Monetary Policy Statement

June 2006

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 Official Cash Rate (OCR) will remain at 7.25 per cent.

Recent economic activity has been weaker than projected in the March Monetary Policy Statement. However, the short-term inflation outlook has worsened.

Growth is expected to remain low through 2006, before recovering in 2007. The much awaited economic rebalancing from domestic spending to exports commenced in late 2005, and is expected to continue over the next two years. Export growth will recover as a result of the lower exchange rate and buoyant demand in world markets. At the same time, household spending will be constrained by a continued weakening in the housing market, high petrol prices and a slowdown in employment growth.

While weaker economic activity will reduce medium-term inflation pressures, the short-term inflation outlook has deteriorated. The sharp decline in the exchange rate over March and April will lead to higher prices on imported goods, although weak domestic demand and foreign exchange hedging by importers may dampen this increase. In addition, oil prices have risen by around 20 per cent since the March Statement, leading to higher prices for petrol and other transport items. These two effects together are now expected to keep headline CPI inflation above 3 per cent well into 2007.

Given the unavoidable nature of these price shocks, it would be inappropriate for monetary policy to try to counteract their short-term inflation effects. However, it is essential that monetary policy hold the line against any second-round effects that could be felt in wages, prices and inflation expectations. A failure to do so would risk inflation becoming entrenched at a higher level, ultimately delaying a return to stronger growth.

We do not expect to tighten policy in response to the high headline inflation in the short term. But, equally, we cannot afford to ease policy until we have more certainty that future inflation outcomes will be trending down comfortably below 3 per cent. Given this situation, we see no scope for an easing of the OCR this year.

Alan Bollard
Governor
2 Overview and key policy judgements

After several years of strong growth, economic activity weakened in the latter half of 2005. Our projections are for the economy to grow only modestly through 2006 and for an overall rebalancing in economic activity. This rebalancing occurs through lower domestic demand, and a recovery in net exports, and will be reinforced by the recent fall in the exchange rate.

With economic activity slowing, medium-term inflation pressures are expected to moderate as pressure on productive capacity eases. Despite the easing in resource pressures, the short-term inflation outlook has worsened. The effect of higher global oil prices will lift inflation over the year ahead. The fall in the exchange rate is expected to boost inflation through higher import prices. These effects are projected to keep CPI inflation above 3 per cent well into 2007.

Our monetary policy deliberations have had to contend with a range of uncertainties affecting the medium-term inflation outlook. These include the extent and duration of the period of slower economic growth, the size of the short-term spike in inflation, and its effects on inflation expectations and ongoing price and wage-setting behaviour.

Figure 2.1
90 day interest rates

![Graph of 90 day interest rates]

Source: RBNZ.

Recent developments

Economic activity contracted slightly in the December quarter of 2005. Over 2005, there had been a gradual softening in domestic demand, while activity in the net export sector remained under pressure from the high exchange rate. The decline in December quarter GDP likely overstates the degree to which underlying economic activity was moderating, given the unusually large rundown of inventories that occurred in that quarter. Nevertheless, it is now apparent that the economy has weakened faster than expected.

There is likely to be a temporary rebound in economic growth in the March quarter statistics. Retail sales and household credit growth have been robust, underpinned by strong growth in employment and labour incomes. Imports of capital equipment have also been strong, suggesting near-term strength in business investment.

However, the outlook for growth over the remainder of 2006 remains subdued. A pick up in exports is expected to occur only gradually, while economic headwinds should continue to dampen domestic activity. Household disposable incomes are under pressure from higher ‘effective’ interest rates and the rise in petrol prices. In addition, the housing market is continuing to moderate. High petrol and oil prices will also negatively impact on firms’ costs of production and profitability.

The overall outlook for activity is a ‘soft landing’. The exchange rate fall has boosted confidence in the export sector, and should promote a recovery of export activity, albeit with a lag. Global economic activity remains robust. Furthermore, the recent upturn in net immigration should underpin domestic activity to some extent.

With slower economic growth, there is less pressure on productive resources, consistent with an easing in measures of capacity utilisation and labour market tightness.

Figure 2.2
GDP growth
(annual average per cent change)

![Graph of GDP growth]

Source: Statistics New Zealand, RBNZ estimates.
Accordingly, our projections incorporate a lower starting point for the gap between actual and potential output.

Since our March assessment, the fall in the exchange rate and higher oil prices have significantly increased the short-term inflation outlook. CPI inflation is now projected to peak at just under 4 per cent by the end of the year. In contrast, our March projections showed inflation returning below 3 per cent by late 2006. This difference in the near-term inflation outlook is mostly due to the unexpected rise in oil prices, and the faster-than-expected fall in the exchange rate (see Box 1 for more details). Annual CPI inflation is now expected to return below 3 per cent in late 2007.

Figure 2.3
CPI inflation
(annual per cent change)

In arriving at our projections, we have had to distinguish carefully between the short and medium-term effects of higher oil prices and the lower exchange rate on activity and inflation. A rise in oil prices will boost inflation in the short term, but is likely to dampen economic activity and inflation further out, due to its adverse effect on real incomes. On the other hand, a lower exchange rate is likely to boost inflation directly in the short term by lifting New Zealand dollar import prices and also add to inflation pressures further out via its positive effect on export sector activity. Assessing the timing, magnitude and balance of these effects is difficult. We rely, as much as we can, on our assessment of how activity and inflation have behaved in the face of similar circumstances in the past, but every episode is different. Furthermore, the outlook for both oil prices and the exchange rate is itself very uncertain.

A critical assessment affecting our medium-term inflation outlook is the degree of pass-through that may result from these one-off cost shocks. An exchange rate depreciation has long been expected, and its most recent fall is a positive development for medium-term growth prospects. The fact that a faster-than-expected fall has happened means that the inflationary impacts are front-loaded; however, we expect the magnitude of the pass-through to be limited. This is in line with experience following the exchange rate depreciation of 1999/2000, which showed that the impact of exchange rate movements on consumer prices has reduced over the past decade or so.

Our discussions with businesses suggest that extensive exchange rate hedging has been carried out by importers, which may limit, or at least flatten the exchange rate pass-through to inflation. Competitive market forces, especially in the retail sector, are also expected to dampen the exchange rate pass-through. In a similar manner, the more subdued domestic economic environment is expected to result in limited pass-through from the higher oil prices. However, should the short-term spike in inflation be passed through more aggressively into inflation expectations, then medium-term inflation pressures could be stronger.

Monetary policy judgements

Monetary policy faces a challenging set of circumstances at present. The challenge is to avoid a situation in which the short-term spike in inflation begins to percolate through into medium-term inflation pressures, thwarting a return of inflation back comfortably within the 1 to 3 per cent target band. This could occur if households and businesses attempt to recoup the loss of real income and higher production costs associated with the inflation spike, through more aggressive wage demands or price increases. Such behaviour would potentially result in inflation outcomes above the target band for a more prolonged period, notwithstanding relatively subdued economic growth. For a country such as New Zealand, which is a net importer of oil, higher world oil...
prices must inevitably mean a reduction in individuals’ real spending power.

