RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Monetary Policy Statement

December 2012[1]

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

Contents

This document is also available on www.rbnz.govt.nz

ISSN 1770-4829

[1] Projections finalised on 23 November 2012. Policy assessment finalised on 5 December 2012

1 Policy assessment

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

Economic growth has slowed in recent months and has been accompanied by low inflation and rising unemployment. However, over the next two years, growth is expected to accelerate to between 2.5 and 3 percent per annum.

The global outlook remains soft but appears less threatening than was the case earlier in the year. The risk of severe near-term deterioration in the euro area has decreased and Chinese economic indicators have been more positive recently. However, uncertainty around the US fiscal position is constraining US growth.

Repairs and construction in Canterbury continue to gather pace, and the housing market is strengthening, particularly in Auckland. Lower funding costs for New Zealand banks, along with increased competition for lending, have seen mortgage interest rates reduce.

Dampening factors include the Government's fiscal consolidation and continued cautiousness by households and businesses in their spending decisions. The high New Zealand dollar continues to be a significant headwind, restricting export earnings and encouraging demand for imports.

The overall outlook is for stronger domestic demand and the elimination of current excess capacity by the end of next year. This is expected to cause inflation to rise gradually towards the 2 percent target midpoint.

Monetary policy remains focused on keeping future average inflation near the 2 percent target midpoint. The Bank is closely monitoring indicators for any sign of further moderation and is mindful of recent downside surprises to employment and inflation outturns. With the reconstruction-driven pick-up in investment now clearly underway, the Bank will also continue to watch for a greater degree of inflation pressure than is assumed.

On balance, it remains appropriate for the OCR to be held at 2.5 percent.

Graeme Wheeler

Governor

2 Overview and key policy judgements

The New Zealand economy continues to recover at a modest pace. Real GDP increased by 1.6 percent in the first half of the year, but growth has slowed more recently. Inflation remains low, with measures of core inflation in the bottom half of the target band. Driven by reconstruction in Canterbury and continued low interest rates, inflation is expected to increase over the medium term. Monetary policy will remain focused on keeping future average inflation near the 2 percent target midpoint.

Inflation developments

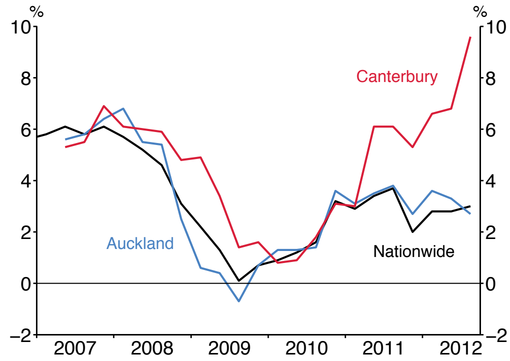
Annual CPI inflation declined to 0.8 percent in the September quarter 2012. In part, low inflation over the past year relates to one-off movements that are unlikely to persist. For example, falling fruit and vegetable prices, related to recovery from the early-2011 Queensland floods, subtracted 0.4 percentage points from headline inflation in the December quarter 2011. This impact will drop out of next quarter's annual figure and inflation is expected to move back inside the target range.

However, much of the move down in inflation seems to indicate a more persistent reduction. Most measures of core inflation have fallen to the lower part of the target band and inflation expectations have moderated. The Bank continues to closely monitor indicators for any sign of further moderation in inflation and is mindful of recent downside surprises to its inflation forecasts.

That said, given the coming reconstruction-driven pick-up in investment activity, it is also important for the Bank to watch for any sign of a turning point. In this regard, pockets of pricing pressure – mostly related to the strengthening housing market – are beginning to emerge.

Construction cost inflation in Canterbury has accelerated markedly over the past 18 months, with the cost of building a house increasing 10 percent in the past year. For now, the flow-on impact to nationwide building costs has been limited (figure 2.1). However, there is a risk that elevated construction cost inflation in Canterbury places upward pressure on costs in other regions. This is especially so given the scale of the rebuild required and the uptrend in building consents in Canterbury of late.

Figure 2.1
Regional construction cost inflation
(annual)



Source: Statistics New Zealand.

Furthermore, house price inflation continues to accelerate in some regions, particularly Auckland. The Bank does not expect this pick-up to substantially increase generalised inflationary pressures. House price inflation is expected to moderate, with house prices already very high. Furthermore, given household focus on consolidation, it is unlikely that the current pick-up in house price inflation will have the flow-on impact to household spending that was seen through the mid-2000s. That said, there is a risk that house price inflation does accelerate further, particularly if supply is constrained by continued low residential construction. Excessive house price inflation would be concerning both from an inflation targeting and financial stability perspective (see box D, chapter 5).

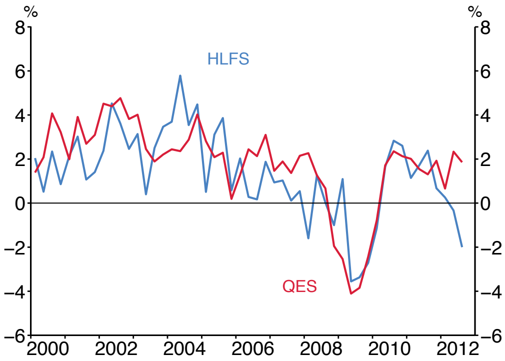
Activity and capacity pressures

Turning to the near-term outlook for activity, economic momentum has slowed following strong growth in the first half of the year. Some expansion in the construction sector looks to have been offset by an easing in primary and services sector growth. Real GDP is estimated to have expanded 0.6 percent through the second half of 2012, after growing 1.6 percent through to the end of June.

Economic indicators provide a mixed picture on how quickly the economy is growing. Some, such as recent inflation outturns, retail spending data, and the Household Labour Force Survey (HLFS) suggest that the economy is weaker, with the latter implying a marked contraction through the second half of the year. Other indicators, such as the Quarterly Employment Survey (QES), the

Quarterly Survey of Business Opinion (QSBO), building consent numbers, and the Performance of Services Index, suggest continued positive GDP growth (figure 2.2). The Bank's view is that the HLFS is overstating the degree of deterioration (see box C, chapter 4) and that the economy continues to expand, albeit slowly.

Figure 2.2
Growth in QES hours paid and HLFS hours worked
(annual growth)



Source: Statistics New Zealand.

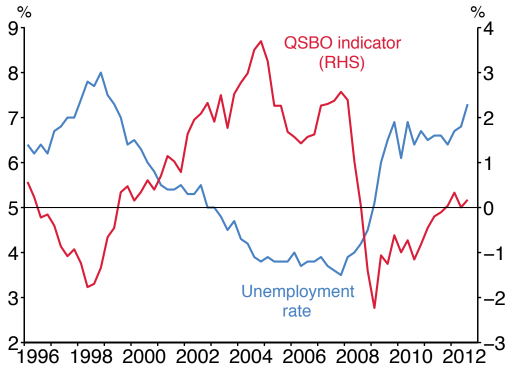
The continued high unemployment rate of the past three years highlights the risk that significant spare capacity remains in the wider economy. Even if the unemployment rate dropped back below 7 percent in the December quarter, the HLFS would still suggest much more economic slack than other capacity indicators such as the QSBO (figure 2.3). Consistent with continued low inflation, the Bank estimates that the economy is currently operating with a negative output gap of about 1 percent of potential GDP.

Economic outlook

Despite a starting point of weak growth, low inflation and continued excess capacity, inflation is expected to increase to near the middle of the target band over the medium term. Supported by continued low interest rates, real GDP growth is forecast to accelerate to about 3 percent towards the end of the projection (figure 2.4). There are four key factors influencing the outlook. These are:

- Repairs and reconstruction in Canterbury are expected to substantially boost construction sector activity. The

Figure 2.3
Unemployment and QSBO cyclical indicator
(seasonally adjusted)



Source: Statistics New Zealand, NZIER, RBNZ estimates.
Note: The cyclical indicator is a combination model of capacity indicators from the QSBO, fitted to cyclical movements in GDP up to 2007.

  Bank has revised upward its forecast for rebuilding.
- Global economic activity and inflation are expected to remain subdued, with trading partner GDP growth heavily reliant on policy support.
- The New Zealand dollar is assumed to remain high.
- Fiscal policy is forecast to tighten markedly, dampening aggregate demand.

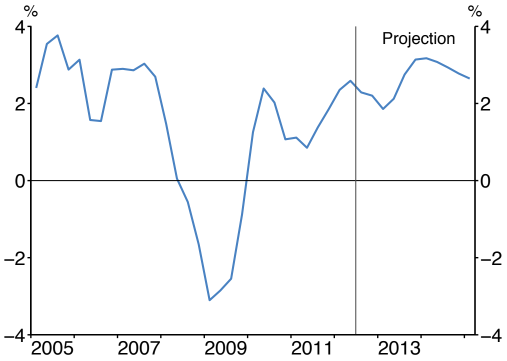
Repairs and construction in Canterbury have a major influence on the economic outlook. As was foreshadowed in the September *Statement*, the Bank has revised upward its estimate of earthquake-driven rebuilding in Canterbury. The cost of reconstruction is now estimated at $30 billion (in 2011 dollars), with about $5 billion of this expected to occur within the projection horizon. Relative to the September projection, the extra building activity is assumed to occur later this decade, so has limited impact on monetary policy for the next few years.

In addition to earthquake reconstruction, an increase in nationwide residential investment is expected. Recent consent and housing turnover data suggest underlying residential investment will rise in the near term.

Negatively affecting the outlook is the projection for continued subdued activity in Europe and the United States. This weak outlook manifests itself through continued high bank funding margins and persistent strength in the New Zealand dollar.

Nonetheless, the global outlook appears less threatening than was the case in September. While continued recovery depends on policy support, the risk of

Figure 2.4
GDP growth
(annual)



Source: Statistics New Zealand, RBNZ estimates.

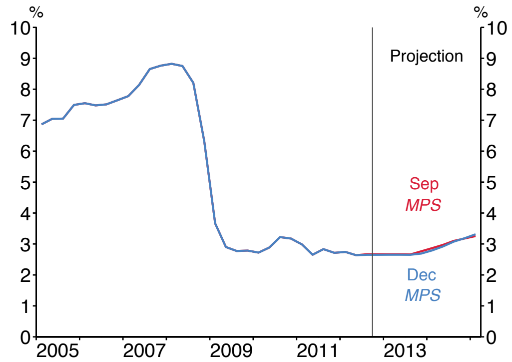
severe near-term deterioration in the euro area appears to have decreased. Recent data indicate that the United States housing market has improved and suggests that the downside risks to the outlook for China have also fallen. In addition, bank funding margins, while still elevated, have reduced.

The New Zealand dollar is assumed to remain elevated over the projection. As well as dampening export earnings, continued strength in the exchange rate will encourage use of imported goods and services. Import volumes are forecast to remain high.

Fiscal consolidation is expected to have a substantial dampening influence on demand growth over the projection horizon. *Budget 2012* signalled an intention to bring the fiscal deficit back to balance in the 2014/15 year. This consolidation implies a cumulative negative impulse of about 4 percent of annual GDP over the projection horizon. The current deficit will shrink partly as an automatic consequence of the economic recovery. However, most of the projected improvement is expected to come via tighter discretionary fiscal policy. Public consumption expenditure, while forecast to increase modestly, is expected to trend lower as a share of GDP over the projection. In addition, announced changes to social support packages will negatively affect household disposable incomes and constrain private consumption.

