Monetary Policy Statement¹

June 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 7
4. Financial market developments 17
5. The macroeconomic outlook 20

Appendices
A. Summary tables 26
B. Chronology 31
C. Companies and organisations contacted during the projection round 32
D. Reserve Bank statements on monetary policy 33
E. The Official Cash Rate chronology 36
F. Upcoming Reserve Bank Monetary Policy Statement and Official Cash Rate release dates 37
G. Policy Targets Agreement 38

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¹ Projections finalised on 31 May 2005, Policy assessment finalised on 8 June 2005.
1 Policy assessment

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

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.

Alan Bollard
Governor
Overview and key policy judgements

The New Zealand economy has expanded rapidly over the past four years, placing pressure on productive resources. We continue to project a slowdown in growth during 2005. However, even allowing for this slowdown, we expect to see inflation outcomes close to 3 per cent over the next two years, providing monetary policy with very little headroom. Recent data suggest that growth is beginning to moderate, but not as quickly as projected in our March Statement. Thus the outlook for medium-term inflation pressures is a little stronger than we thought. As stated in March, and again following our April OCR review, the current outlook offers no scope for an easing of policy in the foreseeable future, and further policy tightening cannot be ruled out.

Retail spending in the March quarter was stronger than expected.

The period of intense competition in the home lending market late last year, recent changes to building regulations and an increased building levy have made recent housing market trends difficult to interpret. While the housing market has softened, it has not slowed to the extent we had expected. In particular, indicators of housing demand have been a little stronger than expected, with house sales, house prices, the median days to sell a house, and household borrowing all remaining robust over the early months of 2005.

Employment growth was flat during the March quarter and the unemployment rate increased slightly. However, the labour market remains tight.

Data on business sector activity and the external sector have generally been more mixed:

- Businesses' assessment of their own activity prospects for the next 12 months (as reflected in the National Bank Business Outlook) have eased substantially in recent surveys. These assessments are broadly consistent with our projections of a slowing in growth. General business confidence measures have fallen more substantially, in some cases to near-record lows. In our assessment, these declines overstate the extent of the economic slowdown we could see over the near term.

- Imports, particularly of investment goods, have remained strong suggesting that business investment will remain at high levels over the coming months.

- Indicators of activity in the construction sector remain strong, suggesting a further increase in non-residential building activity.

- Commodity export prices in world markets have moved to higher levels than expected, although the stronger prices have been largely limited to beef and lamb.

- There has been some further downward revision to the outlook for trading partner growth, although the changes have been marginal.

On the inflation front, although CPI inflation in the March quarter was weaker than expected, the lower result was due entirely to a fall in international airfares. This aside,
inflation pressures (particularly in the non-tradables sector) were marginally stronger than expected. The evidence continues to suggest that wage pressures are intensifying. At the same time, business surveys and many of our recent business contacts have pointed to significant cost pressures, which some businesses may not be able to fully absorb.

Reflecting these developments, underlying inflation pressures in our updated projections in Chapter 5 are marginally stronger and the assumed outlook for short-term interest rates is correspondingly marginally higher. A high New Zealand dollar, a decline in the terms of trade over the coming year, slower population growth and the lagged effects of the previous tightening in monetary policy are projected to place a brake on activity over the year ahead. Some components of aggregate demand – most notably household demand – hold up at marginally stronger levels in the near-term, reflecting recent stronger data. Further out, we are incorporating a slightly stronger stimulus from fiscal policy following the recent Budget. Inflation remains close to 3 per cent for much of the projection period, but eases later in the horizon reflecting the effects of slower growth.

Box 1
Review of monetary policy decisions

In response to strong domestic activity and increasing pressure on resources and prices, the Official Cash Rate (OCR) was gradually increased over 2004, from 5.0 per cent to 6.5 per cent. The OCR was left unchanged between October 2004 and January 2005, as the Bank judged the pipeline effects of previous interest rate increases and the high exchange rate would act to keep inflation within the 1 to 3 per cent target band over the medium term. However, it was noted that with inflation expected to remain near the top of the band, there was little headroom to absorb stronger-than-expected inflation pressures.

At the time of the March 2005 Statement, the outlook for economic activity and medium-term inflation pressures was stronger than previously anticipated, and the OCR was increased to 6.75 per cent. Although policy was left on hold at the subsequent April interim review, inflation pressures were judged to be at least as strong as in March. Accordingly the Bank noted that further policy tightening could not be ruled out and that the current outlook offered no scope for any easing of policy in the foreseeable future.
Monetary policy judgements

Section 2 of the Policy Targets Agreement (PTA) requires the Bank to keep inflation within the 1 to 3 per cent inflation target band on average over the medium term. The Chapter 5 projection suggests that this obligation will be met, albeit with the possibility of a further policy tightening over the coming months. However, there are clearly risks that inflation pressures prove stronger or weaker than projected. Upside surprises to inflation could occur if the slowdown in activity is further delayed or if we have under-estimated the degree of inflation persistence in the economy. Conversely, inflation could fall away more quickly due to factors such as unexpected weakness in external demand or commodity prices, or a more pronounced slowing in household spending connected with the projected downturn in the housing market.

Although the risks to the outlook for economic activity appear to be reasonably even, we consider that the balance of risks around the inflation outlook is on the upside. The Bank continues to have little headroom to absorb upside inflation surprises. Consequently, evidence of stronger-than-expected inflation pressures would likely require a further policy tightening. Conversely, weaker-than-expected inflation pressures would only create scope for easier policy if it became clear that inflation was likely to head into the lower part of the target band.

In Box 2, we present a scenario in which cost pressures associated with the tight labour market and high capacity utilisation, and a more gradual slowdown in GDP growth, create stronger-than-expected inflation pressures. Projected annual inflation is pushed significantly above 3 per cent during 2006. With no headroom to absorb these pressures, further tightening in monetary policy would be required to ensure the Bank’s section 2 obligations under the PTA were met.

Although growth is stronger in this scenario than in the central projection, it does still slow over 2005. The point to note here is that simply seeing evidence of a slowing in growth over the coming months will not automatically imply that easier policy settings can be adopted, given the substantial build-up of inflation pressures to date. What matters is how those inflation pressures are evolving relative to our projections, which will depend on a range of factors including the timing and magnitude of the economic slowdown.

In the second scenario in Box 2, we have modelled the effects of lower inflation arising from a faster slowdown in activity than in the central projection. Under this scenario, the scope to ease monetary policy significantly is limited as inflation continues to reside in the upper range of the target band.

Another set of judgements that we have had to confront concern our obligation under section 4b of the PTA to conduct monetary policy in a manner that avoids unnecessary instability in output, interest rates and the exchange rate. With some signs to hand in recent months that the economy is entering a cyclical downturn, we are conscious that inappropriate monetary policy settings could potentially exacerbate the downturn. Although a sharper downturn would not necessarily generate inflation outcomes inconsistent with the policy target, we have an obligation to avoid unnecessary volatility in the economy. The judgements here are difficult because not responding to inflation pressures on the grounds of avoiding economic volatility can potentially create the need for more aggressive policy action later if inflation proves stronger than expected. Such actions could ultimately have a more disruptive effect on output, interest rates or the exchange rate.