When setting the OCR we are primarily responding to a forward looking assessment of inflation pressures over the medium term rather than current inflation or our projections for inflation in the near future. The Bank’s assessment is that changes in the OCR today affect inflation with a lag of 18 months to two years into the future and have little effect on inflation outcomes in the near term. As described in the Bank’s November 2002 Statement, in typical circumstances, we will give most of our attention to the outlook for CPI inflation over the next three or so years. If the outlook for inflation over that period is inconsistent with the target range, for whatever reason, then monetary policy will generally be adjusted with the goal of ensuring that inflation will be back within the target range by the latter half of that medium-term period.

This approach recognises that it would not be appropriate for monetary policy to attempt to offset the direct short-term inflationary effects of higher oil prices or the lower exchange rate, i.e. to attempt to use policy to affect inflation outcomes in the near future. Such behaviour would risk unnecessarily increasing volatility in economic activity, interest rates and the exchange rate, something we are obliged to avoid under section 4b of the Policy Targets Agreement.

Although monetary policy does not respond directly to short-term disturbances to CPI inflation, policy settings must take account of the risks that higher short-term inflation poses to the medium-term outlook. In our March Statement and again at the April OCR review, we commented that we saw no scope for an easing in monetary policy this calendar year. This reflected a view that lowering the OCR under current circumstances would create the conditions under which the current higher rate of inflation could become reflected in higher medium-term inflation expectations. We were also mindful of the possibility that an early easing in interest rates could risk reigniting inflation pressures in certain sectors of the economy, most notably housing, where demand is still relatively robust.

In interpreting our current policy position, it is important to reiterate that we are not assuming that the current spike in inflation will have significant enduring effects over the medium term. We are mindful that an overly cautious approach in this regard could result in keeping the OCR too high for an extended period with damaging consequences for economic activity. In the projections presented in Chapter 5 – which summarise our current policy outlook – higher oil prices and the lower exchange rate are assumed to have limited pass-through into CPI inflation over the medium term. In the event of a less benign outlook, under which inflation expectations and wage and price-setting behaviour respond more aggressively to the inflation spike, firmer monetary policy settings would be required. Looking ahead, we will clearly need to remain alert to signs of any greater ‘spill-over’ into price and wage-setting behaviour.

To illustrate how some of the risks could play out over the next few years relative to our central projection, we generate alternative scenarios where oil prices remain higher for longer. Higher oil prices mean that inflation remains higher over 2007. Economic activity is weaker relative to the central projection, reflecting lower terms of trade and real incomes. In the first scenario, as in the central projection, we assume only limited pass-through to inflation expectations. As a result, inflation returns to more normal levels as firms and consumers realise that the rise in inflation is due to a specific, one-off shock, and do not aggressively adjust their price and wage-setting behaviour. Under these assumptions, the outlook for nominal interest rates is broadly similar to the central projection – weaker economic activity roughly counteracts the effect of a more protracted period of inflation in the shorter term.

(continued on p. 8)
Oil prices and near-term inflation outlook

Oil prices have increased sharply since the March Statement. Much has been made of the role of geopolitical fears – particularly those surrounding Iran – and speculative activity in driving the recent rise in oil prices. While these factors have undoubtedly played a role, much of the rise in oil prices appears to be a result of ongoing demand growth and constrained supply. This appears to be have been the case for a range of other commodities (including metals and other industrial commodities), which have also recorded strong price rises in recent months – though part of these price increases may also have been accentuated by an element of speculative behaviour.

While world oil consumption is estimated by the US Energy Information Administration (EIA) to have risen to an average of around 80 million barrels per day (bpd) during the past year, excess production capacity is estimated to have shrunk to just 1 million bpd compared to an average of 3-4 million bpd during 1993-2003 (figure 2.5). Inventories have generally increased in line with the growth in consumption, with OECD countries as a whole estimated currently to be holding inventories equivalent to almost 53 days of supply. This is not much below the post-1991 average of 55-56 days. It is apparent that the lack of spare production capacity and continuing demand growth has put considerable upward pressure on oil prices.

Higher oil prices will boost inflation

Oil prices will affect inflation through a variety of channels.

- Changes to world oil prices are passed through almost immediately to domestic petrol prices. With petrol comprising around 4 per cent of the Consumers Price Index, increases in petrol prices have a fairly immediate direct effect on inflation.
- Oil, petrol and other petroleum products are also inputs into firms’ production processes, with fuel costs a significant component of many prices. Hence a rise in oil prices is also likely to lead to price increases for other goods and services, such as air travel. We have assumed that around half of the direct price effects are indirectly passed through into other consumer price increases.
- If the initial rise in CPI inflation spills over into people’s perceptions of medium-term inflation, an oil price shock can also result in ongoing inflationary effects to the extent that firms and households adjust their medium-term price and wage setting behaviour.
Higher oil prices should dampen domestic economic activity

Demand for oil is relatively inelastic. As a result, the rise in oil prices reduces the incomes and spending power of firms and households and damps economic growth. The magnitude of the effect on domestic activity is difficult to determine but, as a rough rule of thumb, a 10 per cent rise in oil prices could reduce annual GDP growth in the New Zealand economy by around 0.1 to 0.2 percentage points after one year.

Economic outlook and assumptions

Our working assumption is for the US dollar price of Dubai oil (the most relevant for the New Zealand economy) to decline moderately from its current peak to around $45 by 2008. This profile is broadly consistent with a range of estimates of the long-run marginal cost of oil production and also with Consensus forecasts for oil prices. Implicit in this assumption is that supply capacity responds to current price levels. There are clear risks around this assumption. A more sluggish supply response could result in a higher price profile. Indeed, oil futures prices have risen even further than spot prices in recent months. While oil futures do not provide an unbiased forecast for oil prices, they underline the risk that oil prices could rise further over the year ahead.

Relative to our March projections, oil prices are higher and the exchange rate has fallen faster than expected, resulting in higher domestic petrol prices. Given our assumptions for oil prices and the TWI, petrol prices are assumed to have reached a peak and are projected to fall to around 158 cents per litre by early 2007. Table 2.1 details how the oil and TWI profiles have raised our short-term CPI forecasts relative to our March assessment. CPI inflation is now expected to peak at 3.9 per cent in early 2007. This compares with our March assessment that inflation would be 2.6 per cent by early 2007.