Given these economic headwinds and current low inflation, monetary policy is projected to remain supportive throughout the projection horizon (figure 2.5). The 90-day interest rates projection is unchanged from September. Nonetheless, because of lower bank funding costs and increased competition among banks, this projection implies a lower forecast for retail interest rates than was the case in the September *Statement*.

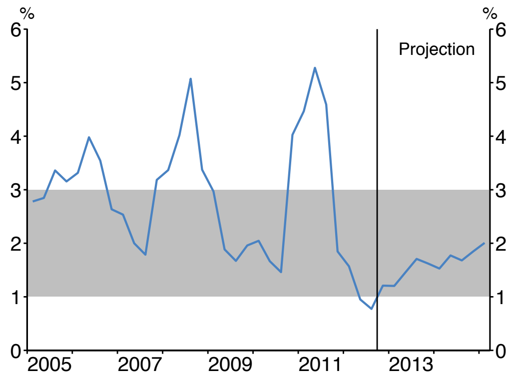
Figure 2.5
90-day interest rate



Source: RBNZ estimates.

Continued 2 to 3 percent GDP growth is expected to see inflationary pressures pick up over the medium term. Over the coming year, non-tradable pressures are expected to become more pronounced, with some acceleration in headline inflation expected through the second half of 2013. Over the forecast period, non-tradable inflation will also be boosted by increases in the tobacco excise tax. Tradable inflation is expected to rise over the projection but remain modest as a result of continued low global inflation and prolonged strength in the exchange rate. In aggregate, annual CPI inflation is expected to rise towards the 2 percent target midpoint (figure 2.6).

Figure 2.6
CPI inflation
(annual)

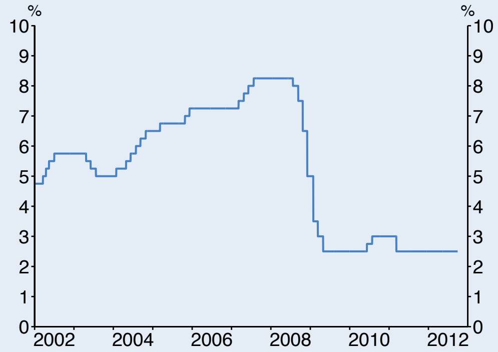


Source: Statistics New Zealand, RBNZ estimates.

Box A
Recent monetary policy decisions

The OCR has been held at the historically low level of 2.5 percent since the March 2011 *Statement* (figure A1). The OCR was lowered to this level to help limit the adverse economic consequences of the Canterbury earthquakes. Since that time, slow GDP growth, low global inflation, and persistent strength in the New Zealand dollar have meant that the inflation outlook has remained subdued.

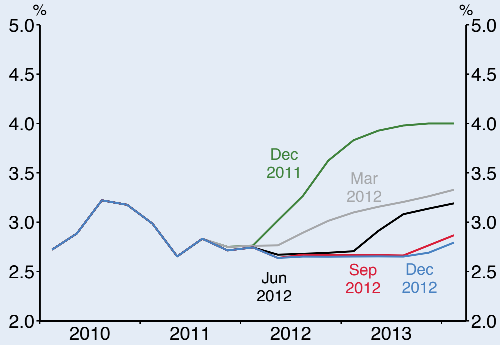
Figure A1
Official Cash Rate



Source: RBNZ.

Annual CPI inflation fell to 0.8 percent in the September quarter 2012. This was the fifth consecutive outturn where inflation turned out lower than the Bank had forecast. While some of these surprises related to idiosyncratic weakness in some components of the CPI, core inflation measures have also moved lower. In response to these downside surprises and reductions in the outlook for inflation, the Bank has significantly reduced its forecast for short-term interest rates (figure A2).

Figure A2
Successive Reserve Bank 90-day interest rate projections



Source: RBNZ estimates.

Box B
The new Policy Targets Agreement

The Policy Targets Agreement (PTA) between the Minister of Finance and the Governor of the Reserve Bank sets operational targets for the conduct of monetary policy, consistent with the Bank's primary goal of stability in the general level of prices. The PTA sets an inflation target and identifies other factors that the Bank should consider. It provides information about how the Bank will pursue its objectives and a framework for holding the Bank accountable in its conduct of monetary policy.

A new PTA took effect in September 2012. It retains an overall focus on price stability indicated by a CPI inflation target. There are three additions to the previous agreement.

- Clause 2a now requires the Bank to monitor "asset prices" among the price indicators it regularly examines.
- Added to the existing target of "future CPI inflation outcomes between 1 percent and 3 percent on average over the medium term", clause 2b now requires the Bank to have "a focus on keeping future average inflation near the 2 percent target midpoint".
- Clause 4b requires the Bank to have regard to "the efficiency and soundness of the financial system" in pursuing price stability.

Through its history the PTA has required the Bank to monitor a range of prices while targeting inflation as measured by the CPI. The *Monetary Policy Statement* regularly reports analysis of movements in a range of price measures, including asset prices. The new reference in clause 2a reinforces this focus.

The added focus on keeping future average inflation near the target's 2 percent midpoint is intended to help anchor inflation expectations around that level. Well-anchored expectations reduce the risk of inflation persistently deviating from target and reduce the need to adjust the OCR in response to economic shocks.

The requirement to "have regard to the efficiency and soundness of the financial system" incorporates language from the Reserve Bank of New Zealand Act 1989. Experience over the past decade illustrates the powerful influence asset and credit market conditions can have on the wider economy, including output losses and deflationary pressure when asset prices collapse and credit provision is disrupted.

The PTA continues to reflect the view that monetary policy's best contribution to long-run economic growth comes through ensuring low and stable inflation, and supporting financial stability. Under the flexible approach to inflation targeting in New Zealand, monetary policy focuses on keeping inflation expectations anchored, and doing so in a way that does not contribute to excessive economic volatility. The latest amendments are evolutions of the approach, consistent with those objectives.

3 Financial market developments

Financial market sentiment has remained broadly positive since the September *Statement*. The European Central Bank's (ECB) policies have helped stabilise market pricing in that region and removed the tail-risk of a significant adverse financial event over the near term. Financial market conditions in China have improved, helped by an improvement in economic data. In the United States, fiscal negotiations could be a source of increased market volatility over the coming month or two.

Easy global monetary policy has had a significant impact on credit markets over the past year. There has been a further reduction in credit spreads over the last quarter. An improved credit quality outlook and low money market rates has driven investors into higher risk products. Many market analysts are beginning to warn of a bubble in fixed income assets, caused by significant central bank liquidity, with some high-risk products being traded for the first time since the global financial crisis.

Improved global financial conditions are helping to reduce funding costs for New Zealand banks. Long-term wholesale and retail deposit funding costs have been declining over recent months and this, along with strong competition, has led banks to reduce mortgage rates to historically low levels.

International market developments

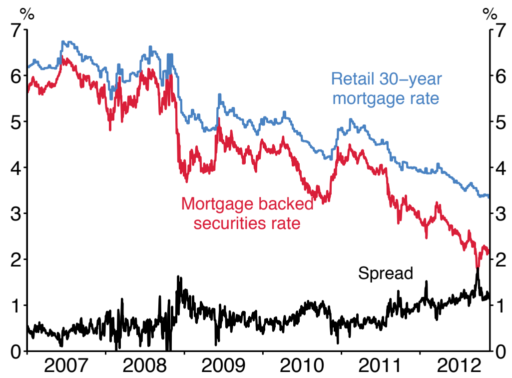
Market conditions were buoyant leading up to the September *Statement*, with an increase in equity prices and falling credit spreads. Since then market conditions have been reasonably stable. Equity and currency markets have not moved much since September, while commodity prices and government bond yields are generally lower.

In the United States, economic data have generally been stronger than market analysts' expectations. The United States election result was in line with market expectations. However, the market's attention has become focused on the "fiscal cliff", which refers to about US$665 billion (4 percent of GDP) of expiring tax cuts, automatic spending cuts, and other fiscal tightening measures that take effect from early next year.

While a positive outcome to the budget negotiations is expected, there is a risk that negotiations become protracted. As the year-end deadline approaches, market volatility could increase, as occurred during similar negotiations in July and August last year.

On the same day as the September *Statement* was released, the United States Federal Reserve announced a new asset purchase programme. The central bank committed to purchasing US$40 billion of mortgage-backed securities (MBS) until "the labour market improves substantially". A noteworthy aspect of the policy easing was the open-ended nature of this new programme. The policy has helped drive down interest rates for MBS and 30-year mortgage rates, albeit with more impact on the former than the latter (figure 3.1). Low mortgage rates in the United States are helping to stimulate the housing market, although more restrictive lending practices have hindered the degree of the recovery to date.

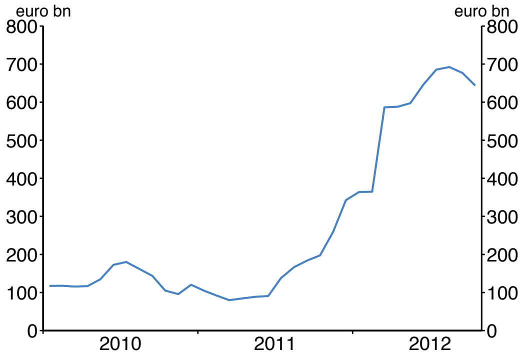
Figure 3.1
United States mortgage and MBS interest rates



Source: Bloomberg.

The ECB's proposed Outright Monetary Transactions (OMT) policy, announced a week before the September *Statement,* significantly reduced the risk of an adverse European financial event in the near term and helped to settle markets. To date, no country has signed up to the programme. Nonetheless, with OMT seen as a credible backstop to troubled European nations, the withdrawal of bank deposits has eased and investors have been more willing to increase holdings of European assets. During September and October, banks in Spain and Italy slightly reduced their reliance on funding from the ECB (figure 3.2).

Figure 3.2
ECB lending to banks in Spain and Italy



Source: Bloomberg.

There are still concerns about Greece's debt sustainability and funding requirements. International lenders eventually agreed to ease Greece's debt burden, following further austerity measures introduced by the Greek Government, but considerable work will be required in coming years to meet agreed fiscal targets. A positive sign is that euro area leaders seem committed to keeping Greece in the euro area for now.

Policymakers continue to work on reducing euro area banking and sovereign risks, including contagion issues. Euro area leaders hope to have a legislative framework for a single banking supervisor in place by the end of this year, with the ECB gradually assuming responsibility during the course of 2013. However, disagreement from non-euro area members and the possible need for changes to the European Union treaty are making these targets look increasingly optimistic.

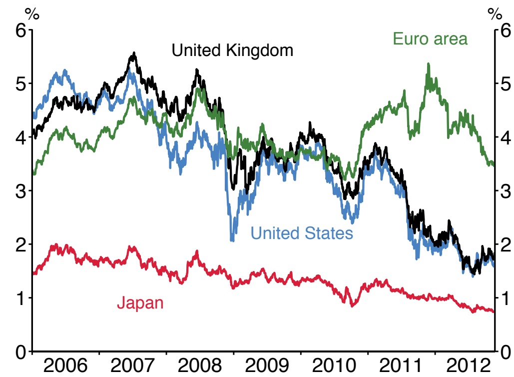
Financial market conditions have improved in China. The September *Statement* noted the decline in iron ore and steel prices, falling equity prices, net capital outflows, and a depreciating currency. Since then, the dataflow has been more positive, suggesting some stabilisation or modest improvement in economic growth and financial conditions. Iron ore prices have recovered significantly, from around US$90 per tonne to US$120, the downward trend in equity prices has stabilised, and the yuan has more than retraced its earlier depreciation to reach record highs against the United States dollar.

