Monetary Policy Statement

March 2007[1]

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

Contents

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[1] Projections finalised on 23 February 2007. Policy assessment finalised on 7 March 2007

1 Policy assessment

The Official Cash Rate (OCR) will increase by 25 basis points to 7.50 percent.

Recent indicators show clear evidence of a pick-up in economic activity in late 2006 and early 2007. Strengthening domestic demand is being supported by a resurgence in the housing market and an expansionary fiscal policy. The acceleration in housing reflects firming net immigration, a recovery in confidence, a continuing rapid expansion of mortgage credit at very low margins, and strong growth in household incomes. The recent lift in export commodity prices – particularly dairy – may also be a factor. All this is adding to resource pressures and increasing the risk of a re-emerging inflation problem in the medium term.

The short-term inflation outlook continues to ease. CPI inflation is projected to be around the middle of the target band through 2007, benefiting from lower oil prices and the high exchange rate. Domestic price inflation is also expected to moderate somewhat in 2007, assisted by the effect of lower headline inflation on inflation expectations. Despite this, domestic inflation is projected to remain at high levels over the medium term and is subject to considerable upside risk.

Our concern is that the recent pick-up in housing and domestic demand may gain momentum, giving rise to a stronger cyclical upturn at a time when resources are already very stretched. This could reverse the rebalancing of the economy that has been underway since late 2005 and present substantial risks to the medium-term inflation outlook. It would also increase the prospect of a more costly correction in the country's external deficit.

We are continuing to assess alternative measures that might support the OCR, working with the relevant government agencies. These include a tightening of tax rules applying to housing investment and changes to bank capital requirements to help moderate the amplifying effect of credit on the housing cycle. However, we will continue to rely on the OCR as the primary instrument of monetary policy.

The current policy tightening is aimed at reducing the risk of an unsustainable rebound in activity. Depending on the persistence of the current upturn, further tightening may be required. A return to a moderating trend in housing and domestic demand will be essential if we are to see a reduction in medium-term inflation pressures.

Alan Bollard

Governor

2 Overview and key policy judgements

Growth slowed significantly over the past year, bringing a degree of rebalancing between domestic demand and net exports. Despite the slowdown, the New Zealand economy has remained near full capacity, with both labour and capital resources continuing to be stretched.

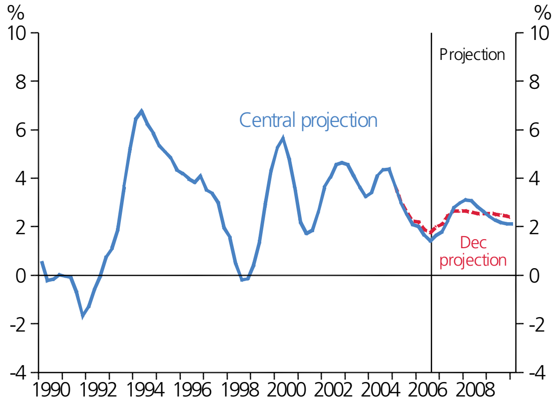
The Bank's recent economic forecasts have projected economic activity and domestic demand to remain subdued for an extended period, leading eventually to an alleviation of pressures on productive resources. However, economic indicators now suggest a much stronger outlook for domestic demand over 2007. The stronger outlook, underpinned by an expansionary fiscal policy and buoyant housing and labour markets, results in heightened medium-term inflation pressures. The renewed strength in demand is also expected to delay the much needed rebalancing in economic activity, in part by supporting a firmer New Zealand dollar.

In contrast, the strength in the exchange rate and lower-than-expected international oil prices have again improved the short-term inflation outlook. While the improvement is temporary, lower headline inflation will assist in containing inflation expectations at a time when productive resources remain stretched.

There remain both upside and downside risks to the economic outlook over 2007. The projected recovery in growth could prove only temporary, reflecting a 'relief' effect from the sharp decline in petrol prices in late 2006. Conversely, the recovery in economic activity could prove more enduring, particularly if the housing market and fiscal policy prove more stimulatory over the period ahead.

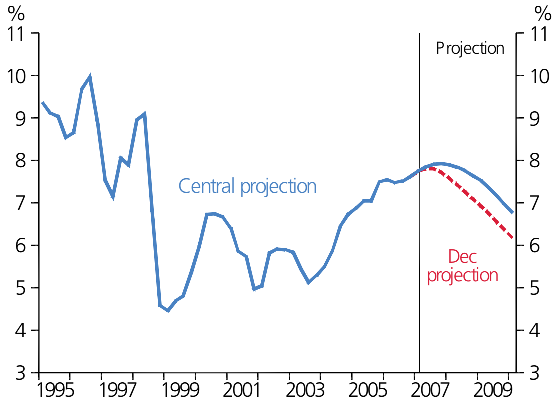
Our policy deliberations have remained focussed on the medium-term inflation outlook and the risks to this outlook, which are closely dependent on the emerging prospects for domestic demand and economic growth.

Figure 2.1
GDP growth
(annual average percent change)



Source: Statistics New Zealand, RBNZ estimates.

Figure 2.2
90-day interest rates



Source: RBNZ.

Recent developments

Since late 2005 economic growth has slowed. We have seen the initial signs of a rebalancing in the composition of economic activity, with weaker domestic demand and an improvement in net exports. The growth slowdown has reduced some of the pressure on productive resources, but an extended period of moderate growth is still required to fully neutralise medium-term inflation pressures.

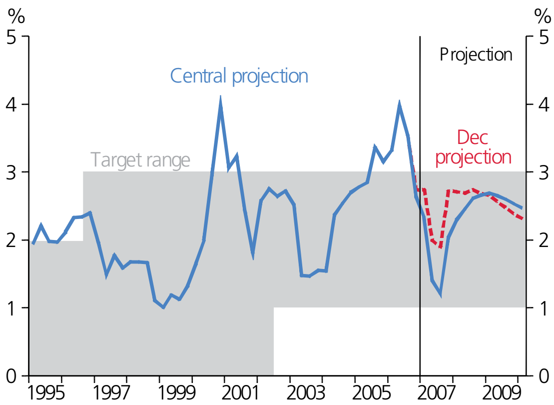
Late last year we began to see signs of stronger activity, with housing market activity remaining resilient and a recovery across a range of business sector indicators. That recovery has continued in recent months, and now indicates a materially stronger outlook for growth and domestic demand over 2007:

- After slowing in the first half of 2006, the housing market has gathered renewed momentum. The number of days to sell newly listed properties has fallen back since late 2006, and house price inflation has proven stronger than expected. The renewed strength in housing is consistent with both stronger net immigration and strong growth in labour incomes.
- Labour incomes are being supported on several fronts. Wage growth has been high, consistent with the very tight labour market. Continued strong demand for labour is underpinning household confidence by providing a high level of job security. Furthermore, recent declines in petrol prices have provided a temporary additional boost to disposable incomes.
- To date, there has been minimal slowing in household credit growth as households continue to dissave at an unsustainable rate. In recent times, households have had unprecedented access to credit, which is being fuelled by intense competition amongst banks. Margins between wholesale and retail interest rates have been driven to extremely low levels, thus weakening the firming effect of higher wholesale interest rates.
- The Working for Families package is providing a significant boost to household disposable incomes. The Bank's estimates indicate that this support package could add around 6 percent on average to the disposable incomes of eligible households. The business tax package that was proposed in the Government's December *Half Year Economic and Fiscal Update* (HYEFU) is also expected to provide some stimulus to business investment over the forecast period.
- While exporters continue to be affected by the high exchange rate, some relief is being provided by record high commodity prices and lower petrol prices. And in general, business sector indicators have been steadily improving, as both global and domestic demand remain robust.

The improvements in such a broad range of economic indicators suggest that the rebound in activity is not temporary. Accordingly, we have revised the growth outlook for 2007 significantly higher. The stronger growth outlook makes a material difference to medium-term inflation as the economy is still experiencing a significant degree of pressure on resources, with unemployment low and capacity utilisation high.

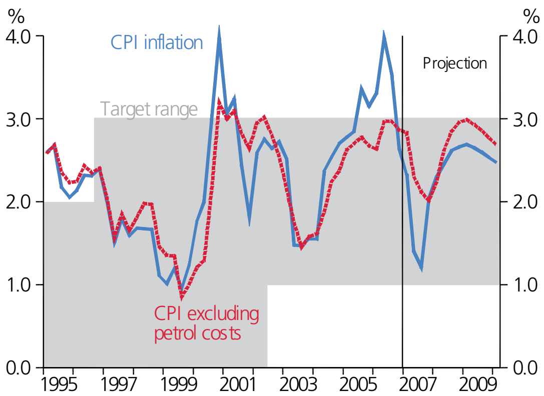
In contrast, the short-term outlook for CPI inflation has again improved. Lower-than-expected petrol prices and the stronger New Zealand dollar are expected to cause annual CPI inflation to fall as low as 1.2 percent this year. While this will clearly have a favourable effect on inflation expectations, the fall in headline inflation is temporary and understates the degree of persistent inflation pressure in the economy. CPI inflation is expected to rise rapidly over 2008 to reach the upper part of the 1 to 3 percent target range, while

Figure 2.3
CPI inflation
(annual percent change)



Source: Statistics New Zealand, RBNZ estimates.

Figure 2.4
Headline inflation and CPI excluding petrol costs
(annual percent change)



Source: Statistics New Zealand, RBNZ estimates.

Box 1

Recent monetary policy decisions

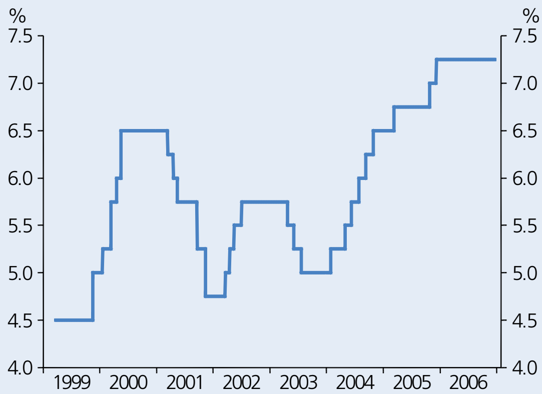
Over 2004 and early-2005, domestic demand grew strongly, buoyed on by a robust labour market and housing related wealth gains. Through this period, growth in domestic demand outpaced growth in the economy's productive capacity. As a result, the economy's resources became increasingly stretched, placing considerable pressure on non-tradable prices. This prompted the Bank to increase the Official Cash Rate (OCR) to 7.25 percent in a series of measured steps over 2004 and 2005.

Since early 2006 the Bank has kept the OCR unchanged, due to a slowing in growth and signs of some easing in capacity pressures, together with a desire to let the full impact of previous policy tightening work its way through the pipeline.

Despite the growth slowdown and steady increases in effective mortgage rates through 2006, it became apparent that medium-term inflation pressures were dissipating only very gradually. Additionally, sharp increases in petrol prices caused CPI inflation to spike to 4 percent in mid-2006. The Bank looked through the short-term increase in headline inflation, but warned against the upside risks for medium-term inflation expectations and price and wage setting behaviour. Given these developments, our policy stance firmed. While leaving the OCR on hold in June and July of 2006, our policy comments tended to defer the time at which OCR reductions could be expected.

From the September 2006 *Statement*, the stance of monetary policy firmed again. Domestic activity was moderating only at a gradual pace as the housing market in particular proved more resilient. These concerns prompted the Bank to note that, not only was any easing in policy a considerable way off, but further tightening could be required. At the January OCR *Review*, the Bank noted that in the absence of clear indications of moderation in housing and domestic demand, it was likely that further monetary policy tightening would be required.

Figure 2.5
Official Cash Rate



Source: RBNZ.

measures of core inflation are likely to remain elevated as headline inflation dips during 2007.

Policy judgements

Over the past year, our policy projections have been based on an outlook where growth in economic activity remained below its trend rate over the next few years. This period of weaker growth would help unwind the inflation pressures that accumulated during the earlier prolonged period of expansion. However, as noted above, since late 2006 a range of indicators have pointed to renewed momentum in some key parts of the economy, most notably housing and consumer spending.

The key challenge in our policy deliberations has been to judge the extent to which these stronger indicators are likely to be sustained going forward. A reasonable initial interpretation of the rebound in activity evident in the indicators in late 2006 was that confidence and activity had received a temporary fillip from the sharp decline in oil prices from their peak levels earlier in the year. A lower oil price could certainly provide a boost to the level of household demand via its impact on disposable income and confidence, but would not be expected to provide a sustained stimulus to growth.

As time goes on, and the positive indicators have continued, we have increasingly moved toward a view that the lift in growth will prove more enduring. In our updated projections, domestic demand pressures are forecast to persist for longer than in the December *Statement*, requiring more offsetting monetary policy action for medium-term inflation to be kept comfortably within the 1 to 3 percent target range.