Table 2.1
Effect of oil prices, petrol prices, and the TWI on CPI inflation

<table>
<thead>
<tr>
<th>March MPS CPI forecast (Qtrly)</th>
<th>June MPS petrol forecast (91 unleaded, c/ltr)*</th>
<th>Incremental contribution to CPI inflation (over March MPS)</th>
<th>June MPS CPI forecast** (Qtrly)</th>
</tr>
</thead>
<tbody>
<tr>
<td>06q2 0.8</td>
<td>169</td>
<td>0.5 Oil price effect</td>
<td>1.4</td>
</tr>
<tr>
<td>06q3 0.6</td>
<td>167</td>
<td>0.1 Oil price effect</td>
<td>0.9</td>
</tr>
<tr>
<td>06q4 0.8</td>
<td>163</td>
<td>0.2 TWI effect</td>
<td>0.9</td>
</tr>
<tr>
<td>07q1 0.4</td>
<td>158</td>
<td>0.2 TWI effect</td>
<td>0.6</td>
</tr>
<tr>
<td>Annual CPI at 2007q1 2.6</td>
<td>0.6</td>
<td>0.7 TWI effect</td>
<td>3.9</td>
</tr>
</tbody>
</table>

* Average price for the quarter
** Numbers may not add up due to rounding

Figure 2.7
International oil price assumption
(Dubai oil price, USD per barrel)

Source: Datastream, RBNZ estimates.

Figure 2.8
Spot and futures prices for oil
(West Texas Intermediate price)

Source: Bloomberg.
The second scenario is the same as the first except that the higher near-term inflation is assumed to result in greater pass-through into medium-term inflation via a more pronounced rise in inflation expectations and ongoing wage and price increases. In this circumstance, additional monetary policy pressure is required to counteract the higher inflation expectations, leading to an even larger fall in activity relative to the central projection. This scenario illustrates the potentially costly and damaging effects that could occur if the increase in short-term inflation became locked-in through higher inflation expectations.
Box 2
Recent monetary policy decisions

The Bank increased the OCR by a total of 225 basis points between June 2004 and December 2005, a more significant and protracted policy tightening than had generally been anticipated. Part of this increase reflected the removal of the precautionary policy easing in 2003, in response to uncertain global conditions associated with the SARS outbreak and sharp declines in global equity markets, together with a sharp fall in domestic business confidence, drought in some parts of the country and electricity shortages. In hindsight, the precautionary reduction in the OCR may have been unnecessary as the economy continued to grow strongly, particularly in the domestic industries such as construction, which exhausted spare productive capacity. The strength in domestic activity, underpinned by a very strong housing market, persisted for considerably longer than expected – notwithstanding a sustained rise in the New Zealand dollar, leading to tighter overall monetary conditions and a sharp braking effect on the export sector.

Although the OCR was increased by 25 basis points in both October and December 2005, GDP statistics subsequently showed weaker-than-expected activity in the second half of 2005. At this stage, these increases still appear to have been appropriate given our current assessment of relatively strong medium-term inflation pressures and the risks created by the short-term upward pressure on inflation due to the fall in the exchange rate and higher world oil prices.

The OCR has been maintained at 7.25 per cent during the first half of 2006. Domestic demand has begun to cool reflecting the removal of some of the earlier drivers, and the lagged effects of the policy tightening in 2004 and 2005. However, at the March 2006 Statement and the April OCR review, the Bank noted that it saw no scope for an easing of monetary policy during the current calendar year. Increasingly, market expectations have also reflected this view, as apparent in financial market prices.

Figure 2.11
Official Cash Rate

Source: RBNZ.
3 The recent economic situation

Overview
The economy grew strongly between 2000 and 2004, absorbing spare capacity and leading to a rise in inflation pressures. Throughout much of this period, domestic demand grew more quickly than production, contributing to a widening trade deficit. Growth has been slowing gradually since late 2004 and continued to ease in 2005.

Despite growth slowing, domestic demand remained strong until late 2005. The resulting pressure on productive resources has seen non-tradables inflation running above 4 per cent since 2004. More recently, tradables inflation has also picked up due to the depreciation of the New Zealand dollar and sharp rises in oil prices. Combined, these conditions have seen inflation rising above 3 per cent.

Recent data have made it clear that activity is continuing to slow, and there has been a material easing in activity and resource pressures. However, the rise in global oil prices and the fall in the New Zealand dollar since the March Statement indicate substantial increases in inflation over the coming quarters.

Global economic developments
The robust world growth seen in 2005 appears to have been sustained in the early part of 2006. US growth rebounded in the March quarter and solid activity has been observed in Australia, the Eurozone and across Asia.

However, there are signs of increasing inflation pressures in our trading partner economies, due mainly to the rising cost of oil and commodities. Concern exists that these price increases may contribute to slowing activity. This is because of the constraining effects of higher prices on spending, and because the stronger inflation pressures may prompt a tightening of monetary conditions. Indeed, official interest rates have already risen in some economies:

- US GDP rebounded in the March quarter with a surge in consumption, and solid gains in both investment and government spending. However, consumption growth is now coming under pressure from higher energy prices and falling consumer confidence. The Federal Open Markets Committee (FOMC) increased the Fed Funds rate by 25 basis points to 5 per cent in May in a move aimed at moderating inflation pressures. The FOMC also noted that further rate increases could be required, though these would be dependent on the data.
- Activity in early 2006 has also remained robust in Australia, with consumption buoyed by a solid labour market. Looking ahead, improving consumer sentiment and recently announced tax cuts signal continued strength in demand, despite rising energy prices. However, as in the US, the strength of domestic demand, combined with stretched capacity and rising prices for commodities, has prompted the Reserve Bank of Australia to increase its cash rate in an attempt to quell inflation pressures.
- The past year has seen a marked improvement in the outlook for activity in Japan. Strength in the labour market continues to support consumption, and increases in industrial activity and capital investment are expected in the coming months. The outlook for activity has now improved to the extent that the Bank of Japan recently announced an end to its quantitative easing. Gradual interest rate increases are now expected as Japan begins to experience positive rates of inflation.
- Activity in China remains strong as a result of a very robust export sector. This strength has encouraged increased investment and solid household demand. Demand conditions also appear to be improving across other parts of Asia (including Hong Kong, South Korea, and Singapore) signalling support for growth going forward. However, these improved outlooks for activity, coupled with rising oil prices, may signal rising inflationary pressures in a number of countries.
- GDP growth in the Eurozone improved in the March quarter, rising by 0.6 per cent. However, thus far the improvement in activity has been centred on industrial production, with consumer spending still remaining subdued. Solid GDP growth has also been observed in the UK in early 2006, but inflation pressures are starting to appear due to rising energy costs, wages and house price inflation.

Overall, the outlook for growth in New Zealand’s trading partner economies is robust. And despite the risk of stronger
inflation and tighter monetary conditions, export demand is likely to be stronger than previously assumed.

Tradables sector activity

New Zealand’s trade position has deteriorated significantly over the past year. The high New Zealand dollar, strong consumer spending and robust business investment have all contributed to strong import growth. At the same time, the high New Zealand dollar has subdued export growth. Combined, these conditions have seen the current account deficit expand to 8.9 per cent of GDP at the end of 2005 (figure 3.1).

