
Monetary Policy Statement

September 2005

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

Contents

1.	Policy assessment	2
2.	Overview and key policy judgements	3
3.	The current economic situation	9
4.	Financial market developments	19
5.	The macroeconomic outlook	22

Appendices

A.	Summary tables	29
B.	Chronology	34
C.	Companies and organisations contacted during the projection round	35
D.	Reserve Bank statements on monetary policy	36
E.	The Official Cash Rate chronology	39
F.	Upcoming Reserve Bank <i>Monetary Policy Statement</i> and Official Cash Rate release dates	40
G.	Policy Targets Agreement	41

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

ISSN 1770-4829

¹ Projections finalised on 6 September 2005. Policy assessment finalised on 14 September 2005.

1 Policy assessment

The Official Cash Rate (OCR) will remain on hold at 6.75 per cent.

Since our June *Monetary Policy Statement*, economic indicators have broadly confirmed the slowdown in activity that commenced in the second half of 2004. The slowdown has been concentrated in sectors such as manufacturing and tourism that have been exposed to the high exchange rate. The non-traded sectors of the economy on the other hand, such as household and business services and construction, have maintained their high growth of recent years. The housing market in particular has remained strong, underpinning consumption growth. Reflecting the slow pullback in domestic demand, capacity and labour shortages are expected to persist well into 2006.

New developments in oil prices have made the future more uncertain. Oil prices have surged in recent months and are now 20 per cent higher than projected in June, some 60 per cent up from the end of 2004. As a consequence, headline CPI inflation is now forecast to approach 4 per cent over the next few quarters before returning below 3 per cent by early 2007. Monetary policy will not attempt to offset the unavoidable first-round price effects of the oil price spike. However, it will be used to resist any flow-through to ongoing price and wage inflation. Further out, the higher oil prices are expected to have a dampening effect on both world and domestic economic activity, thus taking some pressure off monetary policy in the medium-term.

Fiscal policy is also adding to uncertainty. The shape and economic impact of new post-election policies is not clear at this point. However, it does appear likely that fiscal policy will become more expansionary in the period ahead.

Right now, it is too early to make a call on the relative strength of the emerging cross-currents and how these will translate into medium-term inflation pressures. It will be several months before the persistence and global impact of the oil shock become more apparent. A similar period could be needed for the fiscal outlook to be clarified. We are concerned, however, that the risk of higher medium-term inflation has increased. Consequently, further monetary policy tightening may still prove necessary to ensure inflation is kept within the 1 per cent to 3 per cent target band on average over the medium-term. Certainly there remains no prospect of a cut in the OCR in the foreseeable future.



Alan Bollard
Governor

2 Overview and key policy judgements

Inflation pressures in the New Zealand economy remain strong, with sustained growth in activity over recent years stretching productive resources. Growth has been slowing since mid-2004, although the housing market and household spending continue to prove more resilient than we expected. Our updated projections are for growth to continue to cool over the year ahead, which should reduce inflation pressures over the medium term. However, inflation is expected to rise sharply in the near term due to the recent rise in oil prices, posing a risk to the medium-term inflation outlook. Our projections make no allowance for any future changes to fiscal policy other than those contained in the Pre-Election Economic and Fiscal Update (PREFU).

Recent developments

Growth in GDP for the March quarter was lower than anticipated in our June *Statement*, primarily reflecting weakness in parts of the export sector, including manufacturing and tourism. Much of this weakness is likely to reflect the lagged effects of the high New Zealand dollar. However, domestic spending was a little stronger than we had anticipated, consistent with further growth in employment and continued strength in both the housing market and the construction sector.

As discussed further in Chapter 3, the latest indicators suggest that activity in the export sector remains subdued, although commodity export prices have in aggregate been stronger than expected. The evidence on the domestic economy has been mixed. Household demand remained strong through the June quarter. Household mortgage borrowing, housing market turnover and retail spending have remained surprisingly resilient and surveyed consumer confidence remains high. On the other hand, the number of residential building consents has continued to fall away, although part of this fall is due to administrative backlogs. In the business sector, there are signs that investment in plant and machinery has peaked following several years of strong growth. Business confidence surveys generally point to an expected further easing in activity over the coming year.

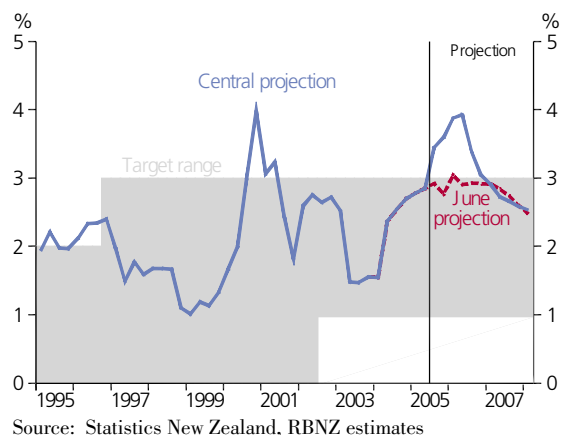
To date, there has been little concrete evidence that inflation pressures are abating significantly. The headline CPI result for the June quarter was in line with our expectation.

However, unexpected weakness in international airfares masked a stronger-than-expected contribution from the housing group, which has continued to underpin the non-tradables component of inflation over the past year. With housing activity remaining relatively robust in recent months, the result highlights the possibility of further strength in non-tradables inflation in the near term.

However, as described in Chapter 5, we continue to expect that medium-term inflation pressures will cool over the period ahead and that the slowdown in activity will become more widespread within the economy. The flow-on effects of a high New Zealand dollar, slower population growth and the lagged effects of the previous tightening in monetary policy will increasingly constrain domestic demand going forward. This in turn is expected to reduce the pressure on productive resources that has led to a rise in inflation over the past two years.

Against this general background, the recent sharp rise in international oil prices over the past few months – which has been accentuated in recent weeks – is expected to put significant upward pressure on CPI inflation over the remainder of 2005 as higher petrol prices ‘at the pump’ and the indirect effects on a range of other prices occur. We now expect CPI inflation to peak at just under 4 per cent by early next year (figure 2.1) before falling away thereafter. Chapter 5 describes our macroeconomic projections in more detail.

Figure 2.1
Consumer price inflation
(annual rate)



Box 1

Review of monetary policy decisions

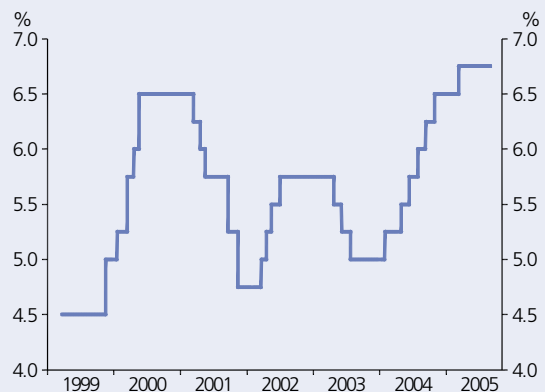
Monetary policy in New Zealand has been in a tightening phase since early 2004, with the OCR increased in a measured series of 25 basis point steps to a total of 175 basis points. The OCR now stands at 6.75 per cent.

The extent of the tightening has been greater than the Bank, the market, and most other forecasters had envisaged at the start of the cycle. The greater-than-expected tightening has reflected the surprising degree of strength in the domestic economy. The persistence of the housing and construction boom in New Zealand has been of particular significance, and has had a material effect on inflation outcomes. The strength of the housing sector may have been accentuated by intense competition for mortgage market share amongst the major banks. In addition, very high world prices for dairy and meat products have cushioned export revenues at a time when the exchange rate has been high.

Our June *Statement* noted that OCR settings looked sufficient to achieve the 1 to 3 per cent inflation target

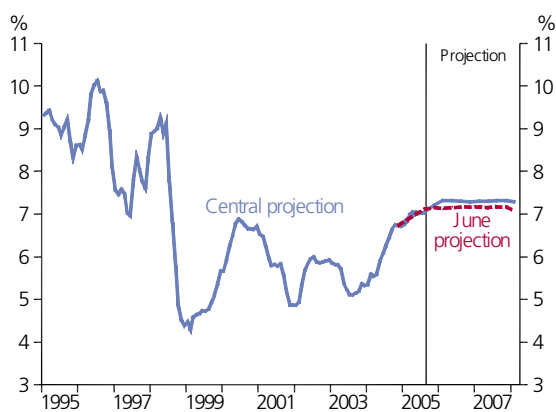
on average over the medium term, given evidence that growth in activity was slowing. However, we noted that the risks to the inflation outlook were to the upside, due to the continuation of strong debt-financed household spending and ongoing cost pressures associated with labour, energy and freight. We reiterated that view again at our OCR review in July. The Bank noted that further monetary policy tightening could not be ruled out and that the outlook offered no scope for any reduction in the OCR in the foreseeable future.

Figure 2.2
Official Cash Rate



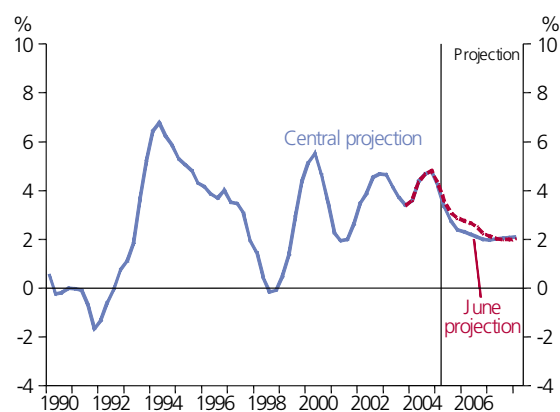
Source: RBNZ

Figure 2.3
90 day rates



Source: RBNZ estimates

Figure 2.4
GDP growth
(annual average per cent change)



Source: Statistics New Zealand, RBNZ estimates.

Monetary policy judgements

The emerging risks to the inflation outlook are operating in both directions. On the downside, we are conscious of the possibility of a sharper downturn in demand than our projections show. For example, the continued strength of the exchange rate could generate greater pressure on some parts of the tradables sector than we are allowing for. Higher oil prices could also dampen activity in New Zealand's trading partners to a greater degree than we are assuming, which would dampen growth further. While to date there have not been major downward revisions to *Consensus'* forecasts of trading partner growth, this does not rule out the possibility of a sharper global effect.

Both our March and June *Statements* noted that monetary policy currently has very little headroom to absorb upward inflation surprises. This continues to be the case. Based on our projections in Chapter 5, inflation is expected to settle at a little below 3 per cent by 2007 once the temporary effects of the recent rise in oil prices have abated. Upside surprises to inflation could occur if, for example, housing market activity and debt-financed household spending continued to surprise us on the upside, even in the face of slowing activity elsewhere in the economy.

The factors contributing to the rise in oil prices are complex and there is considerable uncertainty about the outlook. We are assuming that the CPI inflation spike will be short-lived, and that oil prices will ease from current highs over the next two years. In tracing the effects of oil prices, it is important to distinguish between short-run and longer-run effects. While higher oil prices will boost inflation in the short term, the negative income effect of higher oil prices is likely to provide a dampening influence on household spending, contributing to weaker inflation pressures in the medium term. Box 2 outlines our assumptions regarding oil price effects, but there is clearly uncertainty around these estimates.

Under section 2 of the Policy Targets Agreement (PTA), the Bank is required to keep inflation within the 1 to 3 per cent inflation target band on average over the medium term. Using monetary policy to attempt to offset the direct temporary effects of higher oil prices would not be appropriate as these OCR settings would cause unnecessary

instability elsewhere in the economy, something section 4(b) of the PTA explicitly requires the Bank to avoid. However, section 3 of the PTA is quite clear in noting that the Bank's obligation is to respond to significant disturbances to international commodity prices, such as a sharp rise in world oil prices, in a manner consistent with meeting the medium-term target.

There is a real risk that the sharp rise in oil prices could have more enduring effects on inflation, influencing the medium-term trend of inflation. This could occur if the initial inflationary effects of higher oil prices were to become reflected in inflation expectations, producing changes in wage and price setting behaviour going forward. Clearly the risks of such effects are partly dependent on the timing and durability of the rise in oil prices. We are conscious that with productive resources in the New Zealand economy still relatively stretched, the risk of spill-over effects into inflation expectations is greater than would otherwise be the case.

When estimating the effects of fiscal policy on the inflation outlook, the Bank bases its view on government policy as announced via the regular fiscal updates issued by the Treasury. Our latest projections are therefore based on the PREFU, published in August, and make no allowance for any changes to fiscal policy beyond that. When setting the OCR, it would not be appropriate to second-guess fiscal policy outcomes following the upcoming election. However, in assessing the risks around the medium-term inflation outlook, we need to acknowledge the likelihood that fiscal policy may be more expansionary than outlined in the PREFU.

On balance, it appears likely that fiscal policy will exert a greater stimulus on the economy over the next few years than is implied by the PREFU, regardless of the composition of the government after the election. We will be in a better position to assess future fiscal policy developments once we move into the post-election period. The implications of new fiscal policy initiatives for monetary policy will depend critically on factors such as the type, scale and timing of tax and/or spending changes, as well as concurrent developments in the broader economy.

Clearly, monetary policy faces heightened uncertainty not only about the path of activity but also the inflationary

(continued p 8)

Box 2

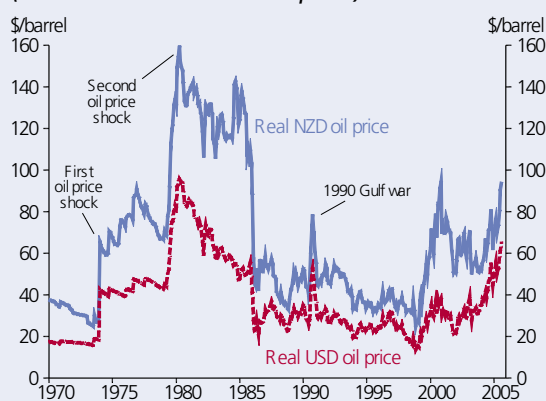
Oil prices, inflation and the monetary policy framework

A key development since the last *Monetary Policy Statement* has been the rapid rise in international oil prices. Upward pressure on oil prices has resulted from stretched productive capacity – particularly in refining. Despite strong increases in US oil inventories and signs that global demand for oil is beginning to slow, prices have continued to climb. Most recently, the devastation wrought by Hurricane Katrina in the southern US has caused major disruptions to a key oil production and refining region. There has been considerable apprehension about the security of existing supplies and uncertainty regarding the time and cost that could be involved in bringing new or alternative energy supplies on stream.

In nominal terms, oil prices have hit record highs and, in real terms (i.e. adjusted for inflation), US dollar prices have reached their highest level since the early 1980s. Despite a relatively strong New Zealand dollar at present, this has pushed real NZD oil prices to levels comparable with those seen in the mid-1980s (figure 2.5).

Figure 2.5

Real oil prices in current dollars (West Texas intermediate price)



Source: Bloomberg, Datastream, RBNZ estimates.