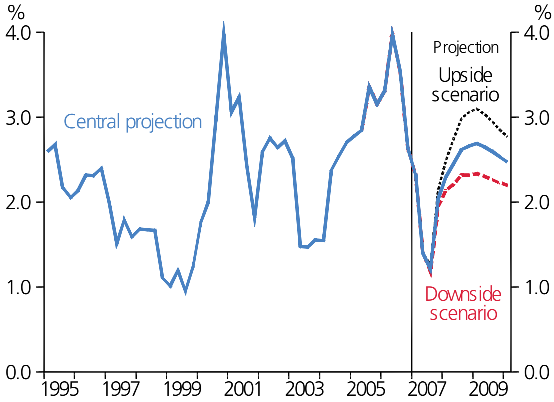
However, this outlook is not without its uncertainties and the economy could evolve differently from our assumptions. As has been the experience over much of the economic cycle, momentum in demand could prove more enduring than we are currently assuming. Conversely, we are conscious that a number of dampening influences are continuing to operate on the economy. Accumulated increases in interest rates have occurred in recent years and the relatively high New Zealand dollar is significantly constraining earnings in the tradables sector. When contemplating appropriate policy settings, we have had to consider likely outcomes in the event that the economy evolves differently to our projections. We have also had to weigh the consequences of different monetary policy responses given this uncertainty.

To illustrate some of the trade-offs involved and the potential for 'policy regret', figures 2.6 and 2.7 show the consequences for inflation and output growth under alternative scenarios. In these scenarios, aggregate demand is assumed to be weaker or stronger than in our central projections and monetary policy is set on the basis of an incorrect assumption about the strength of activity.

In the upside scenario, we assume that interest rates remain unchanged over the next few quarters at recent levels, but that households' willingness to borrow and consume is stronger than expected. In the downside scenario, we assume that interest rates edge upwards but that momentum in the domestic economy turns out to be more short-lived than in the central projection. Figure 2.8 shows the corresponding interest rate paths. From the point of view of future inflation outcomes, upside surprises to domestic demand are currently the source of greater concern. In the upside scenario, if policy is not tightened, projected inflation rises above 3 percent in 2008 and 2009. In the downside scenario on the other hand, where the surge in demand turns out to be temporary, inflation simply approaches the centre of the target band more quickly than in the central projection.

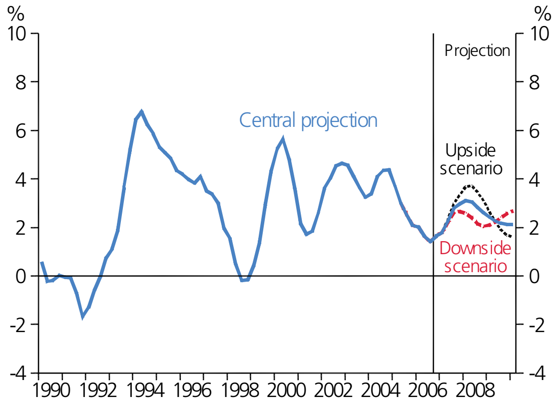
The Bank also needs to remain conscious of its obligation to avoid unnecessary instability in output, the exchange rate and interest rates, as required under section 4b of the Policy Targets Agreement. As shown in figure 2.8, if demand

Figure 2.6
Alternative scenarios: CPI inflation
(annual percent change)



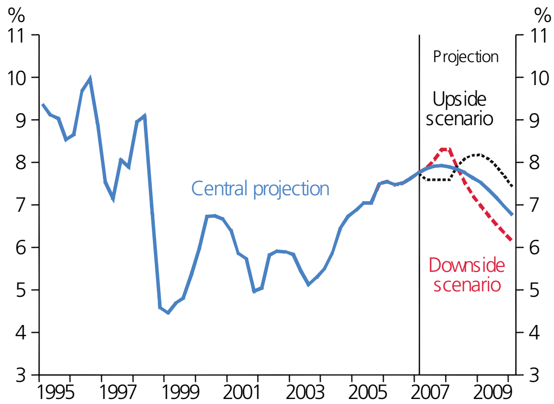
Source: Statistics New Zealand, RBNZ estimates.

Figure 2.7
Alternative scenarios: GDP growth
(annual average percent change)



Source: Statistics New Zealand, RBNZ estimates.

Figure 2.8
Alternative scenarios: 90-day interest rates



Source: RBNZ.

pressures turn out to be more short-lived than in the central projection, further policy tightening now will have to be undone later, risking unnecessary volatility in interest rates and the exchange rate in the near term. On the other hand, failing to anticipate further strength in demand increases the risk of a substantially larger and more persistent cycle in output, and will also require tighter monetary policy further out in the projection. Thus the need to avoid volatility does not necessarily favour a wait-and-see policy approach.

Since late 2005, the Bank, in conjunction with the Treasury and other agencies, has been considering whether there might be other tools or policy options in addition to the OCR that could provide assistance to monetary policy in maintaining low inflation. A motivation for the work has been the persistent strength of domestic demand — emanating largely from the housing sector — and a recognition that increases in the OCR can contribute to upward pressure on the exchange rate, which may put disproportionate pressure on the tradables sector. The rise in the exchange rate over recent years has been accentuated by the unusually low level of interest rates prevailing offshore and a high appetite for risk on the part of international investors. Pressure has also come from the large volume of foreign borrowing that is being undertaken to support mortgage credit growth to the New Zealand housing market. While supporting the strong New Zealand dollar, this borrowing activity also presents potential issues for macro-financial stability. The continuing upward trend in both national and household debt ratios is not sustainable and the longer it goes on the more costly the ultimate adjustment may be.

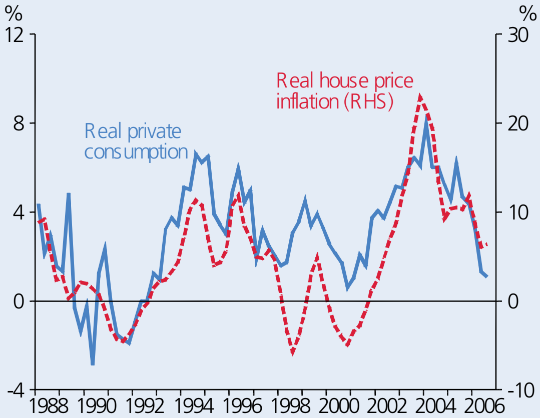
Following an initial report on supplementary instruments published in early 2006, work in this area has been ongoing. The Bank has identified several policy options that it believes could usefully play a part in dampening the housing cycle and thereby promote financial stability over the longer term. There would also be an associated dampening of domestic inflation pressures, potentially reducing the need for large and prolonged increases in the OCR. On the fiscal side, potential measures include greater emphasis on the enforcement of existing tax laws regarding capital gains made on investment properties and changes to the tax rules around investor housing. Development of these options with the relevant agencies is progressing. Also, in the area of mortgage credit growth, we are considering the scope for changes to banks' capital adequacy requirements on housing lending aimed at moderating the credit amplifier effect on the housing market, while at the same time ensuring that banks have an adequate buffer against a possible housing downturn.

Box 2

Housing and farm equity withdrawal

In New Zealand, house price cycles tend to be highly correlated with movements in private consumption. Both are likely to respond to a range of potential influences, including population (itself affected by migration flows), interest rates, and export and labour incomes.

Figure 2.9
Private sector consumption and house price inflation
(annual percent change)

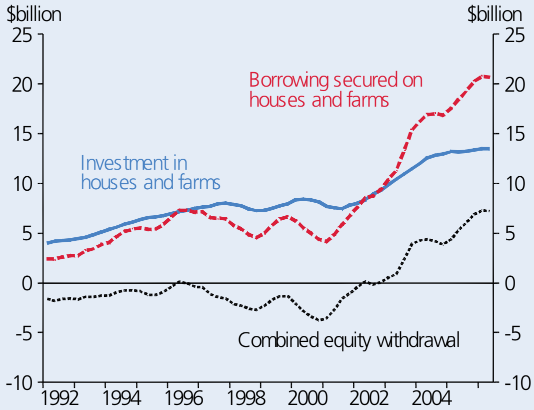


Source: Statistics New Zealand, Quotable Value Ltd.

It is also likely that some form of wealth effect is at work: an increase in property values boosts the notional balance sheet positions of property owners and hence consumer spending. In the absence of a savings buffer, one of the mechanisms through which additional consumer spending can be funded by households is via equity withdrawal. Equity withdrawal for the economy as a whole is the difference between secured borrowing on fixed assets and investment in those assets. The sizeable climb in borrowing secured on property suggests that equity withdrawal has been taking place over the last few years.

Research at the Reserve Bank[1] suggests that at the macroeconomic level the incidence of housing equity withdrawal in New Zealand is a relatively new phenomenon. The historical norm has been a net injection of funds (more funds invested in housing than borrowed). Sizeable increases in rural property prices have also underpinned equity withdrawal from farms. Latest Bank estimates suggest that between the March 2002 and 2006 years approximately $15b of equity has been withdrawn from houses and farms combined. Equity withdrawal appears to have been driven by higher rural and residential mortgage borrowing rather than by declining investment in housing and farms.

Figure 2.10
Estimates of equity withdrawal from houses and farms
(per annum)



Source: RBNZ estimates.

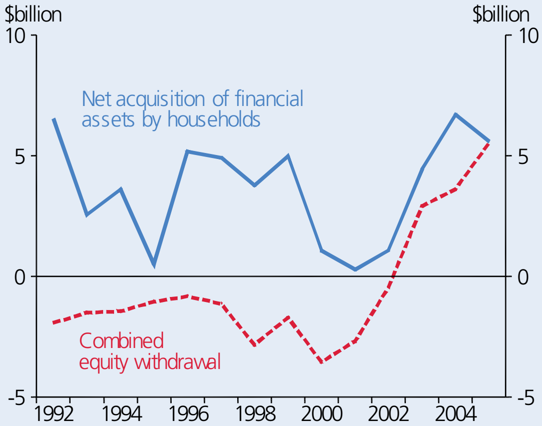
This unlocking of equity can, in principle, have a powerful impact on consumer spending. However, the uses of equity withdrawal over the short term are likely to depend on how the equity is withdrawn:

- Equity can be withdrawn actively via the topping up of existing mortgages or taking out a new mortgage on an existing property. Survey evidence overseas indicates that this form of equity withdrawal is likely to be the more common variety with a larger portion likely to flow through into consumer spending.
- Alternatively, equity withdrawal can occur passively as a result of dwelling transactions. When a dwelling is sold the impact on secured borrowing (and hence equity withdrawal) depends on the respective debt and equity positions of the buyer and seller. Survey evidence overseas points to this form of equity withdrawal being less common than active equity withdrawal, but larger in overall magnitude.

[1] Smith, M (2006), 'What do we know about equity withdrawal by households in New Zealand?', paper prepared for Reserve Bank workshop on 'Housing, saving and the household balance sheet', 14 November 2006.

Quantifying the impact of equity withdrawal by households on consumer spending is not straightforward. This partly reflects data constraints and the difficulty of tracing the uses to which equity withdrawal is directed. The Bank's estimates suggest that between 40 and 70 percent of equity withdrawal may have been consumed over the short term, implying considerable support to consumer spending in recent times. Increasing equity withdrawal has also coincided with a build-up in financial assets (such as bank deposits), which may be used to fund further consumer spending over the years ahead.

Figure 2.11
Equity withdrawal and acquisition of financial assets by households
(per annum)



Source: RBNZ estimates.

Examples of active and passive housing equity withdrawal

Active housing equity withdrawal

A homeowner increases the outstanding principal on their current mortgage by $20,000. They use $8,000 to fund an overseas trip and the remaining $12,000 on home improvements.

- In this instance a net equity withdrawal of $8,000 occurs.

Passive housing equity withdrawal

A residential dwelling is sold for $400,000. The seller is debt free and uses the sale proceeds to purchase a new apartment for $150,000, and puts the remaining $250,000 in an interest bearing term deposit. There is a withdrawal of equity of $250,000 by the seller. The buyer funds 15 percent of the purchase from their own funds and takes out a $340,000 mortgage. There is an equity injection of $60,000 by the buyer.

- In this property transaction there is a net withdrawal of equity of $190,000.

3 The recent economic situation

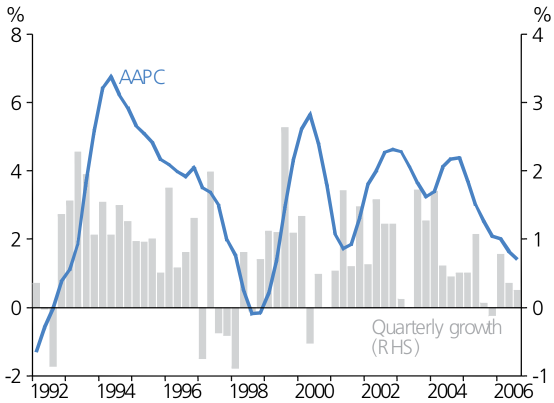
Overview

The New Zealand economy grew strongly between 2000 and early 2005. Over this period growth in domestic demand outstripped growth in productive capacity. As a result, significant inflation pressures developed. Much of the excess demand was met by imports, facilitated by a high level of the New Zealand dollar, which also acted as a disincentive for New Zealand businesses to export. As a consequence the current account deficit widened markedly.