Figure 3.1
Annual current account, goods and services balances

Export growth was subdued over 2005 due to poor agricultural conditions, strong international competition and the negative impact of the high New Zealand dollar. Although the decline in the New Zealand dollar seen in recent months will promote a gradual improvement in exporting conditions, export sector growth looks likely to remain soft for most of this year:

- Weakness in agricultural exports was seen over most of 2005 (figure 3.2). This was largely a result of subdued dairy production and a period of herd rebuilding (though significant de-stocking did occur at the end of 2005). There has also been sustained weakness in forestry exports due to unfavourable conditions in international markets. Moving into 2006, this softness in primary exports looks to have continued, with farmers again taking advantage of favourable weather conditions to build herd sizes.
- Despite the high level of the New Zealand dollar, non-commodity manufactured exports volumes have remained relatively robust (figure 3.2). However, strong international competition, combined with reduced New Zealand dollar revenues, has still seen a substantial retrenchment in this sector. The environment for manufactured exports has now improved following the recent sharp fall in the New Zealand dollar.
- With tourist arrivals relatively flat, exports of services were stagnant over 2005. This was a result of the high New Zealand dollar which eroded the relative price advantage of New Zealand compared to alternative
destinations. However, the lower New Zealand dollar signals improving export returns going forward, and some increase in tourist arrivals has been seen in early 2006.

In recent years, the effects of subdued export volumes on returns to New Zealand producers have been offset by strong international commodity prices. International prices for several of our main exports (such as meat and dairy) have now started to ease (figure 3.3), although, the recent decline in the New Zealand dollar will help to maintain prices measured in New Zealand dollars.

With resources highly stretched, much of the strong domestic demand over recent years has been met by imports. Strong growth was seen in imports of consumer goods and overseas travel as household spending was buoyed by the high New Zealand dollar. Businesses also took advantage of the high New Zealand dollar by importing capital equipment (figure 3.4).

Figure 3.4
Imports of consumer and capital goods
(annual average per cent change)

However, with the recent slowing in domestic demand, import growth has slowed (figure 3.5). Falls were seen in imports of capital equipment and consumer goods in late 2005, as well as reduced numbers of New Zealanders travelling overseas for holidays. Although merchandise imports signal some limited recovery in early 2006, further softening in import growth is likely.
Box 3

International commodity prices

Very strong international commodity prices have been seen in recent years. This has included strong growth in prices for the agricultural commodities (figure 3.6) which form the majority of New Zealand’s merchandise exports. High international prices have helped to maintain returns to New Zealand exporters, despite the high New Zealand dollar. Conversely, the high New Zealand dollar has also partially insulated the domestic economy from the effect of rising prices for other commodities.

Figure 3.6

ANZ world commodity price index and Economist commodity price indices

The tight supply conditions that supported prices for agricultural exports started to ease in 2005, and world prices for agricultural products are now around 5 per cent below the peak seen in May 2005. In contrast, prices for metals and industrial commodities have continued to show exceptional growth, rising more than 20 per cent since May 2005.

The recent price increases for non-agricultural commodities have been due largely to tight supplies and robust global demand, particularly from China. However, an element of speculative behaviour may be accentuating these recent price rises.

This situation leaves New Zealand’s commodity export prices out-of-sync with the broader commodity price cycle – a situation which has important implications for economic activity in New Zealand, particularly for near-term consumption spending and inflation:

- Terms of trade: With international prices for New Zealand’s agricultural exports now lower and import prices higher, the economy is less well off in terms of how many imported goods it can consume. This implies a reduction in real spending power, and an erosion of household disposable incomes.

- The New Zealand dollar: Continued demand for commodities is likely to underpin strength in commodity currencies. However, as agricultural export prices ease, there may be reduced support for the New Zealand dollar relative to other commodity currencies.

- Inflation: Increases in the price of imported commodities signal stronger cost-push inflation pressures. The impact of such pressures is already evident, with transport costs rising strongly over recent months in response to higher oil prices. These effects could be exacerbated if the shifts in commodity prices are compounded by a further depreciation of the New Zealand dollar.

- Current account: Rises in industrial commodity prices (particularly oil) signal a further widening of the current account deficit in the short term. However, this will be offset to some degree by rises in export receipts and reduced import volumes.

It would be unusual for such a large divergence between agricultural and non-agricultural commodity prices to persist for an extended period. It remains to be seen whether economic fundamentals can sustain non-agricultural commodity prices at these high levels, or whether there is any positive spillover into agricultural prices.
Domestic demand

A key contributor to economic growth over recent years has been strong domestic demand (figure 3.7). Household spending has grown strongly (figure 3.8), supported by a buoyant housing market and very strong growth in labour incomes. Household debt levels have also risen rapidly as increases in house prices have enabled the use of housing equity withdrawal to fund spending (figure 3.9). This willingness to take on debt suggests that consumers have felt more confident about their ability to service debt, particularly given the strength in the labour market.

Household spending growth started to ease in late 2005, with weak growth in the December quarter. Further, recent developments indicate that stimulus for consumption spending is dissipating. Strong increases in petrol prices have eroded households’ disposable income, and the decline in the New Zealand dollar has seen rising prices for imported consumer goods. The dampening effect of these developments is already evident across some categories of consumption spending, such as lower vehicle registrations in recent months. In addition, the effects of previous tightening in monetary policy are being felt through rising effective mortgage rates. Indicative of these weaker fundamentals, measures of consumer confidence have fallen to multi-year lows.

Another factor likely to dampen household spending is slowing house price inflation (figure 3.10), with falling house sales and rising days-to-sell pointing to some further near-
term softening in house prices. These developments indicate that housing related wealth will provide less stimulus for consumption growth over the coming quarters.

Residential investment has also slowed, and recent data suggests that further slowing can be expected in the near term. For instance, non-apartment dwelling consents have continued to soften and a general downwards trend has been observed in house sales for some months now (figure 3.11).

Figure 3.11
REINZ house sales and ex-apartment dwelling consents

Another factor weighing on the housing market has been the significant decline in net immigration since 2003. However, net immigration flows have remained positive and have rebounded in recent months due to increasing numbers of people choosing to stay in New Zealand. Relative to historical experience, it is unusual for net immigration to remain positive while the New Zealand economy is growing slower than our trading partners. Positive net immigration indicates some underlying level of demand for housing.

Strong domestic demand has not been limited to the household sector. Strength in business investment has also been observed in recent years (figure 3.12), encouraged by solid consumption spending, high levels of capital and labour utilisation, and the high New Zealand dollar. This strength in business investment appears to have been sustained in early 2006, with continued growth seen in recent imports of capital equipment.

However, there are increasing signs that business investment will slow further ahead. The last year has seen marked deteriorations in business confidence, including large falls in firms’ investment intentions (a sentiment echoed in our recent business visits). Combined with the lower exchange rate making imported capital more expensive, and a softening outlook for activity, this more pessimistic outlook signals reduced business investment going forward. Signs of this are already evident, with non-residential building consents trending down over recent months.

