Monetary Policy Statement

June 2011[1]

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

Contents

Appendices

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[1] Projections finalised on 27 May 2011. Policy assessment finalised on 8 June 2011.

1 Policy assessment

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

The outlook for the New Zealand economy has improved since the publication of the March *Statement*.

Economic activity has been significantly disrupted by the Christchurch earthquake. However, while many firms and households – particularly within Canterbury – continue to be adversely affected, it appears the negative confidence effect of the earthquake on economic activity throughout the rest of the country has been limited.

The early signs of recovery noted in the March *Statement* have continued. Despite some continuing signs of weakness in the world economy, commodity prices remain very strong and firms expect to increase their hiring and capital investment. Reconstruction in Canterbury is projected to add about 2 percentage points to GDP growth over 2012, and boost the level of activity for several years thereafter.

Despite the strong outlook for export earnings, household expenditure is expected to grow only modestly. Household debt remains very high and is expected to constrain retail spending and the housing market for some time. Continued fiscal consolidation will also act to dampen activity.

The New Zealand dollar has appreciated substantially over the past two months. This appreciation, supported by high export prices for primary producers, is negatively affecting other parts of the tradable sector, constraining rebalancing of the New Zealand economy.

Headline inflation is currently being boosted by recent increases in indirect taxes, food and petrol prices, and surveyed expectations of future inflation have edged up. Despite this, indicators of capacity usage and core inflation suggest underlying inflation remains constrained.

As GDP growth picks up, underlying inflation is expected to rise. A gradual increase in the OCR over the next two years will be required to offset this, such that CPI inflation tracks close to the midpoint of the target band over the latter part of the projection. The pace and timing of increases will be guided by the speed of recovery, but for now the OCR remains on hold.

Alan Bollard

Alan Bollard

Governor

2 Overview and key policy judgements

The March *Statement* was released at a time of significant uncertainty. Economic activity had undershot the Bank's forecasts for some time, and just as signs of recovery were emerging, Christchurch was struck by another devastating earthquake. In response, the OCR was reduced pre-emptively to help lessen the economic impact of the earthquake and guard against the risk of the economy slowing sharply.

National business and consumer confidence deteriorated markedly in the immediate aftermath of the earthquake. In Christchurch, retail activity declined and many firms applied for the Earthquake Support Subsidy. Passenger arrivals into Christchurch airport declined sharply, negatively affecting tourism throughout the South Island.

Since then, business confidence and consumer spending have recovered, suggesting the nationwide near-term negative effects of the earthquake have been contained. Within Canterbury, activity is likely to remain subdued due to wealth losses, weakness in tourism and construction, and damage to infrastructure and capital.

The early signs of recovery noted in the March *Statement* have continued. Export earnings continue to rise, firms continue to increase employment and investment, and household spending has increased. It seems probable that GDP increased modestly through the first half of 2011. Looking forward, the pace of growth is expected to increase. Strong global demand remains in place, with New Zealand's export commodity prices very high. Unlike the 2007/08 price spike, which was primarily due to high dairy prices, the current price rise is broad based, with most commodity exporters enjoying high prices. In addition, climatic conditions have been very favourable since December, substantially benefiting agricultural production.

Improved exporter earnings appear to be boosting the confidence of New Zealand firms more generally. Employment and investment intentions sit close to historical averages, suggesting a continued pick-up in hiring and capital investment. Indeed, imports of capital equipment remain well above their early 2010 low.

While the outlook is promising, continued strong export demand is by no means assured. The recent softening in global activity, although assumed to be temporary, could well prove more persistent. Japan is currently dealing with the aftermath of its own earthquake and subsequent tsunami. Significant uncertainty surrounds how long-lasting and severe the impact of disruption to Japanese manufacturing will be for global growth. In the United States, the need for fiscal consolidation could weigh on activity. In Europe, peripheral sovereign debt concerns could lead to a slowdown in Europe and the global economy more broadly. Recent sharp falls in global commodity prices certainly highlight the risk that agricultural commodity prices could moderate.

