RESERVE BANK
OF NEW ZEALAND

Monetary Policy Statement

June 2012[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 1 June 2012. Policy assessment finalised on 13 June 2012

1 Policy assessment

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.5 percent.

New Zealand's economic outlook has weakened a little since the March *Monetary Policy Statement*.

Political and economic stresses in Europe, along with a run of weaker-than-expected data, have seen New Zealand's trading partner outlook worsen. Furthermore, there is a small but growing risk that conditions in the euro area deteriorate more markedly than is projected in the June *Statement*. The Bank is monitoring euro-area developments carefully given the potential for rapid change.

Increased agricultural production and the weakened global outlook have driven New Zealand's export commodity prices lower. The resulting moderation in export incomes, although partially offset by depreciation in the exchange rate, will weigh on economic activity in New Zealand. Fiscal consolidation is also likely to constrain demand growth going forward.

Offsetting these negative influences, housing market activity continues to increase, supported by recent reductions in mortgage interest rates. In addition, repairs and reconstruction in Canterbury are expected to substantially boost construction sector activity in coming quarters. Aggregate GDP growth is projected to pick up slightly to just over 3 percent next year. Given this economic outlook, inflation is expected to settle near the mid-point of the target range.

It remains appropriate for monetary policy to remain stimulatory, with the OCR being held at 2.5 percent.

Alan Bollard

Alan Bollard

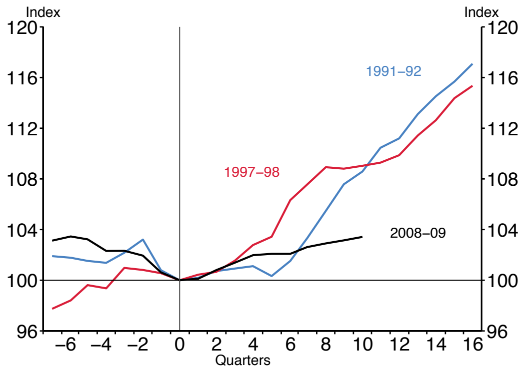
Governor

2 Overview and key policy judgements

The global economic outlook has deteriorated since the March *Statement*. Political and economic uncertainty in the euro area, along with a run of weak international data, have seen major bond yields and global equity and commodity prices fall. This deterioration, along with a large increase in global dairy production, has driven New Zealand's export commodity prices lower, negatively impacting New Zealand's economic outlook.

These developments have resulted in an easing of domestic monetary conditions. Interest rates have fallen, with many residential borrowers now able to secure mortgage interest rates in the range of 5 to 5.25 percent. The New Zealand dollar has also depreciated markedly over the past month or so. This easing in monetary conditions will help support the economy going forward. For now though, economic activity remains weak. GDP growth has been sluggish (figure 2.1) and is estimated to have only recently surpassed its pre-recession level.

Figure 2.1
Recent recoveries in GDP
(quarterly GDP at recession trough = 100)



Source: Statistics New Zealand.

Substantial household and corporate debt, along with persistent strength in the New Zealand dollar and a weak global environment, have restrained GDP growth over the past few years. In an effort to consolidate their balance sheets, households and firms have, where possible, restricted their expenditure. This restraint has been most noticeable with major purchases, such as the undertaking of capital investment. Indeed, construction, both of residential and non-residential buildings, as well as business investment more generally, have been very weak for the past four years.

This reduced capital investment, while having an immediate negative impact on GDP, has also negatively affected the economy's future capacity to grow. In addition, economic uncertainty and cautiousness in the willingness to borrow and lend has limited innovation and risk-taking, further inhibiting potential growth. Consistent with this, indicators of capacity usage are much tighter than would have previously been expected, given the weakness in GDP growth. Surveyed skill shortages, for instance, sit close to their historic norm despite the unemployment rate being near its recessionary peak. Consistent with the skill shortage data, wage inflation is close to its average of the past two decades.

CPI inflation remains contained, with underlying measures of annual inflation close to the mid-point of the target band. Falling tradable prices are expected to bring annual headline CPI inflation close to the bottom of the target band in the June quarter. This dip is expected to be short lived.

There are four key factors influencing the outlook. These are:

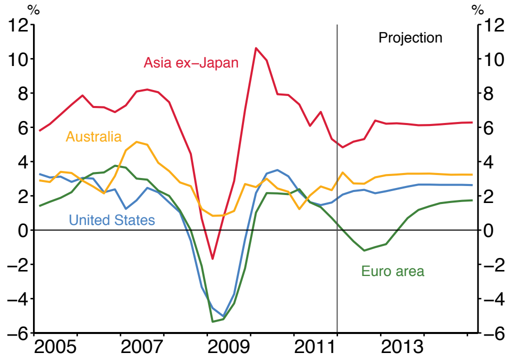
- The euro area is projected to remain in recession throughout 2012 and recover only modestly thereafter. Trading partner growth more generally is expected to remain below average.
- This soft global outlook along with continued gains in global agricultural production is expected to see New Zealand's export commodity prices decline further over the coming 12 months.
- Fiscal policy is expected to tighten over the projection horizon, negatively affecting aggregate demand.
- Repairs and rebuilding in Canterbury are expected to substantially boost construction sector activity.

The global outlook

Economic and political stresses in the euro area have been rising, with fears growing that one or more countries leaves the currency union. This, along with a run of weaker-than-expected data, has seen the global outlook deteriorate since the March *Statement*.

Even if the euro area remains intact, it is clear that economic growth in Europe will be weak over the projection horizon. Underlying the Bank's projection for trading partner growth is an expectation that the euro area will remain in recession for the rest of 2012 and recover only modestly thereafter (figure 2.2).

Figure 2.2
Trading partner GDP growth
(annual)



Source: Haver Analytics, RBNZ estimates. 'Asia ex-Japan' includes China, Hong Kong, India, Indonesia, Malaysia, The Philippines, Singapore, South Korea, Taiwan and Thailand.

Despite the euro area only purchasing a small share of our exports, New Zealand should still be concerned by the European outlook. Given its large, affluent population, Europe consumes a large share of global production. Weakened demand in Europe would therefore, in itself, have a negative influence on commodity prices. In addition, Europe is an important export customer for much of Asia, particularly China.

Indeed, Chinese economic data continue to soften with GDP growth moderating over the past year. In addition, falling investment growth in China has reduced demand for industrial commodities, with Australia's terms of trade suffering as a result. US economic data have also softened of late.

Financial market transmission channels from the euro area are just as important as those from trade. Euro-area banks have substantial claims on the rest of the world, and are heavily involved in the provision of trade finance. With regard to New Zealand, much of our longer-term wholesale bank funding is sourced in Europe. In addition, concerns about euro-area deterioration often lead to bouts of 'risk off' market behaviour that tend to push up the cost of credit for New Zealand banks. Continued European bank fragility is likely to see funding costs for New Zealand banks remain elevated relative to the OCR for some years.

For the moment though, New Zealand banks appear well funded and are aggressively competing to lend for housing. Mortgage rates have fallen and many borrowers have been able to negotiate further discounts on advertised rates. Borrowers have taken advantage of these lower rates, with mortgage approvals increasing noticeably. Increased approvals reflect both new lending and switching between banks by existing borrowers. Net lending growth remains very low though, with many households taking current low interest rates as an opportunity to increase principal repayments.

There is a growing risk that euro-area economic activity contracts much more severely than assumed in the central projection. Box A qualitatively describes such a downside scenario and its possible impact on New Zealand.

Financial markets appear to be pricing in some risk of severe deterioration in Europe. At the time of writing, overnight indexed swap pricing is consistent with the OCR being reduced by about 30 basis points this year, before being increased in 2013. One could interpret this as a small chance of a hefty reduction in the OCR in the event of a major adverse global event, rather than the market expecting further modest easing by the Reserve Bank.

Box A
The impact of severe deterioration in the euro area

The risk of severe deterioration in the euro-area debt crisis has increased since the March *Statement*. Electoral gains by anti-austerity parties in Greece have increased the possibility that Greece will exit the euro area. Should such an exit occur, there would likely be negative flow-on effects to other peripheral countries, which could result in further exits. The exit of a country from the euro area would cause substantial disruption to the world economy, and New Zealand's economy would not be immune.

Even if such an exit does not occur, conditions in Europe could turn out to be markedly worse than incorporated into the central projection. Since the range of potential outcomes is immense, this box sets out the channels whereby such deterioration in the euro area could affect the New Zealand economy, rather than attempt to enumerate a necessarily arbitrary downside scenario. The Bank will continue to monitor developments closely and react appropriately in accordance with the Policy Targets Agreement.

The first channel whereby New Zealand may be affected is via trade linkages. The direct trade with the euro area is comparatively small – the euro area accounts for less than 7 percent of New Zealand's exports. As such, the direct impact on New Zealand export volumes of a much weaker euro area is likely to be contained.

However, the euro area, and the European Union more widely, have a far greater share of world GDP. Adjusted for purchasing power, the euro area accounts for 14 percent of world GDP, and the European Union accounts for about a fifth. Thus deterioration in the euro area will have a significant impact on the rest of Europe and the world.

In particular, European countries are a significant export destination for China and South-East Asia. A more marked slowdown in Europe would result in much weaker exports from Asia. Recent experience from the global financial crisis suggests that the effects of an inventory cycle on industrial production in these economies can be large. This would consequently reduce imports by these countries from New Zealand and Australia. Asian economies and Australia combined account for about two thirds of New Zealand's exports. Hence the major impact of a sharp downturn in euro-area activity on New Zealand's exports will be via the indirect effect on New Zealand's other trading partners.

In addition to the reduction in export volumes, a major downturn in euro-area, and consequently world, activity would put downward pressure on commodity prices. Given the preponderance of commodities in New Zealand's export basket, such a fall in commodity prices could result in a large reduction in the terms of trade, reducing national income.

In the past, sharp declines in world growth have been matched by falls in the New Zealand dollar. While this helps cushion exporter incomes from the reduction in world prices, depreciation does impart some cost on the rest of the economy. A lower TWI would increase import prices, making investment more expensive for firms and increasing the cost of imported consumer goods, generating tradable inflation.

European banks and financial markets would also be severely affected by any major disruption in the euro area. Deposit flight from banking systems in the periphery is evident, and to be effective any euro-area wide banking guarantee would need to ensure that depositors would be protected from denomination risk.

Default by Greece or other borrowers could cause bank failures across Europe. International funding markets could become prohibitively expensive, which would boost New Zealand lending rates and potentially reduce the amount New Zealand banks would be willing to lend. For a given level of inflationary pressure in the economy, 90-day interest rates would have to be correspondingly lower to offset the effects of these higher funding costs.

European banks are also involved in trade finance in Asia. Significant losses in the home market would likely bring about a reduction in this activity which would further impinge on Asian exports.

The final channel whereby New Zealand's economy could be affected by a significant worsening in Europe is confidence. Confidence declined sharply in the aftermath of Lehman Brothers' bankruptcy. The consequent decline in economic activity was faster and sharper than pure trade flows justified. A similar reaction would be expected to an unplanned European default, with firms reducing investment and households reining back expenditure.

Overall, one or more countries leaving the euro area, or a disorderly major default, could significantly reduce inflationary pressures in the New Zealand economy. This would be expected to result in materially weaker monetary conditions in New Zealand.