Since then, some rebalancing of economic activity has occurred. GDP growth has slowed over the past 12 months, due largely to a weakening in domestic demand. At the same time a fall in import volumes has seen net exports recover. However, it now appears that part of the weakness in domestic demand may have been a temporary effect from high petrol prices. Accordingly, measures of household and business sentiment have improved, suggesting a near-term rebound in growth. With signs of resurgence in domestic demand, the rebalancing of the economy appears to have slowed and indeed may have gone into reverse.

Strength in domestic demand has seen non-tradables inflation lingering around 4 percent since 2004. In addition, accelerating oil prices and a weaker New Zealand dollar saw tradables inflation push higher during 2006. This contributed to headline inflation reaching 4 percent in the year to June 2006. Since then oil prices have fallen dramatically, allowing headline inflation to ease back to 2.6 percent in the year to December 2006.

Figure 3.1
Real GDP growth



Source: Statistics New Zealand.

Global economic developments

Global economic activity has remained relatively upbeat, with GDP growth across a number of our main trading partners accelerating in the latter stages of 2006. However, Australian GDP growth slowed in the September quarter as a result of drought conditions.

Falling oil prices over recent months have resulted in reductions in headline inflation across trading partner economies. While the Australian and US central banks have left interest rates on hold recently, a number of other central banks have raised official interest rates since the December *Statement*.

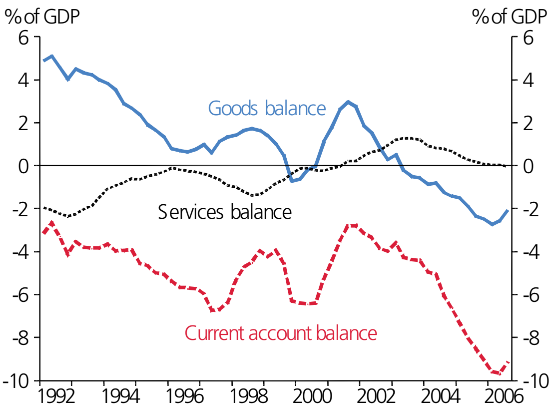
- Following weakness over the first half of 2006, Australian GDP growth slowed further in the September quarter. Continued drought conditions resulted in a decline in agricultural production, while a reduction in fuel prices caused a decline in headline inflation in the December quarter.
- US GDP growth has been on a downward trend since early 2006. However, GDP growth accelerated slightly in the December quarter, driven by strength in private consumption and net exports. Even so, headline inflation has fallen markedly over the past few months, and the core personal consumption expenditure deflator eased in the December quarter.
- Growth has accelerated in both the UK and the Eurozone over the past six months. Recent improvements in UK growth have been driven by strong household demand, stemming from accelerating house price inflation and strong immigration. Meanwhile, Eurozone GDP has shown broad-based growth following a lengthy stagnation.
- GDP growth in Japan picked up in the December quarter following low growth over the previous two quarters. Inflation has remained modest in Japan; nevertheless, the Bank of Japan increased rates in February, citing an expected moderate expansion in activity.
- GDP growth has remained very strong in China, with consumption remaining buoyant. The growth in fixed asset investment has moderated slightly in response to a tightening of monetary conditions by the People's Bank of China.

Tradables sector activity

New Zealand's external position has deteriorated significantly since 2001, with the annual current account deficit reaching a trough of 9.7 percent of GDP in the June quarter of 2006. Strong import growth, driven by both consumption and investment spending, weakened export receipts and a deterioration in the investment income balance were responsible for the deterioration in the current account deficit.

However, a partial recovery in net exports, and an improvement in the investment income balance saw the current account deficit narrow slightly in the September quarter to 9.1 percent (figure 3.2).

Figure 3.2
Annual current account, goods and services balances



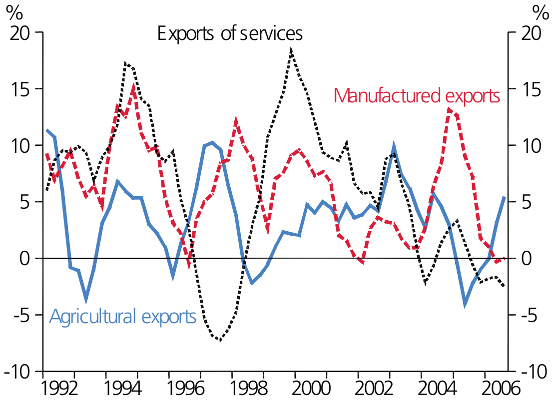
Source: Statistics New Zealand.

Recent strong growth in exports has been concentrated in primary goods (figure 3.3). Primary export volumes increased strongly in the June and September quarters, with particularly large increases in meat, dairy and forestry exports.

In contrast, manufactured and services exports have remained subdued. Growth in manufactured exports slowed sharply in the first half of 2006, with the high level of the New Zealand dollar resulting in difficult trading conditions. However, the decline in manufactured exports was stemmed in the second half of the year.

While visitor numbers continue to show modest growth, the high exchange rate continues to dampen tourist spending, resulting in little growth in exports of services.

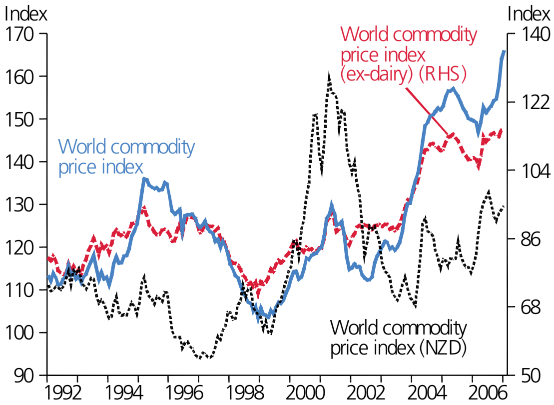
Figure 3.3
Export volumes
(annual average percent change)



Source: Statistics New Zealand.

In addition to a recovery in primary export volumes, prices of some of our key agricultural exports have surged recently. Increases have been centred on dairy prices (see box 3), with other components showing much lower growth over recent months (figure 3.4). Forward contracting and the high level of the New Zealand dollar have meant these gains have not been fully captured at the farm gate.

Figure 3.4
ANZ commodity prices



Source: ANZ National Bank Group Ltd, RBNZ estimates.

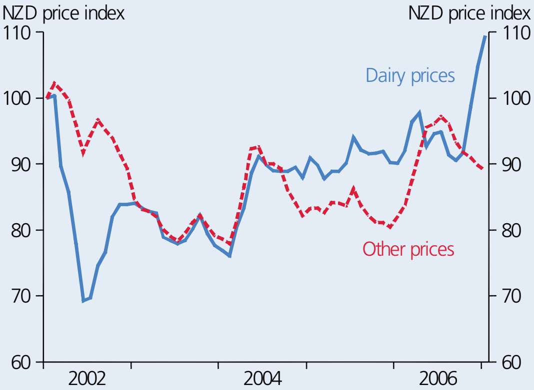
Box 3

Recent commodity price movements

World prices for New Zealand's commodity exports have risen dramatically in recent months. These increases have been large enough to offset the rise in the exchange rate over that period so that New Zealand dollar denominated prices have improved.

However, recent price gains have been seen almost exclusively in dairy prices, rather than being shared amongst all the various commodity exports groups. Since the start of November, international dairy prices have increased by more than 25 percent. Some other prices have improved, such as those received for prime beef exports. But in aggregate, ex-dairy commodity prices have only tracked sideways over the past few months. Indeed, outside of the dairy industry, farm gate prices have actually fallen.

Figure 3.5
New Zealand export commodity prices
(Jan 2002 = 100)



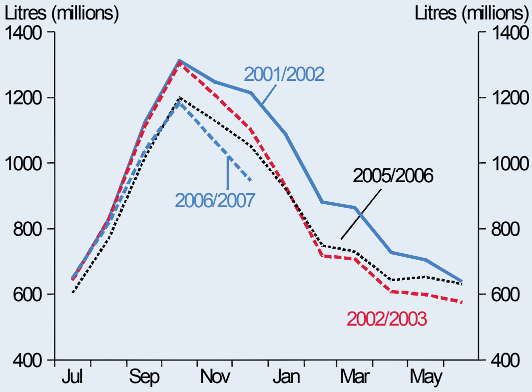
Source: ANZ, RBNZ estimates.

Taken at face value, the rise in dairy prices since November would see export prices 5 percent higher (dairy represents around 20 percent of New Zealand's exports). The full extent to which aggregate export prices increase will depend crucially on the sustainability of these higher dairy prices. The longer prices remain at these high levels, the greater the opportunity for New Zealand dairy exporters to enter supply contracts at these higher prices.

While the outlook is uncertain, it seems that dairy prices are likely to remain well supported due to ongoing global supply shortages:

- In Australia, extreme drought has knocked its agricultural sector, with reports that dairy production could be down 10 percent for the season as a whole. And while dairy production could recover next season, it seems unlikely that a full bounce back will occur. Indeed, Australian milk production is still to recover fully from the 2001/02 drought.

Figure 3.6
Australian monthly milk production



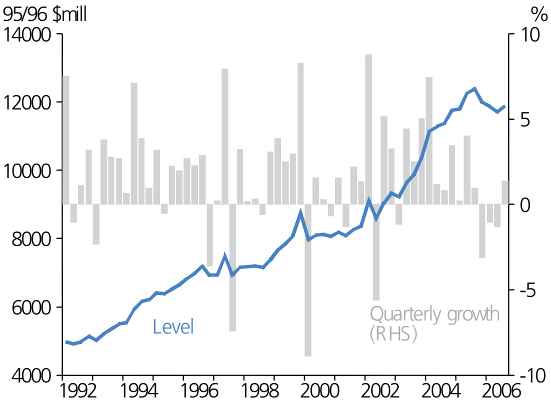
Source: Dairy Australia.

- Developments in the US have also been a significant driver of higher dairy prices. Prior to this season, US dairy production had been expanding rapidly, frequently achieving double digit growth. This had created an expectation that the US would soon begin exporting substantial quantities of dairy products, and the resulting increase in global supply would lead to a softening in dairy prices. However, there has been a drought in most of the key US dairy regions during 2006 which has affected dairy production. Like Australia, a sustained recovery in US production remains uncertain, particularly as high grain prices have significantly increased the cost of dairy farming in the US.
- European production for the 2006 season has fallen short of year ago levels, particularly with respect to milk powders. Continued decoupling of farm subsidies from farm output could result in further reductions to European dairy production.

While supply shortages will provide ongoing support for dairy prices, some moderation from current high levels is also possible. In addition, market reports suggest that the bulk of Oceanic dairy products being traded at the moment are tied up in forward contracts. Given this, it is likely that the current high spot dairy prices are overstating the actual prices being received by New Zealand dairy exporters.

A slowing in domestic demand and a lower New Zealand dollar saw a weakening of import volumes over the first half of 2006. These declines were centred predominantly on capital and intermediate imports, with consumer imports remaining more robust. However, recent (fourth quarter) data have shown a broad-based recovery in imports, consistent with a recovery in domestic demand.

Figure 3.7
Import volumes

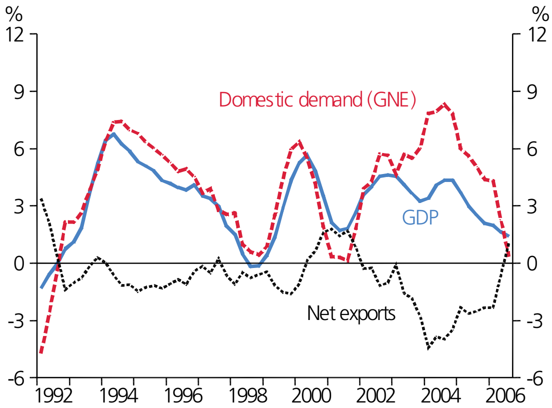


Source: Statistics New Zealand.

Domestic demand

Domestic demand slowed over 2006. However, the national accounts appear to be overstating the underlying weakness, perhaps reflecting the negative impact of the higher petrol prices up to September 2006. More current indicators show strong underlying support for domestic activity from the buoyant housing and labour markets, and from fiscal policy.

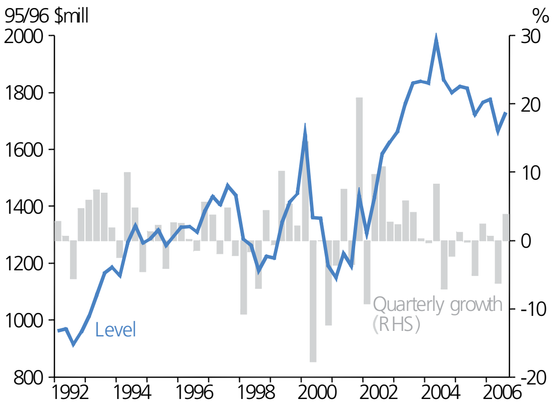
Figure 3.8
Real gross domestic product, domestic demand and net exports
(annual average percent change)



Source: Statistics New Zealand.

