Monetary Policy Statement

September 2004

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

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1 Policy Assessment

The Reserve Bank has increased the Official Cash Rate from 6.00 per cent to 6.25 per cent. Further tightening of monetary policy is likely to be required.

The New Zealand economy is performing very strongly. On balance, the recent economic data has delivered positive surprises. Economic growth is near its peak, but resources will remain stretched for some time, and inflation pressures remain strong.

In terms of the economic outlook, there are risks to consider. The consensus view in our projections is that global economic activity is expanding at a reasonable pace. However, high world oil prices and softer growth in the US could slow global economic growth. Further, if the TWI continues to rise, or if commodity prices fall sharply, our growth prospects would be weaker.

Domestically, the economy is heavily influenced by housing activity, which we expect to continue to slow over coming months. However, if that weakening is delayed, then household spending would continue to expand at a rapid rate, fuelling inflation pressures. This could be compounded by continuing strength in the labour market.

So far, inflation has been kept in check by the rising New Zealand dollar, which has pushed import prices lower. We expect domestic inflation to remain strong due to tight production capacity. Assuming the exchange rate is near a peak, import prices are unlikely to continue falling. As a result, even though economic growth is likely to be slowing next year, inflation is projected to increase.

The Reserve Bank is required to keep inflation between 1 and 3 per cent “on average over the medium term”. Also, section 4(b) of the Policy Targets Agreement requires us to minimise unnecessary instability, hence monetary policy must always be a balancing act. We are using this flexibility to the full. However, looking ahead we do not have much inflation headroom, which is why we are continuing our incremental tightening of monetary policy.

Alan Bollard
Governor
2 Overview and key policy judgements

The New Zealand economy has been performing very strongly. Economic activity is expected to remain strong over the rest of this year before easing over 2005. Inflation pressures have continued to build, and slightly higher interest rates are likely to be required to ensure that inflation over the medium term is consistent with the policy target.

The key drivers of the recent cycle have been well documented. The combination of high net immigration, a strong labour market, relatively low interest rates, rising house prices, and improvements in the terms of trade have underpinned consumption growth and high levels of residential investment. Business investment has also picked up as firms have responded to their productive capacity being stretched. Export volumes have performed well, with strong demand from key markets.

All indicators we monitor point to an economy that has been stretched for some time now. The labour market is tight with unemployment at a 17-year low. Capacity utilisation is still running at very high levels despite the lift in business investment. Likewise, many indicators of core inflation remain at high levels.

To date, annual CPI inflation has been comfortably inside our target range. However, this is because strong non-tradables inflation has been masked by falling New Zealand dollar prices in the tradables sector as the exchange rate has appreciated. Looking ahead, we think that the dampening influence from lower prices in the tradables sector will ease, and CPI inflation will rise.

Figure 1
Cyclical pressures and annual non-tradables inflation

Source: RBNZ estimates.

With economic activity expected to be robust over the remainder of the year, medium-term inflation pressures will remain strong. As the pace of economic activity slows, inflation pressures will ease. However, the economy’s productive capacity is currently stretched and it is prudent to continue with the incremental policy tightening we began early this year.

Stronger for longer
March quarter GDP growth was very strong, outstripping our expectations. Further, household spending has continued at a brisk pace, with retail sales again proving strong in the June quarter. Households are generally in an optimistic mood. The labour market is tight according to almost all measures, and the unemployment rate sits at 4 per cent (figure 4, overleaf). Wage inflation is at cyclical highs and labour incomes will continue to be supported by ongoing strength in the labour market.

World commodity prices have continued to increase, driven by tight international supplies for some key export commodities (beef, lamb, and dairy products) and strong global demand (figure 5, overleaf). Until recently, the strength of the exchange rate had more than offset the gains from higher commodity prices, but as commodity prices have continued to increase, export sector incomes have been boosted.
Box 1
A review of recent monetary policy decisions

Early last year, we projected the New Zealand economy to slow sharply due to the strongly appreciating New Zealand dollar, the potentially damaging effects of the outbreak of the SARS virus, the drought in some areas of the country, and the electricity shortages. The projected slowdown was expected to reduce the inflation pressures we observed in the economy. Hence, between April and July last year the Official Cash Rate (OCR) was reduced from 5.75 per cent to 5 per cent.

By late last year it had become clear that activity was more resilient – and underlying inflation pressures more persistent – than we had initially expected. Hence, in the December 2003 Monetary Policy Statement, we signalled that small OCR increases were likely in the coming months in order to begin removing interest rate stimulus, and the OCR was increased by 25 basis points in January and April of this year.

At the time of our June 2004 Statement, we noted that economic activity and inflation pressures had continued to prove stronger than expected. We increased the OCR by 25 basis points and signalled that further increases in interest rates looked likely to be needed over the year ahead. At our interim review in July, we increased the OCR by an additional 25 basis points, and noted that the economy’s strength may be maintained for longer than we anticipated in June.

Figure 3
Official Cash Rate

Figure 4
Unemployment rate and employment growth

Figure 5
ANZ commodity prices
These factors point to near-term momentum in the economy being stronger than our previous assessment. Instead of slowing by year end, economic growth is now expected to remain robust throughout 2004.

**Figure 6**

GDP

(annual average percentage change)

Our view remains that the pace of economic growth will slow as the impetus from the drivers of the recent strength dissipate. There are already signs of a slowdown in some sectors, such as the housing market. House sales are 25 per cent below their September 2003 peak, and net immigration has slowed. These developments have occurred largely as expected. The lagged effects from higher interest rates will also moderate household disposable incomes and spending.

The exchange rate has moved higher over recent months, largely reflecting trends in the US dollar and renewed concerns about the pace of the global recovery in the face of significantly higher oil prices. At its current high level, the exchange rate will restrain activity in the period ahead, particularly as short-term exchange rate hedges roll off.

The projected slowing is moderate by historical standards, with annual GDP growth expected to be around 2 per cent in the year to March 2006.

**Box 2**

Monetary policy and mortgage interest rates

The transmission of changes in the Official Cash Rate to the interest rates actually paid by households and businesses is an important consideration for monetary policy. Generally, the experience of the past five years suggests there is a relatively close relationship between changes in the OCR and movements in the average mortgage interest rate paid by households – that is, the ‘effective’ rate that is actually being paid on outstanding mortgage debt, as opposed to the rates offered to new borrowers.

However, the response of the effective mortgage rate to the increases in the OCR this year has been slower and more limited than in the previous two interest rate cycles (see figure 7). This appears to reflect two factors.

Firstly, fixed rate mortgage borrowing has become more prevalent and now comprises 68 per cent of all mortgage borrowing compared to 62 per cent in 1998. OCR changes work their way through short-term wholesale interest rates to floating mortgage rates relatively quickly. But, by their very nature, fixed mortgage rates shelter existing borrowers from changes in interest rates until the term of their mortgage expires and it re-prices. At that time, the prevailing level of the OCR and market expectations about future movements are likely to be factors influencing the rates that the mortgagee will face. With almost 30 per cent of fixed rate borrowing due to re-price in less than a year and more than 50 per cent due to re-price in less than two years, this suggests that...
the lags between changes in the OCR and movements in the effective mortgage rate are probably just a little longer than they have been in the past.

Secondly, it appears that the impact of global interest rate developments on fixed rates has played a role in muting the impact of local monetary policy tightening on the effective mortgage rate. During the previous two interest rate cycles, one- and two-year fixed rates were consistently above floating rates as the OCR was raised (see figure 8). In contrast, one- and two-year fixed rates have generally remained below floating this year and have risen at a slower pace. This primarily reflects the influence of relatively low global interest rates, which have limited the extent to which longer-term wholesale interest rates have risen in New Zealand and thereby provided scope for lenders to continue to offer fixed rates that are lower than floating rates. Moreover, this has been reinforced by competitive pressures, with the emergence of ‘special’ fixed rates (such as 18 and 30 month terms) in recent years. These developments have provided an avenue for borrowers to circumvent the direct impact that OCR increases have had on floating mortgage rates.