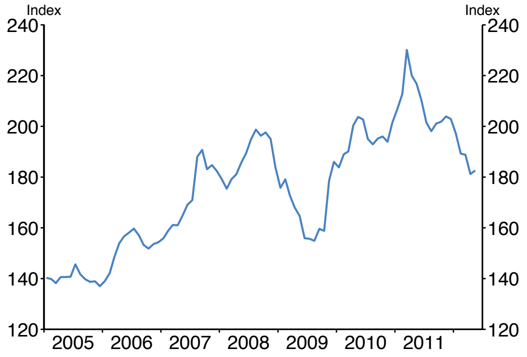
New Zealand's export commodity prices

As a result of the weakened global outlook, commodity prices have fallen since the March *Statement*. In addition to the influence from reduced global growth, increased agricultural production has also undermined New Zealand's export commodity prices. Favourable climatic conditions have seen dairy production, both within New Zealand and in many other dairy producers, increase substantially. Good weather has also seen lamb weights improve.

New Zealand's export commodity prices and the New Zealand dollar have gone through large cycles over the past five years. Prices increased by almost 50 percent between 2006 and 2008, before declining sharply during the global financial crisis. Then, from late 2009 to early 2011, export prices rose sharply again (figure 2.3).

Despite these high commodity prices, farmers have been reluctant to undertake significant expenditure or increase borrowing. The experience of the 2008/09 decline in commodity prices, along with existing high debt, have seen most farmers use the income boost to strengthen their balance sheets rather than purchase more land. Nonetheless, recent declines in export commodity prices will negatively affect GDP growth. Reduced export earnings, along with the risk of further falls, are likely to see farmers and those involved in the agricultural sector trim their spending and capital expenditure. Furthermore, recent depreciation in the New Zealand dollar, which will have been in part driven by the lower commodity prices, will boost the price of imports, thereby reducing the spending power of both those involved in and outside the agricultural sector alike.

Figure 2.3
Export commodity prices
(New Zealand dollar terms)



Source: ANZ National Bank.

Fiscal policy

Turning to the outlook for fiscal policy, the shift from operating surpluses to operating deficits over the past five years has supported aggregate demand. Discretionary revenue and expenditure decisions made through the second half of the 2000s, along with weak GDP growth and the fiscal costs associated with the Canterbury earthquakes, have seen the fiscal balance deteriorate markedly. Government debt, while low by international standards, has risen sharply.

Given the current global financial market and rating agency focus on sovereign debt control, the Government has signalled an intention to bring the fiscal deficit back to surplus in the 2014/15 fiscal year. A portion of the current deficit will be eliminated as the economy picks up from its recent run of weak GDP growth. However, the majority of the projected improvement is expected to come via tighter discretionary fiscal policy. Such tightening will have a negative influence on demand growth over the projection horizon.

Reconstruction in Canterbury

Offsetting these negative influences, repairs and rebuilding in Canterbury are expected to substantially boost construction sector activity. The Reserve Bank continues to assume repairs and reconstruction of about $20 billion (in 2011 dollars) will occur. Various constraints, including the availability of skilled tradespeople, mean reconstruction will take many years. Nonetheless, residential and non-residential construction are still likely to increase markedly over the coming years, adding to GDP growth.

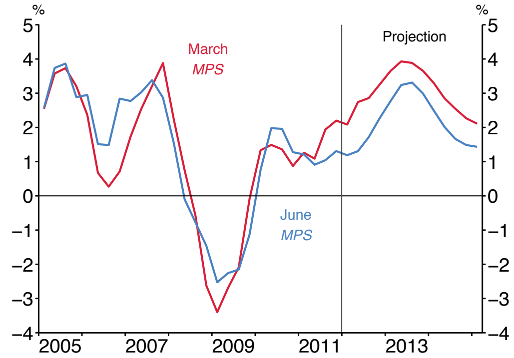
This construction cycle will be quite different to that typically observed. New Zealand construction cycles are usually demand led, with increased demand for housing pushing up the price of existing homes. As existing houses become expensive relative to the cost of building, residential construction increases. The wealth effect from increased house prices flows through to increased retail spending, resulting in house prices, residential investment and private consumption all moving together.

However, earthquake reconstruction represents specific demand for housing, rather than a broad pickup in domestic demand. In addition, the concentrated and relatively co-ordinated nature of reconstruction should limit its impact on house prices. As such, it seems likely that consumer spending and house prices will remain weak, despite residential investment increasing substantially.

The updated projection

Overall, GDP growth is expected to pick up slightly from its current weak pace (figure 2.4). Increased residential investment, along with growth in business investment, is expected to offset household and government consolidation efforts such that annual GDP growth accelerates to just over 3 percent by the middle of 2013.

Figure 2.4
GDP growth
(annual)

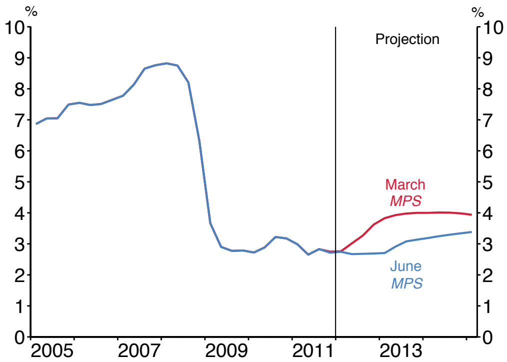


Source: Statistics New Zealand, RBNZ estimates.

The outlook for GDP growth has been reduced relative to the March projection, due to the recent and projected falls in export commodity prices. Historical data have also been revised as part of Statistics New Zealand's annual benchmarking of GDP. While revisions to the production measure of real GDP (shown in figure 2.4) were relatively small, consumption data in the expenditure measure of real GDP were revised noticeably lower (see box C, chapter 4). The updated data fit more closely with other indicators of consumption.

Historically low interest rates are expected to support GDP growth over the projection (figure 2.5). The flow-on impact of recent and projected falls in export prices has lowered the interest rate projection relative to March.

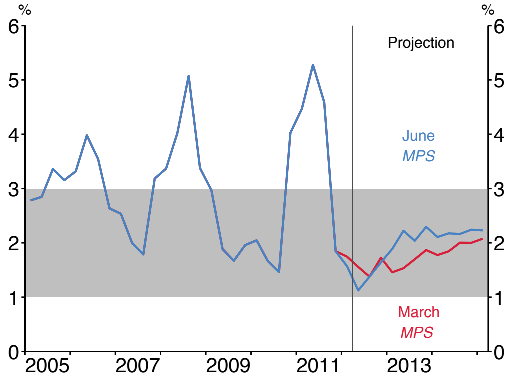
Figure 2.5
90-day interest rate



Source: RBNZ estimates.

The projected pick-up in GDP growth is expected to eliminate current spare capacity over the coming year, causing non-tradable inflation to increase from its current subdued level. Increases in tobacco excise taxes, announced in *Budget 2012*, are also expected to add to non-tradable inflation. Offsetting this, falling commodity prices and the lagged impact of previous appreciation in the New Zealand dollar are expected to keep tradable inflation quite low. Overall, annual CPI inflation is expected to track close to the centre of the target band (figure 2.6).

Figure 2.6
CPI inflation
(annual)



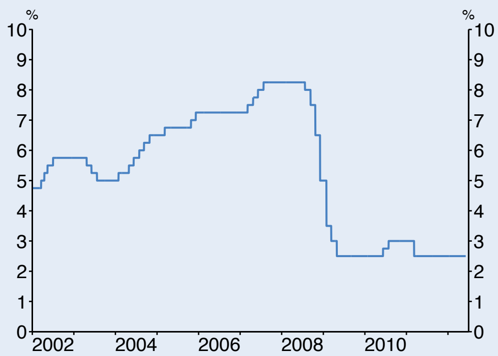
Source: Statistics New Zealand, RBNZ estimates.

The inflation forecast has been revised upwards from 2013 onwards. This upward revision, in part, reflects the direct inflation impact of the planned increases in tobacco excise taxes. This effect impacts sooner than does the negative indirect inflation impact of recent and projected falls in commodity prices.

Box B
Recent monetary policy decisions

The OCR has been held at a record low 2.5 percent for the past 15 months (figure B1). The OCR was reduced to 2.5 percent in March 2011 to offset the potential for the Canterbury earthquakes to have a very adverse economic impact. The lack of momentum in the domestic economy and the deterioration in global economic conditions since then made it appropriate to maintain the OCR at this record low.

Figure B1
Official Cash Rate



Source: RBNZ.

In doing so, the Bank had been conscious of possible upside risks to inflation. In particular, surveyed inflation expectations increased dramatically in early 2011 following the October 2010 increase in the rate of GST. The Bank made the judgement that inflation expectations would increase only temporarily and that surveyed expectations would fall noticeably once the effect of the GST change dropped out of the annual CPI figure. Inflation expectations did decline in this manner.

More recently, persistent strength in the New Zealand dollar and deterioration in the global outlook have supported the Bank's decision to maintain a low OCR.

3 Financial market developments

Financial market sentiment has deteriorated significantly since the March *Statement*. This has been driven by negative surprises on economic data across major countries, and escalating risk in Europe from the deteriorating Spanish banking sector and the lack of a clear result in Greece's parliamentary election. Uncertainty about whether Greece will leave the euro area has increased and investors are worried about the possible contagion effects from a Greek exit.

Since the March *Statement*, global equity markets, commodity prices and the New Zealand dollar have fallen sharply. Investor preference towards lower risk assets has driven government bond yields in many countries to fresh lows, including the United States, Germany, Australia and New Zealand, while government bond yields for troubled nations like Italy and Spain have risen sharply. Signs of stress have re-emerged in some funding markets, although New Zealand banks remain well ahead on their funding programmes.

Overall, monetary conditions in New Zealand have eased significantly. On a TWI basis, the New Zealand dollar has depreciated by 6 percent, domestic swap rates have fallen by up to 70 basis points and government bond rates have fallen to historical lows. Overnight indexed swap rates imply that the Reserve Bank will decrease the OCR through the rest of 2012.

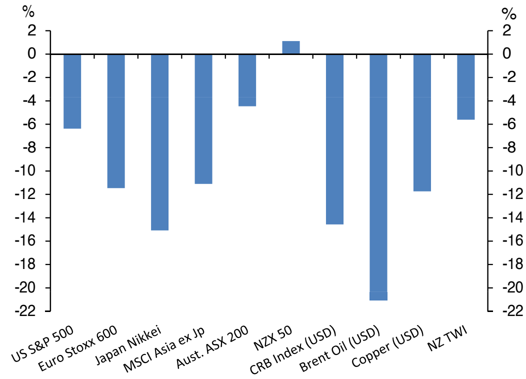
Strong competition, soft credit demand and falling wholesale rates have encouraged domestic banks to lower mortgage rates significantly since the March *Statement*. Many borrowers can now secure mortgage rates in the range of 5 to 5.25 percent, which is substantially lower than the current weighted average mortgage rate of 6 percent.

International market developments

At the time of the March *Statement*, market sentiment had become less downbeat, with equity markets increasing and stronger commodity prices helping to drive the New Zealand dollar higher. Greece was about to complete the largest debt restructuring in history and euro-area finance ministers were agreeing to enlarge the 'firewall' to support troubled nations and prevent contagion risk.