As a consequence of higher oil prices, New Zealand dollar petrol prices have risen sharply, and this will have a significant influence on inflation developments over the period ahead. Oil prices influence inflation and activity in a variety of ways and with different lags. In this context, it is useful to categorise the oil price effects into their different

stages of influence on inflation. In general terms we see three 'rounds' of inflation impacts:

1. **First-round effects.** The most noticeable effects on inflation, and generally the quickest. The first round can be further split into direct and indirect effects.
 - a. **Direct effects.** Changes to international oil prices are passed through to domestic petrol prices almost immediately. Petrol prices are a component of the CPI and increases in petrol prices will have an immediate effect on inflation. Petrol prices carry a weight of around 3.5 per cent in the CPI meaning that a 10 per cent rise in petrol prices will directly lead to a 0.35 per cent rise the CPI.
 - b. **Indirect effects.** This effect takes into account the fact that firms use petrol or oil as an input into their production process and transport is a significant component of many items. We have assumed that around half of any increase in total production costs due to higher oil prices is passed on to consumer prices.
2. **Second-round effects.** This effect occurs when the first-round rise in inflation 'spills over' into people's perceptions of medium-term inflation. If households and firms adjust their price and wage setting behaviour to compensate, then inflation will be higher over the medium term.
3. **Third-round effects.** New Zealand is a net importer of oil so an increase in oil prices will reduce domestic incomes and spending. In addition, high oil prices may also lower economic growth in our main trading partners, which could have further adverse effects on domestic activity. As a rough rule of thumb, a 10 per cent rise in oil prices is expected to reduce annual GDP growth in the New Zealand economy by around 0.1-0.2 percentage points after one year. Lower activity will in turn reduce medium-term inflation pressures.

Economic outlook and assumptions

Amid the current uncertainty, we have had to adopt a working assumption about the path of oil prices over the next three years for the purposes of our policy projections. Our projections assume that US dollar prices for Dubai oil (the most relevant for the New Zealand economy) will remain at current levels for the remainder of 2005 (approximately USD58 per barrel). Oil prices are then assumed to fall to around USD40 per barrel by the end of 2007 (figure 2.6). Considerations behind this assumption include the following:

- The path is broadly consistent with a range of estimates of the long-run marginal cost of oil production.
- Growth in global oil demand is beginning to slow given recent price hikes, and we have assumed some further slowing in demand.
- We are assuming that supply capacity will respond relatively quickly to higher oil prices.

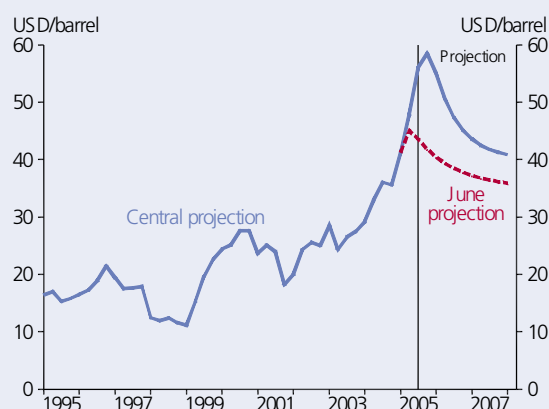
While our working assumption is that the recent oil price increases will be relatively short-lived, there are clearly risks around this assumption. For example, a more sluggish supply response could be envisaged, which could easily support a higher price profile.

Given our assumption for international oil prices and the TWI, we are assuming that New Zealand dollar petrol prices remain around 153 cents per litre for 91 unleaded for the remainder of 2005, and fall by around 10 cents to 143 cents per litre by June 2006. Table 2.1 details how this projected profile affects the annual CPI forecast over the next year. CPI inflation reaches a peak of close to 4 per cent by the March quarter 2006 and then falls rapidly back to below 3 per cent by early 2007.

As noted earlier in this chapter, monetary policy will remain focused on the medium-term inflation impact of oil prices. However, unlike the first-round effects, the effects on inflation at medium-term horizons are more difficult to quantify. The extent of any second-round effects will be influenced by the degree of excess demand pressure and by the degree to which inflation expectations are effectively anchored by the PTA.

The extent of third-round effects will depend on household and business confidence and therefore the degree to which the higher oil prices are seen as a permanent income-reducing 'tax', as opposed to a temporary reduction in income that can be covered by borrowing. Greater clarification of the scale of these effects, both globally and domestically, may be expected to occur gradually over the coming months.

Figure 2.6
International oil price assumption
(Dubai oil, USD per barrel)



Source: Bloomberg, RBNZ estimates.

Table 2.1

Assumptions for oil and petrol prices and first-round effects on CPI

	Dubai oil prices (USD/barrel)*	NZD petrol prices (91 unleaded, c/ltr)*	First-round effects on CPI		Projections for CPI	
			Direct (%)	Indirect (%)	Quarterly (%)	Annual (%)
05q3	56.0	144	0.5	-	1.2	3.5
05q4	58.5	153	0.2	0.1	1.0	3.6
06q1	55.0	148	-0.1	0.1	0.7	3.9
06q2	50.0	143	-0.1	0.1	0.9	3.9

* Average price for the quarter.

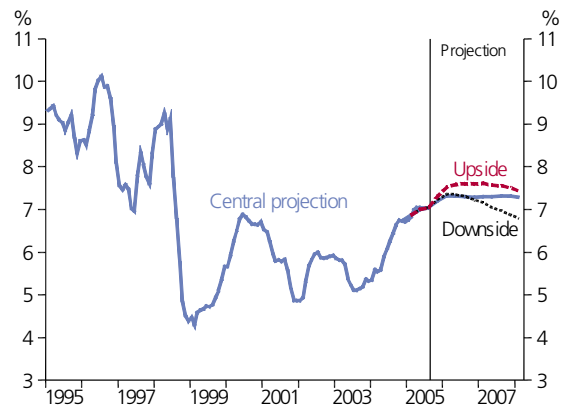
response of the economy. This uncertainty occurs at a time when we have little headroom to absorb upside inflation surprises. We hope to clarify the situation over the coming months as more information becomes available.

Some illustrative scenarios

Our updated projections in Chapter 5 assume that any 'second-round' effects from the oil price shock via inflation expectations are minimal, but the Bank will remain alert to any evidence of such effects. Purely for illustrative purposes, figure 2.4 shows two variations around the central interest rate projection. The first assumes that inflation expectations edge up on the back of the initial effects of higher oil prices to a greater extent than assumed in the central scenario. This has been combined with the assumption that household demand remains stronger for longer – a circumstance that could well fuel medium-term inflation expectations. In this situation, monetary policy would need to respond in order to offset the additional inflationary pressure.

The second scenario shows the outlook under which global economic activity is assumed to be rather weaker than in the central projection, with oil prices exerting

Figure 2.7
90 day interest rates under alternative scenarios



Source: Statistics New Zealand, RBNZ estimates

a greater dampening effect than *Consensus Forecasts* currently suggest. Because weaker global demand affects domestic inflation pressures with a fairly long lag, the near-term interest rate outlook is not significantly different from the central projection. However, interest rates are lower than in the central projection further out.

In both scenarios, because monetary policy is assumed to respond to the stronger or weaker inflationary pressures, CPI inflation outcomes are very similar to the central projection.

3 The current economic situation

Overview

Annual GDP growth looks to have peaked in the middle of 2004 at 5.8 per cent after recording robust growth over 2003 and 2004. GDP growth increased 0.6 per cent in the March quarter – a slightly weaker outturn than we had expected at the time of the June *Statement*.

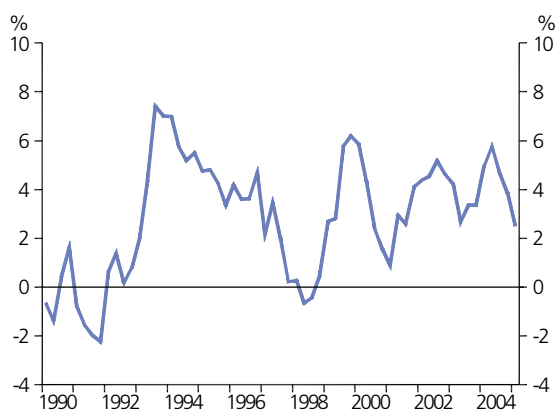
In the most recent March quarter, construction activity rebounded following a relatively weak outturn in the previous quarter, while consumption and investment spending remained strong. In contrast, activity was weaker than expected in some sectors. This weakness was most noticeable in sectors heavily exposed to the high New Zealand dollar – in particular the manufacturing sector and in exports of services.

Strong domestic growth over the past few years has stretched productive resources, and this has been reflected in persistently high non-tradables inflation. These pressures have shown few signs of easing, with non-tradables inflation remaining above 4 per cent throughout 2004 and the first half of 2005. Adding to headline inflation, tradables inflation accelerated quickly over 2004 as appreciation of the New Zealand dollar moderated. Consequently, headline CPI inflation has risen toward the top of the 1-3 per cent target band, with annual inflation reaching 2.8 per cent in the June quarter.

Figure 3.1

GDP growth

(annual per cent change)



Source: Statistics New Zealand

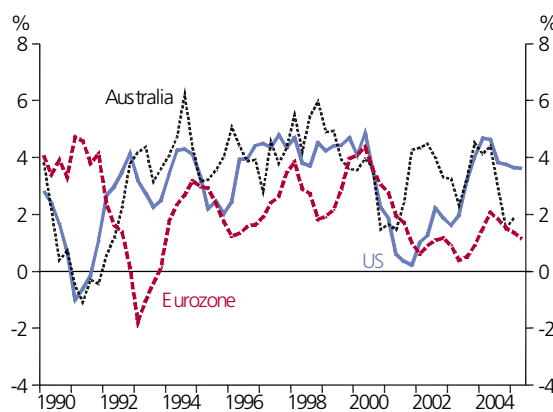
Global economic developments

Global economic growth remains relatively robust, though it has moderated from its peak in 2004 and country-specific developments vary widely. Supporting global growth in the first half of this year has been the performance of the US, Chinese and Japanese economies. Expectations for Australian growth have been scaled back as domestic demand softens, while Eurozone activity continues to disappoint.

Figure 3.2

GDP growth Australia, US and Eurozone

(annual per cent change)



Source: Datastream

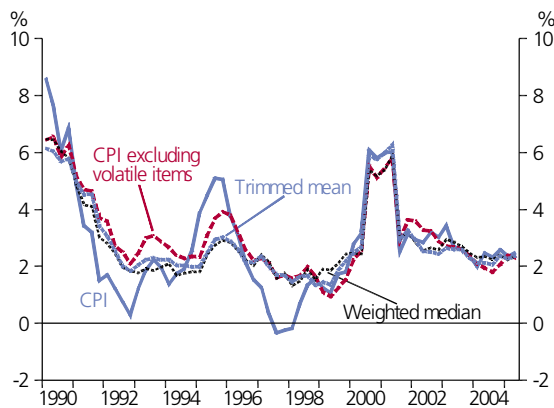
US GDP growth remained robust in the second quarter of 2005, increasing 3.6 per cent in the year to June. Activity was supported by a recent rebound in manufacturing, a buoyant housing market, and a continued improvement in the labour market. Recently, inflationary pressures have shown signs of emerging as headline CPI picked up to 3.2 per cent in July following a couple of subdued months. However, core inflation remains relatively contained to date. Short-term interest rates have climbed to 3.5 per cent as the Federal Reserve has continued its measured tightening of monetary policy.

Growth in China maintained momentum with annualised GDP growth of 9.5 per cent in the June quarter, up slightly from 9.4 per cent in the first quarter. Expansion has been primarily driven by continued strength in net exports, aided by slowing import growth due to increased supply of domestic substitutes and moderation in fixed asset investment growth.

Strength in private demand has underpinned Japan's recovery over 2005. Consumer spending has been supported by improving labour market conditions while investment has benefited from renewed confidence. However, concerns remain for growth prospects further out as export growth is expected to continue easing and fiscal conditions are set to tighten.

Australian domestic demand has moderated. This moderation in growth has occurred despite a strong labour market and recent tax cuts coming into effect. The Reserve Bank of Australia (RBA) has noted that households currently appear to be consolidating their balance sheets reflected by lower rates of growth in debt and spending. 'Underlying' inflation is currently around 2.5 per cent and the RBA expects it to gradually rise over the next year (figure 3.3). However the impact of higher oil prices is likely to push headline inflation significantly higher.

Figure 3.3
Measures of Australian inflation
(annual rate)



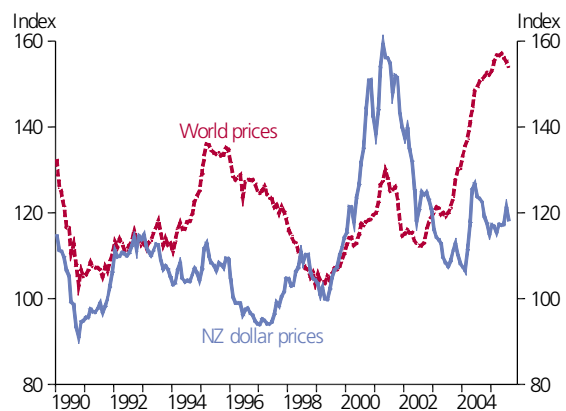
Source: Reserve Bank of Australia, Australian Bureau of Statistics

Activity in the Eurozone remains subdued. Economic activity slowed further in the June 2005 quarter, increasing just 0.3 per cent compared to the 0.5 per cent quarterly growth in the previous quarter. Major Eurozone economies – Germany and France – accounted for most of the recent weakness. Activity in Italy actually rebounded in the June quarter following two consecutive negative quarterly outturns.

Tradables sector activity

One pervasive feature of the New Zealand economy in recent years has been ongoing strength in the New Zealand dollar. The exchange rate appreciation has obviously had a negative impact on exporters' incomes. However, parts of the export sector have been buffered somewhat from the full impact of the rising New Zealand dollar through significant increases in world commodity prices over recent years (figure 3.4).

Figure 3.4
ANZ commodity prices

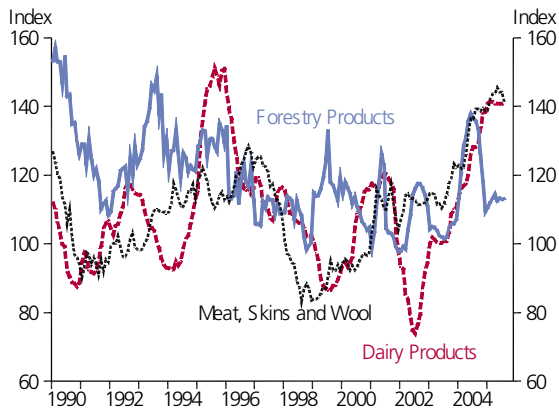


Source: ANZ-National Banking Group Ltd

International prices for some of New Zealand's key export commodities such as beef, lamb and dairy products have been very high, reflecting strong global demand and tight international supplies. Animal disease outbreaks in North America, recent droughts in Australia and the US and relatively poor dairy production seasons in New Zealand and Australia have limited the supply for meat and dairy commodities. Growth in world prices for these key commodities has flattened off, but prices have continued to hold up near record levels over the first half of 2005 (figure 3.5, opposite). However, not all primary commodities have experienced the same growth in world prices. For example, international log prices remain low and, combined with the high New Zealand dollar and low export volumes, incomes in the forestry sector have been depressed.

