Monetary Policy Statement

December 2011[1]

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

Contents

Appendices

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[1] Projections finalised on 25 November 2011. Policy assessment finalised on 7 December 2011.

1 Policy assessment

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.5 percent.

As foreshadowed in the September *Statement*, global conditions have deteriorated. Continuing difficulties related to sovereign and bank debt in a growing number of European economies have resulted in high levels of volatility in financial markets. There has also been a softening in international economic activity, including in the Asia-Pacific region.

Global developments are having some negative impact on New Zealand, though to date it has been limited. Business confidence has declined and investment spending is likely to remain weak for some time. In addition, tightness in international markets means funding costs for New Zealand banks will increase to some degree over the coming year.

There remains a high degree of uncertainty around the global outlook and, as discussed in the scenario in this *Statement*, there is a risk that conditions weaken further.

Domestically, economic activity continues to expand, though at a modest pace. Although off their peaks, export commodity prices remain elevated. In addition, the depreciation of the New Zealand dollar provides some support for the tradable sector of the economy. Over time, repairs and reconstruction in Canterbury will also provide a significant boost to demand for an extended period.

Annual headline inflation is estimated to have returned within the Bank's 1 to 3 percent target band in the December quarter. Underlying inflation continues to sit close to 2 percent. In addition, wage and price setting pressures have remained contained.

Given the current unusual degree of uncertainty around global conditions and the moderate pace of domestic demand, it remains prudent for now to keep the OCR on hold at 2.5 percent.

Alan Bollard

Alan Bollard

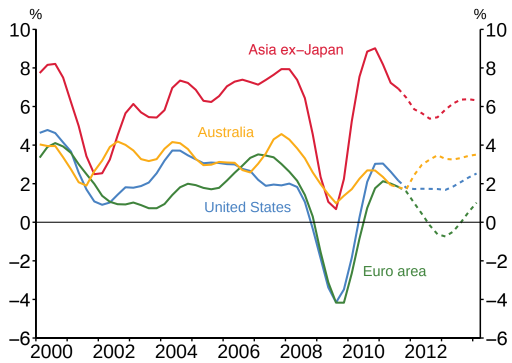
Governor

2 Overview and key policy judgements

Since the September *Statement*, the global economic environment has deteriorated significantly. Continuing difficulties related to sovereign debt in a growing number of European economies have resulted in high levels of volatility in financial markets. In addition, there has been a weakening in euro-area economic activity, and fiscal concerns are likely to weigh on growth in the US. The related declines in international trade and commodity prices, combined with a tightening in global financial conditions, have dampened activity in other regions. Notably, many of New Zealand's major trading partners in the Asia-Pacific region have experienced weaker export growth.

A further slowing in global activity is likely in early 2012 (figure 2.1). Euro-area activity is expected to contract through 2012 as a result of challenging economic conditions and austerity measures to address elevated sovereign debt levels. Some spillover to other regions, including Asia-Pacific economies, is likely. However, the projected downturn in the Asia-Pacific region is modest, consistent with the resilience of domestic demand in the region over recent months.

Figure 2.1
Trading partner GDP
(annual average)



Source: Haver analytics, RBNZ estimates. 'Asia ex-Japan' includes China, Hong Kong, India, Indonesia, Malaysia, The Philippines, Singapore, South Korea, Taiwan and Thailand.

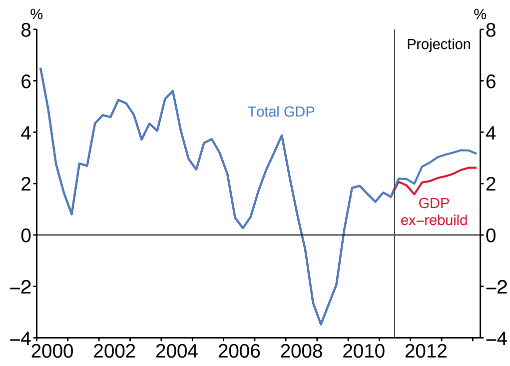
A period of adjustment in global activity is likely. An overhang of public debt will require large reductions in government spending or increases in taxes in many countries. Furthermore, in many of these same economies there is only limited scope for additional support from monetary policy.

The deterioration in global economic conditions and the exposure of private European banks to highly indebted sovereigns have resulted in a tightening in international funding markets. These markets are an important source of funding for domestic banks. Although New Zealand banks are currently well funded, bank funding costs are likely to increase to some degree over the coming year. This is likely to put some upward pressure on retail interest rates relative to the Official Cash Rate (OCR). Monetary policy will need to take account of such pressures.

In terms of the domestic economy, activity has continued to expand through the second half of the year, though at a modest pace. Primary sector earnings have been supported by favourable weather conditions and still-elevated commodity export prices. Spending associated with the Rugby World Cup has also provided some temporary boost for activity. However, underlying domestic demand has remained subdued. Households and businesses continue to be cautious, and have focused on paying down debt. This subdued domestic demand environment and growing uncertainty about global conditions have resulted in a marked reduction in business sentiment.

The pace of growth is expected to remain modest in the near term (figure 2.2). Soft domestic demand continues to weigh on activity, with particular weakness in the construction sector. In addition, developments offshore are dampening activity in New Zealand through trade, confidence and financial channels.

Figure 2.2
GDP
(annual)



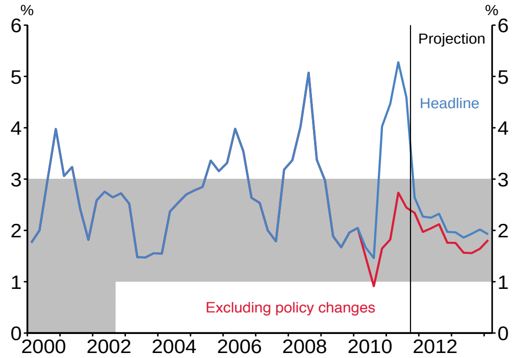
Sources: Statistics New Zealand, RBNZ estimates.

Uncertainty around the global outlook and the softer outlook for domestic activity have resulted in a sharp depreciation in the New Zealand dollar over recent months. This will help to cushion the tradable sector of the economy as global demand softens. In addition, the deterioration in financial market sentiment and the global economic outlook have led to a significant fall in wholesale domestic interest rates and declines in retail mortgage rates.

Over the coming years, annual GDP growth is projected to lift gradually, peaking at just over 3 percent. Repairs and replacement of damaged buildings and houses in the Canterbury region will be important contributors to demand, adding around 1 percent to growth through 2012 and 2013. Underlying economic activity, however, is expected to remain subdued for some time.

The economy has continued to operate with some degree of spare capacity, and underlying inflationary pressures remain contained. Core inflation measures have eased back and, once last year's increase in the rate of GST is excluded, they sit close to the middle of the Bank's target range. Wage inflation has also been modest. Although survey measures of inflation expectations remain elevated, they too have moderated.

Figure 2.3
Consumer Price Index
(annual)



Sources: 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 stationary energy and liquid fuel sectors to the amended Emissions Trading Scheme, and increases in excise tax on tobacco.

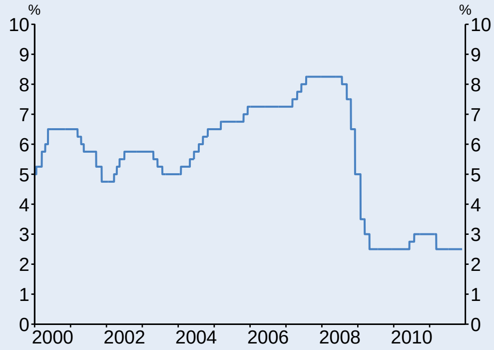
As reconstruction in Canterbury draws spare resources into production, underlying inflationary pressures will increase from current contained levels. However, the

Box A
Recent monetary policy decisions

At the time of the March *Statement*, the Official Cash Rate was pre-emptively reduced by 50 basis points. This reduction aimed to limit the risk of a sharp slowing in nationwide confidence and economic activity following February's devastating earthquake in Canterbury. When reaching this decision, the Bank was conscious that the increase in GST and other policy changes had resulted in headline inflation rising to elevated levels, adding to pressure on longer-term inflation expectations.

Since that time, the OCR has been held at 2.5 percent. Through mid-2011 the economy continued to expand, suggesting that the nationwide activity effects of the earthquakes had been contained. In addition, inflation expectations remained elevated. But while domestic activity had been resilient, global economic and financial conditions began to worsen. Given the risk for the outlook stemming from global conditions, the Bank assessed that it was prudent for the OCR to remain on hold, but noted the likelihood that increases would be necessary as GDP growth and pressure on underlying inflation lifted. This was conditional, however, on global economic and financial risks receding and having an only mild impact on domestic activity. More recently, global risks have intensified and offshore conditions are likely to have a more pronounced dampening impact on domestic activity.

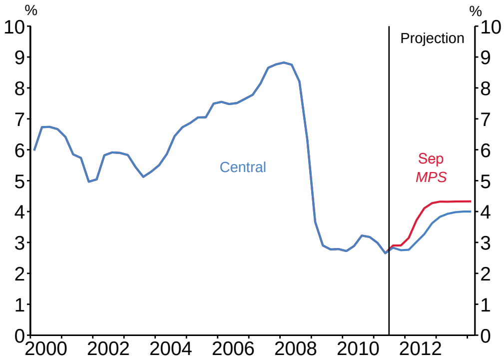
Figure A1
Official Cash Rate



Source: RBNZ.

outlook for global and domestic activity is softer than in September, and funding costs for New Zealand banks will increase to some extent over the coming year. In addition, there has been a material increase in the risks surrounding the outlook. As a result, monetary policy is projected to remain supportive for some time (figure 2.4).

Figure 2.4
90-day interest rate



Source: RBNZ estimates.

Monetary policy judgements

Global conditions

The outlook for global economic conditions is a key judgement and area of risk for the outlook. A major issue for New Zealand will be the extent to which growth in the Asia-Pacific region slows as a result of trade linkages to Europe and financial market turbulence. Economies in the Asia-Pacific region (including Australia) account for around 53 percent of New Zealand's merchandise exports, a significantly larger share than exports to the euro area (at just 7 percent). Nevertheless, the euro area accounts for a significant share of global economic activity, and is an important trading partner for many Asia-Pacific economies. Spillovers from a sharper-than-expected downturn in Europe, or a deeper slowdown in the Asia-Pacific region, could have a marked impact on New Zealand. Box B examines how the outlook would differ if we saw a more pronounced deterioration in global activity.

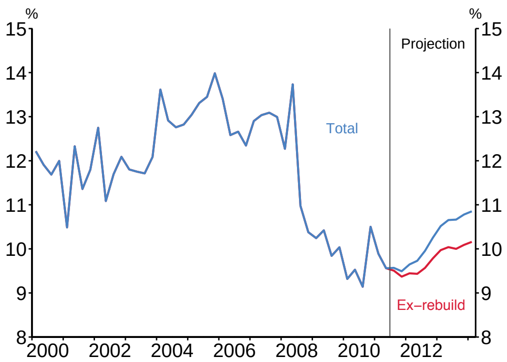
New Zealand is exposed to the weakening in global economic conditions via a number of channels, and recent events are expected to have a clear dampening impact on domestic activity over the coming year. The tightening in international bank funding markets is a particular concern due to the potential impact on borrowing costs for households and firms independent of changes in the OCR. The central projection assumes that New Zealand banks' funding costs will remain higher than they were earlier in the year. Such pressures are likely to persist until credible policies are put in place to ensure that sovereign debt in European economies will return to sustainable positions.