Assuming fixed rates at least remain around current levels in coming months, the effective mortgage rate will continue to rise as fixed mortgages progressively re-price.

**Figure 8**
Floating and fixed mortgage rates for new borrowers

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**Policy Assessment**

In contrast to many of our main trading partners, the New Zealand economy is at an advanced stage of its business cycle (figure 9). While we have been surprised over recent times by the strength of the economy, there are a number of reasons to expect that the pace of activity will slow over the coming year.

In the meantime, however, the enduring strength of the economy has increased the pressure on productive resources and inflation. We have, therefore, continued with the incremental tightening in monetary policy we began early this year. Policy could have been more aggressive, particularly given current economic conditions. But as the turning point in the business cycle nears, the anticipated slowing in activity becomes a more significant consideration in our policy deliberations, hence requiring a balancing act.

If policy does not respond by enough, inflation could prove more persistent over the medium term and spill over into inflation expectations, sparking unhelpful changes to wage and price setting behaviour. The room for complacency is limited here, as CPI inflation is projected to rise steadily over the next 12 months, at a time of significant stretch and labour market tightness. Survey measures of inflation...
expectations among businesses and households have edged up during 2004 (see figure 39, Chapter 3). Although this may simply reflect the recent increase in actual inflation, it highlights the need for caution.

But conversely, reacting too much to current pressures, and not putting sufficient weight on the likely drivers of activity over the next few years, could exacerbate the eventual slowdown in economic activity. In turn, that could lead to greater volatility in interest rates, output and the exchange rate – something we are obliged to avoid under section 4(b) of the Policy Targets Agreement.

On balance, slightly higher interest rates are likely to be needed in the future. We expect CPI inflation to rise steadily over the next 12 months. The recent increase in the exchange rate should provide some moderating influence in the near term, such that annual inflation should peak at a slightly lower rate and a little later than in our June projections. Over the medium term, however, inflation is projected to be more persistent, reflecting more sustained pressure on the economy's productive capacity. Relative to our June Statement, we see a slightly greater role for monetary policy to ensure that inflation is consistent with the policy target, though the policy path remains modest by historical standards.

Annual CPI inflation is expected to rise temporarily above 3 per cent in 2005. This would not be a breach of the Policy Targets Agreement, as the Bank is now required to keep inflation between 1 and 3 per cent “on average over the medium term”. Given that inflation is expected to fall in a reasonable time frame, it would not be appropriate to attempt to offset this short-term increase in inflation using monetary policy.

As always, our policy assessment is contingent on the outlook for economic activity and medium-term inflation. It is possible that economic growth will remain stronger, if the momentum from previous drivers of growth is sustained. Further, more recent developments, such as higher commodity prices and a stronger labour market, may prolong the near-term strength in economic activity.

On the other hand, the projected slowdown in domestic economic activity could prove sharper if recent concerns over the global recovery become more concrete, particularly if oil prices persist at high levels. We continue to expect ongoing strength in global demand – a view that is embodied in the latest Consensus Forecasts. Central to this view is an assumption that oil prices will fall gradually from current levels, even though they are likely to remain volatile as concerns over oil supply fluctuate.

These global developments could have other potential knock-on effects. If concerns about the pace of US recovery continue to build, the US dollar could remain weak as financial markets focus on the structural imbalances present in the US economy. This situation could result in an even stronger New Zealand dollar exchange rate. If the New Zealand dollar were to rise further and remain higher than current levels for a prolonged period, particularly in the face of a weaker world economy, then our policy assessment would change accordingly.
3 The current economic situation

The New Zealand economy has displayed remarkable strength over the past year, with GDP estimated to have grown by around 5 per cent in the year to June. While there are signs of slow-down in some sectors of the economy, such as the housing market, many indicators remain strong, and we again find ourselves surprised by current levels of economic activity. Broadly speaking, we now see the economy as being in a stronger position than we envisaged in June.

Significant inflationary pressures have accumulated in some parts of the economy, and these pressures show few signs of abating. Annual domestic inflation remained at 5 per cent in the June quarter, but imported inflation rose sharply as the lagged effects of the rapid appreciation of the currency began to wane. Annual CPI inflation remains within the target band, although a considerable imbalance remains between inflation in the tradables and domestic sectors of the economy.

Global and financial market developments

Growth in our main trading partners continues at a solid pace, and central banks around the world are beginning to move away from their accommodative policy settings.

A run of unexpectedly weak data in the US, however, has prompted fears about the sustainability of the US recovery. Global long-term interest rates have fallen and the US dollar has depreciated against most currencies. Rising world commodity prices and relatively good growth prospects have seen the ‘commodity currencies’ – such as the New Zealand, the Australian, and the Canadian dollars – gain particular favour amongst global investors (figure 12).

Global markets remain uncertain about the medium-term path of the US dollar. Market participants’ views have largely been contingent on the expected strength of the US recovery and the degree to which structural imbalances, such as the large fiscal and current account deficits, will impinge on future growth prospects and interest rates. As has largely been the case over the past couple of years, future developments for the New Zealand dollar remain heavily dependent on developments in the US.

While recent growth in the US has been surprisingly soft, the Federal Reserve (Fed) views this as only temporary, and likely owing to rising energy prices. The Fed has increased interest rates twice since our June Statement, and reiterated that its accommodative policy settings are likely to be removed in a ‘measured’ fashion; the policy rate in the US is still very low at 1.50 per cent.

Recent data have also been soft in Japan and South Korea, but growth prospects in the rest of Asia have generally been good. The Chinese Government’s efforts to cool investment activity and loan growth appear to have been successful, likely improving the sustainability of Chinese growth going forward.

In Europe, the European Central Bank is expected to keep interest rates on hold for the remainder of 2004. The European recovery appears to be fragile, particularly in Germany, where high unemployment is suppressing consumer confidence.

In contrast, the Bank of England (BOE) recently increased interest rates, emphasising a pickup in manufacturing activity and cost pressures. The BOE views the risks around inflation and growth to be balanced. It also sees some signs that inflation in the housing sector and consumer spending are cooling, which should moderate growth going forward.

After increasing interest rates to 5.25 per cent late in 2003, the Reserve Bank of Australia (RBA) has kept interest rates on hold. The RBA views inflation pressures as reasonably well contained, but has noted that it would be surprised if interest rates did not have to increase further. Markets and analysts expect the RBA to increase interest rates in late 2004 or early 2005.
A central theme in global markets has been high and volatile oil prices (see figure 20, box 3). Strong global demand coupled with ongoing supply concerns in the Middle East and Russia has caused some nervousness amongst market commentators and policy-makers alike. Speculative positioning suggests a market expectation that oil prices might yet go even higher, leaving some uncertainty for global growth and inflation prospects.

**The tradables sector**

The exchange rate rose very rapidly between late 2000 and early this year (see figure 43, Chapter 4). This represents a substantial reduction in the profitability and international competitiveness of many of our exporters. However, some exporters have found relief through hedging the exchange rate, or by having their costs priced in foreign currencies. World prices have also acted to mute the full impact of the exchange rate’s rise – rising to historically high levels in some cases. Yet, despite this, overall export sector revenues fell considerably between 2001 and early 2004 (figure 13). Revenues have since begun to recover, helped by rising world commodity prices and strong growth in export volumes.

![Figure 13](image)

**Nominal export values**

*(annual total)*

Source: Statistics New Zealand, RBNZ estimates.