The Reserve Bank of Australia reduced its target cash rate by 25 basis points to 3.25 percent in early October and left rates unchanged in November. Market expectations are for further easing with slightly more than 50 basis points priced in overall. The Bank of England did not extend its quantitative easing programme in November, but signalled the possibility of further policy easing. The Bank of Japan increased its asset purchase programme by 11 trillion yen in October, taking the total size of the programme to 66 trillion yen.

Financing and credit

Major developed economy bond rates have been largely range-bound since the middle of the year, at levels close to historical lows. Long bond yields remain underpinned by extremely low policy rates and central bank asset purchase programmes (figure 3.3). Italian and Spanish long bond rates have remained in a tight range, well below levels seen around the middle of the year, supported by the ECB's OMT policy.

Figure 3.3
10-year government bond rates

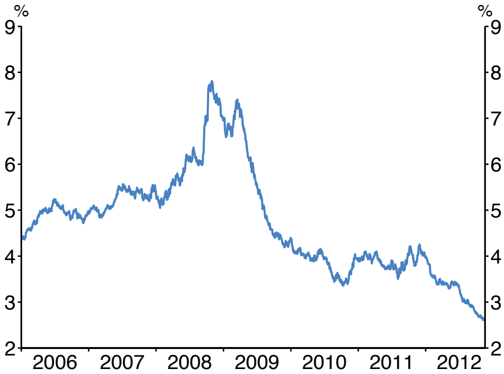


Source: Reuters, RBNZ, Note the euro area yield is a synthetic weighted average for the region.

Easy global monetary policy has had a significant impact on credit markets over the past year. Lower government bond rates and lower credit spreads have driven the yield on global corporate bonds to a historically low level. Figure 3.4, overleaf, illustrates this for investment grade bonds, but the same applies to other credit sectors.

On the demand side, low money market rates are driving investors into higher-risk credit products. On the supply side, corporates are encouraged to raise funds at historically low interest rates. By the end of October, global corporate bond issuance was US$3.3 trillion year to date, close to the record set in 2009. Formerly out-of-favour high-risk credit sectors are attracting renewed interest, such as collaterised loan obligations and "payment-in-kind" bonds (often CCC rated because of the lack of commitment to a regular coupon payment). Many analysts are warning of a bubble in fixed income assets as a direct result of significant central bank liquidity.

Figure 3.4
Yield on global investment grade corporate bonds

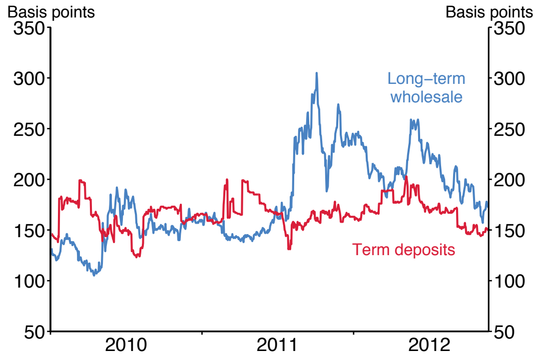


Source: Bank of America Merrill Lynch.

The reduction of a tail-risk financial event in Europe and subsequent improvement in financial market sentiment has helped drive down global funding costs for banks around the world. This is evident in short-term interbank rates such as Euribor and United States dollar libor, bank credit default swap (CDS) spreads, and pricing for new issues in the market. Even troubled European nations and their banks have been able to issue debt. Ireland's first public debt issue since 2010 occurred in late July. In October, Portugal successfully completed a bond swap in what was its first long-term debt issue since the country received a bailout. In recent months, some banks in Ireland, Portugal, and Spain have issued debt in wholesale markets, with private sector capital flows into those regions supported by the ECB's policy stance.

These improved global market conditions are reducing funding costs for New Zealand banks in long-term wholesale markets and this is flowing through into reduced retail deposit interest rates. A proxy indicator for long-term wholesale funds (based on Australian bank CDS spreads and cross-currency basis swaps) shows long-term wholesale funding costs have trended down from early June (figure 3.5). Furthermore, recent deals suggest reductions of about 50 basis points in rates for long-term offshore debt issues, compared to earlier in the year.

Figure 3.5
Funding spreads



Source: RBNZ.

With deposit growth tracking above loans and advances for the past three years, banks' reliance on long-term wholesale funding has lessened as deposits make up an increasing proportion of funding. On-call deposits make up a little under half of total deposits and call rates have been stable. Most term deposits are for short terms (less than one year). The six-month term deposit spread to Overnight Index Swaps (OIS, a wholesale rate linked to market expectations of the future cash rate) has been trending lower and is near the bottom of its range of the past three years (figure 3.5).

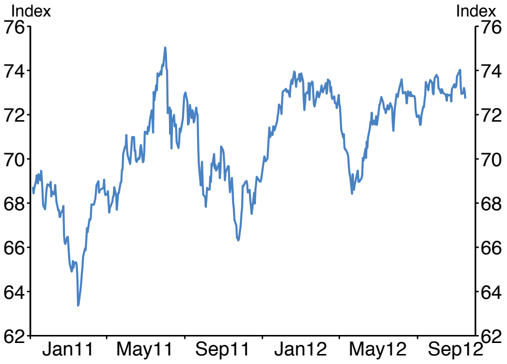
A weighted average marginal funding cost indicator that captures all major sources of funding (call deposits, term deposits, short term and long term wholesale funding) is down about 30 basis points over recent months, although this indicator remains elevated compared to the pre-global financial crisis period.

Foreign exchange market

The New Zealand dollar trade weighted index (TWI) has been in a tight trading range since the September *Statement* (Figure 3.6). The New Zealand dollar TWI has appreciated by about 5 percent against the Japanese yen and is flat-to-down against the other four currencies in the

TWI basket. The yen has weakened, as investors price in a change of government in Japan that is likely to seek a higher inflation target and more expansionary monetary policy.

Figure 3.6
New Zealand dollar TWI



Source: RBNZ.

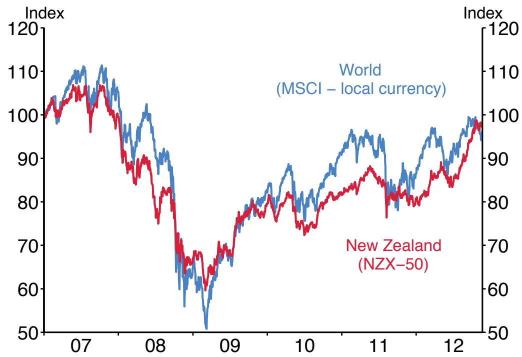
The New Zealand TWI has been range-bound for most of the year. The currency remains closely linked to risk appetite, as evident by its close correlation with measures like the MSCI World Equity Index or volatility indices (such as the VIX index) this year. Interest rate differentials between New Zealand and the world, such as the two-year swap spread, also go some way in explaining the behaviour of the New Zealand dollar this year. The link between the currency and commodity prices appears to have been weaker over the period.

Domestic financial market developments

The New Zealand equity market has been one of the best-performing markets in the world this year. Since the September *Statement*, local share prices have continued to appreciate against the trend of world equities (figure 3.7). The NZX-50 Index has tended to be less volatile than the MSCI World Index over recent years and, since 2007, the New Zealand market has performed more or less in line with world equities in local currency terms.

There has been modest downward pressure on New Zealand interest rates. Wholesale swap rates from two to ten years are down by around 10 basis points since the September *Statement*, more or less in line with global

Figure 3.7
New Zealand and World Equity Indices
(Rebased to 1 Jan 2007 = 100)



Source: Datastream.

trends. Also, the OIS market has moved to price in a greater chance of easier New Zealand monetary policy. By late November, the market had priced in 20 basis points of cuts to the OCR by June 2013, slightly more compared to a few months ago.

New Zealand corporate bond rates also continue to trend lower, helped by historically low government rates and falling credit spreads. In contrast to the global trend, supply is limited in New Zealand. The Bank of New Zealand estimates that this year net corporate debt issuance (excluding local government entities) is a little over $2 billion. Excluding banks and SSAs (supranational, sovereigns and agencies), net corporate issuance is negative, with maturities exceeding new supply.

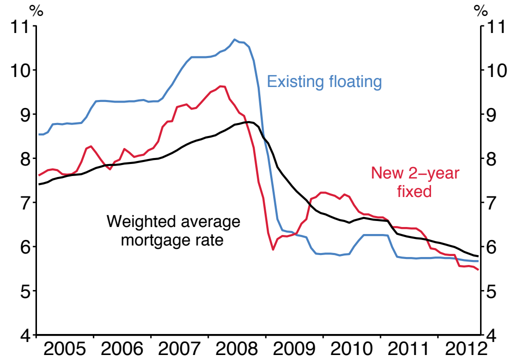
New Zealand government bond tenders have been well supported over the last couple of months, helped by the still-attractive interest rate spread to global markets and the country's lower sovereign debt levels compared to many other countries.

The New Zealand Debt Management Office recently issued a new inflation-indexed bond (maturing September 2025). The inaugural issue was heavily supported. After more than $4 billion of bids, the issue was capped at $2.5 billion at a real yield of 1.96 percent. Strong trading in the secondary market drove the yield down to 1.6 percent by late November. A liquid inflation-indexed bond will allow the calculation of implied break-even inflation rates for New Zealand. This provides a market-based measure of long-term inflation expectations. As at the end of

November, implied inflation expectations were close to 2 percent.

Lower funding costs and strong competition among the banks are putting downward pressure on mortgage interest rates, supported by lacklustre credit demand and the strong funding position of the banks. The average rate paid on existing floating mortgages was 5.67 percent as at the end of September and appears to have trended lower. Interest rates for fixed rate mortgages have moved below the floating rate, so an increasing proportion of borrowers are choosing to fix. In October, the proportion of borrowers on floating rates fell to 57 percent from a peak of 63 percent in April. The Reserve Bank's measure of the weighted-average mortgage rate was 5.78 percent at the end of September, down 40 basis points over the last 12 months.

Figure 3.8
Selected mortgage interest rates



Source: RBNZ.

4 Current economic conditions

Following 1.6 percent real GDP growth in the first half of the year, momentum in the New Zealand economy has slowed. Continued expansion in the construction sector appears to have been offset by an easing in primary and service sector growth.

A weak global recovery has also had a substantial negative impact on the New Zealand economy. This, along with a strong terms of trade and more recent increases in risk appetites, contributed to strength in the New Zealand dollar. The high New Zealand dollar has dampened exporter revenues and encouraged substitution to imported goods and services.

Annual CPI inflation declined to 0.8 percent in the September quarter. Part of this low level of inflation relates to idiosyncratic factors such as falling food and vegetable prices after the early-2011 Queensland floods. However, even after accounting for such influences, core inflation is still low. A persistently high exchange rate over the past year has dampened tradable inflation. Non-tradable inflation is also running at a below average pace, reflecting current spare capacity in the economy. Low inflation has translated into lower inflation expectations.