Productive capacity
The strength of economic activity in recent years has outstripped the economy’s productive capacity, resulting in rising domestic inflation pressures. But with growth and domestic demand slowing more recently, there has been a material easing in resource pressures. This has been reflected in marked easings in key measures of resource strain (figure 3.13, overleaf). The economy has now moved into a position of better balance between demand and supply pressures.

Some pockets of resource pressure remain. In particular, the labour market remains highly stretched with unemployment still very low (figure 3.14, overleaf). But with participation at cyclical highs and economic activity slowing, the scope for further falls in unemployment appears limited.
The labour market and wages

Despite signs of softening economic activity, employment growth has been solid and unemployment remains low at 3.9 per cent. At the same time, ongoing labour market tightness has lifted wage growth. The unadjusted Labour Cost Index (LCI) rose to record levels in March with private sector wages and salaries growing 5.5 percent on average (figure 3.15). Even adjusting for productivity changes, wages and salaries have been rising by around 3 per cent annually - a rate which leaves wage cost inflation at historically high levels.

Strong wage growth combined with favourable employment prospects has seen labour force participation rising to record levels in early 2006 (figure 3.14). There have been particularly large increases in participation among female and older workers. Increased participation among younger workers was also seen in early 2006.

Inflation pressures

In the year to March 2006, consumer prices rose 3.3 per cent (figure 3.16). Domestic resource pressures have been a significant contributor to rising consumer prices, with non-tradables inflation lingering above 4 per cent since early 2004. March’s increase in non-tradables prices was a result of continued strong price growth in both the housing and non-housing components of non-tradables inflation.
In contrast to the strength seen in domestic inflation, tradables prices nudged down slightly in the March quarter due to the usual heavy discounting on international airfares. However the large fall in airfares obscured an increase in wider imported inflation pressures. Indeed, the initial effects of the lower New Zealand dollar and rising international oil prices started to feed into consumer prices with domestic petrol prices rising 5 per cent.

In addition to strong headline inflation, core inflation measures such as weighted-median and trimmed-mean inflation have remained at high levels (figure 3.17). This signals that inflation pressures remain strong and widespread.

Higher petrol prices have been a significant contributor to headline CPI inflation over the past year, reflecting the persistent increases in global oil prices over this period. Nevertheless, excluding petrol prices, it is still apparent that inflation pressures have been rising (figure 3.18, overleaf). This reflects both strong domestic inflation pressures, and the waning impact of the earlier exchange rate appreciation.

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

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Derivatives and analytical series

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Figure 3.18
Headline inflation and CPI excluding petrol costs (annual per cent change)

Source: Statistics New Zealand, RBNZ estimates.

Figure 3.19
One-year ahead inflation expectations


Figure 3.20
Longer-term inflation expectations

Source: Statistics New Zealand, RBNZ, AON Consulting, RBNZ estimates.

Note: Expected inflation implied by indexed bonds is calculated using the 2016 inflation indexed bond.

Inflation expectations

Increases in shorter-term inflation expectations have been seen in recent years (figure 3.19). However, it is longer-term expectations which are of more concern for monetary policy due to their greater impact on economic decision-making. From figure 3.20 we see that, while longer-term inflation expectations have remained better anchored, they too have edged up over the recent period.
4 Financial market developments

International markets

Both short- and long-term interest rates have risen in all of the world’s major markets since the March Statement (figure 4.1). Continued strength in economic activity has been seen by markets as reinforcing the likelihood of ongoing monetary policy tightening in a range of countries. The US Federal Reserve recently announced its sixteenth consecutive 25 basis point rate rise, taking its policy rate to 5 per cent. While there is now increased uncertainty regarding the timing and magnitude of further US rate rises, markets expect at least one more 25 basis point rate rise to be delivered by the end of the year. Markets expect the European Central Bank to follow its two policy rate rises in late 2005/early 2006 with increases over the next 12 months totalling as much as 100 basis points. The Bank of Japan announced in early March that its quantitative easing programme would end and markets expect its policy rate to be lifted from zero by the end of the year. The Reserve Bank of Australia increased its policy rate in May for the first time in 14 months and markets are pricing in some risk of a further rise by the end of the year.

Exchange rates

The US dollar has depreciated against most currencies since the March Statement (figure 4.2). A perception that the US is near the end of its monetary policy tightening cycle contrasts with other central banks – particularly those of Europe and Japan – that are expected to tighten policy to a much greater extent over the year ahead. Despite broad-based weakness in the US dollar, the NZD/USD exchange rate has fallen by just over 1 per cent since the March Statement.

Figure 4.2
Movements in currencies against the US dollar since the March Statement

Accordingly, the New Zealand dollar has fallen against all the major currencies that comprise the TWI since the March Statement. The March quarter decline in the New Zealand dollar (of 10.3 per cent) was one of the largest quarterly declines since the New Zealand dollar was floated. This depreciation has been orderly, and reflects changing perceptions of the relative cyclical position of the New Zealand economy against our main trading partners. The exchange rate adjustment has been consistent with rising interest rate expectations in key offshore markets (figure 4.3).
However, the most recent weakness in the New Zealand dollar has been greater than might have been expected on the basis of movements in relative interest rate expectations, which have recovered from the lows seen following the release of weak December quarter GDP data (as discussed in ‘Domestic markets’ below). Increasingly attractive investment opportunities in major markets associated with a strengthening global economy appear to be drawing investors away from New Zealand dollar investments. In this regard, issuance of Eurokiwi and Uridashi bonds has been considerably weaker in April and May than during the previous six months (figure 4.4).

Overall, the TWI has recently fallen to two year lows and it is widely expected to fall further over the year ahead. Analysts have generally revised down their forecasts for the TWI over recent months and the median forecast in a recent survey was for it to fall a further 7 per cent by March 2007. The Bank’s projection for the TWI (discussed in Chapter 5) is broadly in line with these forecasts.

Domestic markets

Domestic interest rates have risen since the March Statement but there has been considerable volatility over the period. At one stage, following the release of weak December quarter GDP data, the market moved to fully price in a rate cut by July and a total of three rate cuts by the end of the year. However, the subsequent release of stronger data and ongoing New Zealand dollar weakness saw the market increasingly doubt the potential for an early rate cut. Indeed, OCR expectations have risen to the point where they are now higher than at the time of the March Statement, with the market no longer fully pricing in a rate cut by the end of the year (figure 4.5).

Figure 4.3
The New Zealand dollar and relative interest rate expectations

Figure 4.4
New Zealand dollar bond issuance in offshore markets

Figure 4.5
Financial market expectations of the Official Cash Rate

Meanwhile, the spreads between longer-term interest rates in New Zealand and those in key offshore markets have continued to narrow. Notably, New Zealand 10-year bond yields reached parity with Australian 10-year yields at one
stage in May. The narrowing of longer-term interest rate spreads is in line with relative monetary policy developments and changes in associated expectations (figure 4.6). As discussed above, New Zealand policy rate expectations have retraced higher over the past month, but – until recently – policy rate expectations in other key countries have increased to a greater extent. Despite the general narrowing of spreads, longer-term interest rates in key offshore markets have risen to such an extent that they have pushed up the level of New Zealand longer-term interest rates.