World prices for our commodity exports have been increasing since late 2002. Tight international supplies for some key export commodities – such as beef, lamb and dairy products – combined with burgeoning global demand, have driven prices to very high levels. Until recently, the rapidly-rising currency had masked the beneficial effects of these rising world prices, eroding New Zealand dollar prices (see figure 5, Chapter 2). But prices have more than outweighed the effects of the rising currency over recent months, providing a welcome boost to incomes in the export sector. While the overall outlook for the export sector has been improving, log exporters continue to face adverse trading conditions, with weak world prices and rising shipping costs reducing New Zealand dollar returns.

Aside from some pockets of weakness in a few areas, there has been little indication that the high currency is impacting on overall activity levels in the export sector. After falling in early 2003, primary export volumes have grown strongly. Favourable growing conditions and productivity gains in the dairy sector contributed to record milk fat production over the past season, and dairy exports surged into 2004. Dry conditions in parts of the country around the beginning of the year also led to early slaughter of livestock, increasing beef and lamb exports in the March quarter. Non-commodity export volumes have also been performing well, despite sluggish earnings growth following the currency’s rise (figure 14).

![Figure 14](image)

**Non-commodity manufactured exports**

Source: Statistics New Zealand.

Exports of tourism services fell sharply in the first half of 2003, as the negative effects of the war in Iraq and the SARS virus dramatically reduced tourist numbers, particularly from the Asian region. But tourist numbers have since grown strongly (figure 15). Asian visitor arrivals are recovering, and increased capacity and airfare discounting on the
trans-Tasman travel routes have increased Australian tourist numbers to record levels (figure 16).

While tourist numbers increased in March quarter, the amount that they spent did not. The decrease in expenditure was due to both shorter stays by visitors and a compositional shift within our overall visitor numbers, with more visitors coming from Australia and fewer coming from Asia; per-person, Australian tourists spend around half as much as their Asian counterparts. Reduced tourist expenditure could also reflect the impact of a stronger New Zealand dollar.

The rapidly-rising exchange rate, and low inflation amongst our trading partners, has dramatically reduced our import prices over the past few years. But this downward pressure looks likely to ease. The exchange rate has been volatile and is slightly below the peaks it reached earlier this year, and oil prices have risen to very high levels. Strong demand from China is also contributing to higher import prices, stretching world supplies of some building materials (such as steel), and drawing heavily on the world’s shipping capacity – increasing the cost of freight.

Growth in import volumes has remained high. The strong domestic economy has stretched firms’ existing capacity, and this, together with favourable import prices and low interest rates, has prompted a surge in imports of capital goods (figure 17). Likewise, rising household incomes and high levels of residential investment have helped to lift imports of consumer durables to very high levels. Rising household incomes and low airfares have also encouraged a record number of New Zealanders to travel overseas, increasing services imports by over 15 per cent in the year to March.

Overall, our net exports position has deteriorated significantly, shifting from making a positive contribution to GDP growth in 2001 to making a substantial negative contribution at the beginning of 2004 (figure 18). In itself, this is a reflection of the strength of the domestic sector, which drew imports into the economy at a very rapid rate over that period. Our terms of trade have also continued to rise, representing an increase in the purchasing power of New Zealand as a nation (see box 3).
Domestic demand

The domestic economy has experienced a period of robust economic growth over recent years. A surge in net immigration has led to rapid population growth, and this has stretched the economy’s housing resources, fuelling consumer demand and a strong residential investment cycle. A sustained period of strong employment growth, coupled with moderate wage growth, has strengthened household incomes. Domestic demand has also found support from rapidly-growing house prices, relatively low interest rates, and the rising terms of trade. Real Gross National Disposable Income (GNDI) has grown faster than GDP recently.

Box 3

Terms of trade and the New Zealand economy

New Zealand’s terms of trade are at relatively high levels, largely reflecting rising international prices for our commodity exports. The terms of trade are also at multi-year highs in other major commodity exporting countries, such as Canada and Australia.

Since April, oil prices have increased significantly reflecting increased risks to the outlook for international supply. Prices for Dubai oil have risen from around $US30 per barrel to a high of over $US40 per barrel. Prices have since fallen back off their highs, with Dubai oil at around $US37 per barrel.

Figure 19

Terms of trade

Source: Datastream, RBNZ estimates.

Over this time, economic data have indicated further improvements in international prices for New Zealand’s commodity exports (see figure 5, Chapter 2). In US dollar terms, the ANZ commodity price index has increased by around 10 per cent since April. Overall, New Zealand’s terms of trade are likely to have improved further in recent months as the increases in commodity prices outweigh the effects of higher oil prices (see figure 42, Chapter 4). Commodity exports represent around 60 per cent of total exports, while oil represents around 10 per cent of total imports.
highlighting the beneficial effect that the rising terms of trade has had on the economy’s real purchasing power (figure 21).  

**Figure 21**  
GNDI and GDP  
*(annual average percentage change)*

[Graph showing GNDI and GDP trends over time.]

Source: Statistics New Zealand.

Population gain through net immigration has been a major driver of the domestic economy. Net immigration added more than 20,000 persons to the population in the year to June, accounting for around half of the population growth over that time (figure 22). Although net immigration continues to add significant numbers to the population, these gains have fallen substantially. The slowing in net immigration is the result of both a pick-up in departures and a slow-down in arrivals, which may partly reflect improvements in global employment opportunities or an easing of security concerns elsewhere. Another notable driver of the slow-down in arrivals is a large fall in Asian student numbers, particularly in the number of students coming from China.

The rapidly-growing population placed significant pressure on the economy’s existing housing stock over 2003. Residential investment activity rose to historically high levels as a result, placing pressure on the construction sector – and creating long backlogs of work for builders. So far, residential investment has shown little sign of easing as population growth has slowed, suggesting that some backlogs remain. But dwelling consents issued by local authorities over the past few months provide an indication that residential building activity will begin to cool later in the year (figure 23).

To be sure, we continue to see signs that the momentum in the housing market has begun to slow. During 2003, strong demand for housing from new immigrants and New Zealand residents alike led to a record number of house sales and a severe shortage of listings in some areas. Houses were selling at a record pace during that year. The number of days to sell a house fell to below 25 days, and house price inflation rose to over 20 per cent per annum (figure 24). But turnover in the housing market has since slowed, and the number of days to sell a house has increased to

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1 Real GNDI is a measure of the real purchasing power of national disposable income. It is essentially GDP adjusted for changes in our terms of trade plus net investment income plus net transfer payments (see www.stats.govt.nz for further details on real GNDI).
around 30 days. Growth in house prices also appears to have moderated, with annual house price inflation recently falling below the peaks reached earlier this year. House price inflation, however, remains at high levels.

Low interest rates and rising housing-related wealth have encouraged households to take on more debt, which has also been evidenced in high rates of household credit growth (figure 26).

Consumption growth has been strong over the past few years, reflecting an optimistic mood amongst households (figure 25). Large increases in housing-related wealth, rising incomes, and relatively low interest rates have all fuelled consumer demand. As yet, there have been no clear signs that consumption expenditure has begun to slow, with consumption growing by 2.8 per cent in the March quarter alone – its largest quarterly increase since 1996. Indeed, recent retail sales data suggests that consumption growth remained robust over the June quarter of 2004.

Despite rising incomes, the debt to income ratio of households has increased to over 130 per cent. Essentially, businesses have generally been optimistic about their own prospects over the past few years. While business confidence slumped following the outbreak of SARS and the war in Iraq early in 2003, it soon recovered, and business investment grew in excess of 15 per cent per annum into 2004. Low interest rates and a favourable exchange rate were certainly factors encouraging investment over this time. But the primary catalyst has been the continued strength of the domestic economy, which has stretched firms’ existing productive capacity and improved their prospects for the future.

