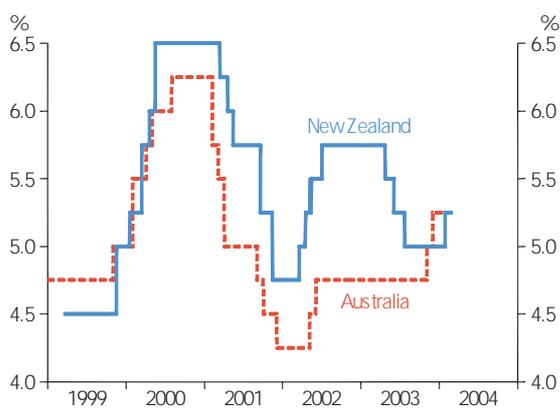
In many ways, recent trends in the Australian economy are similar to those in New Zealand. Both countries have seen strong growth in domestic demand, with a strong housing market cycle leading to rising house prices (figure 14). At the same time, both the Australian and New Zealand dollars have appreciated significantly, which in due course is likely to offset the effects of strong domestic demand and improving world conditions to a degree. Faced with these offsetting forces, both central banks have begun to increase interest rates towards a more neutral setting (figure 15).

Figure 14
House price inflation
(annual rate)



Source: Quotable Value New Zealand, Datastream.

Figure 15
Official cash rate



Source: RBNZ, RBA.

Although many factors continue to support residential investment in Australia such as the strong labour market and relatively low interest rates, there are some tentative signs of a softening in the housing market. These include weaker housing loan approvals, lower auction clearance rates in Sydney and Melbourne, and falls in building approvals.

The Japanese economy continues to show signs of recovery, largely driven by growth in exports. Exports to Asia have been growing strongly, with a growing share of these going to China. To date, the modest appreciation in the Yen against the US dollar does not appear to have had a significant negative effect on Japanese exports.

Business investment in Japan has also picked up over 2003. In contrast, household spending remains soft, and although the unemployment rate has trended down over the past year, it remains at high levels.

Non-Japan Asian economies continue to benefit from a strengthening US economy. In addition, trade between Asian countries has continued to increase, helping to reinforce growth across the individual economies.

Tradables sector activity

The New Zealand dollar has appreciated by around 30 per cent on a trade-weighted basis since the beginning of 2002. The rise in the exchange rate to levels well above its 'trend' will increasingly constrain economic activity, but this occurs through a variety of channels, which are yet to fully play out. Lower prices are dampening the incomes of exporters, which will restrain demand in the economy. This process will take

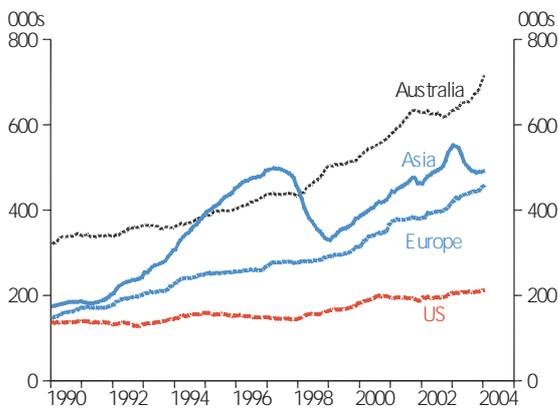
time to occur, partly because of exchange rate hedging and partly because balance sheets in many parts of the export sector have been in good condition following the surge in export earnings over 2000 and 2001. A fall in the profitability and competitiveness of exports is also likely to encourage a reduction in export volumes. In the aggregate, this effect appears to occur with a considerable lag in New Zealand, largely due to the preponderance of agricultural exports in the export basket, the production of which is largely pre-determined by biological and climatic constraints in the short term. On the import side, lower import prices are likely to see demand switch away from domestically-produced goods, which will tend to reinforce the dampening effect on activity occurring through the export sector. However, in the short term lower import prices imply a boost to real incomes, which may promote stronger domestic demand, providing some offset to the contractionary effects.

However, the restraining effects of the exchange rate appreciation are building. New Zealand's net export position – the balance of exports less imports – has become increasingly more negative over the past year, representing a contractionary influence on GDP. To date, most of this fall in the net export position has been driven by stronger imports rather than a marked fall in exports. However, following a long period of modest growth, export volumes contracted in the middle of 2003, with lower exports of both goods and services. This was not wholly an exchange rate story – contributing to this fall was a contraction in agricultural exports, due both to last year's dry conditions and to a build-up in primary stocks in anticipation of better trading conditions. Much of the contraction in exports appears to have since reversed.

Nevertheless some areas of exports have slowed noticeably, most notably exports of tourism services, which may be starting to wane in the face of a strong currency. Tourist numbers have recovered from the falls early last year associated with the outbreak of SARS. Visitor arrivals from Asian countries fell sharply early last year, but arrivals from most have recovered over the second half of 2003. Tourist arrivals from Australia have shown very strong growth throughout 2003, likely reflecting airfare discounting and increased capacity on trans-Tasman routes (figure 16). Although tourist numbers are recovering, the amount they are spending is not. This could reflect a switch in the

composition of tourists, with a higher share coming from Australia. Australian visitors typically spend about half the amount spent by Asian visitors while in New Zealand. Moreover, to the extent overseas visitors apply a fixed budget for their holidays (in their own currency), a higher New Zealand dollar exchange rate may encourage lower New Zealand dollar spending. Reported declines in the number of English language students will have also reduced exports of services.

Figure 16
Visitor arrivals
(000s per year)



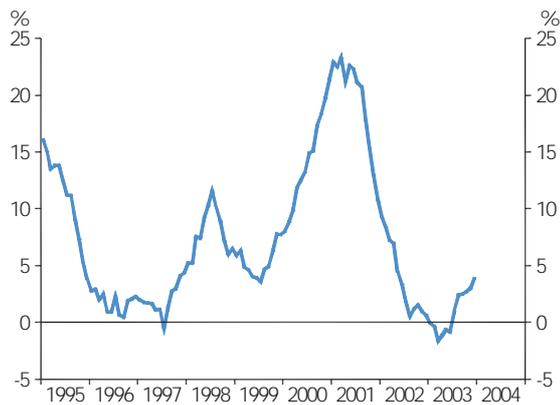
Source: Statistics New Zealand.

Export volumes of forestry products also fell sharply in 2003, with the New Zealand dollar prices of forestry products at cyclical lows, driven by low world prices and the stronger New Zealand dollar. Although world prices of forestry products have increased from their lows towards the end of 2003, this has been offset by further strength in the New Zealand dollar. Exporters in the forestry sector have also been faced with higher shipping costs, further reducing their profitability.

Despite the scale of the exchange rate appreciation over the past couple of years, manufactured export volumes continued to show moderate growth during 2003. Machinery and equipment and transport equipment volumes in particular have recorded strong growth. To be sure, falling prices for many manufactured export goods have continued to place pressure on export revenues. But in aggregate, export earnings for non-commodity manufacturers have begun to recover, despite the continued appreciation in the exchange rate (figure 17). In addition, many manufacturers have been able to offset weaker revenues from export sales with stronger domestic sales. Nevertheless, increasing costs for manufacturers,

particularly higher labour and electricity costs, have been placing downward pressure on profitability. This may be partly offset by the benefit of falling prices for imported inputs.

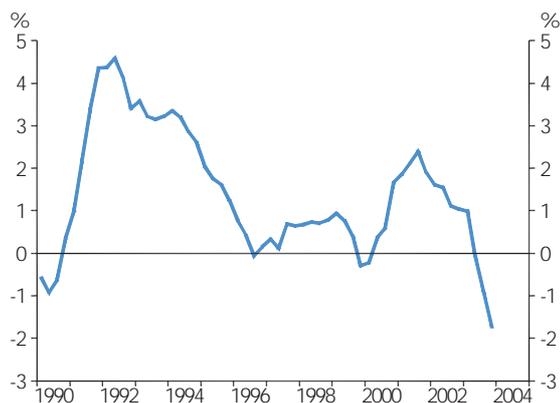
Figure 17
Value of non-commodity manufactured exports
(annual average percentage change)



Source: Statistics New Zealand.

The higher New Zealand dollar is likely to have been a factor promoting a surge in import volumes over the past year. Imports of consumption goods have been rising for some time, as factors such as strong net immigration, a strong housing market, low interest rates and growth in household incomes have fuelled strong growth in household consumption. Falls in import prices will have supported this demand. Imports of capital goods have grown rapidly over the past year, as high levels of capacity utilisation and falling prices of imported capital goods have made capital investment more attractive. There has also been significant growth in imports of intermediate goods.

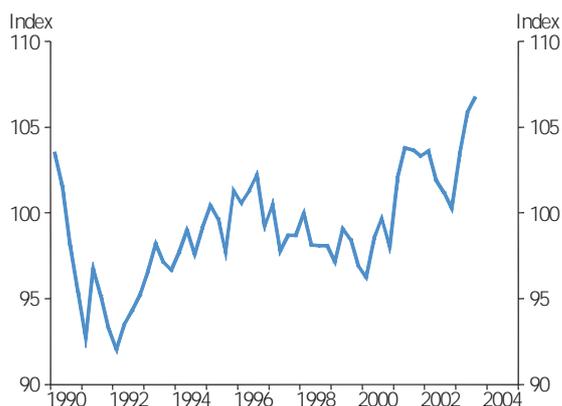
Figure 18
Real trade balance
(% of GDP)



Source: Statistics New Zealand, RBNZ estimates.

In sum, the trade balance has deteriorated over the past year as growth in import volumes has outpaced export volumes (figure 18). This has seen the current account deficit expand over the past year, to reach an estimated 4.9 per cent of GDP by the end of 2003.

Figure 19
Goods and services terms of trade

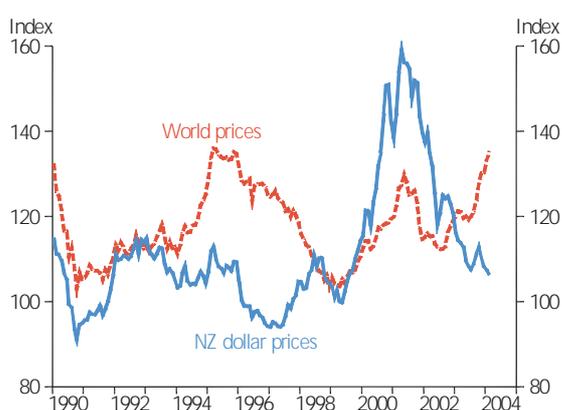


Source: Statistics New Zealand.

Turning to the terms of trade, both export and import prices fell substantially in 2003, spearheaded by the rising exchange rate. However, the fall in import prices was larger than for export prices resulting in an increase in the goods and services terms of trade (figure 19). A key reason for the lesser fall in export prices was the more stable path of export prices for services: because tourism prices are largely established in New Zealand dollars, they tend to show less response to a rising exchange rate.

Nevertheless, New Zealand dollar export prices have declined from the spectacular highs reached in 2001, returning

Figure 20
ANZ commodity prices



Source: ANZ Banking Group Ltd.