Although the risks for funding costs are to the upside, over recent years New Zealand banks have increased their liquidity and capital buffers and have lengthened the maturity profile of their wholesale funding. In addition, there has been strong growth in domestic deposits. Assuming demand for credit from households and firms remains weak, the amount of wholesale funding banks need to raise in the near term is limited. Furthermore, the Reserve Bank has deferred by six months the planned increase in the minimum core funding ratio, which was scheduled to occur in June 2012. These factors may help to limit the extent to which the current turbulence in financial markets affects domestic interest rates. However, persistent increases in global funding costs would increasingly affect domestic interest rates over the longer term.

New Zealand is also exposed to offshore developments via trade channels. Prices for some of our commodity exports have already softened, though to a lesser degree than prices for industrial commodities. Some further moderation is expected, but ongoing demand from emerging economies means that prices are still assumed to remain elevated. Demand for non-commodity exports, such as tourism or manufactured goods, is likely to be weaker than otherwise.

Offshore developments are likely to prompt ongoing caution among households and firms. This is an important contributor to the reduction in expectations for near-term growth. Consumer confidence has moderated and household spending decisions are likely to be pushed out. Furthermore, there has been a decline in businesses' activity expectations and investment intentions. Only limited growth in business investment spending is now expected over the coming quarters, despite the low level of capital expenditure over recent years (figure 2.5).

Figure 2.5
Business investment
(excluding computers and intangible assets, share of potential GDP)



Sources: Statistics New Zealand, RBNZ estimates.

Reconstruction in Canterbury

While global developments are currently a key concern, eventually monetary policy will also need to account for increases in demand that will result due to rebuilding in Canterbury. However, in light of recent developments in Europe, this has been of less concern for financial markets pricing.

Over the coming years, repairs and reconstruction in Canterbury will provide a significant boost to demand for an extended period. The Bank's working assumption remains that $20 billion (in 2011 terms) of reconstruction will be required. This predominantly reflects damage to residential properties, as well as substantial damage to infrastructure, commercial assets and land.

In addition to the size of the rebuild, the pace of reconstruction is a key influence on the degree of resource pressure in the economy. This will be conditional on a number of factors, including seismic stability and access to insurance. While small-scale repairs and demolition work are already occurring, we have maintained our assumption from the September *Statement* that the widespread reconstruction of the region will only begin in earnest in the second half of 2012, peaking in early 2014.

The outlook for rebuilding in Canterbury remains subject to a high degree of uncertainty. But while there may be some delays, reconstruction will eventually provide a boost to demand akin to the mid-2000s housing boom. This will draw spare resources into production, with pressures expected to build in parts of the labour market. Even if activity is delayed, pressure on resources may not be avoided. For instance, demand for rental properties is likely to be higher if reconstruction of houses occurs over a longer-than-expected period.

Inflationary pressures

Headline inflation is currently elevated as a result of last year's increase in GST. As noted in the September *Statement*, this temporary boost to headline inflation is not expected to have a lingering impact on inflationary pressures. Through 2010, measures of inflation expectations and pricing intentions showed an increase following the increase in GST. These same measures have moderated more recently. In addition, wage inflation has remained contained. We continue to expect further declines in inflation expectations through the first half of 2012 as the increase in GST drops out of annual inflation figures.

Box B

Alternative scenario – weaker outlook for global activity

While our central projection is for a moderate downturn in global activity, risks around the outlook have intensified significantly. This is due principally to concerns about the strength of euro-area activity. Activity in the euro area has deteriorated more rapidly than anticipated in recent months. In addition, policymakers are being confronted with the need to significantly tighten fiscal positions over the coming years. Rather than describing a worst-case outcome, this scenario describes how economic conditions could evolve if sovereign debt issues contribute to a more pronounced deterioration in the euro area, and the possible implications for domestic monetary policy.

A sharper-than-expected contraction in euro-area activity would materially reduce activity in other regions, including Asia and Australia. This would occur as a result of a marked deterioration in financial conditions, global trade and commodity prices. With limited scope for additional fiscal or monetary support in many Northern Hemisphere economies, global activity would remain weak for an extended period (figure B1).

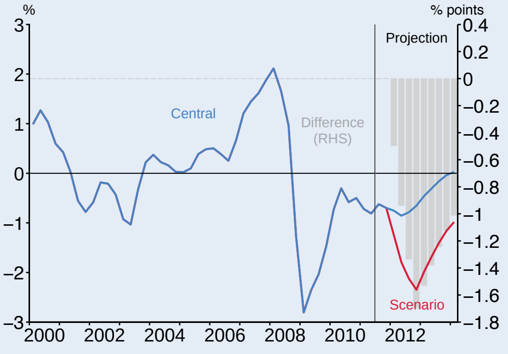
Weakness in global economic conditions would inevitably result in weaker activity in New Zealand, and GDP growth would be much weaker than assumed in the central projection. Export demand and commodity prices would decline sharply (figure B2). There would also be a reduction in domestic demand, with particular weakness in business investment spending. In addition, increases in risk aversion would result in a further tightening in term funding markets, which could exacerbate the downturn in domestic activity.

These conditions would result in lingering excess capacity (figure B3) that would dampen domestic inflationary pressures (figure B4). The New Zealand dollar would also fall (figure B5), moderating the impact of the downturn in global demand on the export sector, but adding to near-term tradable inflation.

Such conditions would necessitate a significantly different monetary policy response than is assumed in the central projection. In such circumstances it would be appropriate for monetary policy to remain supportive for an extended period, even as the reconstruction in Canterbury boosts demand (figure B6). Nevertheless, a weakening in domestic activity would still be likely.

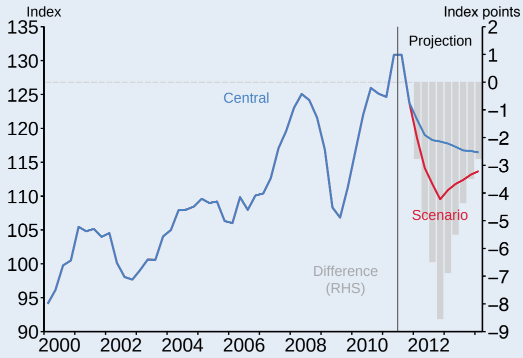
Financial markets' pricing is currently consistent with the 90-day interest rate remaining around current levels for an extended period. This would be consistent with concerns of a more marked downturn in global conditions than is assumed in the central projection.

Figure B1
Trading partner output gap
(trade weighted average of trading partner activity relative to trend)



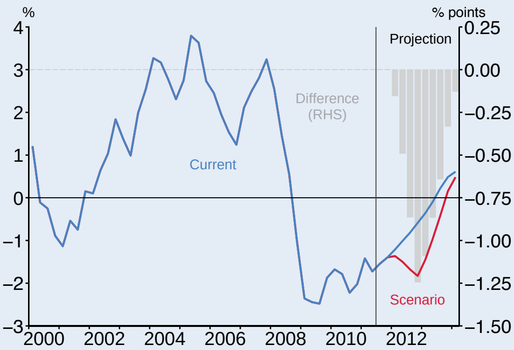
Sources: Haver Analytics, RBNZ estimates.

Figure B2
Terms of trade



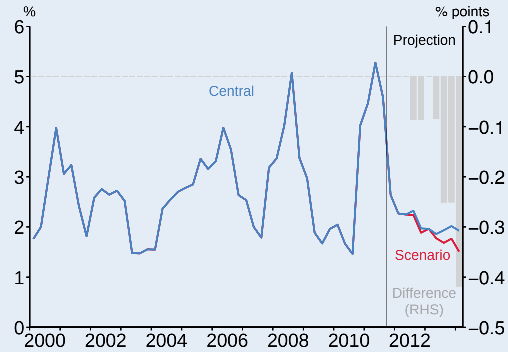
Sources: Statistics New Zealand, RBNZ estimates.

Figure B3
Domestic output gap
(percentage of potential GDP)



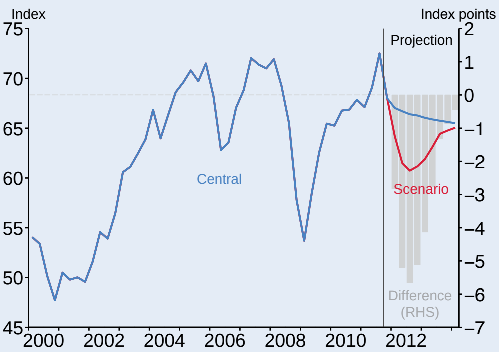
Source: RBNZ estimates.

Figure B4
Consumer Price Index
(annual)



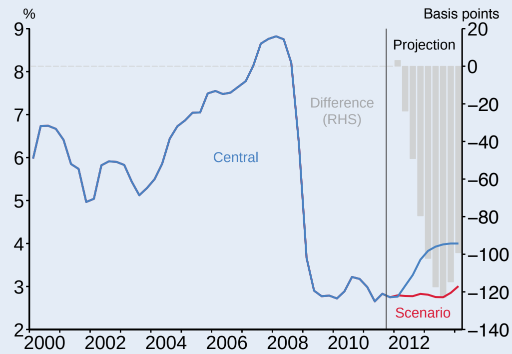
Sources: Statistics New Zealand, RBNZ estimates.

Figure B5
TWI



Source: RBNZ estimates

Figure B6
90-day interest rate



Source: RBNZ estimates.

3 Financial market developments

Overview

Sentiment in global financial markets remains poor. Concerns about the strength of activity in Europe, and the risk of contagion within the region, have intensified. This has generated significant uncertainty about the outlook for the global economy, resulting in rising government bond yields in a number of economies, and adding to stresses in the banking system.

There is increasing evidence that tight funding conditions for European banks are flowing through to the rest of the world, including the US and emerging markets. Domestically, banks have been affected by a tightening in long-term wholesale funding markets. Pressure on domestic banks to return to international funding markets has been mitigated by weak credit growth, strong deposit growth and the Reserve Bank's decision to delay the increase to the required minimum core funding ratio.

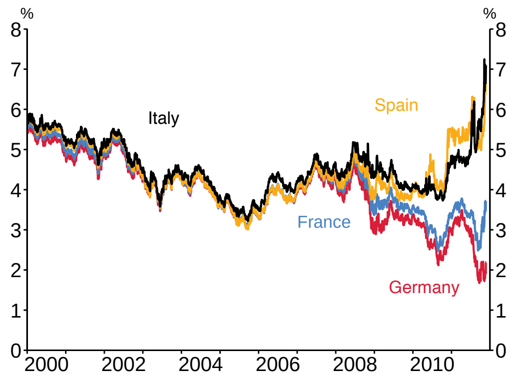
Despite the higher funding costs faced by domestic banks in the long-term wholesale market, overall monetary conditions have eased significantly since the September *Statement*. The deterioration in financial market sentiment and the global economic outlook have led to a significant fall in wholesale domestic interest rates, contributing to declines in retail mortgage rates and deposit rates. The New Zealand dollar has also weakened since the previous *Statement*, following the path of other risk-sensitive currencies.