The plant and machinery investment component of business investment has been trending up over the past couple of years. Yet, despite these significant additions to the economy’s productive capacity, businesses continue to report very high levels of capacity utilisation (figure 27, overleaf). There is a suggestion from our business contacts that difficulties finding labour have prompted a shift toward labour-saving technologies, which might also be adding to plant and machinery investment levels.
Commercial construction activity has been subdued relative to activity in the booming residential housing sector. Thus, increasingly more resources have been diverted towards residential construction, away from the commercial sector.

Our business contacts suggest that there is some degree of substitutability of the labour between the residential and commercial construction sectors. And consents already lodged indicate that non-residential investment will pick-up later in the year (figure 28). With residential activity looking likely to slow, resources could thus be ‘freed up’ for commercial construction, prolonging pressures that already exist in the construction sector as a whole.

The labour market and wages

Pressures on the economy’s labour resources have also been building. While employment has been strong, adding more than 100,000 persons to the workforce since the beginning of 2002, labour shortages have remained. New Zealand’s labour market is very tight according to almost all measures, and the unemployment rate is now just 4 per cent, its lowest level since 1987 and the second lowest rate in the OECD.

The businesses that we have talked with over the past couple of years – and the firms surveyed by the NZIER – have
increasingly cited labour as a key constraint, limiting their ability to produce. This has also been reflected in the labour shortages data, with firms citing continuing difficulties finding both skilled and unskilled labour (figure 30).

**Figure 30**

Labour shortages

![Net % of respondents](image)

Source: NZIER.

Increasingly cited labour as a key constraint, limiting their ability to produce. This has also been reflected in the labour shortages data, with firms citing continuing difficulties finding both skilled and unskilled labour (figure 30).

Our view is that the tight labour market has been broadly reflected in rising wage rates (figure 32). Some industries, such as the construction industry, have been particularly stretched over the past few years, reporting severe shortages of workers, and larger wage increases than in the rest of the economy. Although the wage pressures in the construction sector do not appear to have spilt over into wages in other parts of the economy, pockets of persistent wage pressure raise the risk of higher wage demands becoming more widespread.

**Figure 32**

LCI wage growth and labour shortages.

![LCI wage growth and labour shortages](image)

Source: Statistics New Zealand, NZIER.

Certainly, many of our business contacts, not just those operating in the construction sector, are having difficulties finding staff. Firms have had to pay increasingly higher wages to attract staff, and, in some cases, firms have had to search outside New Zealand to find workers with the right skills. Some of our business contacts are even finding it difficult to retain the skilled staff that they have – due to strong competition for staff amongst employers.

These observations are broadly supported by movements in the distribution of wage increases in the LCI. The proportion of all firms increasing salary and ordinary time wage rates in the June quarter rose to the highest level in the history of the series (figure 33, overleaf). Statistics New Zealand notes that matching market rates, retaining staff, and attracting staff were more likely to be given as reasons for larger wage increases in the June quarter.

Rising wage pressures, however, are not isolated to ordinary-time salary and wage rates. The proportion of firms increasing overtime wage rates has also been trending up.

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2 The adjusted LCI is a measure of salary and wage rates for a fixed quantity and quality of labour, while the unadjusted LCI is a measure that fixes the quantity of labour but not the quality.
over the past few years, and now sits at a historical high (figure 34). This might suggest that firms increasingly need to coax existing staff to work longer hours through overtime wage increases, perhaps because it is becoming more and more difficult to find labour externally.

Figure 33
Distribution of wage increases

![Distribution of wage increases chart]

Source: Statistics New Zealand.

Figure 34
Overtime wage increases and difficulty finding labour

![Overtime wage increases and difficulty finding labour chart]

Source: Statistics New Zealand, NZIER.

Additional labour costs not fully captured by the wage statistics, such as non-wage pecuniary benefits and the incomes of those in self-employment, have probably also been increasing. Some of our business contacts note a greater incidence of non-wage pecuniary benefits (such as company cars and medical insurance) being advanced to some workers. And, in the construction sector, fees for subcontractors – many of whom are self-employed and are thus not fully captured by the wage statistics – have increased significantly over the past couple of years.

Inflation

Although there are tentative signs that activity levels might be beginning to moderate in some sectors of the economy, resource pressures show few signs of easing – and in some areas, such as in the labour market, they continue to intensify. Annual headline CPI inflation, however, has been relatively low over the past year, masking a substantial divergence in the behaviour of inflation in the tradables and non-tradables sectors of the economy (figure 35).

Figure 35
Tradables and non-tradables inflation

![Tradables and non-tradables inflation chart]

Source: RBNZ.

Consistent with our view that the economy has been operating above its capacity for some time, inflation in the non-tradables sector is currently sitting at high levels. Inflation in the housing and construction markets has been particularly strong, with the costs associated with the purchase and construction of new homes rising by more than 8\% per cent in the year to June. But these strong inflationary pressures are by no means isolated to the housing sector, with prices for some non-housing-related components of the CPI, such as electricity, local authority rates and some services, also rising sharply over the year.

Countering the strong non-tradables inflation have been outright price falls (deflation) in the tradables sector. The rapidly appreciating exchange rate over 2003, combined with strong competition in parts of the retail sector, has helped reduce prices for many imported goods. Heavy airfare discounting, particularly on trans-Tasman travel routes, has been a notable driver of the falling tradables inflation (figure 36). Annual tradables inflation turned around sharply in the
June quarter, as the lagged effects of the rapidly appreciating exchange rate in 2003 began to wane, and the effects of higher oil prices impacted on petrol prices.

The divergence between non-tradables and tradables inflation has also been evident in the National Accounts-based price measures that we monitor. While annual growth in the GDP deflator, conceptually one of the broadest measures of prices, has been increasing since late 2002, it has been somewhat subdued by falling New Zealand dollar export prices over that time. Indeed, if we exclude these prices – producing a measure of domestically-sourced inflation, similar to non-tradables inflation – inflation is currently much higher, sitting at just under 6 per cent (figure 38). By looking at the import price deflator from the National Accounts, we also get an alternative steer on imported inflation; like tradables inflation, this measure is currently sitting at very low levels.

A wide divergence between inflation in the tradables and non-tradables sectors makes underlying trends in the CPI difficult to identify. Nevertheless, we continue to monitor a range of indicators of ‘core’ inflation, in an attempt to ‘look through’ the effects of temporary, large movements in particular components of the CPI. The weighted median and trimmed mean measures – derived using statistical methods that exclude volatile items – have been rising recently, and currently both sit at 2.6 per cent (above headline CPI inflation) (figure 37).

Excluding known volatile items from the CPI can also provide us with some idea of underlying inflationary pressures. For instance, if we exclude the influence of international airfares (a component which has been particularly volatile recently), annual CPI inflation edged over 3 per cent in the June quarter of this year.

While these methods of determining underlying inflation are good at removing the effects of a few particularly volatile items from the CPI, they are inevitably influenced by the exchange rate, whose impact on prices is more pervasive. Thus, as mentioned in our June Statement, the recent sharp movements in the exchange rate have prompted us to consider non-tradables inflation as being a better indication of trend inflation at present (table 1, overleaf).
Generally speaking, the same trends that are driving consumers’ prices are also evident in producers’ prices (as measured by the Producers Price Indexes) (table 1). Namely, those industries most exposed to international trading conditions, such as the retail and export sectors, have experienced falling prices over the past couple of years, while those industries servicing domestically-oriented sectors, such as the construction and electricity sectors, have experienced rising prices.

### Inflation expectations

The price- and wage-setting decisions of households and firms are guided by inflation expectations and these expectations are guided, to a certain extent, by actual inflation outcomes. Temporary fluctuations in inflation can thus become ingrained into behaviour, affecting inflation over the medium term. Although inflation expectations are notoriously difficult to gauge (as they are not directly observable), surveyed expectations might provide some insight.