In addition, the New Zealand dollar has appreciated substantially over the past two months. The appreciation is acting to tighten monetary conditions, lowering the cost of imports and offsetting some of the strength in export demand. New Zealand non-commodity producers who compete with the United States, or with those countries that tie their currencies to the United States dollar, will be severely impacted by the extremely high level of the NZD/USD exchange rate. The resultant negative impact on net exports will inhibit rebalancing in the New Zealand economy. Due to the offsetting effects of the historically weak NZD/AUD, the New Zealand dollar TWI remains below its 2007 peak.

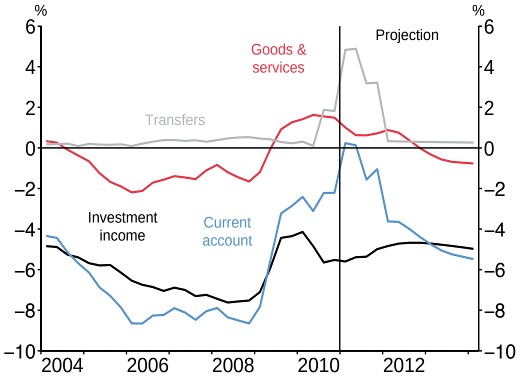
Turning to the outlook for household spending, consumer confidence remains subdued. Even so, retail spending appears to have increased in the March quarter, despite the negative impact of the earthquake on retail spending in Christchurch. Increased retail spending does fit with the recent upturn in house prices and tentative lift in housing turnover. It seems unlikely that consumer spending will continue to grow rapidly. Household debt remains very high and is expected to weigh on retail spending and the housing market throughout the projection.

Upcoming fiscal consolidation is also likely to weigh on consumer spending. The current large fiscal deficit is expected to be progressively eliminated over the next four years. Lower public sector employment growth and tighter eligibility for welfare payments will negatively affect household income growth.

Repairs and reconstruction in Canterbury will see construction sector activity increase markedly, adding to GDP growth. From early 2012, construction sector activity is expected to increase to a share of GDP last seen in the mid-2000s construction boom. Even at this elevated pace, full reconstruction could still take up to a decade to complete.

Substantial import volume growth has caused the trade balance to deteriorate over the past six months. Despite this, the annual current account is estimated to be in surplus. This reflects the accrual recognition of recent reinsurance payments that are boosting the annual current account balance by about 5 percentage points of nominal GDP. While export earnings are likely to increase further over the coming year, continued recovery in business investment and increased imports of building materials are expected to see the trade balance deteriorate further, such that the current account declines to a deficit of about 5 percent of nominal GDP over the latter part of the projection (figure 2.1).

Figure 2.1
Balance on current account
(annual, share of nominal GDP)

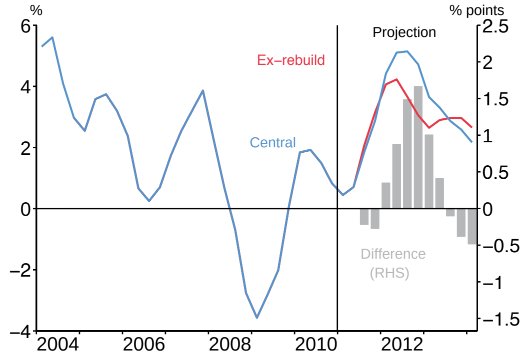


Source: Statistics New Zealand, RBNZ estimates.

GDP growth is expected to increase markedly over the coming year (figure 2.2). Canterbury reconstruction is projected to add about 2 percentage points to growth over 2012. Excluding reconstruction, GDP growth is forecast to still be quite robust, reflecting the stimulatory effects of current high export commodity prices.

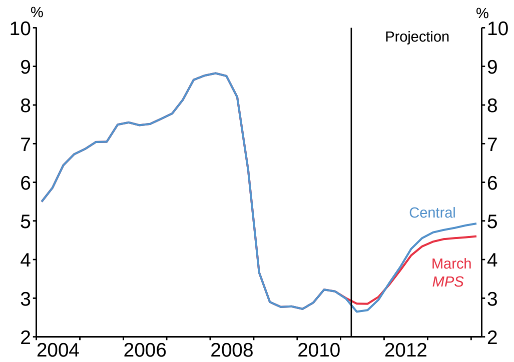
This growth is expected to eliminate current spare capacity over the coming year, causing underlying inflationary pressure to pick up. A gradual increase in interest rates over the next two years (figure 2.3) is expected to offset this, such that annual CPI inflation tracks close to the midpoint of the target band over the latter part of the projection. For now, annual CPI inflation continues to be boosted by recent increases in indirect taxes (figure 2.4). The recent increase in the rate of GST will also add to annual inflation in the June and September quarters of 2011.