We have also had to reach a judgement on the effects of the previous tightening in monetary policy and the high exchange rate, which are yet to fully work their way through into economic activity and inflation. Our view is that there is still a significant tightening effect in the pipeline and our projections take this into account. However, the timing and magnitude of these effects remain uncertain.

Overall, these considerations have led us to similar conclusions to those delivered in our March Statement and the OCR review in April. The current outlook provides no scope for a policy easing in the foreseeable future. And further policy tightening could still be required given the very limited headroom to absorb upside inflation surprises.
Box 2

Alternative scenarios

Our central projection is always subject to risks that must be considered in policy judgements. As in the March Statement, we show two stylised scenarios representing key risks to our current central projection.

Scenario 1

More momentum in the economy and stronger inflation pressure

Under this ‘upside’ scenario, household consumption and economic growth hold up for longer over 2005. We also allow for more pass-through into inflation arising from firms’ rising input costs. This is plausible given ongoing labour market tightness and capacity constraints. We assume:

• That consumption is higher, resulting in annual GDP growth over calendar 2005 that is around 0.5 percentage points higher than in the central scenario.

• A higher pass-through from cost pressures, which adds around 0.3 percentage points to annual CPI over 2006 and 2007.

Given these assumptions, inflation rises significantly above 3 per cent in 2006 and remains high. In this scenario, tighter monetary policy would be required to bring inflation comfortably inside the target range over the medium term.

Scenario 2

More abrupt economic slowdown

Under this ‘downside’ scenario, we assume that GDP growth is around 1 percentage point lower than expected over 2005 due to a weakening in household demand. Given this assumption CPI inflation remains comfortably inside the band and the projected interest rate profile is only marginally lower.

Figure 2.5

CPI inflation (annual rate)

Figure 2.6

90-day rates

Source: Statistics New Zealand, RBNZ estimates.

Source: RBNZ estimates.
Overview

The New Zealand economy grew rapidly over 2004, with annual average GDP growth of 4.8 per cent. The economy was well supported by strength in the domestic sector with consumption, residential investment and business investment all growing significantly.

GDP growth over the latter half of 2004 was weaker than expected, with much of this weakness reflecting lower construction activity. This weakness is expected to be temporary as indicators of non-residential construction (such as non-residential building consents and cement sales) remain at high levels. The economy is expected to remain robust over early-2005, with GDP growth of 1 per cent expected for the March quarter, underpinned by strong consumption and business investment growth.

Strong growth over the past few years has stretched productive resources leading to strong inflationary pressures. Since late 2003, annual non-tradables inflation has been above 4 per cent, and over the past 12 months, price increases have become more broad-based. However, headline CPI inflation has been kept in check by the rising exchange rate, which has dampened tradables sector inflation. Over the past 12 months, the pace of exchange rate appreciation has moderated and tradables inflation has accelerated. As a result, annual CPI inflation has risen from a low of 1.5 per cent in early 2004 to 2.8 per cent in the year to March 2005.

Global economic developments

In the US, GDP grew by 3.7 per cent in the year to March. Most evidence points towards a positive outlook for consumer spending, supported by improving labour market conditions and a buoyant housing market. The outlook for the business sector is more mixed. Investment intentions and profitability remain high, although weaker readings for some business sentiment indicators and a deceleration in industrial production growth point to slightly less favourable business conditions. Higher energy prices have lifted headline inflation. Core inflation measures have also crept up over the past year, but remain contained. Short-term interest rates have risen as the Federal Reserve continues with its ‘measured’ tightening of monetary policy, although long-term interest rates remain low.

Large increases in consumer spending and private investment contributed to the 1.3 per cent quarterly increase in Japanese GDP, although this is likely to be a rebound from the special factors which depressed spending late last year. A larger-than-expected fall in the GDP deflator also contributed to the result and as concerns over deflation have lingered, the Bank of Japan has reaffirmed current loose monetary policy settings. Other indicators, such as industrial production, point to more moderate rates of growth.

Growth in China continues to outpace others in the region, with 9.4 per cent annual growth in the March year. Export performance was particularly strong and has contributed to large current account surpluses. Growth in other components of demand was solid, although there are tentative signs that measures by the authorities to slow fixed investment growth might be having an effect. Chinese CPI inflation eased to 1.8 per cent in April, largely reflecting lower food prices. The pace of export growth in other Asian countries has eased, but this is being offset by stronger domestic demand readings.

In the Euro area, growth has remained subdued. Measures of business and consumer confidence have eased and suggest slowing momentum over the year ahead. Consumer spending remains weak, weighed down by soft labour market conditions and high energy prices. Inflation has been temporarily affected by higher fuel costs but is expected eventually to fall below 2 per cent. Similar activity and inflation trends are evident in the UK. Inflation in the UK is expected to remain contained, once the effects of high oil prices and non-labour input costs abate. The pace of consumer spending in the UK has slowed in recent months, as the housing market continues to ease.

Domestic demand pressures in Australia appear to have eased. In its May Statement, the Reserve Bank of Australia (RBA) noted that if demand pressures continued to ease, firms may absorb some increasing cost pressure into their margins, limiting the pass-through into consumer prices. Although this may reduce some of the upside risk to inflation, inflation is still likely to rise gradually to the top of
the 2-3 per cent target band by the end of next year. There remain areas of infrastructure and labour market constraint despite strong investment to alleviate supply bottlenecks.

International oil prices have been volatile. After rising sharply, oil prices have eased in recent weeks, but still remain at high levels in US dollar terms. Part of the recent fall in oil prices is due to the build-up of US inventories. Strong global demand for oil and tight capacity constraints are expected to keep oil prices high for some time.

**Tradables sector activity**

Over the past few years the rising exchange rate has dampened income in some parts of the export sector. However, increasing commodity prices have meant that export incomes generally have remained relatively robust. At the same time, import volumes have grown significantly, supported by strong domestic demand.

World prices for our commodity exports soared to record highs in 2004 in response to tight international supplies for some of our key commodities (such as beef, lamb and dairy products) and strong global demand (figure 3.1). Over the early months of 2005, international commodity prices have continued to rise, particularly for beef and lamb. International log prices, however, remain at low levels with log exporters also facing higher shipping costs.

New Zealand dollar prices for our commodity exports have been more subdued than world prices because of the dampening effect of the high exchange rate. However, New Zealand dollar commodity prices remain at above-average levels.

Primary export volumes have continued to trend up over recent years (figure 3.2), supported by good international demand for dairy, beef and lamb. Primary export volumes were volatile over 2004 and dipped significantly in the September quarter with only a partial correction in December. The September dip was largely caused by a timing-related fall in dairy exports, while weak meat exports in December due to slaughter delays meant that primary export volumes did not fully recover.

**Figure 3.2**

**Primary export volumes**

(quarterly total)

Source: Statistics New Zealand.

Total non-commodity export volumes experienced robust growth over 2004, despite a higher exchange rate and cheaper ‘third country’ competition (figure 3.3). The strength in non-commodity exports was driven by large volume gains in machinery and transport equipment exports. However, in general non-commodity exports have been affected more by the high TWI than primary exports as they have not benefited from high world commodity prices.

