Monetary Policy Statement

June 2010[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 28 May 2010. Policy assessment finalised on 10 June 2010.

1 Policy assessment

The Reserve Bank today increased the Official Cash Rate (OCR) by 25 basis points to 2.75 percent.

The economy has entered its second year of recovery with growth becoming more broad-based.

The recovery in trading partner activity is continuing, with growth in Asia particularly strong. Along with ongoing growth in Australia and recovery in the United States, this has so far offset weak growth in some other export markets. Against this backdrop, New Zealand's export commodity prices have increased sharply over the past few months, boosting export incomes.

In contrast to signs of global economic recovery there has been renewed turmoil in financial markets. Currently, we expect the main impact on New Zealand to come through continuing upward pressure on the cost of funds to the banking system.

In New Zealand, growth of around 3½ percent is expected this year and next. The main drivers of this outlook are higher export prices and volume growth, an improving labour market and a pick-up in residential and business investment. However, we expect households to remain relatively cautious, with the housing market and credit growth staying subdued. This moderate household spending contributes to some rebalancing in the economy.

Underlying CPI inflation is expected to track within the target range even as the economy expands further. That said, headline CPI inflation will be boosted temporarily by the announced increase in GST and other government-related price changes. Provided households and firms do not reflect this price spike in their wage and price-setting behaviours we do not expect a lasting impact on inflation.

Given this outlook and as previously signalled, we have decided to begin removing some of the monetary policy stimulus that is currently in place. The further removal of stimulus will be reviewed in light of economic and financial market developments.

The fact that bank funding costs are higher, long-term interest rates are higher than short-term interest rates, and a greater proportion of borrowers use floating rate mortgages should all reduce the extent to which the OCR will need to be increased relative to previous cycles.

Alan Bollard

Alan Bollard

Governor

2 Overview and key policy judgements

The New Zealand economy continues to recover. While households and firms are likely to remain relatively cautious, gains in export volumes and an eventual recovery in residential and business investment are expected to see GDP growth remain robust over the projection. This growth is likely to see underlying inflationary pressures increase. As such, given the current low level of the OCR, it is appropriate to gradually remove policy stimulus.

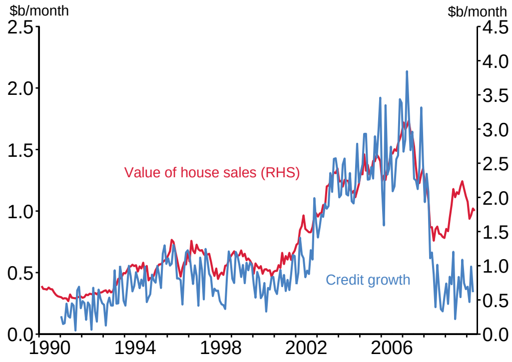
Since the March *Statement*, activity in our trading partners has continued to grow rapidly. Growth in the Asia-Pacific region and the US has been stronger than expected. While inventory rebuilding and fiscal and monetary stimuli have continued to support growth, a more broad-based recovery now appears to be in place. Economic activity in Europe and the UK remains subdued. However, there are risks to our central projection. Concerns regarding high sovereign debt in the euro area are currently causing significant market turbulence.

Nonetheless, New Zealand's export commodity prices continue to increase. In aggregate, prices are now above the peak reached in 2008. The improvement in prices has been broad based, with forestry, aluminium and meat – along with dairy products – all increasing strongly over the past year. The New Zealand dollar TWI, while above its long-term average, is lower than at the time of the 2008 commodity price peak.

These higher prices will substantially boost primary sector incomes over the coming year. However, due to a likely response in global production, export commodity prices are expected to moderate over the projection. Given the temporary nature of the income boost, along with current high agricultural debt, it is likely that primary producers will use much of the coming income gain to reduce debt, rather than substantially increase spending. Such conservatism is evident in recent household sector behaviour, with spending weak and household credit growing only modestly.

Activity in the housing market also reflects this conservatism. Not only has housing turnover continued to be soft, but also housing credit growth remains well below that consistent with this weak rate of housing turnover (figure 2.1). It appears householders are taking advantage of current low floating mortgage interest rates, or perhaps even downsizing their homes, to make unusually large principal repayments on their mortgages.

Figure 2.1
Household credit growth and the value of house sales



Source: REINZ, RBNZ.

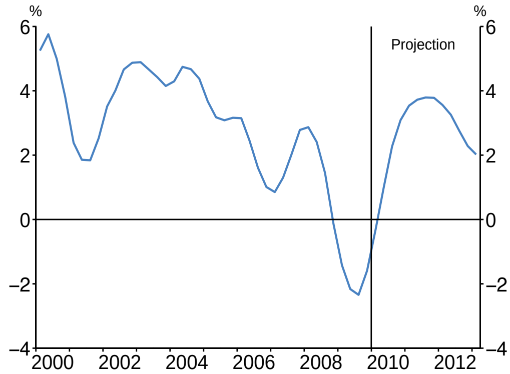
Businesses are also being quite cautious. While there appears to be a growing intention to increase investment in the future, for now capital expenditure remains weak. Firms seem focused on improving their balance sheets by reducing debt. Those that have increased output appear to have done so by increasing the number of hours worked by staff, or by hiring new workers, rather than through capital investment.

Consequently, labour demand has increased since the start of the year. Employment is predicted to continue to increase and the unemployment rate to trend lower over the projection. As unemployment eases, wage inflation is likely to pick up.

Demand for finance is likely to increase as the domestic recovery progresses. It is important that creditworthy businesses and households can access finance on reasonable terms. The New Zealand banking system should be well placed to do this, particularly in light of the sector's reduced reliance on short-term wholesale funding. While banks are likely to continue to be cautious, it is expected that some of the recent tightening in lending standards will be eased over the projection.

Aggregate activity is currently being assisted by both monetary and fiscal stimulus. Over the projection, increased export volumes and an eventual recovery in residential and business investment are expected to see GDP growth remain robust even as this stimulus is withdrawn (figure 2.2).

Figure 2.2
GDP growth
(annual average)

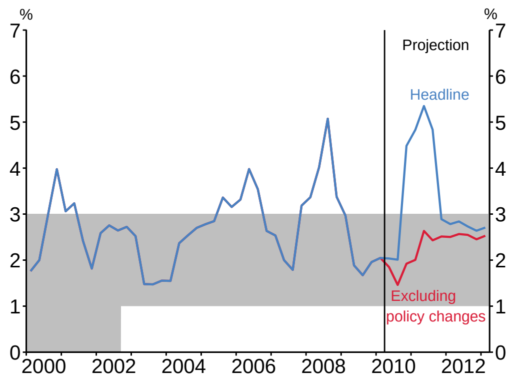


Source: Statistics New Zealand, RBNZ estimates.

This outlook suggests that growth will be slower than in previous recoveries, reflecting our belief that households and firms – as well as lenders – will be relatively cautious over the next few years. However, it is still robust enough to see resource slack eliminated over the coming year and cause underlying inflationary pressures to increase.

The Government has recently announced increases to indirect taxes through an increase in the rate of GST and higher tobacco excise taxes. In addition, the inclusion of the stationary energy sector in the Emissions Trading Scheme on 1 July will boost the price of fuel and electricity. These changes will push headline CPI inflation substantially above its medium-term trend.

Figure 2.3
Headline CPI inflation
(annual)

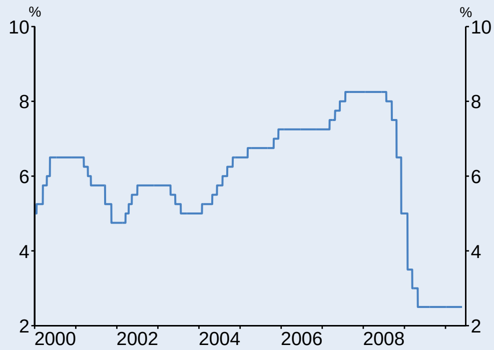


Source: Statistics New Zealand, RBNZ estimates. 'Excluding policy changes' is our CPI projection excluding the direct inflation impacts of the increase in the rate of GST, increases in the excise tax on tobacco and the incorporation of the stationary energy sector in the Emissions Trading Scheme.

Box A
Recent monetary policy decisions

In response to a severe global recession, tight credit conditions, increased bank funding costs and contraction in the New Zealand economy – all of which have seen inflationary pressures reduce noticeably – the OCR has been held at a record low 2.5 percent since the April 2009 OCR review (figure A1). In addition, throughout this time, the Bank communicated its expectation that the OCR would be kept at the current low rate for an extended period.

Figure A1
Official Cash Rate



Source: RBNZ.

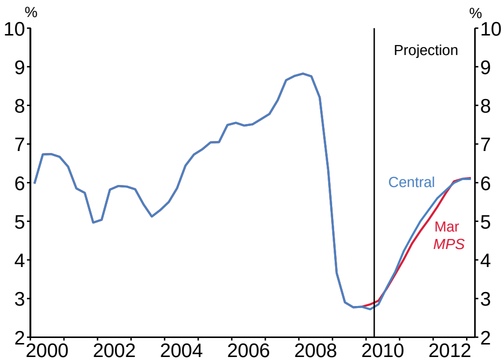
Keeping interest rates low has been appropriate, given the extent to which the New Zealand economy contracted and inflationary pressures abated. Indeed, policy stimulus appears to have helped avoid inflation falling below the bottom of our target band, with annual headline inflation estimated to have remained at or near the centre of the target band for the past five quarters.

Headline annual CPI inflation is expected to increase to 5.4 percent in the June quarter 2011. Assuming only limited medium-term reaction to this temporary increase, headline inflation is expected to moderate thereafter to be inside the target band by the end of the projection. Excluding the government policy changes, annual CPI inflation is expected to peak at 2.6 percent in the June quarter 2011.