Since early April market sentiment has deteriorated markedly. Figure 3.1 highlights the broadly based fall in equity markets, commodity prices and the New Zealand dollar.

Figure 3.1
Selected price movements
(since March Statement*)*



Source: Bloomberg.

Market attention has been focused on Europe over recent months, with pressure points concentrated in Spain and Greece.

Markets have become increasingly concerned about the health of Spain's banking system. A sharp contraction in economic activity, a 30 percent drop in real estate prices and a jump in the unemployment rate to nearly 25 percent have raised concerns about bank asset quality. Furthermore, loan quality is expected to deteriorate further, given that the economy is at the early stages of fiscal austerity.

Spain's government has made some moves to reform the financial sector but the moves had been insufficient to restore market confidence. Market participants were concerned that much more public funding will be required for the rest of the banking sector, putting increasing pressure on government debt levels. Indeed, the yield on Spain's government bonds recently reached fresh highs above 6.5 percent. The higher interest rates go, the larger the negative impact to the balance sheets of the banking sector and the government's accounts. Financial markets reacted favourably to the recent euro-area financed loans to the Spanish banking sector.

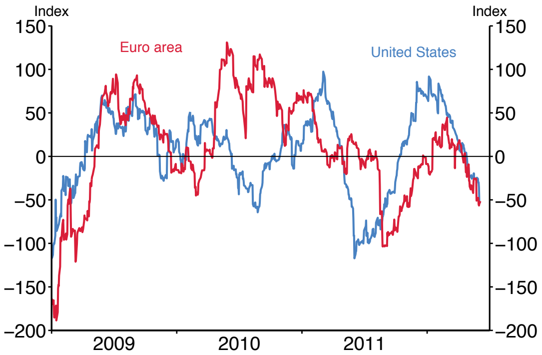
Turning to Greece, the two governing parties attracted much reduced support in the parliamentary elections, an effective rejection of the austerity measures they had backed. Markets reacted negatively to the result and reassessed upwards the probability that Greece might be forced out of the euro area because of a lack of external funding support. Focus now turns to the second election on 17 June.

Despite the reduced support for austerity policies, EU leaders insist that Greece must comply with the agreements which allow further external funding, subject to adopting reform and fiscal austerity plans. An election result which is inconclusive or confirms a lack of support for austerity, thereby threatening Greece's membership of the euro area, would see further deterioration in market confidence. The main concern is the contagion risks if Greece exits the euro area. The outcome of a Greece exit is unpredictable, but market pricing has been moving towards a more adverse scenario.

Over recent months, economic data across major countries such as the United States, China and much of Europe, have disappointed market expectations on average. Economic surprise indices have been trending down recently (figure 3.2). The weaker data flow has prompted central banks into either easing monetary policy or indicating the possibility of further easing, if necessary.

Doubts began to surface about the strength of the United States economic recovery following a run of disappointing labour market data. Whether further monetary stimulus in the United States is likely remains data dependent. The FOMC minutes for the April meeting were interpreted as maintaining the possibility of further

Figure 3.2
Economic surprise indices



Source: Bloomberg.

quantitative easing. The minutes highlighted downside risks to a moderately expanding economy, with several members "indicating that additional monetary policy accommodation could be necessary if the economic recovery lost momentum or the downside risks to the forecast became great enough".

The Chinese economy has also weakened. This has prompted an easing in financial market conditions by the People's Bank of China, which recently cut banks' reserve requirement ratios (RRR) by 50 basis points to 20 percent for large banks. Authorities have now lowered the RRR by 150 basis points since November and have also eased policy via looser credit conditions to local government investment vehicles and the property sector.

The Bank of Japan expanded its asset purchase programme by an additional ¥5 trillion (1.1 percent of GDP) in April. The Bank intends to extend its maturity profile by replacing ¥5 trillion in short-term lending with longer-term bonds, similar to 'Operation Twist' in the United States.

In the United Kingdom, the Bank of England's *Inflation Report* was seen as raising the prospect of further quantitative easing, with the central bank revising down its growth and medium-term inflation forecasts. Its MPC minutes for May reinforced perceptions of a shift in policy bias, noting that the decision not to expand the asset purchase programme was finely balanced.

Closer to home, the Reserve Bank of Australia (RBA) surprised markets in early May by cutting the cash rate by a larger-than-expected 50 basis points to 3.75 percent. The rate cut reflected weaker economic conditions than the RBA had expected and lower inflation. The market then moved to price in further reduction in the quarters ahead, helping to drive interest rates lower across the curve. Australia's cash rate was reduced by a further 25 basis points on 5 June.

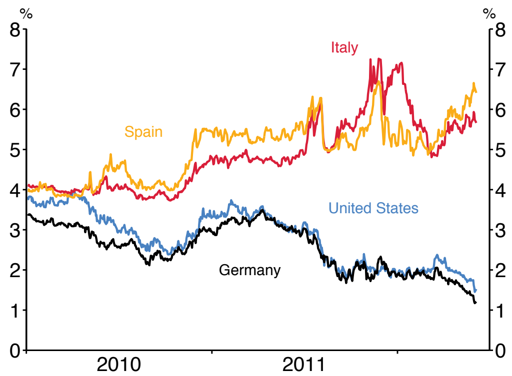
The European Central Bank (ECB) refrained from committing to further policy measures to combat the European debt crisis. The ECB President reiterated previous comments that it is the task of governments to undertake necessary policy changes to address major fiscal and structural weaknesses, to restore market confidence and generate economic growth.

Financing and credit

Worries about the future of the euro area have caused some significant re-pricing of risk across the region. Investors have moved to the perceived safety of the German sovereign bond market, showing a willingness to hold two-year German and Swiss government bonds for no yield. Investors see an embedded "option value" in these instruments on a euro-area break-up scenario – a scenario in which countries would revert to their national currencies and presumably associated with significant appreciation of a new German currency. The Swiss National Bank continues to accumulate foreign reserves to hold down the value of the Swiss Franc exchange rate at 1.20 against the euro, preventing an appreciation.

Ten-year government bond yields reached fresh lows for Germany, United States, United Kingdom, Australia and New Zealand, among other countries, reflecting the flight to perceived low risk assets. At the same time, investors have been withdrawing funds from the troubled European nations, with yields on Spanish and Italian 10-year government bonds reaching fresh highs (figure 3.3).

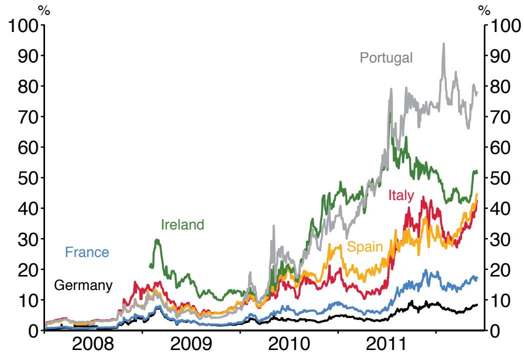
Figure 3.3
Selected 10-year government bond rates



Source: Bloomberg.

Prices on credit default swaps (CDS) tell a story of rising probabilities of default in some countries. Assuming a 40 percent recovery rate, the market is currently pricing a 77 percent probability of default in Portugal within the next five years, a 51 percent probability for Ireland, 42 percent for Spain and 39 percent for Italy (figure 3.4).

Figure 3.4
Sovereign five-year CDS spreads
(implied probability of default)



Source: Bloomberg, RBNZ estimates.

The negative developments in Europe have resulted in increased stress in bank funding markets, following a strong first quarter. Strong European banks are well funded and have no need to seek funding in a distressed market. Weak banks are completely shut out of funding markets and are relying on sourcing funds from the ECB. Since the end of March, the pace of bank bond issuance has fallen significantly across Europe. US commercial paper issuance by non-US banks has also fallen away along with a reduction in the maturity of paper issued, further suggesting that euro-area banks are facing funding difficulties.

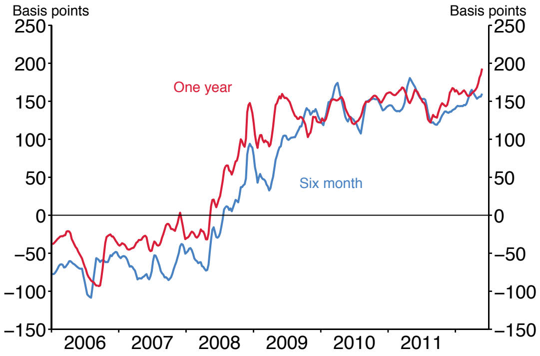
New Zealand banks took advantage of the better funding markets earlier this year and were able to issue a significant amount of long-term debt. The Reserve Bank estimates that since the start of the year the largest four banks issued nearly $3 billion of covered bonds and close to $2 billion of senior unsecured bonds. Issuance has fallen significantly since the March *Statement*, likely reflecting that banks are well ahead on their funding programmes. Growth in domestic deposits has remained strong and at the same time credit growth has been weak.

There is little sign of long-term funding costs receding. The weighted average cost of issuing long-term wholesale bank debt this year has been around 200 basis points over the benchmark 90-day bank bill rate, a level that remains well above historical averages. While recent issuance has been patchy, there is no discernable trend in pricing, with the cost of this source of funding remaining elevated.

Domestic short-term wholesale funding markets have been functioning normally this year, following the brief spike in costs in the September quarter last year when Greece's sovereign debt issues became a focus for market participants.

The dominant source of funding for banks is retail deposits. There have been signs of modest upward pressure on the spread between term deposit to wholesale rates this year, as banks compete for this stable source of funding. Retail investors tend to fix for short periods only. The six-month and one-year term deposit spreads versus wholesale rates are tracking near the top of their two-year trading ranges (figure 3.5).

Figure 3.5
Spread between term deposit and wholesale rates



Source: Bloomberg.

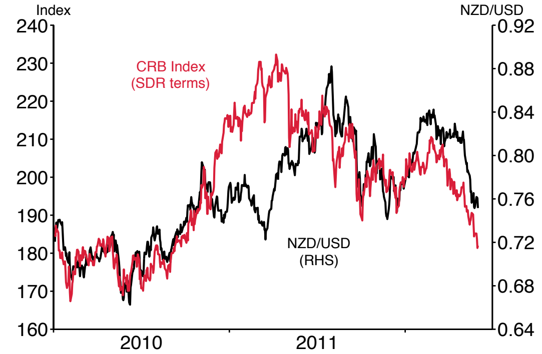
Overall, New Zealand banks remain well funded and deposit growth continues to outstrip credit growth, reducing the requirement to raise long-term debt in overseas markets. Average funding costs can be expected to rise a little further as cheap long-term debt rolls off and is replaced with higher cost funding, but this is not significant.

Foreign exchange market

The New Zealand dollar has depreciated against most major currencies since the March *Statement*, with losses ranging from 2 percent against the euro to 11 percent against the yen. The New Zealand dollar is little changed against the Australian dollar. On a TWI basis, the New Zealand dollar has depreciated by about 6 percent. The TWI recently hit its lowest level since November last year.

Driving the depreciation has been a mix of offshore and, to a lesser extent, domestic factors. As risk appetite fell away due to the intensifying European debt crisis, growth and commodity sensitive currencies, like the New Zealand dollar and Australian dollar, fell out of favour with investors (figure 3.6). Domestic interest rates fell at a faster pace than overseas rates, leading to narrowing interest rate differentials and this was a further contributing factor.