Despite continued strength in aggregate commodity prices, primary export volumes have been relatively subdued in recent quarters. Exports of primary products fell sharply in the September quarter of 2004 and since then have only

Figure 3.5
ANZ world commodity prices by sector

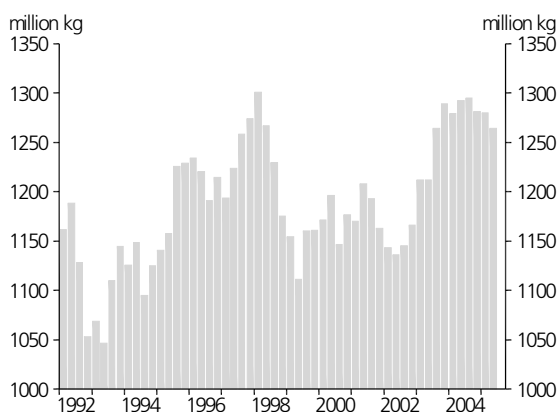


Source: ANZ-National Banking Group Ltd

partially rebounded. The September dip was partly caused by a timing related fall in dairy exports which was largely reversed in subsequent quarters. Overall, however, dairy exports have been lower this season due to lower levels of milk solids production.

Meat exports were unexpectedly weak in the December quarter. We had initially attributed this weakness to a delay in slaughter, expecting a significant rebound in meat exports over the March and June quarters of 2005. However, it now appears the slaughter of beef and lamb did not occur as initially expected. Instead, it seems a period of restocking by farmers has taken place over the past season, perhaps in response to historically high levels of slaughter over the previous two seasons (figure 3.6).

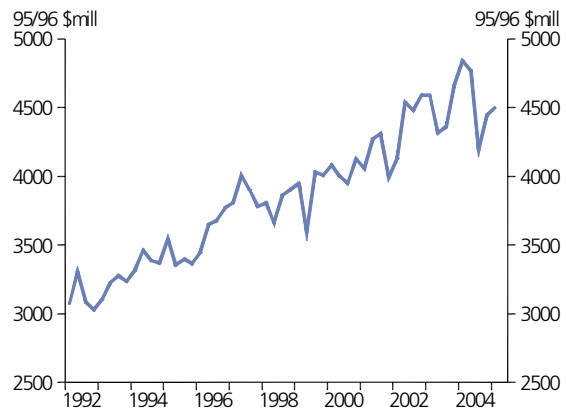
Figure 3.6
Slaughter volumes
(annual total)



Source: Statistics New Zealand

Combined, the poor dairy production season and recent falls in slaughter volumes have left primary export volumes in a relatively weak position (figure 3.7).

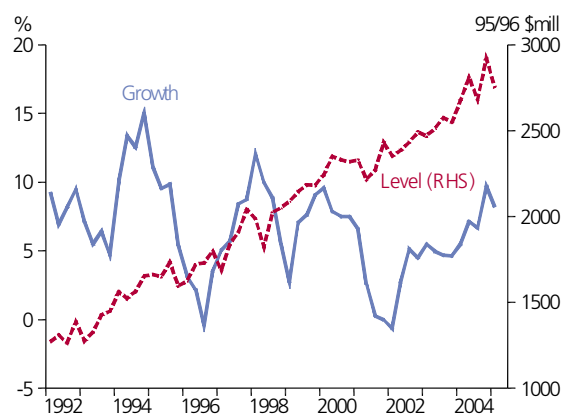
Figure 3.7
Primary export volumes
(quarterly total)



Source: Statistics New Zealand

New Zealand's manufactured non-commodity exporters are one sector that has been particularly exposed to the high New Zealand dollar. This sector has not felt the benefit of higher international prices for its products and faces stiff international competition. Despite this, non-commodity export volumes recorded surprisingly robust growth over 2004, perhaps reflecting the strong recovery in world growth over that period. However, export growth in this sector has slowed recently (figure 3.8). This slowing may be

Figure 3.8
Non-commodity manufactured export volumes
(quarterly total and annual average percentage change)

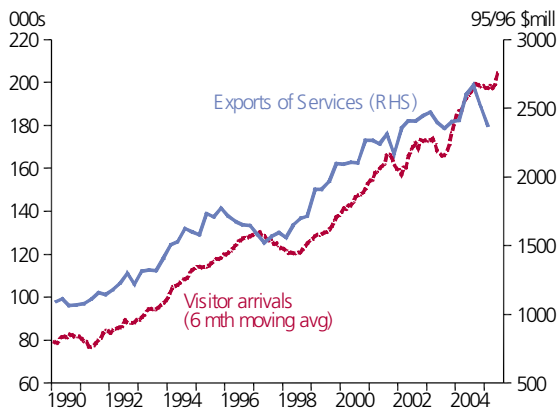


Source: Statistics New Zealand

due to both the lagged effects of the high exchange rate, and world growth decelerating from its peaks.

After increasing strongly over 2004, exports of services fell sharply in the March quarter of 2005 – despite continued growth in the number of visitor arrivals (figure 3.9). In broad terms, exports of services growth has slowed in recent years as the composition of international visitor arrivals has changed. The largest effect has been through an increasing proportion of tourists from Australia, who are traditionally lower-spending tourists. In addition, recent sharp falls in exports of services may be due to the high New Zealand dollar, dampening the overall spending per tourist.

Figure 3.9
Overseas visitor arrivals and services exports

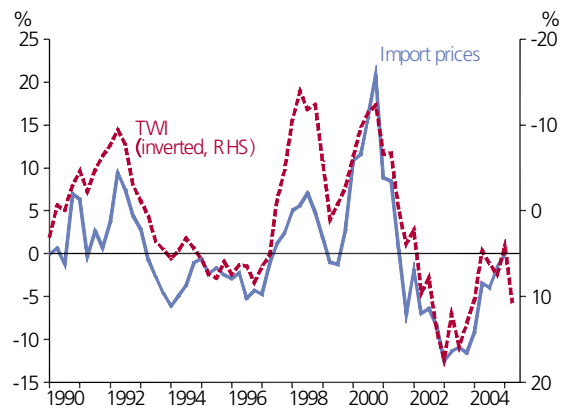


Source: Statistics New Zealand

In line with the appreciation in the TWI, the New Zealand dollar price of imports has fallen steadily (figure 3.10). Consequently import volume growth has increased, accelerating strongly over 2004. Yet from a peak of annual average growth above 15 per cent in the last quarter of 2004, import growth has moderated a little in the early part of 2005.

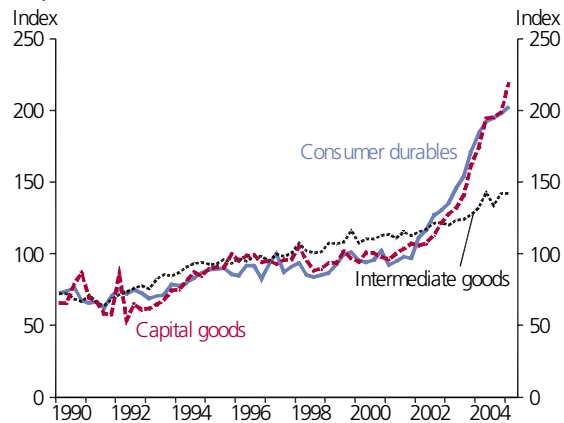
Imports of services have grown very strongly in recent years. Growth has largely been due to increased travel abroad by New Zealanders (figure 3.12). Cheaper trans-Tasman airfares have made travel to Australia more affordable while the strong New Zealand dollar has increased New Zealanders' purchasing power when travelling internationally. In addition, strong labour income growth and increases in households' wealth are likely to have encouraged spending on items such as international holidays.

Figure 3.10
Import prices and the TWI
(annual percent change)



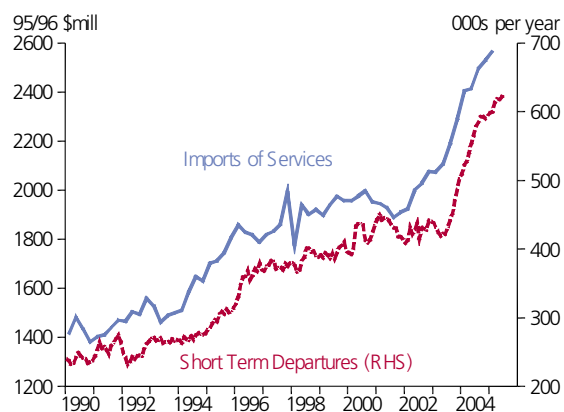
Source: Statistics New Zealand, RBNZ

Figure 3.11
Import volumes



Source: Statistics New Zealand

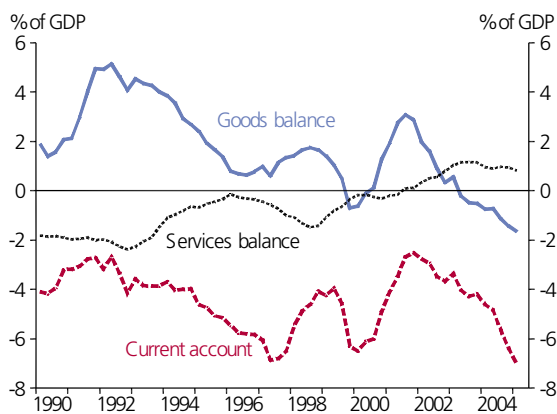
Figure 3.12
Short-term departures of New Zealanders and imports of services



Source: Statistics New Zealand

Growth in import volumes has outpaced growth in export volumes in recent times, pushing New Zealand's trade deficit wider. In turn, this has contributed to a growing current account deficit (figure 3.13). The current account deficit has further expanded as profits of foreign-owned New Zealand firms have grown.

Figure 3.13
Annual current account, goods and services balances



Source: Statistics New Zealand

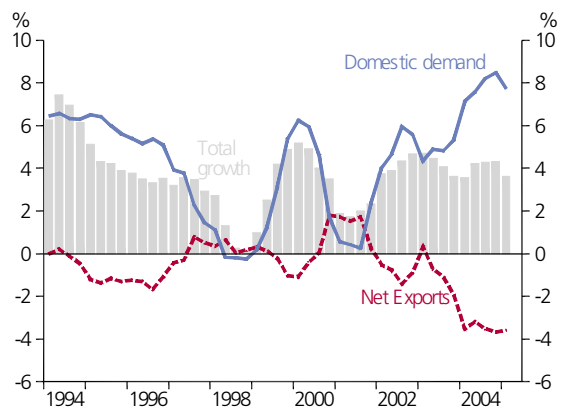
Domestic demand

The domestic economy has been a key contributor to growth since 2002 and remained strong in the first quarter of 2005. A strong housing market, strong consumption growth, robust employment and wage growth and high levels of business investment have all contributed to solid domestic demand growth over recent years.

The housing market continues to be an important driver of the New Zealand economy. While activity has cooled from its mid-2004 peaks as migration has slowed and interest rates have risen, the pace of this slowdown has been only gradual. In fact, there has been somewhat of a 'second wind' in housing activity, mostly reflecting the lagged effects of the low mortgage rates offered by banks toward the end of 2004. Many key housing market indicators, such as median days to sell a house and house sales, have remained at robust levels (figure 3.15). In addition, residential investment increased in the March quarter after falling significantly over the second half of 2004.

Renewed housing market activity over 2005 has also been reflected in annual Quotable Value (QV) house price

Figure 3.14
Contributions to GDP growth
(annual average percent change)¹

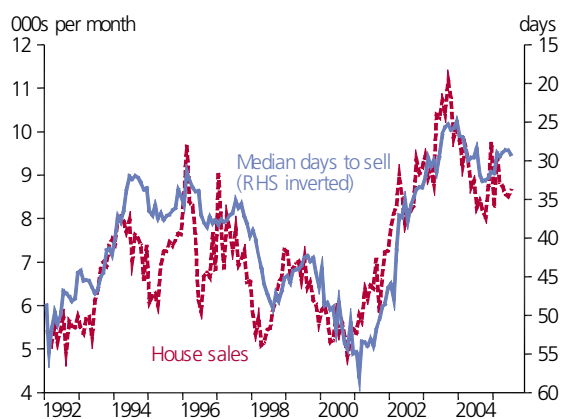


Source: Statistics New Zealand

inflation. House price inflation ticked up in the March quarter though remains well below its late 2003 peaks. More timely monthly REINZ data suggests that house prices have remained well supported over recent months (figure 3.16, overleaf).

Looking ahead, the indicators for residential investment are a little more mixed. Increases in house prices have continued to outstrip increases in construction costs, therefore there remain incentives to continue building new houses. On the other hand, dwelling consents data point toward a sharper slowing in residential construction in the near term (figure 3.17, overleaf). However it should be noted that consents data has been difficult to interpret following

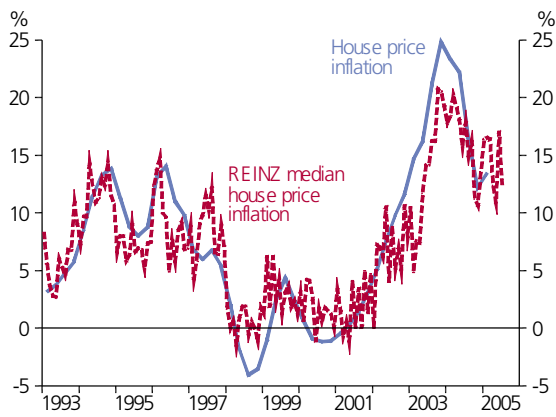
Figure 3.15
REINZ median days to sell and house sales



Source: Real Estate Institute of New Zealand

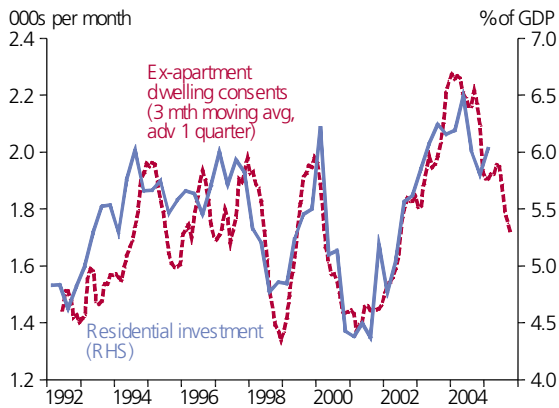
¹ Domestic demand is calculated as GDP less net exports.

Figure 3.16
QV house price inflation and REINZ median house price inflation



Source: Quotable Value Limited, Real Estate Institute of New Zealand

Figure 3.17
Dwelling consents and residential investment



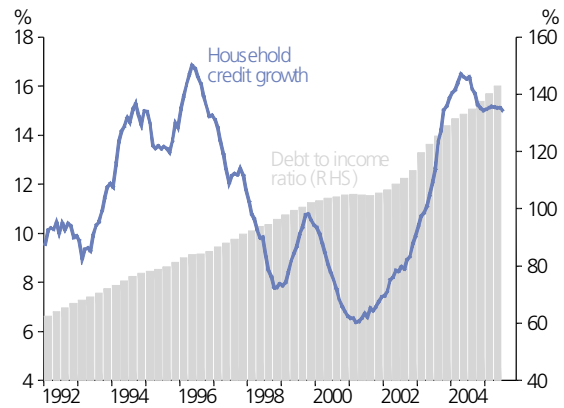
Source: Statistics New Zealand

changes to building act regulations and reports of delays and backlogs in processing consents in some regions.