Monetary policy judgements

Underlying inflationary pressures are expected to increase over the projection. Given the current low level of the OCR, it is therefore appropriate to gradually remove policy stimulus. As a result of increased bank funding costs, a shortening in the duration of both household and business borrowing and a positively sloped yield curve, the Bank expects the removal of monetary stimulus to have quite a powerful and rapid impact on the economy.

Figure 2.4
90-day interest rate



Source: RBNZ estimates.

The central projection, which underpins this policy outlook, relies on three key assumptions. These are that:

- the coming temporary increase in inflation is assumed to have an only limited impact on medium-term inflation expectations;
- households and firms continue to consolidate their balance sheets; and,
- trading partner growth continues to be robust.

The Bank would expect to revise its policy outlook should any of these assumptions prove incorrect.

The Policy Targets Agreement (PTA) defines the Bank's price stability target in terms of the All Groups, or headline, CPI. However, it also instructs the Bank to focus on the medium-term trend in headline inflation, and lists changes in indirect taxes and significant government policy that directly affect prices as specific reasons why headline inflation might vary around its medium-term trend. As such, monetary policy will not attempt to offset the direct inflation impact of the coming policy changes.

However, the PTA also instructs the Bank to ensure future inflation remains between 1 and 3 percent on average over the medium term. Given the staggered nature of the indirect tax increases and the progressive introduction of various sectors to the Emissions Trading Scheme, there is a risk the coming spike in headline inflation causes consumers and businesses to reassess their expectation of medium-term inflation. For now, it is assumed that the coming policy changes will have only limited impact on perceptions of future inflation.

As discussed above, New Zealand's export commodity prices have risen substantially over the past year. These higher prices, along with more generalised robust GDP growth, will provide a substantial boost to New Zealanders' incomes over the projection. A key judgement underlying our central forecast is that despite higher incomes, New Zealanders continue to consolidate their balance sheets. Such consolidation would help reduce New Zealand's vulnerability to any future downturn in global demand.

Over the past year, this assumption has clearly held. Despite the economy recovering steadily from the 2008/09 recession, household and agricultural credit has increased only modestly, while business credit has actually fallen. It is not clear, however, whether this illustrates a typical cyclical response to a period of economic weakness, or the early stages of a more structural change in New Zealanders' attitude to borrowing.

For the coming year, given still high household debt, it seems quite likely that consolidation will continue. However, there is a risk of a greater pick-up in spending than assumed. Such a pick-up, as well as boosting inflationary pressures, would also push up import demand, causing the current account to deteriorate.

New Zealand's trading partners have grown strongly over recent quarters, with activity currently well above that predicted in recent *Statements*. Our central projection is for robust growth to continue. However, there is substantial downside risk to this projection stemming from problems related to high sovereign debt in the euro area.

Indeed, market pricing is consistent with a risk that some euro-area government debt could be restructured or that a sovereign might fail to meet its payment obligations. But even if these risks do not eventuate, market pressures will encourage fiscal consolidation in a number of countries. As a result, our central projection assumes a sizable moderation in euro-area growth.

A more severe slowdown would be likely if sovereign debt problems intensified further. While depreciation in the euro would support export-based economies such as Germany, it is likely that many euro-area countries would go into recession.

New Zealand's limited trade with the euro area, at only 10 percent of our total trade, suggests such a slowdown would have only a small direct impact. International trade linkages suggest that lower European growth would not be sufficient to derail an intra-regional recovery in Asia and Australia.

However, euro-area developments are not merely about sovereign debt problems in the countries directly affected. Euro-area fiscal concerns are increasingly affecting wider financial markets. In particular, concern around the exposure of US and European banks to euro-area sovereign debt has increased pressures in global funding markets. Consequently, there is now some risk that ongoing disruption in these markets will have a material effect on the cost and availability of credit for many countries, including New Zealand.

The ultimate size and impact of such a shock are uncertain. However, the experience of the 2008/09 global financial crisis suggests that a rapid tightening in financial conditions and a loss of global confidence could have a significant impact on Asian trade and growth. Our outlook for trading partner growth would then be considerably weaker than in the central projection. Furthermore, looking more broadly at the fiscal requirements facing many other advanced economies, it seems quite possible that longer-term interest rates increase over the projection – regardless of how long current market turbulence continues. Without substantial fiscal consolidation, population aging is likely to see sovereign debt increase markedly in many advanced economies. As well as pushing up the cost of longer-term funds, this would also have a negative impact on growth in advanced economies.

3 Financial market developments

Overview

Global asset markets posted strong gains through March and April in line with signs that the global economic recovery was strengthening. Risk aversion and funding pressures continued to moderate, largely returning to pre-crisis levels. However, since then significant volatility and weakness has returned. Initially focused on a few highly indebted countries, concerns have broadened to encompass the wider euro area. Indeed, these concerns are now increasingly affecting global financial markets. Should this turbulence prove protracted, there is a risk that it could erode global recovery prospects through its effects on trade, confidence and financing. In particular, ongoing disruption in global funding markets could increase funding costs for local banks, adding upward pressure to interest rates for households and businesses.

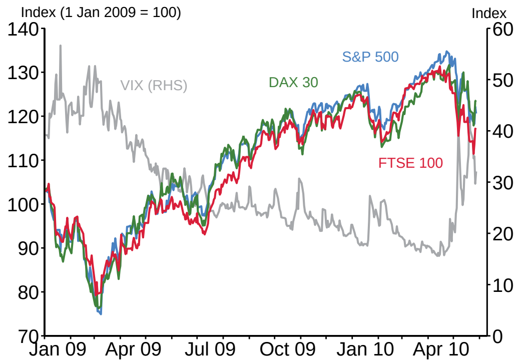
Very little economic and earnings data, which correspond to this period of market turbulence, are currently available. It would seem likely that euro-area GDP growth is being negatively affected and that funding costs for New Zealand banks and corporations have increased. However, the size of the impact is very difficult to assess. The central projection assumes some negative impact on euro-area activity and that bank funding costs remain at elevated rates for the foreseeable future. However, current market pricing, which is consistent with a small but meaningful risk that a euro-area sovereign will fail to meet its payment obligations, would suggest a much more severe deterioration.

Local interest rates have also been affected by developments in Europe. While these moved sharply higher in early May following a large fall in New Zealand's unemployment rate, a large portion of these gains have been pared back in recent weeks.

International financial market developments

Financial market fears of sovereign risk contagion in Europe and the potential impact on world growth has seen global asset prices fall sharply in recent weeks. Equity markets have completely erased their 2010 gains, while the VIX index (a proxy for risk aversion) has reached levels not seen since the equity market lows in March 2009 (figure 3.1). In addition, industrial and energy commodity prices have fallen almost 10 percent from their recent highs.

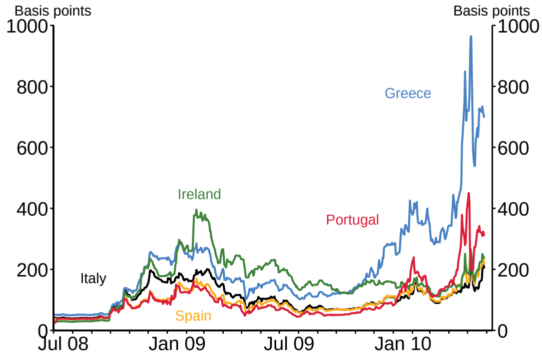
Figure 3.1
Global equity indices and the VIX



Source: Bloomberg.

The deterioration in financial market conditions has occurred despite global economic data and US first quarter earnings results generally surprising on the upside of market expectations. The falls in equity prices have also persisted despite significant rescue efforts from European policymakers and the IMF. However, concerns around European fiscal debt remain, as illustrated by the highly elevated level of sovereign credit default swap spreads (figure 3.2).

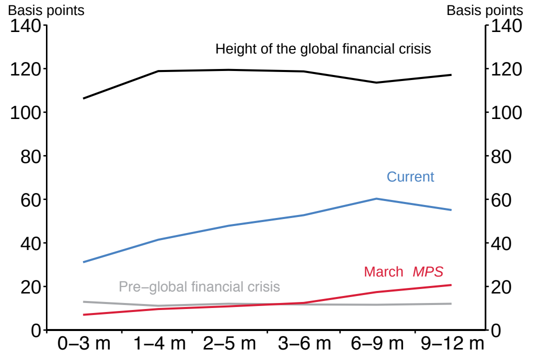
Figure 3.2
Sovereign credit default swap spreads



Source: Bloomberg.

In addition, concerns about financial institutions with large holdings of government bonds from certain euro-area countries have seen European sovereign fears spill over into increased money market pressures. The spreads between US interbank rates and expected policy rates have widened in recent months. However, these remain well below the levels seen at the height of the global financial crisis (figure 3.3). US commercial paper market conditions have become more difficult, with some borrowers only able to issue paper for relatively short terms. There has also been anecdotal evidence of firms cancelling or postponing debt issuance due to the increased funding costs and investor nervousness. There is a risk that global economic conditions deteriorate if the current turmoil in financial markets continues to affect financial markets outside of the euro area.

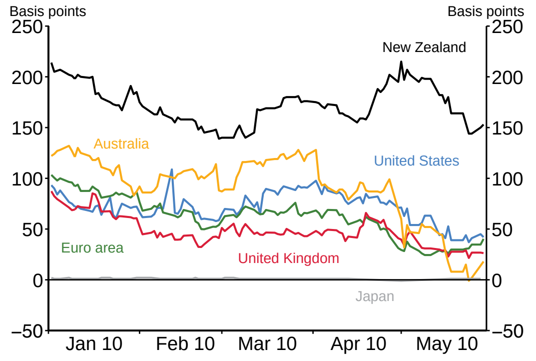
Figure 3.3
Spread between US interbank and expected policy rates



Source: Bloomberg.