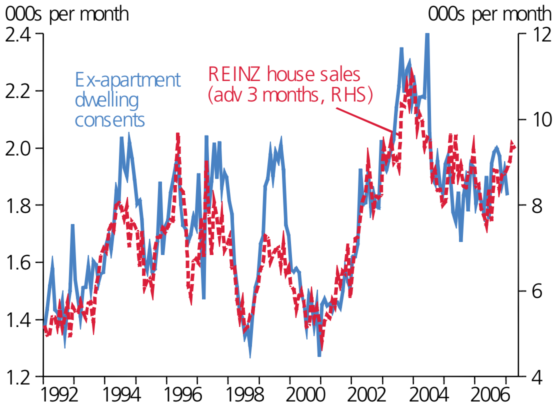
Residential investment spending increased in the September quarter, partly offsetting declines over the previous year (figure 3.9). Further strength is evident in this sector, with recent housing market data remaining robust. Residential building consents have remained at high levels, while the number of house sales has increased (figure 3.10), and the average number of days taken to sell a house has declined (figure 3.11). In addition, net immigration has remained at high levels, providing solid support for housing construction.

Figure 3.9
Real residential investment



Source: Statistics New Zealand.

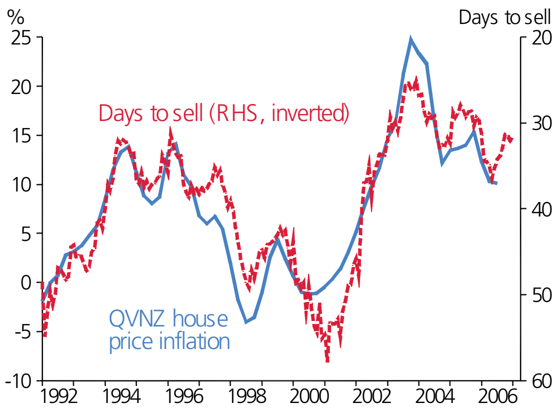
Figure 3.10
REINZ house sales and ex-apartment building consents



Source: Statistics New Zealand, REINZ.

While house price inflation exhibited a downward trend over the first half of 2006, there are signs of a recent acceleration. Prices increased by 10.1 percent in the year to September (as measured by Quotable Value Ltd – figure 3.11). Further, data from the Real Estate Institute of New Zealand suggests that strength remained in the housing market over late 2006. Continued strength in house prices provides support for household balance sheets and further impetus for consumer spending (see box 2 in chapter 2).

Figure 3.11
Annual house price inflation and days to sell

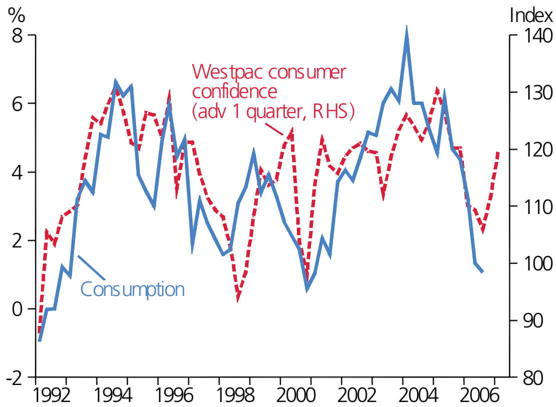


Source: Quotable Value Ltd, REINZ.

Consumer spending has slowed over the past 12 months, with annual consumption growth falling to just over 1 percent in the September quarter. High petrol prices over the first half of 2006 exacerbated this slowing, with sales of motor vehicles showing a particularly large decline.

However, strong wage growth and the Working for Families package have underpinned household income growth. Household balance sheets have also received a temporary boost from the large decline in petrol prices over the second half of 2006. Accordingly, both consumer confidence and retail spending showed increases in the December quarter.

Figure 3.12
Annual consumption growth and consumer confidence

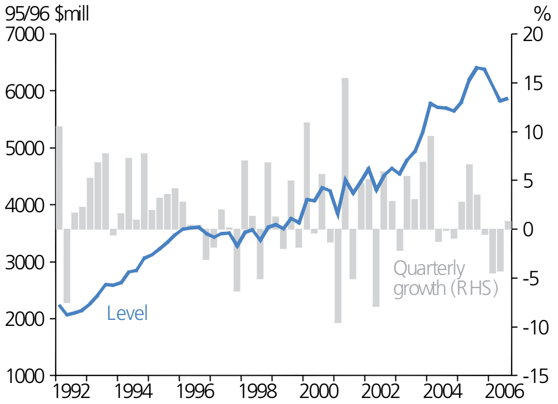


Source: Statistics New Zealand, Westpac McDermott Miller.

Business investment spending increased slightly in the September quarter, following declines in the previous three quarters (figure 3.13). In contrast to recent quarters, non-residential construction declined markedly, while plant and machinery investment and transport equipment investment both increased.

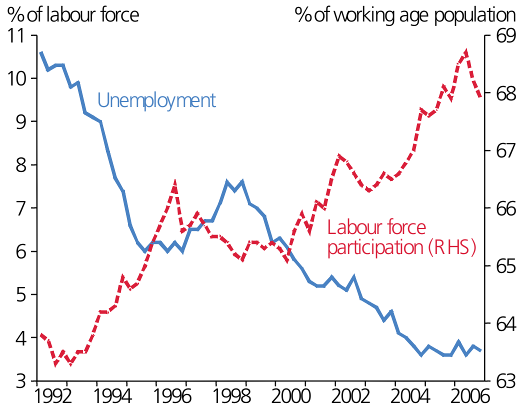
However, non-residential building consent issuance, which tends to lead construction activity, has remained strong in recent months. Additionally, imports of capital equipment increased in the December quarter and survey measures of firms' investment intentions have increased, suggesting a continued pickup in business investment in the near term.

Figure 3.13
Real business investment



Source: Statistics New Zealand.

Figure 3.15
Unemployment and labour force participation rates

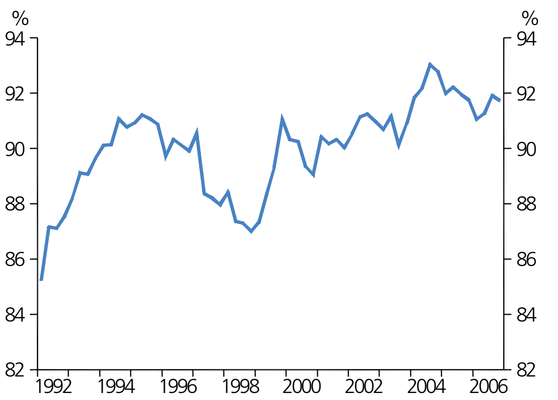


Source: Statistics New Zealand.

Productive capacity and the labour market

Despite a significant slowing in GDP growth over the past year, resource pressures have only gradually eased. This has been reflected in the Quarterly Survey of Business Opinion which showed capacity utilisation remaining at high levels in the December quarter (figure 3.14).

Figure 3.14
QSBO economy wide capacity utilisation

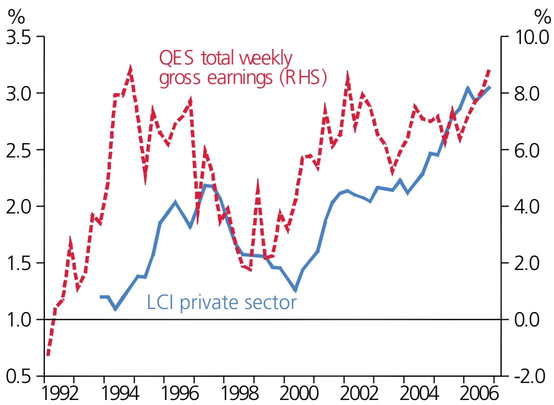


Source: NZIER.

The labour market remains very tight. While growth in employment has softened over the past year, a reduction in participation saw unemployment fall to 3.7 percent in the December quarter. Unemployment has remained below 4 percent since the middle of 2004 (figure 3.15). Accordingly, little spare capacity exists in the labour market with shortages of both skilled and unskilled labour.

Ongoing labour market tightness has contributed to strong growth in labour incomes. Annual growth in private sector labour costs (adjusted for the effects of promotions and bonuses) increased by over 3 percent in the year to December 2006 – an historical high for this series (figure 3.16). Public sector wages have also been increasing at a rapid rate, giving robust growth in total gross earnings.

Figure 3.16
Labour cost and labour earnings measures *(annual percent change)*

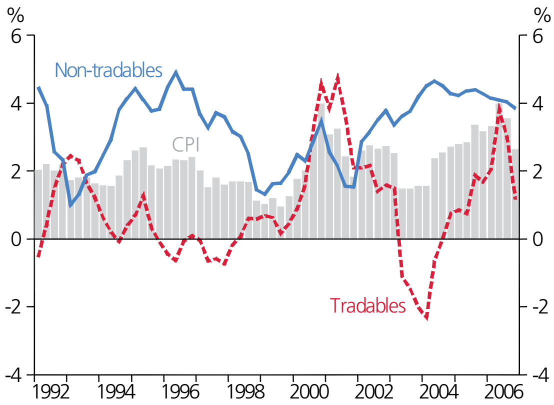


Source: Statistics New Zealand.

Inflation

Over the past 12 months volatility in petrol prices led to a sharp spike in inflation, and then to a fall at the end of 2006. After reaching a peak of 4 percent in the June quarter of 2006, annual *Consumers Price Index* inflation fell to 2.6 percent in the December quarter.

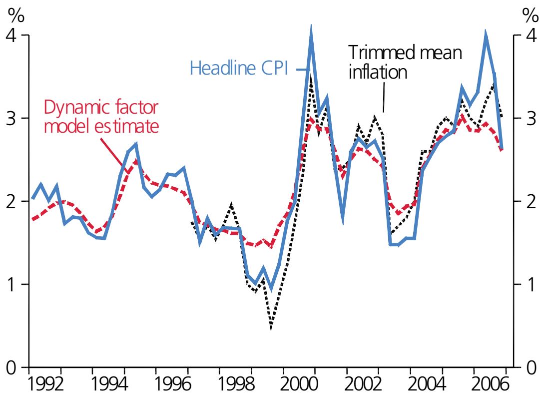
Figure 3.17
Annual CPI, tradables and non-tradables inflation



Source: Statistics New Zealand.

Abstracting from the volatility in headline CPI, inflation pressures have remained strong and widespread, particularly in the non-tradables sector, with annual increases of around 4 percent over the past four years. Construction cost increases, stemming from resource pressures in the construction sector, have been one of the major contributors to high non-tradables inflation this cycle. While construction cost inflation slowed in the December quarter, this followed large increases in the previous two quarters. Recent data has also shown a moderation of the non-housing components of non-tradable inflation, although inflation in these sectors remains at high levels. In addition, our preferred measures of core inflation have shown some signs of easing, but remain toward the top of the inflation target band (figure 3.18).

Figure 3.18
Annual CPI inflation and core inflation measures

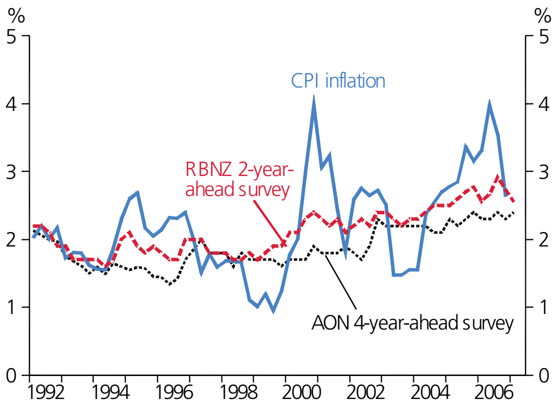


Sources: Statistics New Zealand, RBNZ estimates.

Inflation expectations

When headline inflation rose sharply in mid-2006 there was a significant risk that higher inflation expectations would impact on medium-term wage and price setting behaviour. Longer-term inflation expectations have since eased over the past two quarters, in line with lower headline inflation. Nevertheless, measures of inflation expectations remain at relatively elevated levels (figure 3.19).

Figure 3.19
Longer-term inflation expectations *(annual rates)*



Source: Statistics New Zealand, RBNZ, Alexander Consulting.