Housing market strength has been an important driver of consumption growth in recent years. Strong house price growth has fuelled consumption through wealth effects, increased demand for housing related goods, and by boosting consumer confidence more generally.

Strong household spending has been funded through increasing incomes (due to increased employment and higher wages) but also through a build up in debt. New Zealand's debt-to-income ratio has risen markedly in recent years and, although credit growth has softened a little, it remains at very high levels (figure 3.18).

Figure 3.18
Household debt and annual credit growth

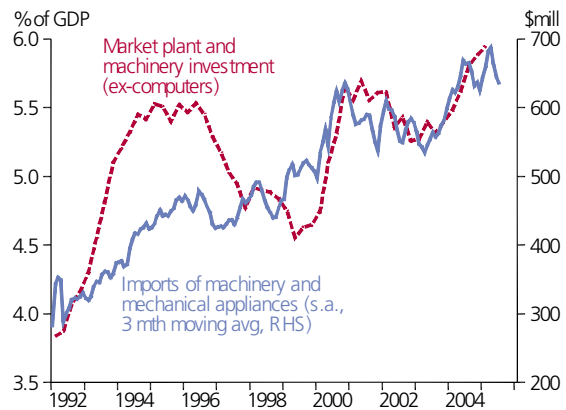


Source: RBNZ

Strong investment has also been a feature of the solid domestic growth observed over the last few years. High levels of capacity utilisation, a very tight labour market and rising wage costs have all encouraged firms to invest in new equipment. The strong New Zealand dollar has also made importing capital equipment an attractive option for businesses. Consequently, investment in plant and machinery equipment has risen to very high levels. Recent months data, however, suggests some slowing in imports of plant and machinery equipment.

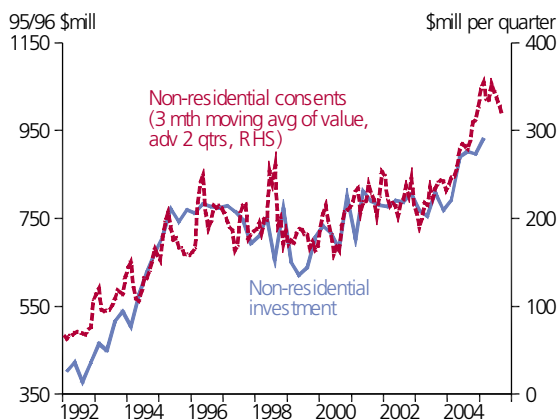
Non-residential building investment has also escalated over the last 12 months. Recent high levels of non-residential building consents suggest that there could be ongoing growth in this sector over the rest of 2005.

Figure 3.19
Market plant and machinery investment and imports of mechanical appliances



Source: Statistics New Zealand

Figure 3.20
Non-residential investment and non-residential consents
(quarterly total)



Source: Statistics New Zealand

Fiscal policy

The Pre-Election Economic and Fiscal Update (PREFU) forecast higher tax revenue compared to the Budget Economic and Fiscal Update (BEFU). This was largely due to updated macroeconomic forecasts which predicted higher nominal GDP growth over 2006 and 2007 and therefore a higher expected tax take. In addition, compared to the BEFU, there was a higher tax base in the 2005 June year. With forecast expenditure little changed from that outlined in the BEFU, the updated PREFU forecast a higher Government operating balance.

Fiscal policy has been a contractionary force on economic growth over the past year, though it is now set to become a positive stimulus in the future based on the PREFU projections.

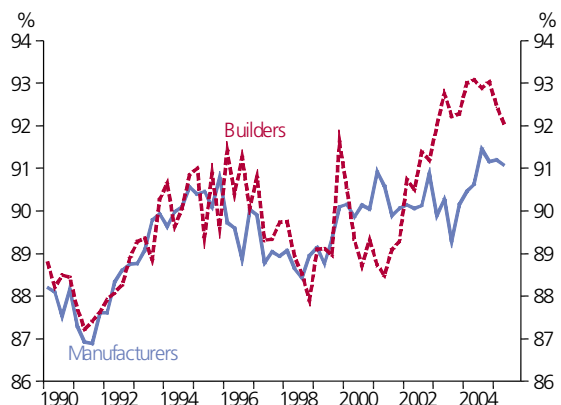
Productive capacity

Following a sustained period of strong economic growth, New Zealand's productive capacity has become extremely stretched. While this remains the case, there have been some tentative signs of an easing in the degree of pressure on resources, particularly in the building sector (figure 3.21).

The extent of resource pressure in the New Zealand economy is emphasised by reported limiting factors of production (figure 3.22). Labour and capital as limiting factors of production remain at high levels, while new orders as a limiting factor of production remains very low.

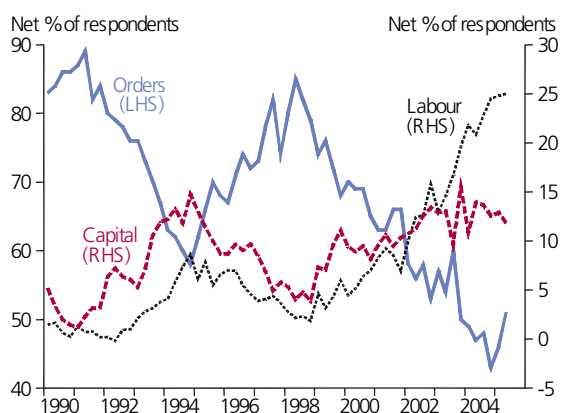
The high degree of stretch is possibly most apparent in the labour market. Reported difficulty in finding both skilled and unskilled labour remains very high.

Figure 3.21
Capacity utilisation
(builders and manufacturers)



Source: NZIER

Figure 3.22
Factors limiting increased production
(Labour, capital and orders)

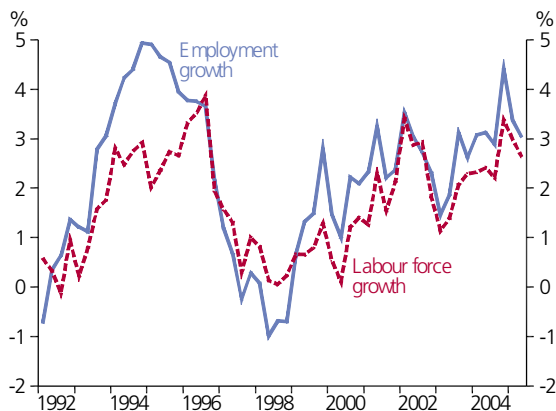


Source: NZIER

The labour market and wages

The labour market has remained highly stretched in 2005. Anecdotal evidence from our business contacts suggest that skilled and unskilled labour remain in very short supply. Across a broad range of industries, firms are having difficulty both finding and retaining staff. Firms' demand for labour has remained robust, boosting the numbers of employed. In the year to June, employment rose by a solid 3 per cent. Recent employment growth has been particularly apparent in service-related industries.

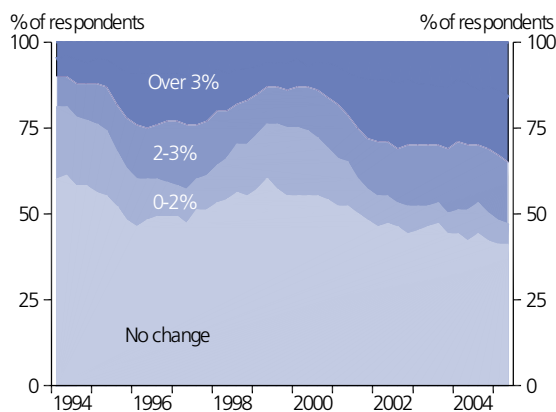
Figure 3.23
Employment and labour force growth
(annual per cent change)



Source: Statistics New Zealand

Strong demand for labour has been a factor supporting strong growth in wage inflation over 2004 and 2005. This is reflected in the high proportion of firms offering wage increases in order to attract and retain staff. In addition, the proportion of respondents in the Labour Cost Index reporting annual wage increases over 3 per cent has continued to expand, reaching a new record high of 35 per cent in the June quarter (figure 3.24).

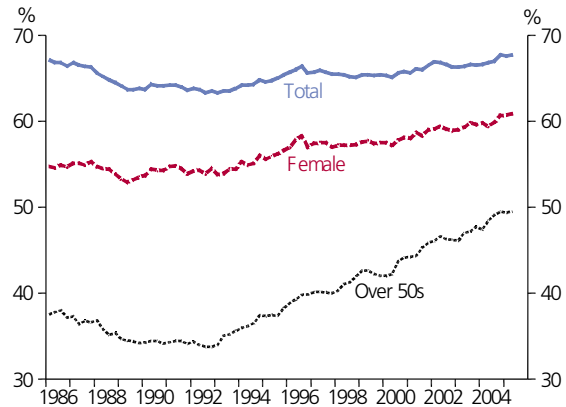
Figure 3.24
Distribution of annual wage increases



Source: Statistics New Zealand

Strong wage growth is likely to have encouraged greater labour force participation in recent times. Participation increased strongly over 2004 and in the June quarter equalled the record high of 67.7 per cent. Increased participation has been supported by greater female participation as well as greater participation by those in the over-50 age bracket.

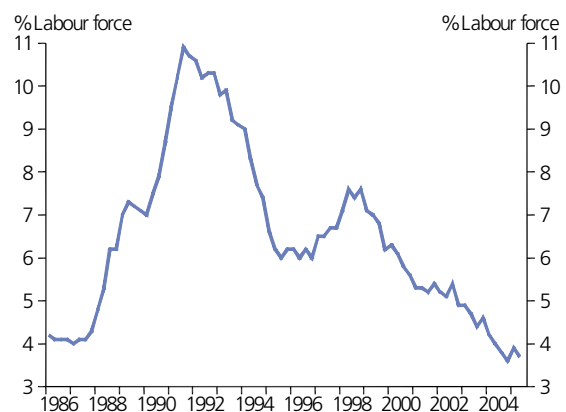
Figure 3.25
Labour force participation rates



Source: Statistics New Zealand

Despite continued increases in labour force participation, employment growth outstripped the rise in participation in the June quarter, lowering the unemployment rate to 3.7 per cent (figure 3.26).

Figure 3.26
Unemployment rate



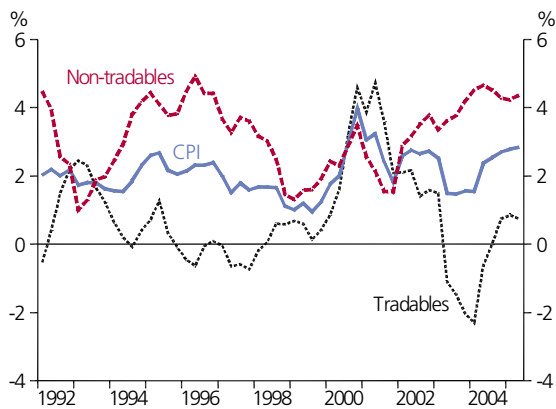
Source: Statistics New Zealand

Inflation pressures

Strong domestic activity, slowing exchange rate appreciation and continued pressure on supply have contributed to annual CPI inflation rising to 2.8 per cent. Annual non-tradables inflation has remained persistently high, hovering above 4 per cent since the beginning of 2004. Meanwhile annual tradables inflation has accelerated since 2004 from a low of -2.3 per cent to reach 0.7 per cent in the June quarter.

Persistent strength in non-tradables inflation to a large extent reflects ongoing pressure in the construction and housing related sectors. Costs associated with the purchase and construction of new dwellings again increased strongly

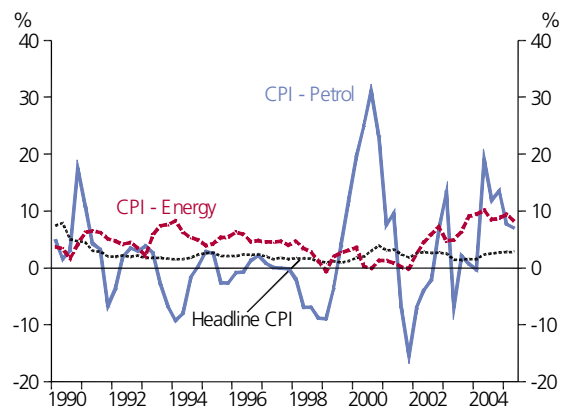
Figure 3.27
CPI, non-tradables and tradables inflation
(annual per cent change)



Source: Statistics New Zealand

in the June quarter. However we are also observing significant increases in other costs. Electricity and other energy costs, including petrol, have been rising strongly (figure 3.28).

Figure 3.28
Energy components and the CPI³
(annual percentage change)



Source: Statistics New Zealand

These components in the CPI have been increasing at annual rates near 10 per cent.

Table 3.1
CPI and other price measures
(annual per cent change)

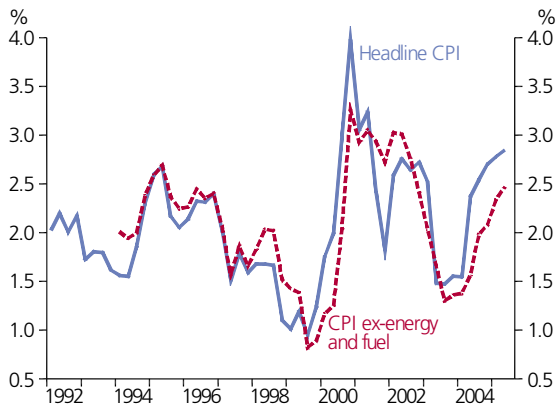
	2003 Dec	2004 Mar	2004 Jun	2004 Sep	2004 Dec	2005 Mar	2005 Jun
CPI	1.6	1.5	2.4	2.5	2.7	2.8	2.8
Food	0.2	0.5	1.1	0.5	1.2	1.5	1.1
Housing	6.6	7.0	7.1	6.7	5.6	5.4	5.7
Household operations	1.5	1.4	1.5	1.0	1.4	1.9	1.8
Apparel	-1.1	-1.0	-0.8	-0.4	-0.3	-0.6	-0.3
Transportation	-3.9	-4.6	-0.6	1.5	3.3	1.9	2.6
Tobacco and alcohol	2.9	2.9	3.2	4.2	3.7	4.2	4.0
Personal and health	2.4	2.7	2.7	2.7	2.6	2.7	2.7
Recreation and education	1.6	2.0	1.4	1.5	1.8	2.3	2.3
Credit services	1.2	-0.9	0.8	-0.2	-4.9	4.4	0.8
Derivatives and analytical series							
CPI ex food, petrol and government charges	1.2	1.2	1.4	2.3	2.5	2.6	3.0
CPI ex energy and fuel ²	1.4	1.4	1.6	2.0	2.1	2.3	2.5
CPI non-tradables	4.2	4.5	4.7	4.5	4.3	4.2	4.4
CPI tradables	-2.0	-2.3	-0.7	0.0	0.7	0.8	0.7
CPI weighted median (of annual price change)	1.9	2.1	2.6	2.6	2.9	3.3	3.1
CPI trimmed mean (of annual price change)	1.8	2.0	2.6	2.6	2.9	3.0	2.9
Merchandise import prices (excluding petrol)	-12.0	-10.6	-5.9	-5.8	-4.8	-1.4	n/a
PPI - Inputs	-0.1	-0.6	1.5	2.5	3.4	4.2	4.7
PPI - Outputs	1.1	0.9	1.9	2.4	2.6	3.2	3.0
Private consumption deflator	-0.1	0.5	1.2	0.6	1.1	1.3	n/a
GDP deflator (derived from expenditure data)	3.7	2.7	3.7	4.4	4.0	2.9	n/a
Retail trade deflator	-0.4	-0.6	0.8	0.5	0.7	1.4	1.0

² Fuel includes petrol and alternative motor fuels.