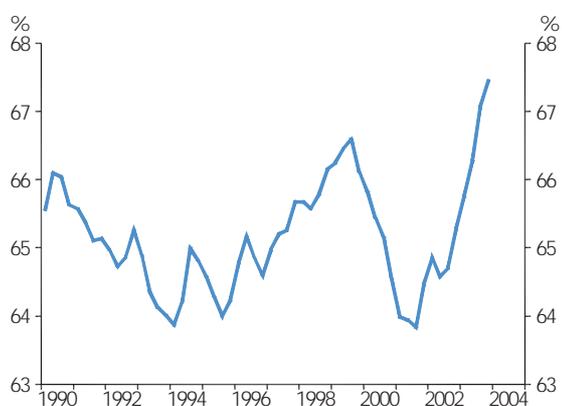
to more average levels. Over the past year, the key factor leading to lower New Zealand dollar export prices has been the appreciation of the New Zealand dollar. In contrast, world prices for our commodities have increased over the past year to reach 8-year highs (figure 20). A number of commodity prices have risen in US dollar terms, as global markets adjust to the lower US dollar. In addition, supply issues may be driving up world prices. For example, the recent droughts in Australia and the US have restricted supplies and driven up prices for beef and dairy products.

Domestic Demand

Continued strength in domestic demand, despite the pressure faced by the tradables sector, is testament to the strength of a number of factors that have underpinned demand in the domestic economy over the past two years. Strong population growth boosted by high net immigration, combined with strong employment growth, low unemployment rates, improving terms of trade, rising housing wealth and low interest rates, have boosted household spending to very high levels (figure 21). Whilst the effect is likely to be waning, the earlier export revenue windfall is also likely to have continued to contribute to spending over 2003.

Although the strength of domestic demand has surprised over the past year, weaker demand conditions look increasingly likely to develop during 2004. In particular, net

Figure 21
Household spending²
(% of GDP)



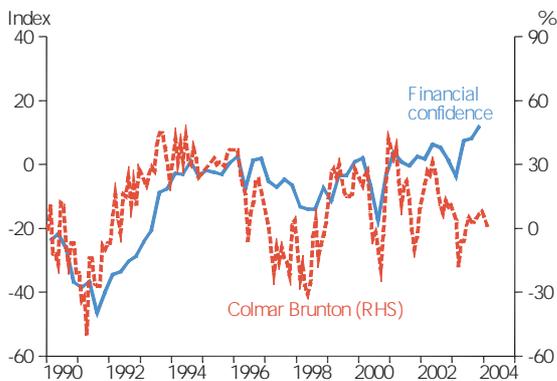
Source: Statistics New Zealand, RBNZ estimates.

² Household spending is the sum of private consumption and residential investment.

immigration has slowed sharply since the middle of 2003, and employment growth appears to have eased towards the end of last year. Evidence is beginning to point to a possible cooling in parts of the domestic economy such as the housing market.

An early hint of the expected softening in domestic demand might be found in the recent fall in consumer confidence. According to the Colmar Brunton survey, consumer confidence dipped early in 2004, and is now slightly below its long-term average. However, over the past year confidence as measured by the Colmar Brunton survey has been much weaker than would be consistent with observed strong growth in household spending. The Westpac McDermott Miller (WMM) survey, which asks a wider range of questions about households' economic and financial wellbeing, has been more consistent with the observed growth over 2003. The last WMM survey, taken in late 2003, suggests that households' confidence about their financial wellbeing remains exceptionally strong, and has not yet given any indication that household consumption is slowing (figure 22).

Figure 22
Consumer confidence³



Source: Colmar Brunton, Westpac McDermott Miller.

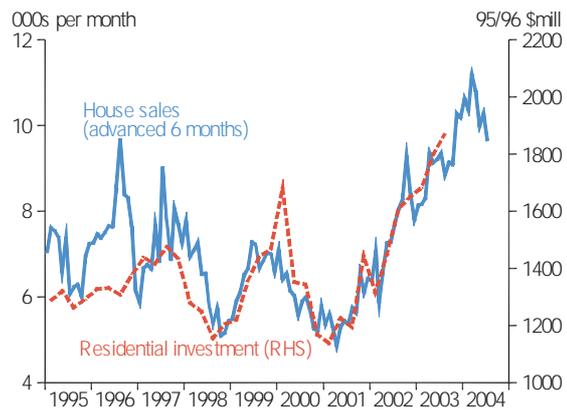
During 2003, retail sales grew rapidly. However, the pace of growth appears to have slowed towards the end of the year, suggesting that momentum in the domestic economy may be slowing, albeit from very fast rates. In particular spending on durable consumption goods, such as furniture, appliances, and motor vehicles, has fallen, following strong growth over the past year. The data also point to a possible slowing in sales in some rural areas after prolonged strength.

³ Financial confidence is measured as the net per cent of respondents that believe they are financially better off now than 12 months earlier.

Our business contacts have also noted such a slowing over recent times.

Momentum in the housing market also appears to be slowing, but current activity levels remain very high following a record number of house sales in 2003. The strong demand for housing from both new immigrants and New Zealand residents saw the time taken to sell a house fall to record lows and house price inflation increase. House price inflation was around 20 per cent per annum at the end of 2003. The number of house sales has declined since September, suggesting housing market activity could have peaked in late 2003 (figure 23). However, houses are still selling very quickly, suggesting that the demand for houses remains strong.

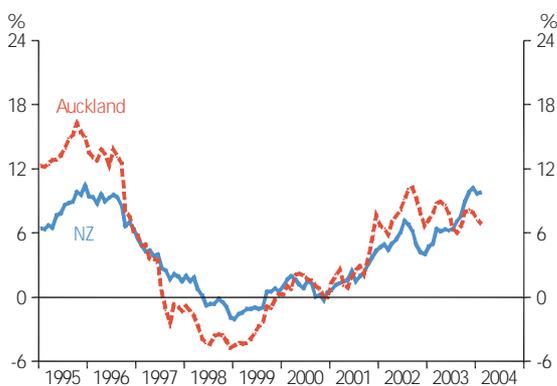
Figure 23
House sales and residential investment



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

Data from the Ministry of Housing show that rentals throughout New Zealand increased by about 10 per cent in 2003, about double the rate seen during 2002. This acceleration appears to have been driven by areas other than Auckland, for which the annual rate of increase, at about 7 per cent, was little changed from a year earlier (figure 24). However, the Ministry of Housing data only cover new rental agreements (from information given on bond lodgement forms), and almost certainly overstate increases in rentals as a whole, because landlords are more likely to change rents for new tenants. Despite increasing sharply over the past two years, movements in rentals have been weaker than those seen in house prices over the same period, implying a fall in yields on rental properties. Although we have heard some anecdotes of a fall in new rentals in Auckland recently, these are not yet evident in the data.

Figure 24
Market rentals
(annual percentage change)



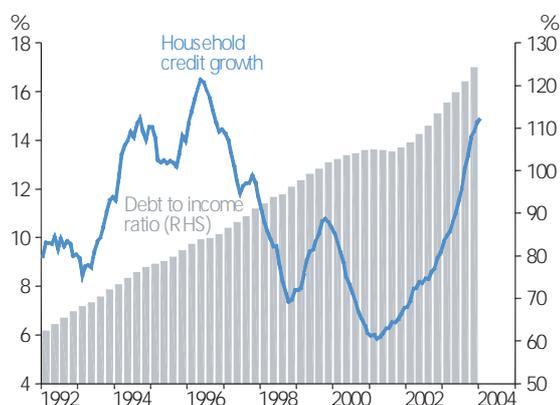
Source: Ministry of Housing.

Construction of new dwellings has expanded to meet the strong demand for housing. Close to 30,000 dwelling units were built in 2003, compared to an average of around 24,000 per annum over the past decade, and this has put pressure on resources in the building sector. Builders have reported long backlogs of work, and delays in building new houses continue. This is despite increased employment in the construction sector over recent years, which has expanded capacity in the sector. While construction activity eased slightly at the end of 2003, strong dwelling consent issuance suggests that building activity will remain strong in the first half of 2004. A decline in the level of housing market activity and slowing net immigration would be expected to feed through into lower construction activity with a lag, as demand for new housing slows. Growth in the size of the construction sector over recent years raises the risk of a potentially sharp downturn if consents issuance slows.

The strength of demand in retailing, housing and construction seen over the past year or so has come at a time when New Zealand's export incomes have been declining, and household income growth has not kept pace with household spending growth. This has seen the household savings rate fall 5 percentage points to -8 per cent of household disposable income in the year to March 2003, and trends in spending and incomes since that time suggest that rate is likely to fall further. Although it is difficult to accurately measure the level of household saving rates, the downward trend is clear. This has resulted in an increase in household credit growth and increasing household debt which, in

aggregate, has risen to over 120 per cent of household disposable income (figure 25).

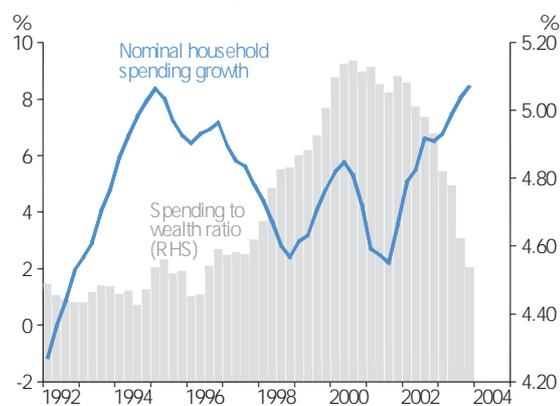
Figure 25
Household debt and household credit growth



Source: RBNZ, Statistics New Zealand.

An increase in the level of household debt would normally be expected to act as a constraint on future household spending. However, recent increases in debt have been more than offset by increases on the asset side of households' balance sheets. Increases in house prices driven by the strong housing market have increased the value of households' housing assets, and non-housing wealth has also risen. The sharp increase in household wealth has actually been greater than the increase in household consumption, which has led to a decline in the ratio of household consumption to net wealth (figure 26).

Figure 26
Household spending

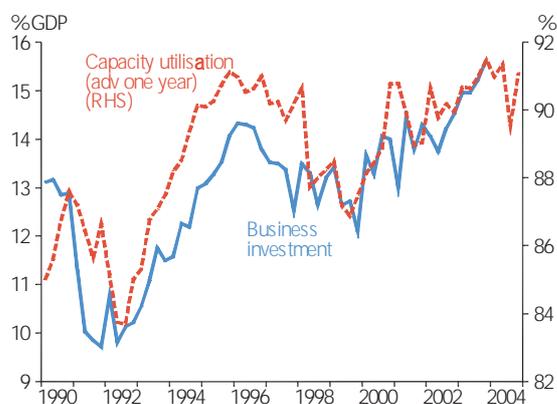


Source: Statistics New Zealand, RBNZ estimates.

While much of the strong growth in domestic demand has been driven by households, business investment growth has also been strong over 2003. Business investment has been growing at around 10 per cent per annum which, although not as fast as the pace seen in the mid-1990s, is still high in a historical context.