Figure 4.6
Interest rate spreads between New Zealand and the US

Source: Bloomberg.

Following the release of weak December quarter GDP data, the yield curve fell and became more inverted as rate cut expectations were brought forward and narrowing spreads more than offset rising global rates. However, as rate cut expectations have receded and global rates continued to rise, the yield curve has ended up higher and flatter than at the time of the March Statement, with longer-term interest rates rising to a greater extent than those at the short end of the curve (figure 4.7).

The initial fall in wholesale rates provided scope for banks to offer lower mortgage rates to new and refi- nancing borrowers than anticipated at the time of the March Statement. However, the recent rise in rates leaves the Bank confident that the average interest rate paid on outstanding mortgage debt – the ’effective’ mortgage rate – will continue to rise through the remainder of 2006 (figure 4.8).

Figure 4.7
The wholesale interest rate curve

Source: Bloomberg.

Figure 4.8
The OCR and the effective mortgage rate

Source: RBNZ.
The macroeconomic outlook

Overview

We expect only moderate economic growth over 2006. Higher world oil prices have been added to a range of factors that are expected to dampen domestic demand and limit economic growth: the ongoing impact of higher interest rates; reduced levels of immigration; and declining world prices for New Zealand’s commodity exports. However, the recent depreciation of the exchange rate is expected to boost exports and discourage import growth, aiding a recovery in economic growth over 2007.

Recent developments have sparked the beginnings of a rebalancing in the New Zealand economy. We are projecting this to continue, with weaker domestic demand, stronger net exports, and a higher rate of household saving.

The recent rise in world oil prices, combined with the depreciation of the TWI, is expected to push CPI inflation to a peak of 3.9 per cent in the near-term. However, looking through this near-term volatility in inflation, the outlook is for medium-term inflation to return below 3 per cent in 2007.

The remainder of this chapter details our economic projections for the next three years.

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. Consensus Forecasts are projecting robust world economic growth of around 3½ per cent per annum for the foreseeable future, suggesting that demand for New Zealand’s exports will remain robust.

The terms of trade

World prices for New Zealand’s exports reached high levels in 2005, partly due to supply constraints on agricultural production in other parts of the world. More recently these supply constraints have eased, and New Zealand’s export prices have fallen. We are predicting further moderate declines in export prices over the projection period. However, recent falls in the exchange rate, combined with an expectation of further depreciation, will more than offset

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

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* 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.
the fall in world export prices. New Zealand dollar returns are expected to improve for most exporters.

World prices for both oil and non-oil commodity imports have risen sharply over the past two years. We are currently in a period of heightened uncertainty around oil prices and other industrial commodity prices. Our projection sees the price of Dubai oil gradually correcting back to USD45 per barrel by 2008. This oil price assumption is consistent with a range of estimates of the long-run marginal cost of bringing new oil to market. Should oil prices hold up at current levels for longer than assumed, short-term inflation would most likely prove higher than currently forecast. For non-oil imports, we are projecting further gradual price increases over the projection period.

Higher import prices, coupled with the fall in export prices, imply a sharp fall in the terms of trade over 2006. However, the terms of trade are projected to recover in the out-years of the projection, to a level that is high by historical standards.

**Figure 5.2**

**Dubai oil price**

*(US dollars per barrel)*

Source: Datastream, RBNZ estimates.

**Figure 5.3**

**OTI terms of trade (goods)**

Source: Statistics New Zealand, RBNZ estimates.

**Exchange rate**

Following recent falls in the exchange rate, our TWI projection is now lower than it was in the March Statement. The TWI is projected to depreciate further, albeit at a more moderate pace, reaching 56 in 2009. Of course, there are considerable uncertainties around this projection for the TWI. A higher TWI would result in less inflationary pressure, while further sharp declines in the TWI would create more inflationary pressure than allowed for in the current projection.

**Figure 5.4**

**Nominal TWI assumption**

Source: RBNZ estimates.

**Export volumes**

We expect the lower exchange rate to promote stronger activity in the export sector, with a strong recovery in overall export volumes projected. However, the timing and extent of recovery will vary from sector to sector:
• **Agricultural exports** have been weak recently, mainly due to climatic factors. We expect this weakness to continue throughout 2006, before a gradual recovery begins in 2007.

• **Non-commodity manufactured export volumes** have held up relatively well during the recent high exchange rate period. Many of New Zealand’s exporters of manufactured goods compete on quality, innovation and reputation, rather than on price. We expect the volume of non-commodity manufactured exports to continue expanding steadily, with a modest additional boost coming from the lower TWI.

• **Forestry exports** have suffered from both low world prices and the high exchange rate, with volumes virtually stagnating in recent years. The fall in the exchange rate has improved the outlook for forestry exports, and we expect a recovery over the coming years.

• **Exports of services** have also been weighed down by the high exchange rate. The tourism industry is expected to receive only a modest boost from the lower exchange rate this year. However, we expect a strong recovery in tourist numbers beginning in 2007.

Figure 5.5
Total export volumes
(per cent of trend output and annual average per cent change)

Source: Statistics New Zealand, RBNZ estimates.

**Import volumes**
In recent years the imbalance between domestic demand and domestic production has been met by a surge in import volumes. In late 2005 we saw some rebalancing of the economy, with lower domestic demand and a fall in import volumes. While we are anticipating a temporary rebound in import volumes in the March 2006 quarter, we expect persistently low import growth in subsequent quarters, due to the combination of lower business investment, weaker household consumption, and higher import prices resulting from the lower TWI.

Figure 5.6
Total import volumes
(per cent of trend output and annual average per cent change)

Source: Statistics New Zealand, RBNZ estimates.

**Current account**
In the short term we expect the current account deficit to widen further, reaching a peak of 9.7 per cent in December 2006. This deterioration mainly reflects higher nominal expenditure on imports due to the fall in the New Zealand dollar and the rise in oil prices. In time, we expect the volume of imports to fall and export receipts to rise rapidly, leading to a substantial improvement in the current account deficit.
Net immigration
As mentioned in Chapter 3, net immigration has increased sharply in the past six months, mainly due to a decline in migrant departures. We believe that the boost to migration will prove temporary, given the slowing in domestic activity, and that net immigration in 2007 will be lower than in 2006.

Residential investment
We are projecting a long period of flat growth in residential investment. Relatively low net immigration and rising effective mortgage rates will continue to weigh on residential investment. Furthermore, low rental yields may make property investment a much less attractive option once capital gains have slowed. However, net immigration has staged something of a recovery in recent months and the current projection for residential investment is now somewhat stronger than we had in the March Statement. The projected downturn in residential investment is mild by historical standards, given that the outlook is for net immigration to remain positive – an unusual result in the down part of the cycle.
 Labour market

While employment growth was surprisingly strong in the March quarter, we are projecting much lower employment growth, following the recent cooling in activity. But we also expect the labour force participation rate to decline slightly from its highs, meaning that the increase in unemployment will be modest.