Demand for safe-haven assets has seen government bond yields fall in major economies. Wholesale interest rates and expectations of policy rate hikes from central banks have also moved lower in recent months (figure 3.4). In response to the continuing sovereign fiscal issues in Europe, the European Central Bank recently announced that it has started sterilised asset purchases to help indebted euro-area countries. The US Federal Reserve has reintroduced currency swap lines with several major central banks to provide support to troubled markets. In contrast, the Bank of Canada recently raised its policy rate and the People's Bank of China has continued to tighten lending conditions. The Reserve Bank of Australia held its policy cash rate at 4.5 percent in May. Market expectations are for the RBA to now hold rates steady over the coming months.

Figure 3.4
Market pricing for central bank rate moves over the next 12 months

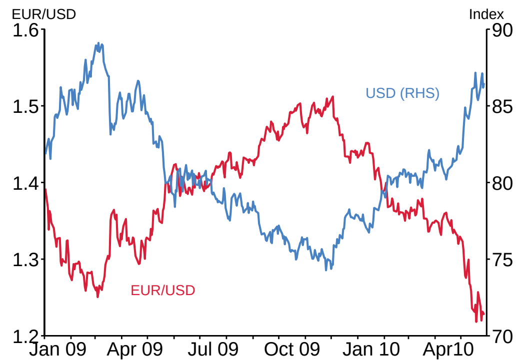


Source: Credit Suisse, Bloomberg.

Foreign exchange markets

Foreign exchange markets have largely been driven by changes in investor risk appetite over recent months. After tracking at relatively low levels throughout March and April, risk aversion measures surged higher in early May on fears over contagion of sovereign debt problems. Consequently, the US dollar appreciated strongly and the euro fell sharply throughout May despite various policy responses (figure 3.5). The British pound has also moved lower over recent months.

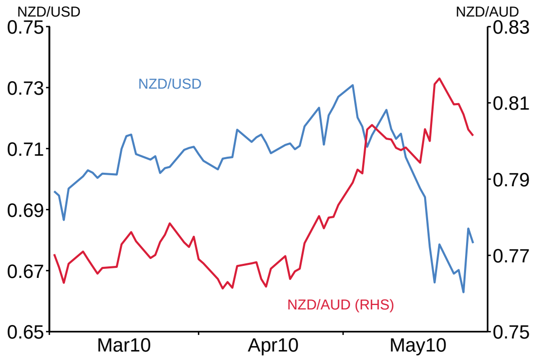
Figure 3.5
EUR/USD and the USD Index



Source: Bloomberg.

Commodity-sensitive currencies have generally weakened as risk aversion has intensified, with the Australian dollar falling substantially since mid-April. The declines have largely reflected the unwinding of positions by investors as commodity and equity prices have moved lower. However, the falls in broad commodity prices have not been reflected to the same extent in the New Zealand dollar – perhaps because energy and industrial commodities, the drivers of the recent declines, make up a very small proportion of New Zealand's export commodity basket. A growing divergence in markets' monetary policy expectations in New Zealand and Australia, has seen the New Zealand dollar push higher against the Australian dollar recently (figure 3.6). Despite significant movements in the New Zealand dollar over recent months, on a TWI basis the New Zealand dollar is little changed from the March *Statement*.

Figure 3.6
NZD/USD and NZD/AUD

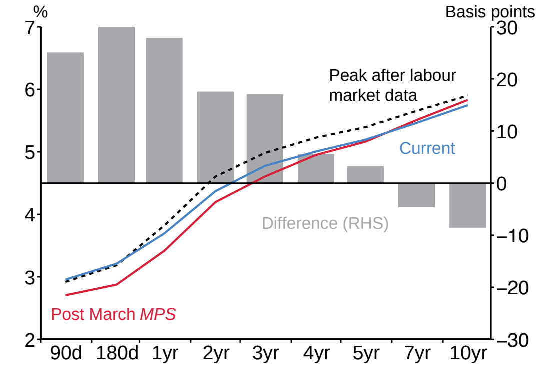


Source: Bloomberg.

Domestic financial market developments

Local interest rates moved higher in early May following the release of stronger than expected labour market data. However, the recent financial market turmoil and associated falls in international interest rates have seen these gains pared back considerably (figure 3.7). The overnight index swap market is currently pricing increases in the OCR of around 150 basis points over the next 12 months, down from nearly 220 basis points following the strong labour market data.

Figure 3.7
NZ wholesale interest rate curve

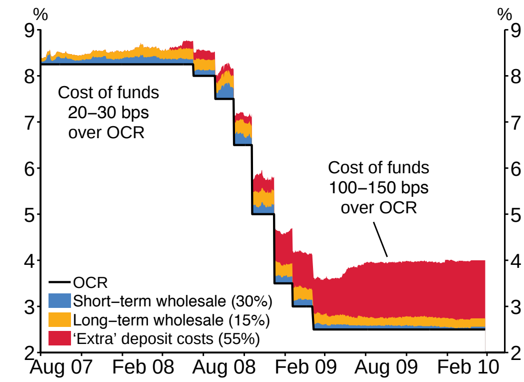


Source: Bloomberg.

Financing and credit

Bank funding costs remain high compared to pre-crisis levels. Banks have come under continuing pressure from markets, rating agencies and regulators to move away from cheaper short-term wholesale funding and into more stable long-term wholesale and retail deposit funding. The Bank estimates that the marginal cost of funds is around 150 basis points above the OCR (figure 3.8). There is some risk that ongoing market turbulence places renewed upward pressure on longer-term term funding costs. For now, market contacts have noted that local banks can still access international funding markets, albeit at a higher cost.

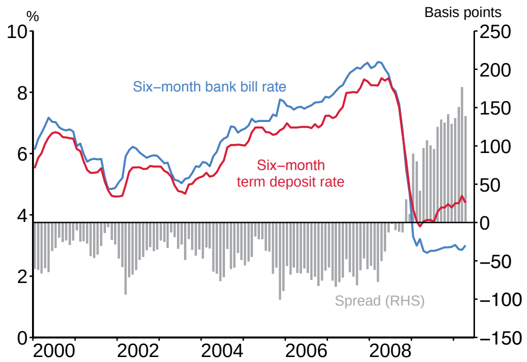
Figure 3.8
Indicative marginal funding costs relative to the OCR



Source: RBNZ estimates.

Ongoing competition for retail funding has seen deposit rates remain around 150 basis points above wholesale rates, compared to the pre-crisis average of around 50 basis points below (figure 3.9). Indeed, 'special' term deposit rates – which have increasingly become the benchmark for competition – are around 200 basis points over wholesale interest rates in some cases.

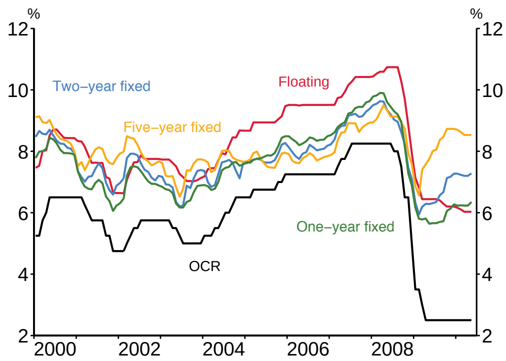
Figure 3.9
Retail and wholesale six-month interest rates



Source: Bloomberg, RBNZ.

Following movements in wholesale interest rates, mortgage interest rates have edged up slightly over recent months. The shape of the mortgage curve remains steeply positively sloped, with floating rates below short-term fixed mortgage rates (figure 3.10). Consequently, both new and existing borrowers have been increasingly selecting floating rates. This has taken the proportion of mortgage debt that is on floating rates to more than 30 percent. This is the highest proportion since the first half of 2004 and is up considerably from the lows of 12-13 percent seen during 2007/08.

Figure 3.10
Mortgage rates offered to new borrowers



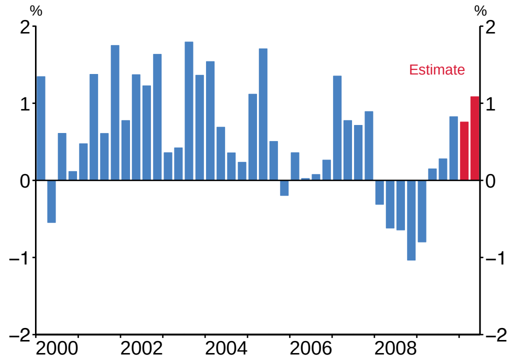
Source: RBNZ.

4 Current economic conditions

Overview

The economy has been expanding for more than a year. Consistent with our previous forecasts, the pace of the recovery has picked up in recent quarters (figure 4.1). Recovery in manufacturing and construction activity is estimated to have led this strong growth. New Zealand's trading partners are also recovering.

Figure 4.1
GDP growth
(quarterly, seasonally adjusted)

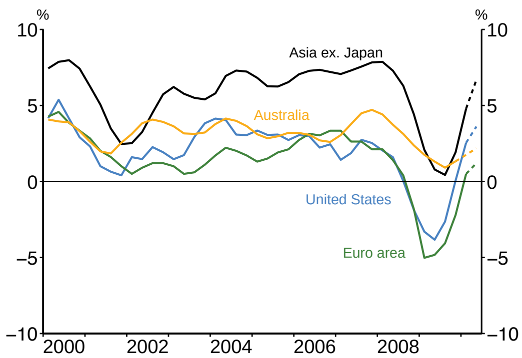


Source: Statistics New Zealand, RBNZ estimates.

International economic conditions

Economic activity in New Zealand's trading partners has continued to improve more rapidly than was previously forecast (figure 4.2). Indeed, trading partner activity is estimated to currently be about 4.3 percent higher than was predicted in the June 2009 *Statement*.

Figure 4.2
GDP growth by region
(annual, dashed lines represent estimates)



Source: Datastream, RBNZ estimates.
Note: Asia ex. Japan comprises: China, Hong Kong, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan, Thailand and Vietnam.