Total exports of services grew strongly over 2004 underpinned by significant increases in visitor arrivals (figure 3.4). However, growth in tourist spending has been moderate because the spend-per-tourist has fallen. The spend-per-tourist has been affected both by a compositional increase in Australian tourists (who traditionally spend less
Import prices have declined considerably over the past five years, predominantly due to the rising exchange rate, although low inflation amongst our trading partners has also had some impact (figure 3.5). Over 2004, however, the downward pressure on import prices eased as the pace of exchange rate appreciation moderated. High oil prices and strong global demand (particularly from China) are also putting some upward pressure on import prices.

Import volumes of consumer durables and capital goods have grown very strongly over the past two years (figure 3.6). Favourable import prices, a strong housing market and increasing household wealth and income have driven growth in consumer durable imports. The high exchange rate and economy-wide capacity constraints have increased the demand for capital goods imports. Growth in imports of intermediate goods has also been reasonably strong as firms have taken advantage of the high exchange rate.

The number of short-term departures from New Zealand has increased rapidly since mid-2003. A strong exchange rate and large falls in international airfares have made overseas travel more attractive. This has been reflected in imports of services, which increased by 10 per cent in the year to December.

Our current account deficit has widened significantly over the past three years (figure 3.7). This is a reflection of

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**Figure 3.3**
Non-commodity manufactured exports
*quarterly total*

![Chart showing non-commodity manufactured exports from 1992 to 2004.](source: Statistics New Zealand)

**Figure 3.4**
Overseas visitor arrivals

![Chart showing overseas visitor arrivals from 1995 to 2004.](source: Statistics New Zealand)

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**Figure 3.5**
Import prices and the TWI
*annual percentage change*

![Chart showing import prices and the TWI from 1990 to 2004.](source: Statistics New Zealand, RBNZ)

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**Figure 3.6**
Import volumes

![Chart showing import volumes from 1990 to 2004.](source: Statistics New Zealand)
the domestic sector drawing imports into the economy at a rapid rate and of the increased profits of foreign-owned New Zealand firms.

The housing market cooled over 2004. Nearly all housing market indicators, such as dwelling consents, house sales, house price inflation and residential investment, eased significantly from their peaks reached in late-2003/early-2004. However, recent housing market trends have been more difficult to interpret.

Recent changes to building regulations and an increased building levy temporarily boosted building consents over the March quarter 2005, and consents have since declined. Together with lower net immigration and increases in interest rates over 2004, indicators continue to point to a slowing in residential investment over the year ahead.

Domestic demand
The domestic economy contributed significantly to GDP growth over 2004 (figure 3.8). Strength in the domestic economy has been characterised by a strong household sector driven by population growth, increased household wealth and rising incomes. Business investment also grew strongly over 2004, reflecting ongoing capacity constraints, strong domestic demand, and the high exchange rate.

However, the low mortgage rates offered by banks towards the end of 2004 appear to have sustained housing demand and house price inflation over the early months of 2005. While the monthly data is volatile, house sales and house price inflation have stabilised, and the median days to sell a house has fallen (figures 3.10, 3.11). Household credit growth also remains robust (see figure 3.14).

Strength in the housing market has been partly responsible for strong growth in consumption over the past few years. Strong housing demand has fed through into demand for housing related goods and services, as well as boosting consumption through the wealth effects of house price inflation. This is particularly apparent in the strong growth in the durables component of consumption (figure 3.12). Consistent with the recent plateau in the house price inflation, consumption growth is likely to remain firm over early 2005.

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Figure 3.7
Annual current account balance

Source: Statistics New Zealand.

Figure 3.8
Contributions to GDP growth
(annual average percentage change)

Source: Statistics New Zealand.

1 Domestic demand is calculated as GDP excluding exports.
Also providing support for recent consumption growth has been the high exchange rate, which has lowered prices for imported goods; and strong growth in employment and labour incomes (figure 3.13).

Figure 3.13
Employment growth and consumption growth (annual percentage change)

Strong growth in household spending has been funded, in part, by a build up in debt (figure 3.14). Household borrowing, mainly in the form of mortgage debt, has been encouraged by rising housing-related wealth. This build up in debt has also been evident in high rates of household credit growth.

Figure 3.14
Household debt and annual credit growth

Strong domestic demand over 2004 and difficulties finding labour have encouraged many firms to increase their capacity by investing in plant and machinery (figure 3.15). In addition, the high exchange rate has encouraged plant
and machinery investment by reducing the cost of imported capital goods (figure 3.16).

Non-residential investment also experienced strong growth over the past 12 months, but dipped slightly in the December quarter. Non-residential building consents have also been affected by recent changes to building regulations. However, those consents have remained at high levels, suggesting that non-residential investment will remain strong over early 2005 (figure 3.17).

Figure 3.16
Capital goods price index: plant and equipment and the TWI

Fiscal policy
The Budget Economic and Fiscal Update showed that the Government’s operating surplus for the year to June 2005 will be higher than previously projected. Strong profits have increased company tax receipts by more than expected. In addition, some government departments have underspent relative to budget, although this is likely to be a timing effect, with the additional spending deferred until the June 2006 year. Fiscal policy is currently constraining economic activity, however this is expected to turn into a net stimulus over the coming years.

Productive capacity
The supply side of the economy has found it difficult to fully respond to the increase in demand over recent years. The stretch in the economy’s productive resources is evident in the NZIER’s Quarterly Survey of Business Opinion (QSBO) measures of capacity utilisation (figure 3.18) and in the labour market. Capacity utilisation has been highest in the building sector, but has also increased in the manufacturing sector over the past two years.

The pressure on supply to meet increased demand is also evident in a large decline in the proportion of firms reporting demand as a factor limiting increased production (figure 3.19). Meanwhile, the proportion of firms reporting labour as a factor limiting increased production has increased to a 20-year historical high (figure 3.20). The proportion of firms reporting capital as a factor limiting production has also remained high.
The labour market and wages
Buoyant domestic demand and a strong agricultural sector have boosted firms’ demand for workers. Increased demand for labour has been evident in strong employment growth with over 100,000 people added to the workforce over the past two years (figure 3.21). The labour force has also grown significantly in response to increased demand for labour. Labour force growth was driven earlier by strong immigration and more recently by an increase in labour force participation – particularly in the 55-plus age group.

Figure 3.18
Capacity utilisation (builders and manufacturers)

Source: NZIER.

Figure 3.19
Factor limiting increased production (demand)

Source: NZIER.

Figure 3.20
Factors limiting increased production (labour and capital)

Source: NZIER.

However, over recent years, growth in the labour force has been outpaced by growth in employment. As a result, the unemployment rate has fallen to under 4 per cent (figure 3.22).

Figure 3.21
Employment and labour force growth (annual percentage change)

Source: Statistics New Zealand.

Figure 3.22
Unemployment rate

Source: Statistics New Zealand.
Excess demand for labour has also put pressure on wages—firms increasingly have paid higher wages to attract and retain staff. Changes in the adjusted Labour Cost Index (LCI) provide a measure of changes in ‘base rates’. The annual increase in the adjusted LCI has been rising steadily and is at a cyclical high, consistent with ongoing labour shortages (figure 3.23).