The pick-up in investment follows a sustained period of high levels of capacity utilisation, which tends to affect business investment with a lag (figure 27). General business confidence as measured by the National Bank and NZIER surveys fell towards the end of 2003 and early 2004, which might be expected to discourage further investment. Much of the dip appears to be related to concerns about the exchange rate, and expected export sales also remained weak. In contrast, expectations about firms' own activity have held up, and are around, or above, average levels. In addition, expectations around profitability remain relatively robust, and investment intentions have picked up. This suggests that the fall in headline business confidence might not act as a significant drag on business investment.

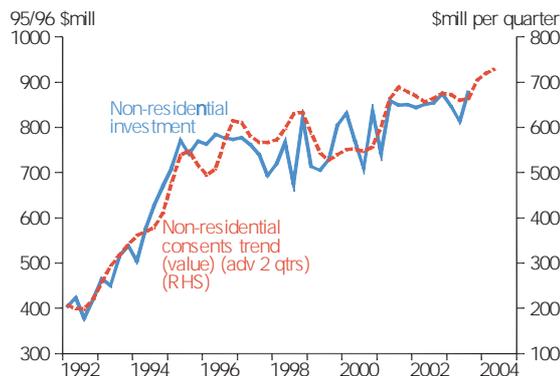
Figure 27
Business investment and capacity utilisation



Source: NZIER, Statistics New Zealand, RBNZ estimates.

The boom in construction over the past two years has been dominated by residential construction, and commercial construction has been relatively steady. However, as we noted in our December *Statement*, non-residential building consents have trended up over 2003, and are pointing to a pick-up in commercial construction early in 2004 (figure 28).

Figure 28
Non-residential investment and consents



Source: Statistics New Zealand.

Cyclical pressures and inflation

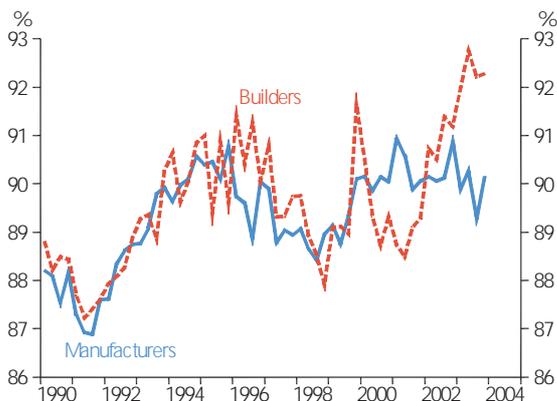
Productive capacity and the labour market

The period of above-average output growth over the past couple of years has put increasing pressure on the economy's productive resources. Growth in production has stretched both capital and labour resources, and many industries, particularly those servicing the domestic sector, are operating at full capacity. Despite recent evidence suggesting that the growth rates of activity may be starting to moderate, indicators of resource use suggest that the pressure on resources remains strong.

Although there is no direct way to measure capital use, there are a number of indicators that are pointing to intense pressure on capital resources. Most of these indicators are survey measures derived from the NZIER's Quarterly Survey of Business Opinion (QSBO). Surveyed capacity utilisation has been at very high levels for the past two years, although the data suggest that recent strength is being dominated by extremely high capacity utilisation in the building sector. Capacity utilisation increased sharply in the December quarter following a dip in the September quarter, suggesting resource pressures remain intense (figure 29). This is despite the recent increase in business investment.

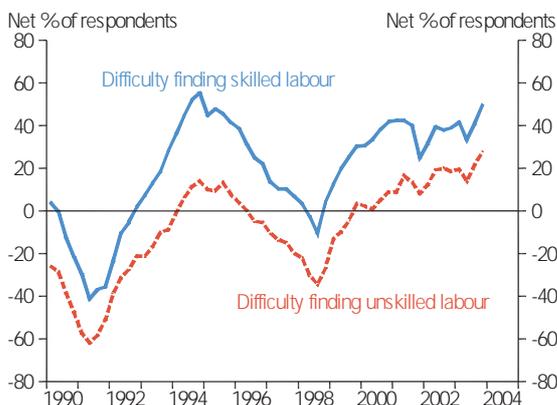
Labour resources have also been stretched, despite the strong net immigration observed over recent years. As reported to us in talks with businesses around the country, and as reflected in surveys, difficulty in finding both skilled and unskilled labour has been rising for some time (figure

Figure 29
Capacity utilisation



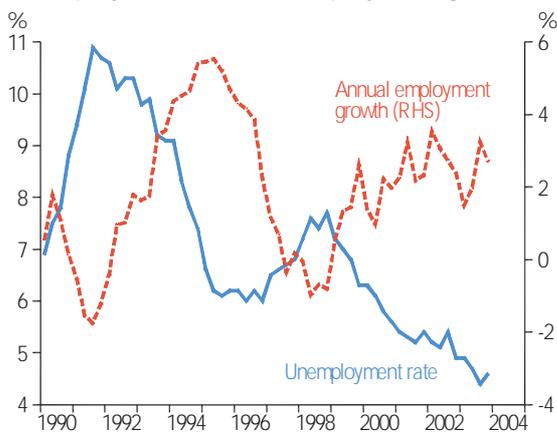
Source: RBNZ estimates based on NZIER's QSBO data.

Figure 30
Labour shortages



Source: RBNZ estimates based on NZIER's QSBO data.

Figure 31
Unemployment rate and employment growth



Source: Statistics New Zealand.

30). Strength in the demand for labour has been accompanied by strong growth in employment, and the unemployment rate has fallen to be near 15-year lows (figure 31). Although

employment growth eased slightly in the December quarter and the unemployment rate ticked up, the labour market remains very tight by almost all measures.

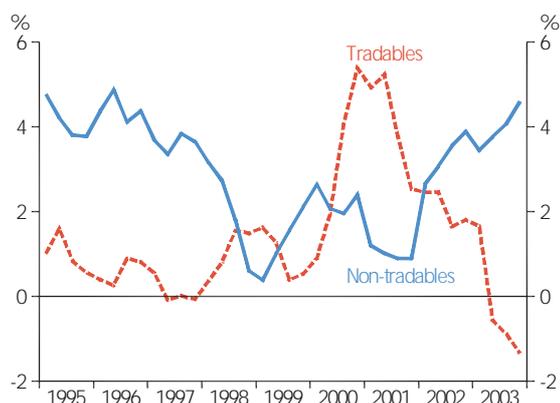
Inflation pressures

As noted, although there is some evidence that activity levels in the economy are moderating, there are few signs that the pressure on resources is easing, and in some areas pressures have continued to intensify. In general, this would be expected to place upward pressure on inflation, and indeed, inflation in non-tradable goods and services has been rising (see table 1). But overall CPI inflation has been trending down, having averaged more than 2½ per cent during 2002, before falling through 2003 to 1½ per cent currently. The overall level of inflation masks considerable differences in the two main components of inflation.

Non-tradables inflation has increased steadily to an annual rate of 4.6 per cent in the December 2003 quarter. Inflation in areas associated with the strong housing and construction markets, in particular, has been strong. Increases in the costs associated with the purchase and construction of new dwellings rose sharply in the December quarter, to an annual rate of more than 8 per cent. Inflation in the services sector more generally has also been strong. Excluding housing-related components, inflation in the non-tradables sector has increased over 2003, and is now around 3.5 per cent.

Growing inflation pressures in the non-tradables sector have been more than offset by declining inflation in the tradables sector (figure 32). In some cases, prices in the

Figure 32
Tradables and non-tradables inflation
(annual rate)



Source: RBNZ.

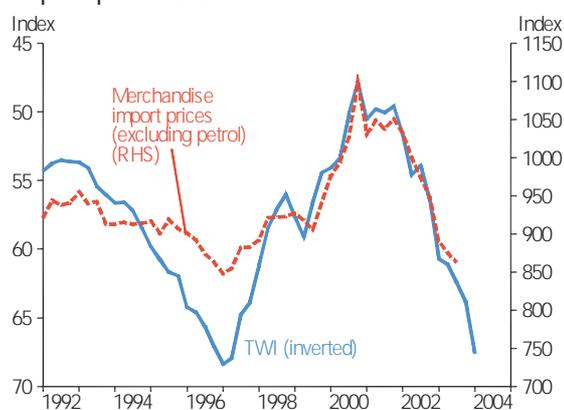
Table 1
CPI and other price measures
(annual percentage changes)

	2002				2003		
	Jun	Sep	Dec	Mar	Jun	Sep	Dec
CPI	2.8	2.6	2.7	2.5	1.5	1.5	1.6
Food	4.1	2.3	0.9	-0.2	0.0	0.3	0.2
Housing	2.8	3.0	4.0	4.0	4.7	5.9	6.6
Household operations	2.7	2.9	2.7	1.9	1.1	0.9	1.5
Apparel	1.7	1.2	0.7	0.8	-0.6	-1.1	-1.1
Transportation	0.9	1.2	3.3	4.3	-1.7	-2.5	-3.9
Tobacco and alcohol	3.8	3.6	3.6	3.1	2.7	2.6	2.9
Personal and health	4.1	4.5	4.2	3.8	3.5	2.6	2.4
Recreation and education	2.5	2.3	2.5	2.7	2.1	1.7	1.6
Credit services	0.0	2.3	1.9	-2.0	0.7	-0.1	1.2
Derivatives and analytical series							
CPI ex food, petrol and government charges	2.7	2.7	2.8	2.7	1.9	1.3	1.2
CPI non-tradables	3.1	3.6	3.9	3.4	3.8	4.1	4.6
CPI tradables	2.5	1.6	1.8	1.7	-0.6	-0.9	-1.3
CPI weighted median (of annual price change)	3.0	2.9	3.3	3.7	2.6	2.3	1.9
CPI trimmed mean (of annual price change)	2.9	2.7	3.0	2.8	1.6	1.7	1.8
Merchandise import prices (excluding petrol)	-4.7	-6.2	-9.8	-13.8	-12.5	-11.4	n/a
PPI - Inputs	1.5	-2.1	-1.4	-1.3	-1.9	0.1	-0.1
PPI - Outputs	2.3	-0.1	-0.1	-0.4	-0.6	0.7	1.1
Private consumption deflator	2.1	2.0	1.8	1.2	0.5	0.6	n/a
GDP deflator (derived from expenditure data)	0.0	1.0	-1.1	-0.4	2.2	2.5	n/a
Retail trade deflator	1.9	1.1	1.0	1.4	-0.7	-0.7	-0.4

tradables sector have been falling, as the appreciation of the New Zealand dollar reduces the price of imported goods. Combined with some one-off influences, such as heavy discounting on airfares on trans-Tasman routes, annual tradables inflation was -1.3 per cent in the December quarter.

The outright fall in tradables prices over the past year is reasonably consistent with what would be expected given the magnitude of the exchange rate appreciation. Import prices 'at the docks' appear to have fallen in line with the exchange rate rise, and this has led to weaker consumer prices (figures 33 and 34). However, it is noteworthy that during the exchange rate appreciation of the mid-1990s, the impact of the exchange rate on import prices was muted, consistent with some widening in margins on the part of foreign suppliers. Although there is no evidence that this has occurred in the current cycle, there is a risk that future exchange rate appreciation may not be passed fully into import prices. There is also a hint in the data that consumer prices might not have fallen to quite the same extent as would normally occur given the fall in import prices. If this is the case, it may be an attempt on the part of importers, distributors, or retailers, to increase margins by more than would be consistent with the usual degree of margin smoothing over the exchange rate cycle.