Wage inflation has remained strong. We expect that past tightness in the labour market will continue feeding through to wage settlements, keeping wage inflation around its current elevated level for some time. However, we would become wary if wage inflation were to accelerate further. If wage settlements attempt to compensate for inflation, irrespective of underlying improvement in productivity, then there is a risk that wage inflation will create an ongoing inflation dynamic.

Household consumption

In recent years we have witnessed strong growth in household consumption, which has outstripped income growth, implying rates of dis-saving that appear unsustainable. A significant driver of this consumption cycle has been the ability of households to withdraw equity from the rising value of houses. More recently, household consumption growth has begun to slow, and we are projecting a further substantial slowdown. The consumption slowdown partly reflects the rise in effective mortgage rates. It also reflects the projected fall in housing inflation which is expected to crimp households’ ability to raise additional credit and dissave. A key risk to this outlook, therefore, is that house price inflation evolves differently to our projection.
Business investment
We expect business investment to contract sharply in 2006, and to remain subdued for the remainder of the projection period. This contraction in business investment is expected to be concentrated mainly in plant and machinery investment, with non-residential construction expected to remain relatively robust.

Gross domestic product
In recent years the economy has been boosted by such factors as an influx of migrants, a higher proportion of people entering the labour force, and strong business investment. All of these factors have added to the rate of potential output growth (the economy’s capacity to supply goods and services without creating inflation). Immigration is now well past its peak, and over the next few years we are predicting lower labour force participation and less business investment. These projections imply a slower rate of potential output growth in the future. Potential output growth is expected to slow from 3.2 per cent currently to 2.6 per cent in 2008.

Growth in Gross Domestic Product was negligible over the second half of 2005. Given the outlook for the components of GDP discussed above, we expect GDP growth to remain at low-but-positive rates over 2006 and 2007. This will see a situation of excess supply gradually
develop, alleviating built-up pressure on economic resources
and putting downward pressure on inflation.

**Figure 5.16**
Potential output growth  
(*annual average per cent change*)

![Potential output growth graph](image)

Source: Statistics New Zealand, RBNZ estimates.

**Figure 5.17**
GDP growth  
(*annual average per cent change*)

![GDP growth graph](image)

Source: RBNZ estimates.

**Inflation**

As mentioned in Chapter 2, we expect the temporary effects of higher world oil prices and the lower exchange rate to substantially boost tradables inflation in the short term. This boost to tradables inflation will be short-lived, but it will push CPI inflation to a peak of 3.9 per cent.

With the weaker-than-expected domestic economy alleviating domestic inflation pressure, non-tradables inflation is expected to fall throughout the projection period. However, the disinflation pressure is likely to be moderated
to some extent by an increase in near-term inflation expectations and the ongoing effects of tight labour market conditions.

Looking through near-term volatility to concentrate on medium-term inflation, the overall outlook is for inflation to fall comfortably within the target band by late 2007. The main threat to this outlook arises from the prospect of inflation expectations responding more strongly to the short-term inflation spike.

**Figure 5.18**
CPI, tradables and non-tradables inflation  
(*annual rate*)

![CPI, tradables and non-tradables inflation graph](image)

Source: Statistics New Zealand, RBNZ estimates.
## Appendix A

### Summary tables

#### Table A
**CPI inflation projections and monetary conditions**

*(CPI is in percentage changes)*

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#### Quarterly projections

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Notes for these tables follow on pages 32-33.
### Table B
Composition of real GDP growth
(*Annual average per cent change, unless specified otherwise*)

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<th>March year</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
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<td>15.1</td>
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<td>19.9</td>
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<td>-7.7</td>
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<td>Total</td>
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<td>Final domestic expenditure</td>
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<td>7.8</td>
<td>1.6</td>
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<td>0.1</td>
<td>1.8</td>
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<td>Imports of goods and services</td>
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<td>4.0</td>
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<td>12.9</td>
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<td>0.9</td>
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(1) Percentage point contribution to the growth rate of GDP.
Table C
Summary of economic projections
(Annual per cent change, unless specified otherwise)

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<td>Import prices (in New Zealand dollars)</td>
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<td>7(\frac{1}{2})</td>
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<td>GDP (production, annual average % change)</td>
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<td>3.7</td>
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<td>3.1</td>
<td>3.4</td>
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<td>4.9</td>
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<td>1.5</td>
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<td>0.7</td>
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<td>-4.8</td>
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<td>-7.8</td>
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<td>-13.7</td>
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<td>-9.7</td>
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<tr>
<td>( % of disposable income, year to March)</td>
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<td>World GDP (annual average % change)</td>
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<td>3.0</td>
<td>3.4</td>
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<td>2.1</td>
<td>2.1</td>
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</table>

s.a. = seasonally adjusted
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, 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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<tbody>
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<td><strong>Government operating balance</strong></td>
<td>Historical source The Treasury. Adjusted by the RBNZ over the projection period.</td>
</tr>
<tr>
<td><strong>Labour productivity</strong></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><strong>Labour cost</strong></td>
<td>Private sector all salary and wage rates. Labour Cost Index.</td>
</tr>
<tr>
<td><strong>Quarterly percentage change</strong></td>
<td>((\text{Quarter/Quarter}_{t-1})\times100)</td>
</tr>
<tr>
<td><strong>Annual percentage change</strong></td>
<td>((\text{Quarter/Quarter}_{t-4})\times100)</td>
</tr>
<tr>
<td><strong>Annual average percentage change</strong></td>
<td>((\text{Year/Year}_{t-1})\times100)</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
Companies and organisations contacted by RBNZ staff during the projection round

ADC Krone Ltd
Alliance Group Ltd
ASB Bank Ltd
Auckland Chamber of Commerce
Auckland International Airport Ltd
Balance Agri-Nutrients Ltd
Beattie Rickman
Blue Sky Meats (NZ) Ltd
BP Oil New Zealand Limited
Briscoes (New Zealand) Ltd
Business New Zealand
Cadbury Confectionery Limited
Canterbury Development Corporation
Canterbury Manufacturer’s Association
Christchurch International Airport Ltd
Comalco New Zealand Limited
Crane Distribution NZ Limited
Employers & Manufacturer’s Assoc. (Northern)
Export New Zealand
Exxon Mobil Oil Ltd
Fairfax New Zealand Ltd
Financial Services Federation Inc
Fletcher Building Ltd
Foodstuffs (South Island) Ltd
Foodstuffs (Wellington) Cooperative Society Limited
Foster Construction Ltd
GE Consumer Finance Ltd
Glengarry Hancocks Ltd
Greenlea Premier Meats Ltd
Green Industries Ltd
Hayes International Ltd
Hume Pine (NZ) Ltd
Invercargill City Council
J.J. Limited
Kathmandu Ltd
Kiwi Discovery