**Figure 3.23**

**Annual LCI movements and skill shortages**

Movements in the distribution of wage increases in the LCI show that the proportion of respondents reporting wage increases of 3 per cent or more has increased to a historical high of 33 per cent (figure 3.24). Wage increases seem to be reflecting increasing CPI inflation and labour constraints—Statistics New Zealand note that the main reasons given for wage increases were to reflect changes in the cost of living, the need to match market rates and to retain staff.

**Figure 3.24**

**Distribution of annual wage increases**

**Inflation pressures**

Over the past 12 months, annual CPI inflation has increased from 1.5 per cent to 2.8 per cent. Underlying this increase in inflation has been an increase in tradables inflation to 0.8 per cent, while non-tradables inflation has remained high at above 4 per cent (figure 3.25).

**Figure 3.25**

**CPI, non-tradables and tradables inflation (annual rate)**

Non-tradables inflation has been very high over the past 18 months, reflecting strong resource pressures. Most of this inflation has been driven by strong pricing pressure in the housing market, with costs associated with the purchase and construction of new dwellings increasing by 7.2 per cent in the year to March.

However, pressures in other sectors of the economy have been gradually building over the past 18 months. Excluding the housing group, non-tradables inflation increased to 3.6 per cent in the year to March and is now above its average of 3.2 per cent for the past decade (figure 3.26).

Inflation is becoming more broad-based—electricity, domestic airfares, gas, dental services, taxi and shuttle hire, vehicle servicing and repairs, and childcare and créche services are just some examples of goods and services that have seen price increases of more than 5 per cent over the past 12 months. Energy prices (electricity, gas and petrol) in particular, have been rising significantly with structural issues being the predominant influences. The annual rate of inflation in energy prices has been around 10 per cent since 2004.
Other measures of ‘core’ inflation point to stronger pricing pressures than headline CPI. The weighted-median-CPI and trimmed-mean-CPI have increased significantly over the past 12-18 months, reaching 3.3 per cent and 3.0 per cent respectively in the March quarter (figure 3.27). The GDP deflator, conceptually the broadest measure of economy-wide inflation, has increased to over 4 per cent in 2004.

Although tradables inflation has been weak, it has picked up significantly over the past 12 months. Low tradables inflation has reflected the strong appreciation of the exchange rate over the past four years. The acceleration in tradables inflation over the past 12 months has been due to a less rapid rate of exchange rate appreciation, as well as higher oil prices and other cost pressures.
Inflation as measured by the Producer Price Indexes (table 3.1) has picked up since early 2003. Some industries have experienced a lot more pricing pressure than others. Prices in the construction sector have increased significantly over the past year, reflecting resource strain in this sector, as have prices in metal manufacturing and gas supply. Meanwhile, prices in textile and apparel manufacturing have been weak reflecting global competitive pressures and the lagged effects of the exchange rate appreciation.

**Inflation expectations**

Changes in inflation expectations can have a significant impact on the wage, price and cost setting behaviour of firms and households. Temporary shocks to the rate of CPI inflation can become ingrained in inflation expectations, affecting wage, price and cost setting behaviour, and thus the path of medium-term inflation. Although inflation expectations are notoriously difficult to gauge, surveyed expectations can provide some insight.

Survey measures of one-year-ahead inflation expectations tend to follow actual inflation relatively closely. Measures from the National Bank’s Survey of Business Opinion (NBBO), the AON consulting survey (covering professional economists), and the RBNZ survey of expectations, have increased since mid-2003 (figure 3.28).

**Figure 3.28**

Inflation expectations (one year ahead) and annual CPI inflation

4 Financial market developments

International markets

The outlook for policy rates has been revised down in most major economies over the past three months. Markets have become increasingly wary regarding the global economic outlook in the face of weaker than expected activity indicators and an increase in oil prices.

The US Federal Reserve has continued to lift its policy rate, announcing 25 basis point increases in late March and early May to take its funds rate to 3 per cent. However, a run of weaker-than-expected March quarter economic activity data has seen expectations of further rises scaled back from their highs in late March (figure 4.1). While the Fed is expected to continue its ‘measured’ tightening programme over the next few months, rate rises are expected to become increasingly contingent on economic and inflation developments thereafter.

Figure 4.1
Financial market expectations of the US Fed funds rate

Concerns over the earnings and credit worthiness of some high profile US corporations have weighed on equity and interest rate markets since March. In particular, the Standard and Poor’s rating agency downgraded the long-term credit ratings for US auto-makers General Motors and Ford. This has led to increased ‘safe haven’ demand for government bonds amidst growing risk aversion, putting further downward pressure on global interest rates. Some increase in risk aversion has been reflected in increased corporate bond spreads, albeit from relatively low levels (figure 4.3), and has seen some paring back of speculative rise have subsequently seen markets largely discount the possibility of another rate rise.

Global long-term interest rates have fallen to an even greater extent and, as a consequence, yield curves have continued to flatten over the past few months (figure 4.2).

Figure 4.2
Movements in global bond rates since the March Statement

Concerns over the earnings and credit worthiness of some high profile US corporations have weighed on equity and interest rate markets since March. In particular, the Standard and Poor’s rating agency downgraded the long-term credit ratings for US auto-makers General Motors and Ford. This has led to increased ‘safe haven’ demand for government bonds amidst growing risk aversion, putting further downward pressure on global interest rates. Some increase in risk aversion has been reflected in increased corporate bond spreads, albeit from relatively low levels (figure 4.3), and has seen some paring back of speculative rise have subsequently seen markets largely discount the possibility of another rate rise.

Global long-term interest rates have fallen to an even greater extent and, as a consequence, yield curves have continued to flatten over the past few months (figure 4.2).

Figure 4.3
US corporate bond spreads

Official interest rate expectations have fallen to an even greater extent in other major economies in the face of disappointing activity indicators. Markets have substantially pared back the chance of tightening in the Euro zone over the next 12 months and have gone so far as to price in some chance of a rate cut in the UK by the end of the year. Australian policy rate expectations have also fallen significantly over the past few months. In the aftermath of the Reserve Bank of Australia’s 25 basis point rate rise in March there was a strong expectation that a further tightening would be delivered. However, signs of slowing Australian economic activity in response to the March rate
positions in foreign exchange, interest rate, and commodities markets.

Notwithstanding these developments, longer-term global interest rates are still low relative to current levels of (and Consensus forecasts for) economic growth and inflation. As discussed in the March Statement, there are a range of factors that have been identified as playing a role in maintaining low long-term rates but there is no consensus on their relative importance. Regardless, the potential for either global growth to validate the current low level of long-term rates, or for those rates to rise substantially, remain downside risks to the New Zealand economic outlook.

Recent oil price movements have offered little encouragement for the global activity outlook. After rising sharply, spot oil prices have fallen from their mid-March highs and longer-term oil futures prices have remained relatively high (figure 4.4). This suggests that markets see oil prices remaining at high levels into the future. Hedging by large consumers could see the impact of high oil prices persist for some time.

Figure 4.4
NYMEX crude oil futures prices

![NYMEX crude oil futures prices](image)

Source: Bloomberg.