³ CPI Energy component includes electricity, gas, coal, charcoal and firewood prices (but not petrol).

Figure 3.29

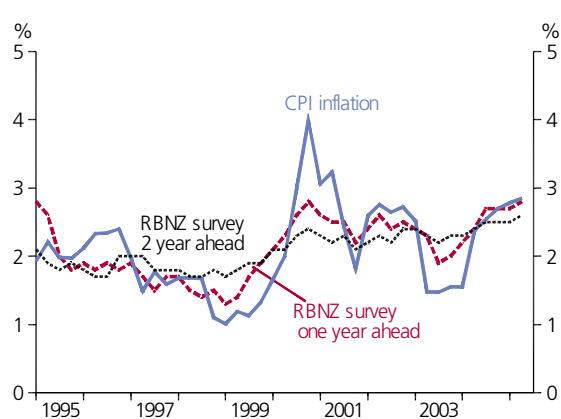
Annual CPI and CPI ex-energy and fuel⁴



Source: Statistics New Zealand, RBNZ

Figure 3.31

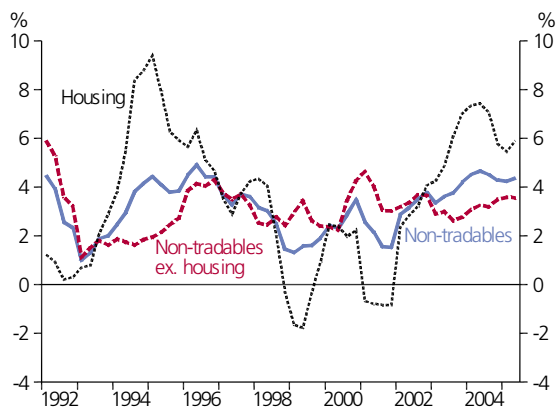
Inflation expectations and annual CPI inflation



Source: RBNZ, Statistics New Zealand

Figure 3.30

Non-tradables inflation excluding housing
(annual per cent change)



Source: Statistics New Zealand, RBNZ

Inflation expectations

Conceptually, changes in inflation expectations can reflect changes in firms' and households' wage and price setting behaviour, which in turn can impact on medium-term inflation. In practice, inflation expectations are difficult to measure. Surveyed measures of inflation expectations can provide some insight, even though surveyed measures tend to follow actual CPI inflation relatively closely. Over the past 18 months, nearly all surveyed measures of expectations have risen significantly. The RBNZ one-year-ahead survey of expectations moved to 2.9 per cent in the September quarter. The less volatile two-year-ahead measure of inflation expectations also moved up reaching 2.7 per cent in the September quarter.

⁴ Fuel includes petrol and alternative motor fuels.

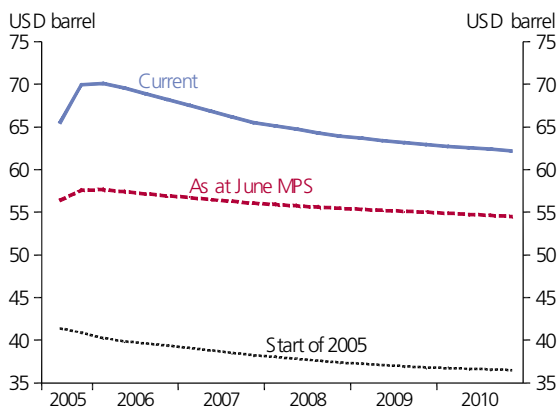
4 Financial market developments

International markets

The relentless rise of oil prices has remained a dominant influence on global financial markets. As has been the case throughout the past year, the ongoing rise in spot oil prices has been broadly matched by increases in longer-term oil futures prices (figure 4.1). The rise in futures prices for late 2005 and early 2006 has been particularly pronounced given oil supply concerns for the upcoming northern hemisphere winter. Apprehension about the security of existing supplies and uncertainty regarding the time and cost that could be involved in bringing new or alternative energy supplies on stream have played a role in underpinning longer-term futures prices, as has associated speculation. However, futures prices are not an unbiased forecast for oil prices. Regardless, hedging by large consumers (such as airlines and petrochemical producers) could see the impact of current high oil prices persist for some time, even if prices were to fall in the near term.

Figure 4.1

NYMEX crude oil futures prices

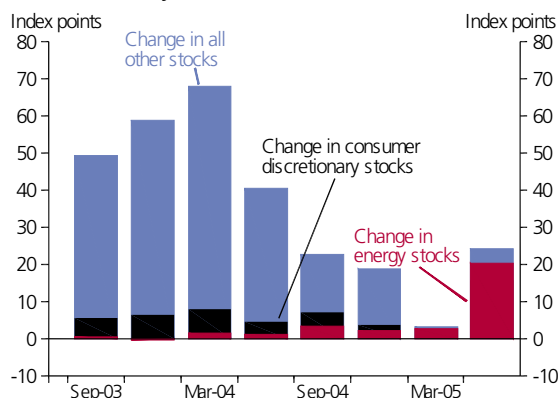


Source: Bloomberg

The rise in oil prices is having an increasing impact on global share markets. The rise in US equity prices over the past year, while fuelled by strong company profit results generally, has become increasingly driven by strength in the share prices of energy companies (figure 4.2). In contrast, fears regarding the impact of higher energy costs on household disposable incomes have been a factor in recent weakness in the share prices of companies involved in markets for discretionary (as opposed to staple) consumer products and services.

Figure 4.2

Index point contributions to US S&P500 movements by sector

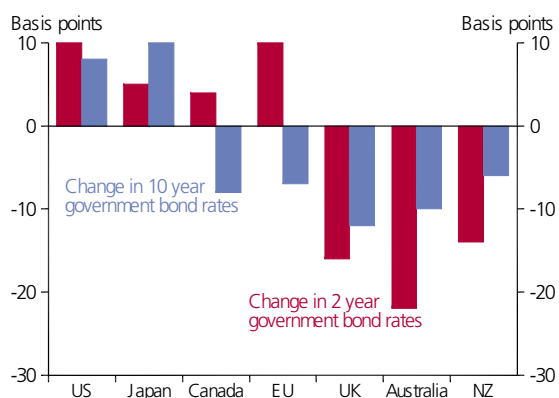


Source: Bloomberg, RBNZ estimates

For much of the few months since the June *Statement*, global interest rate markets have largely shrugged off higher oil prices in the face of better than expected economic activity developments – particularly in the US. The US Federal Reserve has continued to raise its policy rate, with 25 basis point increases in late June and early August taking the fed funds rate to 3.5 per cent. At one point the market was pricing in an expectation that the fed funds rate could

Figure 4.3

Movements in global bond yields since the June *Statement*



Source: Bloomberg, RBNZ

reach 4.25 per cent by late 2005/early 2006. However, these expectations were sharply pared back in late August in the aftermath of Hurricane Katrina. The impact on economic activity in the region, along with the broader consequences for the supply and prices of petroleum products throughout the US, is seen by some as sufficiently significant to cause

the Fed to at least take a pause in its tightening programme. Similarly, even though they are up on the levels prevailing at the time of the June *Statement*, longer-term interest rates in the US have retreated from their highs.

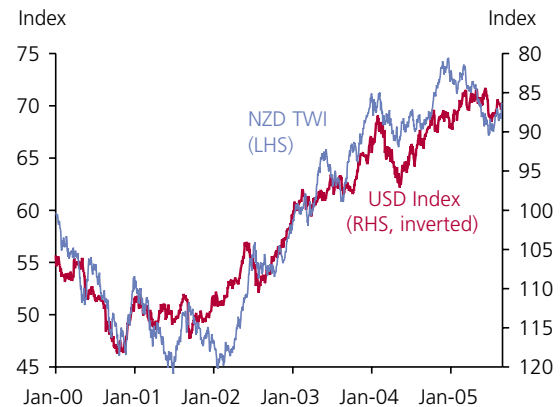
Elsewhere, some improvement in activity indicators in Europe and Japan has put upward pressure on their short-term wholesale interest rates although the market does not expect the central banks in either economy to change their policy stance in the near future. The Bank of England (BoE) cut its policy rate by 25 basis points to 4.5 per cent in early August, citing signs of slowing domestic demand growth. While the market expects this will be followed by another rate cut, this is seen as some way off given comments from BoE officials and the subsequent release of stronger than expected inflation data. Closer to home, the Reserve Bank of Australia was seen by the market as moving from a tightening bias to a more neutral policy stance in its recent *Statement on Monetary Policy*. Given market expectations for a continued slowdown in Australian domestic demand, interest rate markets are pricing in a high probability of a rate cut during the first half of 2006.

Exchange rates

The major development in global foreign exchange markets since the June *Statement* was the announcement by the People's Bank of China of reforms to its currency regime in late July. The fixed yuan peg to the US dollar was replaced with a managed float against a basket of currencies and the yuan was revalued by 2.1 per cent. While current market pricing suggests expectations of a further 3 per cent appreciation against the US dollar over the next 12 months, there has been little further appreciation to date.

Meanwhile, the US dollar has eased from the levels prevailing around the time of the June *Statement*, particularly via some recovery in the euro. However, the recent retracement in the US dollar is generally seen as a consolidation of the gains made since the beginning of the year. Markets remain focused on the relatively stronger performance of the US economy and its higher interest rates compared to Europe and Japan, rather than the structural imbalances (large US current account and fiscal deficits) that plagued the US dollar during 2002 to 2004.

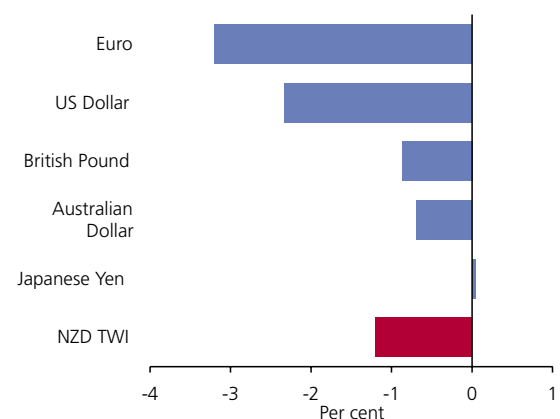
Figure 4.4
New Zealand and US dollar indexes



Source: Reuters

Against this background, the New Zealand dollar TWI has eased slightly since the June *Statement*. The New Zealand dollar has depreciated against most of the major currencies, with the NZD/USD exchange rate retreating further from the post-float highs seen in March. The most significant fall has been seen in the NZD/EUR exchange rate (figure 4.5). Regardless, all of the key New Zealand dollar cross rates – and the New Zealand dollar TWI – remain relatively high from an historic perspective.

Figure 4.5
Movements in key New Zealand dollar cross rates since the June *Statement*

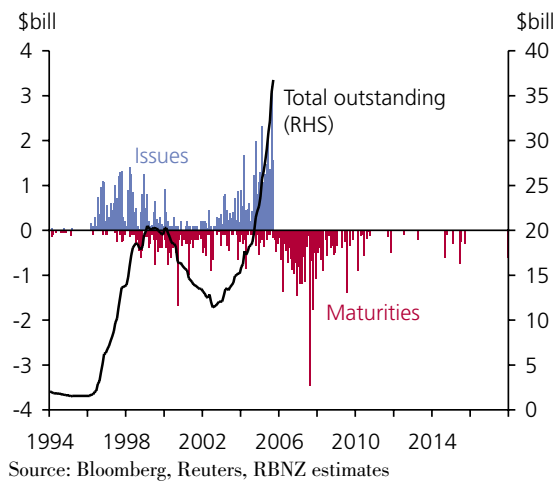


Source: Reuters

The New Zealand dollar has been supported by continued strong foreign demand for New Zealand dollar denominated assets. This has been seen in a rapid pace of issuance of Eurokiwi and New Zealand dollar Uridashi bonds (figure 4.6), as well as a continued increase in the

proportion of New Zealand government securities held by non-residents. The significant volume of maturities due to occur between 2006 and 2008 are seen by some in the market as representing a downside risk to the New Zealand dollar in the future. However, this will depend on the extent to which these maturities are rolled-over, which itself will depend on developments with regard to the New Zealand dollar and interest rate differentials at the time.

Figure 4.6
NZ dollar bond issuance in offshore markets



Domestic markets

The continued strong demand for New Zealand dollar denominated assets has also maintained downward pressure on New Zealand long-term interest rates. Indeed, while US long-term interest rates are up on the levels prevailing around the time of the *June Statement*, New Zealand long-term interest rates have fallen. This has seen the spread between New Zealand and US 10 year bond yields shrink over the past few months (figure 4.7).

With short-term interest rates remaining anchored by the current level of the OCR, the fall in long-term interest rates has seen the New Zealand yield curve become even more negatively sloped (or 'inverted') since the *June Statement* (figure 4.8). This is consistent with market expectations that the New Zealand economy will slow going forward. Accordingly, the market continues to price in an expectation that the OCR will be cut during the next 12 months. However, changes in market pricing over the

Figure 4.7
US 10 year bond yields and the spread between NZ and US 10 year bond yields

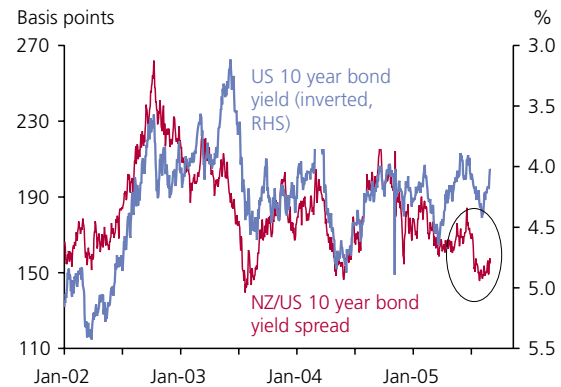
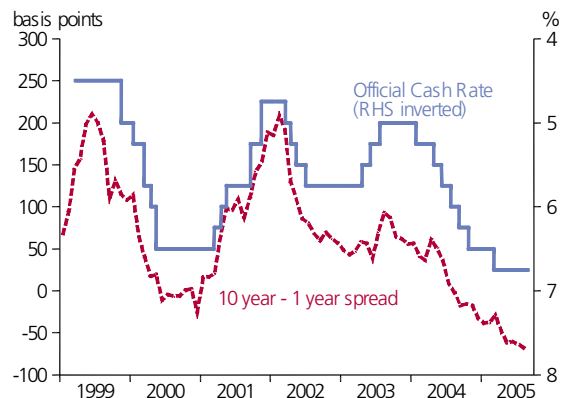


Figure 4.8
The OCR and the slope of the wholesale interest rate curve



past few months suggest that this is now expected to occur later in 2006 than was anticipated at the time of the *June Statement*.

5 The macroeconomic outlook

Overview

After several years of strong growth, productive resources have become highly stretched. Economic growth has shown signs of slowing recently, and growth is projected to continue softening over the period ahead. This projected growth slowdown should eventually ease pressure on productive capacity and gradually unwind the medium-term inflation pressures that have built up to date.