Figure 2.2
GDP growth
(annual)



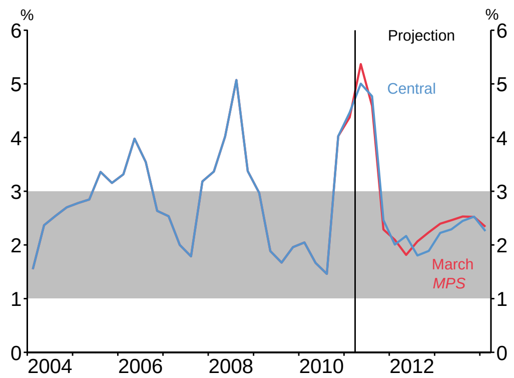
Source: Statistics New Zealand, RBNZ estimates.

Figure 2.3
90-day interest rate



Source: RBNZ estimates.

Figure 2.4
CPI inflation
(annual)



Source: Statistics New Zealand, RBNZ estimates.

Box A

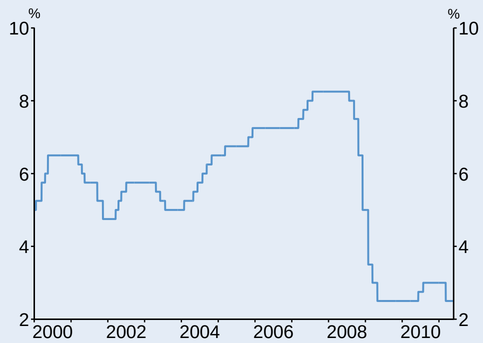
Recent monetary policy decisions

The March *Statement* was released soon after the Christchurch earthquake. While it was difficult to know just how large or how long-lasting the negative impact of the earthquake would be, it did seem clear that the disruption to normal business activity in Canterbury would be immense and likely to persist for some time. As such, the OCR was reduced pre-emptively to help lessen the economic impact of the earthquake and guard against the risk of the economy slowing sharply (figure A1).

Since then, business confidence and consumer spending have recovered, suggesting the nationwide near-term negative effects of the earthquake have been contained. The reduction in the OCR will have helped limit the negative economic effects of the earthquake. Within Canterbury, activity is likely to remain subdued due to wealth losses, weakness in tourism and construction, and damage to infrastructure and capital.

Figure A1

Official Cash Rate



Source: RBNZ.

Monetary policy judgements

The central projection, which underpins the Bank's policy outlook, relies on three key assumptions. These are that:

- construction cost inflation will be subdued relative to its mid-2000s peak;
- households will continue to focus on reducing debt; and,
- recent increases in surveyed inflation expectations will be short lived.

Substantial uncertainty surrounds the timing and magnitude of reconstruction in Canterbury. The central projection assumes reconstruction will begin early next year, causing building activity to increase sharply to a share of the economy last seen during the mid-2000s construction boom. Inevitably, construction costs will increase. Relative to the mid-2000s, however, construction cost inflation is expected to be relatively subdued. The localised nature of reconstruction will lead to some efficiency gains and the centralised management of rebuilding should limit cost pressures. Furthermore, economy-wide capacity pressures are unlikely to build to the same extent as in the mid-2000s.

It is possible that construction cost inflation turns out to be stronger than projected. International experience shows that reconstruction can sometimes be quite rapid following natural disasters. In terms of the influence on monetary policy, it is the pace of reconstruction and the resultant degree of pressure on resources, rather than eventual magnitude of rebuilding, that will have the greatest influence on construction cost inflation.

