Monetary Policy Statement

December 2010[1]

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

Contents

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[1] Projections finalised on 26 November 2010. Policy assessment finalised on 8 December 2010.

1 Policy assessment

The Official Cash Rate (OCR) remains unchanged at 3.0 percent.

Interest rates are now projected to rise to a more limited extent over the next two years than signalled in the September *Statement*.

The pace of economic growth appears to have moderated. Corporate investment intentions are now below average. Household spending also remains weak, with household credit still flat and housing market activity slowing further. House prices may decline a little further in the near term. This continued household and business caution suggests current low interest rates are having a less stimulatory effect than in the past.

On the positive side, activity in New Zealand's trading partners continues to expand. Growth in the Asia-Pacific region remains strong, and growth in the US and UK has turned out a little stronger than was projected. Consistent with this, export commodity prices, which were already very high, continue to increase. While this is encouraging, downside risks to global growth and export prices persist.

Repairs to earthquake damage in Canterbury are expected to add to GDP growth over the projection period. The earthquake appears to have caused about $5 billion of damage to infrastructure, and residential and commercial property.

While the near-term outlook for GDP growth has softened, beyond this, higher export volumes and earthquake repairs are expected to push GDP growth above that projected in the September *Statement*. As growth recovers, current spare capacity will gradually be used up, causing underlying inflation to pick up. More immediately, the recent increase in the rate of GST will cause headline CPI inflation to spike higher temporarily, although there is little evidence of this spike affecting price and wage setting behaviour.

While interest rates are likely to increase modestly over the next two years, for now it seems prudent to keep the OCR low until the recovery becomes more robust and underlying inflationary pressures show more obvious signs of increasing.

The New Zealand dollar has appreciated significantly since the September *Statement*. Sustained strength in the currency is inhibiting the rebalancing of economic activity towards the tradable sector. Accelerated elimination of New Zealand's fiscal deficit could help improve national savings, thereby easing current pressure on interest rates and the New Zealand dollar, and reducing New Zealand's dependence on international borrowing.

Alan Bollard

Alan Bollard

Governor

2 Overview and key policy judgements

The pace of growth appears to have moderated, reflecting weak domestic demand and the constraining effects of the high New Zealand dollar. While growth is expected to strengthen over the coming year, for now it seems prudent to keep the OCR low until the recovery becomes more robust.

Aggregate activity was weaker than expected in the June quarter and forward indicators of growth have softened over recent months. This weakness partly reflects the continued cautious borrowing and spending behaviour of households and firms. When the September *Statement* was published, this caution was seen as reason to expect low interest rates to have a less stimulatory effect on the economy than had historically been the case. Developments since then suggest current interest rates are offering even less support than was assumed in the September *Statement*.

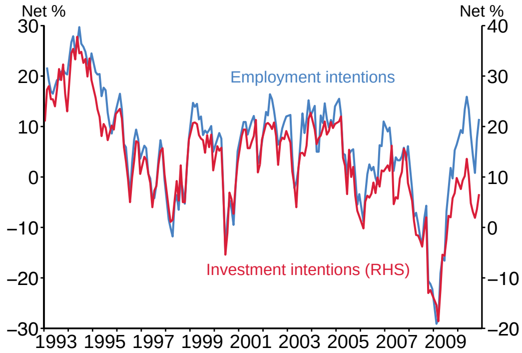
Indeed, despite the floating mortgage rate being below its historic norm, activity in the housing market has weakened further. While some of this slowing was driven by earthquake-related disruptions to the Canterbury housing market, reduced turnover was also observed elsewhere in New Zealand. The current level of house sales is consistent with further declines in house prices over the coming months.

Furthermore, while the interest rates faced by corporate borrowers currently sit close to their historic average, businesses remain reluctant to invest. It would seem firms would prefer not to increase debt at the moment, with many preferring to hire additional staff rather than make the more significant financial commitment required to purchase new capital equipment. The current divergence between hiring and investment intentions is very large by historic standards (figure 2.1).

It is not clear how persistent household and business caution will be. The credit boom and subsequent bust is of a magnitude not observed in New Zealand in recent history. As such, it is difficult to know just what the implications are of this swing in credit growth, nor how enduring these will be.

In addition to the softness in private demand, growth in government spending has also been weak and is likely to remain so throughout the projection. While the unwinding

Figure 2.1
Employment and investment intentions



Source: ANZ National Bank Ltd.

of the current large fiscal deficit is likely to subtract from domestic demand for some years, such a move seems prudent. A more rapid elimination of New Zealand's fiscal deficit than was projected in *Budget 2010* would help improve national savings, thereby easing current pressure on interest rates and the New Zealand dollar, and reducing New Zealand's dependence on international borrowing.

The New Zealand dollar has appreciated significantly since the September *Statement*. Sustained strength in the currency is inhibiting rebalancing of economic activity towards the tradable sector. In particular, continued strength of the New Zealand dollar is restraining tourist spending and further undermining the ability of the manufacturing sector to compete with imports.

On the positive side, activity in our trading partners continues to expand. As has been the case for some time, growth in the Asia-Pacific region remains strong. In addition, growth in the US and the UK has turned out better than was projected. Indeed, aggregate trading partner GDP has, for the past year and a half, consistently turned out stronger than forecast. Activity is currently 4.5 percent above that projected in the June 2009 *Monetary Policy Statement*.

This is not to say the downside risks to the global outlook discussed in recent *Statements* have disappeared. Far from it, the risks posed by high debt in Western economies continue, with downside risks to trading partner growth much more obvious than any upside risks.

New Zealand's export commodity prices continue to increase. These prices are well above even the highs seen in late 2007, with recent gains more than offsetting the recent appreciation in the New Zealand dollar. Global commodity prices are expected to ease only gradually over the projection.

While rural incomes will soon benefit substantially from these high prices, for now farm cash flow remains tight. The agricultural sector is highly indebted and many areas are still recovering from the effects of poor climatic conditions. In this regard, the recent deterioration in soil moisture, while still well above drought readings, is of concern.

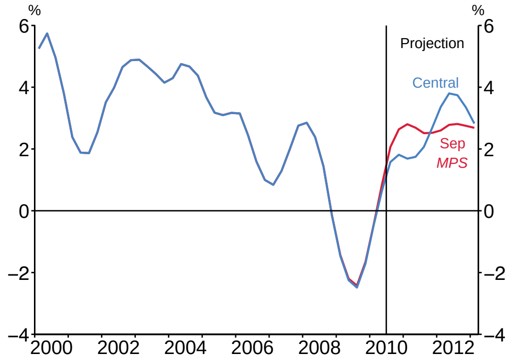
Repairs to earthquake damage in Canterbury are also likely to add to GDP growth over the projection. As well as causing significant trauma to the people of Canterbury, the earthquake appears to have caused about $5 billion of damage to infrastructure, and residential and commercial property. While this damage is obviously undesirable, offshore based reinsurers are likely to bear the majority of the cost of repairs and reconstruction. The majority of property is insured and underinsurance is quite limited.

To date, while some properties and essential infrastructure have been repaired, only a small proportion of reconstruction has occurred. However, once insurance payments are finalised, consents approved, and materials and workers sourced, construction sector activity in the Canterbury region will increase substantially. Because demand for trades people is likely to outstrip the number available, repairs to residential property and infrastructure will be spread out over at least the next two years. Repairs to commercial property are likely to be even more drawn out. Indeed, given high vacancy rates in Canterbury prior to the earthquake, it is quite possible that some property owners will not rebuild, choosing instead to reallocate insurance payments to alternative activities.

The Policy Targets Agreement gives guidance as to how monetary policy should react to the Canterbury earthquake. While defining inflation in terms of the Consumers Price Index, it instructs monetary policy to focus on the medium-term trend in inflation. This allows monetary policy to effectively ignore temporary disturbances to inflation. In the case of the Canterbury earthquake, such temporary influences could be increased rents over the next few months, or perhaps a short-lived spike in emergency call-out rates. Such disturbances will only influence monetary policy to the extent that the medium-term trend in inflation is affected.

In aggregate, the near-term outlook for aggregate activity has reduced, with annual average GDP growth likely to be below 2 percent for most of 2011. This is about a percentage point less than was predicted in the September *Statement*. Beyond this, gains in export volumes and earthquake repairs are expected to see GDP growth accelerate to almost 4 percent in the middle of 2012 – about a percentage point above that previously predicted (figure 2.2).

Figure 2.2
GDP growth
(annual average)

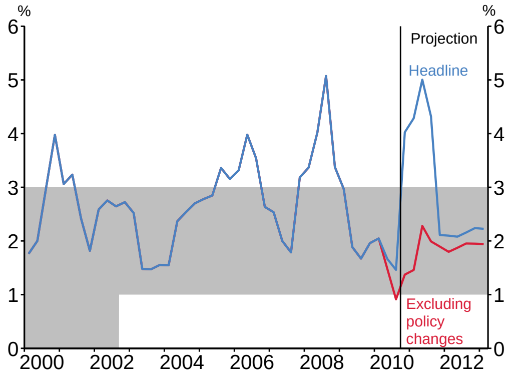


Source: Statistics New Zealand, RBNZ estimates.

Continued GDP growth will see spare resources gradually brought into productive use, causing underlying inflationary pressures to pick up from current weak levels. A modest increase in interest rates over the next two years is expected to offset this pick-up, such that annual CPI inflation tracks close to the midpoint of the target band over the latter part of the projection (figure 2.3).

More immediately, the recent increase in the rate of GST will cause headline CPI inflation to spike markedly higher. The central projection assumes this spike will have little impact on medium-term inflation expectations. Industry contacts suggest that wage claims are not seeking full GST compensation, with the reduction in personal income taxes offsetting the impact of the GST increase on household disposable incomes. Furthermore, previous indirect tax changes, both in New Zealand and abroad, have had little lasting impact on inflation. Monetary policy would act to offset any pick-up in medium-term inflation expectations.

Figure 2.3
CPI inflation
(annual)

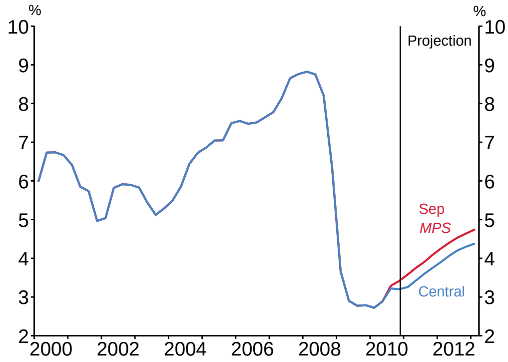


Source: Statistics New Zealand, RBNZ estimates. 'Excluding policy changes' is the Bank's CPI inflation projection which from the June quarter 2010 excludes the direct impact of the increase in the rate of GST, the incorporation of the stationary energy and liquid fuel sectors to the amended Emissions Trading Scheme, and increases in the excise tax on tobacco.