Figure 33
Import prices and the TWI

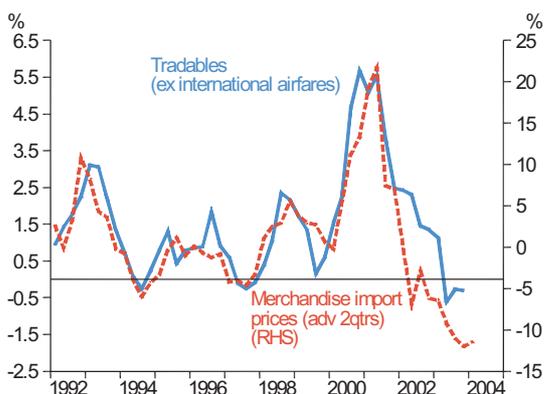


Source: RBNZ, Statistics New Zealand.

Strong domestic demand conditions may have increased the capacity of some sellers to lift margins rather than pass on exchange rate gains to customers. In addition, the tight labour market may be putting upward pressure on the cost of distributing the goods once they arrive in the country.

The divergent movements in tradables and non-tradables inflation make interpretation of underlying trends difficult. Various indicators of 'trend' inflation that we monitor, such as the weighted median of annual changes, the trimmed mean, and the CPI excluding food, petrol and administration

Figure 34
Import prices and tradables inflation
(annual rate)

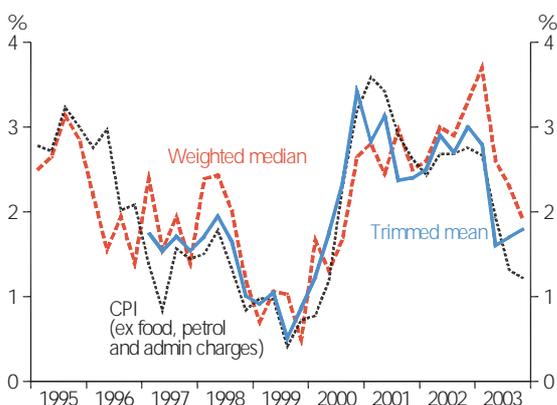


Source: RBNZ, Statistics New Zealand.

charges, have all fallen over 2003 (figure 35). These measures attempt to remove the effect of one-off influences on the CPI to reveal the underlying trend. However, all of these measures are affected by the effects of the exchange rate appreciation, which has reduced inflation across a wide range of goods and services.

Non-CPI-based inflation indicators also give a somewhat mixed picture of inflation pressures. Inflation as measured by the GDP deflator, which is conceptually one of the broadest measures of prices in the economy, has increased since March 2003. This is likely to reflect price pressures in the construction sector as well as an improvement in the terms of trade over 2003. In contrast, inflation as measured by the private consumption deflator, which measures similar goods and services as the CPI, has remained weak, reflecting the effects of the exchange rate appreciation.

Figure 35
Indicators of core inflation
(annual rate)



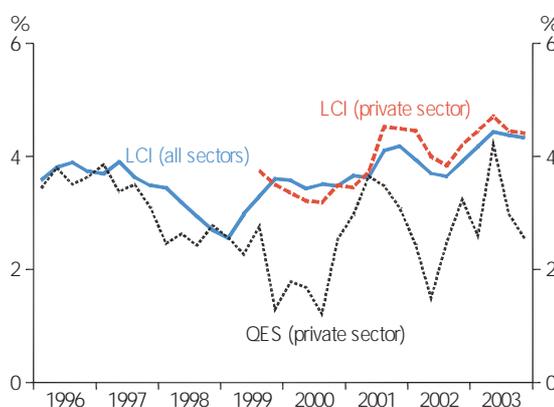
Source: RBNZ.

Wages and inflation expectations

Core factors that influence the trend in inflation over time include movements in labour costs and inflation expectations. Our assessment is that labour costs have not generally been a key driver of inflation over recent years, although labour costs may be partly contributing to inflationary pressures in the construction sector and some other domestic industries.

There are certainly indications that the tight labour market over recent years has led to some upward trend in wage movements, albeit with a considerable lag. The Labour Cost Index (LCI) measure of wage inflation for the private sector, which measures salary and wage rates for a fixed quantity and quality of labour, has drifted up over the past year and is sitting around cyclical highs, consistent with sustained reports of significant skill shortages. The annual rate of increase in the unadjusted LCI, which adjusts for a fixed quantity but not the quality of labour, has also been trending up, although there has recently been a slight dip (figure 36).

Figure 36
Unadjusted LCI and hourly earnings
(annual percentage change, LCI series shown exclude productivity adjustments)



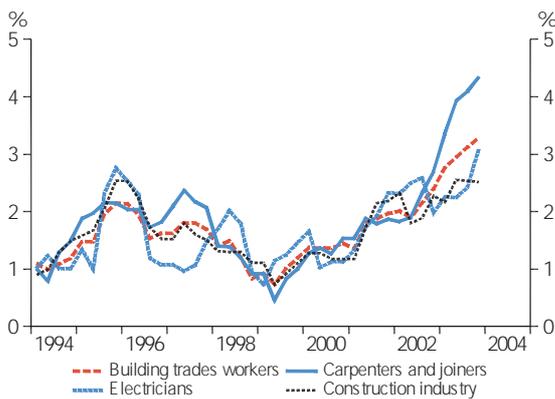
Source: Statistics New Zealand.

The Quarterly Employment Survey's measure of average hourly earnings is a relatively volatile measure of wages because it does not adjust for compositional changes within the labour force. The rate of increase in this measure appears to have trended up over the past few years, although there have been falls in both the September and December quarters.

This picture of still relatively moderate wage increases may be surprising given the indicators of resource pressure, especially in areas such as the construction industry. Digging into the details, there appear to be pockets of very strong

labour cost pressure in some parts of the industry, particularly for some construction-related trades workers. Labour cost increases for carpenters and joiners, electricians, and buildings trades' workers reached historical highs in the December quarter (figure 37). The construction sector has been the most important positive contributor to CPI inflation recently, and strong pockets of wage pressure in this sector raise the risk that inflation pressures in this sector could continue if a feedback from wages to prices occurs. This feedback from wages to prices is suggested by reports from Statistics New Zealand that of the increases in surveyed construction prices in the December quarter CPI, 62 percent of respondents cited rising labour costs as a reason for increased prices.

Figure 37
Construction industry labour costs
(annual percentage change)



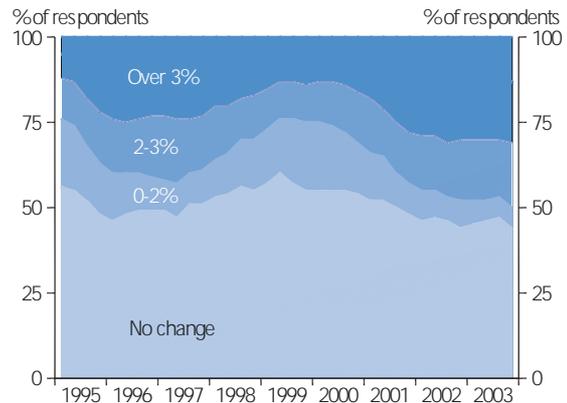
Source: Statistics New Zealand.

Discussions with our business contacts suggest that although overall wage movements remain moderate, firms increasingly have to offer higher wages to attract new staff, particularly skilled workers. In addition, recent movements in the distribution of wage increases suggest that although a significant proportion of respondents continue to receive annual wage increases of less than 2 per cent, the proportion receiving wage increases of more than 3 per cent has increased slightly (figure 38). Although spillover remains limited, it may be starting to occur.

An additional issue not captured by the wage statistics is growth in non-wage forms of labour costs. These may have contributed to increases in construction costs, professional fees and other services costs, which have been a factor behind increases in non-tradables inflation discussed earlier.

Changes in inflation expectations can also have a significant effect on wage, price and cost setting behaviour

Figure 38
Distribution of wage increases

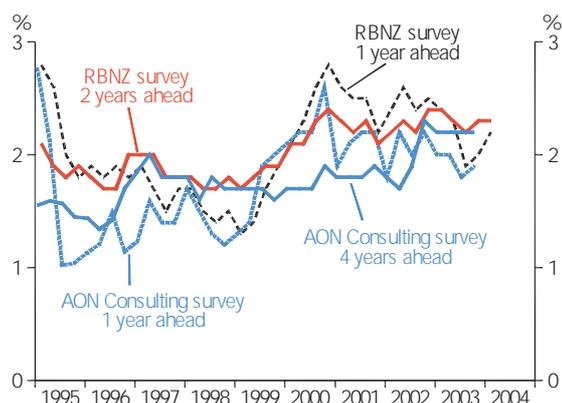


Source: Statistics New Zealand.

of firms and wage earners. Temporary fluctuations in the rate of CPI inflation that become ingrained in inflation expectations can begin to affect behaviour, and hence the medium-term trend of inflation.

Survey measures of inflation expectations one-year ahead tend to follow actual inflation relatively closely. Measures from the Marketscope survey (covering households), the RBNZ survey of expectations, the National Bank survey of pricing intentions, and the AON Consulting survey (all covering business or professional audiences) edged down over most of 2003, likely reflecting falling CPI inflation due to the appreciation of the New Zealand dollar. More recently, these measures have ticked up, which may reflect a view that the exchange rate-related fall in inflation is likely to be temporary. This is supported by longer-horizon measures of inflation expectations, which have been steadier than the one-year horizon measures (figure 39).

Figure 39
Expected inflation
(annual rate)



Source: AON Consulting, RBNZ.

4 The macroeconomic outlook

Overview

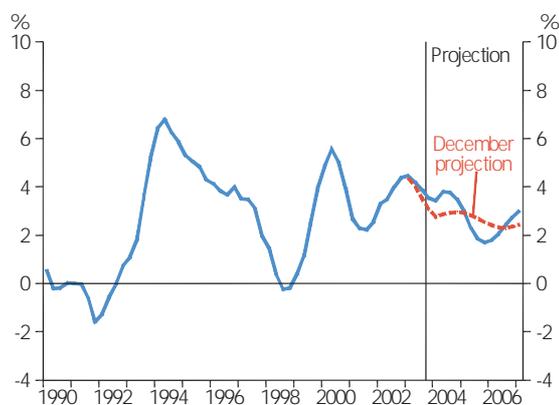
This chapter – and the accompanying tables in the Appendix – sets out an updated projection of economic conditions and the policy outlook. As always, the economic outlook is subject to a range of uncertainties and is contingent on a number of key assumptions and judgements – some of which are not easily represented numerically. 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 few years, and what they might mean for monetary policy over that time.