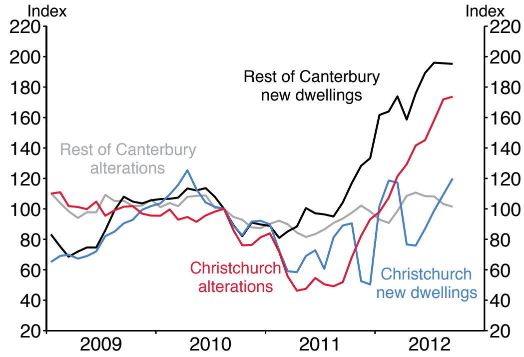
However, inflationary pressures are beginning to emerge in the housing market. Residential consents, particularly in Canterbury, are growing strongly. This is beginning to translate into pressure on resources in the construction sector, with significantly higher construction cost inflation in Canterbury than in the rest of the country. House prices are also beginning to increase at faster rates, notably in Auckland.

Domestic activity

The New Zealand economy is estimated to have expanded by 0.6 percent in the second half of the year following real GDP growth of 1.6 percent in the six months to June. In the first half of the year economic growth was boosted by strong agricultural production and continued expansion in the services sector. The contribution of these sectors to growth is now beginning to wane.

Continued expansion in the construction sector partly offsets this slowing. Residential consents increased by 37 percent in the year to September, signalling an increase in housing investment in coming months. Much of the increase in consents is in Canterbury. Within Christchurch, consents issued primarily relate to alterations and repairs (figure 4.1). Population movements away from Christchurch City account for much of the pick-up in new dwelling consents on the city fringe.

Figure 4.1
Canterbury dwelling consents
(seasonally adjusted, three-month moving average, August 2010=100)

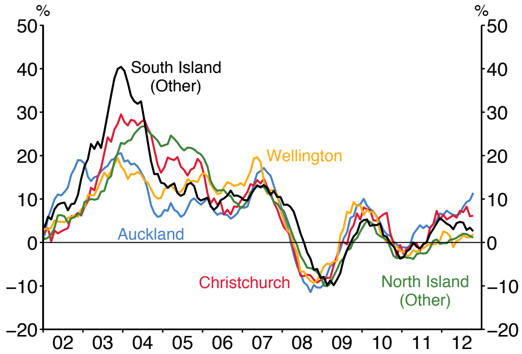


Source: Statistics New Zealand.

Residential construction sector activity has been subdued since the 2008/09 recession, with per capita investment declining through to the beginning of 2011. Tight credit conditions, tax changes and households' focus on debt consolidation are all likely to have restricted housing investment. More recently, household credit growth and house sales have picked up from low levels (figure D1, chapter 5). Together with a lack of new housing supply, these factors have supported growth in house prices. Over the past year house prices nationwide have increased by 5 percent. While this rate of growth is around average, house prices seem elevated relative to fundamental factors, such as income levels and rents. In Auckland, house prices are growing at a faster rate than elsewhere in New Zealand (figure 4.2).

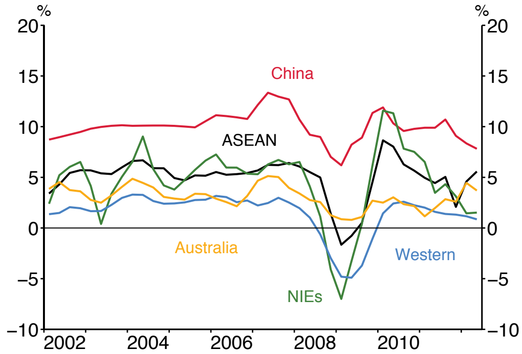
Despite the pick-up in house price inflation, consumers remain cautious in their spending. High household debt levels, coupled with subdued consumer confidence from a soft labour market and lingering uncertainty around the international outlook, have constrained household spending. The subdued domestic recovery and uncertainty around the international outlook have also constrained

Figure 4.2
House price inflation by region
(annual, three month moving average)



Source: REINZ, RBNZ Estimates.

Figure 4.3
Selected trading partner GDP growth
(annual)



Source: Haver Analytics.
Note: ASEAN includes Thailand, Malaysia, Indonesia and The Philippines. NIEs include South Korea, Taiwan, Hong Kong and Singapore. Western includes the United Kingdom, the United States, Canada and the euro area.

businesses' willingness to invest following the 2008/09 recession.

While it appears that economic growth slowed through the second half of 2012, some indicators suggest that economic growth is weaker still. In particular, recent HLFS data suggest activity contracted quite markedly through the second half of the year. Looking at a broad range of labour market data suggests that GDP and employment growth did indeed slow through this time, but not to the extent indicated by the HLFS (see box C).

External sector

Economic growth in New Zealand's trading partners has remained slightly below trend over the past year (figure 4.3). While weakness in the euro area and the United States has dampened demand for New Zealand's exports, these economies only comprise a small share of New Zealand's export basket. Asia and Australia are New Zealand's main export destinations, and growth in these regions has been relatively robust.

Growth in Asia has slowed over the past year, partially due to weakness in exports to the euro area and the United States, but remains firm. In China, annual GDP growth slowed to 7.8 percent in the June quarter from 9.9 percent a year earlier. The Chinese authorities have attempted to support economic growth by increasing infrastructure investment and credit growth. These measures appear to have been successful, with the economy expanding more rapidly on a quarterly basis.

In Australia, the pace of economic growth has increased over the past year. Resource sector investment continues to be the key driver of growth. Although consumption growth has been strong, the continued strength of the Australian dollar has encouraged substitution to imported goods. Investment outside the resource sector has remained subdued, reflecting conditions in the non-mining sectors of the economy.

Challenging economic conditions in some Western economies have had a substantial negative impact on the New Zealand economy. The ongoing uncertainty has dampened consumer and business confidence, and resulted in elevated funding margins for banks, including those in New Zealand. These elevated margins have boosted domestic retail interest rates relative to the low policy rate. As discussed in chapter 3, funding margins have recently reduced, but remain elevated relative to their pre-financial crisis level.

But perhaps the biggest impact of the slow global recovery has been through strength in the New Zealand dollar. The New Zealand economy has been performing better than many major economies, including the euro area, the United States and Japan. While the New Zealand dollar also reflects a high terms of trade and improved market sentiment, the relative performance of the domestic economy contributes to the New Zealand dollar remaining persistently elevated. The high exchange rate has negatively affected the New Zealand economy through a number of channels.

Box C
Recent developments in the labour market

A wide range of statistics on the New Zealand labour market is available. From quarter to quarter, individual measures can be volatile. As such, it is important to consider the broad range of available data when assessing labour market conditions.

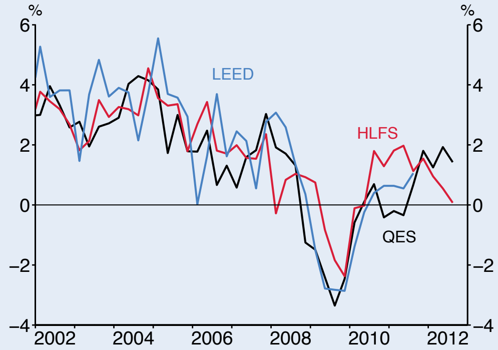
Statistics New Zealand produces several official surveys of employment, unemployment and wages. These include the HLFS, the QES and Linked Employer-Employee Data (LEED). In addition, there are a number of other measures produced by various private and public sector organisations. These include employment and capacity measures from business surveys, unemployment benefit numbers, sector specific surveys like the Performance of Manufacturing Index and the Performance of Services Index, and information on job advertisements.

The HLFS deteriorated significantly in the September quarter, with the unemployment rate increasing to 7.3 percent, and employment declining. However, a broad range of labour market data are at odds with this apparent deterioration.

The HLFS, QES and LEED all include measures of employment. Looking at the data for 2012, the HLFS suggests much weaker employment than the QES. According to the HLFS, employment held steady in the year to the September quarter 2012, while the QES suggests job numbers increased 1.4 percent (figure C1). A similar divergence also exists between the surveys' measures of hours employed (figure 2.2). LEED data, which focus on labour market dynamics – that is job creation and destruction – are published with a significant lag. Figures for the September quarter 2011 were released on 26 November 2012. Since the 2008/09 recession, LEED net job creation has been somewhere near the middle of that suggested by the HLFS and QES.

Part of the differences between the measures relate to coverage and measurement. The HLFS surveys households, whereas the QES surveys businesses

Figure C1
Employment growth
(annual)

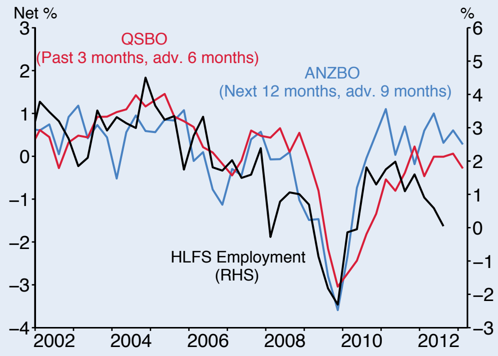


Source: Statistics New Zealand.

with at least three employees or $30,000 in sales, and excludes the self-employed. As with any survey, the results are uncertain and subject to sampling error. The unusual movements of labour and employment patterns due to the Canterbury earthquakes raise additional measurement issues for both surveys. On the other hand, LEED is a census of employer-employee tax data.

In addition to the official labour market statistics, business surveys provide indicators of employment growth. Since the recovery from the recession, employment indicators from the QSBO and ANZBBO have remained around average levels, pointing to modest growth in employment over the period (figure C2). Again, this is a much more positive outcome than suggested by the HLFS.

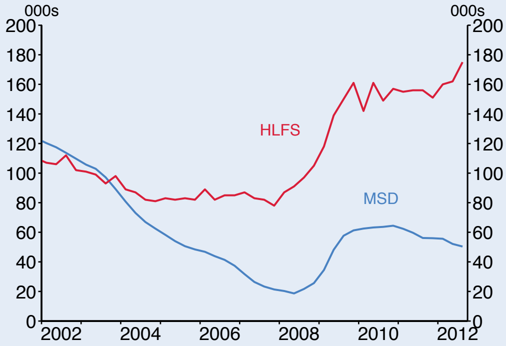
Figure C2
QSBO numbers employed, ANZBO employment intentions and HLFS employment growth



Source: NZIER, ANZ Bank, Statistics New Zealand

In line with weakness in employment growth, the HLFS measure of unemployment moved higher in the September quarter. Such an increase, however, was not seen in the Ministry of Social Development data on unemployment benefit numbers (figure C3). The number of people receiving an unemployment benefit has generally tracked lower over the past couple of years.

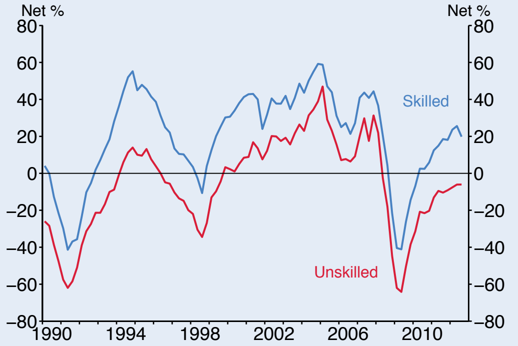
Figure C3
Unemployment benefit numbers and HLFS numbers unemployed
(seasonally adjusted)



Source: Statistics New Zealand, Ministry of Social Development.