All of the surveyed measures of one year ahead inflation expectations that we monitor, including the National Bank’s Survey of Business Opinion (NBBO), the AON consulting survey (covering professional economists), and the RBNZ survey of expectations, have increased recently. While surveyed inflation expectations generally follow headline inflation quite closely, they are less volatile than actual inflation, highlighting a tendency for survey respondents to ‘look through’ inflation fluctuations that they deem to be temporary (figure 39). This has been particularly apparent over the past year, when the rising exchange rate and falling international airfares kept headline inflation temporarily low, while surveyed inflation expectations were rising. Surveyed expectations of inflation further into the future are more stable and have increased by a lesser extent than shorter-term expectations.

---

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

<table>
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<tr>
<th></th>
<th>2002</th>
<th></th>
<th>2003</th>
<th></th>
<th>2004</th>
<th></th>
</tr>
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<tbody>
<tr>
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<td>Mar</td>
<td>Jun</td>
<td>Sep</td>
<td>Dec</td>
<td>Mar</td>
</tr>
<tr>
<td>CPI</td>
<td>2.7</td>
<td>2.5</td>
<td>1.5</td>
<td>1.5</td>
<td>1.6</td>
<td>1.5</td>
</tr>
<tr>
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<td>0.0</td>
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<td>Housing</td>
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<tr>
<td>Household operations</td>
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<td>1.1</td>
<td>0.9</td>
<td>1.5</td>
<td>1.4</td>
</tr>
<tr>
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<td>0.8</td>
<td>-0.6</td>
<td>-1.1</td>
<td>-1.1</td>
<td>-1.0</td>
</tr>
<tr>
<td>Transportation</td>
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<td>4.3</td>
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<td>-2.5</td>
<td>-3.9</td>
<td>-4.6</td>
</tr>
<tr>
<td>Tobacco and alcohol</td>
<td>3.6</td>
<td>3.1</td>
<td>2.7</td>
<td>2.6</td>
<td>2.9</td>
<td>2.9</td>
</tr>
<tr>
<td>Personal and health</td>
<td>4.2</td>
<td>3.8</td>
<td>3.5</td>
<td>2.6</td>
<td>2.4</td>
<td>2.7</td>
</tr>
<tr>
<td>Recreation and education</td>
<td>2.5</td>
<td>2.7</td>
<td>2.1</td>
<td>1.7</td>
<td>1.6</td>
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<td>Credit services</td>
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**Derivatives and analytical series**

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<th>2003</th>
<th></th>
<th>2004</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CPI ex food, petrol and government charges</td>
<td>2.8</td>
<td>2.7</td>
<td>1.9</td>
<td>1.3</td>
<td>1.2</td>
<td>1.2</td>
</tr>
<tr>
<td>CPI non-tradables</td>
<td>3.9</td>
<td>3.4</td>
<td>3.8</td>
<td>4.1</td>
<td>4.6</td>
<td>5.0</td>
</tr>
<tr>
<td>CPI tradables</td>
<td>1.8</td>
<td>1.7</td>
<td>-0.6</td>
<td>-0.9</td>
<td>-1.3</td>
<td>-1.6</td>
</tr>
<tr>
<td>CPI weighted median (of annual price change)</td>
<td>3.3</td>
<td>3.7</td>
<td>2.6</td>
<td>2.3</td>
<td>1.9</td>
<td>2.1</td>
</tr>
<tr>
<td>CPI trimmed mean (of annual price change)</td>
<td>3.0</td>
<td>2.8</td>
<td>1.6</td>
<td>1.7</td>
<td>1.8</td>
<td>2.0</td>
</tr>
<tr>
<td>Merchandise import prices (excluding petrol)</td>
<td>-9.8</td>
<td>-13.8</td>
<td>-12.5</td>
<td>-11.5</td>
<td>-12.0</td>
<td>-10.4</td>
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<td>PPI - Inputs</td>
<td>-1.4</td>
<td>-1.3</td>
<td>-1.9</td>
<td>0.1</td>
<td>-0.1</td>
<td>-0.6</td>
</tr>
<tr>
<td>PPI - Outputs</td>
<td>-0.1</td>
<td>-0.4</td>
<td>-0.6</td>
<td>0.7</td>
<td>1.1</td>
<td>0.9</td>
</tr>
<tr>
<td>Private consumption deflator</td>
<td>1.6</td>
<td>1.4</td>
<td>0.7</td>
<td>0.6</td>
<td>0.3</td>
<td>0.7</td>
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<tr>
<td>GDP deflator (derived from expenditure data)</td>
<td>-1.2</td>
<td>-0.3</td>
<td>2.0</td>
<td>2.4</td>
<td>3.7</td>
<td>2.8</td>
</tr>
<tr>
<td>Retail trade deflator</td>
<td>1.0</td>
<td>1.4</td>
<td>-0.7</td>
<td>-0.7</td>
<td>-0.4</td>
<td>-0.6</td>
</tr>
</tbody>
</table>

**Source:** Statistics New Zealand, RBNZ estimates.
Firms’ pricing intentions can also provide insights into future inflationary pressures within the economy. The firms surveyed by the National Bank have generally intended to increase their prices recently, consistent with observed increases in their input costs (figure 40).

Figure 39
Inflation expectations (one year ahead) and CPI inflation (annual rate)

Figure 40
Pricing intentions and annual PPI inflation

4 The macroeconomic outlook

This chapter broadly describes our projections for economic activity, inflation, and interest rates over the coming years. In the near term, we expect activity in many sectors to remain strong for some months yet, as high house prices, a strong labour market, and favourable terms of trade lend support to households’ wealth and incomes. With strong economic activity coming at a time of significant strain on the economy’s productive resources, medium-term inflation pressures are likely to intensify. Underlying these projections is an assessment that higher interest rates will be required to ensure that medium-term inflation remains consistent with our policy target.

Further ahead, economic growth is expected to slow as the effects of a cooling housing market, lower net immigration, and higher interest rates dampen household spending, while the worsening terms of trade and the lagged effects of the high exchange rate impact on the external sector (see figure 6, Chapter 2).

CPI inflation is expected to rise to above 3 per cent next year, before falling gradually over 2006 and 2007, as pressures on productive resources ease. Relative to the June Statement, we are projecting lower inflation in the near term (mostly due to the higher exchange rate), but higher inflation in the medium term (see figure 10, Chapter 2).

The world economy

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

Global growth is expected to remain strong throughout 2004. There have been some concerns surrounding the likely pace of economic recovery in the US, following weak labour market data and continued high energy prices. However, the outlooks for Australia, Europe and Asia have continued to improve. On balance, the aggregate growth outlook for New Zealand’s trading partners has not changed materially since the June Statement (figure 41).

Consensus forecasts for world inflation have been revised up, but still remain at low levels. Rather than indicating the presence of generalised inflationary pressures, these revisions largely reflect the transitory effect of higher oil

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

<table>
<thead>
<tr>
<th>Country</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004f</th>
<th>2005f</th>
<th>2006f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>2.5</td>
<td>3.8</td>
<td>3.0</td>
<td>3.5</td>
<td>3.5</td>
<td>3.3</td>
</tr>
<tr>
<td>United States</td>
<td>0.8</td>
<td>1.9</td>
<td>3.0</td>
<td>4.4</td>
<td>3.6</td>
<td>3.6</td>
</tr>
<tr>
<td>Japan</td>
<td>0.4</td>
<td>-0.3</td>
<td>2.5</td>
<td>4.3</td>
<td>1.9</td>
<td>1.5</td>
</tr>
<tr>
<td>Canada</td>
<td>1.8</td>
<td>3.4</td>
<td>2.0</td>
<td>2.9</td>
<td>3.4</td>
<td>3.3</td>
</tr>
<tr>
<td>Eurozone**</td>
<td>1.6</td>
<td>0.9</td>
<td>0.5</td>
<td>1.8</td>
<td>2.1</td>
<td>2.3</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>2.3</td>
<td>1.8</td>
<td>2.2</td>
<td>3.3</td>
<td>2.6</td>
<td>2.0</td>
</tr>
<tr>
<td>Asia ex-Japan***</td>
<td>2.0</td>
<td>5.1</td>
<td>4.8</td>
<td>6.8</td>
<td>5.8</td>
<td>6.0</td>
</tr>
<tr>
<td>12 Country Index</td>
<td>1.6</td>
<td>2.6</td>
<td>2.9</td>
<td>4.2</td>
<td>3.5</td>
<td>3.5</td>
</tr>
</tbody>
</table>

* Source: Consensus Economics Inc.  
** Includes Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain.  
*** Includes China, Hong Kong, Malaysia, Singapore, South Korea and Taiwan.
prices. Underlying these Consensus forecasts for economic growth and inflation is an assumption that oil prices will fall from current high levels.