These projections show further solid GDP growth over the first half of 2004, with growth slowing sharply in the period beyond. Domestic demand is expected to produce most of that near-term growth, before slowing through 2005 as the lagged effects of the strong net immigration through 2002/03 pass. In addition, the effects of the strong exchange rate and declining domestic currency export prices continue to keep the export sector under pressure. Increased government spending from 2005 is expected to contribute positively to GDP growth in the later years of the projection.

Compared to December, the GDP growth outlook is stronger to the middle of 2004 but weaker during 2005 (figure 40). Domestic demand has continued to surprise on the upside, and the outlook for the global economy continues to show signs of improvement. However, further exchange rate appreciation and lower than projected net immigration suggest that growth is likely to be quite a bit weaker through 2005. Partially offsetting this additional weakness, the new fiscal spending initiatives outlined in the Treasury's December Economic and Fiscal Update are likely to provide more support to GDP growth from the middle of 2005.

Although the recent exchange rate appreciation is expected to continue putting downward pressure on the price of imported goods, existing strong demand in the domestic sector is projected to edge the CPI inflation rate higher over the next twelve months. On balance, the lagged effects of the rising exchange rate and declining migrant inflows on activity are expected to be largely sufficient to contain CPI inflation within the 1 to 3 per cent target range over the projection horizon. These projections assume that interest rates edge marginally higher to a more neutral level, assisting the reduction in domestic inflation pressures.

Figure 40
GDP
(annual average percentage change)



Source: Statistics New Zealand, RBNZ calculations.

The world economy

Our view on the outlook for New Zealand's main trading partners is largely based on external analysis of individual country prospects. Most of our focus is on understanding the channels through which the international economy is likely to influence activity and prices in New Zealand, the risks and uncertainties around the growth outlook, and the key structural issues that may be affecting trading partners. However, a useful benchmark for the growth outlook for our 12 main trading partners is *Consensus Forecasts*, a structured survey of the main forecasters in the various countries.

The outlook for New Zealand's main trading partners has continued to improve over the past twelve months. Optimism surrounding the outlook is translating into stronger economic data in a number of countries. Growth in the US remained strong in the second half of 2003, driven by strong growth in household consumption and firms' capital investment. Further growth is expected in the near term. The improved outlook for the US economy has supported the prospects for further growth in the economies of our other trading partners. Although risks remain around the robustness of the global recovery, external commentators are increasingly convinced of a sustained recovery. This has been reflected in further, albeit mild, upward revisions to *Consensus Forecasts* (figure 41). Current *Consensus Forecasts* are for a relatively moderate-paced recovery over 2004 and 2005 (see table 2).

While risks clearly exist around this projection for trading partner growth, we currently see them as being fairly balanced. There is the potential that a continuation of the

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

Country	2001	2002	2003f	2004f	2005f	2006f
Australia	2.6	3.6	2.8	3.8	3.4	3.5
United States	0.3	2.4	3.1	4.6	3.6	3.3
Japan	0.4	0.2	2.7	2.2	1.7	1.9
Canada	1.9	3.3	1.6	2.9	3.3	3.1
Eurozone**	1.6	0.9	0.4	1.8	2.2	3.3
United Kingdom	2.1	1.7	2.1	2.8	2.6	2.1
Asia ex-Japan***	1.8	5.0	4.6	6.2	5.8	5.7
12 country index	1.5	2.7	2.9	3.9	3.9	3.4

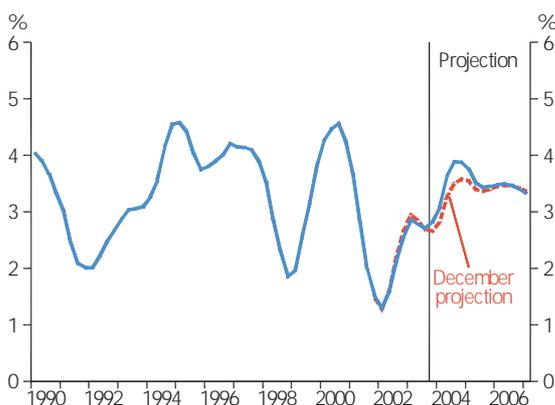
* Source: Consensus Economics Inc.

** Includes Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain.

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

historically low official interest rates and fiscal stimulus in the US could lead to stronger US growth than we have assumed here. Higher US growth would in turn help to reinforce the growth outlook of many of New Zealand's other trading partners such as Australia and the countries in Asia. However, significant structural imbalances remain in several of our trading partners, the unwinding of which may continue to hamper the global recovery.

Figure 41
Trading partner GDP
(annual average percentage change)



Source: Consensus Economics Inc, RBNZ calculations.

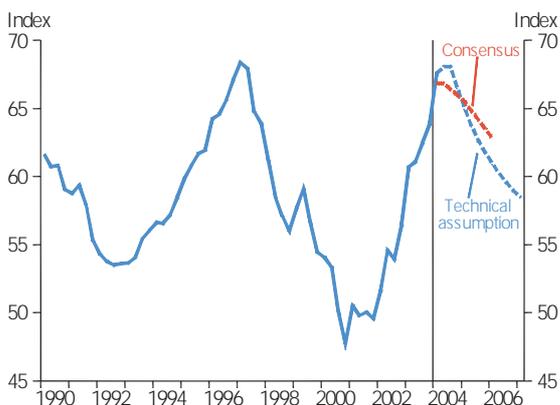
Tradables sector prices and activity

The decline in export incomes discussed in Chapter 3 is expected to continue in the near term, as domestic currency export prices decline and export volumes remain weak. Lower export incomes are projected to lead to a moderation in GDP growth.

The outlook for export prices measured in domestic currency depends on the outlooks for the exchange rate and for world export prices. The exchange rate is starting from a level that is around 5 per cent higher than we had assumed in December. In line with our recent practice, we have assumed that the trade-weighted exchange rate remains at its recently attained level (around 68 on the TWI) until near the end of this year, before falling back gradually towards its long run average level. This profile for the TWI is broadly in line with the expected slowing in the domestic economy and an expected decline in the differential between New Zealand interest rates and those of our main trading partners.

A number of the key risks around our exchange rate assumption were outlined in Chapter 2. One area of uncertainty is the speed with which the exchange rate returns to trend. Our assumed speed of convergence is broadly consistent with previous exchange rate cycles, but a slower or faster pace of convergence is also plausible. On balance, private forecasters have effectively adopted a future path for the exchange rate that is similar to our own (figure 42).

Figure 42
Trade weighted exchange rate



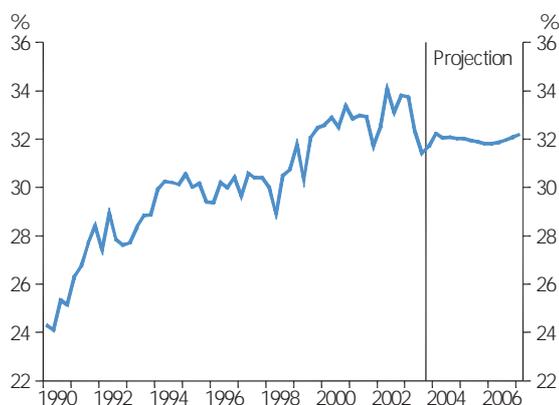
Source: Consensus Economics Inc, RBNZ calculations.

As discussed in Chapter 3, world export prices have remained strong over recent quarters, and indicators such as the ANZ and CBA world commodity price indices suggest this strength will continue in the near term. In terms of New Zealand dollars, these relatively high world prices for our commodities are serving as a partial offset to the negative effects of the rising New Zealand dollar. However, we are projecting world commodity prices to ease over the second half of the year – as temporary supply factors unwind – to a level more consistent with the modest growth path we are assuming for world demand.

Overall, domestic currency export prices are expected to fall further in the near term as a result of recent strength in the exchange rate, and to recover from later this year as the exchange rate is assumed to depreciate. The impact of these price changes on exporters' incomes will be delayed for some exporters, particularly those with long-term foreign exchange contracts.

We are now projecting a weaker forecast for export volumes over the next few years. Part of this reflects weaker than expected outturns, and part reflects the additional exchange rate appreciation that has occurred since the December projections. Most of the projected weakness in export volumes is in the exports of services, which we believe are relatively more impaired by an overvalued exchange rate than are exports of goods. Taking these factors into account, we expect export volumes to remain relatively flat as a share of GDP over the next few years (figure 43). This flat projection is consistent with what we observed following the mid-1990's exchange rate appreciation.

Figure 43
Export volumes
(% of trend output)



Source: Statistics New Zealand, RBNZ calculations.

Consequently, export sector incomes remain low compared to recent years, and we expect this to start providing a significant brake on the economy from around the middle of this year. This is consistent with the exchange rate having moved into contractionary territory around eighteen months ago, and the long lags that occur before aggregate export volumes are affected.

Our forecasts for primary sector exports rely heavily on the advice of the various primary sector agencies and companies. Their views on the outlook for the primary sector take into account detailed factors like climatic conditions, stocks and productivity, and conditions in individual markets. Based on these views, the outlook for agricultural exports is expected to be similar to that assumed in the December projections. Primary sector export volumes were very weak through the middle of 2003, largely reflecting the lagged effects of the 2002/03 summer drought. Some of the weakness appears to have also been a consequence of some exporters increasing their stocks temporarily, awaiting improved global demand conditions. Leading indicators suggest that these increased stocks are now being exported, supporting near-term agricultural export growth. We do not expect the drier than usual weather during the most recent summer or the floods in the lower North Island to have a significant impact on primary sector production (see box 2). Forestry exports are expected to remain weak for some time.

Exports of services are also assumed to be weaker than in our December projection, remaining relatively flat over the projection period. Contrary to our expectations, exports of

Box 2

The North Island floods

Storms and flooding during February caused significant damage to homes, farms, and infrastructure throughout many parts of the lower North Island. In formulating our latest projections, we have borne these losses in mind, whilst also recognising that a significant rebuilding of the capital stock will occur over the coming months.

An important issue is how the floods will affect economic activity and the overall balance of pressure on productive resources. Lower primary production and the flow-on effects of weaker incomes for those affected will directly reduce activity. Those farms experiencing stock, crop or other major damage will face losses in earnings. In some cases, these losses will be large. Our estimates suggest that lost export earnings could plausibly be as high as \$60 million over the coming year. Loss of earnings while farmers rebuild may also involve some additional downstream impacts on spending – for example, through reduced on-farm employment.

On the supply side, damage to land and the capital stock represents a direct reduction in the economy's capacity to supply goods and services. However, much of this damage will be repaired over the coming months

returning the capital stock to levels similar to its pre-flood state. Some estimates suggest that the cost of damage could exceed \$300 million. The associated rebuilding work will presumably be spread over a number of quarters. The rebuilding process could place additional pressures on an already stretched construction sector. A shortage of skilled trades-people in affected areas may exacerbate such pressures. To some extent, rebuilding efforts in the lower North Island may divert equipment and labour away from other areas and projects resulting in a deferral of other work, stretching out the overall time taken to repair damage and possibly causing some increased price pressures.

Our assumption is that rebuilding will be funded through a combination of private (insurance and private savings) and public (central and local government) monies. In some cases, funding is likely to come from existing budgets, resulting in some shift in priorities for public works.