Further cross calibration can be gained from looking at surveyed skill shortages. If unemployment has spiked higher over recent quarters, it is likely that employers would report that it is easier to find staff. To date, no such easing has been seen (figure C4). Since the end of the recession, firms have reported that it is increasingly harder to find both skilled and unskilled staff. Indeed, both series sit close to their long-run averages. At the same time, annual wage inflation has moved higher over the past few years and is currently sitting around 2 percent. These measures point to a steady tightening in the labour market.

Figure C4
QSBO difficulty in finding skilled and unskilled staff
(seasonally adjusted)



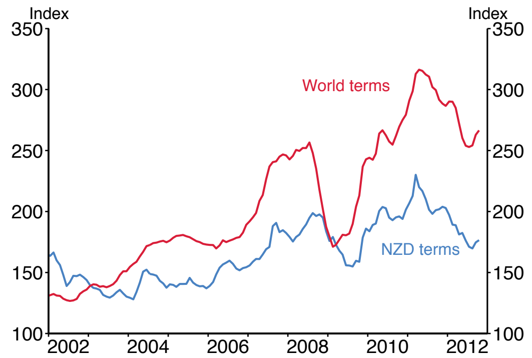
Source: NZIER.

Overall, looking at a broad range of measures, momentum in the labour market has weakened somewhat over the end of 2012. However, we believe this deterioration is less severe than the HLFS alone would suggest.

Lingering strength in the New Zealand dollar has dampened export receipts. Export commodity prices in world terms have declined on an annual basis, but remain elevated relative to the 2009 trough. These prices are lower in New Zealand dollar terms (figure 4.4).

The impact of the high New Zealand dollar is also evident in some components of export volumes. Since 2004, exports of travel services, which include tourism and education of foreign students in New Zealand, have been declining. In part, this is due to the strong New Zealand dollar eroding the spending power of foreigners in New Zealand. Subdued global activity has also contributed to this weakness since 2009. Manufactured export volumes, while above their pre-crisis level, have continued their only slight growth of the past decade. Reflecting favourable

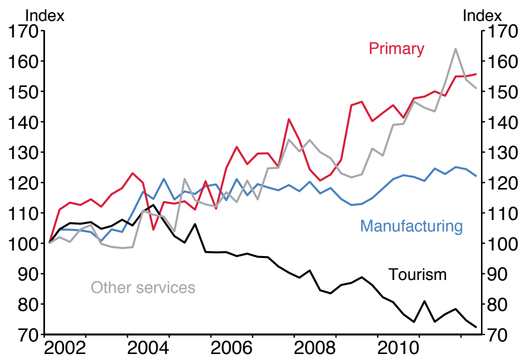
Figure 4.4
Export commodity prices
(monthly)



Source: ANZ Bank.

prices and much improved climatic conditions, primary export volumes have grown quite noticeably over the past few years, as have non-travel service exports (figure 4.5).

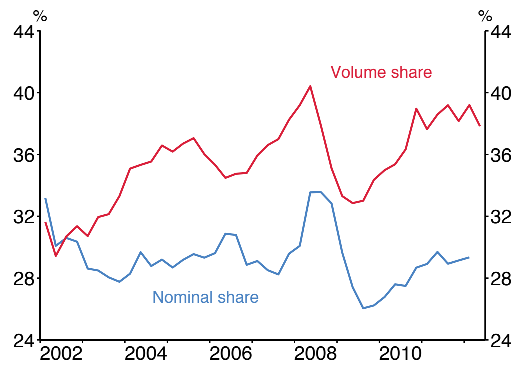
Figure 4.5
Export volumes
(March quarter 2002=100)



Source: Statistics New Zealand.

At the same time, the high New Zealand dollar is encouraging substitution to imported goods and services. Despite high global commodity prices and strong growth in primary export volumes, import values have outstripped export values over the past year, resulting in a merchandise trade deficit. Indeed, the real import share of aggregate GDP has trended higher over the past decade despite the nominal share reducing (figure 4.6). That is, cheaper imports have allowed New Zealanders to obtain greater quantities of imported goods and services without spending more of their incomes on imports. Along with the impact of the higher exchange rate, the emergence of China as a major trading partner has reduced relative import prices.

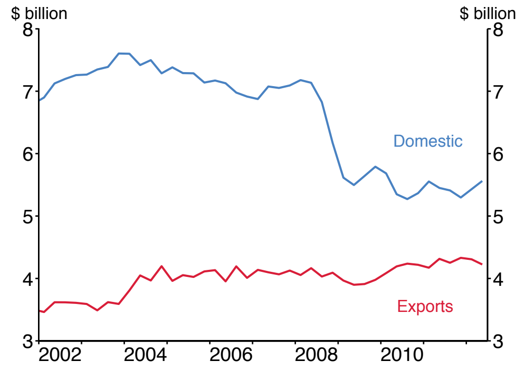
Figure 4.6
Import share of GDP
(seasonally adjusted)



Source: Statistics New Zealand.

Looking specifically at the manufacturing sector, import-competing sales volumes have underperformed exports, particularly relative to before the 2008/09 recession (figure 4.7). While prolonged weakness in the New Zealand construction sector substantially accounts for the decline in domestic sales, the fall and subsequent downtrend also coincide with a higher exchange rate.

Figure 4.7
Quarterly manufacturing sales volumes
(seasonally adjusted)



Source: Statistics New Zealand, RBNZ estimates.

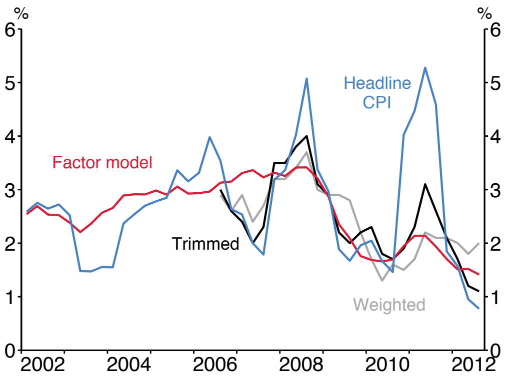
A strong New Zealand dollar has also had some positive effects. It has helped to lower inflation, reduce the domestic cost of imported materials and consumer goods. It has also benefitted exporters sourcing imports from other regions and selling into the Australian market and importers servicing the domestic market. The strong New Zealand dollar has also meant that interest rates are lower than would otherwise be the case.

Inflation and capacity pressures

Weak inflation and the gradual pace of economic recovery suggest that some excess capacity remains in the economy, but there is uncertainty about how much. Recent movements in the unemployment rate suggest that spare resources in the economy have increased over the past three quarters (figure 2.3). Even if the latest movements in the unemployment rate were down-weighted, the HLFS would still suggest that unemployment remains near its recessionary peak. In contrast, business surveys suggest that excess capacity in the wider economy is being steadily employed, consistent with around average wage inflation. Overall, it appears that the level of excess capacity is likely to be between that suggested by the various indicators. We have assumed that the economy is currently operating with a negative output gap of around 1 percent of potential GDP.

Annual CPI inflation declined to 0.8 percent in the September quarter, and was weaker than expected. Part of this low rate of inflation relates to movements in volatile items such as fruit and vegetables over the past year. However, even once these movements are accounted for, core inflation remains low. Indeed, several measures of core inflation are in the lower part of the target band (figure 4.8).

Figure 4.8
Headline and selected core inflation measures *(annual)*



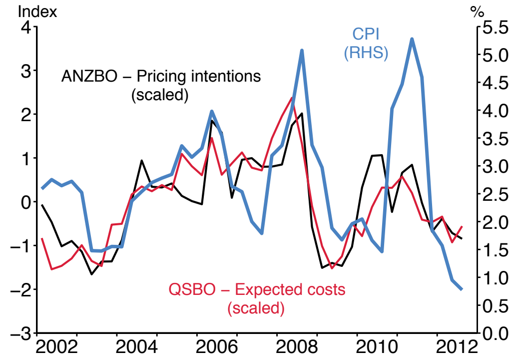
Source: Statistics New Zealand, RBNZ estimates.
Note: Headline CPI includes the 2010 GST increase, whereas the other measures do not.

Falling tradable prices significantly contributed to the low headline inflation outturn. Weak global inflation pressure has resulted in soft import price inflation. In addition, the strong New Zealand dollar has dampened the prices of imported goods.

Non-tradable inflation has also been running at a below-average pace, reflecting some spare capacity in the economy. Most prices are evolving in line with these below-average cyclical pressures. In addition, increased competitive pressures in industries such as communications and domestic air travel have seen prices in these categories fall much more noticeably.

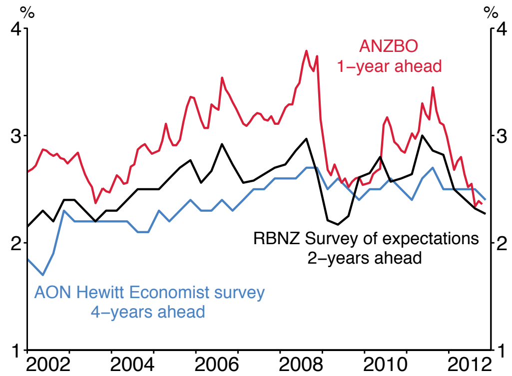
Firms' pricing intentions have also eased. Pricing intentions continue to edge lower and are now slightly below average levels (figure 4.9). In addition, surveyed inflation expectations are lower than in the past few years (figure 4.10).

Figure 4.9
Price and cost expectations and annual CPI inflation



Source: Statistics New Zealand, ANZ Bank, NZIER.

Figure 4.10
Inflation expectations *(annual)*



Source: RBNZ, ANZ Bank, AON Hewitt economist survey.

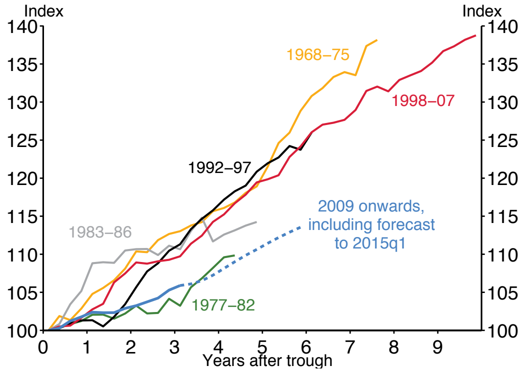
Although inflation is currently low, there are signs that pockets of pressure – mostly related to the strengthening housing market – are beginning to emerge. Housing rental costs have continued to rise and house price inflation, particularly in Auckland, has risen. Construction sector pressures have also been increasing, albeit from low rates, particularly in Canterbury (see figure 2.1). For now such pressures appear contained, but spillover to nationwide construction costs would be of concern.

5 The macroeconomic outlook

Over the medium term, economic activity is expected to be supported by stimulatory interest rates and an increase in construction, particularly in Canterbury. While this will support incomes and consumption, the pace of recovery is expected to remain weaker than previous cycles (figure 5.1). The outlook for growth is dampened by high household debt levels and by projected fiscal consolidation. Continuing adjustments in public and private debt positions in a number of our major trading partner economies also provide some further drag on domestic activity.

As economic activity increases, some build-up of inflationary pressures is expected. But with the economy starting from a position of excess capacity and with lingering strength in the New Zealand dollar, inflationary pressures are expected to remain contained, with headline inflation settling close to 2 percent over the medium term.