La Grouw Corporation Ltd
Marley New Zealand Ltd
Nissan New Zealand Limited
Noel Leeming Ltd
Norsewear of New Zealand Ltd
NZ Council of Trade Unions
P & O Nedlloyd
Paperplus New Zealand Ltd
Pricewaterhousecoopers
Progressive Enterprise Ltd
Queenstown Lakes District Council
Restaurant Brands NZ Ltd
Richina Pacific Ltd
Rotorua District Council
Rydges Hotels and Resorts Ltd
Shotover Jet Ltd
Skope Industries Limited
Skyline Enterprises Limited
Snowy Peak Limited
South Pacific Tyres N.Z. Ltd
Southland Building Society (SBS)
Steel and Tube Holdings Ltd
Tachikawa Forest Products (NZ) Ltd
Tait Electronics Limited
The Heritage Queenstown
The Queenstown Chamber of Commerce
Tidd Ross Todd Limited
Villa Maria Ltd
Vita New Zealand 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 C
Reserve Bank statements on Monetary Policy

OCR unchanged at 7.25 per cent

9 March 2006

The Official Cash Rate (OCR) will remain on hold at 7.25 per cent.

Reserve Bank Governor Alan Bollard said: ‘Recent data have confirmed our earlier view that economic growth is slowing. Business activity and confidence have been softening for some time. On the other hand, household spending has only recently started to wane. A key driver of strong household spending has been the buoyant housing market which, while showing signs of cooling, still remains very active. Over the next two years, we expect overall growth to remain subdued while a major rebalancing takes place, with a recovery in net exports as domestic demand weakens. A decline in the New Zealand dollar exchange rate is expected to play a role in this rebalancing.

‘Despite the slower growth, inflation and cost pressures remain persistent. Labour market and resource pressures have built up over many years of high growth and will take some time to dissipate. Labour costs in particular are growing strongly, at a time when firms are finding it difficult to lift sales and productivity. Realistic wage and price setting behaviour will be an important factor determining the severity of the downturn as inflation pressures are brought under control. The other key inflation risk over the next two years remains the housing market. We need to see this market continue to slow, so that consumption moderates and helps to reduce inflation pressures.

‘As long as these inflation risks remain under control, we do not expect to raise interest rates again in this cycle. However, given the time that it will take to bring inflation back towards the mid-point of the target band, we do not expect to be in a position to ease policy this year. Any earlier easing would require a more rapid reduction in domestic inflation pressures than the substantial slowing already assumed in our projections.’

Review of the Reserve Bank’s Liquidity Management Operations

17 March 2006

The Reserve Bank has issued a consultation document (PDF 191KB) on proposed changes to the Bank’s liquidity management regime. Submissions on the consultation paper are due by the 20 April 2006.

One of the Bank’s priorities for this financial year has been to review its liquidity management operation. The review commenced in mid-2005 and has highlighted that the current liquidity management system faces some issues which need to be resolved.

Under the current system the available collateral is not expanding at a similar rate to demand for liquidity. The resulting pressures affect costs to participants and the credit risks faced by the Reserve Bank.

This is a proposed technical adjustment and there are no monetary policy implications.

Report on supplementary tools released

6 April 2006

The Reserve Bank and the Treasury today released a joint report (PDF 276KB) on possible additional instruments to supplement the role of interest rates in managing demand pressures and inflation.

This report, prepared under terms of reference issued in November 2005, was prompted by the recent strength and persistence of domestic household demand, the scale of the accompanying external imbalances, and the key role played by the house price cycle.

In calling for this report, it was considered that, if additional non-interest rate instruments were available to more directly target the housing sector, they might alleviate some of the pressures on the exchange rate and the traded goods sector. Such instruments would be structured so that they would be relevant for use in any future period of cyclical housing pressure, said Reserve Bank Governor, Alan Bollard, and Secretary to the Treasury, John Whitehead, in a joint statement.
“The report considered a range of possible additional instruments. It concludes that there are no simple, or readily implemented, options that would provide large payoffs in the near-term, without significant complications and costs, but there are some areas in which further work may be appropriate. These will be picked up in the course of ongoing work on macroeconomic policy.

‘We remain interested in the possibility that additional discretionary instruments, including ones not directly related to the housing sector, might be able to mitigate the impact on the tradables sector of cycles in domestic demand, but further work in this area is not a high priority for us at present.’

The report was prepared by a joint team of Treasury and Reserve Bank officials for the Governor and the Secretary, who then made recommendations to the Minister of Finance. Also released today is the letter provided by the Governor and Secretary to the Minister of Finance.

OCR unchanged at 7.25 per cent

27 April 2006

The Official Cash Rate (OCR) will remain at 7.25 per cent.

Reserve Bank Governor Alan Bollard said: ‘Data since our March Monetary Policy Statement (MPS) indicate that, while the economy has weakened faster than expected, short-term inflation pressures have intensified.

‘The anticipated slowdown in domestic demand commenced in the latter part of 2005 and is projected to continue through this year. This will be partly offset by growth in exports and import substitution, reinforced by the recent decline in the exchange rate. Recent economic indicators suggest the economy will continue to grow modestly through 2006.

‘Despite the easing in resource pressures, the short-term inflation outlook has worsened. The exchange rate drop will boost import prices. We also expect significant further price rises over coming quarters as a result of the ongoing world oil shock. These effects are expected to keep annual CPI inflation above 3 per cent for longer than previously projected and risk putting upward pressure on inflation expectations.

‘Monetary policy remains focussed on ensuring that inflation settles back within the 1-3 per cent target band over the medium term. As we have stated previously, policy will not try to counteract the one-off boost to prices from the exchange rate and oil price shocks. In this regard, we still do not expect to raise interest rates again in this cycle. However, monetary policy must remain vigilant against these price shocks spilling over into inflation expectations, and price and wage-setting behaviour. Given the current outlook, we maintain our March MPS view and continue to see no scope for a cut in the OCR this year.’
## Appendix D

### The Official Cash Rate chronology

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<th>Date</th>
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Appendix E
Upcoming Reserve Bank *Monetary Policy Statements* and Official Cash Rate release dates

The following is the Reserve Bank’s schedule for the release of *Monetary Policy Statements* and Official Cash Rate announcements for 2006.

<table>
<thead>
<tr>
<th>Date</th>
<th>Announcement</th>
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<tr>
<td>Thursday 27 July 2006</td>
<td>OCR announcement</td>
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<tr>
<td>Thursday 14 September 2006</td>
<td><em>Monetary Policy Statement</em></td>
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<tr>
<td>Thursday 26 October 2006</td>
<td>OCR announcement</td>
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<tr>
<td>Thursday 7 December 2006</td>
<td><em>Monetary Policy Statement</em></td>
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</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 F
Policy Targets Agreement

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

1.  Price stability

   a) Under Section 8 of the Act the Reserve Bank is required to conduct monetary policy with the goal of maintaining a stable general level of prices

   b) The 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