Overall, while the effects of the flooding have been severe for some, for the economy as a whole the effects may not be large. However, we will continue to refine our estimates of the impact of the floods on economic activity and the capital stock as we receive further information.

services continued to decline following the SARS-induced fall earlier last year. Given reports of a good summer tourist season in New Zealand, we expect exports of services to recover some of this fall over the first two quarters of the projection. Beyond then, the higher exchange rate is expected to deter many tourists and international students from visiting New Zealand, having a significant dampening effect on exports of services. As was discussed in Chapter 3, one of the reasons for the observed weakness in exports of services was that spending per tourist has declined, possibly reflecting a change in the composition of the tourists visiting New Zealand and the influence of the higher exchange rate. A continuation of this pattern would add further downside risk to our exports of services projection.

In contrast, export volumes of manufactured goods have continued to grow modestly over the past year or so. Part of this strength may be because many of our manufactured

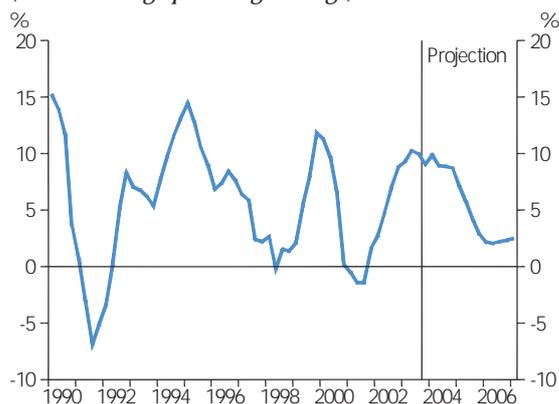
goods are exported to Australia. The Australian economy has performed much better than those of most of our other trading partners, and the New Zealand dollar has not appreciated against the Australian dollar to the same extent as it has against other currencies. Nevertheless, the exchange rate remains strong and is putting downward pressure on prices, and therefore profitability is under some pressure. In addition, competition from foreign competitors is intense. Taking into account these factors, we are expecting a moderate outlook for growth in manufactured export volumes.

As with export prices, the rising exchange rate is putting significant downward pressure on New Zealand dollar import prices. Hence, while the exchange rate is significantly reducing exporters' incomes, it is also serving to boost the purchasing power of others in the economy. However, much of that extra

demand appears to have been met via imports, leading to a continued fall in New Zealand's net export position. Looking ahead, import growth is expected to exceed GDP growth over the coming year, reflecting continued strong growth in domestic demand and the high exchange rate reducing New Zealand dollar import prices. Thereafter, import growth eases, as the exchange rate depreciates and domestic demand growth begins to slow (figure 44).

These projections assume that the high exchange rate will encourage consumers and firms to source a higher proportion of their purchases from offshore. To date we have seen firms purchasing a higher proportion of investment goods from offshore, but this is less so for consumer goods.

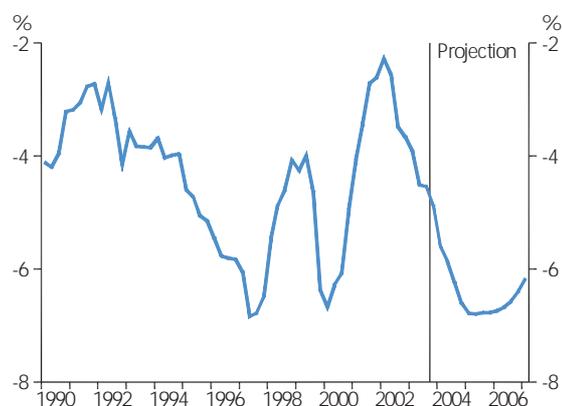
Figure 44
Import volumes
(annual average percentage change)



Source: Statistics New Zealand, RBNZ calculations.

Our outlook for export and import activity implies a further widening in New Zealand's current account deficit over the coming two years to a peak of nearly 7 per cent of GDP (figure 45). Most of the deterioration in the current account is a consequence of growth in import volumes outpacing that of exports, rather than due to a large decline in the terms of trade – which we project to be supported by the improving global demand outlook. Also underlying this current account projection is an assumption that the investment income balance remains relatively stable as a share of GDP.

Figure 45
Current account balance
(% of nominal output)



Source: Statistics New Zealand, RBNZ calculations.

Domestic spending

Domestic demand has recorded very strong growth over the past few years. Strong net immigration over 2002/03 has boosted household consumption and residential investment. As was discussed in Chapter 3, improved household wealth associated with very strong house price inflation is likely to also be providing a significant boost to household consumption. In addition, business investment has grown quite strongly in recent times, despite firms not being overly optimistic about the economy going forward. After some further additional strength, we expect a sharp slowing in domestic demand growth over the projection horizon.

For some time we have been expecting net immigration to begin to ease, with arrivals peaking and departures picking up. Recent data suggest that this is occurring faster than we had expected. As discussed in box 3, we expect net immigration to continue to add modestly to the population over the projection, albeit at much slower rates than we have seen recently.

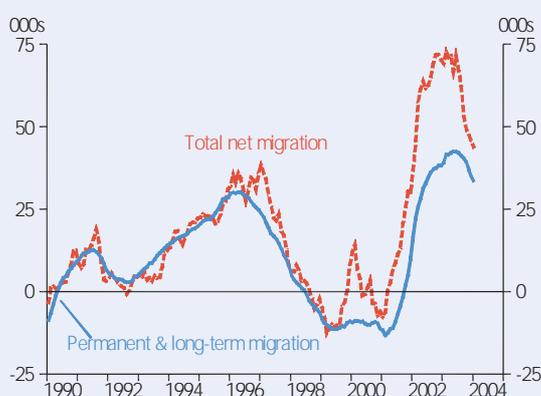
Residential investment growth continues to be boosted by the lagged effect of the strong population growth seen during 2002/03, and residential building consents data suggest that this has continued into 2004. Beyond that, there have been a few limited indicators that suggest the demand for housing may be nearing its peak. However, as we have mentioned in previous *Statements*, we are seeing widespread reports of capacity constraints in the construction industry and expect the resulting backlogs of work to keep residential investment holding up at relatively high levels throughout

Box 3

Trends in net immigration

Our assumption on the outlook for net immigration has an important bearing on our forecasts of domestic demand pressures. In light of weaker than expected net immigration and the likelihood that current downward influences prevail for a while longer, we conclude it is appropriate to revise down our assumed outlook for net immigration relative to previous projections.

Figure 46
Net total and PLT immigration



Source: Statistics New Zealand.

Net permanent and long-term (PLT) migration has fallen from peaks seen in the first half of 2003 (figure 46). In addition, the large discrepancy between net total migration and net PLT migration we have previously noted is closing sharply. Examining PLT statistics on arrivals and departures and New Zealand Immigration Service approvals data reveals:

- fewer non-NZ citizen arrivals, driven by lower growth in international student inflows;
- a pick up in departures of New Zealanders; and
- an increase in non-NZ citizen departures.

Four factors have contributed to the recent turnaround in key migration trends.

1 *Immigration policy changes*

The general slowdown in non-NZ citizen arrivals might reflect transitional policy arrangements that operated prior

to the introduction of the new Skilled Migrant category in December 2003. Under interim arrangements only residency applications with a skilled job offer were considered. Other applications made under the old General Skills category were lapsed. It is too early to tell what effect the new category will have on future migrant inflows. However, the immigration programme currently remains at 45,000. In addition, under the new arrangements the New Zealand Immigration Service is able to undertake targeted promotions abroad to attract expressions of interest. At current levels, monthly approvals are consistent with the immigration programme.

2 *A downturn in New Zealand's international education sector*

International student numbers are under some pressure. Headwinds include an initiative by the Chinese government to promote only accredited education providers in order to raise the quality of providers, with many NZ institutions not yet accredited. At the margin a strong New Zealand dollar is probably also reducing some international students' demand for studying in New Zealand. In addition, some high profile closures of English language schools in the past year have had a negative impact on the sector's reputation.

3 *Improved global economy and fading security concerns*

A pick-up in the global economic outlook and fading health/security concerns have improved prospects for young New Zealanders to live and work overseas. The recent pick-up in departures of New Zealanders probably reflects a return to normal flows, which we expect to persist.

4 *Turnaround in earlier large inflows of non-New Zealand citizens*

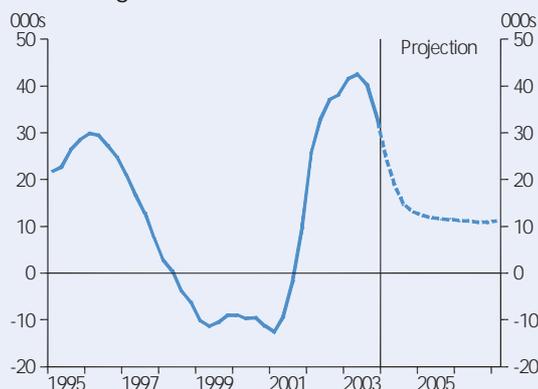
Departures of non-New Zealand citizens have increased recently partly due to international students completing their studies. This trend will probably continue as earlier strong arrivals unwind.

We expect these factors to continue to have a downward effect on net immigration over the next few years. As a result we have reduced our assumptions for net immigration (figure 47). In our central scenario we expect

net immigration to weaken significantly relative to the levels seen in 2003, but to remain positive over the forecast horizon.

Although our latest net immigration assumptions are consistent with market expectations, there is a risk that net immigration flows could differ significantly given the difficulty in predicting such flows.

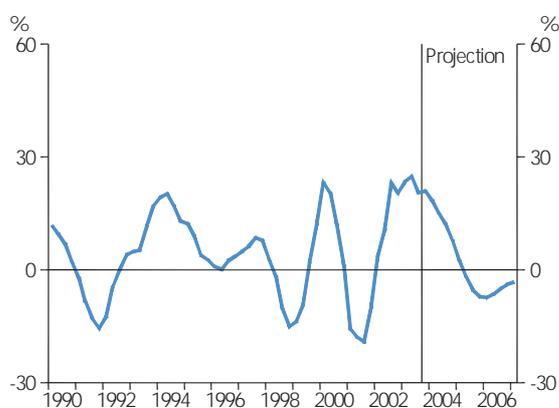
Figure 47
Net immigration



Source: Statistics New Zealand, RBNZ estimates.

2004. By 2005, slowing population growth is likely to reduce the demand for new houses, with new housing activity likely to fall away (figure 48).

Figure 48
Residential investment
(annual average percentage change)

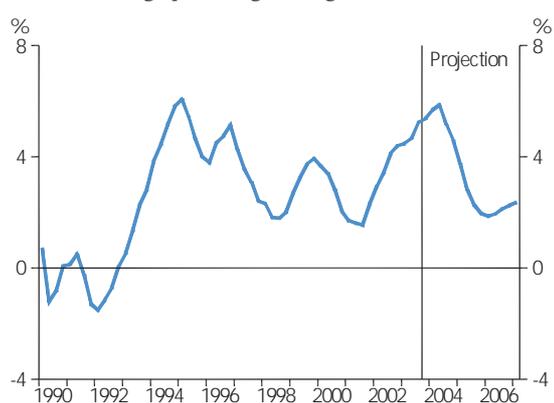


Source: Statistics New Zealand, RBNZ calculations.