The tradables sector
As mentioned in Chapter 3, New Zealand’s terms of trade have continued to improve, as world prices for our commodities have risen further. The terms of trade are now expected to moderate toward the end of the year (figure 42). Furthermore, the current account balance is expected to deteriorate as the exchange rate dampens net exports.

Figure 42
Terms of trade

World export prices
World prices of New Zealand’s exports have risen very strongly over the past year, mainly due to strong international demand and tight international supply conditions. Indications are that these factors will remain largely in place for the remainder of 2004, continuing to support world export prices. Further ahead, we expect moderation in world prices as overseas production of some of our products increases.

Exchange rate
The exchange rate has risen in recent months, leaving the TWI 5 per cent higher than the level assumed in the June Statement. Our technical assumption is for the trade-weighted exchange rate to remain around its current level for some months yet, before gradually reverting towards its long-term average level (figure 43).

Export volumes
Overall, export volumes are set to remain at their current high levels for the remainder of 2004, but we are projecting only moderate growth in 2005, reflecting the lagged effects of the high exchange rate (figure 44). This strong volumes picture, combined with strong prices, will ensure that exporters’ incomes remain healthy despite the high exchange rate.

Figure 44
Export volumes

We expect some export sectors to fare better than others.
• Manufactured exports have grown strongly recently. Very strong imports of plant and machinery investment goods, and a relatively good outlook for demand coming from Australia, are factors that suggest this strength will continue going forward.
• Our projections for primary exports rely heavily on the advice of various primary sector agencies and...
companies. The recent strength in the volume of primary sector exports appears to be due to a rundown of high stock levels in the dairy export sector, and high levels of beef and lamb slaughter at the start of 2004. Going forward, we expect primary export volumes to fall to more normal levels.

- **Forestry export** volumes are projected to remain quite weak until 2005, largely because of low world prices for logs and high shipping costs.
- We expect strong growth in **exports of services** to continue this year, as tourist numbers increase post-SARS. Further ahead, we expect a return to moderate growth in exports of services.

**Import prices**

World prices for many of our imports have been rising, with oil being the most obvious example. The world price of oil has increased strongly over recent months due to supply uncertainties and strong demand, and there are no real signs of these price-positive factors easing in the near term. We have adopted an assumption that oil prices will remain high for some months yet, before declining gradually to more normal levels further ahead. However, there is a risk that high oil prices will persist for longer, with potential knock-on effects to global growth prospects.

Strong demand, most notably out of China, but increasingly from other industrial economies, is expected to underpin increases in the world price of non-oil imports. This will outweigh the effect of falling oil prices on the terms of trade. Our overall projection for a deterioration in the terms of trade reflects strong increases in world import prices, plus the gradual fall in export prices outlined above.

**Import volumes**

The past year has seen a significant increase in the growth of import volumes, reflecting continued strength in the domestic economy. In addition, the high exchange rate has seen consumers and businesses alike take advantage of the higher purchasing power of the New Zealand dollar. We project that imports of capital goods will continue to underpin strong import volumes, as firms continue to invest in labour-saving capital and expand their productive capacity. Further ahead, import volume growth is projected to moderate as the pace of the domestic economy slows and the exchange rate falls (figure 45).

**Figure 45**

Import volumes

\[
\text{(\% of trend output)}
\]

Source: Statistics New Zealand, RBNZ estimates.

**Household spending**

**Consumption spending**

Household consumption is projected to remain robust over most of 2004. Household incomes have been supported by the high terms of trade and strong labour incomes, while house price inflation has boosted household wealth. Further ahead, consumption growth is expected to slow as these supporting factors moderate and interest rates rise (figure 46).

The very strong house price inflation cycle over recent years now appears to be past its peak, possibly as a result of slowing net immigration. Recent developments suggest...
that net immigration is likely to continue falling, particularly as overseas job markets continue to improve (figure 47). As a consequence, we project that house price inflation will slow markedly over the coming years (figure 48). This is expected to moderate household consumption through falling household wealth.

**Figure 47**
Net immigration
*(annual total)*

**Figure 48**
Annual house price inflation

Residential investment

Strong net immigration over recent years precipitated a flurry of residential construction activity, which is continuing apace. We project that residential investment will remain very strong in the near term. However, the residential investment cycle is probably past its peak, and we are projecting declines going forward (figure 49). Much of the labour and capital that is freed up as a consequence of this slowdown will be needed for non-residential construction activity and infrastructural developments, meaning that very tight resource constraints in the construction sector are not likely to ease any time soon.

**Figure 49**
Residential investment
*(% of trend output)*

Labour market

Labour market tightness is likely to continue supporting household incomes for some time yet – both directly through more employment, and indirectly through wage inflation. Even with unemployment hitting a 17-year low of 4 per cent, we believe that the strong economy will support further employment growth. We project unemployment to remain low for quite some time, before increasing in the later years of the projection (figure 50). It remains to be seen how much longer wage growth will remain moderate with such low rates of unemployment.

**Figure 50**
Unemployment rate

Business investment

Robust demand both domestically and abroad, coupled with the high exchange rate, has been encouraging strong investment in new capital. We project further strong growth in business investment over 2004, as ongoing labour
shortages and the possibility of rising wage rates encourage investment in labour-saving capital. Further ahead, business investment is projected to slow with the economic cycle (figure 51).

**Figure 51**

**Business investment**

(annual average percentage change)

![Business investment graph](image)

Source: Statistics New Zealand, RBNZ estimates.

**Inflation and monetary policy**

Based on our projections, our assessment is that medium-term inflation pressures have intensified since the June Statement was published. While we still expect tradables inflation to rise, the projected turnaround is now more modest than we expected in June, due to the higher exchange rate. As a result, annual CPI inflation is projected to peak slightly lower and later than we projected in June (see figure 10, Chapter 2).

Our central view is that non-tradables inflation will moderate from its current high level, as the pace of economic activity slows. However, the robustness in economic activity that we expect throughout this year comes at a time when productive resources are already very stretched, suggesting that medium-term inflationary pressures will be more persistent than we previously expected. Accordingly, higher interest rates are likely to be needed to ensure that inflation remains consistent with our policy target.