As has been the case in many recent *Statements*, the risks to the Bank's December growth projections are asymmetric. Again, New Zealand faces the risk that global conditions could deteriorate – either through activity in one of our major trading partners slowing sharply, or via a marked increase in international funding costs. In addition, the housing market is very weak at present, with little sign that activity is about to improve. Further declines in house prices would have a negative impact on household spending. While it is more likely that global growth remains robust and that recent employment gains induce some recovery in the housing market, these downside risks cannot be ignored.

As such, while interest rates are likely to increase modestly over the next two years, for now it seems prudent to keep the OCR low until the recovery becomes more robust and underlying inflationary pressures show more obvious signs of increasing (figure 2.4).

Figure 2.4
90-day interest rate



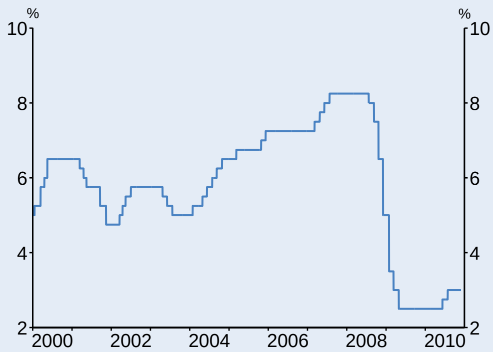
Source: RBNZ estimates.

Box A
Recent monetary policy decisions

The OCR was held at a record low 2.5 percent from the April 2009 OCR review through to the June 2010 *Statement*. This low OCR was appropriate given the extent to which bank funding costs increased, the New Zealand economy contracted and inflationary pressures abated during the 2008/09 recession. Indeed, policy stimulus appears to have helped avoid inflation falling excessively, with annual CPI inflation remaining near the centre of the target band for the past year and a half.

The OCR was increased by 25 basis points in June and July of this year (figure A1). The Bank judged that it was no longer appropriate to maintain the extraordinary level of support implemented during the recession. Since then, the OCR has been held constant.

Figure A1
Official Cash Rate



Source: RBNZ.

Box B

The implications of New Zealand's fiscal deficit

The fiscal balance has deteriorated sharply in recent years, worsening by about 7 percentage points of GDP since 2008. *Budget 2010* forecast a core Crown operating deficit (excluding valuation gains and losses) of 5.1 percent of GDP for the 2011 fiscal year.[1] As recently as 2008, this measure of fiscal balance was still in surplus by 2.7 percent of GDP.

Some of this deterioration has been due to the shift from the economy running beyond capacity through the middle part of the previous decade, to one with some surplus resources currently. In a buoyant economy, taxation revenue tends to rise as a share of GDP, without any new policy measures. The reverse happens when the economy is operating below potential. Core Crown revenue peaked at 34.5 percent of GDP in the year ended June 2006. *Budget 2010* projected that revenue would be 29.6 percent of GDP this year.

However, much of the deterioration in the fiscal position appears more structural, and will thus persist even as the effects of the recession fade. The Treasury estimates that the cyclically adjusted fiscal balance is in deficit by 4.0 percent of GDP. Similarly, the OECD estimates that New Zealand has a cyclically-adjusted general government deficit (a measure that captures central and local government, and capital and current spending) of around 3.5 percent of GDP.

Indeed, reduced tax rates and weakened trend growth in GDP will limit the extent of any future increase in taxation revenue. Moreover, many items of government spending (e.g. real spending on schools, hospitals, the core public service, or superannuation) are not much directly influenced by the state of the cycle. Unemployment benefit spending fluctuates, but the amounts are quite small. Almost all the increase in Core Crown operating spending, from 29 percent in 2005 to a projected 34.7 percent this year, reflects choices about policy programmes.

Furthermore, most cyclical adjustment measures do not take account of moves in the terms of trade.[2] Tax revenues are currently being boosted by a terms of trade that is well above its long-term average. As such, if part of the improvement in export prices is not sustained, the underlying structural deficit may even be larger than the Treasury and OECD estimates suggest.

Stimulatory fiscal policy helped support aggregate demand over recent years. However, that support has meant interest rates have probably been higher than they would otherwise have been. And it is likely that the exchange rate has also been higher than it would otherwise have been.

Discretionary actions to tighten fiscal policy typically result in some fall in the exchange rate, because monetary policy is typically set somewhat looser than otherwise to offset the reduction in domestic demand. Fiscal consolidations can sometimes boost the exchange rate as market confidence lifts. In contrast to the case in New Zealand, where sovereign debt is quite low, this sort of reaction typically occurs in cases where markets have already turned very negative on the fiscal situation of the country concerned and the exchange rate has already been under downward pressure.

The pressure the current exchange rate is placing on the tradable sector is significant. Improving national savings could relieve some of this pressure. Changing private sector savings behaviour is a slow process, whereas changing public sector savings can be made in the shorter term as an explicit policy choice.

1 The Treasury will release updated forecasts on 14 December.

2 This issue is discussed in "Estimating New Zealand's Structural Budget Balance", New Zealand Treasury *Working Paper* 10/08, November 2010.

3 Financial market developments

Overview

Global financial markets have experienced significant volatility since the September *Statement*. Investor sentiment was initially buoyed by expectations of further monetary stimulus from the US Federal Reserve. Such expectations provided strong support for a range of markets, helping to drive equity and commodity prices to new post-crisis highs. Since the Federal Open Market Committee (FOMC) announced a second round of quantitative easing in November, financial markets have retraced some of their earlier gains. These moves reflect a combination of renewed sovereign concerns about the peripheral European countries and fears that policy tightening in emerging market countries, particularly China, will dampen world growth.

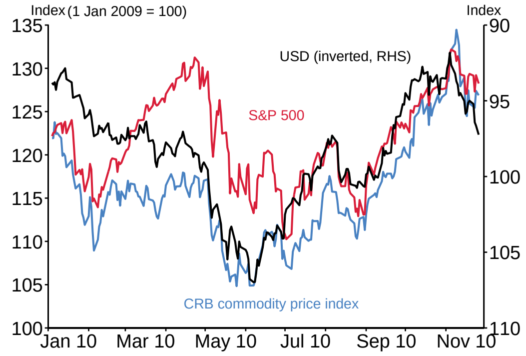
The speculation and subsequent announcement of further policy stimulus in the US has also had a significant influence on currency markets. The US dollar depreciated sharply through September and October as expectations of further monetary policy easing in the US developed. Since the FOMC announcement, the US dollar has rebounded somewhat, supported by better US economic data and safe-haven demand following a resurfacing of sovereign concerns in Europe. The New Zealand dollar has strengthened against most major trading-partner currencies since the September *Statement*.

Markets continue to expect the OCR to remain on hold for some months yet. However, longer term interest rates in New Zealand have moved higher since the September *Statement*, reflecting gains in offshore interest rates and market expectations that the OCR will ultimately be increased to a greater extent than previously priced. These increases in wholesale interest rates have not been reflected in the mortgage market, with mortgage rates little changed in recent months.

International financial market developments

Ahead of its November meeting, expectations of further policy stimulus from the FOMC underpinned investors' risk appetite and generated a significant rally in equity and commodity prices globally. At the same time, expectations of increased purchases of Treasury bonds by the Federal Reserve have put downward pressure on US interest rates and the US dollar (figure 3.1).

Figure 3.1
Equity and commodity prices, and the US dollar



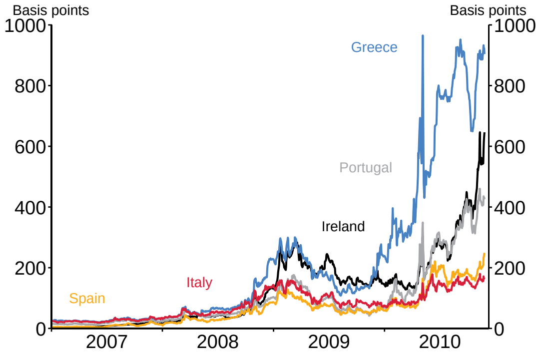
Source: Bloomberg.

In line with market expectations, the FOMC announced at its November meeting it would purchase a total of US$600 billion Treasury securities by the end of June next year. These purchases are additional to the previously announced reinvestment of maturing mortgage backed securities. Financial markets initially responded favourably to the FOMC announcement, however, there has since been growing scepticism among market participants regarding its impact. Some have expressed concern about the risk of excessive inflation, currency debasement and potential asset bubbles in emerging market economies. These concerns, together with more encouraging US economic data recently, have prompted a rebound in US interest rates.

Since the FOMC announcement, market attention has increasingly turned to sovereign concerns about the peripheral countries in the euro zone. In particular, concerns over the Irish banking sector and the health of its Government's balance sheet have pushed Irish Credit Default Swap (CDS) and bond spreads to record highs.

Amidst the market and political pressure, Ireland approached the EU and IMF for a rescue package worth 85 billion euros. While the anticipation and subsequent announcement of this aid package offered some relief to markets, these improvements were short-lived. Fears of further contagion within the euro zone have put renewed upward pressure on CDS and bond spreads for other European countries that are also seen as vulnerable to sovereign risk (figure 3.2).

Figure 3.2
Selected 10-year government bond spreads
(relative to German Bunds)

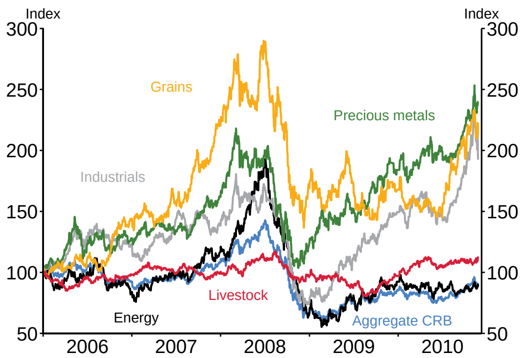


Source: Bloomberg.

Besides sovereign debt fears in Europe, recent weakness in financial markets also reflected growth concerns stemming from monetary policy tightening in emerging market countries. Rising domestic inflation pressure in many of these economies has prompted authorities there to tighten monetary policy and introduce administrative measures recently. In the case of China, the People's Bank of China (PBoC) has announced a series of more aggressive than expected tightening measures in recent months.

Financial markets reacted negatively to these developments, with sharp declines in the Shanghai stock index sending jitters to other equity markets. Commodity prices moved lower as investors feared that aggressive tightening by the PBoC would reduce China's commodity demand. However, these retracements were small relative to the significant run-up in commodity prices since the middle of this year (figure 3.3).

Figure 3.3
CRB commodity price index

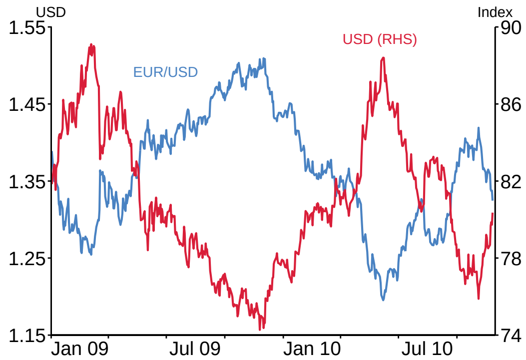


Source: Bloomberg.