As discussed in Chapter 3, the house price inflation associated with the strong housing market cycle over the past two years has improved household wealth, and has served to provide a significant boost to household consumption, despite incomes being under pressure from declining export revenues. Consistent with declining population growth and the associated 'cooling down' of the residential property market, we expect house price inflation to fall sharply over the course of 2004/05. As such, we expect household wealth to continue to grow strongly for the next two quarters, before levelling off towards the end of the year.

Given the view that household wealth has continued to grow rapidly to date, we expect household consumption to continue to grow strongly until around the middle of this year – albeit at slower rates than seen recently. Beyond that point, we expect the more subdued outlook for housing wealth and limited employment growth to reduce the growth rate in consumption quite sharply. Declining population growth will also contribute significantly to lower household consumption growth through 2005 (figure 49).

Figure 49
Household consumption
(annual average percentage change)



Source: Statistics New Zealand, RBNZ calculations.

The recent pick-up in permanent and long-term departures could be the start of a stronger trend than we have allowed for, and could subsequently lead to weaker domestic demand. In addition, exporters' incomes, and hence their consumption patterns, may be hit harder by the

exchange rate's appreciation than we have assumed. Conversely, house prices may rise further than we have assumed, providing a further boost to household wealth and hence consumption, at least in the near term.

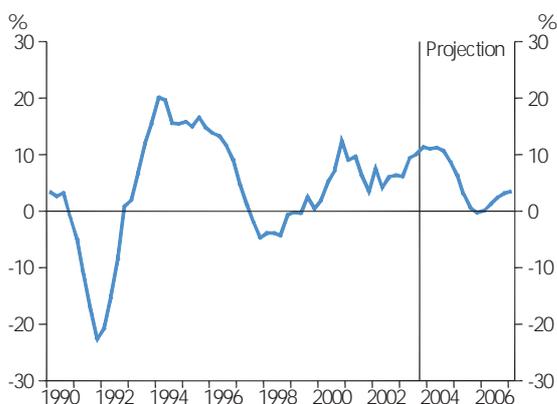
Business investment has accelerated recently, and indicators such as firms' investment intentions suggest that this increase may continue. This is supported by discussions with our business contacts, with most firms reporting an intention to continue investing at around current levels. As discussed in Chapter 3, the value of consents for non-residential buildings appears to be trending up, and we expect this to lead to an increase in commercial construction activity during the first half of 2004. In addition, imports of capital goods have been strong, suggesting firms are taking advantage of the high exchange rate to purchase investment goods from offshore more cheaply. As a result, we project further strong investment growth over the next few quarters, before slowing as the domestic economy cools (figure 50).

One risk to this business investment projection is that the recent reduction in surveyed business confidence leads to a sooner or sharper decline in business investment growth than we have assumed.

Fiscal policy

Our projections of the fiscal position and the contributions of the government's fiscal operations on economic activity are based on the Treasury's December Economic and Fiscal Update (DEFU). However, our projected fiscal outlook also incorporates our own assessment of the economic cycle, which affects projections of tax revenues and some transfer payments, such as unemployment benefits. Relative to our December projections, these forecasts have higher government expenditure for the three years from 2005. This higher expenditure is projected to be reflected in increased government consumption, investment, and transfers. On its own, this higher expenditure would provide significant stimulus to the domestic economy in the later years of the projection. Some offset to this higher spending has come from the fact that tax revenues have been stronger than expected over the past twelve months. While we believe some of this increase in tax revenues is likely to persist, we have assumed that some of the increase is due to the current strength of the economy. Consequently we expect some of these gains to unwind as the economy slows. In total, we see the increased government spending as likely to provide more stimulus to the economy than the increased revenues will offset.

Figure 50
Business investment
(annual average percentage change)



Source: Statistics New Zealand, RBNZ calculations.

Inflation and monetary policy

On average over the projection period, CPI inflation is projected to remain comfortably within the 1 to 3 per cent target range. The profile for CPI inflation is shaped by our assumption for the exchange rate and the monetary policy stance. In the near-term, the recent appreciation of the exchange rate continues to place downward pressure on CPI inflation by reducing the prices of tradable goods. However, the higher than expected inflation reading for Q4 2003 and the stronger near-term economic activity has prompted us to increase our near-term projection for non-tradables inflation, with the annual non-tradables inflation rate now projected to peak just above 5 per cent around the middle of this year.

Later in the projection period, the exchange rate starts depreciating towards its long term average, helping to push

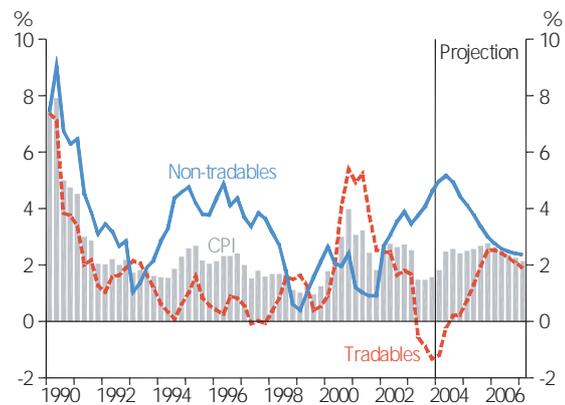
annual tradables inflation up to around 2.4 per cent. Working to offset the rise in tradables inflation, slowing GDP growth is expected to reduce capacity constraints in the economy, and to lower domestic inflationary pressure.

The projected cooling in the domestic economy and the subsequent exchange rate depreciation are expected to combine to produce a gradual decline in firms' margins. In addition, we project the labour market to remain tight, keeping wage inflation around current levels for some time. While slower economic growth will reduce demand for labour – particularly in the residential construction sector, lower net immigration means that the supply of labour will not grow as quickly as it has over the past few years. Finally, inflation expectations are projected to remain around current levels, before easing towards the end of the projection.

Overall, CPI inflation is projected to increase over the next twelve months, before gradually declining from a peak of around 2.7 per cent (figure 51).

The slowing in GDP growth and medium-term CPI inflation is assumed to occur with interest rates that edge up slightly, to levels that are broadly neutral.

Figure 51
CPI, tradables and non-tradables inflation
(annual rate)



Source: Statistics New Zealand, RBNZ calculations.

Appendix 1¹

Summary tables

Table A

CPI inflation projections and monetary conditions

(CPI is in percentage changes)

		CPI* Quarterly	CPI** Annual	TWI	90-day bank bill rate
1997	Jun.	0.3	1.7	58.5	9.1
	Sep.	0.6	1.7	57.1	6.8
	Dec.	0.5	1.1	56.0	4.6
1999	Mar.	0.3	1.0	57.6	4.5
	Jun.	0.3	1.2	59.1	4.7
	Sep.	0.6	1.1	56.7	4.8
2000	Dec.	-0.1	1.3	54.4	5.4
	Mar.	0.2	1.7	54.1	6.0
	Jun.	0.5	0.9	53.4	6.7
2001	Sep.	0.4	1.2	50.1	6.7
	Dec.	0.2	1.8	47.7	6.7
	Mar.	0.7	3.1	50.5	6.4
2002	Jun.	0.7	3.2	49.8	5.9
	Sep.	1.4	2.4	50.0	5.7
	Dec.	1.2	1.8	49.6	5.0
2003	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
2004	Dec.	0.6	2.7	56.4	5.9
	Mar.	0.4	2.5	60.7	5.8
	Jun.	0.0	1.5	61.1	5.4
2005	Sep.	0.5	1.5	62.4	5.1
	Dec.	0.7	1.6	63.9	5.3
2006	First half average	$\frac{3}{4}$	$2\frac{1}{4}$	$67\frac{3}{4}$	$5\frac{1}{2}$
	Second half average	$\frac{1}{2}$	$2\frac{1}{2}$	$67\frac{1}{4}$	$5\frac{3}{4}$
2007	First half average	$\frac{3}{4}$	$2\frac{1}{2}$	$64\frac{1}{4}$	$5\frac{3}{4}$
	Second half average	$\frac{3}{4}$	$2\frac{3}{4}$	$62\frac{1}{4}$	$5\frac{3}{4}$
2008	First half average	$\frac{1}{2}$	$2\frac{1}{2}$	$60\frac{1}{2}$	$5\frac{3}{4}$
	Second half average	$\frac{1}{2}$	$2\frac{1}{4}$	$59\frac{1}{4}$	$5\frac{3}{4}$

Quarterly projections

2003	Mar.	0.4	2.5
	Jun.	0.0	1.5
	Sep.	0.5	1.5
	Dec.	0.7	1.6
2004	Mar.	0.6	1.8
	Jun.	0.6	2.5

(1) Notes for these tables follow on page 33.

* 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				
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Final consumption expenditure										
Private	2.2	2.5	3.8	1.7	3.0	4.6	5 1/2	3 3/4	1 3/4	2 1/4
Public authority	8.8	-2.1	7.3	-2.1	4.6	2.3	2 3/4	4 1/2	3 1/4	4 1/2
Total	3.7	1.4	4.6	0.8	3.4	4.1	4 3/4	3 3/4	2 1/4	2 3/4
Gross fixed capital formation										
Market sector:										
Residential	3.0	-14.0	22.8	-15.7	3.4	23.4	18 1/2	2 1/2	-7 1/2	-3 1/4
Business	-4.0	-0.3	1.8	9.5	7.3	6.1	11 1/2	6 1/2	0	3 1/2
Non-market government sector	8.5	-1.6	16.2	-16.8	4.7	2.0	12 3/4	3 1/2	8 3/4	1 1/4
Total	-0.9	-4.1	8.6	-0.6	6.1	9.6	13 1/4	5	-1	1 3/4
Final domestic expenditure	2.7	0.2	5.4	0.5	3.9	5.2	6 3/4	4 1/4	1 1/2	2 1/2
Stockbuilding (1)	-0.1	-0.5	1.2	-0.4	0.3	-0.3	1/4	-1/4	1/4	0
Gross national expenditure	2.5	-0.2	6.6	0.1	4.2	4.8	6 3/4	3 3/4	1 1/2	2 3/4
Exports of goods and services	3.9	3.1	7.0	6.1	2.0	7.0	-1 3/4	4	2 3/4	3 3/4
Imports of goods and services	2.6	2.1	11.5	-0.4	2.4	9.4	9 3/4	7 1/4	2 1/4	2 1/2
Expenditure on GDP	2.9	0.1	5.2	2.2	4.0	4.1	3	2 3/4	1 3/4	3
GDP (production)	1.5	0.4	4.9	2.7	3.3	4.5	3 1/2	3	1 3/4	3
GDP (production, March qtr to March qtr)	0.1	2.4	6.1	0.9	4.0	4.3	4	1 3/4	2 1/4	3 1/4
Potential output	2.9	2.4	2.6	2.8	3.1	3.4	3 1/2	3 1/2	3 1/2	3 1/4
Output gap (% of potential GDP, year average)	0.1	-1.9	0.2	0.1	0.3	1.3	1 1/4	3/4	-3/4	-1