Expansion in the global economy has been concentrated in the Asia-Pacific region. Strong growth in most Asian economies has broadly returned activity to its pre-crisis trend. Some of this recent growth reflects rebuilding of inventories and fiscal stimulus. However, Asian economies have also seen strong rebounds in retail activity and business investment, suggesting that more broad-based growth has set in. Intra-regional trade has also expanded rapidly, supported by strong growth in China. While spare capacity remains, and underlying inflation measures have been moderate to date, asset prices have been rising rapidly and authorities in some economies have begun to remove monetary stimulus.

The Australian mining sector has benefited from increased Asian demand. Major investment projects are coming on line and employment has grown strongly over the past year. This, combined with strong net immigration flows, has boosted housing demand in Australia. To date, retail activity and investment outside the mining sector suggest that households and businesses remain more cautious than before the global financial crisis. However, spare capacity has diminished significantly, and monetary policy settings have now returned to more average levels.

Economic activity has recovered somewhat in the United States. Despite high unemployment, low consumer confidence and depressed asset prices, GDP has increased by 2.7 percent over the past three quarters.

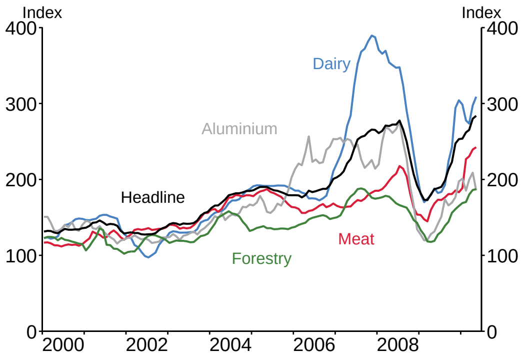
In Europe, activity remains weak. Financial market concerns about high sovereign debt have led to increased pressure for fiscal consolidation and to a tightening in European financial conditions.

Domestic economic conditions

External sector

New Zealand's export commodity prices have risen substantially over the past year. In aggregate, prices are now above the peak reached in 2008. The improvement in prices has been broad based, with forestry, aluminium and meat – along with dairy products – all increasing strongly over the past year. Furthermore, the New Zealand dollar TWI, while above its long-term average, is lower than at the time of the 2008 commodity price peak. Strong demand from China, combined with supply disruptions in Chile, has assisted the rise in forestry prices. Supply shortages in Australasia have also translated into higher meat prices.

Figure 4.3
Export commodity prices
(SDR terms)

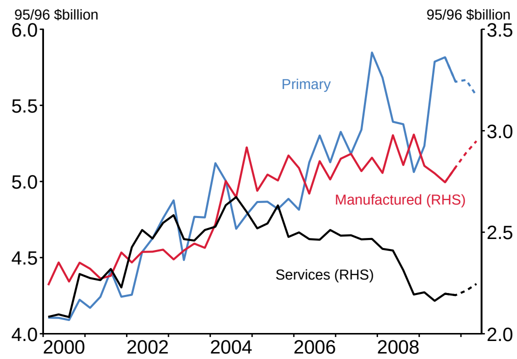


Source: ANZ National Bank Ltd.

These higher prices will provide a substantial boost to primary sector incomes over the coming year. Fonterra has already indicated its 2010/11 season milk price will be very high. In 2008, a similar boost saw consumer spending increase in anticipation of higher export earnings, but to date there has been no such response, with consumers remaining cautious in their spending and borrowing decisions.

In addition to strong prices, the quantity of primary exports has remained strong over recent months, with log and meat export volumes increasing. Manufactured exports have shown signs of growth (figure 4.4), with domestic production growing rapidly.

Figure 4.4
Export volumes
(quarterly, seasonally adjusted, dashed lines represent estimates)



Source: Statistics New Zealand, RBNZ estimates.

Import volumes remain weak. In part this is related to the composition of demand, with investment and stock building – both with a typically high import content – very weak. Combined with surprisingly strong export volumes, New Zealand's trade account is now in surplus.

At the same time, the investment income balance has improved considerably, reflecting provisions by the banking sector for one-off tax liabilities and low profit payments to foreign owners of New Zealand firms. Furthermore, with domestic interest rates low, payments to offshore lenders are also low.

Overall, we estimate that the annual current account deficit is currently at 4.3 percent of nominal GDP.

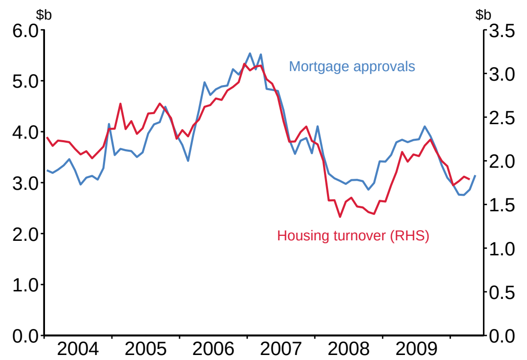
Household sector

Consumption spending continues to recover, but at a very sluggish pace. An improvement in the terms of trade is expected to eventually lead to higher consumption. But for now, households remain focused on reducing debt.

The retail sector remains highly competitive, with significant discounts offered to consumers. While households appear to be taking advantage of this to increase the volume of purchases, nominal spending remains weak, with household credit growing only modestly.

Consistent with household caution, activity in the housing market remains weak. It appears householders are taking advantage of current low floating mortgage interest rates to make unusually large principal repayments on their mortgages, rather than buy houses. The latest mortgage approvals data suggest turnover continues to be weak (figure 4.5).

Figure 4.5
Value of house sales and mortgage approvals
(monthly, seasonally adjusted)



Source: REINZ, RBNZ.

Despite the weak housing market, residential construction is beginning to recover, providing a significant boost to growth. Building consent issuance has been rising fairly steadily, supported by relatively robust population growth.

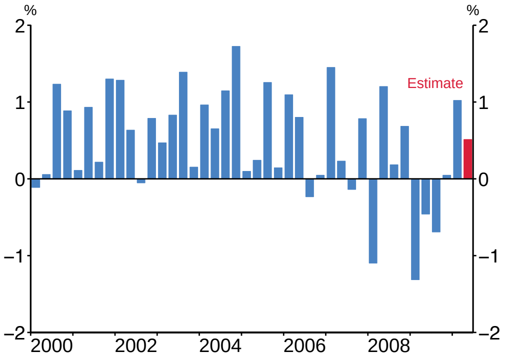
Labour market

Looking across a wide range of data, demand for workers has picked up. We estimate that employment increased by 33,000 people over the first half of the year, recovering more than half the 54,000 decline in employment seen through the recession (figure 4.6). At the same time, labour force participation has remained at a high level.

Consistent with the economy growing for more than a year now, there has been a marked improvement in labour demand, with the unemployment rate decreasing to 6.0 percent.

Wage inflation, which typically lags moves in unemployment is currently quite subdued. A tightening labour market should see wage inflation recover.

Figure 4.6
Employment growth
(quarterly, seasonally adjusted)

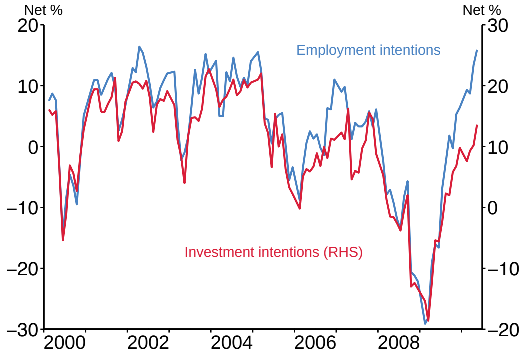


Source: Statistics New Zealand, RBNZ estimates.

Business sector

Over the past two years firms have cut costs and improved efficiencies. While now relatively well placed, they remain cautious and so have focused more on using additional workers to increase production rather than undertaking capital investment (figure 4.7).

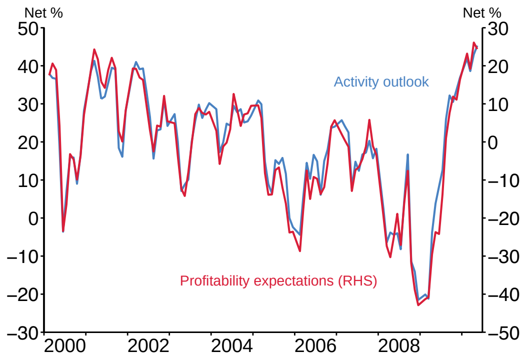
Figure 4.7
Employment and investment intentions



Source: ANZ National Bank Group Ltd.

Nevertheless, surveyed business confidence is very high. Own activity expectations are at an 11 year high with a net 45.3 percent having a positive outlook (figure 4.8). Moreover, business profitability is improving.

Figure 4.8
Activity and profitability outlooks



Source: ANZ National Bank Group Ltd.

Prices

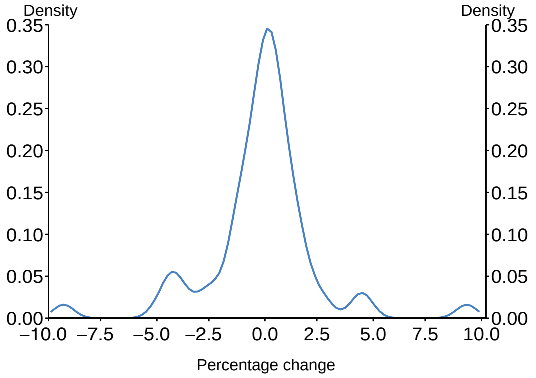
Annual headline CPI inflation is estimated to have remained at or near the centre of the target band for the past five quarters. We estimate most subgroups of the CPI recorded only modest price changes in the June quarter (figure 4.9).

Looking first at tradable inflation, petrol prices have increased by 11 percent since the start of the year. Offsetting this, relatively favourable climatic conditions have kept fruit and vegetable prices down, which are now 5 percent lower than a year ago. Furthermore, retailers are passing through discounts on durable consumer goods, from the appreciation of the TWI towards the end of 2009.