**Fiscal policy**

Our projection for the contribution that the government’s fiscal operations are likely to make to economic activity is based on the Treasury’s Budget Economic and Fiscal Update (BEFU). The increased expenditure announced in last June’s BEFU will provide some stimulus to the domestic economy in the later years of this projection – and there is a risk that expenditure could be higher than the BEFU has allowed for, particularly in the area of infrastructure spending. However, the stimulatory impact of higher expenditure is likely to be partially offset by increased tax revenues due to higher nominal GDP growth.
**Appendix 1**

**Summary tables**

**Table A**

CPI inflation projections and monetary conditions  
(*CPI is in percentage changes*)

<table>
<thead>
<tr>
<th>Year</th>
<th>Quarter</th>
<th>CPI* Quarterly</th>
<th>CPI** Annual</th>
<th>TWI</th>
<th>90-day bank bill rate</th>
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<tr>
<td>1998</td>
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<tr>
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<td>56.7</td>
<td>4.8</td>
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<tr>
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<td>2.0</td>
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</tr>
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<td>49.8</td>
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</tr>
<tr>
<td></td>
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<td>50.0</td>
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<td></td>
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<td>54.6</td>
<td>5.8</td>
</tr>
<tr>
<td></td>
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<td>2.6</td>
<td>53.9</td>
<td>5.9</td>
</tr>
<tr>
<td></td>
<td>Dec.</td>
<td>0.6</td>
<td>2.7</td>
<td>56.4</td>
<td>5.9</td>
</tr>
<tr>
<td>2003</td>
<td>Mar.</td>
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<td>2.5</td>
<td>60.6</td>
<td>5.8</td>
</tr>
<tr>
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<td>61.1</td>
<td>5.4</td>
</tr>
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<td>1.5</td>
<td>62.4</td>
<td>5.1</td>
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<tr>
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<td>63.9</td>
<td>5.3</td>
</tr>
<tr>
<td>2004</td>
<td>Mar.</td>
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<td>1.5</td>
<td>66.9</td>
<td>5.5</td>
</tr>
<tr>
<td></td>
<td>Jun.</td>
<td>0.8</td>
<td>2.4</td>
<td>64.0</td>
<td>5.9</td>
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Quarterly projections

<table>
<thead>
<tr>
<th>Year</th>
<th>Quarter</th>
<th>CPI* Monthly</th>
</tr>
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<tbody>
<tr>
<td>2003</td>
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</tr>
<tr>
<td>2004</td>
<td>Mar.</td>
<td>0.4</td>
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<tr>
<td></td>
<td>Jun.</td>
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<tr>
<td></td>
<td>Sep.</td>
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<tr>
<td></td>
<td>Dec.</td>
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</table>

---

**Notes for these tables follow on pages 28-29.**

* 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 percentage change, unless specified otherwise)*

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<td><strong>Final consumption expenditure</strong></td>
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<td><strong>Total</strong></td>
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<td><strong>Total</strong></td>
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<td>Exports of goods and services</td>
<td>3.9</td>
<td>3.1</td>
<td>7.3</td>
<td>5.3</td>
<td>2.3</td>
<td>7.4</td>
<td>1.1</td>
<td>5/4</td>
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<tr>
<td>Imports of goods and services</td>
<td>2.6</td>
<td>2.1</td>
<td>11.5</td>
<td>-0.2</td>
<td>2.4</td>
<td>9.3</td>
<td>12.1</td>
<td>10/4</td>
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<td>4.1</td>
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<tr>
<td><strong>GDP (production)</strong></td>
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<td>4.8</td>
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<td>3.3</td>
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<tr>
<td>GDP (production, March qtr to March qtr)</td>
<td>0.2</td>
<td>2.5</td>
<td>5.7</td>
<td>1.2</td>
<td>3.9</td>
<td>4.2</td>
<td>4.8</td>
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<td><strong>Potential output</strong></td>
<td>2.9</td>
<td>2.5</td>
<td>2.5</td>
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<td>3.1</td>
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<tr>
<td>Output gap (% of potential GDP, year average)</td>
<td>0.1</td>
<td>-1.9</td>
<td>0.3</td>
<td>0.2</td>
<td>0.3</td>
<td>1.2</td>
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<td>1/4</td>
<td>1/4</td>
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(1) Percentage point contribution to the growth rate of GDP.
### Table C

**Summary of economic projections**

*(Annual percentage change, unless specified otherwise)*

<table>
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<th>March year</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
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<td>CPI*</td>
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<td>2.2</td>
<td>2.1</td>
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<td>Import prices (in New Zealand dollars)</td>
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<td>2.7</td>
<td>11.2</td>
<td>7.4</td>
<td>-2.9</td>
<td>-11.1</td>
<td>-10.4</td>
<td>6/4</td>
<td>5/4</td>
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<td>Export prices (in New Zealand dollars)</td>
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<td>-0.6</td>
<td>9.9</td>
<td>20.6</td>
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<td>90-day rate (year average)</td>
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<td>6.6</td>
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<td>TWI (year average)</td>
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<tr>
<td>GDP (production, annual average % change)</td>
<td>1.5</td>
<td>0.4</td>
<td>4.8</td>
<td>2.7</td>
<td>3.3</td>
<td>4.4</td>
<td>3.6</td>
<td>4</td>
<td>2</td>
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<tr>
<td>GDP (production, March qtr to March qtr)</td>
<td>0.2</td>
<td>2.5</td>
<td>5.7</td>
<td>1.2</td>
<td>3.9</td>
<td>4.2</td>
<td>4.8</td>
<td>2/4</td>
<td>2</td>
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<tr>
<td>Output gap (% of potential GDP, year average)</td>
<td>0.1</td>
<td>-1.9</td>
<td>0.3</td>
<td>0.2</td>
<td>0.3</td>
<td>1.2</td>
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<td>Total employment</td>
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<td>2.3</td>
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<td>1.5</td>
<td>3.1</td>
<td>1/4</td>
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<td>Unemployment rate (March qtr, s.a.)</td>
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<td>7.1</td>
<td>6.3</td>
<td>5.4</td>
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<td>4.9</td>
<td>4.3</td>
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<td>4/4</td>
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<td>Trend labour productivity (annual % change)</td>
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<td>1.5</td>
<td>1.4</td>
<td>1.4</td>
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<tr>
<td>Government operating balance (% of GDP, year to June)</td>
<td>2.5</td>
<td>1.7</td>
<td>1.3</td>
<td>1.2</td>
<td>1.9</td>
<td>1.5</td>
<td>4/4</td>
<td>4/4</td>
<td>3/4</td>
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<tr>
<td>Current account balance (% of GDP, year to March)</td>
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<td>-4.2</td>
<td>-6.5</td>
<td>-4.1</td>
<td>-2.2</td>
<td>-3.3</td>
<td>-4.2</td>
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<td>Terms of trade (OTI measure, annual average % change)</td>
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<td>-0.2</td>
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<td>4.2</td>
<td>-5.7</td>
<td>3.9</td>
<td>2/4</td>
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<tr>
<td>World GDP (annual average % change)</td>
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<td>2.0</td>
<td>4.2</td>
<td>3.7</td>
<td>1.4</td>
<td>2.9</td>
<td>3.3</td>
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<td>1.4</td>
<td>2.2</td>
<td>1.5</td>
<td>2/4</td>
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</table>

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 Consensus Forecasts. Seasonally adjusted.

World CPI inflation
RBNZ definition and estimate. TWI trading partners’ CPI inflation (euro-zone proxied by Germany), weighted by TWI weights. Projections based on Consensus Forecasts.

Import prices
Domestic currency import prices. Overseas Trade Indexes.

Export prices
Domestic currency export prices. Overseas Trade Indexes.

Terms of trade
Constructed using domestic-currency export and import prices. Overseas Trade Indexes.

Private consumption
System of National Accounts.

Public authority consumption
System of National Accounts.

Residential investment

Business investment
RBNZ definition. Total investment less the sum of non-market investment and residential investment. System of National Accounts.

Non-market investment
RBNZ definition. The System of National Accounts annual nominal government non-market/market investment ratio is interpolated into quarterly data. This ratio is used to split quarterly expenditure GDP government investment into market and non-market components.

Final domestic expenditure
RBNZ definition. The sum of total consumption and total investment. System of National Accounts.

Stockbuilding
Percentage point contribution to the growth of GDP by stocks. System of National Accounts.

Gross national expenditure

Exports of goods and services
System of National Accounts.

Imports of goods and services
System of National Accounts.

GDP (production)
System of National Accounts.