Foreign exchange market

The speculation and subsequent announcement of further policy stimulus in the US has had a significant influence on currency markets since the September *Statement*. The US dollar weakened through September and October as expectations of further monetary policy support in the US developed. Many currencies rose to multi-year highs against the US dollar, prompting some countries to adopt currency intervention and capital control measures. More recently, however, the US dollar has rebounded somewhat, supported by a combination of better US data and safe-haven demand in response to sovereign concerns in Europe, policy tightening in China and re-emerging geopolitical tension on the Korean peninsula (figure 3.4).

Figure 3.4
EUR/USD and the USD Index

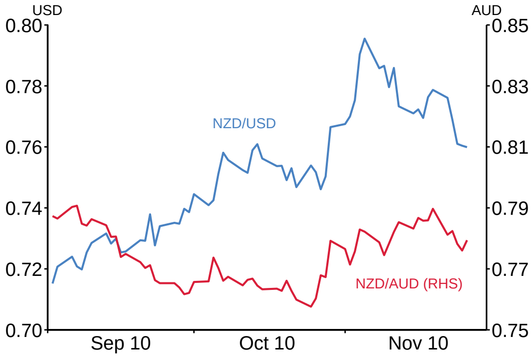


Source: Bloomberg.

The initial US dollar weakness also put significant upward pressure on the New Zealand dollar (figure 3.5). Relatively high New Zealand interest rates, rising commodity prices and emerging market growth have reinforced these gains. The New Zealand dollar has also recovered some ground against the Australian dollar over the past month, but the NZD/AUD remains relatively weak from a historic perspective. The appreciation of the New Zealand dollar against a range of currencies has contributed to a rise in the New Zealand dollar TWI since the September *Statement*.

Figure 3.5

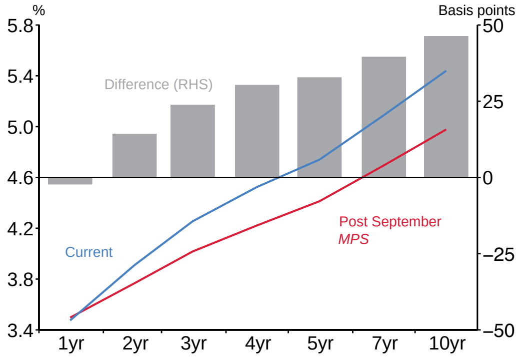
NZD/USD and NZD/AUD



Source: Bloomberg.

Figure 3.6

Wholesale interest rate curve



Source: Bloomberg.

Domestic financial market developments

Markets continue to expect the OCR to remain on hold for some months yet. However, longer-term New Zealand wholesale interest rates have moved higher since the September *Statement*, reflecting moves in offshore interest rates and market expectations that the OCR will ultimately be increased to a greater extent than previously priced (figure 3.6). Some of the increase in interest rates has been pared back more recently following an announcement from ratings agency Standard & Poor's that the outlook for New Zealand's sovereign credit rating has been revised down to "negative" from "stable" (see box C).

Financing and credit

Despite the increase in wholesale interest rates, there has been little movement in mortgage interest rates since the September *Statement* (figure 3.7). While the floating mortgage rate has risen and fixed rates reduced this year, the mortgage curve remains positively sloped, causing borrowers to continue to favour floating rate loans. As a result, the proportion of floating rate mortgage debt has continued to rise, reaching over 42 percent for the first time since early 2000. Accordingly, the average time to repricing of mortgage debt has fallen to just eight months – down considerably from the high of near 20 months in the middle of 2007 (figure 3.8).

Box C
New Zealand's sovereign credit rating

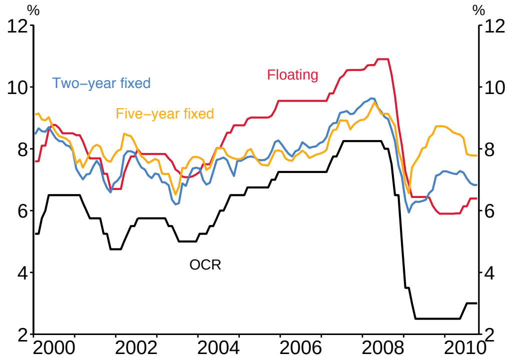
Ratings agency Standard & Poor's (S&P) recently announced the affirmation of New Zealand's AA+ foreign currency long-term sovereign credit rating. However, it also revised the outlook on this rating to negative from stable. Moody's Investor Service holds a AAA (stable) foreign currency credit rating for New Zealand, while Fitch rates New Zealand AA+ (negative outlook).

This revised outlook reflects a reassessment of sovereign risks in light of recent global developments that have brought into focus underlying vulnerabilities in New Zealand's external position. In particular, S&P highlighted the risks stemming from widening external balances, weakened fiscal flexibility, high relative levels of external debt and the vulnerability to external shocks stemming from a relatively undiversified economy.

Overall, while S&P assumes greater deterioration in external conditions than incorporated into current Reserve Bank forecasts, the change in ratings outlook does highlight the importance of rebalancing for the New Zealand economy.

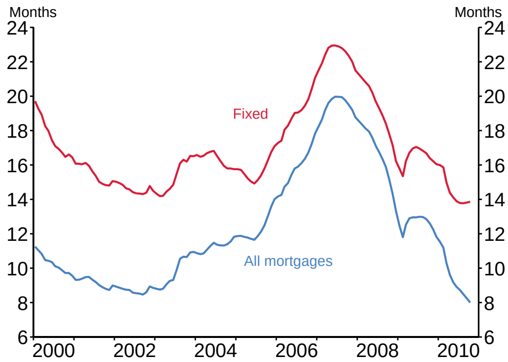
Bank funding costs remain significantly above pre-crisis levels. The marginal cost of funding remains around 150 basis points over the OCR, compared to 20-30 basis points prior to the onset of the financial crisis (figure 3.9). This reflects both higher local deposit rates and increased costs of raising wholesale funds in offshore markets.

Figure 3.7
Mortgage rates offered to new borrowers



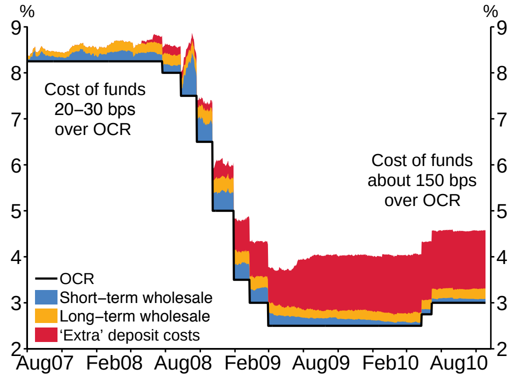
Source: RBNZ.

Figure 3.8
Average mortgage duration



Source: RBNZ.

Figure 3.9
Indicative marginal funding costs relative to the OCR



Source: RBNZ estimates.

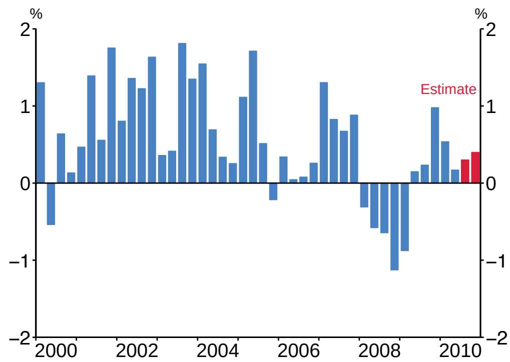
4 Current economic conditions

Overview

The pace of economic growth appears to have moderated. Aggregate activity was weaker than expected in the June quarter, and surveys of business sentiment have generally softened over recent months.

Reflecting this loss of momentum, the economy is estimated to have expanded only modestly in the September and December quarters (figure 4.1). Economic activity is estimated to remain slightly below its pre-recession level.

Figure 4.1
GDP growth
(seasonally adjusted, quarterly)



Source: Statistics New Zealand, RBNZ estimates.

Elevated commodity prices and a recovery in New Zealand's trading partner economies are helping to support the economy. In addition to this, monetary policy and fiscal policy remain somewhat stimulatory.

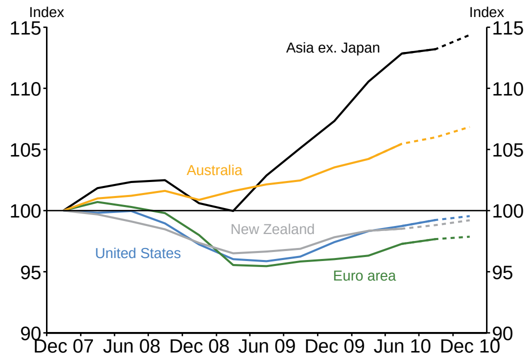
However, households remain cautious, with the housing market continuing to deteriorate and household spending weak. The business sector also remains cautious in its approach to both borrowing and spending decisions.

The short-term disruption to household and business activity following the Canterbury earthquake is estimated to have had a 0.1 percentage point adverse impact on GDP in the September quarter.

International economic conditions

Activity in New Zealand's trading partner economies continues to recover. The Asia-Pacific region, which now accounts for more than half of New Zealand's exports, continues to be robust. As a result, activity in New Zealand's trading partners is estimated to be 3.6 percent above its pre-recession peak, despite ongoing sluggishness in major Western economies (figure 4.2).

Figure 4.2
GDP by region
(2007Q4=100, dashed lines represent estimates)



Source: Haver Analytics, RBNZ estimates.
Note: Asia ex. Japan comprises: China, Hong Kong, Indonesia, Malaysia, The Philippines, Singapore, South Korea, Taiwan, Thailand and Vietnam.

The pace of GDP growth has slowed somewhat in emerging Asia through the second half of the year. This reflects a stabilisation in activity following a strong inventory and stimulus driven recovery. Domestic demand appears firm throughout the region, with unemployment rates back to pre-crisis levels. Housing and asset prices have been increasing rapidly, prompting some administrative controls.

The Australian economy continues to be a strong performer, although growth has eased in the third quarter. Demand for hard commodities is underpinning substantial investment in the mining sector. However, households appear cautious, with signs of retail sales softening.

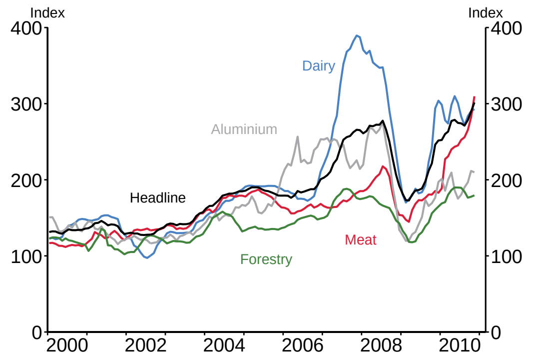
Western economies face ongoing headwinds to growth, and are estimated to have expanded only modestly over the second half of the year. Labour market recoveries are proving drawn out. In addition, with concerns around levels of sovereign debt, more aggressive fiscal consolidation plans are being implemented in some European economies. Inflation remains subdued in Western economies, consistent with substantial excess capacity.