International financial market developments

Financial markets have remained volatile since the September *Statement*. This is a result of ongoing sovereign debt concerns in European economies (particularly Greece and Italy) and the increased risk of spillover to other regions. In response to these concerns, European governments have announced an outline of a package that involves acceptance of losses on Greek debt by private sector bondholders, a bank recapitalisation plan, and leveraging of the European Financial Stability Facility (EFSF) to help provide a backstop for other European countries. Governments have also proposed harsher austerity measures to lower public debt levels.

Markets have become increasingly cautious towards holding debt of peripheral European nations. In addition, concerns around European sovereign debt have now spread to the larger countries of Europe such as France. Consequently, investors are discriminating between euro-area economies, with a clear divergence in euro-area government bond yields (figure 3.1). Safe-haven demand continues to keep German government bond yields at historically low levels. Worryingly, the spread between French and German bonds has widened, recently reaching 200 basis points at the 10-year maturity, because of large French private-sector exposure to peripheral debt and the prospect of a sovereign rating downgrade. If France were downgraded then Germany would be the only large AAA-rated country remaining in the euro area. Such a downgrade would make it difficult for the EFSF to successfully function as a support mechanism.

Figure 3.1
10-year government bond yields

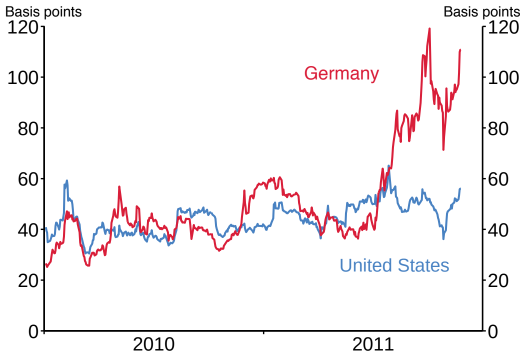


Source: Bloomberg.

Indeed, the credibility of the EFSF to deal with the financial crisis appears to be diminishing. Lately, the EFSF has been struggling to raise funding. Market participants are questioning the efficacy of euro-area governments' guarantee commitments to the fund. It is now also doubtful whether the fund will be able to be leveraged, given the lack of investor support.

Stresses have also emerged in Germany, with an increased gap in CDS spreads – an indicator of default risk – between Germany and the United States (figure 3.2). A €6 billion auction of 10-year German debt in late November was only 60 percent filled, with the residual being taken up by the Bundesbank. However, this likely reflects poor liquidity and stress in the banking system, rather than any clear evidence of a lack of buyers of German debt.

Figure 3.2
Sovereign CDS spreads



Source: Bloomberg.

There are increasing calls on Germany to agree to the concept of common euro-area bonds. These bonds would mean pooling sovereign issuance among member states, and sharing associated revenue flows and debt servicing costs. Such issuance would have to be in conjunction with significantly tighter controls over euro-area members' budgets. The AAA-rated countries of the region firmly oppose the issuance of common euro-area bonds. Issuance of these bonds would not solve the underlying debt problems of the troubled nations but they could relieve some of the current market pressure by improving confidence.

Some analysts suggest that only the European Central Bank (ECB) can provide a circuit breaker to turn around sentiment in financial markets. There is mounting pressure on the ECB to increase the purchase of government debt in the secondary market and not sterilise these purchases. But this kind of monetary expansion is strongly opposed by Germany, for fear of driving inflation higher.

Financing and credit

Due to concerns about European banks' exposures to bonds issued by peripheral euro-area governments, it is becoming increasingly difficult and costly for European banks to fund. Since the middle of the year, raising unsecured long-term funding has been particularly problematic.

Funding is required to replace maturing debt and meet increased capital requirements. The European Banking Authority (EBA) recently announced that around 40 banks needed to increase their capital base by a total of €106 billion to meet the tougher rules being introduced. The EBA's estimate of capital requirements is after banks mark to market current holdings of sovereign bonds. However, falling sovereign bond prices — caused by widespread selling — are accentuating mark-to-market losses and effectively increasing the capital banks need to raise.

With share prices at deep discounts relative to book value, banks are choosing not to raise capital by diluting existing shareholders. Instead, they are opting to reduce the size of their balance sheets by cutting back on lending. Banks are also choosing to deleverage by selling down assets, particularly US dollar assets. This has been prompted by difficulties in accessing US dollars.

The Federal Reserve's most recent Senior Loan Officer survey indicated US banks were tightening their credit standards to European banks and institutions. United States money market funds have also been actively reducing their exposure by not rolling over commercial paper issued by European banks. This has pushed out European basis swap spreads, making it more expensive for European banks to obtain US dollar funding and forcing them to rely more on ECB dollar swap facilities.

The tighter access to funding markets has forced many euro-area banks to raise credit standards on lending to business and household borrowers. The latest ECB Bank Lending Survey (taken in October) shows a sharp rise in the number of banks tightening credit standards, with respondents noting the tighter standards are due to worsening funding market conditions and deterioration in expected economic conditions.

By reducing the size of their balance sheets, European banks are tightening credit conditions, both within Europe and in overseas markets. To the extent that restricting credit causes economic conditions to weaken, this makes resolving the debt crisis even more difficult.

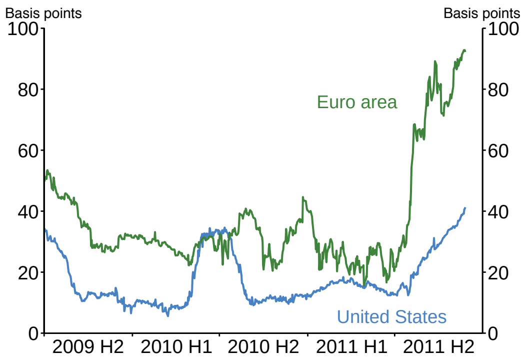
Central banks' policy responses so far have been to shore up liquidity in the market, but this does little to address the underlying credit risk concerns. Various central banks have reopened US dollar swap lines with the Federal Reserve. The ECB has also been increasingly injecting liquidity into the European market, but commercial bank reserves held at the

ECB continue to rise, suggesting that much of the additional liquidity is returning to the ECB's balance sheet.

US dollar funding is also available through the ECB swap facility, but so far there has been only limited use. This likely reflected the higher cost of the facility compared to market pricing but, more importantly, the stigma attached to banks who access the swap facility. At the end of November, the cost of accessing the facility was cut by 50 basis points to encourage its use and ease liquidity strains in accessing US dollars.

It is not just European banks that are cautious. US banks are depositing cash at the Fed rather than lending out the excess reserves in the market. The spread between interbank and expected policy rates, as measured by the FRA-OIS spread, has also been nudging higher recently, indicating tension in the interbank market (figure 3.3).

Figure 3.3
Spread between interbank and expected policy rates



Source: Bloomberg.

As noted above, euro-area banks are tightening lending to both domestic and international borrowers, leading to concerns of contagion from the euro-area banking system to financial systems in the rest of the world, especially in emerging market economies. For New Zealand, an important focus is on any potential impact on Asia through both financial market and trade channels.

Bank for International Settlements data indicate that since 2009, lending by European banks to emerging Asian banks has risen to nearly US$1.5 trillion, with the highest lending to China and Hong Kong. Bank lending surveys confirm that during the September quarter, overall funding conditions faced by Asian banks have worsened. So far, there are few signs of stress in local currency funding markets, with little sign of spreads of money market rates to policy rates widening in most countries within the region. However, there are indications of tensions in the market for foreign currency funding faced by Asian banks. This is reflected in wider basis swap spreads in many Asian countries, especially at longer maturities, since the current concerns over euro-area sovereign debt began in August.

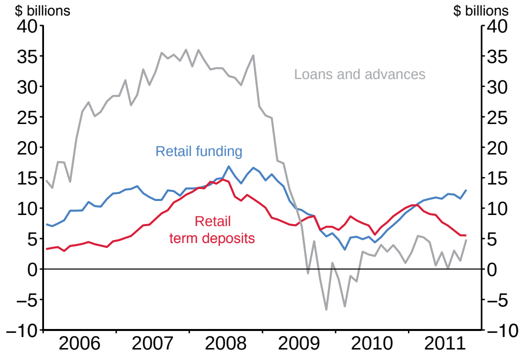
In New Zealand, strong deposit growth and weak credit demand have significantly reduced the pressures on banks to raise term funding. In aggregate, banks are currently comfortably above minimum regulatory funding requirements and, if current trends in deposits and credit continue, only a modest level of wholesale term funding will need to be raised over the coming year.

Credit growth is a key driver of bank funding requirements. Credit growth peaked in 2007, fell markedly leading up to the height of the global financial crisis and, since the middle of 2009, has been very tepid. The stock of loans and advances for registered banks is approximately $320 billion and has barely risen over the past 12 months. Comparing October 2011 to a year earlier, loans and advances rose by 1.5 percent or just under $5 billion (figure 3.4). Weak credit growth reflects soft economic conditions, global market uncertainty and pressures on households and businesses to reduce debt levels.

Simultaneously, banks are experiencing strong deposit growth, with annual growth running close to 9 percent in October. This equates to close to $13 billion in extra deposits, taking the stock of retail deposits to about $160 billion.

While it appears that modest growth in credit could be met from rising deposits, banks also have maturing wholesale debt on their balance sheet. Banks are estimated to have about $15 billion of maturing core funding over the next 12 months or so. If credit growth remains subdued and deposit growth remains strong, then much of that maturing funding could be met from retail deposits. If credit growth picks up, then clearly the banks' funding requirements would increase.

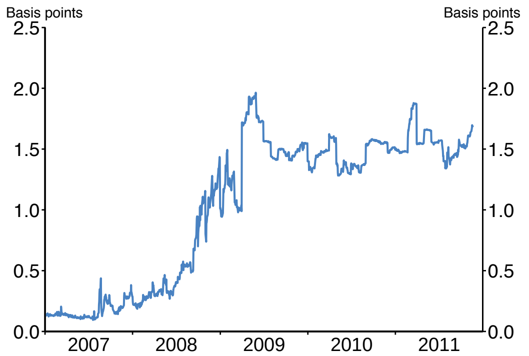
Figure 3.4
Deposit and loan growth
(annual)



Source: RBNZ.

Marginal bank funding costs have been relatively steady over the past 18 months or so. However, they are nearer the top end of recent experience, driven by higher long-term wholesale funding costs. Recent deals transacted in international funding markets have been particularly costly to banks, suggesting significant upward pressure at present (figure 3.5).

Figure 3.5
Funding cost indicator
(basis point spread to OCR)



Source: RBNZ.