Table 3.1

Measures of inflation and inflation expectations

(annual percent change)

	2005			2006			
	Jun	Sep	Dec	Mar	Jun	Sep	Dec
CPI	**2.8**	**3.4**	**3.2**	**3.3**	**4.0**	**3.5**	**2.6**
CPI Components							
CPI non-tradables	4.4	4.4	4.3	4.1	4.1	4.0	3.8
Non-tradables housing components	6.1	5.8	5.7	5.3	4.6	4.5	4.2
Non-tradables ex-housing, cigarettes and tobacco components	3.6	3.8	3.7	3.7	3.9	3.9	3.7
CPI tradables	0.7	1.9	1.7	2.1	3.8	3.0	1.2
Petrol	7.0	20.3	17.4	23.5	32.2	15.9	1.3
Other inflation measures							
Factor model estimate of core CPI inflation	2.8	3.0	2.9	2.8	2.9	2.8	2.6
CPI trimmed mean (of annual price change)	2.9	3.2	3.0	2.9	3.2	3.4	3.0
Exponentially smoothed core inflation	2.4	2.5	2.6	2.7	2.9	3.1	3.0
CPI weighted median (of annual price change)	3.1	3.2	3.2	3.1	3.2	3.6	3.3
CPI ex-food, petrol and government charges	3.0	2.8	2.6	2.4	2.8	2.7	2.5
CPI ex-energy and fuel	2.4	2.6	2.6	2.4	2.8	2.8	2.7
GDP deflator (derived from expenditure data)	2.9	2.5	1.9	2.2	1.8	2.4	n/a

	2005			2006				2007
	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
Inflation expectation measures								
RBNZ Survey of Expectations - inflation one-year-ahead	2.8	2.9	3.2	2.9	3.2	3.5	3.0	2.7
RBNZ Survey of Expectations - inflation two-years-ahead	2.6	2.7	2.8	2.6	2.7	2.9	2.7	2.6
AON Economist survey- inflation one-year-ahead	2.7	2.7	3.2	3.0	3.0	3.2	2.7	2.4
AON Economist survey- inflation four-years-ahead	2.2	2.3	2.4	2.3	2.3	2.4	2.3	2.4
NBBO - inflation one-year-ahead (quarterly average)	3.0	3.0	3.3	3.1	3.2	3.4	3.3	n/a

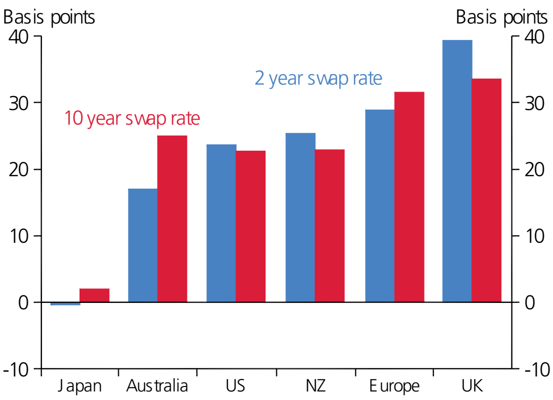
4 Financial market developments

International markets

As discussed in Chapter 3, policy rates have been raised in a number of economies since the December *Statement*, including Japan, Europe and the UK. In Europe and the UK, these policy rate rises and market expectations for further rate rises have put upward pressure on wholesale interest rates (figure 4.1). In contrast, wholesale interest rates in Japan are little changed from levels prevailing at the time of the December *Statement*, despite the Bank of Japan announcing a policy rate rise in February. The Bank of Japan has signalled that any further rises will be gradual and, given ongoing questions about the strength and sustainability of Japanese growth, markets have become circumspect regarding the timing and extent of future rate rises.

The US Federal Reserve has left its policy rate on hold since last raising it in June. Changes in market expectations regarding the potential for policy rate cuts over the coming year have underpinned US wholesale interest rates. US markets had been pricing-in at least two rate cuts during 2007 at the time of the December *Statement*. However, continued robust US economic activity – particularly a lack of significant contagion from housing market weakness to other sectors of the economy – has seen markets scale back rate cut expectations.

Figure 4.1
Movements in wholesale interest rates since the December *Statement*

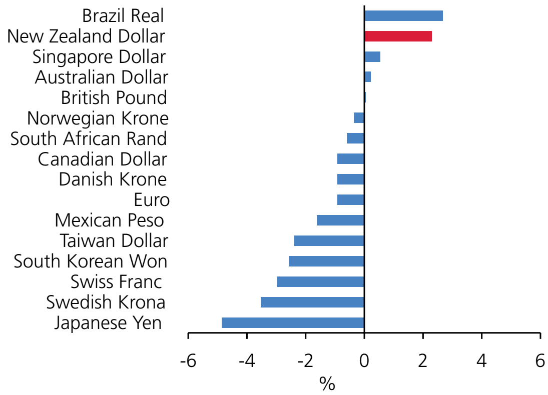


Source: Bloomberg.

Exchange rates

The reduction in US policy rate cut expectations has also resulted in the US dollar strengthening against a broad range of currencies since the last *Statement* (figure 4.2). Amongst the major economies, the change in relative interest rate expectations has been most significant between the US and Japan. Accordingly, of the main currencies, the Japanese Yen has been the weakest against the US dollar over the period. Despite broad-based strength in the US dollar, the NZD/USD exchange rate has risen by more than two percent since the December *Statement*.

Figure 4.2
Movements in currencies against the US dollar since the December *Statement*

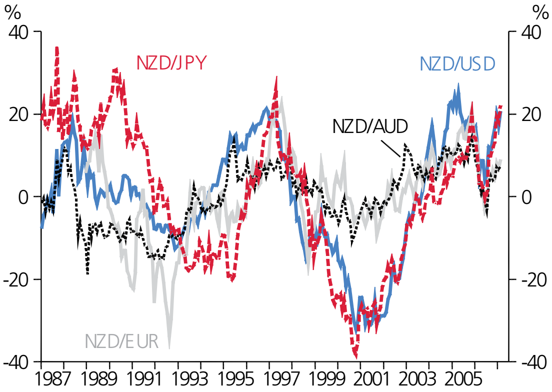


Source: Bloomberg.

The contrasting fortunes of the New Zealand dollar and the Japanese Yen over the past few months have seen the NZD/JPY rise almost 7 percent since the December *Statement*. Of the major New Zealand dollar cross rates, the NZD/JPY and the NZD/USD are currently around 20 percent above their long term averages (figure 4.3). The NZD/JPY is at its highest level, relative to its long term average, since the peak of the previous exchange rate cycle in early 1997.

Figure 4.3

New Zealand dollar cross rates – deviations from long-term averages



Source: Bloomberg, RBNZ.

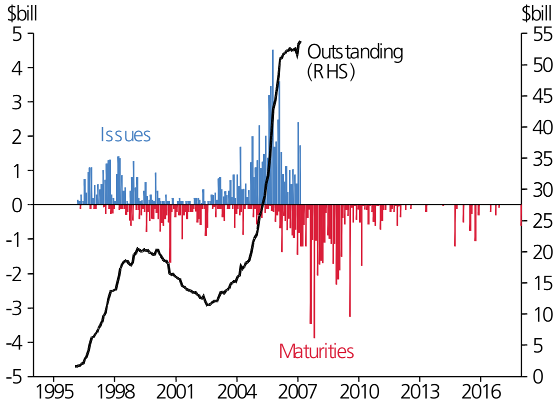
Note: Each index is based at the long-term average of the cross rate. Prior to 1999, the Euro is a calculated weighted average of the constituent currencies.

Recent gains in the New Zealand dollar are partly a result of 'carry trades'. This involves borrowing in low interest rate currencies (such as the Japanese Yen and Swiss Franc) and investing in higher interest rate currencies (including the New Zealand dollar, South African Rand and Brazilian Real). Carry trades have been supported by a global environment of relatively low risk aversion and generally low market volatility – circumstances that make investors less fearful of sharp market movements (either in currencies or interest rates) that could eliminate the gains generated by the interest rate differential.

More generally, interest in New Zealand dollar denominated securities remains strong. After slowing during 2006, there has been a resurgence in issuance of New Zealand dollar bonds in offshore markets since the beginning of 2007 (figure 4.4). Eurokiwi issuance has been particularly strong over this period, while New Zealand dollar Uridashi issuance continues to keep pace with the amount of bonds maturing. Nevertheless, there is a more significant maturity profile over the next two years and this represents a downside risk to the New Zealand dollar.

Figure 4.4

New Zealand dollar denominated offshore bond issuance



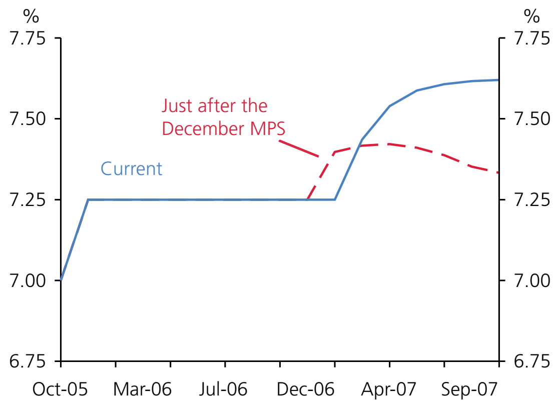
Source: Bloomberg, Reuters, RBNZ.

Domestic markets

Domestic interest rates have risen since the December *Statement*. Market pricing of the risk of an OCR rise has increased substantially over the past few months (figure 4.5). As at the time of writing, the market was fully pricing-in an OCR rise to 7.50 percent within the next couple of months and some probability of a further rise thereafter.

Figure 4.5

Financial market expectations of the Official Cash Rate

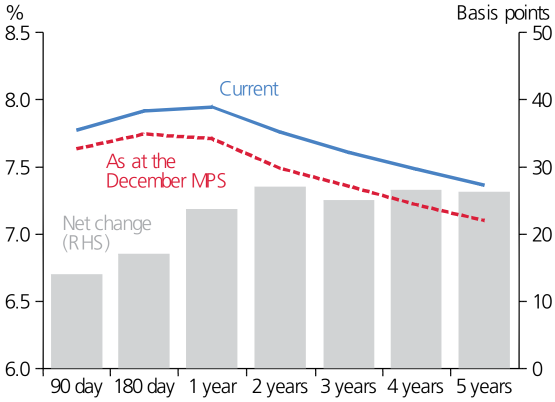


Source: RBNZ estimates from overnight indexed swap rates.

The combination of higher local policy rate expectations and the upward pressure associated with higher longer-term interest rates in key offshore markets has seen wholesale interest rates rise across the yield curve since the December *Statement* (figure 4.6). Wholesale interest rates for terms of one year and beyond have risen by 20-30 basis points.

Figure 4.6

The wholesale interest rate curve



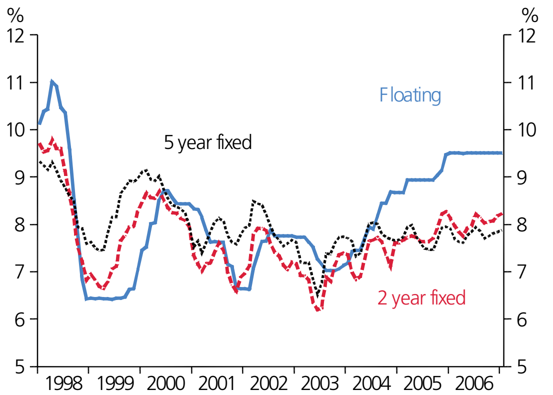
Source: Bloomberg, RBNZ.

The rise in wholesale rates has pushed up the fixed mortgage rates being offered to new borrowers and those facing re-pricing of existing mortgages (figure 4.7). While advertised fixed rates have risen to near their cycle highs, movements in the actual rates being paid on mortgages suggest that banks have been increasingly willing to negotiate lower rates. This has partly offset the impact of the recent increases in advertised mortgage rates. Moreover, as has been the case since mid-2005, the inversion of the yield curve has seen five year fixed rates remain below two year rates. The gap between the two has now widened to almost 40 basis points – the most that five year rates have been below two year rates since mid-1998.

Borrowers have responded to the recent absolute and relative changes in mortgage rates by continuing to favour longer-term fixed rates. This has seen an ongoing increase in the weighted average time to re-pricing for mortgages – the 'duration' of outstanding mortgages. The average

Figure 4.7

Mortgage rates offered to new borrowers

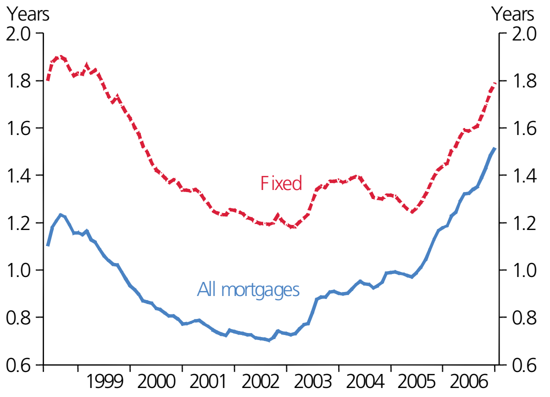


Source: RBNZ.

duration of all outstanding mortgages has increased to a new high of around 18 months and the duration of fixed mortgages is approaching the highs seen in the late 1990s (figure 4.8).

Figure 4.8

Weighted average time to re-pricing for mortgages

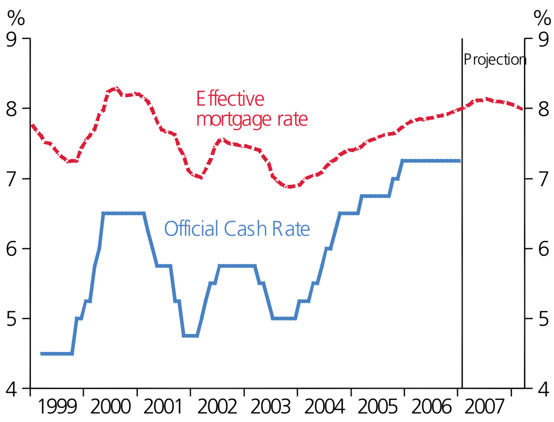


Source: RBNZ estimates.