Figure 4.9

Distribution of estimated price changes

(June quarter 2010)

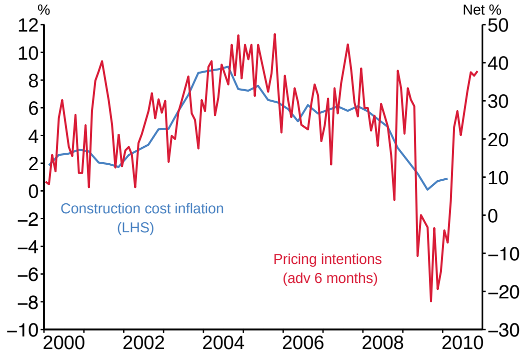


Source: RBNZ estimates.

Widespread spare capacity is keeping non-tradable inflation low, particularly for the housing sector. A weak housing market has led to rents increasing very little. While construction cost inflation has also been very low, builders' pricing intentions suggest a strong rebound in the near future (figure 4.10). An increase in the excise tax on tobacco pushed non-tradable inflation higher. This change is expected to eventually boost headline inflation by 0.3 percentage points. Price increases for other non-tradable subgroups are estimated to be benign.

Figure 4.10

Annual construction cost inflation and builders' price intentions



Source: Statistics New Zealand, ANZ National bank Group Ltd.

Inflation expectations are high relative to current economic conditions and CPI inflation. However, with GDP growing strongly, commodity prices increasing, indirect taxes increasing and the implementation of the amended Emissions Trading Scheme, it is unsurprising that inflation expectations have risen (table 4.1).

Table 4.1

Measures of inflation and inflation expectations

(annual)

	2008		2009				2010
	Sep	Dec	Mar	Jun	Sep	Dec	Mar
CPI	5.1	3.4	3.0	1.9	1.7	2.0	2.0
CPI components							
CPI non-tradables	4.1	4.3	3.8	3.3	3.0	2.3	2.1
Non-tradables housing components	3.2	2.4	1.5	1.0	0.6	0.8	1.2
Non-tradables ex housing, cigarettes and tobacco components	4.5	5.1	4.8	4.3	4.2	2.9	2.6
CPI tradables	6.3	2.3	1.7	0.2	-0.1	1.5	2.0
Petrol	29.3	-4.8	-9.3	-17.0	-19.0	3.3	11.5
Other inflation measures							
Factor model estimate of core CPI inflation	3.5	3.1	2.8	2.3	2.1	2.1	2.0
CPI trimmed mean (of annual price change)	4.0	3.1	2.9	2.2	2.0	2.2	2.3
CPI weighted median (of annual price change)	3.7	3.0	2.9	2.9	2.8	2.2	1.7
CPI ex food, petrol and government charges	2.2	2.0	1.9	1.6	1.9	1.7	1.3
CPI ex food and energy	2.1	2.2	2.3	2.1	2.5	2.1	1.7
GDP deflator (derived from expenditure data)	2.4	2.5	2.6	2.0	2.7	0.1	n/a

	2008		2009				2010	
	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
Inflation expectation measures								
RBNZ Survey of Expectations - inflation one-year-ahead	3.6	2.8	2.0	1.8	1.8	2.1	2.1	2.9
RBNZ Survey of Expectations - inflation two-years-ahead	3.0	2.7	2.2	2.2	2.3	2.6	2.7	2.8
AON Economist survey - inflation one-year-ahead	3.5	3.0	2.1	2.2	1.7	1.6	2.2	n/a
AON Economist survey - inflation four-years-ahead	2.7	2.7	2.5	2.6	2.5	2.4	2.5	n/a
NBBO - inflation one-year-ahead (quarterly average)	3.7	3.5	2.7	2.6	2.6	2.6	2.6	n/a

5 The macroeconomic outlook

Overview

The current recovery in domestic economic activity should consolidate over the projection. Higher export commodity prices, and stimulatory monetary and fiscal policy, will provide support over the coming year.

Further into the projection, stronger world activity, particularly in Asia-Pacific economies, is forecast to increase demand for New Zealand's exports. Furthermore, business and residential investment will pick up from current low levels.

Inflationary pressures are expected to build over the forecast. In addition, changes to indirect taxes and government policy are likely to cause headline inflation to diverge markedly from its medium-term trend over the next year or so.

There remain risks to the overall outlook. Chiefly, the potential disruptions arising from high sovereign debt in Europe would provide downside news to these projections. But should the current boost to terms of trade not prove temporary as forecast, domestic activity could be stronger, increasing inflationary pressure in the economy.

Trading partner activity

There are signs of firming private demand in most of our trading partners. However, regional prospects remain very divergent. Overall, the outlook continues to be for a more protracted recovery than usual.

The sharp rebound in activity in Asia-Pacific economies is projected to continue. The recovery is supported in the near term by intra-regional developments: inventory rebuilding, expansionary fiscal and monetary policies, and growing demand in China. While some of these factors are temporary, there have also been strong recoveries in consumption and investment demand in the region. This is likely to generate stronger inflation pressures by the second half of this year. Strong growth in Asia is also likely to continue to provide support for mineral commodity prices and the Australian terms of trade.

By contrast, the outlook for Western economies remains soft. Weak confidence, softness in property markets, and strained public and private sector balance sheets are likely to continue weighing on activity. Among these economies, the outlook for the US has improved as its labour market has turned and signs of a more broad-based recovery in household incomes and spending have emerged. In addition, Japan has benefited from the recovery in global trade. The outlook for Europe, on the other hand, has deteriorated as a result of problems related to high sovereign debt in some euro-area economies. At a minimum, market pressures are likely to encourage an acceleration of fiscal consolidation in the region, dampening economic activity.

Our central projection assumes that any fall-out from recent events in Europe remains contained and that regional momentum continues to drive growth in the Asia-Pacific region. However, there is a substantial risk that the spill-over from European sovereign debt problems could be more material than we assume.

Table 5.1

Forecasts of trading partner GDP growth

(calendar year, annual average)

Country	2003	2004	2005	2006	2007	2008	2009	2010f	2011f	2012f
Australia	3.2	3.6	3.2	2.6	4.7	2.4	1.3	2.9	3.6	3.9
Asia ex-Japan*	5.4	7.2	6.5	7.2	7.8	4.4	1.9	7.9	6.3	6.8
United States	2.5	3.6	3.1	2.7	2.1	0.4	-2.4	3.3	3.0	2.8
Japan	1.5	2.7	1.9	2.0	2.3	-1.2	-5.2	2.4	1.7	2.2
Euro area**	0.8	1.9	1.7	3.1	2.7	0.5	-4.0	1.0	1.2	1.5
United Kingdom	2.8	3.0	2.2	2.9	2.6	0.5	-4.9	1.2	1.9	2.0
16 Country Index	3.1	4.1	3.6	3.7	4.4	1.9	-0.7	4.2	4.0	4.3

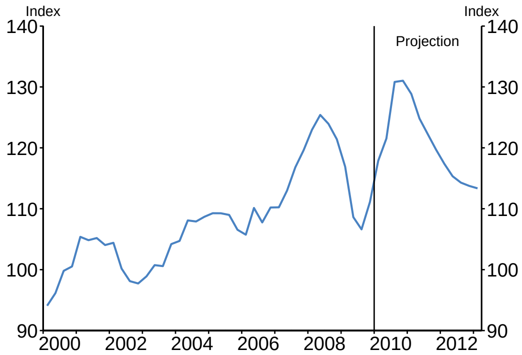
Source: DataStream, Haver, RBNZ estimates.
* Includes China, Hong Kong, Malaysia, Singapore, South Korea, Taiwan, Indonesia, Thailand, Vietnam and the Philippines.
** Includes Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia and Spain.

Terms of trade

New Zealand's export commodity prices are forecast to ease over the projection. Recent disruptions to global supply are expected to unwind over the latter half of 2010, with some moderation in demand conditions. These factors are expected to see commodity prices decline relative to world consumer prices throughout the forecast. Despite this, export prices are forecast to remain historically high.

The world prices of New Zealand's imports declined markedly during the global financial crisis. Despite world commodity prices increasing significantly since then, import prices remain muted. Over the course of the projection, import prices are forecast to return to their medium-term trend level relative to world consumer prices. Overall, the terms of trade are expected to decline over the latter half of the projection (figure 5.1).

Figure 5.1
OTI terms of trade (goods)
(seasonally adjusted)

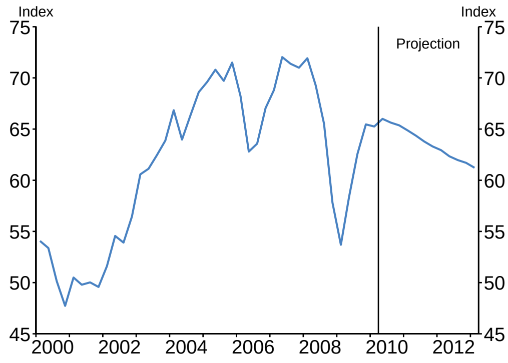


Source: Statistics New Zealand, RBNZ estimates.

Exchange rate

The New Zealand dollar TWI is assumed to remain around current levels throughout the second half of 2010. Thereafter, as the terms of trade decline and global interest rates rise, the TWI is assumed to depreciate. The level of the TWI at the end of the projection remains above the average of the past 25 years (figure 5.2).

Figure 5.2
New Zealand dollar TWI



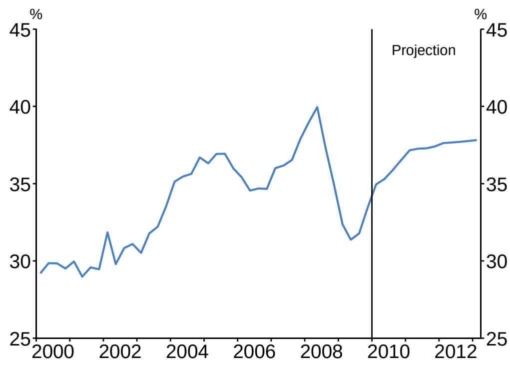
Source: RBNZ estimates.