Domestic economic conditions

External sector

Demand from Asian consumers is resulting in ongoing strength in New Zealand's export commodity prices (figure 4.3). Meat and wool prices have increased particularly strongly since the start of the year. Dairy and forestry prices are also at historically elevated levels.

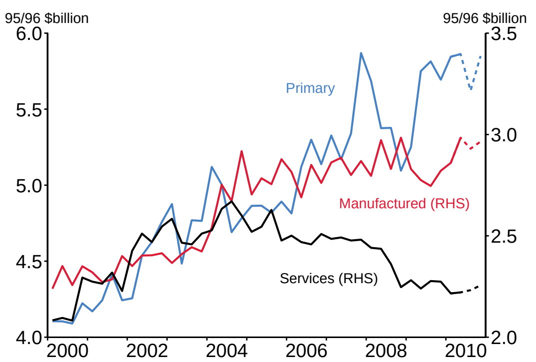
Figure 4.3
Export commodity prices
(SDR terms)



Source: ANZ National Bank Ltd.

Primary export volumes remain strong (figure 4.4). Also, manufactured exports have returned to pre-recession levels, supported by a robust Australian economy and favourable NZD/AUD exchange rate. Services exports have remained low, hampered by the high level of the TWI and weakness in visitor numbers from the Northern Hemisphere.

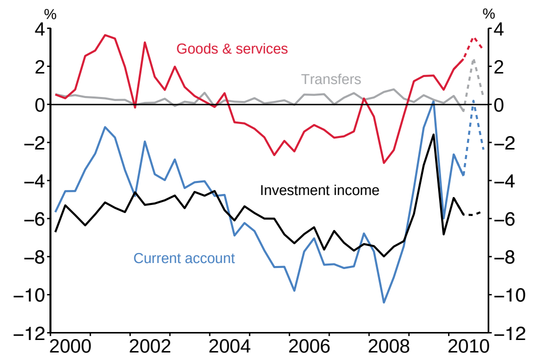
Figure 4.4
Export volumes
(dashed lines represent estimates)



Source: Statistics New Zealand, RBNZ estimates.

As the domestic economy recovers, import volumes are increasing. This is estimated to have caused the trade balance to deteriorate, in volume terms, over the second half of 2010. However, given the current elevated terms of trade, the nominal trade balance continues to improve and is contributing to a near-term improvement in New Zealand's current account (figure 4.5).

Figure 4.5
Current account, trade, transfers and investment income balances
(seasonally adjusted, quarterly, share of nominal GDP, dashed lines represent estimates)



Source: Statistics New Zealand, RBNZ estimates.

In addition, the current account will improve in the September quarter as a result of re-insurance inflows relating to the Canterbury earthquake. According to Statistics New Zealand, these will be recorded as a negative debit in the current transfers component of the current account. The insurance transactions are to be recorded in the period that the event occurred. Consequently, as claims become finalised over time there are likely to be significant upwards revisions to the September quarter reading of this component.

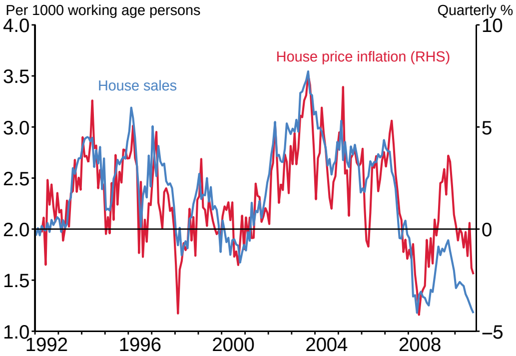
Household sector

Household spending growth has been subdued, despite a recovering labour market and relatively stimulatory monetary and fiscal policy settings. This was highlighted in the June quarter with private consumption spending flat on the quarter prior. Household spending is likely to have increased only modestly over the second half of 2010.

Consumers appear to have brought forward some spending to precede the increase in GST on 1 October. Spending on some durable items, such as furniture and appliances, increased strongly in September. Following this, the proportion of households who considered it a good time to buy a major household item fell sharply in October.

The housing market has deteriorated further over recent months (figure 4.6). Housing turnover has continued to decline, despite a recovery in net immigration, and house prices have fallen further. Sellers appear to be holding back from putting properties on the market, with listings low.

Figure 4.6
House sales and house price inflation
(seasonally adjusted)



Source: REINZ, Statistics New Zealand.

In Canterbury many homes suffered significant earthquake damage. A total of 159,059 claims were lodged with the Earthquake Commission. However with the majority of insurance payouts yet to be settled, little residential rebuild has taken place so far.

Residential investment is expected to have weakened in the December quarter following weaker consent issuance.

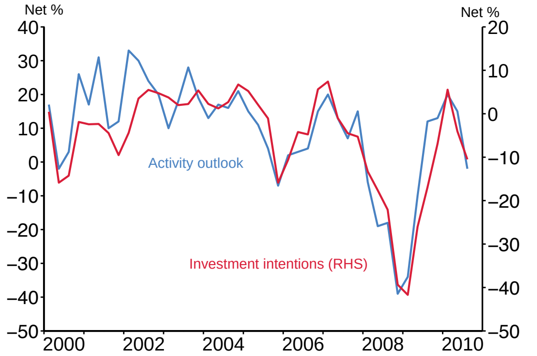
Business sector and output

Like households, the business sector remains very cautious. In general, firms appear reluctant to undertake major capital expenditure, with the spending that is taking place mostly directed at repairing or replacing existing capital.

In addition, sentiment among firms has generally been softer than in the first half of the year. Businesses are feeling less optimistic about the outlook for the economy and this appears to be translating into decisions about their own expansion plans (figure 4.7).

In the Canterbury region, business operation and trading was disrupted following September's earthquake. The resulting loss of activity is estimated to have had a 0.1 percentage point adverse impact on economy-wide growth in the September quarter. In addition to this, there has been considerable damage to property, commercial buildings and infrastructure. Although the rebuild and repair effort is expected to take several years, more urgent repairs are under way.

Figure 4.7
Business sentiment
(seasonally adjusted)



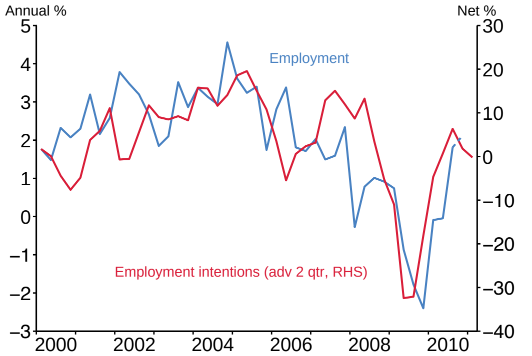
Source: NZIER. Investment intentions are an average of plant and machinery, and new buildings intentions.

Labour market

The labour market continues to gradually recover. After substantial volatility in recent quarters the unemployment rate declined to 6.4 percent in the June quarter. The trend unemployment rate published by Statistics New Zealand has now fallen by 0.5 percentage points since its peak in late 2009.

Underpinning this has been a return to hiring by firms, with employment increasing through 2010, according to both the Household Labour Force Survey and the Quarterly Employment Survey. There are signs that the pace of employment growth may now be moderating with firms'

Figure 4.8
HLFS employment growth and employment intentions
(seasonally adjusted, dashed lines represent estimates)



Source: Statistics New Zealand, NZIER.

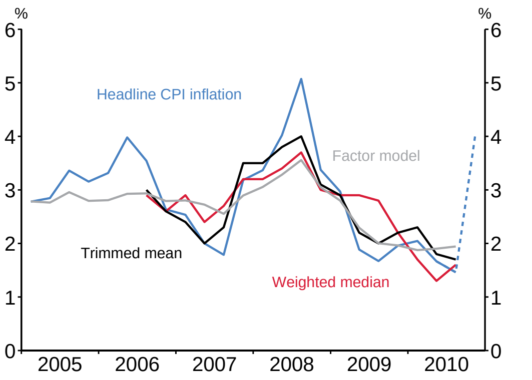
surveyed employment intentions beginning to soften (figure 4.8).

Some firms have reported difficulty in finding skilled staff. This does not appear to be translating into substantial wage pressures, with productivity-adjusted wage inflation remaining at a modest 1.5 percent in annual terms.

Prices

Annual CPI inflation was 1.5 percent in the September quarter, and has now been at or below the middle of the target band for the past six quarters. The lagged effects of falling import prices and the appreciation of the New Zealand dollar are holding down tradable inflation. Meanwhile, softening domestic activity has also seen non-tradable inflation pressures moderate. Core inflation measures are sitting close to headline (figure 4.9).

Figure 4.9
Headline CPI inflation and core inflation measures
(annual, dashed lines represent estimates)

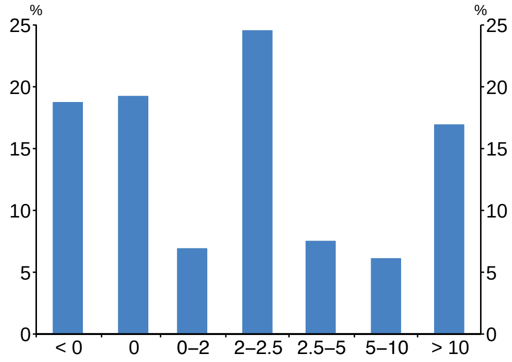


Source: Statistics New Zealand, RBNZ estimates.

The September quarter CPI inflation outturn was boosted by several new or increased government charges. Among these was the addition of the stationary energy and liquid fossil fuel sectors to the Emissions Trading Scheme. Apart from government charges, the main contributor to the September quarter CPI increase was the normal seasonal high in fruit and vegetable prices.

The increase in GST on 1 October will result in a sharp spike in CPI inflation in the December quarter. As not all items in the CPI basket attract GST (rents are a notable exception), the marginal effect on the CPI from direct pass-through of the GST increase would be a 2.0 percent increase. Data released with the latest Food Price Index showed around 60 percent of surveyed prices increased in the month of October (figure 4.10).

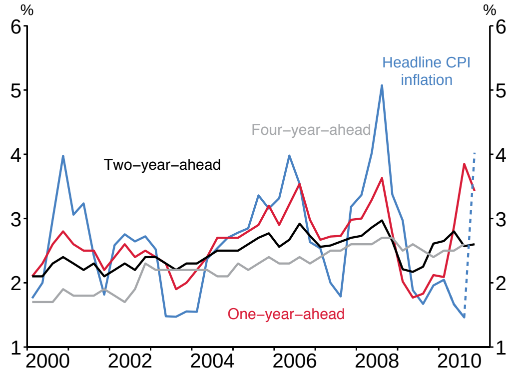
Figure 4.10
Distribution of percentage price changes for items collected monthly in October 2010
(percentage of prices)



Source: Statistics New Zealand. This data covers 27 percent of the CPI basket including the food group as well as selected other categories measured monthly.