The effective mortgage rate – the average rate being paid on outstanding mortgage debt – has now increased by 110 basis points since its lows in late 2003 (figure 4.9). More than 30 percent of existing fixed rate mortgage debt will re-price over the next 12 months, from an average existing rate of around 7.7 percent. Accordingly, if sustained, the recent rise in mortgage rates being offered to new borrowers and those facing re-pricing will see the effective mortgage rate rise somewhat further over the coming year.

Figure 4.9

The OCR and the effective mortgage rate



Source: RBNZ.

5 The macroeconomic outlook

Overview

The New Zealand economy began to slow in early 2005. Over the last year, this slowdown has become increasingly gradual and recent indicators suggest that activity is now picking up.

The labour market remains tight and the housing market has showed signs of renewed strength. The sharp fall in oil prices in late 2006 has supported domestic demand and consumer confidence has recovered. We now expect consumption growth to rise over the near term. As resource pressures have persisted, this additional growth is expected to place upward pressure on inflation. In response, our projections show a higher track for 90-day interest rates.

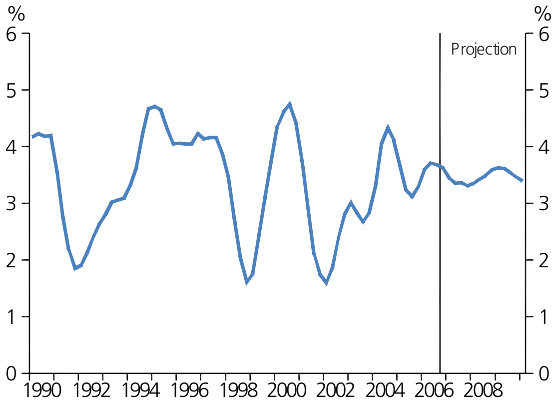
The New Zealand dollar has continued to appreciate since the December *Statement*. While the dollar is expected to depreciate going forward, the stronger outlook for growth, relative interest rate differentials, and commodity prices keeps the profile of the TWI elevated relative to our earlier projection. This delays any further rebalancing of the domestic and external sectors, which is reflected in the very modest improvement that we now expect in the current account deficit.

Further out, we still anticipate that consumption growth will need to slow to reduce both the current level of dissaving by the household sector and medium-term inflation pressures. We expect this consumption slowing to be linked to an easing in house price inflation and reduced scope for housing equity withdrawal (see box 2, chapter 2).

World outlook

The outlook for New Zealand's major trading partners is based on the February *Consensus Forecasts*. Following a period of above trend growth, world economic activity is expected to slow over the coming year, driven by weakness in the US outlook. However, the projected slowing is only temporary and world growth is expected to return above trend in 2008, indicating relatively robust global demand for New Zealand's exports.

Figure 5.1
Trading partner GDP
(annual average percent change)



Source: Consensus Economics Inc., RBNZ estimates.

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

Country	2002	2003	2004	2005	2006f	2007f	2008f
Australia	4.1	3.0	3.7	2.8	2.5	2.9	3.3
United States	1.6	2.5	3.9	3.2	3.4	2.7	3.0
Japan	0.3	1.5	2.7	1.9	2.2	1.9	2.3
Canada	2.9	1.8	3.3	2.9	2.7	2.3	2.9
Eurozone**	0.9	0.8	1.7	1.5	2.8	2.1	2.1
United Kingdom	2.1	2.7	3.3	1.9	2.7	2.6	2.4
Asia ex-Japan***	5.6	5.3	7.6	6.6	7.3	6.3	6.5
12 Country Index	2.8	2.8	4.1	3.3	3.6	3.3	3.6

* Source: Consensus Economics Inc.
** Includes Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain.
*** Includes China, Hong Kong, Malaysia, Singapore, South Korea and Taiwan.

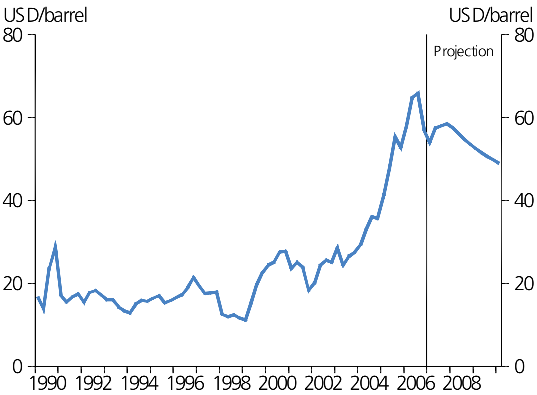
The terms of trade

After reaching high levels in 2005, world export prices began to decline. However, in recent months, prices have recovered all of this ground as global dairy supply has remained tight. We expect a small increase in export prices over the near term based on very high dairy prices (see box 3, chapter 3). Further out, we expect a gradual easing in prices, consistent with an eventual alleviation of supply shortages.

Oil prices have fallen further since the December *Statement*, reaching a low of approximately USD50 per barrel (Dubai) in mid-January. More recently, oil prices have regained some momentum in response to ongoing supply concerns. In line with the February *Consensus Forecasts*, we expect oil prices to rebound further and then stabilise at around USD58 (Dubai) over the coming year.

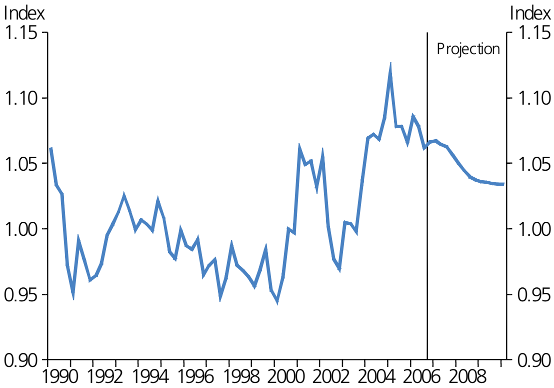
Over the past three years the terms of trade have reached high levels relative to New Zealand's recent history. Going forward, we expect some easing in the terms of trade, consistent with our forecasts for moderating world export prices and flat world import prices. However, the terms of trade are still expected to settle at a high level.

Figure 5.2
Dubai oil price
(US dollars per barrel)



Source: Datastream, RBNZ estimates.

Figure 5.3
OTI terms of trade (goods)

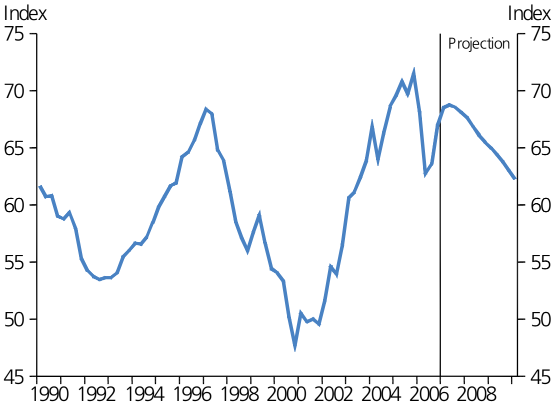


Source: Statistics New Zealand, RBNZ estimates.

Exchange rate

The New Zealand dollar has continued to rebound after falling over the first half of 2006. We still assume that the dollar will ultimately depreciate. However compared to the December *Statement*, the depreciation is expected to be more protracted because of the stronger near-term outlook for domestic demand and commodity prices, and higher interest rates.

Figure 5.4
Nominal TWI assumption

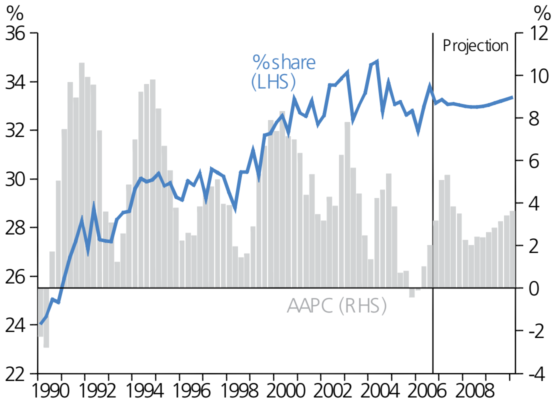


Source: RBNZ estimates.

Export volumes

Export volumes have grown strongly over recent quarters, partly reflecting a rundown in agricultural inventories. We expect some pullback in export volumes over the near term, due to inventory replenishment. The continuing strength in the currency is also expected to constrain export growth over the projection period.

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

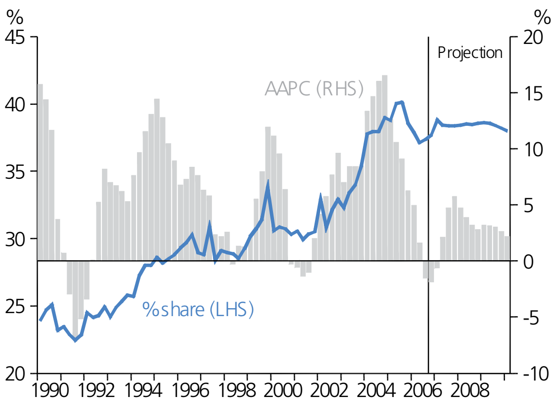


Source: Statistics New Zealand, RBNZ estimates.

Import volumes

Since late 2005 import growth has been falling as domestic demand has slowed. However, import growth has recently shown signs of recovery, and we expect this to continue over the near term. The recovery in imports reflects the pick-up in domestic demand and the renewed strength in the currency. Imports are again acting as a partial 'release valve' to help meet the rebound in domestic demand.

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

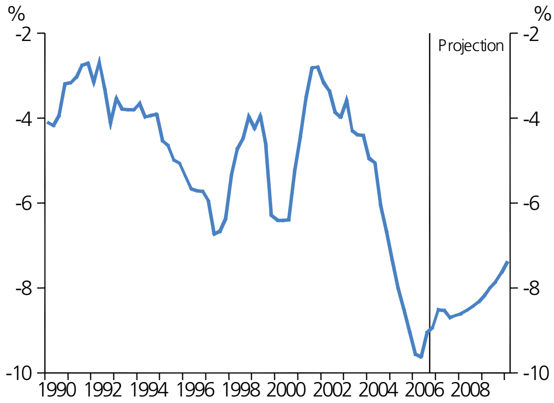


Source: Statistics New Zealand, RBNZ estimates.

Current account

The current account balance began to recover in 2006. While we continue to assume that the current account balance will narrow, the stronger TWI and consequent weaker outlook for net exports now mean that the expected recovery will be more gradual.

Figure 5.7
Current account balance
(percent of nominal GDP)

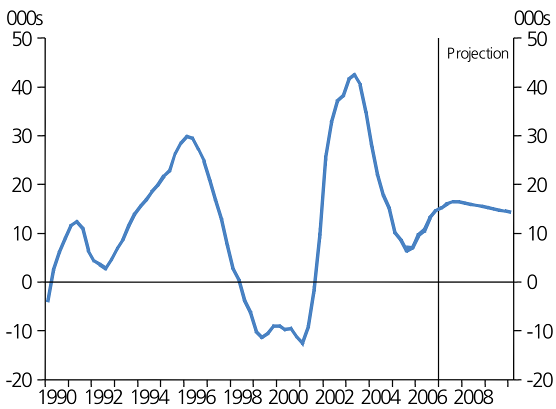


Source: Statistics New Zealand, RBNZ estimates.

Net immigration

Net immigration has been gradually recovering since late 2005. We expect this recovery to continue over 2007 and that net immigration will stabilise at around 13,000 persons per annum. While the net inflow is running well below the levels experienced over recent years, it has remained positive and provided underlying support for the housing market and domestic demand.

Figure 5.8
Net permanent and long-term immigration
(annual total)

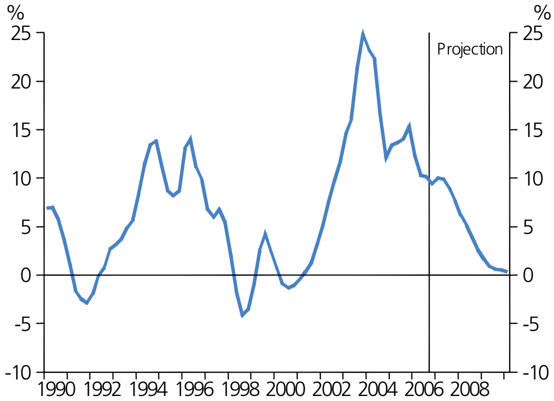


Source: Statistics New Zealand, RBNZ estimates.

House prices

While house price inflation has fallen markedly since 2004, it has recently begun to rise. In line with the latest data, we have revised upwards our projections for house price inflation. Further out, we assume that house price inflation will fall to more moderate levels, eventually reaching zero at the end of the forecast period. Over recent years, we have been surprised by the resilience of the housing market and the willingness of households to take on additional debt. However, house prices look stretched across a variety of measures and current rates of household dissaving are unsustainable.