Trade volumes

Growth in trading partner activity will generate higher demand for New Zealand exports. In particular, the relatively robust outlook for East Asia should support exports of meat, dairy and forestry products. The improved world outlook should also encourage higher tourist spending within New Zealand.

The recovery in business investment over the course of the projection, combined with a historically high TWI, results in an increase in the import penetration ratio in the coming quarters. This ratio settles at a similar level as that prevalent immediately before the domestic recession (figure 5.3).

Figure 5.3
Import volumes
(percent of GDP, seasonally adjusted)



Source: Statistics New Zealand, RBNZ estimates.

Government

This *Statement* incorporates the updated fiscal projections from *Budget 2010*. *Budget 2010* included provisions to increase the rate of GST, reduce personal income and company taxes, and change the tax treatment of buildings. The overall aim of the tax reform was to shift the focus of taxation from income-based taxes to consumption-based taxes. The reductions in personal tax rates more than fully compensate earners at all levels of income for the increase in GST (table 5.2). Beneficiaries and superannuitants will also be compensated for the change in GST.

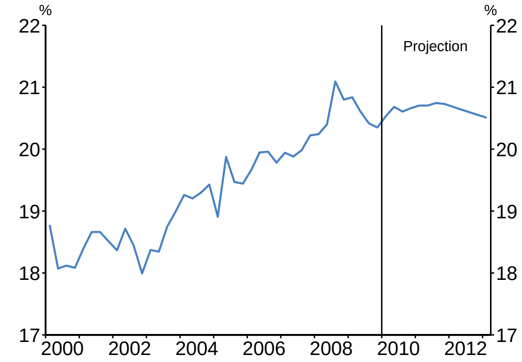
Table 5.2
Effects of reduction in personal tax rates
(dollars per annum)

Gross income	Tax reduction	Percent gain
20,000	490	2.4
30,000	840	2.8
40,000	1190	3.0
50,000	1530	3.1
60,000	1830	3.0
70,000	2130	3.0
80,000	2630	3.3
90,000	3130	3.5
100,000	3630	3.6
200,000	8630	4.3

Source: www.taxguide.govt.nz

In net terms, fiscal impulse for the 2010/11 fiscal year is larger than was assumed in the March *Statement*. Fiscal restraint is forecast to see government spending volumes decline modestly relative to total GDP over the latter part of the projection (figure 5.4). This results in a much weaker fiscal impulse in the second half of the forecast than was seen in recent years.

Figure 5.4
Government spending volumes
(percent of trend GDP, seasonally adjusted)

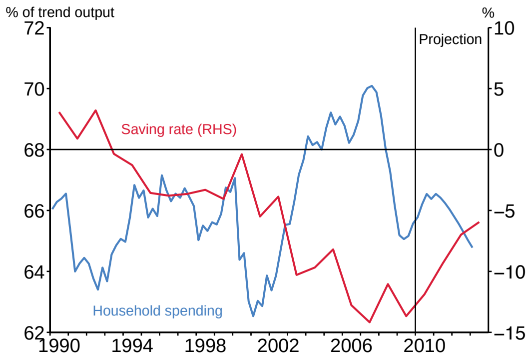


Source: Statistics New Zealand, RBNZ estimates.

Households

Households are projected to undertake a period of consolidation. Annual growth in consumer spending is forecast to slow over the projection, reaching 0.9 percent in 2012. However, some short-term volatility is projected in the second half of 2010 as households bring forward spending ahead of the increase in the rate of GST. Consumer spending is assumed to fall relative to output over the projection, accompanied by an increase in the saving rate (figure 5.5).

Figure 5.5
Household spending and saving
(saving as a percent of household disposable income, spending is seasonally adjusted)



Source: Statistics New Zealand, RBNZ estimates.

This assumption rests in part on the forecast that the higher terms of trade will be short lived. If primary producers believe the income boost is temporary they are more likely to save the proceeds. However, should the boost to the terms of trade be more prolonged, they may view the real income gain as permanent and adjust their spending accordingly.

This would present an upside risk to our projections for household spending and inflationary pressures.

Consistent with the projection for consumption, housing market activity is expected to remain subdued. Houses remain expensive relative to household income, and increases in mortgage interest rates will further impinge on demand. Partly offsetting these factors, employment and wage growth are expected to pick up, and net immigration is expected to remain positive. Nonetheless, real house prices are forecast to decline slightly over the projection. Relative to the March *Statement*, house prices are around 2 percent lower over the projection, which is consistent with the *Budget 2010* estimate of the effect of the changes to the tax treatment of buildings.

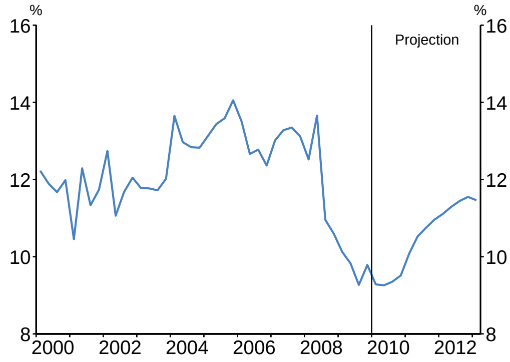
Continued above-average population growth and previously weak construction is expected to drive a cyclical recovery in residential investment. This recovery would be tempered somewhat should emigration to Australia turn out stronger than expected. Despite the cyclical recovery, residential investment is projected to remain weak relative to aggregate activity.

Business sector

With measures of capacity pressure high relative to the position in the cycle, businesses will require more capital and labour inputs over the projection. Initially, businesses are expected to raise output by increasing hours worked and hiring new staff. But there will eventually be a need for greater capital spending.

The factors currently restraining investment are expected to moderate over the projection. Increased demand will result in greater profitability, providing firms with a greater level of retained earnings. Furthermore, current tightness in credit conditions should ease somewhat over the projection. As the unemployment rate falls, difficulties in hiring skilled workers will re-emerge, making capital investment relatively more attractive. Capital goods are also likely to be comparatively cheap given the above average level of the exchange rate. Business investment is consequently expected to increase from its current low share of trend output (figure 5.6).

Figure 5.6
Business investment
(excluding computer and intangible assets, percent of trend output, seasonally adjusted)



Source: Statistics New Zealand, RBNZ estimates.

Gross Domestic Product

The recovery in production is expected to be broad based across sectors. Increases in world activity will provide stronger demand for exports. Household spending will increase, and investment will support growth in the latter part of the projection. As highlighted in previous *Statements*, this recovery is slower than typical following a recession.

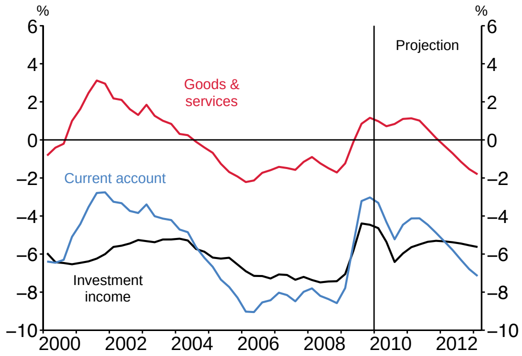
Balance of payments

The higher terms of trade are projected to maintain a positive annual trade balance through to the end of 2011. Thereafter, declining export prices and higher import volumes are expected to result in a renewed deficit on trade.

Given our assumption that the boost to the terms of trade will prove relatively short lived, primary exporters are expected to use the proceeds for the main part to pay down debt. New Zealand's net foreign liabilities are expected to fall relative to nominal GDP. The quarterly investment income deficit consequently narrows somewhat over the early part of the projection, although the volatility of previous quarters continues to affect the annual total. But as domestic profitability and interest rates rise, the quarterly deficit widens once more in the latter part of the projection.

The overall current account deficit is projected to widen over the latter half of the projection, to around 7 percent of nominal GDP by the end of the forecast (figure 5.7).

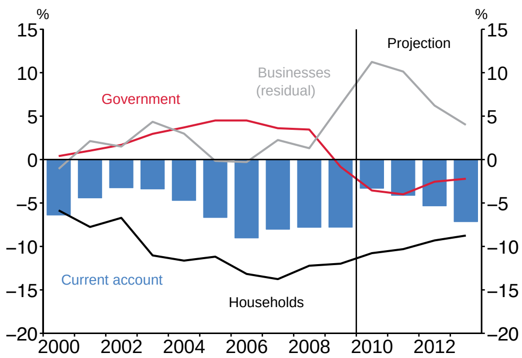
Figure 5.7
Current account, trade and investment income balances
(annual, percent of nominal GDP)



Source: Statistics New Zealand, RBNZ estimates.

The forecast in the widening current account deficit is a result of a growing imbalance between domestic saving and investment. As mentioned above, the household sector is forecast to reduce its rate of dissaving over the projection. Offsetting this, as business investment increases from its current low level, the net saving by the business sector will fall. The government sector ran a surplus over the first decade of the millennium, but moved into deficit as tax revenue fell and expenditure increased during the recession. According to *Budget 2010* this shortfall is expected to moderate through the projection (figure 5.8).

Figure 5.8
Estimated sectoral net lending
(annual, percent of nominal GDP)



Source: RBNZ estimates.

Consequently, some investment will require funding from overseas. Given the projected level of investment, a greater level of saving by the corporate or household sectors, or a faster rate of fiscal consolidation, will be required for the current account to narrow.