Exchange rates

The US dollar has appreciated since the March Statement. Market sentiment toward the US dollar has improved as the Fed has continued its ‘measured’ rate rises. Currency markets have begun to focus more on the US economy’s comparatively high interest rates and better growth outlook relative to the other major economies, where growth prospects have been downgraded to an even greater extent. At least for the time being, this is dominating concerns over the large US current account and fiscal deficits which had weakened the US dollar over the past few years.

Meanwhile, conjecture over the likelihood and timing of any changes to China’s fixed exchange rate regime has remained an underlying theme in currency markets. This was reinvigorated by Chinese officials’ comments in early May that suggested the country is better prepared for an adjustment to its exchange rate regime, and that plans for currency reform may be prudently accelerated. Speculation regarding the potential for change was also fuelled by the Chinese Government’s decision to increase the number of traded currencies in the Chinese interbank market from four to twelve. As an indicator of expectations, the non-deliverable forwards market has priced-in an elevated risk of revaluation since mid-April, but this has been tempered somewhat by the appreciation of the US dollar (figure 4.5). Moreover, speculation over revaluation has put some upward pressure on other Asian currencies against the US dollar.

Figure 4.5
US dollar index and market expectation of Chinese Yuan (CNY) revaluation

![US dollar index and market expectation of Chinese Yuan (CNY) revaluation](image)

Source: Bloomberg.

An appreciating US dollar has undermined the NZD/USD exchange rate, which has slipped from the post-float highs seen in March. However, the impact of this on the Trade Weighted Index has been partly offset by the New Zealand dollar remaining relatively stable or appreciating against other major currencies (particularly the Euro and British pound). The New Zealand dollar has generally remained supported by strong investment in New Zealand dollar...
denominated assets. But expectations of slowing growth appear to have played a role in the New Zealand dollar easing from its March highs.

**Figure 4.6**
Movements in key New Zealand dollar cross rates since the March Statement

<table>
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<tr>
<td>Japanese yen</td>
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<tr>
<td>Australian dollar</td>
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<td></td>
</tr>
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<td>British pound</td>
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<td></td>
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<tr>
<td>Euro</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Bloomberg.

**Domestic markets**

The New Zealand yield curve has become even more negatively sloped (or ‘inverted’) since the March Statement (figure 4.7). Short-term interest rates remain anchored by the current level of the OCR, although the market is increasingly pricing in an expectation that the OCR will be cut during the next 12 months. Longer-term New Zealand interest rates have fallen, largely reflecting falls in global long-term interest rates and strong demand (both domestic and offshore) for the relatively high yields on New Zealand government bonds. The inverted yield curve is consistent with market expectations that the New Zealand economy will slow going forward.

**Figure 4.7**
The OCR and the slope of the wholesale interest rate curve

Source: RBNZ, Reuters.

Against this background, the effective mortgage rate (the average rate that is being paid on outstanding debt, as opposed to the rates offered to new borrowers) continues to rise (figure 4.8). As at the end of April, the effective rate had risen 65 basis points from its lows in late 2003. While this is considerably less than the 175 basis point increase in the OCR over 2004/05, significant further increases in the effective mortgage rate are likely over the months ahead as fixed rate mortgages are re-priced.

For some borrowers – particularly those who took up 2-year fixed rates at their lows in mid 2003 – there will be a substantial increase in financing costs over coming months. For example, a mortgage fixed for two years in mid-2003 at the lows close to 6 per cent will face re-pricing over the next few months at rates that will be 100 to 150 basis points higher (figure 4.9).

**Figure 4.8**
The OCR and the effective mortgage rate

Source: RBNZ estimates.

**Figure 4.9**
Two-year fixed-rate mortgages

Source: RBNZ.
5 The macroeconomic outlook

Overview

This chapter describes our projections for economic activity, inflation and interest rates over the coming years. Despite recent low GDP outturns, we are expecting robust GDP growth in early 2005. Productive resources remain stretched, keeping medium-term inflation pressures strong. CPI inflation is expected to remain around 3 per cent until early 2007.

Economic growth is expected to slow. The key factors for a slowdown remain in place – the combination of higher interest rates, lower net immigration, and a cooling housing market are expected to dampen household spending. Also, a moderation in the terms of trade and the lagged effects of the high exchange rate are expected to impact on the external sector. The projected slowdown in economic activity will eventually moderate domestic inflation pressures, allowing a fall in CPI inflation from 2007.

Compared to our March assessment, medium-term inflation pressures are now slightly stronger. The terms of trade have continued to improve and we are now expecting a more gradual slowdown in house price inflation. These factors should moderate the slowdown in household demand over the coming year, relative to the March Statement. The new initiatives announced in the recent Budget are expected to add slightly to demand pressure further out in the projection. Compared to the March Statement, the projected interest rate profile is marginally higher (see figure 2.2, Chapter 2).

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. Global growth is expected to ease back over 2005 and 2006 (figure 5.1). World inflation is expected to increase a little over the same period.

Table 5.1

Forecasts of export partner GDP growth*
(calendaryear, annual average percentage change)

<table>
<thead>
<tr>
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<td>2.6</td>
<td>3.1</td>
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<td>3.0</td>
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<td>3.5</td>
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<td>3.3</td>
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<td>Japan</td>
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<td>1.0</td>
<td>1.7</td>
<td>1.5</td>
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<td>Canada</td>
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<td>3.4</td>
<td>2.0</td>
<td>2.8</td>
<td>2.6</td>
<td>3.0</td>
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<td>Eurozone**</td>
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<td>0.5</td>
<td>1.8</td>
<td>1.5</td>
<td>1.9</td>
<td>2.1</td>
</tr>
<tr>
<td>United Kingdom</td>
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<td>1.8</td>
<td>2.2</td>
<td>3.1</td>
<td>2.5</td>
<td>2.3</td>
<td>2.1</td>
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<tr>
<td>Asia ex-Japan***</td>
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<tr>
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<td>4.0</td>
<td>3.0</td>
<td>3.3</td>
<td>3.4</td>
</tr>
</tbody>
</table>

* 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.
While the global economic outlook conveys a relatively orderly picture, there is a risk of larger downward adjustments to global growth given the structural imbalances in the US economy.

**Tradables prices**

Over recent months, world prices for New Zealand’s exports have increased further, due to ongoing strong global demand and tight supply for some of our key commodity 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 exchange rate over the projection period.

World import prices have also risen in recent months, especially oil prices. We are assuming that both oil prices and other import prices will gradually moderate over the coming years. However, the outlook for import prices remains a key source of uncertainty.

The projected decline in world export prices outweighs the fall in import prices, resulting in a fall in the terms of trade over the coming years (figure 5.2). However, the terms of trade are higher throughout the current projection than was assumed in the March Statement.

**Export volumes**

Export volume growth was strong over 2004. Only modest growth is expected over the period ahead (figure 5.4). However, the outlook varies by sector:

- Non-commodity manufactured exports are expected to slow from an annual average growth rate of 10 per cent in calendar 2004 to 3 per cent in 2005 and 2 per cent in 2006, as the lagged effect of the high exchange rate takes hold.
- Agricultural exports are expected to rebound strongly in 2005, and to grow moderately thereafter.
- Forestry export volumes are projected to remain quite weak until at least 2006, due to a combination of low world prices, high shipping costs, and the high exchange rate.
- Exports of services have continued to perform well in recent times, but we maintain our view that growth in this sector will slow in the next two years, as the lagged effects of the high New Zealand dollar feed through.
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).