Figure 5.1
Recoveries in GDP
(seasonally adjusted)

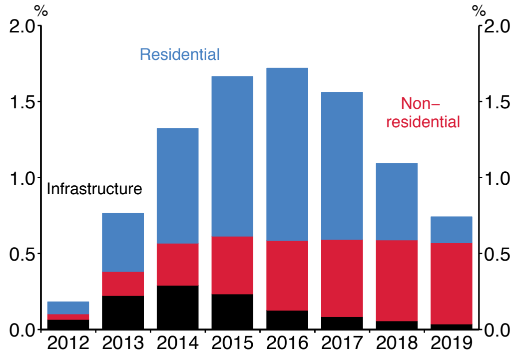


Source: Statistics New Zealand, RBNZ estimates.

Activity outlook

GDP is forecast to increase by 2 to 3 percent per annum over the projection, underpinned by an increase in investment spending. A significant contributor to the increase in growth will be post-earthquake construction activity, which will boost residential and non-residential investment spending for an extended period (figure 5.2). As foreshadowed in the September *Statement*, the cost of reconstruction in Canterbury is likely to exceed the $20 billion (in 2011 dollars) that had previously been assumed. Revised estimates of damage caused by the earthquakes indicate that there was a greater amount of damage to commercial assets than had previously been estimated. Furthermore, plans for reconstruction include considerable discretionary improvements (such as the redevelopment of the central business district). Some assets will also be repaired or built to a higher standard to meet higher earthquake-strengthening requirements. After accounting for these developments, around $30 billion (in 2011 dollars) of earthquake-related investment and reconstruction spending is assumed to be now occuring over an extended period. This is equivalent to around 15 percent of annual nominal GDP.

Figure 5.2
Earthquake related investment and reconstruction
(share of potential GDP)



Source: RBNZ estimates.

Our updated estimates for earthquake-related investment and construction spending are based on discussions with businesses, insurers and government agencies. There remains a considerable degree of uncertainty around the cost and timing of the reconstruction process. Consequently, this estimate is still best viewed as a working assumption that has been rounded to the nearest $5 billion.

Residential investment more generally is also expected to increase from current low levels (figure 5.3, overleaf). Residential investment per capita has been unusually low in recent years. Over the projection, increases in house building are expected, driven by continued low interest rates, modest population growth and regular maintenance of the housing stock. Combined with construction in Canterbury, this will result in residential investment rising

Box D
The implications of an excessive pick-up in house price inflation

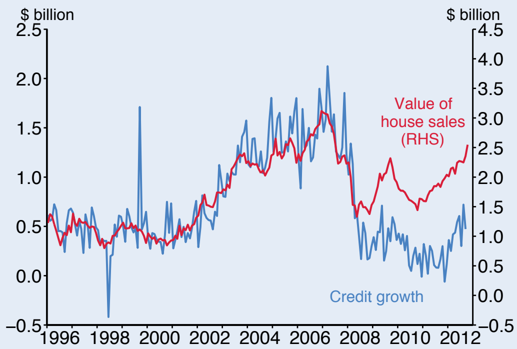
The household sector has exhibited a cautious approach to investment and saving since the global financial crisis. Housing turnover has been relatively weak and household borrowing has tracked well below its historical relationship with housing activity (figure D1). Many householders appear to have taken advantage of low interest rates to increase the principal repayments on their mortgages.

More recently, however, household credit growth, housing market turnover and house price inflation have all picked up. Aggressive competition for mortgage lending and lower bank funding costs have seen mortgage interest rates reduce from already low levels. Combined with a relaxation of maximum loan-to-value restrictions by some lenders, lower interest rates appear to have increased the attractiveness of housing for potential first-time home buyers, leading to a rise in the share of high loan-to-value ratio lending throughout 2012. If the housing market continues to gather momentum, there is a risk of a stronger pick-up in household credit and further increase in house price inflation.

Such developments would have implications for the appropriate stance of monetary policy. Higher house price inflation and increased household expenditure would likely lead to higher inflationary pressures than is currently projected. All else equal, such a development could necessitate a higher OCR.

Beyond the risks to inflation, the Bank would also be concerned by such developments from the perspective of its mandate to promote the soundness and efficiency of the financial system. As reviewed in the latest *Financial Stability Report*, a credit-fuelled expansion in house prices would expose households and banks to a sharp fall in house prices

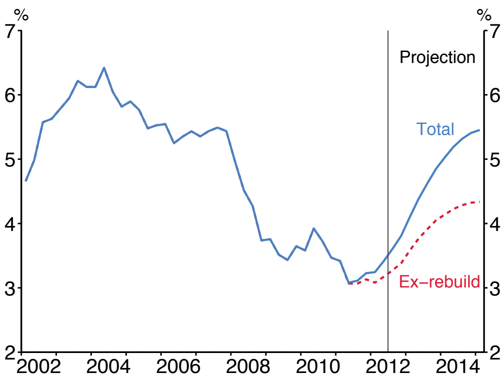
Figure D1
House sales and credit growth
(monthly)



Source: REINZ, RBNZ.

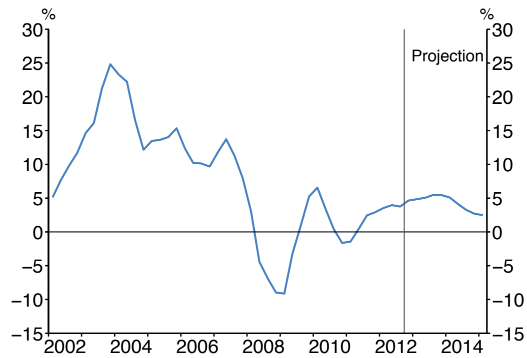
to a share of potential GDP similar to that seen during the mid-2000s housing boom. The associated increase in the housing stock, as well as elevated household debt levels, is expected to limit house price inflation over the coming years (figure 5.4).

Figure 5.3
Residential investment
(seasonally adjusted, share of potential GDP)



Source: Statistics New Zealand, RBNZ estimates.

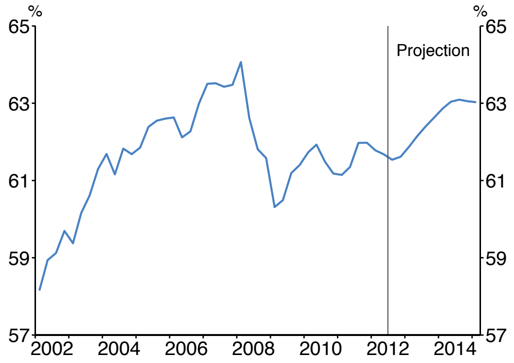
Figure 5.4
House price inflation
(annual)



Source: Property IQ, RBNZ estimates.

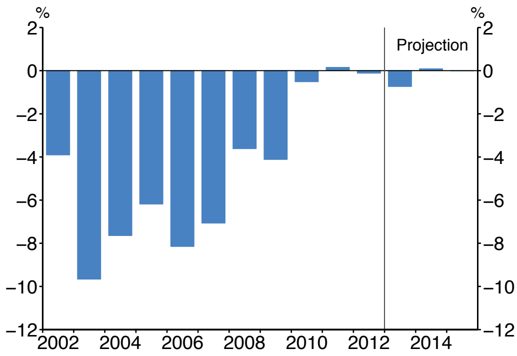
Underpinned by increases in investment, domestic activity will lift over the coming years. This will support increases in employment and consumption over the projection. Nevertheless, household spending growth is still expected to remain below the elevated levels seen during the previous cycle (figure 5.5). High debt levels, coupled with moderate house price inflation, are expected to constrain consumption growth, with the improvement in the household savings rate in recent years expected to be maintained (figure 5.6).

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



Source: Statistics New Zealand, RBNZ estimates.

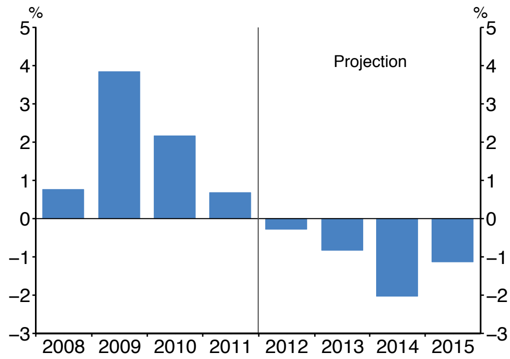
Figure 5.6
Household saving rate
(March year, share of disposable income)



Source: Statistics New Zealand, RBNZ estimates.

The outlook for household consumption is also dampened by projected fiscal consolidation. The Government has signalled its intention to return the fiscal balance to a zero position by 2014/15, through a combination of reduced spending growth and an increase in revenues. The latter is expected to occur through a pick-up in domestic activity and higher indirect taxes. These taxes increase the price level, and constrain the growth in consumers' real disposable incomes. Fiscal consolidation measures introduced in recent years have reduced net transfers to households. This is through a tightening in the availability of social support packages, and reduced government contributions to retirement saving schemes. The Government has also announced restrictions on allowances for new spending, with nominal core Crown expenses projected to grow at an average pace of around 2 percent per annum over the projection (compared to an average rate of growth of around 7 percent per annum over the previous decade). These measures result in fiscal policy tightening by around 1 percent per annum over the coming years, with a cumulative negative fiscal impulse of around 4 percent of nominal GDP over the projection (figure 5.7).

Figure 5.7
Fiscal impulse
(share of nominal GDP, June years)

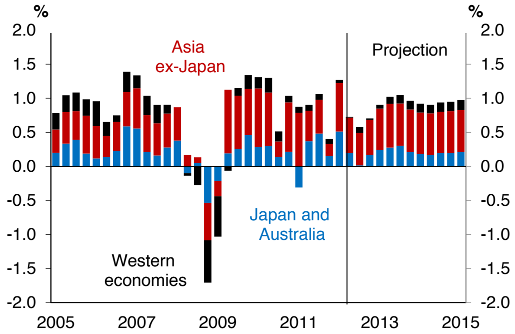


Source: The Treasury.

Global growth is projected to lift over the coming year, driven by growth in Asia (figure 5.8, overleaf). Nevertheless, on-going adjustments in public and private debt positions will continue to weigh on confidence and demand in a number of Western economies.

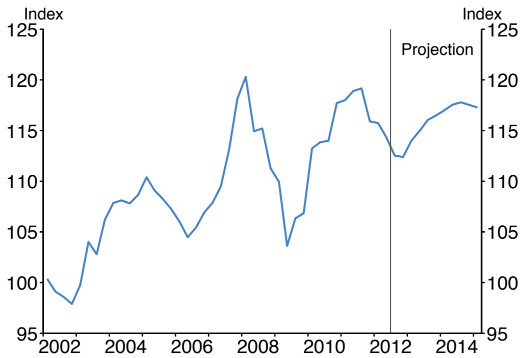
Growth in New Zealand's Asia Pacific trading partners (that account for around 53 percent of New Zealand's merchandise trade) is expected to be more robust, supporting continued modest growth in New Zealand's terms of trade (figure 5.9, overleaf). Growth is expected to stabilise in China, supporting activity in the rest of Asia. Australia is expected to grow at around average rates

Figure 5.8
Trading partner GDP growth
(seasonally adjusted, bars indicate contributions to quarterly growth)



Source: Haver Analytics, RBNZ estimates.
Note: ASEAN includes Thailand, Malaysia, Indonesia and The Philippines. NIEs include South Korea, Taiwan, Hong Kong and Singapore. Western includes the United Kingdom, the United States, Canada and the euro area.