The Bank will closely monitor measures of inflation expectations for any signs that temporary price increases are fuelling more persistent medium-term inflation pressures. Encouraging in this regard has been a moderation in pricing intentions in recent business surveys. Longer-term inflation expectations also appear contained (figure 4.11).

Figure 4.11
Headline CPI inflation and inflation expectations
(annual, dashed lines represent estimates)



Source: Statistics New Zealand, RBNZ estimates, AON.

Box D

The impact of the Canterbury earthquake

Initial impact

The short-term disruption to household and business activity following the Canterbury earthquake is estimated to have reduced GDP growth by 0.1 percent of GDP in the September quarter. This estimate is based on indications that rates of displacement of retail sales and manufacturing activity have been relatively modest. Further, the impact on some components of GDP is unlikely to be captured in the official data.

Rebuilding

Earthquake-related reconstruction spending is estimated to add around $5 billion to GDP (2.6 percent of nominal annual GDP). This is in line with updated estimates of damage to residential property from the Earthquake Commision (EQC). Most of this spending is assumed to occur over 2011 and 2012, with some pull-back in growth from late 2012 as reconstruction winds down. Uncertainty surrounds how the rebuilding will impact on other activity.

Residential building

Earthquake claims received by the EQC provide the best early indication of the likely total cost. Bank estimates of an average cost per claim generate a total residential rebuilding cost of about $3 billion.[1]

It is likely that houses with minor damage will be repaired first, with the EQC aiming to settle claims below $10,000 by the end of this year. Given the relatively short lags involved in doing repair work, it is likely that some of these payments will translate to higher residential investment in the December 2010 quarter. At the peak of rebuilding, which we expect to be at the end of 2011, the level of residential investment will be lifted by nearly 20 percent, relative to non-earthquake related residential investment.

[1] Assuming around 50,000 claims are for less than $10,000, 60,000 claims between $10,000 and $100,000 and 10,000 claims above $100,000.

Infrastructure and commercial building

The Bank continues to assume damage of $1 billion to commercial buildings and $1 billion to infrastructure assets in the Canterbury region. To provide some context, the combined capital value of commercial and industrial property across the three affected council areas is about $15 billion, whereas the combined value of infrastructure assets is around $4.6 billion.[2]

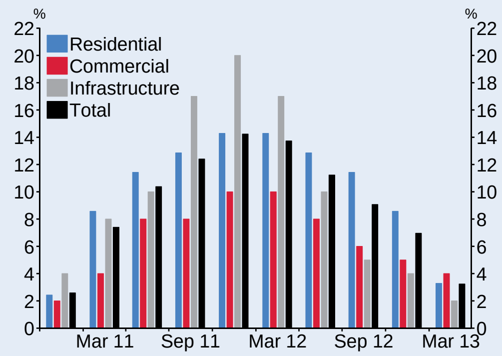
The timing of repair work is uncertain. Essential infrastructure repair is likely to be a priority, and this is assumed to occur in a relatively frontloaded fashion in the projection, with 85 percent complete by June 2012.

On the other hand, feedback from our business visits generally suggested that commercial rebuild could be a very drawn out process, and take several years. In addition, given the large amount of spare capacity in Christchurch City, it is possible that some businesses may relocate rather than rebuild. This projection assumes that only 50 percent of the commercial damage is repaired by the end of 2012.

Figure D1

Assumed timing of reconstruction spending

(share of rebuilding completed in quarter)



Source: RBNZ estimates.

[2] Property IQ Ltd, Council annual reports.

Effect on inflation pressure and monetary policy response

Reconstruction following the Canterbury earthquake will take place at a time when the housing market is very weak and the construction sector has a great deal of spare capacity. Nonetheless, the scale of the work required is such that excess capacity will be absorbed rapidly. As such, the cost of construction and materials is likely to rise as demand for these increases. While a large portion of work will be centrally managed, those outside this process will likely face a scarcity of labour and materials. Further, accommodation costs in the region are likely to increase, driven by demand from an influx of labour, although this may be offset by reduced demand in other regions.

The Policy Targets Agreement (PTA) instructs the Bank to focus on medium term inflation effects and recognizes there will be fluctuations away from the target due to temporary effects, such as natural disasters in clause 3:

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

Essentially, the PTA guides the Bank to assess the medium term impact of the increased activity in Canterbury, and how that will affect nationwide inflation expectations. Reconstruction expenditure will be significant, causing activity, and therefore inflation, to be higher than would otherwise be the case. However, because of the regional concentration of the reconstruction, and because it is largely financed by insurance payments, it is unlikely that inflation expectations will be affected.

Table 4.1

Measures of inflation and inflation expectations

(annual)

	2009 Mar	Jun	Sep	Dec	2010 Mar	Jun	Sep
CPI	3.0	1.9	1.7	2.0	2.0	1.7	1.5
CPI components							
CPI non-tradable	3.8	3.3	3.0	2.3	2.1	2.2	2.5
Non-tradables housing component	1.5	1.0	0.6	0.8	1.2	1.4	1.7
Non-tradables ex housing, cigarettes and tobacco component	4.8	4.3	4.2	2.9	2.6	2.2	2.1
CPI tradable	1.7	0.2	-0.1	1.5	2.0	1.0	0.3
Petrol	-9.3	-17.0	-19.0	3.3	11.5	9.5	5.8
Other inflation measures							
Factor model estimate of core CPI inflation	2.8	2.3	2.0	2.0	1.9	1.9	1.9
CPI trimmed mean (of annual price change)	2.9	2.2	2.0	2.2	2.3	1.8	1.7
CPI weighted median (of annual price change)	2.9	2.9	2.8	2.2	1.7	1.3	1.6
CPI ex food, petrol and government charges	1.9	1.6	1.9	1.7	1.3	1.4	1.0
CPI ex food and energy	2.3	2.1	2.5	2.1	1.7	1.9	1.4
GDP deflator (derived from expenditure data)	2.5	3.2	2.3	0.2	1.0	2.3	n/a

	2009 Mar	Jun	Sep	Dec	2010 Mar	Jun	Sep	Dec
Inflation expectation measures								
RBNZ Survey of Expectations - inflation one-year-ahead	2.0	1.8	1.8	2.1	2.1	2.9	3.9	3.4
RBNZ Survey of Expectations - inflation two-years-ahead	2.2	2.2	2.3	2.6	2.7	2.8	2.6	2.6
AON Economist survey - inflation one-year-ahead	2.1	2.2	1.7	1.6	2.2	3.4	5.0	n/a
AON Economist survey - inflation four-years-ahead	2.5	2.6	2.5	2.4	2.5	2.5	2.6	n/a
NBBO - inflation one-year-ahead (quarterly average)	2.7	2.6	2.6	2.6	2.6	2.8	3.1	n/a

5 The macroeconomic outlook

Overview

Despite the loss of momentum in domestic activity in the second half of 2010, growth is expected to accelerate over the coming year. The continuing recovery in global activity will support export volumes and commodity prices. Post-earthquake rebuilding will provide a substantial but temporary boost to activity. These conditions will reduce surplus capacity, contributing to a pick-up in inflationary pressures. Nevertheless, underlying domestic demand is expected to remain subdued for some time, and medium-term inflation near the middle of the target range.

Trading partner activity

Growth in New Zealand's trading partner economies has eased in the latter half of 2010 as the boost to activity from fiscal stimulus and inventory cycles has dissipated. Further ahead, modest growth is expected (table 5.1). This reflects the positive outlook for the Asia-Pacific region, which is becoming an increasingly important destination for New Zealand exports. Activity in developed economies is expected to continue growing, albeit slowly.

Growth in Asia-Pacific economies is expected to increase in 2011 and remain firm thereafter. The strong outlook for domestic demand in Asia ex-Japan is expected to offset much of the drag to the region from soft Western demand. Solid growth in private consumption is likely to persist, given that unemployment is back to pre-crisis levels. Further to this, current high levels of capacity utilisation are supportive of further investment. Expansionary monetary and financial conditions are expected to facilitate growth over the next year, although rising asset prices and growing inflation pressures pose risks to the outlook.

The strong outlook for growth in Asia provides favourable conditions for Australia's commodity exports. This is expected to translate into exceptional strength in resource -related investment, which is likely to have spillovers to the wider economy. Continued improvements in labour incomes are expected to support household consumption, although some caution may remain in spending behaviour.

The recoveries in Western economies are expected to be very gradual and fragile. The outlook for Europe is dominated by fiscal austerity and by financial market concerns around sovereign debt in some member states. However, Germany is expected to support growth in the region, given favourable trading patterns with fast-growing emerging markets. US growth will be weighed down by the slow recovery in labour markets and the need for ongoing repair of household balance sheets. This process is likely to be prolonged, with housing markets remaining depressed for some time.

Terms of trade

New Zealand's terms of trade is expected to ease over the projection horizon, but remain at a historically high level (figure 5.1). Export prices are expected to soften as global supply pressures ease, while further recovery in global activity is likely to see import prices increase from their current low level. Nevertheless, favourable international demand conditions (particularly in the Asia-Pacific region) mean that prices for New Zealand's main commodity exports

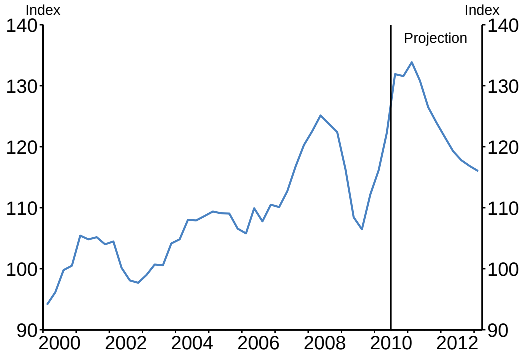
Table 5.1
Forecasts of trading partner GDP growth
(calendar year, annual average)

Country	2003	2004	2005	2006	2007	2008	2009	2010f	2011f	2012f
Australia	3.2	3.6	3.2	2.6	4.8	2.2	1.2	3.1	3.5	4.0
Asia ex-Japan*	5.4	7.2	6.5	7.2	7.9	4.5	2.0	8.6	6.4	7.3
United States	2.5	3.6	3.1	2.7	1.9	0.0	-2.6	2.7	2.2	3.0
Japan	1.5	2.7	1.9	2.0	2.3	-1.2	-5.3	3.5	1.5	2.0
Euro area	0.8	1.9	1.7	3.1	2.8	0.4	-4.0	1.6	1.3	1.5
United Kingdom	2.8	3.0	2.2	2.8	2.7	-0.1	-5.0	1.8	2.1	2.1
16 Country Index	3.1	4.1	3.6	3.7	4.4	1.7	-0.8	4.6	3.8	4.5

Source: Haver Analytics, RBNZ estimates
* Includes China, Hong Kong, Indonesia, Malaysia, The Phillipines, Singapore, South Korea, Taiwan, Thailand and Vietnam.

will remain elevated, underpinning strength in the terms of trade.