Current account
The current account deficit is projected to remain around $6^{1/2}$ per cent of GDP throughout the projection period, as net exports remain weak. This high current account deficit partly reflects strong investment in productive resources. However, it is also a reflection of unprecedented dissaving by households. A current account deficit of $6^{1/2}$ per cent of GDP is unlikely to be sustained in the medium term.

Net immigration and residential investment
Net permanent and long-term immigration is expected to continue falling over 2005 and 2006, troughing at a net inflow of 5,000 people per annum (figure 5.6). As net immigration falls, we expect a subsequent fall in residential investment activity (figure 5.7).

Current account
The current account deficit is projected to remain around $6^{1/2}$ per cent of GDP throughout the projection period, as net exports remain weak. This high current account deficit partly reflects strong investment in productive resources. However, it is also a reflection of unprecedented dissaving by households. A current account deficit of $6^{1/2}$ per cent of GDP is unlikely to be sustained in the medium term.
House prices
Lower net immigration and higher interest rates are the driving factors behind our projection for a sharp decline in house price inflation in the coming years (figure 5.8). However, reflecting recent house price data, we expect the fall in house price inflation to occur slightly later than we projected in the March Statement.

Figure 5.8
Annual house price inflation

Household balance sheets
As households have borrowed to fund consumption in recent years, the debt-to-income ratio has increased steadily and the current account deficit has risen. Household savings, measured as the difference between current income and consumption expenditure, has been negative and declining. However, the increase in the household debt-to-income ratio has been more than offset by increases in the ratio of household assets to income. As a result, the net wealth-to-income ratio has increased from 350 per cent in 2001 to around 450 per cent in 2004 (figure 5.10).

This increase in household net wealth (due to rising house prices) has enabled households to maintain high levels of consumption from current income. As such, the sustainability of high consumption levels is highly dependant on developments in house prices.

Household consumption
While rising incomes have played a role, much of the increase in household consumption over recent years has been funded through debt. In turn, much of this debt has been secured against rising asset prices. Household consumption is expected to moderate over the period ahead as house price inflation falls, the migration cycle wanes, the terms of trade fall, and debt servicing costs rise (figure 5.9). However, relative to our March Statement the projected consumption slowdown is more gradual over 2005, consistent with the outlook for house price inflation over the next few quarters.

Figure 5.9
Real household consumption (per cent of trend output)
Labour market

Despite the recent up-tick in unemployment, the labour market remains very tight. Demand for labour is likely to remain strong, keeping the unemployment rate below 4 per cent for some time (figure 5.11). The strong labour market is bringing an increasing number of people into paid work. Coupled with higher wages, this is acting to enhance household incomes and underpin domestic spending.

Figure 5.11
Unemployment rate

Consistent with low unemployment and reported labour shortages, we expect higher wage growth over the coming years. Where this is not matched by productivity increases it could have unhelpful consequences for pricing behaviour and inflation expectations.

Business investment

Robust demand from home and abroad, coupled with the high exchange rate, has encouraged strong investment in new capital. Indications are that business investment increased strongly in early 2005. However, over the coming period business investment growth is expected to weaken in line with the economic cycle (figure 5.12). Plant and machinery investment is expected to weaken in the second half of 2005, while longer lead-times should postpone any downturn in non-residential construction activity until 2006.

Figure 5.12
Business investment
(annual average percentage change)

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 Budget Economic and Fiscal Update (BEFU). However, our projected fiscal balance is based on our own assessment of the economic cycle, which affects projections of tax revenues and some transfer payments, such as unemployment benefits.

When assessing the impact of discretionary fiscal policy on economic growth, we adopt the Treasury’s estimates of fiscal impulse (this measure is unaffected by differences in the projected economic cycle between the Reserve Bank and the Treasury). The estimates from the BEFU indicate that fiscal policy had a contractionary influence over 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, opposite). Most of this projected fiscal expansion was already incorporated in the March Statement.

The balance of risks around the projected fiscal impulse continues to lie on the upside. In addition to the inherent uncertainty of the election later this year, the Working for Families package could have a larger than expected impact if the families receiving the transfers have a relatively high propensity to consume. Similarly, government infrastructure investment could place further pressures on the capacity-constrained construction sector.
Figure 5.13
Estimated fiscal impulse*
(per cent of GDP)

Source: The Treasury.
* A positive number indicates expansionary fiscal policy.

Inflation

CPI inflation is expected to remain close to 3 per cent until mid-2007 (see figure 2.1, chapter 2). Compared to the March Statement, the inflation outlook is broadly unchanged over 2005 and 2006, but is stronger over 2007. This reflects our assessment that medium-term inflation pressure has increased.

The stronger outlook for CPI inflation is based on high non-tradables inflation (figure 5.14). Given the current degree of stretch on resources, non-tradables inflation is projected to remain above 4 per cent until the full effects of recent monetary policy tightenings act to dampen domestic inflation pressures over 2006. High non-tradables inflation has been masked thus far by low inflation in the tradables sector. But with the exchange rate assumed to be depreciating from current levels, tradables inflation is projected to rise over the period ahead.
Appendix A ¹
Summary tables

Table A

CPI inflation, monetary conditions, and near-term GDP projections

(CPI and GDP are 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>
<tr>
<td></td>
<td>Second Half Average</td>
<td>³ ³ ¹ ⁴ ² ⁴ ⁴ ⁴</td>
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<tr>
<td>2006</td>
<td>First Half Average</td>
<td>¾ ³ ⁴ ⁴ ³ ³ ³ ³</td>
<td>7 7</td>
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<td>7 7</td>
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<td>7 7</td>
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<td>7 7</td>
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<th>Quarter</th>
<th>CPI* (Quarterly)</th>
<th>CPI** (Annual)</th>
<th>GDP (Quarterly)</th>
<th>GDP (Annual Average)</th>
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<td>0.7</td>
<td>2.8</td>
<td></td>
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</table>

¹ Notes for these tables follow on pages 29-30.
² This series is quarterly CPI inflation, excluding credit services, until the June 1999 quarter, and quarterly CPI inflation thereafter.
²² 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)

<table>
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<th>March year</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>Actuals</th>
<th>Projections</th>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private</td>
<td>3.1</td>
<td>3.3</td>
<td>1.9</td>
<td>2.9</td>
<td>4.6</td>
<td>5.6</td>
<td>$5%$</td>
<td>$3%$</td>
</tr>
<tr>
<td>Public authority</td>
<td>-0.2</td>
<td>5.3</td>
<td>-2.5</td>
<td>4.9</td>
<td>2.5</td>
<td>3.1</td>
<td>$6%$</td>
<td>5.0</td>
</tr>
<tr>
<td>Total</td>
<td>2.3</td>
<td>3.8</td>
<td>0.9</td>
<td>3.4</td>
<td>4.1</td>
<td>5.1</td>
<td>$5%$</td>
<td>4.0</td>
</tr>
</tbody>
</table>