Labour market

As economic activity builds, more workers will be encouraged to enter the labour force. The shift from income to consumption taxes in *Budget 2010* is projected to encourage some workers to enter the labour force, providing a marginal increase to participation over the forecast. Further out in the projection, demographic trends are expected to lower aggregate participation as baby boomers begin retiring. But it is also possible that these workers will opt to delay retirement, which would result in higher participation than currently forecast.

The rebound in economic activity has already resulted in a turnaround in the labour market. Employment is expected to continue to grow over the projection, as firms initially rely relatively more on increased employment to boost production. Annual employment growth is expected to peak at 2.9 percent by the end of 2010. The unemployment rate is consequently projected to trend lower over the projection, settling around 4.7 percent (figure 5.9).

Figure 5.9
Unemployment rate
(seasonally adjusted)

Source: Statistics New Zealand, RBNZ estimates.

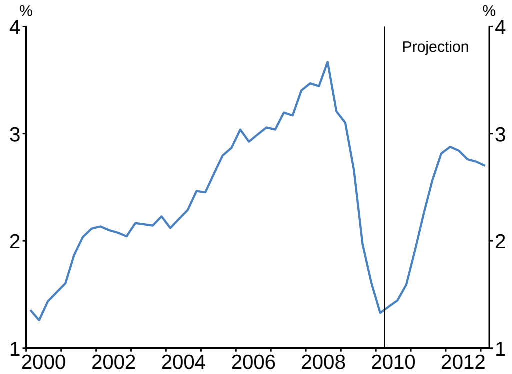
Inflation

Changes to indirect taxes and the inclusion of the stationary energy sector to the Emissions Trading Scheme will cause headline CPI inflation to diverge markedly from its medium-term trend level over the coming year or so. The extent to which monetary policy reacts to these increases will be governed by the extent to which inflation expectations and wage claims are affected.

Budget 2010 included reductions to personal tax rates that more than offset the effects of the increase in GST on real incomes. The GST increase is therefore assumed to have no effect on wage bargaining. Increases in other indirect taxes are assumed to have only a limited impact on inflation expectations.

As the labour market tightens and profitability increases over the forecast, wage inflation is expected to pick up from its current low level. Annual LCI inflation is projected to peak at 2.9 percent in early 2012 (figure 5.10).

Figure 5.10
LCI wage inflation
(annual)



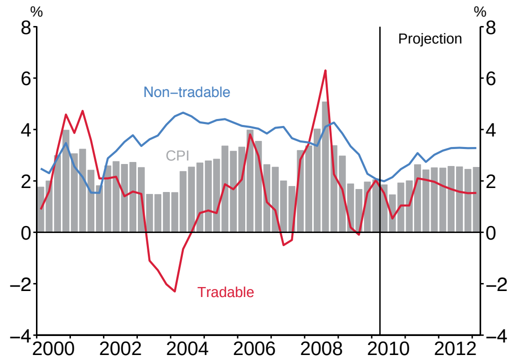
Source: Statistics New Zealand, RBNZ estimates.

Underlying tradable inflation is projected to average around 2 percent through the medium term as world prices increase and the exchange rate is assumed to depreciate.

The slack in the economy generated by the recession is expected to be eliminated by early 2011. Increased pressure on domestic resources will result in higher non-tradable inflation, reaching a little over 3 percent by the end of the projection.

The build-up in inflationary pressure is expected to be offset somewhat by the higher funding costs faced by financial institutions. The spread between wholesale rates and retail rates is expected to be high relative to levels common over the past decade. Consequently, annual CPI inflation excluding policy changes is projected to remain steady around 2.5 percent over the latter part of the projection (figure 5.11).

Figure 5.11
CPI, tradable and non-tradable inflation
(annual, excluding policy changes)



Source: Statistics New Zealand, RBNZ estimates. 'Excluding policy changes' is our CPI projection excluding the direct inflation impacts of the increase in the rate of GST, increases in the excise tax on tobacco and the incorporation of the stationary energy sector in the Emissions Trading Scheme.

Box B

Increased government charges and the CPI

Changes to indirect taxes and the implementation of the Emissions Trading Scheme (ETS) will cause headline CPI inflation to diverge markedly from its medium-term trend over the coming year or so. This box discusses the inflation impacts of the increase in the rate of GST, the implementation of the amended Emissions Trading Scheme and larger-than-normal increases in tobacco excise taxes. Other government charges will also add to inflation over the projection. However, these increases do not appear to be significantly larger than has been typical over recent years.

Tobacco excise

The excise taxes on cigarettes and loose tobacco were increased by 10 and 25 percent respectively in April 2010. Further increases of 10 percent each are planned for January 2011 and 2012. Each of these increases boosts CPI inflation by 0.2 percent once applied.

Emissions Trading Scheme

A charge will be applied to carbon emissions from the stationary energy sector from 1 July this year. Prices of fuel and electricity are expected to rise by between 3 and 8 percent, boosting CPI inflation by 0.3 percent. A similarly sized increase is planned for 1 January 2013. Inclusion of the industrial processing sector in the scheme is not expected to have a noticeable direct impact on consumer prices. See box B of the March 2010 *Statement* for a fuller explanation of the effect of the ETS on inflation.

GST

The rate of GST will rise from 12.5 percent to 15 percent on 1 October 2010, a price increase of 2.22 percent. This translates to only a 2.02 percent increase in CPI inflation as not all items in the CPI basket attract GST. In particular, rents, school donations and credit services are exempt from GST.

Table B1

Direct effects of selected increased government charges

Quarter		Cumulative contribution to annual CPI inflation	Contribution to quarterly CPI inflation	Drivers
2010	Jun	0.2	0.2	Tobacco excise
	Sep	0.6	0.4	Tobacco excise (0.1), ETS (0.3)
	Dec	2.6	2.0	GST
2011	Mar	2.8	0.2	Tobacco excise
	Jun	2.6		
	Sep	2.2		
	Dec	0.2		
2012	Mar	0.2	0.2	Tobacco excise

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
2002	Mar	0.8	0.6	2.6	51.6	5.0
	Jun	1.4	1.0	2.8	54.6	5.8
	Sep	1.2	0.5	2.6	53.9	5.9
	Dec	1.6	0.6	2.7	56.4	5.9
2003	Mar	0.4	0.4	2.5	60.6	5.8
	Jun	0.4	0.0	1.5	61.1	5.4
	Sep	1.8	0.5	1.5	62.4	5.1
	Dec	1.4	0.7	1.6	63.9	5.3
2004	Mar	1.5	0.4	1.5	66.8	5.5
	Jun	0.7	0.8	2.4	64.0	5.9
	Sep	0.4	0.6	2.5	66.3	6.4
	Dec	0.2	0.9	2.7	68.6	6.7
2005	Mar	1.1	0.4	2.8	69.6	6.9
	Jun	1.7	0.9	2.8	70.8	7.0
	Sep	0.5	1.1	3.4	69.7	7.0
	Dec	-0.2	0.7	3.2	71.5	7.5
2006	Mar	0.4	0.6	3.3	68.2	7.5
	Jun	0.0	1.5	4.0	62.8	7.5
	Sep	0.1	0.7	3.5	63.6	7.5
	Dec	0.3	-0.2	2.6	67.0	7.6
2007	Mar	1.4	0.5	2.5	68.8	7.8
	Jun	0.8	1.0	2.0	72.0	8.1
	Sep	0.7	0.5	1.8	71.4	8.7
	Dec	0.9	1.2	3.2	71.0	8.8
2008	Mar	-0.3	0.7	3.4	71.9	8.8
	Jun	-0.6	1.6	4.0	69.3	8.8
	Sep	-0.6	1.5	5.1	65.5	8.2
	Dec	-1.0	-0.5	3.4	57.8	6.3
2009	Mar	-0.8	0.3	3.0	53.7	3.7
	Jun	0.1	0.6	1.9	58.4	2.9
	Sep	0.3	1.3	1.7	62.6	2.8
	Dec	0.8	-0.2	2.0	65.5	2.8
2010	Mar	0.8	0.4	2.0	65.3	2.7
	Jun	1.1	0.5	2.0	66.0	2.9
	Sep	0.9	1.3	2.0	65.6	3.3
	Dec	0.9	2.2	4.5	65.4	3.7
2011	Mar	0.9	0.7	4.8	64.9	4.2
	Jun	1.0	1.0	5.3	64.4	4.6
	Sep	1.1	0.8	4.8	63.8	5.0
	Dec	0.6	0.3	2.9	63.3	5.3
2012	Mar	0.2	0.6	2.8	62.9	5.6
	Jun	0.6	1.1	2.8	62.3	5.8
	Sep	0.5	0.7	2.7	62.0	6.0
	Dec	0.4	0.2	2.6	61.7	6.1
2013	Mar	0.3	0.7	2.7	61.2	6.1

[1] Notes for these tables follow on pages 26 and 27.