Figure 5.1
OTI terms of trade (goods)
(seasonally adjusted)

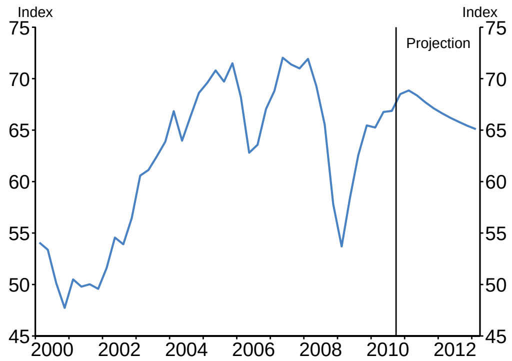


Source: Statistics New Zealand, RBNZ estimates.

Exchange rate

The New Zealand dollar TWI is assumed to remain around current levels through early 2011 before gradually depreciating thereafter (figure 5.2). Sustained strength in the New Zealand dollar would inhibit rebalancing of economic activity towards the tradable sector.

Figure 5.2
New Zealand dollar TWI



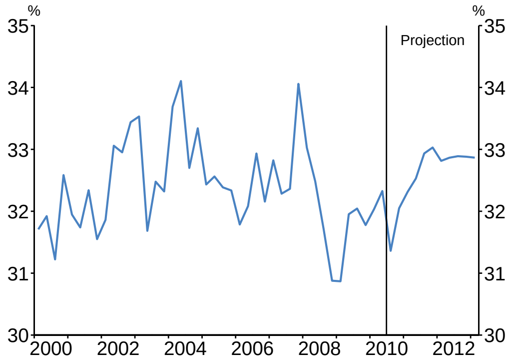
Source: RBNZ estimates.

Trade and the balance of payments

Export volumes are projected to expand at a modest pace (figure 5.3). While trading partner demand is expected to be robust, assumed continued strength in the New Zealand dollar is expected to limit growth in export volumes. The outlook for exports differs significantly by industry.

- Steady growth in commodity export volumes is expected over the projection as a result of elevated international prices.
- Manufactured export volumes are expected to grow at a more modest pace. While weakness in the US dollar will create difficult conditions for most exporters, ongoing strength in demand from Australia (which takes the majority of our manufactured exports), as well as a favourable AUD/NZD cross rate, will support sales.
- Despite the boost from the 2011 Rugby World Cup, services exports are expected to recover only very gradually. The elevated New Zealand dollar and ongoing softness in many major tourism markets is likely to inhibit tourist spending.

Figure 5.3
Export volumes
(share of potential GDP, seasonally adjusted)



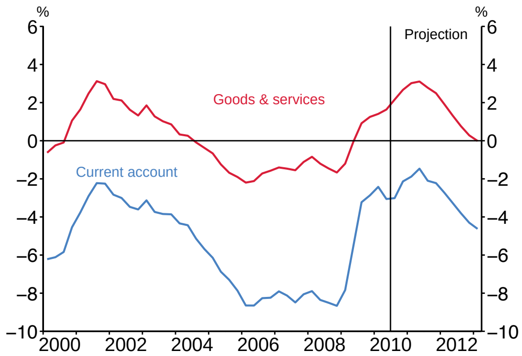
Source: Statistics New Zealand, RBNZ estimates.

Import volumes are expected to increase at a modest pace, consistent with the recoveries in domestic consumption and investment spending. The elevated level of the New Zealand dollar will also support increases in import demand.

The current account is projected to settle around 4.6 percent of GDP at the end of the projection, as export prices ease and gradual improvement in the domestic economy results in increased imports of capital and consumer goods.

With households and firms focused on balance sheet consolidation, New Zealand's net foreign liabilities are expected to decrease. This will reduce New Zealand's reliance on foreign borrowing and vulnerability to external shocks. The resultant reduction in interest payments will lead to an improvement in the investment income balance.

Figure 5.4
Current account and trade balance
(annual, share of nominal GDP)



Source: Statistics New Zealand, RBNZ estimates.

Households

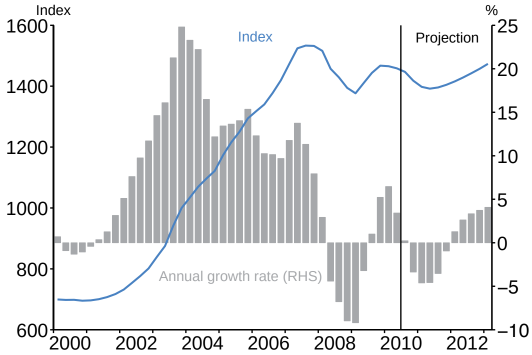
Despite current low interest rates, household spending growth is forecast to remain subdued over the projection (figure 5.5). High levels of debt and an only gradual recovery in the labour market are expected to prompt continuing caution among households. The household savings rate is projected to increase over the next few years.

Figure 5.5
Household consumption
(share of potential GDP, seasonally adjusted)

Source: Statistics New Zealand, RBNZ estimates.

Contributing to the weak outlook for household spending, house prices are likely to decline further in 2011 (figure 5.6). House prices remain elevated relative to household incomes and rents. This overvaluation, along with some gradual increase in mortgage interest rates, is expected to see house prices rise only gradually beyond 2011.

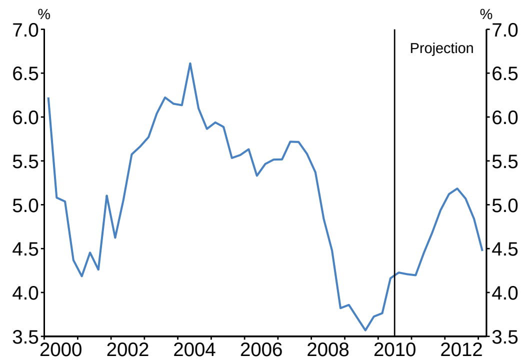
Figure 5.6
House prices
(seasonally adjusted)



Source: QVNZ, RBNZ estimates.

Despite underlying softness in the housing market, residential investment is set to increase sharply as a result of reconstruction spending in the Canterbury region (figure 5.7). Outside of Canterbury, however, residential investment is projected to remain subdued. Furthermore, reconstruction spending is expected to provide only a limited boost to activity more generally. This is due to the localised nature of construction activity and the fact that spending is to replace damaged assets, rather than to grow the capital stock.

Figure 5.7
Residential investment
(share of potential GDP, seasonally adjusted)

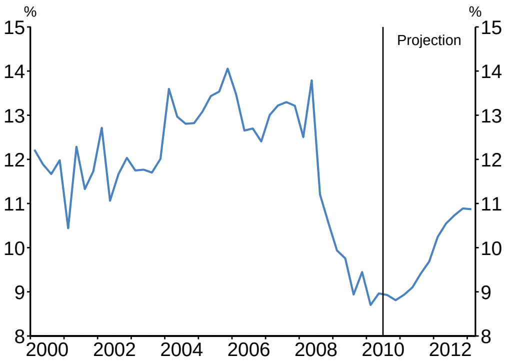


Source: Statistics New Zealand, RBNZ estimates.

Business sector

Softness in the domestic economy and the resulting uncertainty about the outlook have weighed on businesses' expectations for growth. Combined with lingering tightness in credit conditions, these soft conditions will

Figure 5.8
Business investment
(excluding computer and intangible assets, share of potential GDP, seasonally adjusted)



Source: Statistics New Zealand, RBNZ estimates.

prompt ongoing caution among firms. Like households, firms are expected to continue focusing on balance sheet consolidation. Business investment is expected to be focused mainly on the maintenance of existing capital in the near term and to remain soft throughout the projection (figure 5.8).

Repairs and replacement will provide some boost to business investment in the Canterbury region, but this spending is likely to occur over a period of several years as resources will initially be focused on the repairs to homes and essential infrastructure.

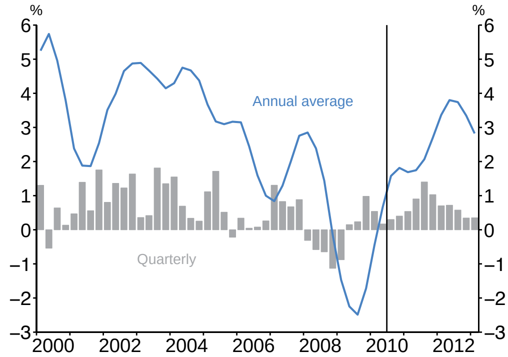
Government

In *Budget 2010* the Government announced its intention to return to surplus in 2015/16. In line with this, core Crown expenditure is projected to grow at a slower pace than overall activity to enable this fiscal goal to be achieved. Revenues this year have been below *Budget* and the soft outlook for domestic demand will weigh on revenue growth. However, this revenue shortfall is assumed to be largely temporary and over the medium term the Government's fiscal goals are assumed to be achieved.

Gross Domestic Product and the labour market

Growth is expected to accelerate over the coming year, reducing surplus capacity in the economy. The continuing recovery in global activity will support export volumes. Post-earthquake rebuilding will also provide a substantial but temporary boost to activity (figure 5.9).

Figure 5.9
GDP
(seasonally adjusted)

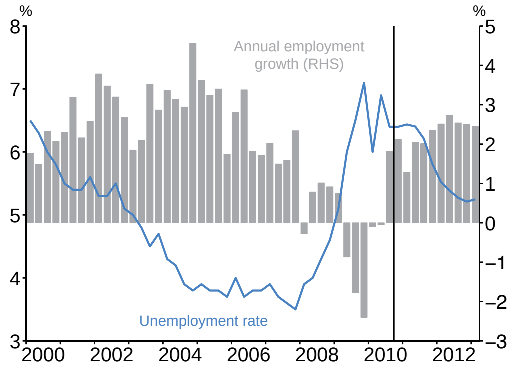


Source: Statistics New Zealand, RBNZ estimates.

Nevertheless, underlying domestic demand is expected to remain subdued for some time. Household spending growth is expected to remain subdued as households continue to focus on reducing debt. This will prompt continued caution among firms, resulting in only gradual growth in business investment spending.

The recovery in domestic activity and associated elimination of excess capacity will contribute to steady gains in employment. This will result in the unemployment rate moving lower throughout the projection (figure 5.10). The gradual improvement in the labour market will encourage workers to enter the labour market. This effect, combined with a trend increase in participation among older workers, will result in labour force participation increasing modestly over the coming years.

Figure 5.10
Employment and unemployment rate
(seasonally adjusted)



Source: Statistics New Zealand, RBNZ estimates.

Inflation

Following a GST-related spike in late 2010, annual inflation is expected to return to within the 1 to 3 percent target range. Underlying softness in domestic activity and the income tax cuts that accompanied the October increases in GST will offset pressure on wage setting behaviour from the 2010/11 inflation spike.