Figure 3.6
NZD/USD cross rate and commodity price index



Source: Bloomberg.

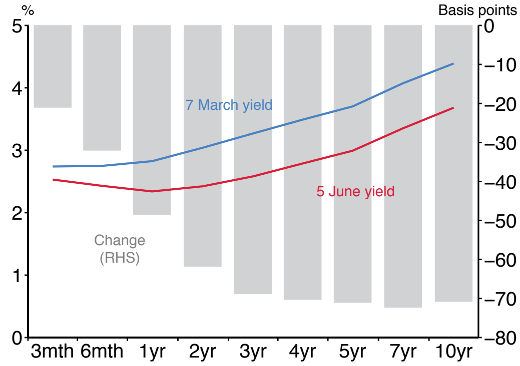
Domestic financial market developments

New Zealand interest rates have fallen significantly since the March *Statement*, with two and 10-year swap rates both reaching historical lows of around 2.4 percent and 3.6 percent respectively, down in the order of 70 basis points (figure 3.7). Falling interest rates reflect global trends, but a contributing factor was the market's interpretation of the Reserve Bank's April OCR Review. The policy statement in April was softer than expected and many interpreted it as opening the door for a possible cut to the OCR. Overnight indexed swap rates imply that the Reserve Bank will reduce the OCR through 2012, before tightening in early 2013.

The steep fall in wholesale rates and strong competition have helped trigger a fall in fixed rate mortgages, with rates falling 30 to 40 basis points. Furthermore, there has been increased publicity about the ease of negotiating lower than advertised mortgage rates. Many new borrowers have been able to achieve rates in the order of 5 to 5.25

percent, which is substantially below the current weighted average mortgage rate of 6.0 percent. Rate reductions add further evidence that banks are well funded and are reasonably comfortable with funding cost pressures at this point.

Figure 3.7
NZ bank bill and swap rates



Source: Bloomberg.

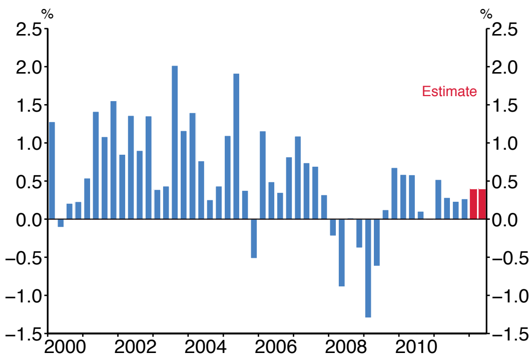
4 Current economic conditions

The headwinds for activity stemming from the global environment have intensified over recent months. Ongoing concerns relating to sovereign and bank debt in a number of European economies have resulted in a deterioration in global financial conditions. In addition, there has been softer activity across a number of economies, including in some of our major trading partners in the Asia-Pacific region. Combined, these developments have contributed to a marked depreciation in the New Zealand dollar and in the prices for some of New Zealand's major exports.

Over the past year, the New Zealand economy continued to expand, but at a modest pace (figure 4.1). This is despite the boost to activity from favourable weather conditions, strength in export commodity prices and spending associated with the Rugby World Cup. In 2012, the economy is continuing to expand at a modest pace. However, the drivers of growth are shifting from the external sector towards domestic demand. Notably, there has been a continued lift in housing market activity, with residential construction likely to increase from current low levels over the coming months.

The economy has continued to operate with some spare capacity. Combined with earlier appreciation in the New Zealand dollar and declines in commodity prices, this has resulted in subdued inflationary pressures.

Figure 4.1
GDP growth
(quarterly, seasonally adjusted)

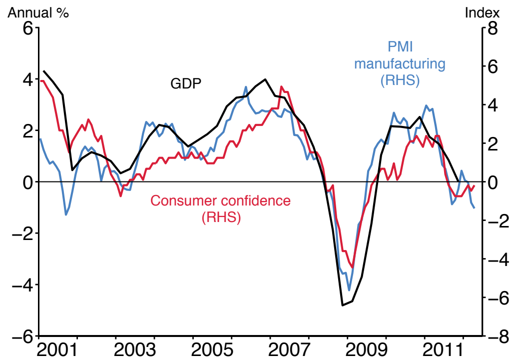


Source: Statistics New Zealand, RBNZ estimates.

External sector

As discussed in chapter 3, economic activity in a number of major economies has surprised on the downside of market expectations in recent months, contributing to a deterioration in financial market conditions. Financial markets have been particularly focused on the euro area, where large structural imbalances and the need for fiscal consolidation in a number of economies continue to constrain economic activity. In the case of Greece, the unsustainably high debt burden has resulted in ongoing political negotiations within the European Union. The resulting uncertainty about the resolution of the sovereign debt crisis, and potential changes to the Economic and Monetary Union, has weighed on euro-area consumer and business sentiment (figure 4.2).

Figure 4.2
Euro-area GDP growth and activity indicators



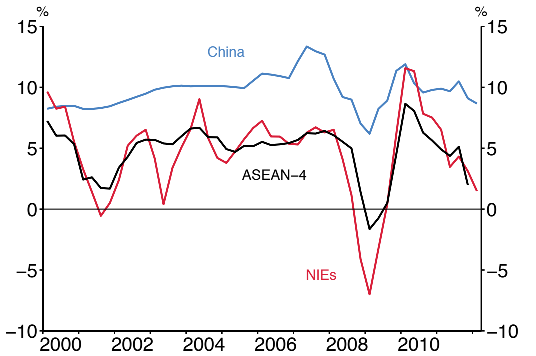
Source: Haver Analytics.
Note: Activity indicators have been scaled to be comparable to GDP growth.

In the March quarter, aggregate euro-area activity remained unchanged, with stronger activity in France and Germany (which together comprise almost half the euro-area economy) offsetting weakness in other economies. However, activity across the region remains weak with several economies, including Spain, Italy and Portugal, having already entered recession. Indicators point to a further weakening in activity in the near term.

New Zealand's direct exposure to weakness in Europe, via a deterioration in export sales to the region, is relatively low. Nevertheless, developments in European economies have resulted in a more challenging economic environment for New Zealand. In addition to the effects on financial conditions, as discussed in chapter 3, the deterioration in the European economy resulted in declines in international commodity prices. Declines in European demand have also contributed to a softening in activity in many of New Zealand's major trading partners in the Asia-Pacific region.

China has experienced a slowdown in GDP growth (figure 4.3). This follows a period of relatively tight fiscal and monetary policy, put in place towards the end of 2010, aimed at controlling inflation. In addition, external demand growth has been limited, in part due to the weakening in euro-area growth. Inflation has now moderated, while weaker industrial output growth and soft survey indicators are pointing to a further deceleration in near-term growth. Some policy easing measures, including a reduction in reserve requirement ratios, have been introduced in recent months in an effort to support activity.

Figure 4.3
GDP growth in China, NIE and ASEAN
(annual)



Source: Haver Analytics.
Note: ASEAN-4 includes Indonesia, Malaysia, The Philippines and Thailand. NIEs include Hong Kong, Singapore, South Korea, and Taiwan.

Growth in the smaller Asian economies increased significantly in the March quarter following a sharp slowing in activity over the second half of 2011. This follows the recovery of the Thai economy from severe flooding in October 2011, and an increase in demand from the United States. Japan grew strongly in the March quarter, contributed to by an increase in activity and reconstruction work following the March 2011 earthquake and tsunami.

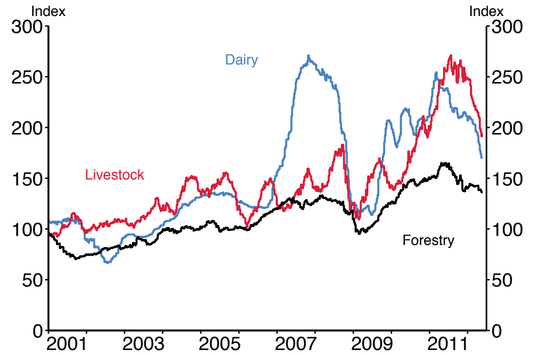
In Australia, a high level of investment in resource sector projects continues, but the spillover effects to the aggregate economy appear weaker than previously expected. The high level of the Australian dollar has reduced business profitability in the non-mining sector, resulting in restrained investment and hiring activity outside of the resource sector. Weighing on the outlook, prices for a number of Australia's key mineral exports have declined in recent months.

The United States economy continues to expand at an only moderate pace, with GDP growth of 2 percent in the year to March. Private consumption and business investment are currently driving growth. In addition, residential building has recently begun to recover, after falling for several years to a historically low level. This is an encouraging development for the economy, given that the sector is relatively labour intensive. However, fiscal consolidation will dampen demand.

Moderate global growth and spare capacity in major Western economies are continuing to dampen inflationary pressures in New Zealand's trading partner economies. This is contributing to a modest rate of manufactured import price inflation in New Zealand. Softness in imported inflationary pressures has been reinforced by sharp declines in prices for many commodities, with the aggregate CRB index down around 13 percent in SDR terms since March.

The deterioration in global activity and financial markets has had a dampening effect on New Zealand's tradable sector, with sharp declines in the prices for a number of our major primary exports, particularly dairy and lamb (figure 4.4). This downward pressure on agricultural export prices has been compounded by increases in production, both domestically and internationally. Consequently, New Zealand's terms of trade declined in early 2012.

Figure 4.4
Export commodity prices
(US dollar terms)



Source: ASB Bank.

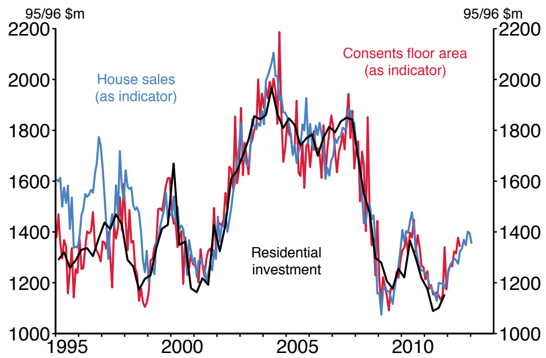
Although weaker global conditions have contributed to a depreciation of the New Zealand dollar, it remains around the elevated levels seen in late 2011. Combined with subdued global demand, this hampers the competiveness of non-primary exports and import-competing manufactures, and encourages continued import substitution. Exports of services also remain subdued, although there was a temporary lift associated with the Rugby World Cup. These conditions indicate a narrowing in New Zealand's trade surplus in early 2012.

Activity

The New Zealand economy grew by 1.3 percent in 2011. In part, this was a result of favourable weather conditions that provided a substantial boost to agricultural production. While the effects of these conditions will wane over the coming year, a shift in the drivers of growth from the external sector to domestic demand is occurring. Consequently, the economy has continued to expand in early 2012, though at a still modest pace.

In recent months, there has been a further lift in housing market activity. House sales and building consent issuance have continued to increase, with residential construction likely to increase from current low levels throughout 2012 (figure 4.5). While these developments are in part a result of repairs related to the earthquakes in Canterbury, there has been a more general lift in housing market activity in recent months.