Table B
Composition of real GDP growth

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

	Actuals							Projections			
March year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Final consumption expenditure											
Private	4.6	6.4	4.5	4.5	2.4	3.2	-1.1	0.5	2.2	1.2	0.8
Public authority	1.3	5.0	4.0	5.0	4.8	4.6	4.2	1.0	2.4	2.0	1.2
Total	3.9	6.1	4.4	4.6	2.9	3.5	0.1	0.6	2.2	1.4	0.9
Gross fixed capital formation											
Market sector:											
Residential	23.7	14.9	2.8	-5.3	-1.4	4.4	-22.6	-10.4	24.6	7.4	-0.8
Business	2.8	12.0	10.7	10.0	-1.7	8.4	-4.8	-10.1	6.6	12.5	7.1
Non-market government sector	14.4	14.3	13.6	3.1	-4.9	-14.5	17.9	-7.4	7.4	5.6	4.1
Total	7.8	12.8	9.0	6.0	-1.9	6.0	-7.1	-10.0	9.6	11.0	5.4
Final domestic expenditure	4.8	7.7	5.5	5.0	1.7	4.1	-1.7	-1.9	3.8	3.6	2.0
Stockbuilding [1]	-0.1	0.2	0.2	-0.5	-0.7	0.7	-0.2	-1.7	1.8	0.0	0.0
Gross national expenditure	4.7	7.8	6.0	4.7	0.8	5.1	-1.8	-3.7	5.6	3.6	2.0
Exports of goods and services	7.8	1.1	4.9	-0.1	2.9	3.0	-3.3	2.7	2.2	5.1	2.7
Imports of goods and services	7.0	12.9	12.4	4.2	-1.4	9.9	-4.6	-8.9	12.6	6.4	2.9
Expenditure on GDP	4.9	4.0	3.5	3.3	2.3	2.8	-1.3	0.2	2.2	3.1	1.9
GDP (production)	4.9	4.3	3.7	3.1	0.9	2.9	-1.4	-0.3	3.5	3.6	2.0
GDP (production, March qtr to March qtr)	4.7	5.2	2.4	2.4	1.7	2.1	-3.1	2.0	3.8	2.9	1.9

[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	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Price measures											
CPI	2.5	1.5	2.8	3.3	2.5	3.4	3.0	2.0	4.8	2.8	2.7
Labour costs	2.2	2.1	2.5	3.0	3.0	3.5	3.1	1.3	1.9	2.9	2.7
Import prices (in New Zealand dollars)	-10.7	-10.3	0.6	6.9	0.4	0.7	12.6	-11.1	6.6	8.8	6.9
Export prices (in New Zealand dollars)	-15.4	-5.0	5.0	3.5	4.6	12.3	7.1	-10.4	16.5	-0.9	3.3
Monetary conditions											
90-day rate (year average)	5.9	5.3	6.5	7.3	7.6	8.6	6.7	2.8	3.5	5.1	6.0
TWI (year average)	56.4	63.6	67.1	70.1	65.6	71.6	61.6	62.9	65.5	63.6	61.8
Output											
GDP (production, annual average % change)	4.9	4.3	3.7	3.1	0.9	2.9	-1.4	-0.3	3.5	3.6	2.0
Potential output (annual average % change)	3.3	3.2	3.0	2.6	2.2	1.9	1.7	1.7	1.9	2.1	2.2
Output gap (% of potential GDP, year average)	1.1	2.1	2.8	3.3	2.0	2.9	-0.3	-2.3	-0.7	0.8	0.6
Labour market											
Total employment (seasonally adjusted)	1.8	3.4	3.7	2.8	2.1	-0.2	0.7	-0.1	2.2	1.6	0.4
Unemployment rate (March qtr, seasonally adjusted)	5.0	4.3	3.9	4.0	3.9	3.9	5.1	6.0	5.5	4.6	4.8
Trend labour productivity	1.2	1.0	0.8	0.8	0.8	0.8	0.9	1.1	1.2	1.3	1.2
Key balances											
Government operating balance (% of GDP, year to June)	3.3	3.9	4.7	4.4	3.5	3.1	-2.1	-3.8	-3.9	-2.2	-2.4
Current account balance (% of GDP)	-3.4	-4.7	-6.7	-9.0	-8.0	-7.8	-7.8	-3.3	-4.1	-5.3	-7.2
Terms of trade (OTI measure, annual average % change)	-5.6	3.9	5.8	-0.8	1.8	7.8	3.2	-8.9	15.3	-5.5	-5.7
Household saving rate (% of disposable income)	-10.3	-9.7	-8.2	-12.8	-14.2	-11.0	-13.7	-11.9	-9.4	-7.0	-6.0
World economy											
Trading partner GDP (annual average % change)	3.2	3.5	3.7	3.8	3.8	4.2	0.3	1.0	4.1	4.1	4.4
Trading partner CPI (TWI weighted, annual % change)	2.2	1.4	2.1	2.5	1.9	3.3	0.9	1.7	1.2	2.2	2.1

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. *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 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*.
Real gross domestic income	The real purchasing power of domestic income, taking into account changes in the terms of trade. *System of National Accounts*.
Quarterly percent change	$(\text{Quarter}/\text{Quarter}_{-1} - 1)*100$
Annual percent change	$(\text{Quarter}/\text{Quarter}_{-4} - 1)*100$
Annual average percent 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 Reserve Bank staff during the projection round

Amalgamated Builders 2001 Ltd
Arthur Barnett Ltd
Auckland International Airport Ltd
Bay of Plenty Federated Farmers of NZ
C3 Ltd
Colliers International New Zealand Ltd
Council of Trade Unions
Crane Distribution New Zealand Ltd
Culham Engineering Ltd
CWF Hamilton & Co Ltd
Dunedin City Council
Electropar New Zealand Ltd
Environment Canterbury
Fletcher Building Limited
Fulton Hogan Ltd
Gallagher Group Limited
Gallaway Cook Allan
Gilmore Brown Ltd
Golden Bay Cement Ltd
H.G. Livingstone Limited
Hallenstein Glasson Holdings Ltd
Harcourts Group Ltd
Hayes Knight NZ Limited
Henderson Reeves Connell Rishworth
Hume Pine (NZ) Ltd
Jenkins Group Limited
Kathmandu Ltd
Lockwood Group Ltd
MacRennie Commercial Construction Ltd
Mainzeal Property & Construction Ltd
Marley New Zealand Ltd
McDowell Real Estate Ltd
McRaes Trading Ltd
Mighty River Power Ltd
Motor Trade Finances Ltd
National Aluminium Ltd
Northland Chamber of Commerce
OCG Consulting Ltd
Orion New Zealand Ltd
Paperplus New Zealand Ltd
Perry Group Ltd
PF Olsen Limited
Port of Tauranga Ltd
Ravensdown Fertiliser Co-operative Ltd
Real Estate Ltd
Rio Tinto Alcan New Zealand Ltd
Scott Technology Ltd
Sika Technology Limited
Silver Fern Farms Ltd
Skope Industries Ltd
Sky City Group Ltd
Solid Energy New Zealand Limited
Subaru of New Zealand Ltd
Tachikawa Forest Products (NZ) Ltd
Tauranga Mitre10 Mega Ltd
Tecpak Industries Ltd
Torpedo7 Ltd
Tidd Ross Todd Ltd
Waikato Chamber of Commerce & Industry
Watson Davies Transport Ltd
Zespri International Ltd

Appendix C
Reserve Bank statements on monetary policy

OCR unchanged at 2.5 percent

11 March 2010

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

Reserve Bank Governor Alan Bollard said: "The New Zealand economy is recovering broadly as expected and growth is predicted to pick-up further through 2010.

"Trading partner activity has recovered a little faster than expected. Currently, growth is strongest in China, Australia, and emerging Asia, but is much more muted in other trading partners. At the same time, risks around the global outlook have increased, although not to the extreme levels seen at the height of the crisis.

"We estimate the New Zealand economy grew at a stronger pace in the December and March quarters than in the prior two quarters. Looking forward, while growth is expected to increase to about 4 percent next year, this is subdued relative to previous recoveries.

"Policy stimulus and improved consumer confidence have seen a pick-up in household spending. That said, households are still cautious with house sales and credit growth remaining subdued. Business spending is weak despite much improved confidence.

"Annual CPI inflation is currently at 2 percent, and is expected to track within the target range over the medium term. In the short term, implementation of the amended Emissions Trading Scheme and increases in ACC charges will push CPI inflation toward the top of the target range.

"Higher bank funding costs have reduced the level of stimulus that would normally be associated with any given level of the OCR. We expect these costs to persist over the projection reducing the extent of future increases in the OCR. Fiscal consolidation would also help reduce the work that monetary policy might otherwise need to do.

"We continue to expect to begin removing policy stimulus around the middle of 2010."

OCR unchanged at 2.5 percent

29 April 2010

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

Reserve Bank Governor Alan Bollard said: "The New Zealand economy is recovering broadly as expected and growth is predicted to pick up further through 2010.

"Trading partner activity has recovered more quickly than we expected. Growth in Asia has been particularly strong. Consistent with this, export commodity prices have increased close to their 2008 peak. At the same time, risks to the global outlook remain elevated.

"Notwithstanding the impact of stronger than expected export earnings, New Zealand households remain cautious, with the housing market and household credit growth subdued. Similarly, business spending is weak and firms continue to reduce debt.

"On balance, we continue to expect the New Zealand economy to recover in line with or slightly faster than our March Statement projection. Annual CPI inflation, which has been close to 2 percent for the past year, is expected to track within the target range over the medium term.

"As previously indicated, we expect to begin removing policy stimulus over the coming months, provided the economy continues to evolve as projected.

"The increased wedge between the OCR and lending rates, as well as a steeply positive-sloped interest rate curve, is expected to make OCR increases more effective than in the past. Accordingly, these factors should reduce the extent to which the OCR will need to be increased relative to previous cycles."

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		
16 May 2001	5.75	8 December 2005	7.25		
4 July 2001	5.75	26 January 2006	7.25		
15 August 2001	5.75	9 March 2006	7.25		
19 September 2001	5.25	27 April 2006	7.25		
3 October 2001	5.25	8 June 2006	7.25		
14 November 2001	4.75	27 July 2006	7.25		
23 January 2002	4.75	14 September 2006	7.25		
20 March 2002	5.00	26 October 2006	7.25		
17 April 2002	5.25	7 December 2006	7.25		
15 May 2002	5.50	25 January 2007	7.25		
3 July 2002	5.75	8 March 2007	7.50		
14 August 2002	5.75	26 April 2007	7.75		
2 October 2002	5.75	7 June 2007	8.00		
20 November 2002	5.75	26 July 2007	8.25		
23 January 2003	5.75	13 September 2007	8.25		
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 2010:

2010	
Thursday 29 July 2010	OCR announcement
Thursday 16 September 2010	*Monetary Policy Statement* and OCR announcement
Thursday 28 October 2010	OCR announcement
Thursday 9 December 2010	*Monetary Policy Statement* and OCR announcement

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