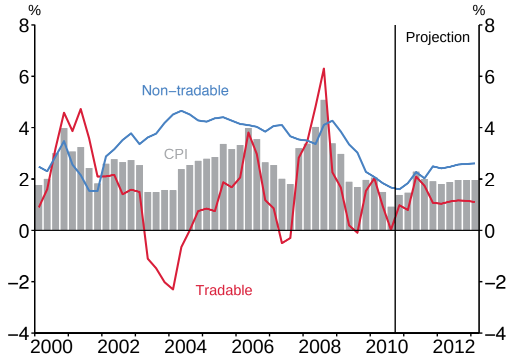
Over the projection, underlying inflationary pressures are expected to increase (figure 5.11). The recovery in domestic activity will result in the gradual elimination of excess capacity and encourage firms to take on more employees. These developments will reduce the downward pressure on non-tradable inflation of recent quarters, with non-tradable inflation expected to increase to around 2.6 percent by the end of the projection. Tradable inflation is expected to average around 1.2 percent over the medium term, reflecting modest increases in import prices and an assumed depreciation in the New Zealand dollar.

The gradual removal of policy stimulus is expected to offset the accumulation of underlying inflation pressures such that annual CPI inflation, excluding the direct effects of recent government policy changes, tracks close to the mid-point of the target band over the latter part of the projection.

Figure 5.11

CPI, tradable and non-tradable inflation

(annual, excluding government policy changes)



Source: Statistics New Zealand, RBNZ estimates. 'Excluding government policy changes' is the Bank's CPI inflation projection which from the June quarter 2010 excludes the direct impact of the increase in the rate of GST, the incorporation of the stationary energy and liquid fuel sectors to the amended Emissions Trading Scheme, and increases in the excise tax on tobacco.

Appendix A[1]

Summary tables

Table A

Projections of GDP growth, CPI inflation and monetary conditions

(CPI and GDP are percent changes, GDP data seasonally adjusted)

		GDP Quarterly	CPI Quarterly	CPI Annual	TWI	90-day bank bill rate
2002	Mar	0.8	0.6	2.6	51.6	5.0
	Jun	1.4	1.0	2.8	54.6	5.8
	Sep	1.2	0.5	2.6	53.9	5.9
	Dec	1.6	0.6	2.7	56.4	5.9
2003	Mar	0.4	0.4	2.5	60.6	5.8
	Jun	0.4	0.0	1.5	61.1	5.4
	Sep	1.8	0.5	1.5	62.4	5.1
	Dec	1.4	0.7	1.6	63.9	5.3
2004	Mar	1.5	0.4	1.5	66.8	5.5
	Jun	0.7	0.8	2.4	64.0	5.9
	Sep	0.3	0.6	2.5	66.3	6.4
	Dec	0.3	0.9	2.7	68.6	6.7
2005	Mar	1.1	0.4	2.8	69.6	6.9
	Jun	1.7	0.9	2.8	70.8	7.0
	Sep	0.5	1.1	3.4	69.7	7.0
	Dec	-0.2	0.7	3.2	71.5	7.5
2006	Mar	0.3	0.6	3.3	68.2	7.5
	Jun	0.0	1.5	4.0	62.8	7.5
	Sep	0.1	0.7	3.5	63.6	7.5
	Dec	0.3	-0.2	2.6	67.0	7.6
2007	Mar	1.3	0.5	2.5	68.8	7.8
	Jun	0.8	1.0	2.0	72.0	8.1
	Sep	0.7	0.5	1.8	71.4	8.7
	Dec	0.9	1.2	3.2	71.0	8.8
2008	Mar	-0.3	0.7	3.4	71.9	8.8
	Jun	-0.6	1.6	4.0	69.3	8.8
	Sep	-0.6	1.5	5.1	65.5	8.2
	Dec	-1.1	-0.5	3.4	57.8	6.3
2009	Mar	-0.9	0.3	3.0	53.7	3.7
	Jun	0.1	0.6	1.9	58.4	2.9
	Sep	0.2	1.3	1.7	62.6	2.8
	Dec	1.0	-0.2	2.0	65.5	2.8
2010	Mar	0.5	0.4	2.0	65.3	2.7
	Jun	0.2	0.2	1.7	66.8	2.9
	Sep	0.3	1.1	1.5	66.9	3.2
	Dec	0.4	2.3	4.0	68.5	3.2
2011	Mar	0.5	0.6	4.3	68.9	3.3
	Jun	0.9	0.9	5.0	68.4	3.4
	Sep	1.4	0.4	4.3	67.7	3.6
	Dec	1.0	0.2	2.1	67.1	3.8
2012	Mar	0.7	0.6	2.1	66.6	3.9
	Jun	0.7	0.9	2.1	66.2	4.1
	Sep	0.6	0.5	2.2	65.8	4.2
	Dec	0.3	0.3	2.2	65.4	4.3
2013	Mar	0.3	0.6	2.2	65.1	4.4

[1] Notes for these tables follow on pages 26 and 27.

Table B
Composition of real GDP growth

(annual average percent change, seasonally adjusted, unless specified otherwise)

	Actuals								Projections		
March year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Final consumption expenditure											
Private	4.6	6.5	4.5	4.5	2.4	3.2	-1.1	0.5	1.6	0.5	1.4
Public authority	1.3	5.0	4.0	5.0	4.8	4.6	4.3	1.2	2.4	1.7	1.2
Total	3.9	6.1	4.4	4.6	2.9	3.5	0.1	0.7	1.8	0.8	1.4
Gross fixed capital formation											
Market sector:											
Residential	23.7	14.9	2.8	-5.3	-1.4	4.4	-22.9	-11.7	15.6	16.5	4.0
Business	2.8	12.0	10.7	10.0	-1.7	8.4	-4.5	-11.6	5.2	8.5	10.3
Non-market government sector	14.3	14.3	13.6	3.2	-5.1	-14.0	16.4	5.1	-2.7	4.1	4.1
Total	7.9	12.8	9.0	6.0	-1.9	6.0	-7.0	-10.4	6.3	9.6	8.7
Final domestic expenditure	4.8	7.7	5.5	5.0	1.7	4.1	-1.7	-2.0	2.8	2.8	3.1
Stockbuilding [1]	-0.1	0.2	0.2	-0.5	-0.7	0.8	-0.3	-1.8	0.7	1.1	0.1
Gross national expenditure	4.7	7.8	6.0	4.7	0.8	5.2	-1.9	-3.7	3.6	3.6	3.2
Exports of goods and services	7.8	1.1	4.9	-0.1	2.9	3.2	-2.9	3.0	1.9	4.5	2.2
Imports of goods and services	7.0	12.9	12.4	4.2	-1.4	9.9	-4.1	-9.6	7.9	7.0	4.3
Expenditure on GDP	5.0	4.0	3.5	3.3	2.3	2.9	-1.4	0.5	1.7	2.7	2.5
GDP (production)	4.9	4.3	3.7	3.1	0.8	2.9	-1.5	-0.4	1.7	3.4	2.8
GDP (production, March qtr to March qtr)	4.7	5.2	2.4	2.4	1.7	2.1	-3.2	1.9	1.4	4.1	2.0

[1] Percentage point contribution to the growth rate of GDP.

Table C

Summary of economic projections

(annual percent change, unless specified otherwise)

	Actuals								Projections		
March year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Price measures											
CPI	2.5	1.5	2.8	3.3	2.5	3.4	3.0	2.0	4.3	2.1	2.2
Labour costs	2.2	2.1	2.5	3.0	3.0	3.5	3.1	1.3	1.9	2.3	2.2
Import prices (in New Zealand dollars)	-10.7	-10.3	0.6	6.9	0.2	0.5	12.4	-8.3	-3.4	8.3	5.1
Export prices (in New Zealand dollars)	-15.4	-5.0	5.0	3.4	4.3	11.9	6.7	-8.4	11.3	-1.7	0.3
Monetary conditions											
90-day rate (year average)	5.9	5.3	6.5	7.3	7.6	8.6	6.7	2.8	3.1	3.7	4.2
TWI (year average)	56.4	63.6	67.1	70.1	65.6	71.6	61.6	62.9	67.7	67.4	65.6
Output											
GDP (production, annual average % change)	4.9	4.3	3.7	3.1	0.8	2.9	-1.5	-0.4	1.7	3.4	2.8
Potential output (annual average % change)	3.4	3.3	3.0	2.6	2.2	1.8	1.5	1.5	1.7	1.9	2.1
Output gap (% of potential GDP, year average)	1.0	2.0	2.7	3.2	1.8	2.9	-0.2	-2.1	-2.2	-0.8	-0.1
Labour market											
Total employment (seasonally adjusted)	1.8	3.4	3.6	2.8	2.0	-0.3	0.7	-0.1	1.3	2.5	2.5
Unemployment rate (March qtr, seasonally adjusted)	5.0	4.3	3.9	4.0	3.9	3.9	5.1	6.0	6.4	5.5	5.2
Trend labour productivity	1.2	1.0	0.9	0.7	0.7	0.6	0.5	0.5	0.6	0.6	0.7
Key balances											
Government operating balance (% of GDP, year to June)	3.3	3.9	4.7	4.4	3.5	3.1	-2.1	-3.8	-4.9	-3.3	-3.0
Current account balance (% of GDP)	-3.1	-4.3	-6.1	-8.6	-7.9	-7.9	-7.8	-2.4	-1.9	-2.7	-4.6
Terms of trade (OTI measure, annual average % change)	-5.6	3.9	5.8	-0.8	1.8	7.8	3.2	-9.1	17.2	-3.2	-6.5
Household saving rate (% of disposable income)	-10.3	-9.7	-8.2	-12.8	-14.2	-11.0	-13.7	-11.7	-8.1	-6.2	-4.5
World economy											
Trading partner GDP (annual average % change)	3.2	3.5	3.7	3.8	3.8	4.2	0.1	1.1	4.1	4.1	4.4
Trading partner CPI (TWI weighted, annual % change)	2.2	1.4	2.1	2.5	1.9	3.3	0.9	1.7	1.1	2.0	1.8

Notes to the tables

CPI	Consumer Price Index. Quarterly projections rounded to one decimal place.
TWI	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 area.
90-day bank bill rate	The interest yield on 90-day bank bills.
World GDP	RBNZ definition. 16-country index, export weighted. Seasonally adjusted.
World CPI inflation	RBNZ definition. Five-country index, TWI weighted.
Import prices	Domestic currency import prices. *Overseas Trade Indexes*.
Export prices	Domestic currency export prices. *Overseas Trade Indexes*.
Terms of trade	Constructed using domestic currency export and import prices. *Overseas Trade Indexes*.
Private consumption	*System of National Accounts*.
Public authority consumption	*System of National Accounts*.
Residential investment	RBNZ definition. Private sector and government market sector residential investment. *System of National Accounts*.
Business investment	RBNZ definition. Total investment less the sum of non-market investment and residential investment. *System of National Accounts*.
Non-market investment	RBNZ definition. The *System of National Accounts* annual nominal government non-market/market investment ratio is interpolated into quarterly data. This ratio is used to split quarterly expenditure GDP government investment into market and non-market components.
Final domestic expenditure	RBNZ definition. The sum of total consumption and total investment. *System of National Accounts*.
Stockbuilding	Percentage point contribution to the growth of GDP by stocks. *System of National Accounts*.
Gross national expenditure	Final domestic expenditure plus stocks. *System of National Accounts*.
Exports of goods and services	*System of National Accounts*.
Imports of goods and services	*System of National Accounts*.
GDP (production)	*System of National Accounts*.
Potential output	RBNZ definition and estimate.
Output gap	RBNZ definition and estimate. The percentage difference between real GDP (production, seasonally adjusted) and potential output GDP.
Current account balance	*Balance of Payments*.
Total employment	*Household Labour Force Survey*.
Unemployment rate	*Household Labour Force Survey*.
Household saving rate	*Household Income and Outlay Account*.