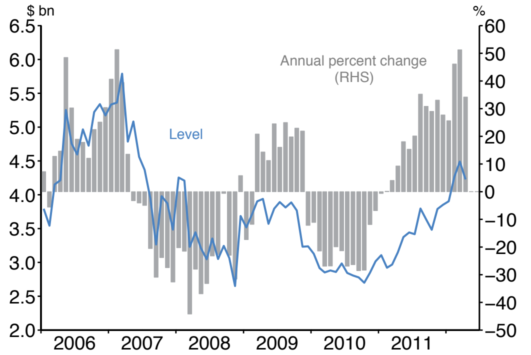
Figure 4.5
Housing market indicators



Source: Statistics New Zealand.
Note: Sales and consents data have been scaled to be comparable to residential investment.

The sharp increase in housing loan approvals over recent months also signals a lift in housing market activity (figure 4.6). Competition among banks has encouraged borrowers to apply to several lenders. However, low mortgage rates have also encouraged a lift in new lending.

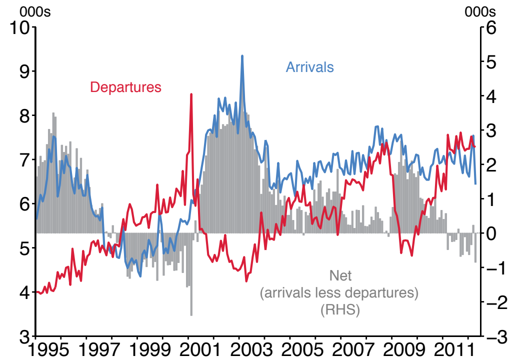
Figure 4.6
Housing loan approvals
(monthly)



Source: RBNZ.

The lift in housing market activity has occurred despite weak net migration over the past year. Net permanent and long term migration has remained at low levels since early 2011 (figure 4.7). This has been a result of an increase in the number of departures.

Figure 4.7
Net permanent and long term migration

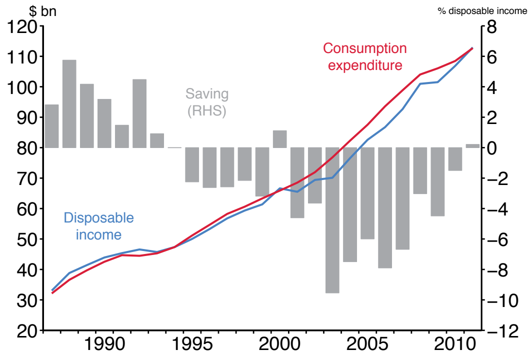


Source: Statistics New Zealand.

Recent revisions to GDP (discussed in box C) indicate that over the past year household consumption spending was weaker than previously assumed. In early 2012, consumption spending has remained modest, with some pull back following the Rugby World Cup. However, indicators of strength in the household sector have improved over recent months, with an increase in labour incomes and consumer confidence. In addition, there has been increased spending on durables as the housing market has continued to improve.

A degree of caution in households' behaviour is still evident. Household income growth has outpaced spending growth in recent months as households have continued to focus on debt consolidation (figure 4.8). In addition, many households have maintained the level of their borrowing repayments despite the reduction in mortgage rates, and have consequently increased principal repayments on outstanding mortgages.

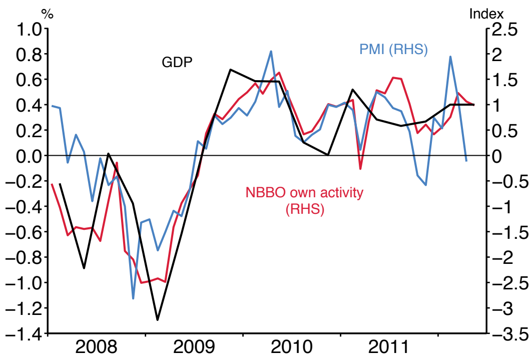
Figure 4.8
Nominal household consumption and disposable income



Source: Statistics New Zealand.

Business indicators have been mixed, but remain consistent with a gradual improvement in activity (figure 4.9). Nevertheless, with lingering uncertainty around the economic outlook, capital expenditure has remained subdued in early 2012.

Figure 4.9
GDP growth and activity indicators *(quarterly)*

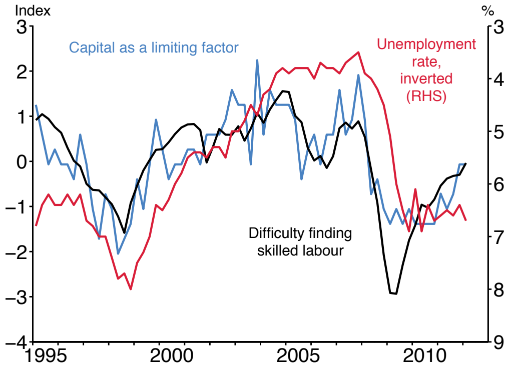


Source: Statistics New Zealand, ANZ National Bank, BNZ, RBNZ estimates.
Note: Business surveys have been scaled to be comparable to GDP growth.

Capacity pressures and inflation

Survey measures of capacity pressures have tightened and in many cases are approaching historical averages (figure 4.10). Notably, there are signs that pressures are building in the construction sector, particularly in Canterbury.

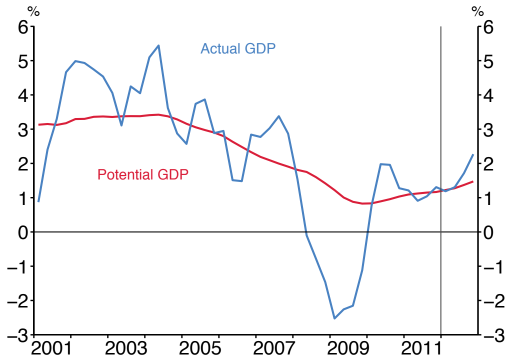
Figure 4.10
Capacity pressures and the unemployment rate



Source: NZIER, Statistics New Zealand.
Note: Business survey data have been scaled.

This lift in surveyed capacity pressures has occurred despite the modest pace of economic growth over recent quarters. Following the global financial crisis, business investment spending has been subdued, and growth in the working age population has been limited. Growth in labour productivity has also been low over this period. These conditions have resulted in the economy's potential rate of growth falling to an estimated rate of around 1.2 percent per annum (figure 4.11). Nevertheless, it appears the economy is continuing to operate with at least some spare capacity, particularly given elevated unemployment.

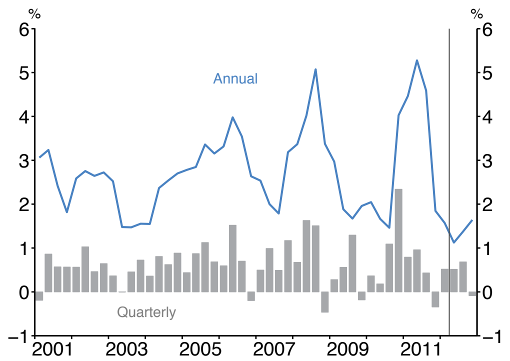
Figure 4.11
Actual and potential GDP growth
(annual)



Source: Statistics New Zealand, RBNZ estimates.

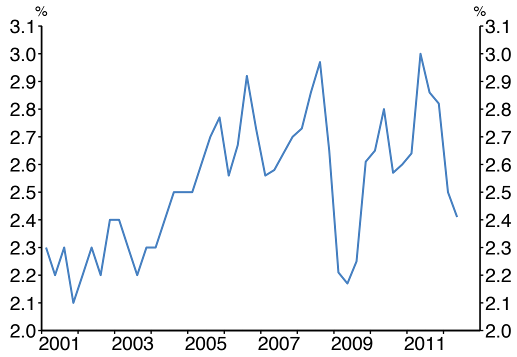
With the economy continuing to operate with some spare capacity, non-tradable inflation has remained contained. At the same time, last year's appreciation of the New Zealand dollar and modest inflation in the world prices of imports have resulted in continued declines in the price of many tradable items. Subdued global food price inflation has also had a significant dampening effect on tradable inflationary pressures. Combined, these conditions have resulted in low rates of headline inflation, with annual CPI inflation falling to 1.6 percent in the March quarter. Annual inflation is expected to remain subdued over the coming quarters, reaching a low of 1.1 percent in the current quarter (figure 4.12). There has also been a continued decline in inflation expectations, which are now below the levels seen prior to the increase in the rate of GST (figure 4.13).

Figure 4.12
CPI inflation
(annual)



Source: Statistics New Zealand, RBNZ estimates.

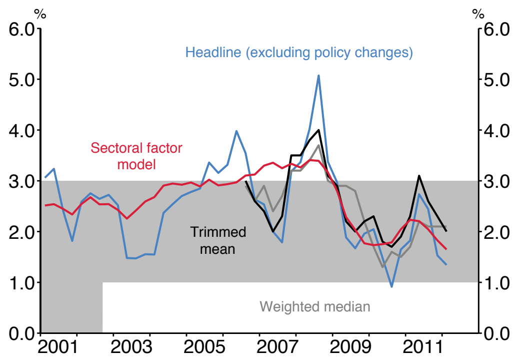
Figure 4.13
Two-year ahead inflation
(annual)



Source: RBNZ.

Much of the recent softness in inflation has been a result of sharp declines in prices for imported commodities, including fruit and vegetables. Measures of underlying inflation indicate that, while inflationary pressures in the economy are modest, they remain consistent with medium-term inflation remaining around the mid-point of the Bank's target band. Core inflation measures are close to 2 percent in annual terms (figure 4.14). Additionally, businesses' pricing intentions have remained stable at average, rather than low levels. Furthermore, while nominal wage inflation has remained contained, limited productivity growth over recent years means that real unit labour costs have lifted.

Figure 4.14
Core inflation measures
(annual, all excluding GST)



Source: Statistics New Zealand, RBNZ.

Box C
Recent revisions to GDP

This box discusses the recent revisions to historical Gross Domestic Product data released by Statistics New Zealand on 15 May 2012, and how these have affected the Bank's assessment of inflationary pressures in the economy. Such revisions are a regular feature of GDP and other macroeconomic data, contributing to uncertainty over the state of the economy and representing a continuous challenge to policymakers.

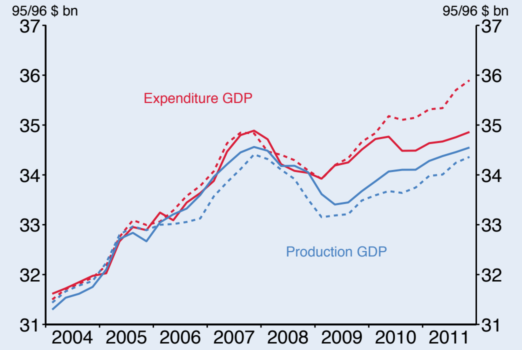
Revisions to GDP data typically fall into three categories. First, quarterly revisions as new data become available affect the estimates for quarterly indicators such as the Retail Trade Survey, or the Balance of Payments. Second, annual benchmarking, which incorporates additional information only available on an annual basis. And third, methodological changes.

Statistics New Zealand's revised estimates for GDP provide a more accurate picture of GDP over the recent past. These revisions incorporate a move to the Australia and New Zealand Standard Industrial Classification 2006 (ANZSIC06), which better reflects the current industrial composition of the economy. The revised data also include new information from the inclusion of annual benchmarks for the years ending March 2008 and 2009 for production GDP and 2011 for expenditure GDP.