As discussed above, New Zealand's export commodity prices have risen substantially over the past year. These higher prices, along with a more generalised pick up in GDP growth, will provide a substantial boost to New Zealanders' incomes over the projection (see box B). A key judgement underlying the central projection is that despite higher incomes, New Zealanders continue to focus on reducing debt. Indeed, household debt remains very high and is expected to weigh on retail spending and the housing market throughout the projection. Reductions in public sector employment growth and eligibility for welfare payments are also likely to weigh on consumer spending over the projection.

Falling economic activity during the 2008/09 recession led to a fall in capacity pressures with many job losses and a decline in the utilisation rate of capital equipment, premises and machines. While employment and GDP have expanded since then, unemployment remains at a cyclical high and capital utilisation below average. It seems GDP growth has

Box B

The high terms of trade

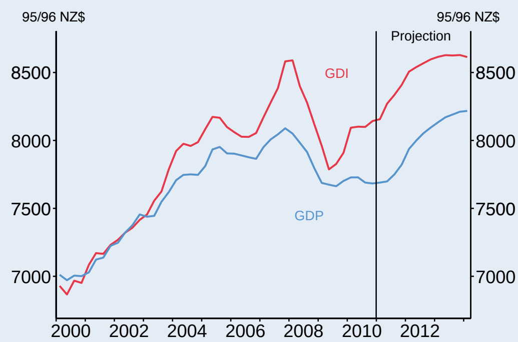
New Zealand's export commodity prices have increased substantially over the past year. Commodity prices in a number of key export markets have reached record levels, while the rise in New Zealand's import prices has been more subdued. This had led to a substantial improvement in New Zealand's terms of trade, which has risen to its highest level in almost four decades. The terms of trade is expected to remain elevated over the medium term, as export commodity prices are underpinned by income growth and urbanisation in Asia.

This rise in export prices represents a significant revenue gain for the New Zealand economy. Given current export volumes, a 1 percent rise in export prices boosts annual export revenue by about $440 million. Export prices increased by 6 percent over the past year.

Reflecting this increase in export prices and the resultant improvement in the terms of trade, real per capita Gross Domestic Income (GDI) has improved substantially. This is despite per capita GDP remaining relatively subdued (figure B1). Real GDI measures the purchasing power of GDP, given changes in the terms of trade.

In the near term, this growth in real incomes has allowed primary producers to pay down debt that was accumulated during the 2007/08 run-up in export commodity prices. Looking forward, the high terms of trade is expected to increasingly feed through to expenditure and support broader expansion in the economy. Improved profitability in the primary sector will facilitate a rise in investment and increased export volumes over the medium term. This increased activity will stimulate household and corporate incomes more generally.

Figure B1
Quarterly GDP and GDI per capita *(seasonally adjusted)*



Source: Statistics New Zealand, RBNZ estimates.

only just kept pace with growth in the population and the capital stock.

Despite this, some indicators of capacity suggest the degree of slack in the economy has reduced over recent quarters. Respondents to the *Quarterly Survey of Business Opinion* report surprising difficulty in finding staff given the still high rate of unemployment. From the same survey, the number of firms citing a lack of capital equipment as the main factor limiting production ticked up in March.

Furthermore, surveyed inflation expectations and indicators of firms' pricing intentions have picked up recently. The Bank's own survey of two-year-ahead annual inflation expectations spiked higher in the June quarter, rising to 3.0 percent. May's ANZ National Bank Business Outlook showed a similar increase in one-year-ahead annual inflation expectations, while longer dated AON Hewitt measures showed a less pronounced pick up. But even before the latest surveys, all these measures were quite inflated relative to the weakness seen in GDP growth.

As noted in the Governor's August 2010 speech, "Keeping inflation expectations anchored during economic recovery", the Bank has been monitoring inflation expectations even more closely since GST was increased in October 2010. It would be of concern if the recent pick up and relatively high level of surveyed inflation expectations persisted. The central projection assumes that the pick up reflects the current high level of headline CPI inflation, with surveyed expectations therefore likely to moderate over the coming year. However, the increase could also represent a more embedded increase. Heightened inflation expectations would limit the scope for monetary policy to absorb any upside inflation surprises.

For now, it remains appropriate for monetary policy to be supportive given the current softness of the economy and the inflated level of the New Zealand dollar. New Zealand's current positively sloped yield curve and the reduced duration of private debt enhances the efficacy of monetary policy.