Figure 5.9
QV house index
(annual percent change)

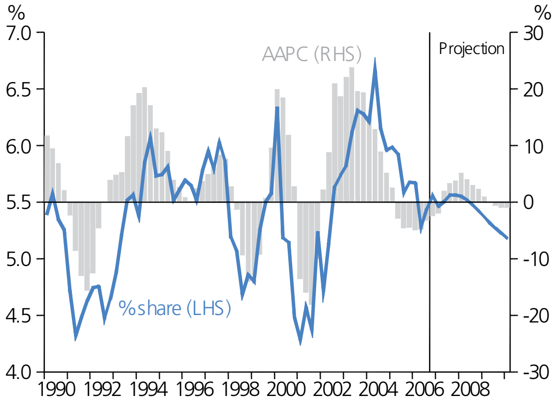


Source: Quotable Value Ltd., RBNZ estimates.

Residential investment

In 2004 residential construction began to slow from very high levels. Recent data suggest construction activity has begun to increase again, in line with the recovery in net immigration and continued price increases in the existing housing stock. We expect further modest growth in residential construction over 2007.

Figure 5.10
Residential investment
(percent of trend output and annual average percent change)



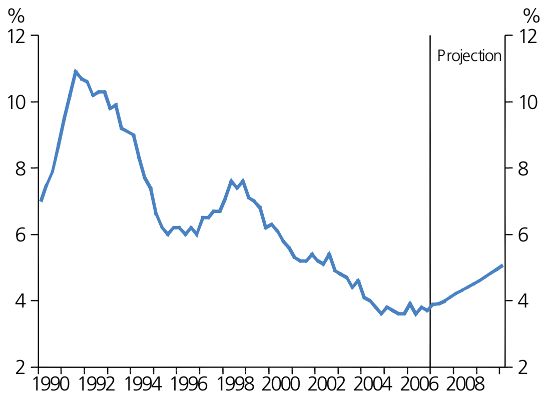
Source: Statistics New Zealand, RBNZ estimates.

Labour market

In recent quarters, the labour market has remained tight. We expect this tightness to persist over the near term as a rebound in growth maintains firms' demand for labour. We have assumed a very gradual rise in the unemployment rate.

While wage inflation is already sitting at relatively high levels, continued growth in demand is expected to place further pressure on wage growth. This will support household incomes and underpin our stronger projections for household consumption.

Figure 5.11
Unemployment rate

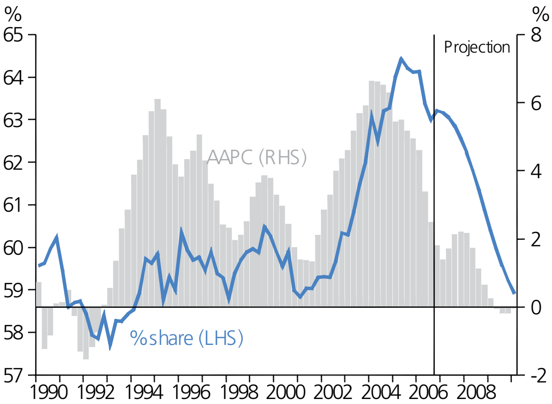


Source: Statistics New Zealand, RBNZ estimates.

Household consumption

Consumption growth has been falling since 2004 in line with slower housing market activity, lower consumer confidence and higher petrol prices. In recent quarters, these drivers of consumption have reversed and now suggest a pick-up in growth over the coming year. Besides strong employment and wage growth, many household incomes have been boosted significantly by the Working for Families package. The unexpected strength in domestic demand has been reflected in a recovery in consumer confidence. We continue to assume that house prices and consumption will eventually slow as household debt levels become increasingly burdensome. However, this slowing has been pushed out further into the projection horizon.

Figure 5.12
Real household consumption
(percent of trend output and annual average percent change)

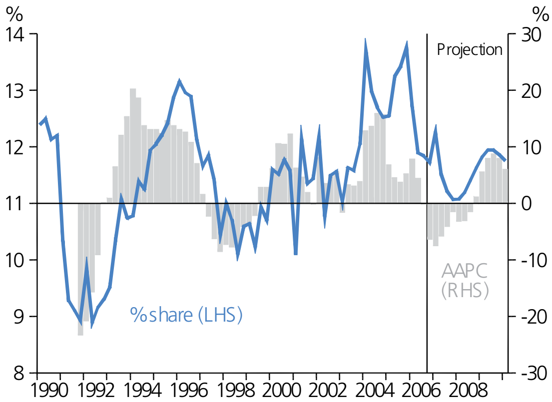


Source: Statistics New Zealand, RBNZ estimates.

Business investment

After slowing sharply over the first half of 2006, business investment is projected to recover over the forecast horizon. This partly reflects renewed business confidence, a rebound in economic growth and continued pressure on firms' productive capacity. The Government's business tax package is expected to further boost business investment over 2008.

Figure 5.13
Business investment (excluding computers and intangible assets)
(percent of trend output and annual average percent change)

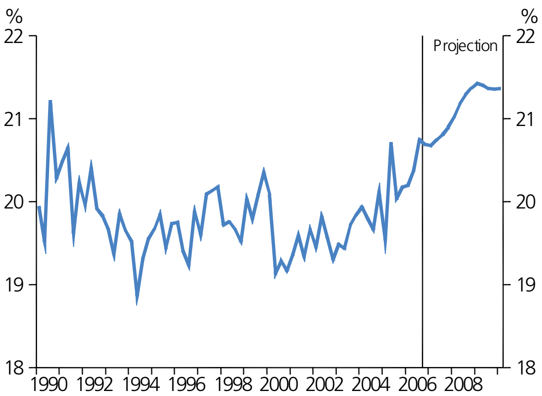


Source: Statistics New Zealand, RBNZ estimates.

Government

Our projections for fiscal policy are based on the Treasury's December 2006 HYEFU. Fiscal policy is expected to become more expansionary over the next few years as Government spending increases and revenue growth slows. Box 4 provides more details on the fiscal outlook.

Figure 5.14
Government consumption and investment (excluding military spending)
(percent of trend output)



Source: Statistics New Zealand, RBNZ estimates.

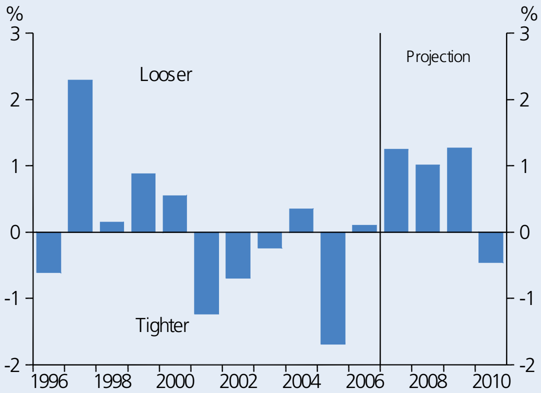
Box 4

Fiscal policy: recent history and outlook

Government spending is an important component of New Zealand aggregate demand, and Government tax and transfer policy can clearly have important impacts on other components of aggregate demand such as household spending.

Over recent history, Government revenue growth has outpaced increases in Government spending, so that the Government has recorded strong surpluses. This is reflected in the Treasury's estimates of 'fiscal impulse', as reported in the December 2006 HYEFU, and shown in figure 5.15. Over 2001-2006, fiscal policy has thus appeared to be generally contractionary.

Figure 5.15
Fiscal impulse



Source: The Treasury.

A forthcoming Reserve Bank *Bulletin* article discusses some of the disaggregate details which can affect the macroeconomic consequences of fiscal policy. For example, some of the contractionary impulse between 2001 and 2006 has reflected surprising strength in company tax receipts. This strength partly reflects past tax losses increasingly being written off, so that firms are now paying higher tax bills. But this is largely only a timing surprise. Also, some of the incidence of company tax is on foreign owners, who are less likely to have spent after-tax profits in New Zealand. Accordingly, the recent strength in company tax may have only had a relatively small contractionary impact.

Recently, fiscal policy has become more stimulatory. Government spending (as a share of output) rose significantly in the 2006 fiscal year, and is expected to record another significant rise in the 2007 fiscal year, outpacing growth in nominal GDP (table 5.2). This reflects a range of spending initiatives including increased allocations to Education, Health and Transport, as well as the introduction of the Working for Families package. The extra Government spending implied by initiatives in areas such as Education and Health contributes directly to aggregate demand. Furthermore, household income is boosted directly by transfers such as the Working for Families package, and indirectly through increased Government spending flowing through to Government employees and contractors. Our estimates suggest households eligible for Working for

Table 5.2
Government spending (Total core spending and selected components, 2005-2007)

$ Million, June Years	2005 Actual	2006 Actual	2007 Forecast	2005-2007 Growth
Social Security and Welfare[1]	14,682	15,598	16,970	16%
Health	8,813	9,547	10,673	21%
Education	7,930	9,914	9,640	22%
Transport and Communications	1,635	1,818	2,481	52%
Total Core	46,234	49,900	53,963	17%
Nominal GDP (Production Basis, RBNZ estimates)	150,600	157,300	164,600	9%

[1] This item includes the Working for Families package.

Families support are likely to see disposable income gains of around 6% on average.

Another component of the stimulatory fiscal impulse is the business tax package which, as described in the HYEFU, is to be implemented from 1 April 2008. While the exact details are still to be finalised, the business tax package is likely to stimulate corporate investment by reducing the effective after tax cost of capital. In the long term, this should increase the sustainable level of production within New Zealand, but in the short term it may put further pressure on resources.

Gross domestic product

Economic growth in New Zealand has been relatively strong since 2000, with significant increases in labour force participation and business investment. In 2005, rates of GDP growth slowed and the annual average rate of growth fell to 1.4 percent in the September quarter of 2006. We expect growth to recover over the coming year, but remain relatively weak further out. This reflects our view that household spending growth will eventually be curtailed by higher levels of household debt and the effects of the high exchange rate on the tradable sector.

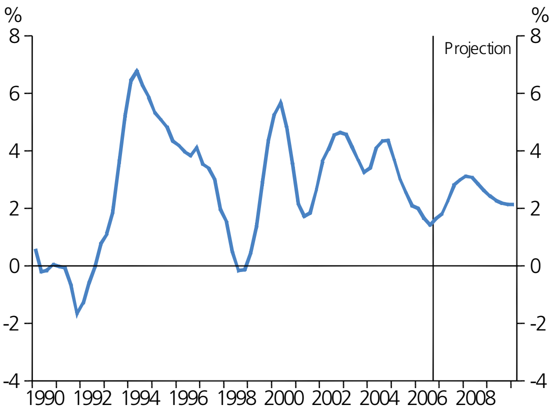
Despite the slowing in GDP growth, to date there have been few signs of this translating through to a material easing in resource pressures. Both capacity utilisation and unemployment remain at extreme levels. The expected recovery in growth over the next few quarters suggests resource pressures are likely to persist over the near term.

Inflation

We expect weaker near-term inflation due to the recent declines in oil prices and in the stronger New Zealand dollar. Inflation is projected to reach a low of around 1.2 percent in the latter half of this year.

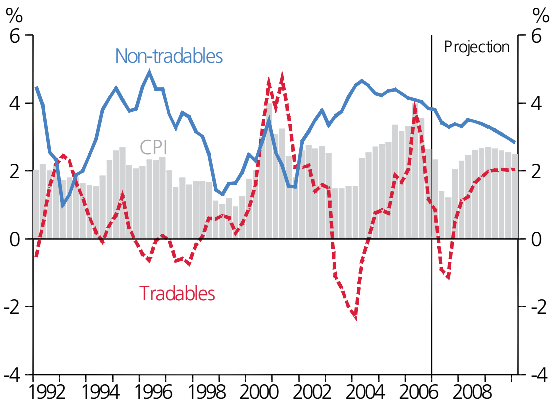
The lower rates of near-term inflation are expected to reduce inflation expectations, and there is already some evidence of this in the latest survey measures. Lower inflation expectations will help to minimise the risk of spillover into medium-term price and wage setting behaviour at a time when productive resources remain stretched. Overall, since the December *Statement*, we assess that medium-term inflation pressures have increased as a result of our stronger outlook for near-term growth. In response, 90-day rates are projected to be higher throughout the projection horizon.

Figure 5.16
Gross domestic product
(annual average percent change)



Source: Statistics New Zealand, RBNZ estimates.

Figure 5.17
CPI, tradables and non-tradables inflation
(annual rate)



Source: Statistics New Zealand, RBNZ estimates.