These annual benchmarks were delayed while Statistics New Zealand concentrated on the move to the new industrial classification. This delay resulted in a historically large divergence between the production and expenditure measures of GDP (see box C of the December 2011 *Statement*). This gap has been markedly reduced, although not entirely eliminated (figure C1), and the profile of past GDP has been substantially revised.

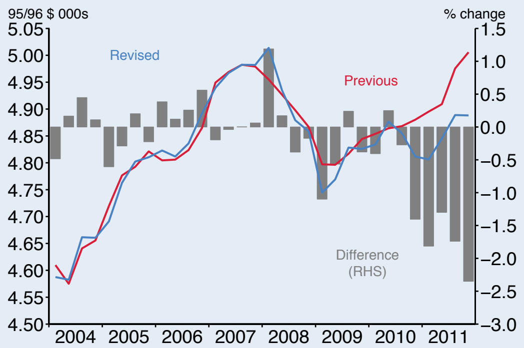
GDP growth was more muted over the recent past than previously thought. Production GDP growth in 2011 was revised down to 1.3 percent from 1.8 percent in the previous release. For expenditure GDP, both its 2011 level and growth rate were revised substantially lower. The previous figures suggested that real consumption per capita had exceeded its pre-GFC levels, but the revised figures show a decline (figure C2).

Figure C1
Revisions to level of real production and expenditure
(seasonally adjusted)



Source: Statistics New Zealand.
Note: Solid lines represent revised estimates, broken lines represent previous estimates.

Figure C2
Real consumption per capita



Source: Statistics New Zealand.

This revised view of consumption is more attuned to other indicators of household sector behaviour, such as credit growth. As such, it removes a puzzle in the previous vintage of the data. Nonetheless, the gap between production and expenditure GDP remains quite large, particularly over the 2009-10 period. This divergence should be eliminated in future annual benchmarking, implying that further substantial revisions to GDP will be made. Further, the correlation between the quarterly growth rates of production and expenditure GDP has fallen in the latest data, clouding the interpretation of the two measures.

Prior to the revisions, the two measures of GDP had markedly different implications for inflationary pressure within the economy and hence how monetary policy should react. The previous size of the disparity between the two measures injected unwelcome additional uncertainty into policymaking. However, the Bank uses a wide range of indicators in its assessment of the current economic outlook, given the inherent uncertainty of real-time data, and neither measure of GDP is taken at face value in monetary policy deliberations. Consequently, these revisions have not materially affected the Bank's judgement of inflationary pressures within the economy.

5 The macroeconomic outlook

The pace of growth is expected to pick up slightly from its current weak pace over the next year. Earthquake reconstruction activity along with an underlying recovery in residential investment will support this pick-up. Subdued household consumption and government spending will offset this to some degree. Current spare capacity in the economy will be absorbed as domestic activity increases, leading to some inflationary pressure. The removal of some monetary stimulus will offset this, with inflation expected to remain within the target band over the medium term.

International economic projection

Risks around the euro area outlook have increased since the March *Statement*. Euro-area activity is expected to contract over 2012 (figure 2.2). The June *Statement* projection incorporates a sharper recession than *Consensus* forecasts. Current published *Consensus* forecasts are unlikely to have incorporated the most recent deterioration in financial conditions and economic indicators. However, the central projection still assumes an orderly resolution to the euro-area debt crisis.

Consumer and business confidence are likely to remain depressed in the euro area this year. Looking further ahead, the better placed European economies and steady global expansion should support a stabilisation and modest pick-up in euro-area growth, whereas fiscal consolidation will continue to weigh on growth.

The outlook for activity in Asia remains relatively strong. GDP growth in China is expected to stabilise around mid-2012. Additional policy easing measures, including spending on infrastructure, are likely to offset recent softness in private and external demand. Although policy easing is expected to support the economy, the potential growth rate of the Chinese economy has probably declined somewhat in recent years. GDP growth is expected to stabilise about 8 percent over the forecast period, slightly lower than *Consensus* estimates.

Activity in Japan will be boosted by reconstruction activity required over the forecast period. This should help support smaller economies in Asia, where growth is forecast to remain strong.

The Australian economy is expected to grow at around 3 percent, its trend rate, over the forecast period. A high level of investment in the resource sector is currently under way, and is expected to take several years to complete. However, spending outside the resource sector is likely to remain restrained given the outlook for slow trading partner growth. As in other Western economies, fiscal consolidation will also limit GDP growth over the next year or so. There is potential for monetary policy to be eased further if growth slows.

The moderate recovery in the United States is forecast to continue. Continued steady growth in the private sector is likely to drive the recovery, supported by easy monetary policy. At the same time, high household debt and further fiscal consolidation should result in the recovery in activity being modest by historic standards.

Domestic economic projection

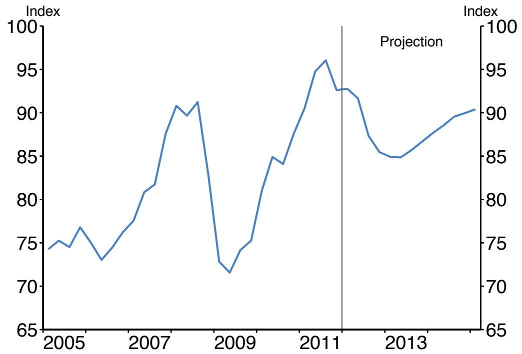
Weakness in US and European activity will weigh on domestic activity through a number of channels. Weaker trading partner demand will put downward pressure on goods exports and export prices. In addition, subdued worldwide incomes will discourage both tourist numbers and average tourist expenditure, depressing exports of services.

Uncertainty over the outlook for European activity is also likely to weigh on business confidence in New Zealand, hampering employment and investment. This uncertainty will see funding costs for New Zealand banks remain elevated.

Weakness in trading partner demand has seen New Zealand's commodity prices fall in recent months. In addition, strong production in key export markets has put downward pressure on prices, with further falls expected (figure 5.1, overleaf).

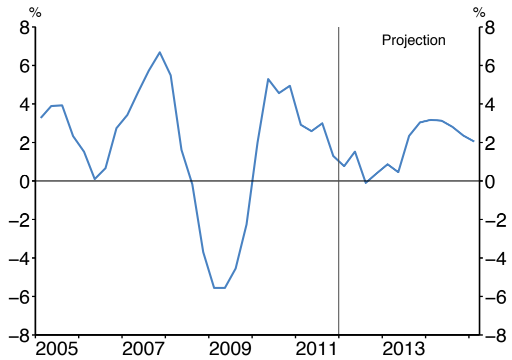
Strength in primary sector incomes has been a factor supporting domestic activity over the past year. An improving terms of trade resulted in growth in real Gross Domestic Income (GDI) outpacing GDP growth in recent years (figure 5.2, overleaf, Real GDI measures the purchasing power of GDP, given changes in the terms of trade). The projected decline in the terms of trade will see

Figure 5.1
SNA export prices
(seasonally adjusted, world price terms)



Source: Statistics New Zealand, RBNZ estimates.

Figure 5.2
Real Gross Domestic Income growth
(annual)



Source: Statistics New Zealand, RBNZ estimates.

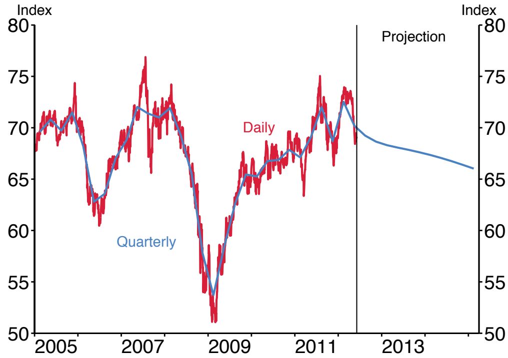
real GDI growth moderate, resulting in less support for investment and general spending, before recovering over the end of the projection.

The recent depreciation of the New Zealand dollar has provided some offset to the fall in export prices. The New Zealand dollar TWI is expected to depreciate gradually over the forecast horizon (figure 5.3).

Despite a subdued external outlook, GDP growth is projected to increase modestly from its current weak pace over the next year (figure 5.4). A continued rise in residential investment is an important driver of this increase.

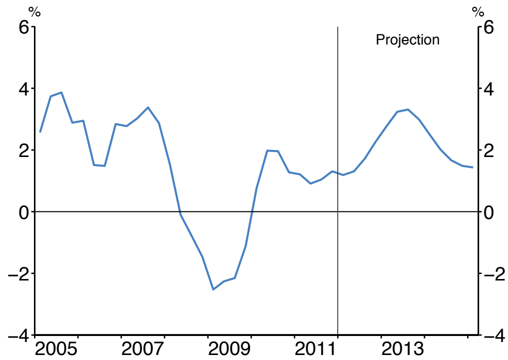
Reconstruction activity in Canterbury will boost residential investment (figure 5.5) as well as business investment over the next few years. Reconstruction spending is expected to total around $20 billion, with this activity peaking in 2014.

Figure 5.3
New Zealand dollar TWI



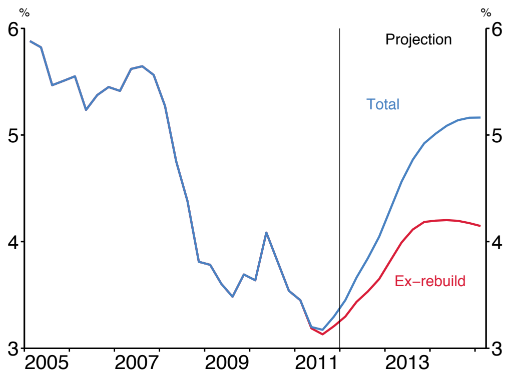
Source: RBNZ estimates.

Figure 5.4
GDP growth
(annual)



Source: Statistics New Zealand, RBNZ estimates.

Figure 5.5
Residential investment
(seasonally adjusted, share of potential GDP)



Source: Statistics New Zealand, RBNZ estimates.

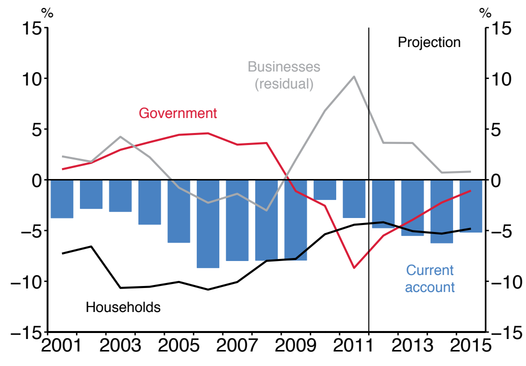
In addition to this activity, underlying (ex-rebuild) residential investment is also expected to pick up. Modest population growth along with a recovery in the labour market is expected to support an increase in underlying residential investment toward more average levels.

While strong growth in residential investment is projected over the next few years, growth in household consumption is forecast to be modest. Households have run up a significant amount of debt and are expected to undertake a period of consolidation. This, along with weak house price inflation and slightly higher interest rates, is expected to see consumption growth remain modest.