Potential output

Output gap
RBNZ definition and estimate. The percentage difference between real GDP (production, seasonally adjusted) and potential output GDP.

Current account balance
Balance of Payments.

Total employment
Household Labour Force Survey.

Unemployment rate
Household Labour Force Survey.

Household savings rate
Household Income and Outlay Accounts.
<table>
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<th>Indicator</th>
<th>Description</th>
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<td>Government operating balance</td>
<td>Historical source The Treasury. Adjusted by the RBNZ over the projection period.</td>
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<td>Labour productivity</td>
<td>The series shown is the annual percentage change in a trend measure of labour productivity. Labour productivity is defined as GDP (production) divided by HLFS hours worked.</td>
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<tr>
<td>Wages</td>
<td>Private sector all salary and wage rates. Labour Cost Index.</td>
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<td>Quarterly percentage change</td>
<td>((\text{Quarter}/\text{Quarter}_{-1} - 1)*100)</td>
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<tr>
<td>Annual percentage change</td>
<td>((\text{Quarter}/\text{Quarter}_{-4} - 1)*100)</td>
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<tr>
<td>Annual average percentage change</td>
<td>((\text{Year}/\text{Year}_{-1} - 1)*100)</td>
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</table>

Source: Unless otherwise specified, all data conform to Statistics New Zealand definitions, and are not seasonally adjusted. Rounding: Unless otherwise specified, all projection data are rounded to the nearest quarter per cent.
Appendix 2
Chronology

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

2004
10 June  The Reserve Bank released its forty-second Monetary Policy Statement, increasing the Official Cash Rate from 5.5 per cent to 5.75 per cent. The news release accompanying the Statement is reproduced in Appendix 4.

25 June  Production GDP figures were released showing that the New Zealand economy grew by 2.3 per cent in the March quarter of 2004.

15 July  CPI statistics were released for the June quarter of 2004 showing that the CPI increased by 0.8 per cent over the quarter, and by 2.4 per cent in the year to June 2004.

29 July  At the intra-quarter review, the Reserve Bank increased the Official Cash Rate from 5.75 per cent to 6.0 per cent. The accompanying news release is reproduced in Appendix 4.
Appendix 3
Companies and organisations contacted by RBNZ staff during the projection round

APN New Zealand National Publishing Ltd  LWR Industries Ltd
Ashburton Implement Services Ltd  Lyttelton Engineering Ltd
Auckland Chamber of Commerce  Lyttelton Port Company Ltd
Axiam Group Ltd  Mace Group of Companies
Bayleys Real Estate Limited  Macpac Wilderness Equipment Ltd
Bell-Booth Ltd  Mainzeal Property & Construction Ltd
BP Oil NZ Ltd  Meco Engineering Company Ltd
Briscoes (New Zealand) Limited  Methanex New Zealand Ltd
Business New Zealand  Nelson Pine Industries Ltd
Canterbury Confectionery Limited  Nissan New Zealand Limited
Canterbury Electronics Group  NZ King Salmon Company Ltd
Canterbury Employers Chamber of Commerce  Port of Nelson Ltd
Canterbury Manufacturers’ Association  Repco Ltd
Canterbury Meatpackers Ltd  Restaurant Brands NZ Ltd
Cerebos Gregg’s Limited  South Pacific NZ Tyres Ltd
Christchurch International Airport  Steel & Tube Holdings Ltd
Clelands Construction Ltd  Suzuki New Zealand Ltd
Click-Clack Industries Ltd  Taranaki Sawmills Ltd
Collins Mitre 10 Ltd  Telecom New Zealand Ltd
Comalco New Zealand Ltd  Tenon Ltd
Electricity Ashburton Ltd  Tourism Auckland
Employers & Manufacturers Association  Tourism Nelson Tasman Ltd
Export Institute of New Zealand Inc  Toyota New Zealand Ltd
Fairfax New Zealand Ltd  Turners & Growers Ltd
Farmers Mutual Ltd  United Fisheries Ltd
Farmers Trading Co Ltd  Vector Limited
Fonterra Cooperative Group  Vision Manawatu Ltd
Foodstuffs (Wellington) Co-operative Society Ltd  Wanganui Gas Ltd
Freight & Bulk Transport Ltd  Wanganui Newspapers Ltd
Frukor Beverages Ltd  Zespri Ltd
Genesis Power Ltd
Giibbons Holdings Ltd
Holcim (New Zealand) Ltd
Hooker Bros Holdings Ltd
K-Mart New Zealand

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 4

Reserve Bank statements on Monetary Policy

OCR increased to 5.75 per cent
10 June 2004

The Reserve Bank today increased the Official Cash Rate from 5.5 to 5.75 per cent.

Speaking at the release of the Reserve Bank’s June 2004 Monetary Policy Statement, Reserve Bank Governor Alan Bollard said “The New Zealand economy has enjoyed strong growth over an extended period. For some time, we have been expecting growth to slow due to a range of factors such as the high exchange rate and declining population growth. But activity has continued to prove stronger than expected, and stretched productive resources have caused inflation pressures to increase across a range of industries.

“There remain compelling reasons to expect that momentum in the economy will slow. However, improvements in global demand, rising commodity export prices, and the recent fall in the exchange rate to a less contractionary level point to stronger activity than we projected in March. Moving interest rates higher is thus appropriate to ensure that medium-term inflation remains within the target range. At this stage, further increases in interest rates look likely to be needed over the year ahead, but to a modest degree by historical standards.

“Although we expect medium-term inflation to remain consistent with the target range, the recent decline in the exchange rate and higher oil prices mean that we are now projecting annual inflation to rise temporarily above 3 per cent in 2005. This would not be a breach of the Policy Targets Agreement, as the Bank is now required to keep inflation between 1 and 3 per cent “on average over the medium term”. Given that inflation is expected to fall in a reasonable time frame, it would not be appropriate to attempt to offset this short-term increase in inflation using monetary policy. However, we will need to remain alert to signs of more enduring effects that could arise if wage or price setting behaviour starts to change.
Were that the case, additional monetary policy pressure might be required to keep medium-term inflation pressures in check.

“We will continue to update our view of inflation pressures and the policy outlook, as new data come to hand.”

OCR increased to 6.00 per cent
29 July 2004

The Reserve Bank today increased the Official Cash Rate from 5.75 per cent to 6.00 per cent.

Reserve Bank Governor Alan Bollard said “Today's OCR increase reflects a continued buoyant economy that is placing considerable strain on resource capacity and hence leading to inflation pressures. This broad assessment and policy decision remains consistent with our June Monetary Policy Statement.

“Overall, the domestic economy remains strong. Labour markets remain tight, and productive resources are stretched. However, as we have projected for some time now, there are signs of a slowing in some domestic sectors.

“There has been positive news on the export front. Commodity prices have been rising and export incomes are improving. This is despite the continued strength and volatility in the New Zealand dollar.

“It appears that current economic strength may be maintained for longer than we anticipated in June and it could add to price pressures. Further tightening of monetary policy looks likely to be necessary.”
Appendix 5
The Official Cash Rate chronology

<table>
<thead>
<tr>
<th>Date</th>
<th>OCR (per cent)</th>
<th>Date</th>
<th>OCR (per cent)</th>
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<td>4.50</td>
<td>6 March 2003</td>
<td>5.75</td>
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<td>21 April 1999</td>
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<td>19 May 1999</td>
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<td>18 August 1999</td>
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## Appendix 6

### 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 2004.

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
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<tr>
<td>Thursday 28 October 2004</td>
<td>OCR announcement</td>
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<tr>
<td>Thursday 9 December 2004</td>
<td><em>Monetary Policy Statement</em></td>
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<td>Thursday 27 January 2005</td>
<td>OCR announcement</td>
</tr>
<tr>
<td>Thursday 10 March 2005</td>
<td><em>Monetary Policy Statement</em></td>
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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 7
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