Gross fixed capital formation

| Market sector | | | | | | | | |
| Residential | -13.0 | 19.5 | -12.5 | 3.3 | 23.0 | 15.9 | $1\%$ | $-5\%$ | $-4\%$ | $1\%$ |
| Business | 0.3 | 7.3 | 8.6 | 10.2 | 3.0 | 14.5 | $14\%$ | $5\%$ | -1.0 | $2\%$ |
| Non-market government sector | -7.8 | 17.6 | -18.0 | 16.4 | 3.0 | 2.2 | $-2\%$ | $2\%$ | $4\%$ | 7.0 |
| Total | -4.2 | 11.3 | 0.1 | 9.2 | 7.3 | 13.7 | $9\%$ | $2\%$ | $-1\%$ | $2\%$ |

Final domestic expenditure

| | | | | | | | | |
| Stockbuilding (1) | -0.3 | 1.2 | -0.4 | 0.3 | -0.5 | 0.2 | $1\%$ | $-2\%$ | $-3\%$ | 0.0 |
| Gross national expenditure | 0.6 | 6.5 | 0.3 | 4.9 | 4.2 | 7.2 | 7.0 | $2\%$ | $1\%$ | $1\%$ |

| | | | | | | | | |
| Exports of goods and services | 3.1 | 7.3 | 5.1 | 2.4 | 7.6 | 1.0 | $4\%$ | $3\%$ | $2\%$ | $3\%$ |
| Imports of goods and services | 1.9 | 11.5 | -0.1 | 3.5 | 7.4 | 11.9 | $13\%$ | $4\%$ | $1\%$ | $2\%$ |
| Expenditure on GDP | 1.0 | 5.2 | 2.0 | 4.4 | 4.3 | 3.4 | $3\%$ | $2\%$ | 2.0 | 2.0 |

| | | | | | | | | |
| GDP (production) | 0.5 | 5.2 | 2.3 | 3.5 | 4.6 | 3.6 | $4\%$ | $2\%$ | 2.0 | 2.0 |
| GDP (production, March qtr to March qtr) | 2.6 | 5.8 | 0.9 | 4.4 | 4.2 | 5.0 | 3.0 | $2\%$ | 2.0 | $2\%$ |
| Potential output | 2.5 | 2.6 | 2.8 | 3.2 | 3.6 | 3.6 | $3\%$ | $3\%$ | $3\%$ | 3.0 |
| Output gap (% of potential GDP, year average) | -1.9 | 0.5 | 0.0 | 0.3 | 1.3 | 1.2 | 2.0 | $1\%$ | $1\%$ | $-1\%$ |

(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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<td>CPI*</td>
<td>1.0</td>
<td>1.7</td>
<td>3.1</td>
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<td>1.5</td>
<td>2(^1/4)</td>
<td>3</td>
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<td>2(^1/2)</td>
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<td>1.6</td>
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<td>2.2</td>
<td>2.1</td>
<td>2(^1/4)</td>
<td>2(^1/2)</td>
<td>2(^1/2)</td>
<td>2(^1/2)</td>
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<td>Import prices (in New Zealand dollars)</td>
<td>2.7</td>
<td>11.2</td>
<td>7.4</td>
<td>-2.9</td>
<td>-11.1</td>
<td>-10.5</td>
<td>2</td>
<td>2</td>
<td>5(^1/2)</td>
<td>4(^1/2)</td>
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<td>Export prices (in New Zealand dollars)</td>
<td>-0.6</td>
<td>9.9</td>
<td>20.6</td>
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<td>-15.5</td>
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<td>4(^1/4)</td>
<td>1(^1/2)</td>
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<td><strong>Monetary conditions</strong></td>
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<tr>
<td>90-day rate (year average)</td>
<td>6.2</td>
<td>5.2</td>
<td>6.6</td>
<td>5.4</td>
<td>5.9</td>
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<td>TWI (year average)</td>
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<td><strong>Output</strong></td>
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<tr>
<td>GDP (production, annual average % change)</td>
<td>0.5</td>
<td>5.2</td>
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<td>4.6</td>
<td>3.6</td>
<td>4(^1/4)</td>
<td>2(^1/4)</td>
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<td>2</td>
</tr>
<tr>
<td>GDP (production, March qtr to March qtr)</td>
<td>2.6</td>
<td>5.8</td>
<td>0.9</td>
<td>4.4</td>
<td>4.2</td>
<td>5.0</td>
<td>3</td>
<td>2(^1/2)</td>
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<td>2(^1/4)</td>
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<td>Output gap (% of potential GDP, year average)</td>
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<td>0.5</td>
<td>0.0</td>
<td>0.3</td>
<td>1.3</td>
<td>1.2</td>
<td>2</td>
<td>1(^1/4)</td>
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<td>Total employment</td>
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<td>3.5</td>
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<td>3.1</td>
<td>3(^1/4)</td>
<td>1(^1/2)</td>
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<td>Unemployment rate (March qtr, s.a.)</td>
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<td>5.4</td>
<td>5.2</td>
<td>4.9</td>
<td>4.2</td>
<td>4</td>
<td>3(^1/4)</td>
<td>4(^1/4)</td>
<td>4(^1/4)</td>
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<td>Trend labour productivity (annual % change)</td>
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<td>1.5</td>
<td>1.5</td>
<td>1.4</td>
<td>1.2</td>
<td>1.2</td>
<td>1(^1/4)</td>
<td>1(^1/4)</td>
<td>1(^1/2)</td>
<td>2</td>
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<tr>
<td>Government operating balance (% of GDP, year to June)</td>
<td>1.7</td>
<td>1.4</td>
<td>1.2</td>
<td>1.9</td>
<td>1.5</td>
<td>5.3</td>
<td>4</td>
<td>4(^1/2)</td>
<td>3(^1/4)</td>
<td>2(^1/2)</td>
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<tr>
<td>Current account balance (% of GDP, year to March)</td>
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<td>-6.5</td>
<td>-4.1</td>
<td>-2.7</td>
<td>-3.4</td>
<td>-4.6</td>
<td>-6(^1/2)</td>
<td>-6(^1/2)</td>
<td>-6(^1/2)</td>
<td>-6(^1/2)</td>
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<td>Terms of trade (OTI measure, annual average % change)</td>
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<td>-0.2</td>
<td>4.4</td>
<td>4.2</td>
<td>-5.7</td>
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<td>5(^1/4)</td>
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<td>-1(^1/2)</td>
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<td>Household savings rate</td>
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<td>-4.5</td>
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<td>-12.3</td>
<td>-12</td>
<td>-14</td>
<td>-13(^1/4)</td>
<td>-11(^1/2)</td>
</tr>
</tbody>
</table>

| **World economy** |      |      |      |      |      |      |      |      |      |      |
| World GDP (annual average % change) | 1.9  | 4.2  | 3.6  | 1.4  | 2.9  | 3.3  | 3\(^1/2\) | 3\(^1/4\) | 3\(^1/4\) | 3\(^1/2\) |
| World CPI inflation | 1.1  | 2.0  | 2.7  | 1.4  | 2.2  | 1.5  | 2    | 2    | 2    | 2    |

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 (Eurozone 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>
<thead>
<tr>
<th>Indicator</th>
<th>Description</th>
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<tr>
<td>Government operating balance</td>
<td>Historical source The Treasury. Adjusted by the RBNZ over the projection period.</td>
</tr>
<tr>
<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>
</tr>
<tr>
<td>Wages</td>
<td>Private sector all salary and wage rates. Labour Cost Index.</td>
</tr>
<tr>
<td>Quarterly percentage change</td>
<td>((\text{Quarter}/\text{Quarter}_t - 1) \times 100)</td>
</tr>
<tr>
<td>Annual percentage change</td>
<td>((\text{Quarter}/\text{Quarter}_t - 1) \times 100)</td>
</tr>
<tr>
<td>Annual average percentage change</td>
<td>((\text{Year}/\text{Year}_t - 1) \times 100)</td>
</tr>
</tbody>
</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 B
Chronology

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

2005

10 March  The Reserve Bank released its forty-fifth Monetary Policy Statement, increasing the Official Cash Rate to 6.75 per cent. The news release accompanying the Statement is reproduced in Appendix D.