Government operating balance	Operating balance before gains and losses. Historical source: The Treasury. Adjusted by the Reserve Bank 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 *Household Labour Force Survey* hours worked.
Labour cost	Private sector all salary and wage rates. *Labour Cost Index*.
Real gross domestic income	The real purchasing power of domestic income, taking into account changes in the terms of trade. *System of National Accounts*.
Quarterly percent change	(Quarter/Quarter$_{-1}$ - 1)*100
Annual percent change	(Quarter/Quarter$_{-4}$ - 1)*100
Annual average percent change	(Year/Year$_{-1}$ - 1)*100

Source: Unless otherwise specified, all data conform to Statistics New Zealand definitions, and are not seasonally adjusted.
Rounding: All projections data are rounded to one decimal place.

Appendix B
Companies and organisations contacted by Reserve Bank staff during the projection round

AECOM Ltd
Antons Seafood Ltd
Barfoot & Thompson
Canterbury Employer Chamber of Commerce
Christchurch & Canterbury Tourism
Christchurch International Airport Ltd
Cleland Construction Ltd
Click Clack Ltd
Colliers International Ltd
Council of Trade Unions
Energy Direct NZ Ltd
Ezibuy Ltd
Federated Farmers Waikato
Fisher & Paykel Appliances Ltd
Fletcher Building Ltd
Foster Construction Ltd
Fullers Group Ltd
Fulton Hogan Ltd
GDM Group Ltd
Greens Industries Ltd
H & J Smith Ltd
Hawkins Construction Ltd
Heritage Queenstown Ltd
IAG New Zealand Ltd
Iplex Pipelines NZ Ltd
JJ Ltd
Kiwi Discovery Shop Ltd
Kordamentha
Kordia Solutions Ltd
Lion Nathan New Zealand Ltd
Livestock Improvement Corporation
Lyttelton Engineering Ltd
Lyttelton Port Of Christchurch Ltd
Mace Engineering Ltd
Mainzeal Property & Construction Ltd
Millbrook Resort Ltd
Minter Ellison Rudd Watts Lawyers
New Zealand Oil and Gas Ltd
New Zealand Manufacturers and Exporters Association
NZSki Ltd
NZX Ltd
Otago Federated Farmers Inc
Palmerston North City Council
Port Taranaki Ltd
Prepared Foods Ltd
PricewaterhouseCoopers
Property Council of New Zealand
Registered Master Builders Federation
Silk Chartered Accountants
Skyline Enterprises Ltd
Smith & Caughey Ltd
Smith City Group Ltd
Southland Building Society Ltd
Staples Rodway Ltd
Suzuki New Zealand Ltd
Taranakipine Ltd
Todd Energy Ltd
Totally Tourism and the Helicopter Line Ltd
Toyota New Zealand Ltd
TSB Bank Ltd
UBS New Zealand Ltd
Vero Insurance New Zealand Ltd
Villa Maria Estate Ltd
Weston Milling Ltd
Wight Aluminium Ltd
Yunca Group Ltd

Appendix C
Reserve Bank statements on monetary policy

OCR unchanged at 3.0 percent

16 September 2010

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 3.0 percent.

Reserve Bank Governor Alan Bollard said: "While the global and domestic economies continue to recover, the outlook has weakened since our June *Statement*. We consider it appropriate at this point to keep the OCR on hold.

"The earthquake that struck Canterbury on 4 September has significantly disrupted economic activity and is likely to continue to do so for some time yet. Many homes and businesses have been damaged, as have significant parts of Canterbury's public infrastructure. Eventual reconstruction and repairs will require considerable resources over the next year or two, particularly in the construction sector. If, in the aftermath of the earthquake, the prices of some goods and services increase temporarily, monetary policy would remain focused on the medium-term trend in inflation. The Policy Targets Agreement explicitly instructs the Bank to look through temporary price increases generated by a natural disaster.

"Looking more generally at the domestic economy, the household sector remains cautious, with consumer spending soft, house sales falling and house prices remaining flat. With continued soft demand for credit, this suggests household spending will not increase to the extent previously projected.

"The pace of expansion in the global economy appears to have slowed in recent months with forward indicators of US growth, in particular, deteriorating noticeably. Nevertheless, continued strong growth in Australia and China will support demand for New Zealand exports, reinforcing the continued contribution of high export commodity prices.

"Overall, despite the weakened outlook, we still expect that growth will progressively absorb current surplus capacity over the next few years. In addition, changes to indirect taxes and earthquake impacts will cause headline inflation to spike higher over the coming year. Previous experience of GST increases, the fact that annual CPI inflation has been near 2 percent for the past year and a half, and the subdued state of domestic demand suggest this inflation spike will have little impact on medium-term inflation expectations.

"Over time, it is likely that further removal of monetary policy support will be required. The pace and extent of further OCR increases is likely to be more moderate than was projected in the June *Statement*."

OCR unchanged at 3.0 percent

28 October 2010

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 3.0 percent.

Reserve Bank Governor Alan Bollard said: "Despite some data turning out weaker than projected, the medium-term outlook for the New Zealand economy remains broadly in line with that assumed at the time of the September *Monetary Policy Statement*.

"Downside risks to the outlook for global growth continue, with high public and private debt inhibiting recovery in many developed economies. Moreover, it is unclear how further policy support would impact on the outlook for growth in our Western trading partners. Offsetting this weakness, strong growth continues in China, Australia and emerging Asia.

"Domestically, recent data has turned out weaker than projected. Continued household caution has seen consumer spending and housing market activity remain muted, and many firms have become less optimistic about their future prospects. However, continued high export prices, along with reconstruction and repairs in Canterbury, will support activity over the coming year.

"Overall, continued GDP growth is expected to gradually absorb current surplus capacity over the next few years. Headline inflation is expected to move higher following the recent increase in the rate of GST. The subdued state of domestic demand suggests this inflation spike will have limited impact on medium-term inflation expectations.

"While it is appropriate to keep the OCR on hold today, it remains likely that further removal of monetary policy support will be required at some stage."

Appendix D
The Official Cash Rate chronology

Date	OCR (percent)	Date	OCR (percent)	Date	OCR (percent)
17 March 1999	4.50	4 September 2003	5.00	24 April 2008	8.25
21 April 1999	4.50	23 October 2003	5.00	5 June 2008	8.25
19 May 1999	4.50	4 December 2003	5.00	24 July 2008	8.00
30 June 1999	4.50	29 January 2004	5.25	11 September 2008	7.50
18 August 1999	4.50	11 March 2004	5.25	23 October 2008	6.50
29 September 1999	4.50	29 April 2004	5.50	4 December 2008	5.00
17 November 1999	5.00	10 June 2004	5.75	29 January 2009	3.50
19 January 2000	5.25	29 July 2004	6.00	12 March 2009	3.00
15 March 2000	5.75	9 September 2004	6.25	30 April 2009	2.50
19 April 2000	6.00	28 October 2004	6.50	11 June 2009	2.50
17 May 2000	6.50	9 December 2004	6.50	30 July 2009	2.50
5 July 2000	6.50	27 January 2005	6.50	10 September 2009	2.50
16 August 2000	6.50	10 March 2005	6.75	29 October 2009	2.50
4 October 2000	6.50	28 April 2005	6.75	10 December 2009	2.50
6 December 2000	6.50	9 June 2005	6.75	28 January 2010	2.50
24 January 2001	6.50	28 July 2005	6.75	11 March 2010	2.50
14 March 2001	6.25	15 September 2005	6.75	29 April 2010	2.50
19 April 2001	6.00	27 October 2005	7.00	10 June 2010	2.75
16 May 2001	5.75	8 December 2005	7.25	29 July 2010	3.00
4 July 2001	5.75	26 January 2006	7.25	16 September 2010	3.00
15 August 2001	5.75	9 March 2006	7.25	28 October 2010	3.00
19 September 2001	5.25	27 April 2006	7.25		
3 October 2001	5.25	8 June 2006	7.25		
14 November 2001	4.75	27 July 2006	7.25		
23 January 2002	4.75	14 September 2006	7.25		
20 March 2002	5.00	26 October 2006	7.25		
17 April 2002	5.25	7 December 2006	7.25		
15 May 2002	5.50	25 January 2007	7.25		
3 July 2002	5.75	8 March 2007	7.50		
14 August 2002	5.75	26 April 2007	7.75		
2 October 2002	5.75	7 June 2007	8.00		
20 November 2002	5.75	26 July 2007	8.25		
23 January 2003	5.75	13 September 2007	8.25		
6 March 2003	5.75	25 October 2007	8.25		
24 April 2003	5.50	6 December 2007	8.25		
5 June 2003	5.25	24 January 2008	8.25		
24 July 2003	5.00	6 March 2008	8.25		

Appendix E
Upcoming Reserve Bank *Monetary Policy Statements* and Official Cash Rate release dates

The following is the Reserve Bank's schedule for the release of *Monetary Policy Statements* and Official Cash Rate announcements for 2011-12:

2011

Thursday 27 January 2011	OCR announcement
Thursday 10 March 2011	*Monetary Policy Statement*
Thursday 28 April 2011	OCR announcement
Thursday 9 June 2011	*Monetary Policy Statement*
Thursday 28 July 2011	OCR announcement
Thursday 15 September 2011	*Monetary Policy Statement*
Thursday 27 October 2011	OCR announcement
Thursday 8 December 2011	*Monetary Policy Statement*

2012

Thursday 26 January 2012	OCR announcement
Thursday 8 March 2012	*Monetary Policy Statement*
Thursday 26 April 2012	OCR announcement
Thursday 14 June 2012	*Monetary Policy Statement*

Dates for 2012 are provisional, subject to confirmation in August 2011.

The Reserve Bank reserves the right to make changes to this schedule, if required, due to unexpected developments. In that unlikely event, the markets and the media will be given as much warning as possible.

The announcement will be made at 9:00 am on the day concerned. Please note that the Reserve Bank reserves the right to make changes, if required due to unexpected developments. In that unlikely event, the markets and the media would be given as much warning as possible.

Appendix F
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 Government's economic objective is to promote a growing, open and competitive economy as the best means of delivering permanently higher incomes and living standards for New Zealanders. Price stability plays an important part in supporting this objective.

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 Bill English

Minister of Finance

Dr Alan E Bollard

Governor

Reserve Bank of New Zealand

Dated at Wellington this 18th day of December 2008