Figure 5.9
SNA terms of trade
(seasonally adjusted)

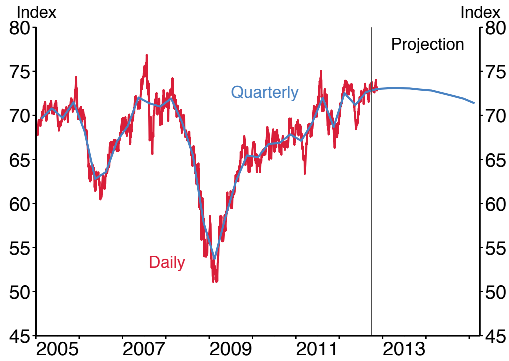


Source: Statistics New Zealand, RBNZ estimates.

over the forecast period. However, with investment in Australia's resource sector expected to peak during 2013, a lift in spending in other areas will be required to support Australian growth. Activity in the euro area is expected to remain weak for some time yet, and only moderate growth is expected in the United States.

Global conditions are expected to weigh on domestic activity. In addition to dampening global trade, soft outlooks for major Western economies, combined with a firm outlook for export commodity prices, are assumed to contribute to lingering strength in the New Zealand dollar TWI (figure 5.10). As well as dampening export earnings, this encourages substitution towards imported goods and services.

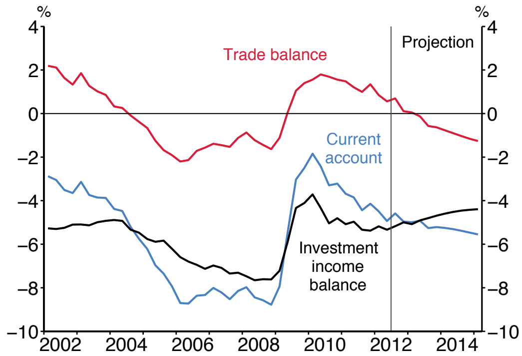
Figure 5.10
New Zealand dollar TWI



Source: RBNZ estimates.

New Zealand's trade balance is projected to deteriorate over the coming years, resulting in the current account deficit widening to about 6 percent of GDP (figure 5.11). While total export volumes are expected to increase, largely supported by strength in primary exports and exports of other services, exports of travel services are expected to remain weak. Simultaneously, import growth is expected to rise, supported by increases in investment spending and strength in the New Zealand dollar.

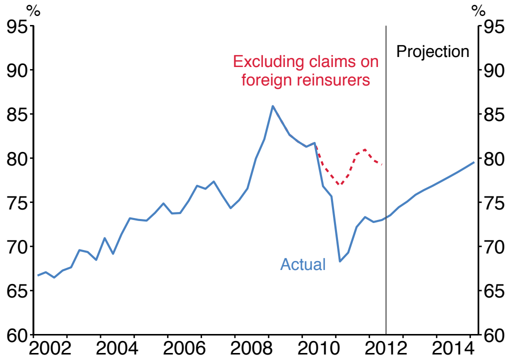
Figure 5.11
Current account balance
(annual, share of nominal GDP)



Source: Statistics New Zealand, RBNZ estimates.

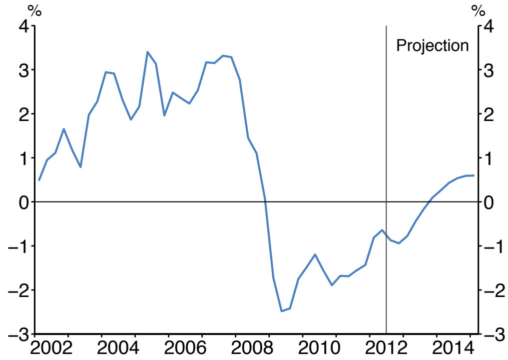
Increases in investment spending and the related deterioration in the current account will also result in New Zealand's net foreign liabilities increasing gradually over the projection. Much of this increase reflects the spending of insurance payments on reconstruction. As at June 2012, the accrual recognition of outstanding reinsurance claims was estimated at $12.8 billion, with an estimated $5.1 billion reinsurance claims settled since September 2010 (figure 5.12).

Figure 5.12
Net foreign liabilities
(share of nominal GDP, seasonally adjusted)



Source: Statistics New Zealand, RBNZ estimates.

Figure 5.14
Output gap
(share of potential output)

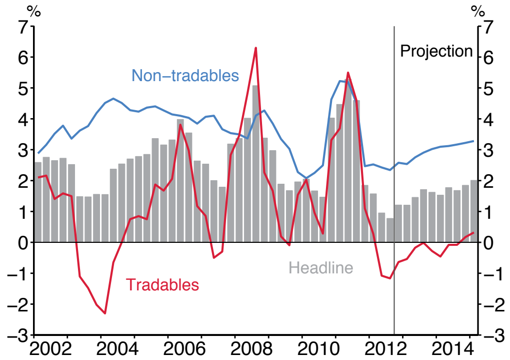


Source: RBNZ estimates.

Inflationary pressures

Following weaker than expected outturns in 2012, inflation is expected to remain in the lower part of the target band over the coming year (figure 5.13). This reflects current levels of excess capacity (figure 5.14), the current slow pace of recovery and that the New Zealand dollar is assumed to remain elevated.

Figure 5.13
CPI, tradable and non-tradable inflation
(annual)



Source: Statistics New Zealand, RBNZ estimates.

Over the medium term, CPI inflation is expected to lift, settling near 2 percent in the latter part of the projection. Along with stimulatory interest rates, the main factors supporting this CPI projection are as follows.

- Increases in domestic activity will result in some accumulation of resource pressures, particularly in the construction sector, with a corresponding increase in non-tradable inflation. However, consolidation in the government and household sectors will offset this to some degree.
- Tradable inflation is expected to increase over the projection, but to remain modest as a result of continuing softness in global economic conditions.
- Inflation over the medium term will be boosted by annual increases in the tobacco excise tax. These increases are expected to add around 0.2 percentage points to annual inflation each year over the projection period.

Appendix A[1]
Summary tables

Table A
Projections of GDP growth, CPI inflation and monetary conditions
(CPI and GDP are percent changes, GDP seasonally adjusted)

		GDP Quarterly	CPI Quarterly	CPI Annual	TWI	90-day bank bill rate
2004	Mar	1.5	0.4	1.5	66.8	5.5
	Jun	0.8	0.8	2.4	64.0	5.9
	Sep	0.2	0.6	2.5	66.3	6.4
	Dec	0.3	0.9	2.7	68.6	6.7
2005	Mar	1.0	0.4	2.8	69.6	6.9
	Jun	2.0	0.9	2.8	70.8	7.0
	Sep	0.4	1.1	3.4	69.7	7.0
	Dec	-0.5	0.7	3.2	71.5	7.5
2006	Mar	1.1	0.6	3.3	68.2	7.5
	Jun	0.4	1.5	4.0	62.8	7.5
	Sep	0.4	0.7	3.5	63.6	7.5
	Dec	0.8	-0.2	2.6	67.0	7.6
2007	Mar	1.1	0.5	2.5	68.8	7.8
	Jun	0.5	1.0	2.0	72.0	8.1
	Sep	0.6	0.5	1.8	71.4	8.7
	Dec	0.4	1.2	3.2	71.0	8.8
2008	Mar	-0.1	0.7	3.4	71.9	8.8
	Jun	-0.9	1.6	4.0	69.3	8.8
	Sep	-0.0	1.5	5.1	65.5	8.2
	Dec	-0.7	-0.5	3.4	57.8	6.3
2009	Mar	-1.6	0.3	3.0	53.7	3.7
	Jun	-0.5	0.6	1.9	58.4	2.9
	Sep	0.3	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	0.6	0.2	1.7	66.8	2.9
	Sep	-0.1	1.1	1.5	66.9	3.2
	Dec	0.0	2.3	4.0	67.8	3.2
2011	Mar	0.6	0.8	4.5	67.1	3.0
	Jun	0.3	1.0	5.3	69.1	2.7
	Sep	0.5	0.4	4.6	72.0	2.8
	Dec	0.5	-0.3	1.8	68.7	2.7
2012	Mar	1.0	0.5	1.6	72.5	2.7
	Jun	0.6	0.3	1.0	71.2	2.6
	Sep	0.2	0.3	0.8	72.6	2.7
	Dec	0.4	0.1	1.2	73.0	2.6
2013	Mar	0.7	0.5	1.2	73.1	2.7
	Jun	0.8	0.6	1.5	73.1	2.7
	Sep	0.8	0.5	1.7	73.1	2.7
	Dec	0.8	0.0	1.6	72.9	2.7
2014	Mar	0.7	0.4	1.5	72.8	2.8
	Jun	0.7	0.8	1.8	72.5	2.9
	Sep	0.7	0.4	1.7	72.2	3.1
	Dec	0.6	0.2	1.8	71.9	3.2
2015	Mar	0.6	0.6	2.0	71.4	3.3

[1] Notes for these tables follow on pages 28 and 29.

Table B

Measures and indicators of inflation

	2011				2012			
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
Inflation (annual rates)								
CPI	4.5	5.3	4.6	1.8	1.6	1.0	0.8	
CPI non-tradable	5.2	5.2	4.5	2.5	2.5	2.4	2.3	
CPI tradable	3.7	5.5	4.6	1.1	0.3	-1.1	-1.2	
Sector factor model estimate of core inflation ex-GST	2.1	2.1	1.9	1.7	1.5	1.5	1.4	
CPI trimmed mean (of annual price change) ex-GST	2.3	3.1	2.6	2.1	1.7	1.2	1.1	
CPI weighted median (of annual price change) ex-GST	1.7	2.2	2.1	2.1	2.0	1.8	2.0	
GDP deflator (derived from expenditure data)	4.3	4.5	3.2	0.8	1.0	2.3		
PPI - Input prices	5.3	4.8	4.7	4.2	2.3	1.9	0.3	
PPI - Output prices	4.2	4.5	3.5	3.4	1.6	0.5	-0.6	
Inflation expectations (annual rates)								
RBNZ survey of expectations - inflation one-year-ahead	2.9	3.1	2.9	2.7	2.2	2.0	2.0	1.8
RBNZ survey of expectations - inflation two-years-ahead	2.6	3.0	2.9	2.8	2.5	2.4	2.3	2.3
ANZ Bank Business Outlook - inflation one-year-ahead (quarterly average to date)	3.0	3.2	3.3	3.1	2.7	2.7	2.4	2.4
AON Hewitt Economist Survey - inflation one-year-ahead	2.6	3.0	2.8	2.5	2.3	2.2	2.0	2.0
AON Hewitt Economist Survey - inflation four-years-ahead	2.4	2.6	2.7	2.5	2.5	2.5	2.5	2.4
Pricing and costs (net balances)								
ANZ Bank Business Outlook - pricing intentions, next 3 months (quarterly average to date)	28.2	29.5	23.0	18.1	20.4	17.9	16.9	14.5
QSBO average selling prices, next three months (economy wide)	37.0	35.0	30.0	33.6	30.1	24.4	26.1	
QSBO average costs, past three months (economy wide)	14.5	31.0	22.0	17.0	23.0	10.0	14.0	
Asset prices (annual percentage changes)								
Quarterly house price index (Quotable Value Limited)	-1.4	0.4	2.4	2.9	3.5	4.0		
REINZ Farm Price Index (quarterly average to date)	9.4	12.7	13.7	5.9	19.9	0.7	-4.4	6.0
NZX-50 (end of quarter)	5.3	16.0	5.2	-1.0	2.0	-1.4	14.7	