New Zealand banks have done very little unsecured long-term funding this year, but there has been some success in issuing covered bonds. Since June, three of the major trading banks have successfully issued covered bonds, although pricing has been on an upward trend.

In mid-November, two Australian banks issued covered bonds for the first time, following changes to Australian legislation that allowed banks to access this source of funding. Since then, market conditions have deteriorated and the pricing of any subsequent issues is likely to be considerably higher. Plans for New Zealand banks to issue covered bonds have likely been pushed out, given pricing conditions and the risk of being crowded out by their parent banks. With raising unsecured term funding still problematic, it seems that New Zealand banks will have to rely on domestic retail deposits over the near term for more stable sources of funding. Should wholesale term funding markets remain problematic well into next year, there is the risk of local banks tightening lending conditions or upward pressure on interest rates faced by domestic firms and households.

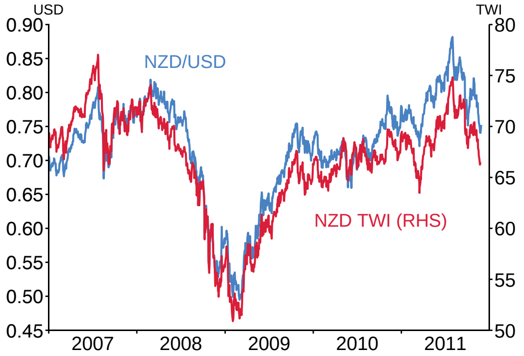
Overall, pricing pressures on bank funding are likely to remain high over the foreseeable future. The recent downgrade of New Zealand Government's sovereign long-term credit rating has had little impact on bank funding conditions. However, a further downgrade to the sovereign rating could elicit a more substantial market reaction.

Foreign exchange market

Since the September *Statement*, the New Zealand dollar TWI has depreciated markedly. Major contributors to this depreciation have been the weaker outlook for global growth and the related decline in risk appetite, as well as the moderation in commodity prices.

Falls in the New Zealand dollar have been broad based (figure 3.6). This suggests that domestic factors have also contributed to the recent declines. This includes weaker activity and inflation data, which have encouraged a larger fall in interest rates in New Zealand compared to other countries. These conditions have reduced the appeal of the New Zealand dollar from a carry-trade perspective.

Figure 3.6
NZD/USD and the New Zealand dollar TWI



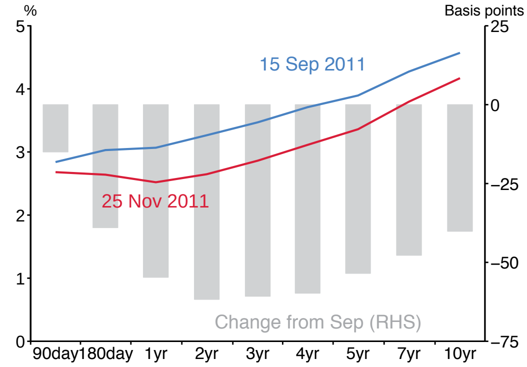
Source: Bloomberg.

Domestic financial market developments

Since the previous *Statement*, the New Zealand wholesale yield curve has shifted substantially lower across all maturities. This reflects the global trend towards lower interest rates in countries like the US, Germany and Australia, as well as softer domestic activity and inflation. These developments have led the market to remove any expectations of tighter monetary policy in New Zealand over the next 12 months.

Major New Zealand banks have lowered their fixed-term mortgage rates over the past month, while the floating mortgage rate is unchanged. Lower wholesale rates (figure 3.7), a view that the Reserve Bank will keep rates lower for longer, low credit growth and strong retail deposit growth are likely to have contributed to the banks' decisions to cut mortgage rates. The effective mortgage rate (the average across all mortgages held in New Zealand) continues to nudge lower, as borrowers roll off fixed-rate mortgages that were set a year or two ago and face lower interest rates today.

Figure 3.7
New Zealand wholesale interest rates



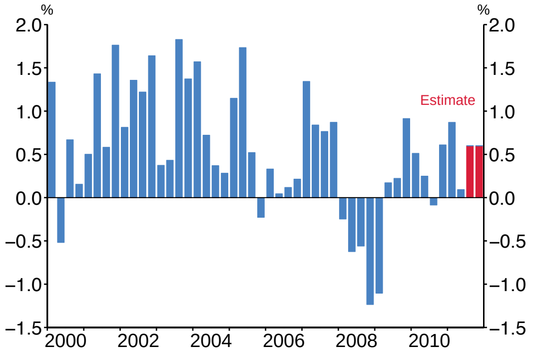
Source: Bloomberg.

4 Current economic conditions

Overview

Through the latter half of 2011, economic activity continued to expand, but at a modest pace (figure 4.1). Strength in commodity prices and favourable agricultural conditions helped to support primary sector incomes. In addition, the Rugby World Cup provided some temporary boost to activity. However, underlying domestic demand has remained subdued with households continuing to focus on debt consolidation. Spare capacity remains in the economy, with near-term inflationary pressures modest. Inflation expectations have eased somewhat after increasing over the first half of the year. These higher inflation expectations have had limited impact on wage and price-setting behaviour to date.

Figure 4.1
GDP growth
(quarterly, seasonally adjusted)



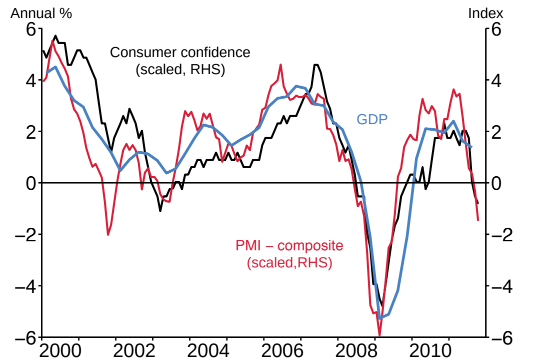
Source: Statistics New Zealand, RBNZ estimates.

International conditions

The unresolved European debt situation has dampened growth across New Zealand's trading partners. Austerity measures adopted by indebted European sovereigns have had a direct negative impact on growth. Moreover, the high level of uncertainty around the European economic outlook has caused businesses and households to postpone investment and spending decisions. In addition, as discussed in Chapter 3, global financial conditions have deteriorated, placing pressure on funding costs and credit conditions globally. While domestic demand appears to have remained resilient across the Asia-Pacific region, lower demand from Western economies is flowing through to weaker exports.

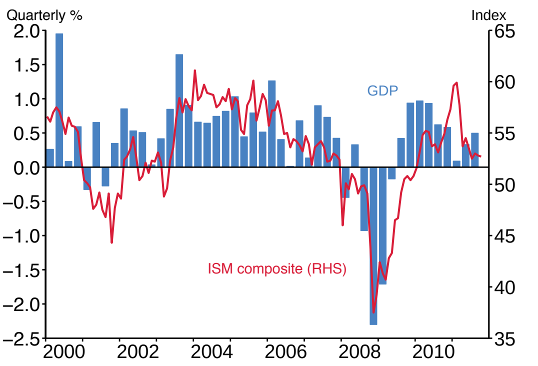
In Western economies, output growth slowed markedly over the first half of 2011. The slowdown was partly due to temporary factors, such as high fuel prices and trade supply disruptions caused by the Tohoku earthquake in Japan in March. Some of these factors have dissipated over the past months. However, underlying growth remains weak. In Europe, indicators of business and consumer sentiment have fallen sharply to levels usually associated with contraction (figure 4.2). Indicators point to continuing soft growth in the US (figure 4.3).

Figure 4.2
Euro-area GDP and activity indicators



Source: Haver Analytics.
Note: Activity indicators have been scaled to be comparable to GDP growth.

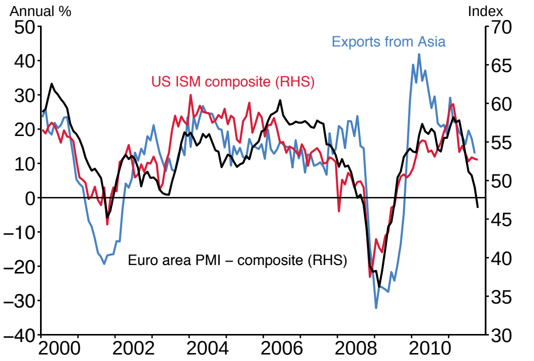
Figure 4.3
US GDP and ISM



Source: Haver Analytics.

In Asia, weaker demand from Western economies is weighing on export growth (figure 4.4), though the impact on GDP is being partly offset by slower growth in imports. Domestic demand in Asia has remained resilient, supported mainly by robust consumption spending. In China, although exports rose at the slowest pace in almost two years in October, GDP growth is still being underpinned by significant increases in investment, particularly in the construction sector.

Figure 4.4
Western economy manufacturing performance and exports from selected Asian economies



Source: Haver Analytics. Includes Hong Kong, Indonesia, Malaysia, The Philippines, Singapore, South Korea, Taiwan, and Thailand.

The Australian economy has grown at a moderate pace through 2011. Despite a slight fall in commodity prices, Australia's terms of trade remain elevated, and the mining industry is still growing strongly. The Reserve Bank of Australia reduced the policy interest rate in November citing the likely influence of weaker external growth and an increase in the unemployment rate. Consumer sentiment has recently improved slightly from earlier in the year.

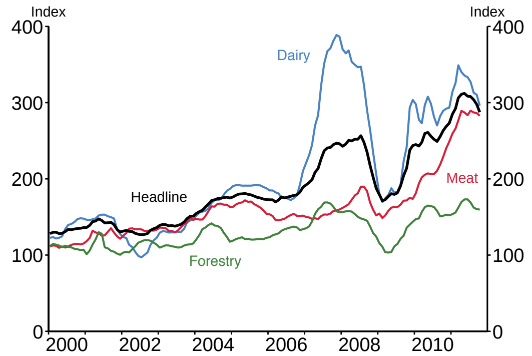
Trading partner inflation appears to have stabilised, following a decline in commodity prices in recent months. Core inflation has trended higher in the US and in some Asian economies, but is likely to be contained due to the slowdown in global demand. Central banks have either cut or kept interest rates on hold in recent months, due to heightened uncertainty around the economic outlook.

Domestic conditions

The deterioration in the outlook for global activity, along with a worsening in conditions in global financial markets, has begun to have an adverse impact on domestic economic conditions.

Weaker global growth has put downward pressure on New Zealand's export prices (figure 4.5). This pressure has been reinforced by favourable weather conditions, which have boosted production of some key primary sector exports. Nevertheless, New Zealand's export prices remain at elevated levels, and have not fallen as markedly as global commodity prices more generally. As a result, primary sector incomes remain relatively high, helping to support general domestic activity.

Figure 4.5
ANZ commodity price indices

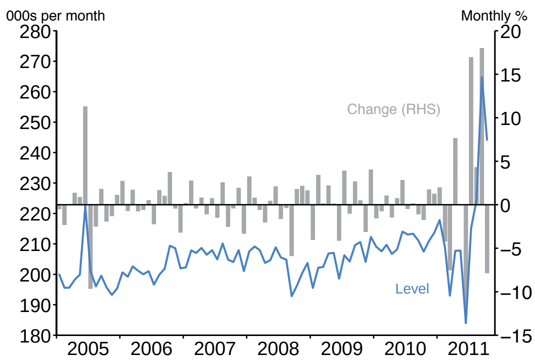


Source: ANZ National Bank.