(1) 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				
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Price measures										
CPI*	1.7	1.0	1.7	3.1	2.6	2.5	1 3/4	2 1/2	2 3/4	2 1/4
Labour costs	1.9	1.6	1.4	1.6	2.1	2.2	2 1/4	2 1/4	2 1/4	2
Import prices (in New Zealand dollars)	2.9	2.7	11.2	7.4	-2.9	-11.1	-8 1/2	8 1/2	6 1/4	4 1/4
Export prices (in New Zealand dollars)	4.2	-0.6	9.9	20.6	-3.5	-15.5	-8 1/4	4 3/4	6 1/4	4 3/4
Monetary conditions										
90-day rate (year average)	8.0	6.2	5.2	6.6	5.4	5.9	5 1/4	5 3/4	5 3/4	5 3/4
TWI (year average)	64.4	57.3	56.1	50.4	50.3	56.4	63 3/4	67	62 1/4	59 1/4
Output										
GDP (production, annual average % change)	1.5	0.4	4.9	2.7	3.3	4.5	3 1/2	3	1 3/4	3
GDP (production, March qtr to March qtr)	0.1	2.4	6.1	0.9	4.0	4.3	4	1 3/4	2 1/4	3 1/4
Output gap (% of potential GDP, year average)	0.1	-1.9	0.2	0.1	0.3	1.3	1 1/4	3/4	-3/4	-1
Labour market										
Total employment	0.0	0.6	1.4	2.3	3.5	1.5	2 3/4	1 1/4	1/2	3/4
Unemployment rate (March qtr, s.a.)	7.2	7.2	6.3	5.4	5.2	4.9	4 1/2	4 1/2	5 1/4	5 1/2
Trend labour productivity (annual % change)	1.3	1.5	1.5	1.5	1.5	1.3	1 1/4	1 1/2	1 3/4	2
Key balances										
Government operating balance (% of GDP, year to June)	2.5	1.7	1.3	1.2	1.9	1.5	4 1/2	4	3 1/4	3
Current account balance (% of GDP, year to March)	-5.5	-4.3	-6.7	-4.1	-2.3	-3.9	-5 3/4	-6 3/4	-6 3/4	-6 1/4
Terms of trade (OTI measure, annual average % change)	-1.0	-0.4	-0.2	4.4	4.2	-5.7	2	-4 3/4	1/4	1/2
Household savings rate	-4.0	-4.8	-0.8	-4.4	-3.0	-8.2	-11	-11 1/2	-9 3/4	-8 3/4
World economy										
World GDP (annual average % change)	3.5	2.0	4.3	3.7	1.3	2.9	3 1/4	3 3/4	3 1/2	3 1/4
World CPI inflation	2.2	1.1	2.0	2.7	1.4	2.2	1 1/4	1 1/2	1 3/4	1 3/4

s.a. = seasonally adjusted

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

Notes to the tables

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

Total employment	<i>Household Labour Force Survey.</i>
Unemployment rate	<i>Household Labour Force Survey.</i>
Household savings rate	<i>Household Income and Outlay Accounts.</i>
Government operating balance	Historical source The Treasury. Adjusted by the RBNZ over the projection period.
Labour productivity	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.

Appendix 2

Chronology

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

2003

4 December The Reserve Bank released its fortieth Monetary Policy Statement, leaving the Official Cash Rate unchanged at 5.0 per cent. The news release accompanying the Statement is reproduced in Appendix 4.

19 December Production GDP figures were released showing that the New Zealand economy grew by 1.5 per cent in the September quarter of 2003.

2004

20 January CPI statistics were released for the December quarter of 2003 showing that the CPI increased by 0.7 per cent over the quarter, and by 1.6 per cent in the year to December 2003.

29 January At the intra-quarter review, the Reserve bank increased the Official Cash Rate from 5.0 per cent to 5.25 per cent. The accompanying news release is reproduced in Appendix 4.

Appendix 3

Companies and organisations contacted by RBNZ staff during the projection round

Alliance Group Ltd

Canterbury Meat Packers Ltd

Christchurch International Airport Ltd

Employers & Manufacturers Association (Manufacturing Division)

Farmers Ltd

Fisher & Paykel Limited (Whiteware Division)

Fletcher Building Limited

Fonterra Co-operative Group Ltd

Jade Software Corporation

Kirkaldie & Stains Ltd

M-Co Ltd

Ministry of Agriculture & Forestry

Morgan Furniture Ltd

Motor Trade Finances Ltd

New Zealand Meat & Wool Innovation Ltd

New Zealand Tourism Board

Port of Tauranga Ltd

Real Estate Institute of New Zealand

Rembrandt Ltd

Retail Merchants Association

The Warehouse Ltd

Wenita Forest Ltd

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

Appendix 4

Reserve Bank statements on monetary policy

OCR unchanged

4 December 2003

The Reserve Bank today decided to leave the Official Cash Rate unchanged at 5.0 per cent.

Reserve Bank Governor Alan Bollard commented "In saying that, small increases in the OCR may be required over the year ahead to ensure that inflation remains comfortably within the target range over the medium term.

"New Zealand's economy has continued to perform well in 2003, although growth has been seated in the domestic economy rather than the export sector, where earnings are under pressure from the rising NZ dollar. New Zealand's current account deficit is again building and some key asset prices appear to be moving beyond their sustainable level. The strong activity, especially in housing and construction, spurred by rapid population growth and high consumer confidence, has produced quite intense inflation pressures in parts of the domestic economy.

"Despite the domestic inflation pressures, CPI inflation has fallen over the past year largely due to falling import prices. Although the immediate outlook for the exchange rate is uncertain, the sharp falls in import prices seem unlikely to be sustained. CPI inflation is therefore expected to lift over the next year or so, driven by underlying domestic inflation pressure. Slower population growth and the flow-on effects of weaker export activity will help to limit inflation pressures, although a modest increase in the OCR may be required to keep inflation comfortably within the Bank's inflation target as defined in the Policy Targets Agreement.

"As always this assessment is subject to change as new economic data emerge. We will pay close attention to the path of the domestic economy, which has proven more robust over 2003 than we expected. We will also be closely monitoring the path of the New Zealand dollar, with a particular focus on what it means for the export sector and the medium-term path of inflation."

OCR increased to 5.25 per cent

29 January 2004

The Reserve Bank today increased the Official Cash Rate from 5 per cent to 5.25 per cent.

Governor Alan Bollard said "An increase in the OCR appears warranted to ensure that inflation remains comfortably within the target range over the medium term.

"The New Zealand economy has experienced a period of impressive growth over the past two years. But now productive capacity and the labour market are becoming relatively tight. Reflecting this, inflation pressures in some parts of the domestic economy have started to become more apparent. Although falling import prices due to the rising exchange rate have so far kept CPI inflation low, those reductions are unlikely to be sustained. If domestic inflation is left unchecked, the CPI may start to rise to uncomfortable levels.

"Data since December have pointed to stronger activity than we then thought in areas such as household spending, construction and the housing market, further fuelling inflation. Further inflation pressure is likely in the next few months from areas such as construction costs and energy. Interest rates have been stimulating demand as shown in further solid growth in household credit.

"On balance, these developments strengthen our view, foreshadowed in our December Monetary Policy Statement (MPS), that it is now prudent to begin returning interest rates to levels that will have less stimulatory effects on demand. By historical standards we do not expect that a large adjustment in interest rates will be necessary.

"By raising interest rates now, we hope to avoid having to increase interest rates more aggressively later on.

"The New Zealand dollar has risen sharply, and we are aware that this has placed pressure on the export sector. However, as yet this has not had much effect on spending in the local economy. In time this will happen, probably reducing the need for interest rates to rise as much as they otherwise might. We will need to monitor these trends, and will be reviewing the OCR in early March with the release of our next MPS".

Appendix 5

The Official Cash Rate chronology

Date	Change in OCR (basis points)	OCR (per cent)
17 March 1999	OCR introduced	4.50
21 April 1999	No change	4.50
19 May 1999	No change	4.50
30 June 1999	No change	4.50
18 August 1999	No change	4.50
29 September 1999	No change	4.50
17 November 1999	+ 50	5.00
19 January 2000	+ 25	5.25
15 March 2000	+ 50	5.75
19 April 2000	+ 25	6.00
17 May 2000	+ 50	6.50
5 July 2000	No change	6.50
16 August 2000	No change	6.50
4 October 2000	No change	6.50
6 December 2000	No change	6.50
24 January 2001	No change	6.50
14 March 2001	- 25	6.25
19 April 2001	- 25	6.00
16 May 2001	- 25	5.75
4 July 2001	No change	5.75
15 August 2001	No change	5.75
19 September 2001	- 50	5.25
3 October 2001	No change	5.25
14 November 2001	- 50	4.75
23 January 2002	No change	4.75
20 March 2002	+ 25	5.00
17 April 2002	+ 25	5.25
15 May 2002	+ 25	5.50
3 July 2002	+ 25	5.75
14 August 2002	No change	5.75
2 October 2002	No change	5.75
20 November 2002	No change	5.75
23 January 2003	No change	5.75
6 March 2003	No change	5.75
24 April 2003	-25	5.50
5 June 2003	-25	5.25
24 July 2003	-25	5.00
4 September 2003	No change	5.00
23 October 2003	No change	5.00
4 December 2003	No change	5.00
29 January 2004	+25	5.25

Appendix 6

Policy Targets Agreement

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

1. Price stability

- a) Under Section 8 of the Act the Reserve Bank is required to conduct monetary policy with the goal of maintaining a stable general level of prices
- b) The objective of the Government's economic policy is to promote sustainable and balanced economic development in order to create full employment, higher real incomes and a more equitable distribution of incomes. Price stability plays an important part in supporting the achievement of wider economic and social objectives.

2. Policy target

- a) In pursuing the objective of a stable general level of prices, the Bank shall monitor prices as measured by a range of price indices. The price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), as published by Statistics New Zealand.
- b) For the purpose of this agreement, the policy target shall be to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term.

3. Inflation variations around target

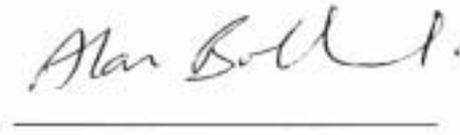
- a) For a variety of reasons, the actual annual rate of CPI inflation will vary around the medium-term trend of inflation, which is the focus of the policy target. Amongst these reasons, there is a range of events whose impact would normally be temporary. Such events include, for example, shifts in the aggregate price level as a result of exceptional movements in the prices of commodities traded in world markets, changes in indirect taxes, significant government policy changes that directly affect prices, or a natural disaster affecting a major part of the economy.
- b) When disturbances of the kind described in clause 3(a) arise, the Bank will respond consistent with meeting its medium-term target.

4. Communication, implementation and accountability

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



Hon Dr Michael Cullen
Minister of Finance



Dr Alan E Bollard
Governor Designate
Reserve Bank of New Zealand

Dated at Wellington this 17th day of September 2002