Over the next year, however, CPI inflation is likely to spike higher, close to an annual rate of around 4 per cent by early 2006. The rise in CPI inflation over the near term reflects the first-round effects from recent large increases in international oil prices. Our central projections assume that this CPI spike will not lead to a significant rise in medium-term inflation expectations. This partly reflects the view that oil prices will fall back over the period ahead, which will largely unwind the near-term CPI spike. As such, CPI inflation is projected to fall significantly over the latter half of 2006 and be below 3 per cent in 2007.

Over the medium term, inflation pressures are projected to be broadly similar to our June assessment. Many of the drivers are in place for a continued softening in economic growth: lower net immigration, higher interest rates, and the lagged effect of the high exchange rate. In addition, we continue to expect a fall in the terms of trade, and a significant slowing in housing market activity – factors that will moderate domestic demand. While the growth outlook is little changed from June, the degree of uncertainty and

risks to the inflation outlook have become greater, given the oil price disturbance that is now apparent.

Our central projections incorporate the fiscal outlook contained in Treasury's Pre-Election Economic and Fiscal Update (PREFU), which were little changed from the May Budget Economic and Fiscal Update (BEFU). While the projections take into consideration the policies of the existing government, they make no allowance for the recently announced (post-PREFU) policies of the main political parties. As such, our projections are subject to an upside risk on domestic demand and inflation pressure, regardless of the composition of the government after the election.

World outlook

Our view on the outlook for New Zealand's main trading partners is largely based on *Consensus Forecasts*, a survey of the main forecasters in our trading partner economies. From an above-trend rate of growth in 2004, global growth is expected to ease back over 2005 and 2006. World inflation has picked up recently, largely reflecting the effect of higher oil prices. Over the period ahead, however, inflation is expected to moderate.

While the global economic outlook conveys a relatively orderly picture, there are downside risks to the growth outlook. Global growth forecasts could be revised lower in response to persistently high oil prices. There also remain structural imbalances in the US economy, which present additional downside risks.

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

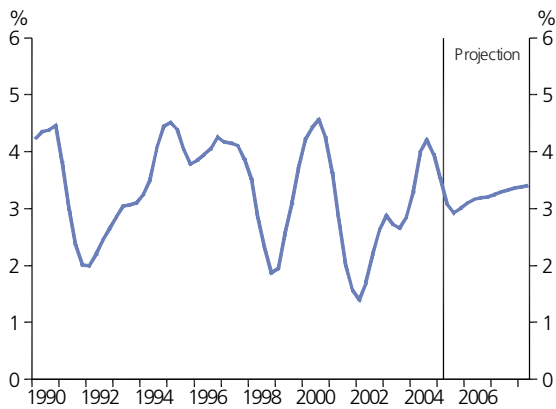
Country	2001	2002	2003	2004	2005f	2006f	2007f
Australia	2.5	4.0	3.3	3.2	2.3	3.1	3.4
United States	0.8	1.6	2.7	4.2	3.6	3.3	3.3
Japan	0.2	-0.3	1.4	2.6	1.6	1.5	1.5
Canada	1.8	3.1	2.0	2.9	2.7	2.9	3.1
Eurozone**	1.8	1.0	0.7	1.7	1.3	1.7	2.1
United Kingdom	2.2	2.0	2.5	3.2	2.0	2.2	2.1
Asia ex-Japan***	2.0	5.3	4.9	7.3	5.7	5.8	6.0
12 Country Index	1.6	2.6	2.9	4.0	3.0	3.2	3.4

* Source: Consensus Economics Inc., RBNZ estimates

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

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

Figure 5.1
Trading partner GDP
(annual average growth)



Source: Consensus Economics Inc., RBNZ estimates

Tradables prices

Over recent months, world prices for New Zealand's exports have continued to rise, particularly for meat exports. While global demand is expected to remain robust, international supply for some primary products is expected to increase, resulting in some moderation in world prices. New Zealand dollar returns are likely to be buffered to some extent due to the assumed depreciation of the TWI over the projection period.

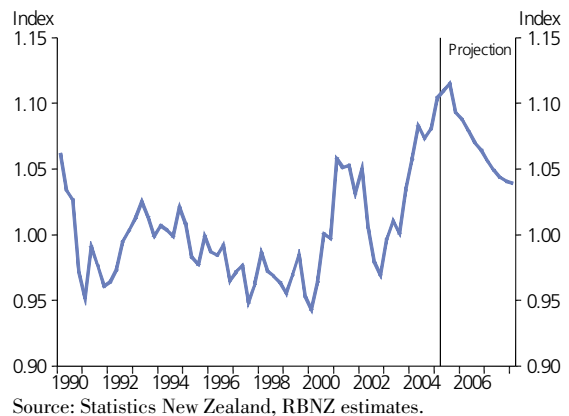
World import prices have risen in recent months, though not to the same extent as the increase in oil prices. In particular, international prices for manufactured goods have been falling for some time, and changes to prices for non-oil industrial commodities have been more subdued. We are assuming that oil prices will fall significantly from 2006 onwards, back towards a level that some analysts believe will be sustainable over the medium to long term. From its current level, prices for Dubai oil are assumed to fall to around USD40 per barrel by the end of 2007. We recognise this as a key source of uncertainty.

Relative to our June assessment, the terms of trade has improved with the increase in export prices outweighing the increase in import prices. While there has been a significant rise in oil prices, oil represents a much smaller proportion of New Zealand's import basket, relative to the commodity share of total exports. The value of oil imports represents around 10 per cent of total imported goods. In contrast, the value of commodity exports make up around 60 per cent

of total goods exports. Over the period ahead, we continue to assume a deterioration in the terms of trade, though it should remain high by historical standards.

The negative effect of higher oil prices on domestic activity (so-called 'third-round' effects, as described in Box 2, Chapter 2) has been reflected in the terms of trade profile. In the absence of the rise in oil prices, New Zealand's terms of trade would be stronger. These third-round effects are relatively muted in our projections given the assumption that the sharp rise in oil prices will be short lived, though the risk here is to the downside.

Figure 5.2
Terms of trade
(OTI goods)

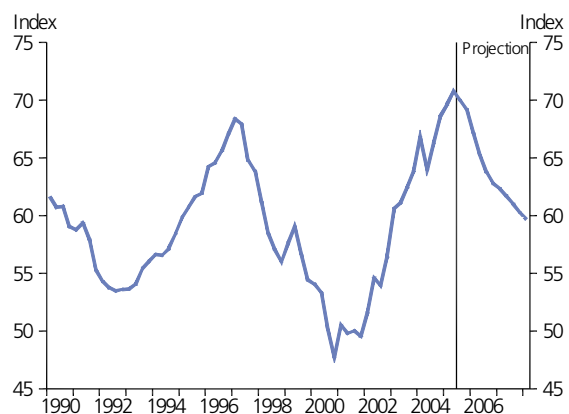


Source: Statistics New Zealand, RBNZ estimates.

Exchange rate

The starting point for the TWI, at 70, is around the level that was assumed in our June *Statement*. Our assumption is for the TWI to depreciate from here towards to its long-term

Figure 5.3
Nominal TWI assumption



Source: RBNZ estimates.

average. The profile of the TWI is modelled to be consistent with the projected decline in export prices and a narrowing in the short-term interest rate differential between New Zealand and the rest of the world.

Export volumes

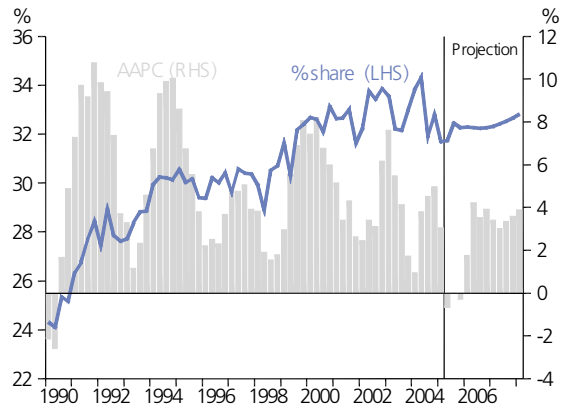
Over recent quarters, export volume growth has slowed markedly to rates not seen in well over a decade. We do not expect the magnitude of the recent slowdown to continue and project a modest growth recovery over the period ahead (figure 5.4). However, the outlook varies by sector:

- Non-commodity manufactured export growth is expected to continue slowing reflecting the lagged effect of the high exchange and a slowing in world growth. From an annual average growth rate of 10 per cent in calendar 2004, growth in this sector is expected to fall to close to zero in 2007.
- Agricultural export growth has recently fallen to rates not seen in over a decade. Poor export volume growth over the past season has reflected a weather-related disruption to dairy production, and temporarily lower meat production due to an element of herd rebuilding. Production levels are expected to recover gradually over the season ahead, resulting in improved agricultural export volume growth.
- Forestry export volumes are projected to remain quite weak due to a combination of low world prices, high shipping costs, and the high exchange rate.
- Exports of services growth has fallen sharply in recent quarters. Growth in this sector is expected to remain soft over 2006 as the high exchange rate continues to dampen tourist spending. However, further out, growth is expected to recover strongly given the assumed depreciation of the TWI, and the ongoing high number of visitor arrivals.

Figure 5.4

Total export volumes

(per cent of trend output and annual average growth)



Source: Statistics New Zealand, RBNZ estimates.

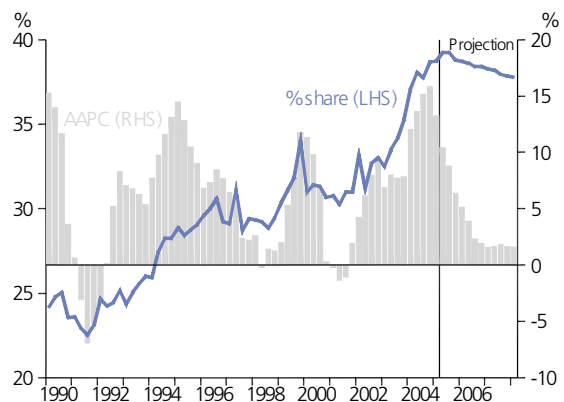
Import volumes

Import volumes have increased significantly over recent years, underpinned by strong growth in consumption and business investment. Imports have been further fuelled by the high exchange rate. Import volume growth is expected to slow significantly in the period ahead, as economic growth slows and the exchange rate falls (figure 5.5).

Figure 5.5

Total import volumes

(per cent of trend output and annual average growth)



Source: Statistics New Zealand, RBNZ estimates.

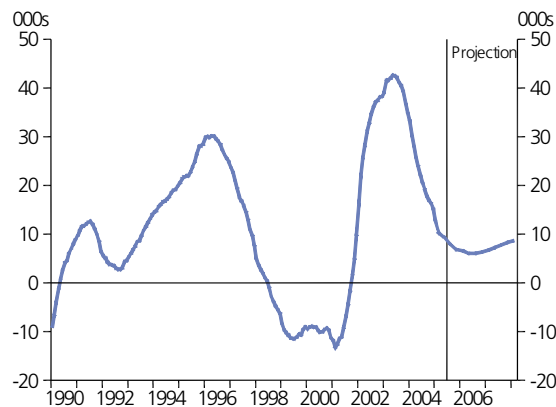
Current account

The current account deficit has widened by more than expected over recent months to around 7 per cent of GDP. By the end of 2006 the deficit is expected to reach around 7¼ per cent of GDP given the outlook for only a gradual recovery in net exports. This high current account deficit partly reflects strong investment in productive resources. However, it is also a reflection of unprecedented dissaving by households, which is not expected to be sustained in the medium term.

Net immigration and residential investment

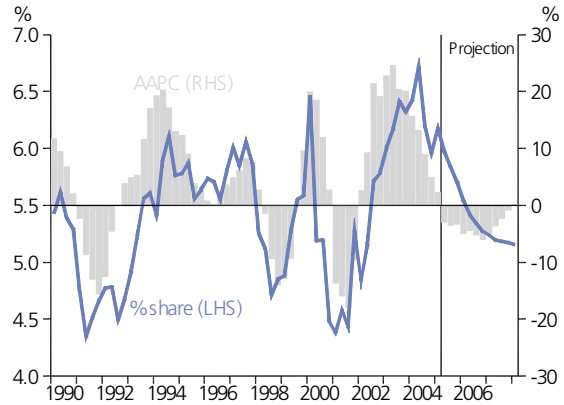
Net permanent and long-term immigration has fallen and is assumed to remain modest over the projection period. Consistent with the net migration outlook, residential investment activity is projected to trend lower (figure 5.7).

Figure 5.6
Net permanent and long-term immigration
(annual total)



Source: Statistics New Zealand, RBNZ estimates.

Figure 5.7
Residential investment
(per cent of trend output and annual average growth)

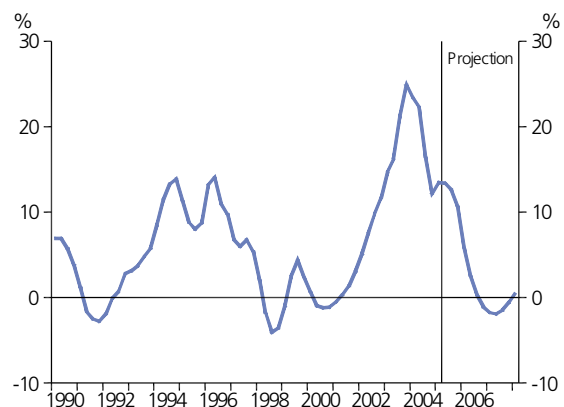


Source: Statistics New Zealand, RBNZ estimates.

House prices

House price inflation has been slightly stronger than expected over recent months, reflecting robust momentum in housing market activity. We continue to project a sharp decline in house price inflation in the coming years as lower net immigration and higher interest rates slow underlying demand.

Figure 5.8
Annual house price inflation



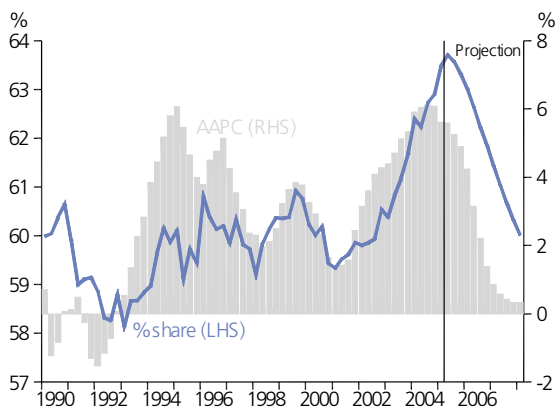
Source: Quotable Value Ltd, RBNZ estimates.

Household consumption

After several years of strong consumption growth, the real consumption share of trend GDP has reached a record high. Consumption is expected to slow significantly as lower net immigration, lower house price inflation, falling terms of

trade and rising interest rates dampen household spending over the period ahead. However, in our projections, a significant slowdown in the housing market remains the key factor necessary to bring about a sustained slowing in consumption growth.