The New Zealand dollar depreciated sharply over November, which will limit the impact of the decline in export prices on export sector incomes. The recent weakness in some global commodity prices such as oil and other industrial products will also limit import price pressure, helping to keep New Zealand's terms of trade at elevated levels.

The Rugby World Cup provided some temporary support for the export sector during the latter part of 2011. Visitor arrivals increased strongly over the past few months (figure 4.6), with a total of 133,200 visitors arriving for the tournament. This significantly boosted exports of services towards the end of the year.

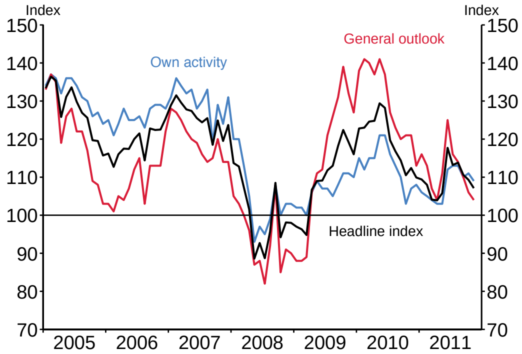
Figure 4.6
Visitor arrivals
(monthly, seasonally adjusted)



Source: Statistics New Zealand.

Household sector spending has been subdued recently with households continuing to focus on debt consolidation (see box E for further discussion). Growth in employment has been limited during 2011, which has provided little impetus for consumption growth. In addition, consumer confidence has deteriorated recently (figure 4.7). While retail sales did rise strongly in the September quarter, it is likely a significant amount of this increase reflected growth in tourist spending during the Rugby World Cup.

Figure 4.7
Consumer confidence



Source: Roy-Morgan.

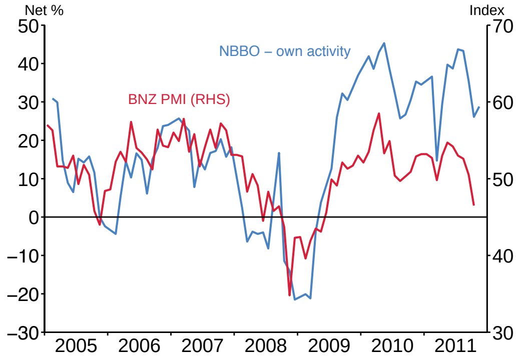
Construction sector activity has remained weak over the past year. However, building consents have picked up recently, and housing market activity has improved somewhat from subdued levels. This is likely to result in a construction sector activity pick up from low levels over the end of the year.

International developments have also weighed on business confidence and activity, with a broad range of business sector indicators deteriorating in recent months (figure 4.8). Business investment spending has levelled off after recovering over 2010. It is likely that this deterioration in business confidence and general uncertainty over the economic outlook will weigh on business investment in the near term.

Capacity pressures and inflation

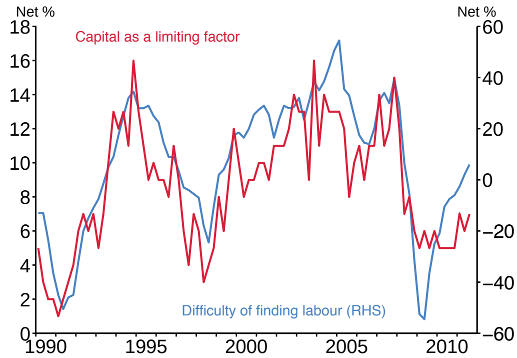
The economy continues to operate with some spare capacity. Surveyed capacity pressures have remained fairly stable since the recession (figure 4.9). While firms still report some difficulty finding skilled staff, the unemployment rate has remained at an elevated level over recent quarters (figure 4.10).

Figure 4.8
Business confidence and PMI



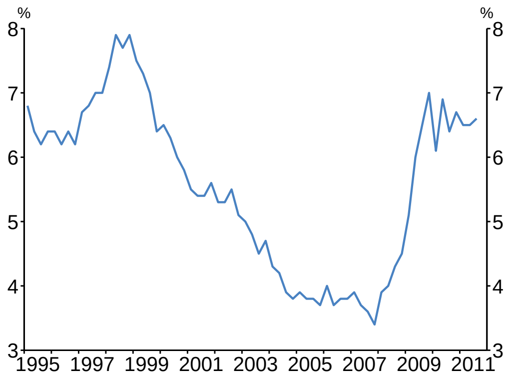
Source: ANZ National Bank, Business New Zealand.

Figure 4.9
Survey measures of capacity pressure



Source: NZIER.

Figure 4.10
Unemployment rate
(seasonally adjusted)



Source: Statistics New Zealand, RBNZ estimates.

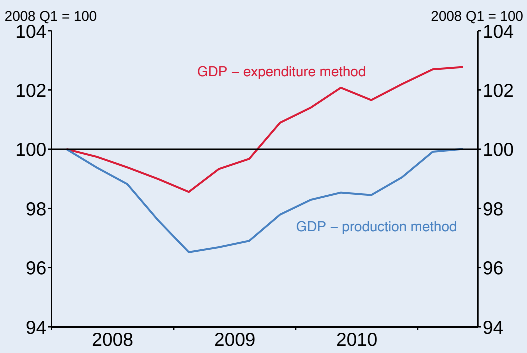
Box C

Measuring economic growth in the short term

There are three standard methods of measuring GDP: the production, income and expenditure approaches. All three approaches should produce the same value for GDP. However, these approaches require a large amount of information, which is not very timely. To produce timely estimates, indicators are used to estimate the different measures of GDP. The impact of this is sometimes a difference or discrepancy between the measures.

In New Zealand, real GDP estimates using the production and expenditure approaches are produced on a quarterly basis. In recent years a gap has emerged between the two series. Over the past three years, the quarterly measure of real expenditure GDP has grown almost 3 percent, while the production measure has only just returned to March 2008 levels. This discrepancy is quite large (figure C1) and there is the potential for correspondingly large revisions. While this would not necessarily affect our assessment of cyclical pressures in the economy, it adds to uncertainty about the economic environment and can make decision making in real time more difficult.

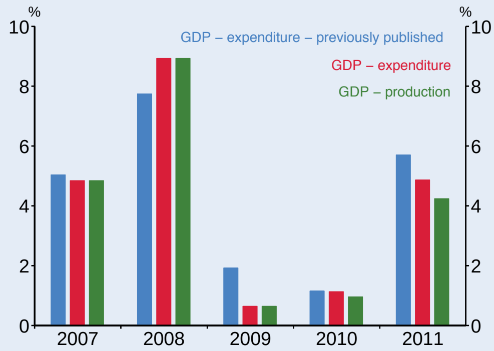
Figure C1
Expenditure and production GDP



Source: Statistics New Zealand.

Adding to uncertainty about the state of the economy, annual nominal GDP estimates were released in October. Figure C2 shows the size of the revisions that occurred to historical data. It will be some time before these revisions are reflected in quarterly real GDP series and it is not possible to anticipate how the measurement of real GDP will be affected.

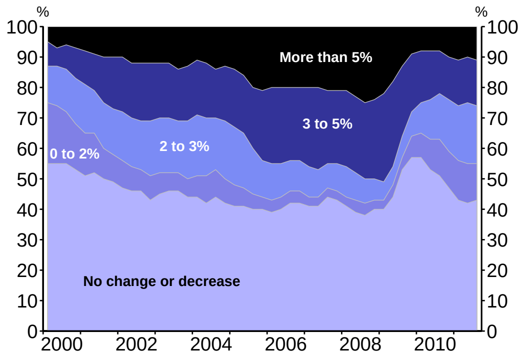
Figure C2
Nominal GDP growth
(annual)



Source: Statistics New Zealand.

Wage inflation has remained below average levels. While the proportion of negative or zero wage changes has decreased over the past few years, there are currently fewer settlements above 3 percent compared with 2008 (figure 4.11). Measures of core inflation have moderated recently. Box D discusses the evolution of core inflation measures in more detail.

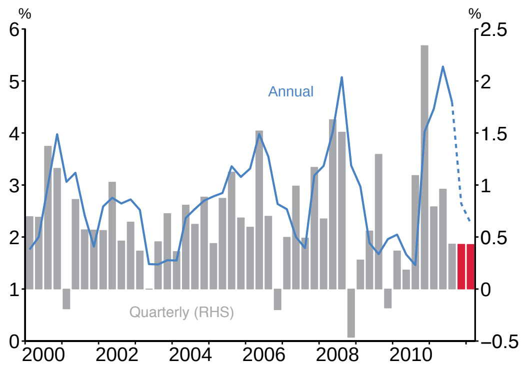
Figure 4.11
Distribution of wage changes



Source: Statistics New Zealand.

Consistent with spare capacity in the economy, quarterly CPI inflation is currently modest. However, annual inflation has been boosted by the increase in the rate of GST in the December 2010 quarter (figure 4.12).

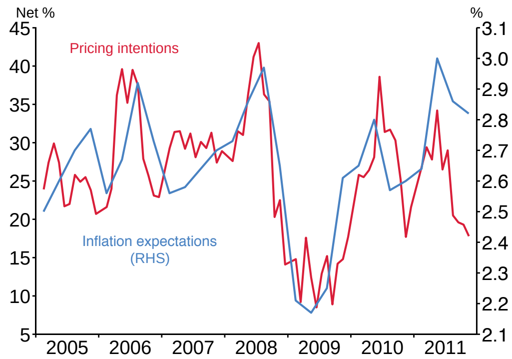
Figure 4.12
CPI inflation



Source: Statistics New Zealand, RBNZ estimates.

The increase in annual inflation following the rise in the rate of GST was followed by an increase in surveyed inflation expectations (figure 4.13). These expectations have since moderated, and a further decline is expected as the GST increase drops out of the annual rate of inflation. There has been little evidence that the increase in inflation expectations or the high rate of annual inflation have passed through to wage and price-setting behaviour (see table 4.1 and Box D). Moreover, firms' pricing intentions have continued to decline in recent months, despite the elevated level of surveyed inflation expectations.

Figure 4.13
Pricing intentions and annual two-year ahead inflation expectations



Source: ANZ National Bank, RBNZ.

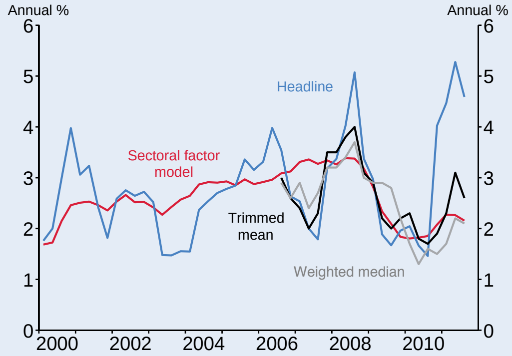
Box D

The impact of the GST increase on headline and underling CPI inflation

On 1 October 2010 the rate of the Goods and Services Tax (GST) rose from 12.5 percent to 15 percent. This increase affected about 90 percent of the CPI basket of goods and services.[1] As a result, the December 2010 quarter CPI recorded the largest quarterly increase since the September 1989 quarter, when GST increased from 10 percent to 12.5 percent.