Fiscal consolidation will act as a drag on domestic activity over the next few years. The Government aims to return to surplus by the 2014/15 fiscal year, through a combination of restraint in spending growth and a recovery in revenues driven by a pick-up in domestic activity and discretionary tax changes. As a result, government consumption and investment is forecast to fall relative to total domestic activity over the projection horizon.

Despite this weak consumption and government spending growth, the current account is still expected to deteriorate somewhat over the next few years. A large increase in investment more than offsets an improvement in government and household saving. This will see the current account deficit increase to about 6 percent of nominal GDP (figure 5.6).

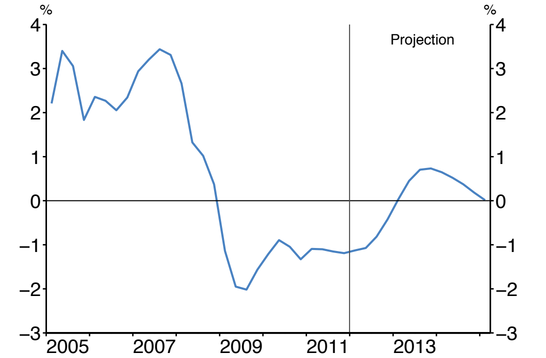
Figure 5.6
Estimated sectoral net lending
(annual, share of nominal GDP)



Source: Statistics New Zealand, RBNZ estimates.

As discussed in chapter 4, the economy's potential growth rate has fallen in recent years. As such, the modest projected increase in GDP growth is estimated to see the remaining spare resources in the economy absorbed over the next year (figure 5.7). However, GDP growth is not expected to run significantly ahead of potential over the forecast horizon.

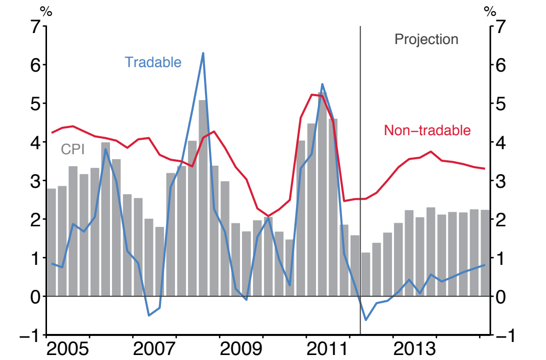
Figure 5.7
Output gap
(seasonally adjusted)



Source: RBNZ estimates.

A moderate removal of monetary stimulus will be enough to offset any inflationary consequences of an absorption of spare resources. As a result, inflation is expected to remain near the centre of the target band over the medium term (figure 5.8).

Figure 5.8
CPI, tradable and non-tradable inflation
(annual)



Source: Statistics New Zealand, RBNZ estimates.

Appendix A[1]
Summary tables

Table A

Projections of GDP growth, CPI inflation and monetary conditions

(CPI and GDP are percent changes, GDP data seasonally adjusted)

		GDP Quarterly	CPI Quarterly	CPI Annual	TWI	90-day bank bill rate
2004	Mar	1.4	0.4	1.5	66.8	5.5
	Jun	0.8	0.8	2.4	64.0	5.9
	Sep	0.3	0.6	2.5	66.3	6.4
	Dec	0.4	0.9	2.7	68.6	6.7
2005	Mar	1.1	0.4	2.8	69.6	6.9
	Jun	1.9	0.9	2.8	70.8	7.0
	Sep	0.4	1.1	3.4	69.7	7.0
	Dec	-0.5	0.7	3.2	71.5	7.5
2006	Mar	1.2	0.6	3.3	68.2	7.5
	Jun	0.5	1.5	4.0	62.8	7.5
	Sep	0.3	0.7	3.5	63.6	7.5
	Dec	0.8	-0.2	2.6	67.0	7.6
2007	Mar	1.1	0.5	2.5	68.8	7.8
	Jun	0.7	1.0	2.0	72.0	8.1
	Sep	0.7	0.5	1.8	71.4	8.7
	Dec	0.3	1.2	3.2	71.0	8.8
2008	Mar	-0.2	0.7	3.4	71.9	8.8
	Jun	-0.9	1.6	4.0	69.3	8.8
	Sep	0.0	1.5	5.1	65.5	8.2
	Dec	-0.4	-0.5	3.4	57.8	6.3
2009	Mar	-1.3	0.3	3.0	53.7	3.7
	Jun	-0.6	0.6	1.9	58.4	2.9
	Sep	0.1	1.3	1.7	62.6	2.8
	Dec	0.7	-0.2	2.0	65.5	2.8
2010	Mar	0.6	0.4	2.0	65.3	2.7
	Jun	0.6	0.2	1.7	66.8	2.9
	Sep	0.1	1.1	1.5	66.9	3.2
	Dec	0.0	2.3	4.0	67.8	3.2
2011	Mar	0.5	0.8	4.5	67.1	3.0
	Jun	0.3	1.0	5.3	69.1	2.7
	Sep	0.2	0.4	4.6	72.0	2.8
	Dec	0.3	-0.3	1.8	68.7	2.7
2012	Mar	0.4	0.5	1.6	72.5	2.7
	Jun	0.4	0.5	1.1	70.2	2.7
	Sep	0.6	0.7	1.4	69.2	2.7
	Dec	0.8	-0.1	1.6	68.6	2.7
2013	Mar	0.9	0.8	1.9	68.3	2.7
	Jun	0.9	0.8	2.2	68.1	2.9
	Sep	0.7	0.5	2.0	67.9	3.1
	Dec	0.5	0.2	2.3	67.6	3.1
2014	Mar	0.4	0.6	2.1	67.3	3.2
	Jun	0.4	0.9	2.2	67.1	3.2
	Sep	0.4	0.5	2.2	66.7	3.3
	Dec	0.3	0.2	2.2	66.4	3.3
2015	Mar	0.3	0.6	2.2	66.0	3.4

[1] Notes for these tables follow on pages 28 and 29.

Table B

Measures of inflation and inflation expectations

(annual)

	2010		2011				2012
	Sep	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**	**Mar**
CPI	1.5	4.0	4.5	5.3	4.6	1.8	1.6
CPI components							
CPI non-tradable	2.5	4.6	5.2	5.2	4.5	2.5	2.5
Non-tradables housing component	1.7	2.7	2.8	3.0	2.9	2.0	2.4
Non-tradables ex housing, cigarettes and tobacco component	2.1	4.8	5.1	5.5	5.0	2.5	2.2
CPI tradable	0.3	3.3	3.7	5.5	4.6	1.1	0.3
Petrol	5.8	14.2	17.1	20.1	17.7	11.2	3.7
Other inflation measures							
Sectoral factor model estimate of core CPI inflation ex-GST	1.8	2.0	2.2	2.2	2.0	1.8	1.6
CPI trimmed mean (of annual price change) ex-GST	1.7	1.9	2.3	3.1	2.6	2.3	2.0
CPI weighted median (of annual price change) ex-GST	1.6	1.5	1.7	2.2	2.1	2.1	2.1
CPI ex food, petrol and government charges *	1.0	2.8	3.1	3.4	3.2	1.0	1.5
CPI ex food and energy	1.4	3.1	3.3	3.6	3.2	1.1	1.6
GDP deflator (derived from expenditure data)	4.2	6.9	3.9	4.6	3.4	0.9	n/a

	2010		2011				2012	
	Sep	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**	**Mar**	**Jun**
Inflation expectation measures								
RBNZ Survey of Expectations - inflation one-year-ahead	3.9	3.4	2.9	3.1	2.9	2.7	2.2	2.0
RBNZ Survey of Expectations - inflation two-years-ahead	2.6	2.6	2.6	3.0	2.9	2.8	2.5	2.4
AON Hewitt Economist survey - inflation one-year-ahead	5.0	4.3	2.6	3.0	2.8	2.5	2.3	2.2
AON Hewitt Economist survey - inflation four-years-ahead	2.6	2.5	2.4	2.6	2.7	2.5	2.5	2.5
NBBO - inflation one-year-ahead (quarterly average)	3.1	2.9	3.0	3.2	3.3	3.1	2.7	n/a

* excludes food items and petrol, as well as government related goods and services. This measure still includes the impact of the rise in GST on non-government related goods and services.

Table C

Composition of real GDP growth

(annual average percent change, seasonally adjusted, unless specified otherwise)

March year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
	Actuals							Projections			
Final consumption expenditure											
Private	4.4	4.4	2.7	3.4	-1.7	0.4	1.6	1.5	2.0	1.9	0.5
Public authority	4.6	4.7	4.1	5.2	4.6	0.2	0.3	0.2	-0.8	-0.2	0.6
Total	4.5	4.5	3.0	3.8	-0.3	0.4	1.3	1.2	1.4	1.4	0.5
Gross fixed capital formation											
Market sector:											
Residential	2.8	-5.3	-1.6	4.9	-23.2	-13.0	4.3	-10.8	22.6	23.7	8.9
Business	10.0	10.5	-2.0	9.5	-6.8	-12.1	9.3	3.7	4.6	11.1	2.8
Non-market government sector	10.8	6.5	-6.7	-10.5	20.4	-8.5	-15.5	-4.4	9.1	4.1	4.1
Total	8.3	6.6	-2.3	7.2	-8.5	-11.9	6.5	0.9	7.4	12.8	4.0
Final domestic expenditure	5.4	5.0	1.6	4.6	-2.4	-2.5	2.4	1.1	2.7	4.1	1.4
Stockbuilding[1]	0.2	-0.5	-1.2	1.2	-0.5	-1.5	1.5	1.2	-0.3	-0.5	-0.1
Gross national expenditure	5.9	4.7	0.2	6.0	-2.4	-3.6	3.4	2.4	2.4	3.5	1.3
Exports of goods and services	4.9	-0.1	3.0	3.4	-3.0	4.8	2.0	1.3	0.9	2.1	2.4
Imports of goods and services	12.2	4.3	-1.5	10.4	-4.3	-9.3	11.0	6.2	2.2	3.8	1.5
Expenditure on GDP	3.5	3.3	1.7	3.6	-1.9	1.0	0.5	0.6	1.9	3.0	1.6
GDP (production)	3.6	3.4	2.2	2.7	-1.2	-1.2	1.6	1.1	2.0	3.0	1.6
GDP (production, March qtr to March qtr)	2.6	2.9	2.8	1.5	-2.5	0.8	1.2	1.2	2.8	2.5	1.4

[1] Percentage point contribution to the growth rate of GDP.