Table C
Composition of real GDP growth
(annual average percent change, seasonally adjusted, unless specified otherwise)

	Actuals								Projections		
March year	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Final consumption expenditure											
Private	4.4	4.4	2.7	3.4	-1.7	0.4	1.6	1.9	1.5	3.5	3.2
Public authority	4.6	4.7	4.1	5.2	4.6	0.2	0.4	0.6	-0.8	-0.6	0.6
Total	4.5	4.5	3.0	3.8	-0.3	0.3	1.3	1.6	1.0	2.6	2.6
Gross fixed capital formation											
Market sector:											
Residential	2.3	-5.0	-1.9	1.6	-22.5	-12.0	3.7	-11.6	19.9	29.1	15.7
Business	10.2	10.3	-3.4	10.4	-7.9	-14.5	9.4	2.4	8.2	7.2	6.4
Non-market government sector	10.8	6.4	2.2	-10.7	27.8	-5.0	-13.8	-12.3	-6.9	7.9	4.1
Total	8.3	6.6	-2.7	7.0	-8.5	-13.3	6.2	-1.0	8.9	10.8	8.0
Final domestic expenditure	5.4	5.0	1.5	4.6	-2.4	-2.9	2.3	1.1	2.6	4.4	3.9
Stockbuilding[1]	0.2	-0.5	-1.2	1.2	-0.5	-1.3	1.3	0.7	-0.6	0.3	0.0
Gross national expenditure	5.9	4.7	0.2	5.9	-2.4	-3.7	3.1	2.4	1.2	4.7	3.9
Exports of goods and services	4.9	-0.1	3.2	3.6	-2.6	4.9	2.7	2.6	1.9	0.9	1.8
Imports of goods and services	12.3	4.4	-1.4	10.6	-4.1	-9.0	11.5	6.3	1.1	6.3	4.9
Expenditure on GDP	3.5	3.3	1.7	3.6	-1.9	0.9	0.3	1.1	1.5	2.8	2.9
GDP (production)	3.6	3.3	2.2	2.5	-1.3	-1.3	1.6	1.6	2.2	2.8	2.9
GDP (production, March qtr to March qtr)	2.3	3.1	2.9	1.4	-3.1	1.2	1.1	2.3	1.9	3.2	2.6

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

Table D

Summary of economic projections

(annual percent change, unless specified otherwise)

	Actuals								Projections		
March year	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Price measures											
CPI	2.8	3.3	2.5	3.4	3.0	2.0	4.5	1.6	1.2	1.5	2.0
Labour costs	2.5	3.0	3.0	3.5	3.1	1.3	2.0	2.1	2.0	2.1	2.1
Export prices (in New Zealand dollars)	3.7	3.1	2.5	11.9	7.4	-8.3	8.0	-3.5	-4.9	1.8	3.3
Import prices (in New Zealand dollars)	1.3	7.3	0.7	0.4	17.5	-11.0	3.6	-1.6	-3.5	-0.8	3.1
Monetary conditions											
90-day rate (year average)	6.5	7.3	7.6	8.6	6.7	2.8	3.1	2.7	2.6	2.7	3.1
TWI (year average)	67.1	70.1	65.6	71.6	61.6	62.9	67.1	70.6	72.5	73.0	72.0
Output											
GDP (production, annual average % change)	3.6	3.3	2.2	2.5	-1.3	-1.3	1.6	1.6	2.2	2.8	2.9
Potential output (annual average % change)	3.3	2.9	2.4	2.0	1.5	1.0	1.2	1.4	1.6	2.1	2.3
Output gap (% of potential GDP, year average)	2.3	2.7	2.6	3.1	0.2	-2.0	-1.6	-1.4	-0.8	-0.1	0.5
Labour market											
Total employment (seasonally adjusted)	3.7	2.8	2.0	-0.3	0.7	-0.1	1.7	0.9	0.2	3.2	1.6
Unemployment rate (March qtr, seasonally adjusted)	3.9	4.0	3.9	3.9	5.1	6.1	6.5	6.7	7.1	5.9	4.9
Trend labour productivity	1.0	1.0	0.9	0.7	0.5	0.5	0.5	0.7	0.8	0.8	0.9
Key balances											
Government operating balance (% of GDP, year to June)	4.6	4.4	3.4	3.1	-2.1	-3.3	-9.2	-4.1	-4.1	-1.7	-0.8
Current account balance (% of GDP)	-6.2	-8.6	-8.0	-7.9	-7.9	-1.8	-3.6	-4.4	-4.9	-5.2	-5.5
Terms of trade (SNA measure, annual average % change)	3.3	-1.0	-1.4	8.6	-2.1	-4.7	7.8	1.3	-3.5	2.5	1.2
Household saving rate (% of disposable income)	-6.2	-8.2	-7.1	-3.6	-4.1	-0.5	0.2	-0.1	-0.7	0.1	-0.0
World economy											
Trading partner GDP (annual average % change)	3.8	3.8	3.8	4.3	0.1	1.2	4.3	3.3	3.2	3.7	3.8
Trading partner CPI (TWI weighted, annual % change)	2.1	2.4	1.9	3.3	0.9	1.7	2.2	2.2	1.8	1.9	2.0

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. System of National Accounts.
Export prices	Domestic currency export prices. System of National Accounts.
Terms of trade	Constructed using domestic currency export and import prices. System of National Accounts
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 Domestic Income	The real purchasing power of domestic income, taking into account changes in the terms of trade. 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)	Gross Domestic Product. 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.
Quarterly percent change	$(\text{Quarter}/\text{Quarter}_{-1} - 1)*100$
Annual percent change	$(\text{Quarter}/\text{Quarter}_{-4} - 1)*100$
Annual average percent change	$(\text{Year}/\text{Year}_{-1} - 1)*100$

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

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

Air New Zealand Ltd
Amalgamated Builders (2001) Ltd
Barfoot & Thompson
Bay of Plenty Federated Farmers of NZ
Blue Sky Meats Ltd
C3 Ltd
Carter Holt Harvey Ltd
Christchurch International Airport Ltd
Darroch Ltd
Ernst & Young
Ezibuy Ltd
Fairfax New Zealand Ltd
Fletcher Building Ltd
Gallagher Group Ltd
H & J Smith Ltd
Hagley Building Products Ltd
Hawkins Construction Ltd
Hellaby Holdings Ltd
Heritage Hotel Queenstown
Higgs Builders Ltd
HRS Construction Ltd
Ian Harrison & Associates Ltd
Infratil Ltd
Kelly Services (New Zealand) Ltd
Livestock Improvement Corporation
LJ Hooker Group Ltd
Lyttelton Port Christchurch Ltd
Mitre 10 (NZ) Ltd
Morgan Furniture Ltd
New Zealand Retailers Association
New Zealand Sugar Company Ltd
NZSki Ltd
Paymark Ltd
Perry Group Ltd
PGG Wrightson Ltd
Port of Tauranga Ltd
Rakon Ltd
Ray White Real Estate
Redward Associates Ltd
Registered Master Builders Federation
Skyline Enterprises Ltd
Snowy Peak Ltd
Southern Response Earthquake Services Ltd
Southland Building Society Ltd
Southland District Council
SYL Research Ltd
Tauranga Mitre 10 Mega Ltd
The Warehouse Ltd
Trojan Holdings Ltd
Vballance Agri-Nutrients Ltd
Viterra Ltd
Xero Ltd
Yunca Group Ltd
Zespri International Ltd

Appendix C
Reserve Bank statements on monetary policy

OCR unchanged at 2.5 percent

13 September 2012

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

Reserve Bank Governor Alan Bollard said: “New Zealand’s economic outlook remains broadly consistent with that described in the June *Monetary Policy Statement*.

“New Zealand’s trading partner outlook remains weak. Several euro-area economies are in recession and Chinese growth has slowed. The risk of significant deterioration in the euro area persists.

“Domestically, the Bank continues to expect economic activity to grow modestly over the next few years. Housing market activity continues to increase as forecast, and repairs and reconstruction in Canterbury are expected to further boost the construction sector. Offsetting this, fiscal consolidation is constraining demand growth, and the high New Zealand dollar continues to undermine export earnings and encourage substitution toward imported goods and services.

“Underlying annual inflation, which recently moved below 2 percent, is expected to settle near the mid-point of the target range over the medium term.

“It remains appropriate for the OCR to be held at 2.5 percent.”

OCR unchanged at 2.5 percent

25 October 2012

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

Reserve Bank Governor Graeme Wheeler said: “the global economy remains fragile, with further recovery heavily dependent on policy implementation. That said, market sentiment has improved from earlier in the year, suggesting the risks to the global outlook are more balanced.

“Domestically, GDP continues to expand at a modest pace. Housing market activity is increasing as expected, and repairs and reconstruction in Canterbury are boosting the construction sector. Offsetting this, fiscal consolidation is constraining demand growth, and the high New Zealand dollar is undermining export earnings and encouraging substitution toward imported goods and services.

“While annual CPI inflation has fallen to 0.8 percent, the Bank continues to expect inflation to head back towards the middle of the target range. We will continue to monitor inflation indicators, such as pricing intention and inflation expectation data, closely over coming months.

“For now it remains appropriate for the OCR to be held at 2.5 percent.”

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	8 December 2011	2.50
2 October 2002	5.75	7 June 2007	8.00	26 January 2012	2.50
20 November 2002	5.75	26 July 2007	8.25	8 March 2012	2.50
23 January 2003	5.75	13 September 2007	8.25	26 April 2012	2.50
6 March 2003	5.75	25 October 2007	8.25	14 June 2012	2.50
24 April 2003	5.50	6 December 2007	8.25	26 July 2012	2.50
5 June 2003	5.25	24 January 2008	8.25	13 September 2012	2.50
24 July 2003	5.00	6 March 2008	8.25	25 October 2012	2.50

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 (OCR) announcements. 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.

Announcements are made at 9.00am on the day concerned and are posted to the website shortly after.

2013

31 January 2013	OCR announcement
14 March 2013	*Monetary Policy Statement* and OCR announcement (Media conference and webcast)
24 April 2013*	OCR announcement
13 June 2013	*Monetary Policy Statement* and OCR announcement (Media conference and webcast)
25 July 2013	OCR announcement
12 September 2013	*Monetary Policy Statement* and OCR announcement (Media conference and webcast)
31 October 2013	OCR announcement
12 December 2013	*Monetary Policy Statement* and OCR announcement (Media conference and webcast)

2014

30 January 2014	OCR announcement
13 March 2014	*Monetary Policy Statement* and OCR announcement (Media conference and webcast)
24 April 2014	OCR announcement
12 June 2014	*Monetary Policy Statement* and OCR announcement (Media conference and webcast)

* Please note: this announcement will be held on a Wednesday, as Thursday 25 April is a public holiday.

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

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.

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

In pursuing the objective of a stable general level of prices, the Bank shall monitor prices, including asset 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.

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, with a focus on keeping future average inflation near the 2 per cent target midpoint.

3. Inflation variations around target

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.

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

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.

In pursuing its price stability objective, the Bank shall implement monetary policy in a sustainable, consistent and transparent manner, have regard to the efficiency and soundness of the financial system, and seek to avoid unnecessary instability in output, interest rates and the exchange rate.

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

Hon Bill English

Minister of Finance

Graeme Wheeler

Governor Designate
Reserve Bank of New Zealand

Dated at Wellington 20 September 2012