24 March  Production GDP figures were released showing that the New Zealand economy grew by 0.4 per cent in the December quarter of 2004.

15 April  CPI statistics were released for the December quarter of 2004 showing that the CPI increased by 0.4 per cent over the quarter, and by 2.8 per cent in the year to March 2005.

28 April  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 during the projection round

ANZ Bank Ltd
ANZCO Foods Ltd
Arthur Barnett Ltd
Auckland International Airport
Balance Agri-Nutrients Ltd
Bayleys Real Estate Limited
Betacom Ltd
Blue Sky Meats (N.Z.) Ltd
Boise New Zealand Ltd
Business New Zealand
Canterbury Employers’ Chamber of Commerce
Canterbury Manufacturers’ Association
Carters Ltd
Christchurch International Airport
City Forest Ltd
Clive Wilson Ltd
Colliers International New Zealand Ltd
Delta Ltd
Donaghys Ltd
Dorchester Pacific Limited
Employers and Manufacturers Association
Evergreen Forests Limited
ExxonMobil Limited
Fletcher Aluminium Ltd
Fliway International Ltd
GFG Group Ltd
Hayes International Ltd
Hertz New Zealand Ltd
Hume Pine (NZ) Ltd
Invercargill City Council
J J Limited
KPMG
La Grouw Corporation Ltd
Landmark Homes Ltd
Macpac Wilderness Equipment Ltd
Master Plumbers, Gasfitters & Drainlayers NZ Inc.
Masurel Fils (NZ) Ltd
Maurice Kain Textiles Ltd
Motel Association of New Zealand Inc
Multiplex Constructions (NZ) Ltd
Naylor Love Properties Ltd
NCI (NZ) Packaging Ltd
Nor West Arch Ltd
NZ Food & Grocery Council Inc
NZF Stainless Ltd
Port of Tauranga Ltd
Pukepines Sawmills (1998) Ltd
Ravensdown Fertiliser Co-operative Ltd
Recruitment & Consulting Services Association
Rotorua District Council
Seeka Kiwifruit Industries Ltd
Snowy Peak Limited
Southland Times Co Ltd
Tachikawa Forest Products (NZ) Ltd
Tamahine Holdings
Tecpak Industries Ltd
The Neil Group Limited
Toll Owens Group Limited
Windsor Engineering Group Ltd
Zespri International 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

OCR unchanged at 6.50 per cent

9 December 2004

The Reserve Bank has left the OCR unchanged at 6.50 per cent.

Speaking at the release of the Reserve Bank’s December 2004 Monetary Policy Statement, Reserve Bank Governor Alan Bollard said “As indicated in our October Review, we continue to expect that the current policy position will achieve inflation between 1 and 3 per cent on average over the medium term. This outlook assumes that significant pipeline effects from past interest and exchange rate increases will eventuate and act to further constrain the economy over the period ahead.

“Since the last review, overall economic indicators have continued to surprise on the upside. As a result, we have revised upwards our GDP estimates for the second half of 2004 and pushed out our expected timing of the economic slowdown. But the slowdown is still expected in 2005. The easing in house sales, residential building consents and net immigration remain in line with our earlier projections. Reinforcing this outlook is a weakening exports picture, based on softer world growth and the constraining effects of the strong NZ dollar.

“Inflation is projected to rise close to 3 per cent before easing back later in 2006. The risks to the inflation outlook are two-sided. On the upside there is clearly a risk that the current momentum in household demand will hold up longer than expected. Rising wage and salary pressures also present an upside inflation risk given the current labour market tightness. On the downside there is the possibility of more exaggerated movements in the US dollar and US interest rates, leading to a stronger New Zealand TWI, weaker exports and less inflation pressure.

“The tightening in monetary policy over the past year currently looks sufficient to keep medium term inflation pressures in check. However, with inflation expected to remain toward the top of the 1 to 3 per cent target band over the medium term, there is little headroom to absorb stronger than expected inflation pressures. If such pressures emerge, a further policy tightening cannot be ruled out.

Further, the current outlook offers little scope for an easing in policy in the foreseeable future. We will continue to assess inflation pressures carefully as the economic data come to hand.”

OCR unchanged at 6.50 per cent

27 January 2005

The Reserve Bank has left the OCR unchanged at 6.50 per cent.

Reserve Bank Governor Alan Bollard said “As indicated in our last Monetary Policy Statement, we continue to expect that the current policy position will achieve inflation between 1 and 3 per cent on average over the medium term. This outlook assumes that significant pipeline effects from past interest and exchange rate increases will eventuate and act to further constrain the economy over the period ahead.

“Economic developments are generally proving at least as strong as we anticipated, although a slowdown is still expected over the year ahead. Inflation has risen to close to 3 per cent and is expected to remain around this level before easing back later in 2006. On the upside there is clearly a risk that the current momentum in household demand will hold up longer than expected. Rising wage and salary pressures also present an upside inflation risk given persistent labour market tightness. On the downside there is the possibility of more exaggerated movements in the US dollar and US interest rates, leading to a stronger New Zealand TWI, weaker exports and less inflation pressure.

“The tightening in monetary policy over the past year currently looks sufficient to keep medium term inflation pressures in check. However, with inflation expected to remain toward the top of the 1 to 3 per cent target band over the medium term, there is little headroom to absorb stronger than expected inflation pressures. If such pressures emerge, a further policy tightening cannot be ruled out.

Further, the current outlook offers little scope for an easing in policy in the foreseeable future. We will review the situation at the March Monetary Policy Statement.”
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.
Appendix E
The Official Cash Rate chronology

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<th>Date</th>
<th>OCR (per cent)</th>
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<td>4.50</td>
<td>6 March 2003</td>
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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 2005.

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
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<tbody>
<tr>
<td>Thursday 28 July 2005</td>
<td>OCR announcement</td>
</tr>
<tr>
<td>Thursday 15 September 2005</td>
<td>Monetary Policy Statement</td>
</tr>
<tr>
<td>Thursday 27 October 2005</td>
<td>OCR announcement</td>
</tr>
<tr>
<td>Thursday 8 December 2005</td>
<td>Monetary Policy Statement</td>
</tr>
</tbody>
</table>

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