Figure 5.9
Real household consumption
(per cent of trend output and annual average growth)



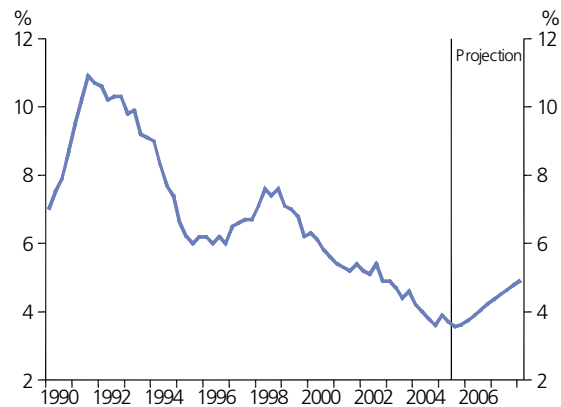
Source: Statistics New Zealand, RBNZ estimates.

Labour market

The labour market remains very tight as evidenced by the near-record low unemployment rate of 3.7 per cent. The strong labour market is bringing an increasing number of people into paid work and lifting wage growth. While the labour market is expected to remain robust over the period ahead, the pressure on labour resources is expected to gradually ease.

We expect relatively high wage growth over the coming years reflecting the lagged effect of the current tight labour market conditions. However, if higher wage increases are not matched by productivity increases, but are simply in response to the short-lived spike in inflation, they will have unhelpful consequences for pricing behaviour and medium-term inflation outcomes.

Figure 5.10
Unemployment rate

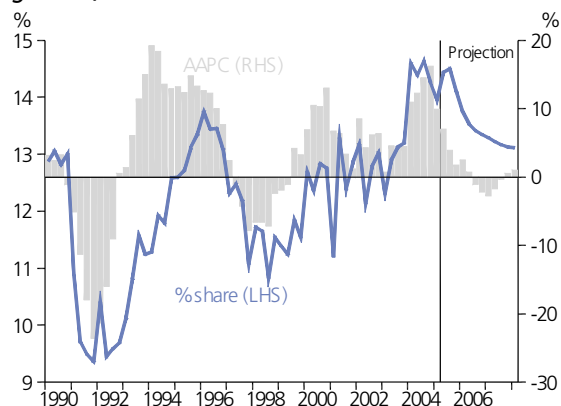


Source: Statistics New Zealand, RBNZ estimates.

Business investment

Robust demand from home and abroad, coupled with the high exchange rate, has encouraged strong investment in new capital. However, over the coming period business investment growth is expected to slow in line with the economic cycle. Plant and machinery investment is expected to weaken in the second half of 2005, while longer lead-times should postpone the cyclical downturn in non-residential construction until 2006. While investment growth is projected to slow, investment should remain high as a share of GDP. The recent period of strong investment is expected to result in an improvement in productivity growth over future years.

Figure 5.11
Business investment excluding computers
(per cent of trend output and annual average growth)



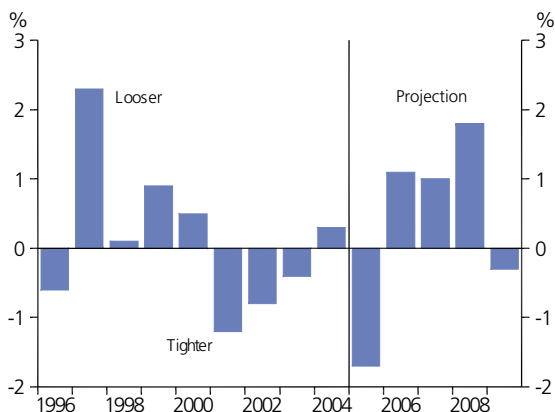
Source: Statistics New Zealand, RBNZ estimates.

Government

Our projections for the fiscal position and the contributions of the government's fiscal operations to economic activity are based on The Treasury's PREFU. In particular, The Treasury's measure of fiscal impulse provides a useful summary of the estimated effect of fiscal policy on GDP growth. The PREFU suggested that fiscal policy had a contractionary influence on GDP growth for the year to June 2005. However, fiscal policy is projected to become increasingly stimulatory from next year onwards, mainly due to an increase in government expenditure as a proportion of GDP (figure 5.13). Relative to BEFU, the PREFU outlook is broadly similar – tax revenues are projected to be slightly higher and there is to be slightly more expenditure on roading.

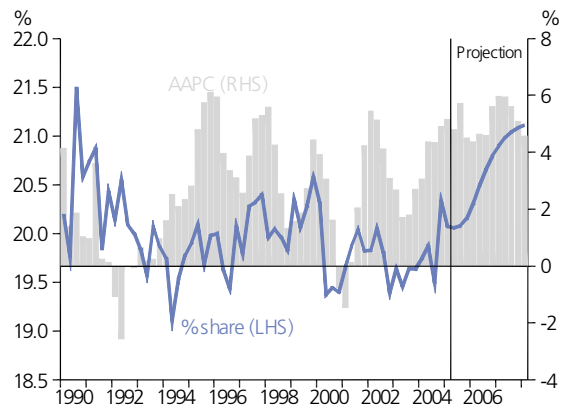
The balance of risks around the projected fiscal impulse continues to lie on the upside. The government's family support package could have a larger than expected impact on final economic activity if the families receiving the transfers have a relatively high propensity to consume. Similarly, planned new government infrastructure investment could place further pressures on the capacity-constrained construction sector. Lastly, the tenor of recent policy announcements by both major political parties suggests the likelihood of a more expansionary fiscal policy over the coming years.

Figure 5.12
Estimated fiscal impulse*
(per cent of GDP, June years)



Source: The Treasury – based on PREFU
 * These numbers provide an estimate of the effect of fiscal policy on GDP growth. A positive number indicates expansionary fiscal policy.

Figure 5.13
Government consumption and non-market investment*
(per cent of trend output and annual average growth)

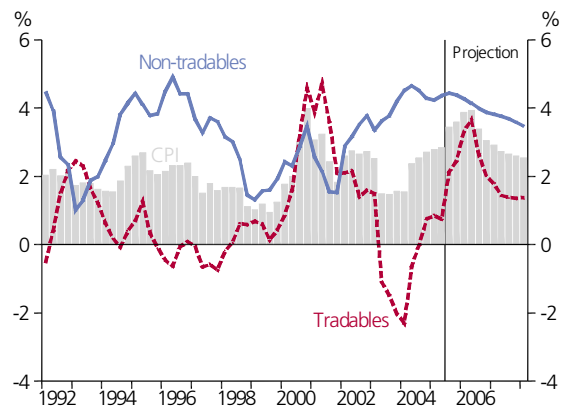


Source: Statistics New Zealand, RBNZ estimates.
 * Excluding frigates and other military spending.

Inflation

CPI inflation is expected to reach a peak of close to 4 per cent in early 2006, but is expected to fall away thereafter, heading below 3 per cent by 2007. At that medium-term horizon, inflation is projected to be broadly similar to our June assessment. However, there is now a greater degree of uncertainty. Principally, we are unsure how much pass-through there could be to medium-term inflation from the near-term spike in CPI inflation. Our projections assume

Figure 5.14
CPI, tradables and non-tradables inflation
(annual rate)



Source: Statistics New Zealand, RBNZ estimates.

there will be limited damage to inflation expectations. However, should the second round pass-through prove greater, then inflation would persist at higher levels over the medium term.

Appendix A¹

Summary tables

Table A

CPI inflation projections and monetary conditions

(CPI is in percentage changes)

		CPI*	CPI**	TWI	90-day bank bill rate
		Quarterly	Annual		
2000	Sep.	0.5	1.1	56.7	4.8
	Dec.	0.4	1.3	54.4	5.4
	Mar.	0.2	1.7	54.1	6.0
	Jun.	0.7	2.0	53.4	6.7
2001	Sep.	0.7	3.0	50.1	6.7
	Dec.	1.4	4.0	47.7	6.7
	Mar.	1.2	3.1	50.5	6.4
	Jun.	-0.2	3.2	49.8	5.9
2002	Sep.	0.9	2.4	50.0	5.7
	Dec.	0.6	1.8	49.6	5.0
	Mar.	0.6	2.6	51.6	5.0
	Jun.	0.6	2.8	54.6	5.8
2003	Sep.	1.0	2.6	53.9	5.9
	Dec.	0.5	2.7	56.4	5.9
	Mar.	0.6	2.5	60.6	5.8
	Jun.	0.0	1.5	61.1	5.4
2004	Sep.	0.5	1.5	62.4	5.1
	Dec.	0.7	1.6	63.9	5.3
	Mar.	0.4	1.5	66.9	5.5
	Jun.	0.8	2.4	64.0	5.9
2005	Sep.	0.6	2.5	66.3	6.4
	Dec.	0.9	2.7	68.6	6.7
	Mar.	0.4	2.8	69.6	6.9
	Jun.	0.9	2.8	70.8	7.0
2006	Second Half Average	1	3 $\frac{1}{2}$	69 $\frac{1}{2}$	7 $\frac{1}{4}$
	First Half Average	$\frac{3}{4}$	4	66 $\frac{1}{4}$	7 $\frac{1}{4}$
2007	Second Half Average	$\frac{3}{4}$	3 $\frac{1}{4}$	63 $\frac{1}{4}$	7 $\frac{1}{4}$
	First Half Average	$\frac{3}{4}$	2 $\frac{3}{4}$	62	7 $\frac{1}{4}$
	Second Half Average	$\frac{1}{2}$	2 $\frac{1}{2}$	60 $\frac{3}{4}$	7 $\frac{1}{4}$

Quarterly projections

		CPI	CPI	GDP	GDP
		quarterly	annual	quarterly	annual average
2005	Dec.	0.9	2.7	0.3	4.8
	Mar.	0.4	2.8	0.6	4.2
	Jun.	0.9	2.8	0.8	3.3
	Sep.	1.2	3.5	0.6	2.8
	Dec.	1.0	3.6		

¹ Notes for these tables follow on pages 32-33.

* This series is quarterly CPI inflation, excluding credit services, until the June 1999 quarter, and quarterly CPI inflation thereafter.

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

Table B

Composition of real GDP growth

(Annual average per cent change, unless specified otherwise)

March year	Actuals										Projections				
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008					
Final consumption expenditure															
Private	3.1	3.3	1.4	3.2	4.5	5.7	5.7	4 ¹ / ₄	3 ³ / ₄	1 ¹ / ₄					
Public authority	-0.2	5.3	-2.1	4.6	2.3	3.1	6.4	5 ¹ / ₂	6 ¹ / ₄	3 ¹ / ₂					
Total	2.3	3.8	0.6	3.5	4.0	5.1	5.9	4 ¹ / ₂	2	1					
Gross fixed capital formation															
Market sector:															
Residential	-13.0	19.5	-13.3	2.5	22.5	15.8	2.0	-4 ³ / ₄	-4 ³ / ₄	1 ¹ / ₄					
Business	0.2	7.3	9.2	8.1	4.1	15.4	13.1	5	-1 ¹ / ₂	2 ¹ / ₄					
Non-market government sector	-7.8	17.6	-17.4	12.0	6.0	2.5	-5.0	5 ¹ / ₄	8 ³ / ₄	7					
Total	-4.2	11.4	0.3	7.2	8.3	14.3	8.8	2 ³ / ₄	-3 ¹ / ₄	2 ¹ / ₄					
Final domestic expenditure	0.9	5.3	0.5	4.3	5.0	7.2	6.6	4	1 ¹ / ₄	1 ¹ / ₄					
Stockbuilding ⁽¹⁾	-0.3	1.2	-0.4	0.1	-0.3	0.2	0.4	-1 ¹ / ₂	0	0					
Gross national expenditure	0.6	6.5	0.2	4.3	4.6	7.4	6.9	3 ¹ / ₂	1 ¹ / ₂	1 ¹ / ₄					
Exports of goods and services	3.1	7.3	5.1	2.4	7.5	1.0	2.9	1 ³ / ₄	3 ¹ / ₂	4					
Imports of goods and services	1.9	11.5	-0.1	3.8	7.1	11.9	13.3	5	1 ¹ / ₂	1 ³ / ₄					
Expenditure on GDP	1.0	5.2	1.8	3.8	4.7	3.6	3.6	2 ¹ / ₂	2	2					
GDP (production)	0.5	5.2	2.3	3.5	4.6	3.6	4.2	2 ¹ / ₄	2	2					
GDP (production, March qtr to March qtr)	2.6	5.8	0.9	4.4	4.2	5.0	2.5	2 ¹ / ₄	2	2 ¹ / ₄					
Potential output	2.5	2.6	2.8	3.2	3.6	3.6	3.4	3 ¹ / ₄	3	2 ³ / ₄					
Output gap (% of potential GDP, year average)	-1.9	0.5	0.0	0.3	1.3	1.3	2.0	1	0	-3 ¹ / ₄					

(1) Percentage point contribution to the growth rate of GDP.

Table C

Summary of economic projections

(Annual percentage change, unless specified otherwise)

March year	Actuals					Projections				
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Price measures										
CPI*	1.0	1.7	3.1	2.6	2.5	1.5	2.8	4	3	2½
Labour costs	1.6	1.4	1.6	2.1	2.2	2.1	2.5	3	3	2½
Import prices (in New Zealand dollars)	2.7	11.2	7.4	-2.9	-11.1	-10.5	0.5	4	7¼	4¾
Export prices (in New Zealand dollars)	-0.6	9.9	20.6	-3.5	-15.5	-5.1	4.9	2½	4¼	3
Monetary conditions										
90-day rate (year average)	6.2	5.2	6.6	5.4	5.9	5.3	6.5	7¼	7¼	7¼
TWI (year average)	57.3	56.1	50.4	50.3	56.4	63.6	67.1	69¼	63¾	60¾
Output										
GDP (production, annual average % change)	0.5	5.2	2.3	3.5	4.6	3.6	4.2	2¼	2	2
GDP (production, March qtr to March qtr)	2.6	5.8	0.9	4.4	4.2	5.0	2.5	2¼	2	2¼
Output gap (% of potential GDP, year average)	-1.9	0.5	0.0	0.3	1.3	1.3	2.0	1	0	-¾
Labour market										
Total employment	0.7	1.5	2.2	3.6	1.5	3.1	3.4	1¼	0	¼
Unemployment rate (March qtr, s.a.)	7.1	6.3	5.4	5.2	4.9	4.2	3.9	3¾	4¼	5
Trend labour productivity (annual % change)	1.5	1.5	1.5	1.4	1.2	1.1	1.1	1¼	1½	1¾
Key balances										
Government operating balance (% of GDP, year to June)	1.7	1.4	1.2	1.9	1.5	5.3	4.0	5	4¼	2¾
Current account balance (% of GDP, year to March)	-4.2	-6.5	-4.1	-2.8	-3.4	-4.6	-7.0	-7¼	7¼	6¾
Terms of trade (OTI measure, annual average % change)	-0.4	-0.2	4.4	4.2	-5.7	3.9	5.8	1½	-3	-2¼
Household savings rate	-4.6	-1.5	-4.9	-4.9	-11.1	-12.3	-12.4	-15½	-14¾	-12¼
(% of disposable income, year to March)										
World economy										
World GDP (annual average % change)	2.0	4.2	3.6	1.4	2.9	3.3	3.5	3	3¼	3½
World CPI inflation	1.1	2.0	2.7	1.4	2.2	1.5	2.0	2¼	1¾	2¼