Analytical CPI measures remove the influence of short-term disturbances, and isolate more persistent underlying price changes. These measures include Statistics New Zealand's (SNZ) trimmed mean and weighted median CPI series (which SNZ has adjusted to exclude the direct impact of the rise in GST) and the Reserve Bank's sectoral factor model series. After adjusting for the change in GST, analytical CPI inflation measures have remained below the headline CPI inflation rate, highlighting the impact of recent large, but temporary, increases in some consumer prices on headline inflation (for instance, prices for imported vegetables through mid-2011). Analytical CPI measures have moderated in recent months and generally sit close to the mid-point of the Bank's target band for inflation (figure D1).

Figure D1
Headline inflation and ex-GST core inflation measures
(annual)



Sources: Statistics New Zealand, RBNZ.

[1] Housing rentals, school donations, life insurance, and credit services make up about 9 percent of the CPI and are exempt from GST. Further, some items in the CPI basket are zero-rated for GST, such as international air fares, international package holidays, and some international postage. These items made up a further 2 percent of the CPI.

Table 4.1

Measures of inflation and inflation expectations

(annual)

	2010				2011		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep
CPI	2.0	1.7	1.5	4.0	4.5	5.3	4.6
CPI components							
CPI non-tradable	2.1	2.2	2.5	4.6	5.2	5.2	4.5
Non-tradables housing component	1.2	1.4	1.7	2.7	2.8	3.0	2.9
Non-tradables ex housing, cigarettes and tobacco component	2.6	2.2	2.1	4.8	5.1	5.5	5.0
CPI tradable	2.0	1.0	0.3	3.3	3.7	5.5	4.6
Petrol	11.5	9.5	5.8	14.2	17.1	20.1	17.7
Other inflation measures							
Sectoral factor model estimate of core CPI inflation ex-GST	1.8	1.8	1.9	2.1	2.3	2.3	2.2
CPI trimmed mean (of annual price change) ex-GST	2.3	1.8	1.7	1.9	2.3	3.1	2.6
CPI weighted median (of annual price change) ex-GST	1.7	1.3	1.6	1.5	1.7	2.2	2.1
CPI ex-food, petrol and government charges *	1.3	1.4	1.0	2.7	3.1	3.4	3.2
CPI ex-food and energy	1.7	1.7	1.4	3.1	3.3	3.6	3.2
GDP deflator (derived from expenditure data)	-0.0	1.9	3.0	5.9	4.4	4.0	n/a

	2010				2011			
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
Inflation expectation measures								
RBNZ Survey of Expectations - inflation one-year-ahead	2.1	2.9	3.9	3.4	2.9	3.1	2.9	2.7
RBNZ Survey of Expectations - inflation two-years-ahead	2.7	2.8	2.6	2.6	2.6	3.0	2.9	2.8
AON Hewitt Economist survey - inflation one-year-ahead	2.2	3.4	5.0	4.3	2.6	3.0	2.8	2.5
AON Hewitt Economist survey - inflation four-years-ahead	2.5	2.5	2.6	2.5	2.4	2.6	2.7	2.5
NBBO - inflation one-year-ahead (quarterly average)	2.6	2.8	3.1	2.9	3.0	3.2	3.3	3.1

*Excludes food items and petrol, as well as government related goods and services. This measure still includes the impact of the rise in GST on non-government related goods and services.

5 The macroeconomic outlook

Overview

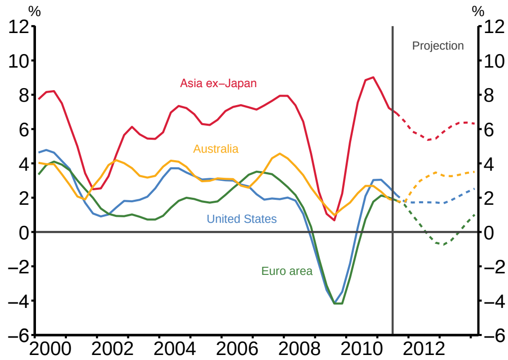
The macroeconomic outlook is dominated by the outlook for trading partner growth. Concerns remain over European sovereign debt and how a subsequent slowdown in the euro area could impinge on domestic prospects. Export prices are projected to ease over the forecast period, and tourist spending is projected to remain subdued. Household spending growth is expected to be restrained as households act to reduce debt. Nonetheless, spare resources are projected to be slowly absorbed, particularly as reconstruction following the Canterbury earthquakes gathers pace. Headline inflation is expected to settle around the centre of the target band over the medium term.

International economic projection

The growth outlook for New Zealand's trading partners has deteriorated sharply since the previous *Statement*, and the medium-term projection has been revised substantially downwards. The growth outlook is dominated by expectations of a prolonged recession in Europe and slow growth in the United States. Weaker demand from Western economies will lead to further slowing in export growth across Asia (figure 5.1), offset by stronger growth in Australia.

It is likely that the euro area has already entered into recession. The high level of uncertainty surrounding the resolution of unsustainable sovereign fiscal positions contributes to lower domestic demand as both businesses and households delay expenditure. Concerns over the banking sector's exposure to sovereigns will hinder attempts to improve capital buffers, which will likely curtail lending growth. Moreover, the fiscal positions across Europe provide little room for the public sector to offset the effects of lower domestic demand. Indeed, consolidation by the public sector will exacerbate the slowdown in the private sector.

Figure 5.1
Trading partner GDP growth
(annual, seasonally adjusted)



Source: Haver Analytics, RBNZ estimates. 'Asia ex-Japan' includes China, Hong Kong, India, Indonesia, Malaysia, The Philippines, Singapore, South Korea, Taiwan and Thailand.

In the United States, forward indicators continue to point to softness in growth. Conditions in the household sector are subdued, with falling house prices and high unemployment. In addition, substantial fiscal retrenchment is likely over the projection.

The outlook for growth in Asia has been revised down relative to the previous *Statement*. The weaker outlook for Western demand will lead to further slowing in export growth across the region, although the effect of this on

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

Country	2004	2005	2006	2007	2008	2009	2010	2011f	2012f	2013f
Australia	3.8	3.1	2.6	4.6	2.6	1.4	2.7	1.7	3.5	3.4
Asia ex-Japan*	7.2	6.5	7.3	7.9	4.6	2.2	9.0	6.5	5.4	6.4
United States	3.5	3.1	2.7	1.9	-0.3	-3.5	3.0	1.8	1.7	2.3
Japan	2.7	1.9	2.0	2.3	-1.2	-6.3	4.0	-0.5	1.7	3.3
Euro area	2.0	1.8	3.3	3.0	0.3	-4.2	1.8	1.6	-0.6	0.5
United Kingdom	3.0	2.1	2.6	3.5	-1.1	-4.4	1.8	1.0	0.7	1.4
16 country index	4.2	3.6	3.8	4.4	1.7	-0.9	4.7	3.1	3.4	4.1

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

GDP will be muted by weaker imports. Moreover, domestic demand is being supported by robust consumption spending. However, the weakening of the external sector is expected to drag on domestic demand via weaker revenues and employment.

In China, the external sector has weakened in recent months. However, a high level of investment is projected to underpin growth in economic activity. New construction starts have continued to post strong gains, despite tighter credit conditions and actions by the authorities to discourage residential investment.

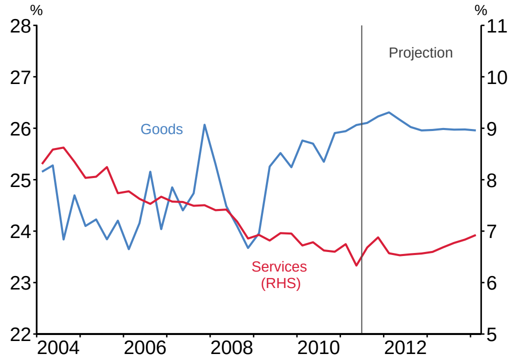
In Australia, GDP growth is forecast to increase over the coming year. Domestic demand continues to grow at around average pace, and consumer confidence has improved. Export growth has picked up in recent months, as mining production has returned to normal. A high level of mining investment is expected to further support export growth. Commodity prices have fallen slightly in recent months, but these falls were anticipated and are not expected to deter current investment decisions.

Trading partner inflation is expected to moderate slightly over the forecast period. Headline inflation increased rapidly over the first half of 2011 due to higher food and energy prices and the recovery in global demand. Commodity price inflation has started to moderate, and weaker global demand is expected to translate into lower wage and cost pressures.

Domestic economic projection

The slowdown in trading partner activity will transmit to domestic activity via a number of channels. First, weaker offshore demand will put downward pressure on goods exports, which are expected to grow only modestly over the projection. In addition, weaker worldwide incomes will discourage both tourist numbers and average tourist expenditure, depressing exports of travel services (figure 5.2).

Figure 5.2
Export volumes
(share of potential GDP, seasonally adjusted)

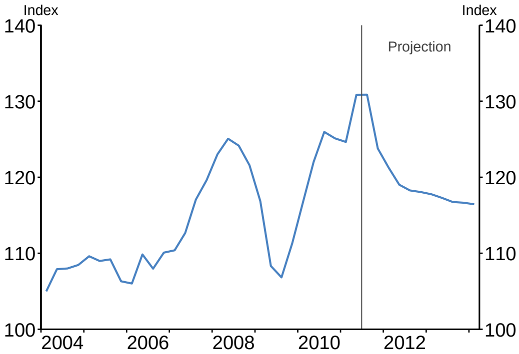


Source: Statistics New Zealand, RBNZ estimates.

Second, the softer outlook for world activity is likely to restrain the prices of New Zealand's export commodities. As global supply improves from the weather-induced disruptions that occurred over the recent past, these prices are projected to moderate over 2012. However, the increased demand arising from rising incomes in emerging markets is expected to maintain agricultural commodity prices at levels higher than those witnessed over recent decades.

Whereas oil prices are also projected to moderate over the projection, the prices of other imported goods are expected to increase in line with world consumer prices. This results in a projected deterioration in the terms of trade, albeit to still robust levels (figure 5.3).

Figure 5.3
OTI terms of trade (goods)
(seasonally adjusted)



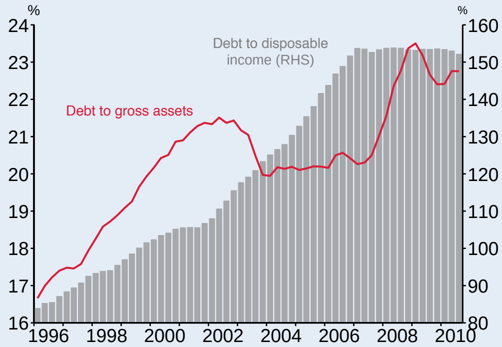
Source: Statistics New Zealand, RBNZ estimates.