Appendix A[1]

Summary tables

Table A

Projections of CPI inflation and monetary conditions

(CPI is in percent changes)

		CPI Quarterly	CPI Annual	TWI	90-day bank bill rate
2001	Mar	-0.2	3.1	50.5	6.4
	Jun	0.9	3.2	49.8	5.9
	Sep	0.6	2.4	50.0	5.7
	Dec	0.6	1.8	49.6	5.0
2002	Mar	0.6	2.6	51.6	5.0
	Jun	1.0	2.8	54.6	5.8
	Sep	0.5	2.6	53.9	5.9
	Dec	0.6	2.7	56.4	5.9
2003	Mar	0.4	2.5	60.6	5.8
	Jun	0.0	1.5	61.1	5.4
	Sep	0.5	1.5	62.4	5.1
	Dec	0.7	1.6	63.9	5.3
2004	Mar	0.4	1.5	66.9	5.5
	Jun	0.8	2.4	64.0	5.9
	Sep	0.6	2.5	66.3	6.4
	Dec	0.9	2.7	68.6	6.7
2005	Mar	0.4	2.8	69.6	6.9
	Jun	0.9	2.8	70.8	7.0
	Sep	1.1	3.4	69.7	7.0
	Dec	0.7	3.2	71.5	7.5
2006	Mar	0.6	3.3	68.2	7.5
	Jun	1.5	4.0	62.8	7.5
	Sep	0.7	3.5	63.6	7.5
	Dec	-0.2	2.6	67.0	7.6
2007	First half average	0.4	1.9	68.6	7.8
	Second half average	0.6	1.6	68.3	7.9
2008	First half average	0.7	2.4	67.3	7.9
	Second half average	0.7	2.6	65.8	7.7
2009	First half average	0.6	2.7	64.7	7.4
	Second half average	0.6	2.6	63.4	7.1

Quarterly projections		CPI Quarterly	CPI Annual	GDP Quarterly	GDP Annual average
2006	Jun	1.5	4.0	0.4	1.6
	Sep	0.7	3.5	0.3	1.4
	Dec	-0.2	2.6	1.0	1.6
2007	Mar	0.3	2.3	0.8	1.8
	Jun	0.6	1.4		

[1] Notes for these tables follow on pages 31-32.

Table B
Composition of real GDP growth

(Annual average percent change, unless specified otherwise)

	Actuals						Projections			
March year	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Final consumption expenditure										
Private	1.4	2.9	4.8	6.5	5.5	4.5	1.3	1.9	0.4	0.0
Public authority	-2.0	3.9	1.6	3.7	4.6	4.7	4.8	4.2	4.2	3.2
Total	0.6	3.1	4.0	5.9	5.3	4.6	2.0	2.4	1.3	0.7
Gross fixed capital formation										
Market sector:										
Residential	-13.3	1.9	22.0	15.3	2.3	-4.7	-2.0	5.2	1.0	-1.0
Business	9.2	7.1	1.8	15.4	10.3	9.6	-5.4	1.7	7.1	6.3
Non-market government sector	-18.1	16.7	14.1	13.8	-2.0	4.4	9.1	7.0	6.7	2.2
Total	0.7	6.8	7.1	15.2	7.2	5.9	-3.4	3.0	5.8	4.4
Final domestic expenditure	0.6	3.9	4.7	8.1	5.8	4.9	0.6	2.6	2.4	1.7
Stockbuilding (1)	-0.4	0.1	0.0	0.0	0.3	-0.6	-0.8	1.1	0.2	0.0
Gross national expenditure	0.3	4.0	4.6	8.0	6.0	4.6	-0.1	3.6	2.5	1.6
Exports of goods and services	6.3	3.0	7.8	1.4	3.8	-0.1	4.8	2.5	2.6	3.6
Imports of goods and services	-0.7	4.0	7.2	13.2	12.8	5.0	-0.3	5.1	3.2	2.2
Expenditure on GDP	2.5	3.6	4.9	3.7	3.2	2.1	1.6	2.8	2.4	2.1
GDP (production)	2.1	3.6	4.6	3.4	3.7	2.0	1.8	3.1	2.4	2.1
GDP (production, March qtr to March qtr)	0.5	4.5	4.2	4.8	2.2	1.8	2.4	3.0	2.2	2.2
Potential output	2.8	3.1	3.3	3.3	3.1	3.0	3.0	3.0	2.8	2.8
Output gap (% of potential GDP, year average)	-0.1	0.4	1.6	1.7	2.3	1.3	0.1	0.2	-0.2	-0.8

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

Table C

Summary of economic projections

(Annual percent change, unless specified otherwise)

	Actuals						Projections			
March year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Price measures										
CPI	3.1	2.6	2.5	1.5	2.8	3.3	2.3	2.3	2.7	2.5
Labour costs	1.6	2.1	2.2	2.1	2.5	3.0	3.1	2.6	2.3	2.2
Import prices (in New Zealand dollars)	7.4	-2.9	-11.1	-10.5	0.5	6.9	3.4	-0.4	3.9	4.0
Export prices (in New Zealand dollars)	20.6	-3.5	-15.5	-5.1	4.9	3.6	1.6	-1.9	2.5	3.8
Monetary conditions										
90-day rate (year average)	6.6	5.4	5.9	5.3	6.5	7.3	7.6	7.9	7.7	7.1
TWI (year average)	50.4	50.3	56.4	63.6	67.1	70.0	65.5	68.2	65.9	63.4
Output										
GDP (production, annual average % change)	2.1	3.6	4.6	3.4	3.7	2.0	1.8	3.1	2.4	2.1
GDP (production, March qtr to March qtr)	0.5	4.5	4.2	4.8	2.2	1.8	2.4	3.0	2.2	2.2
Output gap (% of potential GDP, year average)	-0.1	0.4	1.6	1.7	2.3	1.3	0.1	0.2	-0.2	-0.8
Labour market										
Total employment	2.3	3.5	1.5	3.1	3.4	2.6	0.9	0.6	0.6	0.7
Unemployment rate (March qtr, s.a.)	5.3	5.2	4.8	4.1	3.8	3.9	3.9	4.2	4.6	5.1
Trend labour productivity (annual % change)	1.5	1.4	1.0	0.8	0.7	0.7	1.0	1.4	1.6	1.8
Key balances										
Government operating balance (% of GDP, year to June)	1.1	1.9	1.5	5.2	4.1	7.3	4.0	3.7	2.7	2.7
Current account balance (% of GDP, year to March)	-4.4	-3.2	-3.6	-5.0	-7.4	-9.6	-8.6	-8.5	-8.1	-7.3
Terms of trade (OTI measure, annual average % change)	4.4	4.2	-5.7	3.9	5.8	-0.8	-0.8	-0.9	-1.8	-0.5
Household savings rate	-5.7	-5.6	-12.9	-12.7	-15.0	-17.5	-15.5	-13.7	-12	-9.4
(% of disposable income, year to March)										
World economy										
World GDP (annual average % change)	3.7	1.6	3.0	3.3	3.7	3.6	3.5	3.4	3.6	3.4
World CPI inflation	2.7	1.4	2.2	1.5	2.1	2.4	2.0	2.0	2.1	2.2

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 percent.
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	RBNZ definition. Private sector and government market sector residential investment. *System of National Accounts*.
Business investment	RBNZ definition. Total investment less the sum of non-market investment and residential investment. *System of National Accounts*.
Non-market investment	RBNZ definition. The *System of National Accounts* annual nominal government non-market/market investment ratio is interpolated into quarterly data. This ratio is used to split quarterly expenditure GDP government investment into market and non-market components.
Final domestic expenditure	RBNZ definition. The sum of total consumption and total investment. *System of National Accounts*.
Stockbuilding	Percentage point contribution to the growth of GDP by stocks. *System of National Accounts*.
Gross national expenditure	Final domestic expenditure plus stocks. *System of National Accounts*.
Exports of goods and services	*System of National Accounts*.
Imports of goods and services	*System of National Accounts*.
GDP (production)	*System of National Accounts*.
Potential output	RBNZ definition and estimate. Refer to Conway, P and B Hunt (1997), 'Estimating Potential Output: a semi-structural approach', *Reserve Bank of New Zealand Discussion Paper*, G97/9.
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*.

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

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

Appendix B

Companies and organisations contacted by RBNZ staff during the projection round

Affco Ltd

Auckland International Airport Ltd

Employers & Manufacturers Association (Northern)

H & J Smith Limited

Hospitality Association of New Zealand

Mainzeal Property and Construction Ltd

Ministry of Tourism

Nelson Regional Economic Development Agency

New Zealand Council of Trade Unions

Nissan New Zealand Ltd

Ports of Auckland Ltd

Ports of Tauranga Ltd

Rabobank

Real Estate Institute of New Zealand

Retailers and Merchants Association

Skyline Enterprises Ltd

The Warehouse 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 percent

7 December 2006

The Official Cash Rate (OCR) will remain unchanged at 7.25 percent.

Reserve Bank Governor Alan Bollard said: "Medium-term inflation pressures remain persistent. While the short-term inflation outlook has improved, we are less optimistic about medium-term prospects. Economic activity has been stronger than expected, given the resilience in domestic demand, and medium-term inflation risks appear weighted to the upside.

"A welcome decline in oil prices has improved the near-term inflation outlook. As foreshadowed in our October OCR Review, we expect to see a very low December quarter CPI figure. Annual inflation could be as low as 2 percent next year, which should help to restrain inflation expectations and therefore give some assistance in containing medium-term inflation pressures.

"But household spending continues to show surprising resilience. The labour market remains very firm, with continued strong growth in incomes despite some easing in employment in the third quarter. There has been some improvement in business and consumer confidence. The housing market appears to have developed new momentum after slowing in the first half of the year. Houses are now selling as fast as at any time this year.

"Many exporters are feeling pressure from the high exchange rate which, if sustained, could threaten the ongoing rebalancing of the economy. However, primary exporters are getting significant relief from favourable world commodity prices, which are now expected to continue for longer as a result of global supply shortages.

"While overall medium-term inflation pressures have increased, the balance of risks also appears to be on the upside. The housing market could continue to defy predictions of a downturn, and domestic demand could be further boosted by a fiscal expansion over and above the stimulus that is already allowed for in our projections (based on the Government's 2006 Budget).

"Looking ahead, our projections and risk assessment suggest that a firmer monetary policy stance could still be required to maintain downward pressure on inflation in the medium term. Further tightening cannot therefore be ruled out. This will depend on economic outcomes and in particular the emerging trends in housing and domestic demand indicators. Any easing of policy must remain some considerable way off."

OCR unchanged at 7.25 percent

25 January 2007

The Official Cash Rate (OCR) will remain unchanged at 7.25 percent.

Reserve Bank Governor Alan Bollard said: "While indicators show that economic growth was continuing to moderate in the third quarter of 2006, it is increasingly apparent that domestic demand has rebounded since then, with retail trade picking up, a resurgent housing market and consumer and business confidence recovering strongly. The main drivers appear to be the decline in petrol prices since last October, a pickup in net immigration and an expansionary fiscal policy.

"At the same time, headline inflation has reduced as a result of the lower oil prices and the strengthening of the exchange rate in the fourth quarter. Annual CPI inflation fell to 2.6 percent in December and is projected to decrease considerably further through 2007, thus helping to lower inflation expectations. But the medium-term outlook is less rosy, with annual rates of inflation projected to return to the upper part of our target range through 2008 and into 2009.

"While the near-term inflation outlook is relatively benign, we remain concerned about the upside risks to medium-term inflation. In particular, our assumption that the housing market and consumer demand will resume their slowing trend over 2007 and 2008 is looking more uncertain, particularly if further fiscal expansion occurs.

"In the absence of clear indications of a moderation in housing and domestic demand, it is likely that further policy tightening will be required. The situation will be reassessed in the light of a full review of our economic forecasts at the March Monetary Policy Statement. A return to a moderating trend in housing and domestic demand will be essential if we are to see a reduction in medium-term inflation pressures."

Appendix D
The Official Cash Rate chronology

Date	OCR (percent)	Date	OCR (percent)
17 March 1999	4.50	6 March 2003	5.75
21 April 1999	4.50	24 April 2003	5.50
19 May 1999	4.50	5 June 2003	5.25
30 June 1999	4.50	24 July 2003	5.00
18 August 1999	4.50	4 September 2003	5.00
29 September 1999	4.50	23 October 2003	5.00
17 November 1999	5.00	4 December 2003	5.00
19 January 2000	5.25	29 January 2004	5.25
15 March 2000	5.75	11 March 2004	5.25
19 April 2000	6.00	29 April 2004	5.50
17 May 2000	6.50	10 June 2004	5.75
5 July 2000	6.50	29 July 2004	6.00
16 August 2000	6.50	9 September 2004	6.25
4 October 2000	6.50	28 October 2004	6.50
6 December 2000	6.50	9 December 2004	6.50
24 January 2001	6.50	27 January 2005	6.50
14 March 2001	6.25	10 March 2005	6.75
19 April 2001	6.00	28 April 2005	6.75
16 May 2001	5.75	9 June 2005	6.75
4 July 2001	5.75	28 July 2005	6.75
15 August 2001	5.75	15 September 2005	6.75
19 September 2001	5.25	27 October 2005	7.00
3 October 2001	5.25	8 December 2005	7.25
14 November 2001	4.75	26 January 2006	7.25
23 January 2002	4.75	9 March 2006	7.25
20 March 2002	5.00	27 April 2006	7.25
17 April 2002	5.25	8 June 2006	7.25
15 May 2002	5.50	27 July 2006	7.25
3 July 2002	5.75	14 September 2006	7.25
14 August 2002	5.75	26 October 2006	7.25
2 October 2002	5.75	7 December 2006	7.25
20 November 2002	5.75	25 January 2007	7.25
23 January 2003	5.75		

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 2007.

26 April 2007	OCR announcement
7 June 2007	*Monetary Policy Statement*
26 July 2007	OCR announcement
13 September 2007	*Monetary Policy Statement*
25 October 2007	OCR announcement
6 December 2007	*Monetary Policy Statement*

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 percent and 3 percent 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