s.a. = seasonally adjusted

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

Notes to the tables

CPI	Consumers Price Index. Quarterly projections rounded to 1 decimal place.
TWI	RBNZ. Nominal Trade Weighted Index of the exchange rate. Defined as a geometrically-weighted index of the New Zealand dollar bilateral exchange rates against the currencies of Australia, Japan, the United States, the United Kingdom, and the Euro.
90-day bank bill rate	RBNZ. Defined as the interest yield on 90-day bank bills. Forecasts rounded to the nearest quarter per cent.
World GDP	Reserve Bank definition. 12-country index, export weighted. Projections based on <i>Consensus Forecasts</i> . Seasonally adjusted.
World CPI inflation	RBNZ definition and estimate. TWI trading partners' CPI inflation (Eurozone proxied by Germany), weighted by TWI weights. Projections based on <i>Consensus Forecasts</i> .
Import prices	Domestic currency import prices. <i>Overseas Trade Indexes</i> .
Export prices	Domestic currency export prices. <i>Overseas Trade Indexes</i> .
Terms of trade	Constructed using domestic-currency export and import prices. <i>Overseas Trade Indexes</i> .
Private consumption	<i>System of National Accounts</i> .
Public authority consumption	<i>System of National Accounts</i> .
Residential investment	RBNZ definition. Private sector and government market sector residential investment. <i>System of National Accounts</i> .
Business investment	RBNZ definition. Total investment less the sum of non-market investment and residential investment. <i>System of National Accounts</i> .
Non-market investment	RBNZ definition. The <i>System of National Accounts</i> annual nominal government non-market/market investment ratio is interpolated into quarterly data. This ratio is used to split quarterly expenditure GDP government investment into market and non-market components.
Final domestic expenditure	RBNZ definition. The sum of total consumption and total investment. <i>System of National Accounts</i> .
Stockbuilding	Percentage point contribution to the growth of GDP by stocks. <i>System of National Accounts</i> .
Gross national expenditure	Final domestic expenditure plus stocks. <i>System of National Accounts</i> .
Exports of goods and services	<i>System of National Accounts</i> .
Imports of goods and services	<i>System of National Accounts</i> .
GDP (production)	<i>System of National Accounts</i> .
Potential output	RBNZ definition and estimate. Refer to Conway, P and B Hunt (1997), 'Estimating Potential Output: a semi-structural approach', <i>Reserve Bank of New Zealand Discussion Paper</i> , G97/9.
Output gap	RBNZ definition and estimate. The percentage difference between real GDP (production, seasonally adjusted) and potential output GDP.
Current account balance	<i>Balance of Payments</i> .
Total employment	<i>Household Labour Force Survey</i> .
Unemployment rate	<i>Household Labour Force Survey</i> .
Household savings rate	<i>Household Income and Outlay Accounts</i> .

Government operating balance	Historical source The Treasury. Adjusted by the RBNZ over the projection period.
Labour productivity	The series shown is the annual percentage change in a trend measure of labour productivity. Labour productivity is defined as GDP (production) divided by HLF5 hours worked.
Wages	Private sector all salary and wage rates. Labour Cost Index.
Quarterly percentage change	$(\text{Quarter}/\text{Quarter}_{-1} - 1) * 100$
Annual percentage change	$(\text{Quarter}/\text{Quarter}_{-4} - 1) * 100$
Annual average percentage change	$(\text{Year}/\text{Year}_{-1} - 1) * 100$

Source: Unless otherwise specified, all data conform to Statistics New Zealand definitions, and are not seasonally adjusted.
Rounding: Unless otherwise specified, all projection data are rounded to the nearest quarter per cent.

Appendix B

Chronology

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

2005

- 9 June The Reserve Bank released its forty-sixth *Monetary Policy Statement*, leaving the Official Cash Rate unchanged at 6.75 per cent. The news release accompanying the *Statement* is reproduced in Appendix D.
- 24 June Production GDP figures were released showing that the New Zealand economy grew by 0.6 per cent in the March quarter of 2005.
- 14 July CPI statistics were released for the June quarter of 2005 showing that the CPI increased by 0.9 per cent over the quarter, and by 2.8 per cent in the year to June 2005.
- 28 July At the intra-quarter review, the Reserve Bank left the Official Cash Rate unchanged at 6.75 per cent. The accompanying news release is reproduced in Appendix D.

Appendix C

Companies and organisations contacted by RBNZ staff during the projection round

A.E. Tilley Ltd	Ngai Tahu Seafood Ltd
Air New Zealand Ltd	NZ Building Federation
Ancor Kiwi Packaging Ltd	NZ King Salmon Company Ltd
Aoraki Development Trust	Pacific Aerospace Corporation Ltd
Ashburton Implement Services Ltd	Philips New Zealand Ltd
Auckland Chamber of Commerce	Pod Ltd
Auckland Regional Transport Authority	Port of Napier Ltd
Bell-Booth Ltd	Port of Nelson Ltd
Canterbury Electronics Group	PPCS Richmond Ltd
Click-Clack Industries Ltd	Prepared Foods Ltd
Collins Mitre 10 Ltd	Pricewaterhousecoopers
Council of Trade Unions	Primeport New Zealand
Dan Gosgrove Ltd	Pyne Gould Corporation
Electricity Ashburton Ltd	Sealy New Zealand Ltd
Engineering, Printing and Manufacturers' Union	Sony New Zealand Ltd
Farmers Mutual Ltd	Tidd Ross Todd Limited
Farmlands Trading Society Ltd	Toll NZ Ltd
Federated Farmers of NZ Inc	Tourism Nelson Tasman Ltd
Fonterra Cooperative Group Ltd	Toyota New Zealand Ltd
Formway Furniture Ltd	Transit New Zealand
Gallagher Group Ltd	Unilever New Zealand Ltd
GFG Group Ltd	Vero Insurance New Zealand Ltd
Gibbons Holdings Ltd	Vita New Zealand Ltd
HPM New Zealand Ltd	Vodafone NZ Ltd
Lyttleton Engineering Ltd	Wellington International Airport Ltd
Lyttleton Port Company Ltd	Williams & Kettle Ltd
Mainzeal Construction Ltd	Wyatt Wilson Print Ltd
Methven Ltd	
Mitsubishi Motors Ltd	
Nelson Pine Industries Ltd	
New Zealand Honey Producers Co-operative Ltd	
New Zealand Post Ltd	

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

Appendix D

Reserve Bank statements on Monetary Policy

Reserve Bank increases OCR to 6.75 per cent

10 March 2005

The Reserve Bank has increased the Official Cash Rate (OCR) by 25 basis points to 6.75 per cent.

Speaking at the release of the Reserve Bank's March 2005 Monetary Policy Statement, Reserve Bank Governor Alan Bollard said: "In our December and January reviews we emphasised that inflation was expected to remain toward the top of the 1 to 3 per cent target band over the medium term, providing little headroom to absorb additional inflation pressures. We also projected a near-term economic slowdown which was expected to constrain inflation consistent with the Policy Targets Agreement. With the economy remaining very strong and resources becoming increasingly stretched, we assess that a further tightening of policy is now necessary.

"The momentum in today's economy is underlined by the continuing vigorous employment growth through December and by ongoing high levels of business and consumer confidence. Investment remains at record levels, our terms of trade remain very favourable and exports are generally holding up well despite the high exchange rate.

"Our revised economic projections incorporate a stronger outlook for activity in the near-term with the projected slowing in growth now not occurring until later in 2005. World demand and export prices are projected to moderate through 2005. Net immigration has slowed appreciably. Housing activity continues to ease, but has been held up at least temporarily by last year's mortgage price war. The pipeline effects from last year's policy tightening will continue to raise average effective mortgage rates through this year but the impact will be gradual. The greater momentum in activity in the near term implies stronger underlying inflation pressures than we expected. The additional tightening today is required to contain these pressures.

"Since we remain of the view that the economy is close to a turning point, we have to carefully confront the possibility that a further tightening in policy at this stage of the cycle might exacerbate an eventual slowing in activity. However, not responding to the prospect of stronger inflation

pressures now would create a risk that inflation expectations and wage and price setting behaviour could change in a way that would make the task of containing inflation more difficult in the future, even if growth slows. Being prudent now reduces the prospect of a tighter monetary policy later on.

"Whether there is any further tightening ahead will depend on how the risks play out over the coming period. Certainly, the current outlook offers little scope for an easing of policy in the foreseeable future."

OCR unchanged at 6.75 per cent

28 April 2005

The Reserve Bank has left the OCR unchanged at 6.75 per cent.

Reserve Bank Governor Alan Bollard said: "At the March MPS we expressed concern about the persistence of inflation pressures in the economy which were severely limiting our inflation headroom. We still take that view. While recent indicators have shown signs of a slowdown in the second half of 2004, analysis of the data suggests that underlying demand and inflation pressures remain strong. In this environment, further policy tightening cannot be ruled out.

Recent GDP data and business surveys have been difficult to interpret in the context of the economic cycle. Several years of strong growth have led to productive resources becoming stretched, with capacity utilisation and measures of labour shortages remaining at or near record highs. The recent soft GDP outturns may have been affected by these capacity constraints and do not necessarily reflect a weakening of aggregate demand. Recent indicators of demand support this view, with retail trade, housing market data and imports all remaining very robust. Consequently, we expect some rebound in GDP growth over the first half of 2005.

Price data also point to inflation pressures remaining at least as strong as in our March assessment. The March quarter CPI was heavily influenced by temporary factors,

such as the large seasonal fall in international airfares. Underlying inflation pressures are persisting, as evidenced by rising business costs and ongoing labour market tightness.

Over the coming weeks we will be reviewing our forecasts in more detail, in particular to assess the strength of pipeline interest and exchange rate effects, household demand and ongoing labour market pressures. This assessment will be used to confirm whether further policy tightening is warranted at the June Monetary Policy Statement. Certainly, the current outlook offers no scope for an easing of policy in the foreseeable future.

OCR unchanged at 6.75 per cent

9 June 2005

The Reserve Bank has left the Official Cash Rate (OCR) unchanged at 6.75 per cent.

Speaking at the release of the Reserve Bank's June 2005 Monetary Policy Statement, Reserve Bank Governor Alan Bollard said: "Our current review confirms what we said in the March Statement and again at the April OCR review. Activity remains strong across many parts of the economy and inflation pressures remain persistent. Several years of strong growth have led to productive resources becoming stretched, with capacity utilisation and measures of labour shortages remaining at or near record highs.

"However, there is sufficient evidence that the economy is slowing, and that past policy tightenings are yet to have their full effect, for us to leave policy on hold at this point.

"While many businesses see more difficult trading conditions ahead, activity and inflation pressures in some sectors are proving stronger than anticipated. Export prices for some commodities have edged up in recent months. Household spending and housing market activity have remained firmer than expected. Non-residential construction and business investment look likely to be sustained at high levels in the near-term.

"Overall, we assess that the balance of inflation risks remains on the upside. We base this view on the ongoing growth in debt-financed household spending; and on increases in costs – of labour, energy and freight – that are now putting considerable pressure on margins and prices.

"With inflation projected to remain around 3 per cent through most of this year and next, a firm policy stance will be required for some time. We will be watching closely to see if inflation pressures are contained, and further tightening in monetary policy would likely be required if there are upside surprises to the inflation outlook. Certainly, there is no scope for an easing in policy in the foreseeable future."

OCR unchanged at 6.75 per cent

28 July 2005

The Reserve Bank has left the Official Cash Rate (OCR) unchanged at 6.75 per cent.

Reserve Bank Governor Alan Bollard said: "The economy has recently shown signs of softening. GDP growth has continued to ease over recent quarters, particularly in sectors such as manufacturing that are exposed to the strong exchange rate. Indicators of business activity have been pointing downwards for some months and it now appears that household consumption growth is also beginning to weaken. However, residential housing market indicators remain firm, representing an upside risk for the future path of household spending and inflation. We view the overall easing in activity as broadly consistent with our June MPS economic outlook.

"Inflation pressures nevertheless remain present. Several years of strong growth have led to productive resources becoming stretched and the resulting inflation pressures will take some time to unwind. Moreover, additional short-term inflation pressures have recently emerged as a result of surging oil prices and the waning impact of the strength in the exchange rate over recent years. These short-term inflation pressures, which could easily be exacerbated, are now expected to push CPI inflation temporarily above 3 per cent over the coming quarters.

"Looking further ahead, we expect that current policy settings will be sufficient to achieve our objective of 1-3 per cent inflation on average over the medium term. However, in the current environment, monetary policy must remain vigilant. We remain vulnerable to upside inflation risks and monetary policy must continue to work at reducing the ongoing excess demand pressures. A firm policy stance

is also necessary to prevent the expected short-term inflation pressures from becoming entrenched in inflation expectations. A further tightening of policy could not be ruled out in the event of a resurgence in medium-term inflation pressures. Certainly there remains no prospect of a policy easing in the foreseeable future.”

Appendix E

The Official Cash Rate chronology

Date	OCR (per cent)	Date	OCR (per cent)
17 March 1999	4.50	6 March 2003	5.75
21 April 1999	4.50	24 April 2003	5.50
19 May 1999	4.50	5 June 2003	5.25
30 June 1999	4.50	24 July 2003	5.00
18 August 1999	4.50	4 September 2003	5.00
29 September 1999	4.50	23 October 2003	5.00
17 November 1999	5.00	4 December 2003	5.00
19 January 2000	5.25	29 January 2004	5.25
15 March 2000	5.75	11 March 2004	5.25
19 April 2000	6.00	29 April 2004	5.50
17 May 2000	6.50	10 June 2004	5.75
5 July 2000	6.50	29 July 2004	6.00
16 August 2000	6.50	9 September 2004	6.25
4 October 2000	6.50	28 October 2004	6.50
6 December 2000	6.50	9 December 2004	6.50
24 January 2001	6.50	27 January 2005	6.50
14 March 2001	6.25	10 March 2005	6.75
19 April 2001	6.00	28 April 2005	6.75
16 May 2001	5.75	9 June 2005	6.75
4 July 2001	5.75	28 July 2005	6.75
15 August 2001	5.75		
19 September 2001	5.25		
3 October 2001	5.25		
14 November 2001	4.75		
23 January 2002	4.75		
20 March 2002	5.00		
17 April 2002	5.25		
15 May 2002	5.50		
3 July 2002	5.75		
14 August 2002	5.75		
2 October 2002	5.75		
20 November 2002	5.75		
23 January 2003	5.75		

Appendix F

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 the remainder of 2005, and for 2006.

Thursday 27 October 2005	OCR announcement
Thursday 8 December 2005	<i>Monetary Policy Statement</i>
Thursday 26 January 2006	OCR announcement
Thursday 9 March 2006	<i>Monetary Policy Statement</i>
Thursday 27 April 2006	OCR announcement
Thursday 8 June 2006	<i>Monetary Policy Statement</i>
Thursday 27 July 2006	OCR announcement
Thursday 14 September 2006	<i>Monetary Policy Statement</i>
Thursday 26 October 2006	OCR announcement
Thursday 7 December 2006	<i>Monetary Policy Statement</i>

The announcement will be made at 9:00am 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 G

Policy Targets Agreement

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

1. Price stability

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

2. Policy target

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

3. Inflation variations around target

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

4. Communication, implementation and accountability

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



Hon Dr Michael Cullen
Minister of Finance



Dr Alan E Bollard
Governor Designate
Reserve Bank of New Zealand

Dated at Wellington this 17th day of September 2002