Box E

Household rebalancing

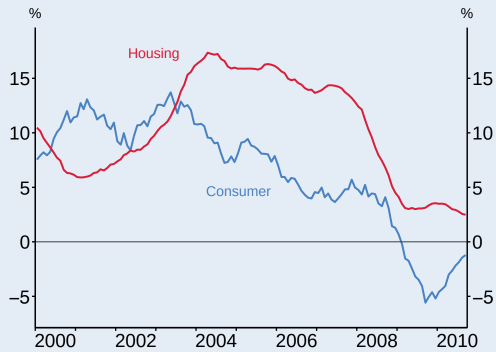
The subdued outlook for household spending in part reflects the increased focus on debt consolidation among consumers that has been observed in recent years. After a prolonged period of rapid increase, 2007 saw a leveling off of household debt as a percentage of disposable income (figure E1). Household credit growth declined sharply during 2007 and 2008, and remains at historically low levels (figure E2). There has also been a marked increase in housing equity injection, with many mortgage holders maintaining monthly payments as interest rates have fallen, thus paying off principal at a greater rate. While these changes have, to date, resulted in only limited changes in the level of debt to income, they have contributed to restrained consumption growth over recent years.

Figure E1
Change in household debt profile



Source: RBNZ

Figure E2
Household credit growth
(annual percent change)

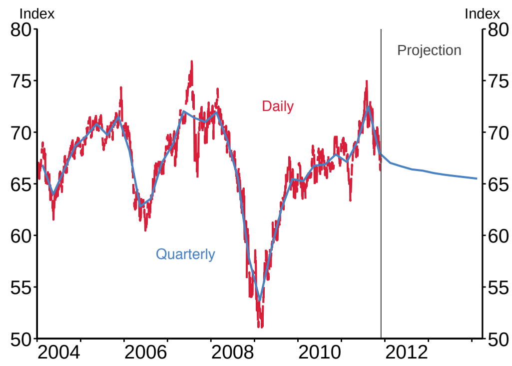


Source: RBNZ

The New Zealand dollar TWI depreciated in the last quarter of 2011 as the global outlook deteriorated and commodity prices moderated. The lower TWI partly offsets the downward impulse from the global situation by boosting New Zealand dollar receipts of exporters. In time the lower TWI will also stimulate demand for New Zealand exports. The New Zealand dollar TWI is assumed to depreciate slowly over the remainder of the projection (figure 5.4).

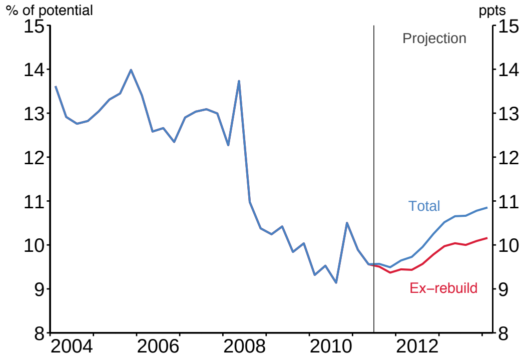
In addition to the direct effects on the economy via export receipts, uncertainty over the denouement of the sovereign debt situation in Europe is forecast to inject caution into businesses' investment and hiring intentions. Excluding the direct effects of the reconstruction in Canterbury, business investment is projected to remain weak throughout 2012. Thereafter, investment should increase as firms replace worn-out machinery and the reconstruction of commercial buildings in Canterbury gathers pace (figure 5.5).

Figure 5.4
New Zealand dollar TWI



Source: RBNZ estimates.

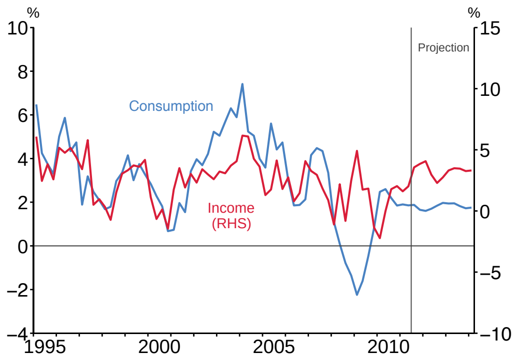
Figure 5.5
Business investment
(excluding computers and intangible assets, share of potential GDP, seasonally adjusted)



Source: Statistics New Zealand, RBNZ estimates.

Caution is also expected in the household sector, as offshore news weighs on sentiment. But in part this also reflects the high level of debt held by the household sector, and the projected continued deleveraging over the forecast horizon (box E). In addition, real house prices are projected to be flat over the forecast period, restraining growth in household wealth. Consumption growth is therefore expected to be subdued over the forecast horizon, averaging around 2 percent per year (figure 5.6), despite a recovery in labour incomes.

Figure 5.6
Growth in real after-tax labour income and consumption spending
(annual)

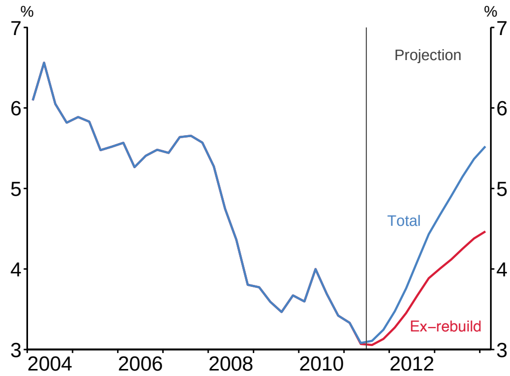


Source: Statistics New Zealand, RBNZ estimates.

In addition to household deleveraging, consumption will also be weighed down by higher mortgage rates. The current turmoil in financial markets has increased the premium that New Zealand banks pay for long-term wholesale funding. While weak loan growth and continued deposit growth from increased saving will reduce the need for banks to borrow offshore, some funding scheduled to mature in 2012 will likely need to be rolled over. Assuming some leakage into higher domestic deposit rates, this implies that average bank funding costs will increase, and put upward pressure on the spread of mortgage rates relative to 90-day rates.

Nonetheless, there are signs that the housing market has reached a turning point, with house sales, consents and house prices all pointing to a pick-up in activity. Underlying residential investment is projected to increase from the start of 2012. The substantial rebuilding of housing stock damaged in the Canterbury earthquakes will further boost housing construction (figure 5.7).

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



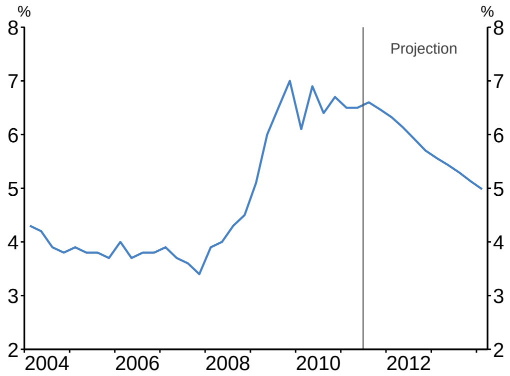
Source: Statistics New Zealand, RBNZ estimates.

The exact timing, and magnitude, of the rebuild in Canterbury remains uncertain. Continued aftershocks and issues surrounding the provision of insurance have delayed the start of the process. Overall, the rebuild is expected to start in earnest in the latter half of 2012. A substantial portion of the rebuild, particularly for commercial buildings, is expected to take place beyond the forecast horizon. Earthquake-related costs have had a significant impact on the fiscal accounts, which showed a large deficit in the June 2011 fiscal year. According to the 2011 *Pre-Election Economic and Fiscal Update*, the government's budget should return to surplus in the June 2015 fiscal year.

As exporter incomes eventually pass through to investment spending, and the rebuild in Canterbury gets under way, the pace of economic activity should pick up over the forecast horizon. Annual GDP growth is projected to reach around 3.5 percent by the end of the forecast horizon.

This should slowly soak up spare capacity in the economy, with the margin of slack resources expected to close towards the latter half of 2013. As these spare resources are used up, the unemployment rate is projected to fall over the forecast (figure 5.8).

Figure 5.8
Unemployment rate
(seasonally adjusted)

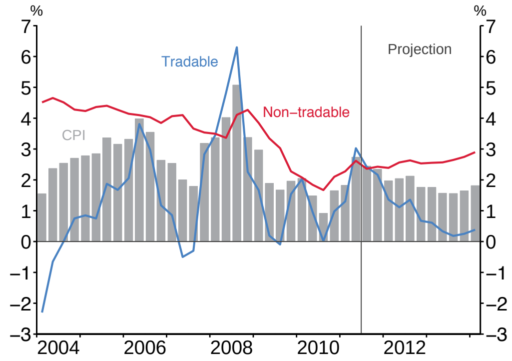


Source: Statistics New Zealand, RBNZ estimates.

As the labour market tightens, wage inflation is projected to pick up somewhat. Annual LCI inflation is forecast to peak at 2.3 in the middle of 2012. Thereafter, wage inflation should moderate as inflation returns to the mid-point of the target band. As noted in the previous *Statement*, wage pressure is likely to be most visible in the construction sector in Canterbury. However, this is not expected to spill over significantly into the rest of the economy.

The depreciation of the TWI in recent quarters will put upward pressure on tradable inflation during 2012. Thereafter, tradable inflation is projected to moderate as the pace of TWI depreciation slows and global pricing pressure moderates. Conversely, as capacity pressures increase and reconstruction in Canterbury gets under way in earnest, underlying non-tradable inflation will pick up modestly over the forecast. As a result, annual CPI inflation excluding policy changes is projected to remain around the middle of the target band throughout the latter part of the projection (figure 5.9).

Figure 5.9
CPI, tradable and non-tradable inflation
(annual, excluding policy changes)



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 stationary energy and liquid fuel sectors to the amended Emissions Trading Scheme, and increases in 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
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	1.6	0.4	1.5	66.8	5.5
	Jun	0.7	0.8	2.4	64.0	5.9
	Sep	0.4	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	0.2	-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	0.8	0.5	1.8	71.4	8.7
	Dec	0.9	1.2	3.2	71.0	8.8
2008	Mar	-0.2	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	-1.2	-0.5	3.4	57.8	6.3
2009	Mar	-1.1	0.3	3.0	53.7	3.7
	Jun	0.2	0.6	1.9	58.4	2.9
	Sep	0.2	1.3	1.7	62.6	2.8
	Dec	0.9	-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	-0.1	1.1	1.5	66.9	3.2
	Dec	0.6	2.3	4.0	67.8	3.2
2011	Mar	0.9	0.8	4.5	67.1	3.0
	Jun	0.1	1.0	5.3	69.1	2.7
	Sep	0.6	0.4	4.6	72.5	2.8
	Dec	0.6	0.4	2.6	68.0	2.7
2012	Mar	0.7	0.4	2.3	67.0	2.8
	Jun	0.7	0.9	2.2	66.7	3.0
	Sep	0.8	0.5	2.3	66.4	3.3
	Dec	0.8	0.1	2.0	66.3	3.6
2013	Mar	0.8	0.4	2.0	66.0	3.8
	Jun	0.8	0.8	1.9	65.9	3.9
	Sep	0.8	0.6	1.9	65.7	4.0
	Dec	0.8	0.2	2.0	65.6	4.0
2014	Mar	0.7	0.3	1.9	65.5	4.0

[1] Notes for these tables follow on pages 29 and 30.