Table D

Summary of economic projections

(annual percent change, unless specified otherwise)

	Actuals							Projections			
March year	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Price measures											
CPI	2.8	3.3	2.5	3.4	3.0	2.0	4.5	1.6	1.9	2.1	2.2
Labour costs	2.5	3.0	3.0	3.5	3.1	1.3	2.0	2.1	2.0	2.1	2.3
Import prices (in New Zealand dollars)	3.7	3.1	2.5	12.0	7.4	-8.4	8.6	-5.2	-2.8	4.7	5.2
Export prices (in New Zealand dollars)	1.3	7.4	0.7	0.4	17.5	-11.1	3.7	-4.0	2.1	2.7	3.5
Monetary conditions											
90-day rate (year average)	6.5	7.3	7.6	8.6	6.7	2.8	3.1	2.7	2.7	3.1	3.3
TWI (year average)	67.1	70.1	65.6	71.6	61.6	62.9	67.1	70.6	69.1	67.7	66.6
Output											
GDP (production, annual average % change)	3.6	3.4	2.2	2.7	-1.2	-1.2	1.6	1.1	2.0	3.0	1.6
Potential output (annual average % change)	3.3	2.9	2.4	2.0	1.5	0.9	1.0	1.2	1.4	1.8	2.1
Output gap (% of potential GDP, year average)	2.2	2.7	2.4	3.2	0.4	-1.7	-1.1	-1.1	-0.6	0.6	0.3
Labour market											
Total employment (seasonally adjusted)	3.7	2.8	2.0	-0.3	0.7	-0.1	1.7	0.9	2.6	2.3	0.7
Unemployment rate (March qtr, seasonally adjusted)	3.9	4.0	3.9	3.9	5.1	6.1	6.6	6.7	5.5	4.8	5.0
Trend labour productivity	1.0	1.0	0.9	0.7	0.5	0.3	0.1	0.1	0.3	0.5	0.7
Key balances											
Government operating balance (% of GDP, year to June)	4.7	4.4	3.5	3.1	-2.1	-3.4	-9.5	-4.2	-4.1	-1.6	-1.1
Current account balance (% of GDP)	-6.2	-8.7	-8.0	-7.9	-7.9	-2.0	-3.7	-4.7	-5.5	-6.2	-5.2
Terms of trade (SNA measure, annual average % change)	3.3	-1.0	-1.3	8.6	-2.0	-4.7	8.0	2.1	-3.4	-2.0	2.5
Household saving rate (% of disposable income)	-6.0	-7.9	-6.7	-3.0	-4.5	-1.5	0.2	-0.4	-0.4	1.0	2.7
World economy											
Trading partner GDP (annual average % change)	3.8	3.8	3.8	4.3	0.1	1.2	4.4	3.1	3.5	3.9	3.9
Trading partner CPI (TWI weighted, annual % change)	2.1	2.4	1.9	3.3	0.9	1.7	2.2	2.2	1.8	2.0	2.0

Notes to the tables

CPI	Consumer Price Index. Quarterly projections rounded to one decimal place.
TWI	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 area.
90-day bank bill rate	The interest yield on 90-day bank bills.
World GDP	RBNZ definition. 16-country index, export weighted. Seasonally adjusted.
World CPI inflation	RBNZ definition. Five-country index, TWI weighted.
Import prices	Domestic currency import prices. System of National Accounts.
Export prices	Domestic currency export prices. System of National Accounts.
Terms of trade	Constructed using domestic currency export and import prices. System of National Accounts
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 Domestic Income	The real purchasing power of domestic income, taking into account changes in the terms of trade. 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)	Gross Domestic Product. System of National Accounts.
Potential output	RBNZ definition and estimate.
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 saving rate	Household Income and Outlay Account.

Government operating balance	Operating balance before gains and losses. Historical source: The Treasury. Adjusted by the Reserve Bank 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 Household Labour Force Survey hours worked.
Labour cost	Private sector all salary and wage rates. Labour Cost Index.
Quarterly percent change	(Quarter/Quarter$_{-1}$ - 1)*100
Annual percent change	(Quarter/Quarter$_{-4}$ - 1)*100
Annual average percent change	(Year/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 Reserve Bank staff during the projection round

Amalgamated Builders Ltd
Anton's Seafood Ltd
Arthur Barnett Ltd
Auckland Chamber of Commerce
Augusta Capital Ltd
Cadbury New Zealand Ltd
Canterbury Development Corporation
Canterbury Employers Chamber of Commerce
CB Richard Ellis Ltd
Clelands Construction Ltd
Colliers International New Zealand Ltd
Contact Energy Ltd
Delta Ltd
Dunedin City Holdings Ltd
Dunlop Living Ltd
ECOLAB Ltd
Environment Canterbury
Export New Zealand
Federated Farmers Taranaki Inc
Federated Farmers Waikato
Fisher and Paykel Applicances Ltd
Fisher and Paykel Healthcare Ltd
Foley Plumbers and Electrical
Foster Construction Ltd
Global Culture Group Ltd
Godfrey Hirst New Zealand Ltd
Gough Group Ltd
Hancocks Ltd
Hawkins Construction Ltd
Hayes, Knight New Zealand Ltd
Heartland Ltd
Hertz New Zealand Ltd
Hume Pine (NZ)
Kathmandu Ltd
Kirkcaldies and Stains Ltd
KPMG Audit and Risk Advisory Services
Lion Nathan New Zealand Ltd
Lockwood Group Ltd
Lumley General Insurance Ltd
Mainzeal Construction Ltd
McDowell Real Estate Ltd
Meat Industry Association
Motim Technologies Ltd
Naylor Love Construction Ltd
New Zealand Manufacturers and Exporters Association
Orion New Zealand Ltd
Otago Chamber of Commerce
PF Olsen Ltd
Port of Otago Ltd
Port Taranaki Ltd
PricewaterhouseCoopers
Property Council of New Zealand
Scott Technology Ltd
Silver Fern Farms Ltd
Skycity Entertainment Group Ltd
Solid Energy New Zealand Ltd
Tachikawa Forest Products (NZ) Ltd
Taranaki Newspapers
Taranakipine
Tecpak Industries Ltd
TelstraClear Ltd
Tidd Ross Todd Ltd
Tonkin and Taylor Ltd
Tooline Ltd
TSB Bank Ltd
Two Degrees Mobile Ltd
Villa Maria Estate
Weatherford Ltd
Wellington Employers Chamber of Commerce

Appendix C
Reserve Bank statements on monetary policy

OCR unchanged at 2.5 percent

8 March 2012

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.5 percent.

Reserve Bank Governor Alan Bollard said: "Inflation has settled near the middle of the Bank's target range, and inflation expectations have fallen.

"The domestic economy is showing signs of recovery. Household spending appears to have picked up over the past few months and a recovery in building activity appears to be underway. That recovery will strengthen as repairs and reconstruction in Canterbury pick up later in the year. High export commodity prices are also helping to support a continuing recovery in domestic activity.

"Policy actions from a number of central banks have boosted global confidence. While encouraging, financial market sentiment remains fragile and risks to the global outlook remain. Furthermore, the easing in global monetary policy and resultant recovery in risk appetite has contributed to a marked appreciation in the New Zealand dollar.

"While helping contain inflation, the high value of the New Zealand dollar is detrimental to the tradable sector, undermines GDP growth and inhibits rebalancing in the New Zealand economy. Sustained strength in the New Zealand dollar would reduce the need for future increases in the OCR.

"Given the medium-term outlook for inflation, it remains prudent to hold the OCR at 2.5 percent."

OCR unchanged at 2.5 percent

26 April 2012

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.5 percent.

Reserve Bank Governor Alan Bollard said: "Inflation is restrained and is expected to stay near the middle of the Bank's target range.

"The domestic economy is showing signs of recovery. Housing market activity continues to increase and a recovery in building activity appears to be underway, as forecast. That recovery will strengthen as repairs and reconstruction in Canterbury pick up later in the year.

"However, the global outlook remains of concern. Near-term indicators have moderated and financial market sentiment is still fragile.

"The New Zealand dollar has stayed elevated despite recent falls in commodity prices. Should the exchange rate remain strong without anything else changing, the Bank would need to reassess the outlook for monetary policy settings.

"For now, it is appropriate for the OCR to remain at 2.5 percent."

Appendix D
The Official Cash Rate chronology

Date	OCR (percent)	Date	OCR (percent)	Date	OCR (percent)
17 March 1999	4.50	4 September 2003	5.00	24 April 2008	8.25
21 April 1999	4.50	23 October 2003	5.00	5 June 2008	8.25
19 May 1999	4.50	4 December 2003	5.00	24 July 2008	8.00
30 June 1999	4.50	29 January 2004	5.25	11 September 2008	7.50
18 August 1999	4.50	11 March 2004	5.25	23 October 2008	6.50
29 September 1999	4.50	29 April 2004	5.50	4 December 2008	5.00
17 November 1999	5.00	10 June 2004	5.75	29 January 2009	3.50
19 January 2000	5.25	29 July 2004	6.00	12 March 2009	3.00
15 March 2000	5.75	9 September 2004	6.25	30 April 2009	2.50
19 April 2000	6.00	28 October 2004	6.50	11 June 2009	2.50
17 May 2000	6.50	9 December 2004	6.50	30 July 2009	2.50
5 July 2000	6.50	27 January 2005	6.50	10 September 2009	2.50
16 August 2000	6.50	10 March 2005	6.75	29 October 2009	2.50
4 October 2000	6.50	28 April 2005	6.75	10 December 2009	2.50
6 December 2000	6.50	9 June 2005	6.75	28 January 2010	2.50
24 January 2001	6.50	28 July 2005	6.75	11 March 2010	2.50
14 March 2001	6.25	15 September 2005	6.75	29 April 2010	2.50
19 April 2001	6.00	27 October 2005	7.00	10 June 2010	2.75
16 May 2001	5.75	8 December 2005	7.25	29 July 2010	3.00
4 July 2001	5.75	26 January 2006	7.25	16 September 2010	3.00
15 August 2001	5.75	9 March 2006	7.25	28 October 2010	3.00
19 September 2001	5.25	27 April 2006	7.25	9 December 2010	3.00
3 October 2001	5.25	8 June 2006	7.25	27 January 2011	3.00
14 November 2001	4.75	27 July 2006	7.25	10 March 2011	2.50
23 January 2002	4.75	14 September 2006	7.25	28 April 2011	2.50
20 March 2002	5.00	26 October 2006	7.25	9 June 2011	2.50
17 April 2002	5.25	7 December 2006	7.25	28 July 2011	2.50
15 May 2002	5.50	25 January 2007	7.25	15 September 2011	2.50
3 July 2002	5.75	8 March 2007	7.50	27 October 2011	2.50
14 August 2002	5.75	26 April 2007	7.75	8 December 2011	2.50
2 October 2002	5.75	7 June 2007	8.00	26 January 2012	2.50
20 November 2002	5.75	26 July 2007	8.25	8 March 2012	2.50
23 January 2003	5.75	13 September 2007	8.25	26 April 2012	2.50
6 March 2003	5.75	25 October 2007	8.25		
24 April 2003	5.50	6 December 2007	8.25		
5 June 2003	5.25	24 January 2008	8.25		
24 July 2003	5.00	6 March 2008	8.25		

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 the remainder of 2012 and into mid-2013:

2012	
Thursday 26 July 2012	OCR announcement
Thursday 13 September 2012	*Monetary Policy Statement*
Thursday 25 October 2012	OCR announcement
Thursday 6 December 2012	*Monetary Policy Statement*
2013	
Thursday 31 January 2013	OCR announcement
Thursday 14 March 2013	*Monetary Policy Statement*
Thursday 24 April 2013	OCR announcement
Thursday 13 June 2013	*Monetary Policy Statement*

Dates for 2013 are provisional, subject to confirmation in August 2012.

The announcement will be made at 9:00 am 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 Government's economic objective is to promote a growing, open and competitive economy as the best means of delivering permanently higher incomes and living standards for New Zealanders. Price stability plays an important part in supporting this objective.

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 Bill English

Minister of Finance

Dr Alan E Bollard

Governor

Reserve Bank of New Zealand

Dated at Wellington this 18th day of December 2008