Table B
Composition of real GDP growth

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

	Actuals								Projections		
March year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Final consumption expenditure											
Private	6.3	4.5	4.4	2.5	3.3	-1.1	0.3	2.1	1.7	1.9	1.8
Public authority	5.0	4.5	4.9	4.4	4.7	4.2	0.2	3.8	1.7	-0.1	-0.3
Total	6.0	4.5	4.5	2.9	3.6	0.1	0.3	2.5	1.7	1.4	1.3
Gross fixed capital formation											
Market sector:											
Residential	14.9	2.8	-5.3	-1.4	4.4	-23.4	-13.1	2.1	-9.2	34.2	26.2
Business	12.6	10.9	10.1	-1.9	8.9	-5.7	-9.2	6.7	3.5	6.9	7.8
Non-market government sector	14.7	10.9	6.6	-6.8	-10.4	20.0	-8.2	7.0	2.4	2.9	4.1
Total	13.3	8.9	6.3	-2.2	6.7	-7.8	-9.8	6.0	1.5	10.3	10.6
Final domestic expenditure	7.7	5.6	5.0	1.6	4.4	-1.9	-2.1	3.3	1.7	3.4	3.5
Stockbuilding[1]	0.2	0.2	-0.5	-0.7	0.6	-0.0	-1.9	1.4	0.4	0.1	0.0
Gross national expenditure	7.8	6.0	4.7	0.7	5.4	-2.0	-3.6	4.7	2.0	3.2	3.6
Exports of goods and services	1.1	4.9	-0.1	3.0	3.4	-3.0	4.9	1.7	2.7	1.5	2.8
Imports of goods and services	12.9	12.4	4.2	-1.5	10.3	-4.1	-9.5	10.4	4.5	3.3	4.3
Expenditure on GDP	4.1	3.5	3.3	2.1	3.1	-1.5	1.2	1.8	1.3	2.6	3.0
GDP (production)	4.4	3.8	3.2	0.8	3.0	-1.5	-0.7	1.6	2.0	2.9	3.2
GDP (production, March qtr to March qtr)	5.3	2.5	2.4	1.7	2.2	-3.5	1.8	1.7	2.0	3.1	3.2

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

Table C

Summary of economic projections

(annual percent change, unless specified otherwise)

March year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Price measures											
CPI	1.5	2.8	3.3	2.5	3.4	3.0	2.0	4.5	2.3	2.0	1.9
Labour costs	2.1	2.5	3.0	3.0	3.5	3.1	1.3	2.0	2.1	2.0	2.0
Import prices (in New Zealand dollars)	-10.3	0.6	6.8	0.2	0.3	12.1	-8.5	3.7	6.1	0.9	1.9
Export prices (in New Zealand dollars)	-5.0	5.0	3.3	4.3	11.8	6.5	-8.6	10.7	3.2	-2.1	0.7
Monetary conditions											
90-day rate (year average)	5.3	6.5	7.3	7.6	8.6	6.7	2.8	3.1	2.7	3.4	4.0
TWI (year average)	63.6	67.1	70.1	65.6	71.6	61.6	62.9	67.1	69.2	66.3	65.7
Output											
GDP (production, annual average % change)	4.4	3.8	3.2	0.8	3.0	-1.5	-0.7	1.6	2.0	2.9	3.2
Potential output (annual average % change)	3.4	3.2	2.8	2.3	1.9	1.6	1.1	1.3	1.6	2.1	2.2
Output gap (% of potential GDP, year average)	2.2	2.7	3.2	1.7	2.8	-0.3	-2.1	-1.9	-1.5	-0.7	0.3
Labour market											
Total employment (seasonally adjusted)	3.3	3.7	2.8	2.0	-0.3	0.7	-0.1	1.8	1.1	2.6	2.5
Unemployment rate (March qtr, seasonally adjusted)	4.3	3.9	4.0	3.9	3.9	5.1	6.1	6.5	6.3	5.6	5.0
Trend labour productivity	1.1	0.9	0.8	0.7	0.6	0.5	0.4	0.4	0.5	0.7	0.8
Key balances											
Government operating balance (% of GDP, year to June)	3.9	4.7	4.4	3.5	3.1	-2.1	-3.4	-9.2	-5.3	-2.5	-1.3
Current account balance (% of GDP)	-4.4	-6.2	-8.7	-8.0	-8.0	-7.9	-1.9	-3.7	-3.4	-4.4	-5.0
Terms of trade (OTI measure, annual average % change)	3.9	5.8	-0.8	1.8	7.8	3.2	-9.1	12.3	1.8	-6.6	-1.3
Household saving rate (% of disposable income)	-7.4	-6.0	-8.3	-8.9	-4.0	-4.5	-2.2	-1.3	0.0	0.4	1.2
World economy											
Trading partner GDP (annual average % change)	3.6	3.8	3.8	3.8	4.3	0.1	1.1	4.3	3.1	3.5	4.2
Trading partner CPI (TWI weighted, annual % change)	1.5	2.1	2.5	1.9	3.3	0.9	1.7	2.2	1.9	1.6	2.1

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

AE Tilley Ltd

AECOM NZ Ltd

Ballance Agri-Nutrients Limited

Barfoot & Thompson Ltd

Blue Sky Meats Ltd

Budget Rent a Car Ltd

C3 Limited

Christchurch International Airport Limited

Colliers International New Zealand Ltd

Crane Distribution NZ Ltd

Destination Queenstown

Employers and Manufacturers Association (Northern) Inc

Ernst & Young

EziBuy Limited

Federated Farmers of New Zealand (Tauranga)

Gallagher Group Limited

Global Cultural Group Limited

Greens Global Limited

H&J Smith Holdings Limited

HamiltonJet Ltd

Hawkins Construction Ltd

Hawkins Construction Ltd (South Island)

IAG New Zealand Limited

Kiwi Discovery

Livestock Improvement Corporation

LJ Hooker Group Ltd NZ

Lyttelton Port of Christchurch

Mace Engineering Limited

Mike Pero (New Zealand) Ltd

Mitre 10 (New Zealand) Ltd

Mitre 10 MEGA Tauranga

Morgan Furniture Int. Ltd

Naylor Love Construction Limited

New Zealand Sugar Company Limited

NZ Retailers Association

Perry Group Limited

Port of Tauranga Limited

Ravensdown Ltd

Registered Master Builders Federation

Salt Recruitment

SKOPE Industries Limited

Smith & Caughey Ltd

Southland Building Society

Southland District Council

Squirrel Mortgages

SYL Research Limited

T.P. Cookson Boat Builder Limited

The Heritage Hotel Queenstown Limited

The Warehouse Limited

Tonkin & Taylor Ltd

Torpedo7 Ltd

Totally Tourism Ltd

Trojan Holdings Ltd

Vero Insurance New Zealand Limited

Vodafone New Zealand Ltd

Waikato Chamber of Commerce and Industry Inc

Wellington Employers Chamber of Commerce

Xero Ltd

Yunca Group Ltd

ZESPRI International Limited

Appendix C
Reserve Bank statements on monetary policy

OCR unchanged at 2.5 percent

15 September 2011

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.5 percent.

Reserve Bank Governor Alan Bollard said: "The New Zealand economy has performed relatively well while headline inflation has increased somewhat since the June Statement. At the same time, however, global economic and financial risks have increased.

"Domestic economic activity has surprised on the upside and capacity usage appears to have increased. Continued high export commodity prices and, in time, reconstruction in Canterbury are expected to provide impetus to demand over the projection horizon.

"However, the outlook for New Zealand's trading partners has deteriorated markedly. There is now a real risk that global economic activity slows sharply.

"Global financial market sentiment has also deteriorated. Sovereign debt concerns in Europe and the weakened global outlook have caused international bank funding markets to tighten. If conditions do not improve, New Zealand bank funding costs will increase.

"Largely because the New Zealand economy has been doing better than many others, the New Zealand dollar has appreciated since the June *Statement*. The high level of the New Zealand dollar is having a dampening influence on some parts of the tradable sector and on imported inflation.

"Annual headline CPI inflation continues to be above the Bank's 1 to 3 percent target band. However, much of the current spike in inflation has been driven by last year's increase in the rate of GST, and will therefore be temporary. Wage and price setters should focus on underlying inflation, which, while rising, is currently estimated to be near 2 percent.

"If recent global developments have only a mild impact on the New Zealand economy, it is likely that the OCR will need to increase. For now, given the recent intensification in global economic and financial risks, it is prudent to continue to hold the OCR at 2.5 percent."

OCR unchanged at 2.5 percent

27 October 2011

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.5 percent.

Reserve Bank Governor Alan Bollard said: "Domestic activity has continued to expand at only a modest pace despite relatively strong commodity prices. More recently, domestic business confidence has fallen back somewhat. Further ahead, earthquake repairs and reconstruction in Canterbury are still expected to provide significant impetus for demand.

"As foreshadowed at the time of the September *Monetary Policy Statement*, there is a real risk that the European sovereign debt crisis could cause a further slowing in global activity, putting downward pressure on New Zealand's commodity export prices. The difficult international market conditions could also result in increased New Zealand bank funding costs over the coming year.

"Annual headline CPI inflation continues to be above the Bank's 1 to 3 percent target band. That largely reflects the one-off effect of last year's increase in the rate of GST. September quarter inflation data suggest that, once GST and other one-off influences have passed, underlying inflation is settling near 2 percent.

"Given the ongoing global economic and financial risks, it remains prudent to continue to keep the OCR on hold at 2.5 percent for now. However, if global developments have only a mild impact on the New Zealand economy, it is likely that gradually increasing pressure on domestic resources will require future OCR increases."

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	9 December 2010	3.00
3 October 2001	5.25	8 June 2006	7.25	27 January 2011	3.00
14 November 2001	4.75	27 July 2006	7.25	10 March 2011	2.50
23 January 2002	4.75	14 September 2006	7.25	28 April 2011	2.50
20 March 2002	5.00	26 October 2006	7.25	9 June 2011	2.50
17 April 2002	5.25	7 December 2006	7.25	28 July 2011	2.50
15 May 2002	5.50	25 January 2007	7.25	15 September 2011	2.50
3 July 2002	5.75	8 March 2007	7.50	27 October 2011	2.50
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 2012-13:

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*
Thursday 26 July 2012	OCR announcement
Thursday 13 September 2012	*Monetary Policy Statement*
Thursday 25 October 2012	OCR announcement
Thursday 6 December 2012	*Monetary Policy Statement*

2013	
Thursday 31 January 2013	OCR announcement
Thursday 14 March 2013	*Monetary Policy Statement*
Thursday 24 April 2013	OCR announcement
Thursday 13 June 2013	*Monetary Policy Statement*

Dates for 2013 are provisional, subject to confirmation in August 2012.

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