3 Financial market developments

Overview

Financial markets have experienced significant volatility since the March *Statement*. The Japanese earthquake, disappointing economic data, renewed sovereign debt concerns in Europe and significant falls in commodity prices have created considerable uncertainty. Yields on government bonds in major economies have fallen as the momentum of global growth appears to have slowed and expectations of policy tightening have moderated.

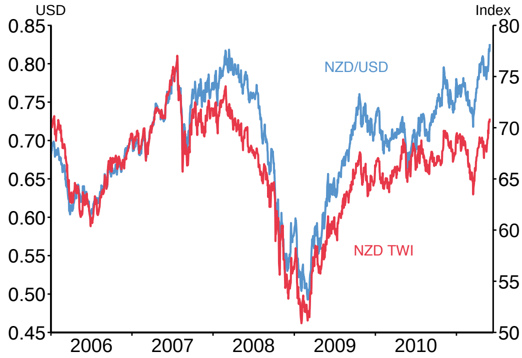
The New Zealand dollar has strengthened against all major trading partner currencies since the March *Statement*, supported by positive local developments and declines in other currencies. Meanwhile, financial markets continue to price a gradual increase in the OCR over the coming year, with the first increase expected around December. Domestic wholesale interest rates have risen since the March *Statement* despite declines in New Zealand government bond yields and falls in interest rates in key global funding markets.

Foreign exchange market

The New Zealand dollar has appreciated considerably since the March *Statement*. Strong agricultural commodity prices, encouraging local data and increased offshore demand for New Zealand government debt have provided support to the New Zealand dollar. In addition, weakness in the United States dollar and the euro has contributed to a higher New Zealand dollar, as the economic outlook for these economies has deteriorated and interest rates have declined. The New Zealand dollar recently reached a new post-float high against the United States dollar. However, it remains well below its 2007 peak on a trade-weighted basis (figure 3.1).

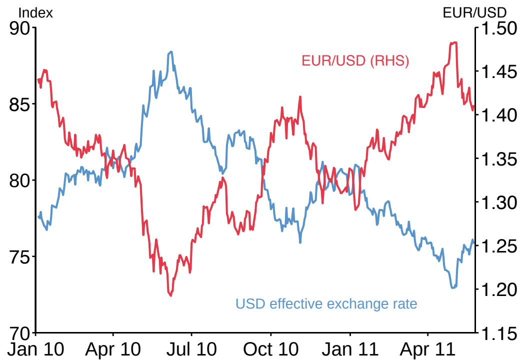
A recovery in investor risk sentiment following the Japanese earthquake saw the United States dollar decline to an almost three-year low in early May on a trade-weighted basis. However, the United States dollar has recovered recently as volatility in commodity markets and renewed focus on peripheral Europe have supported safe-haven currencies and seen the euro weaken considerably (figure 3.2). Throughout April, improvements in global risk sentiment and gains in commodity prices helped commodity-related currencies such as the Australian dollar, Canadian dollar and New Zealand dollar appreciate strongly. However, the recent falls in commodity prices have seen some of these gains reversed.

Figure 3.1
NZD/USD and the New Zealand dollar TWI



Source: Bloomberg, RBNZ.

Figure 3.2
USD effective exchange rate and the EUR/USD

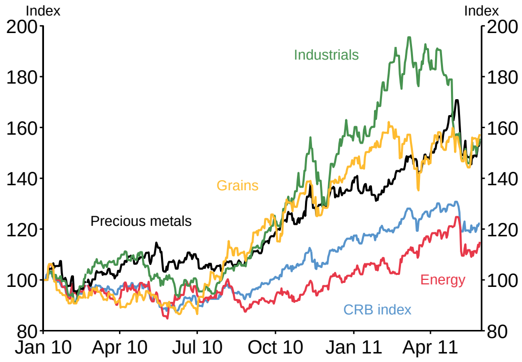


Source: Bloomberg, Bank of England.

International financial market developments

Commodity prices have traded over a wide range since the March *Statement*. After the lows reached following the Japanese earthquake, commodity prices rose strongly through March and April. Oil prices led the advances as investors became increasingly concerned about possible supply disruptions from political unrest in North Africa and the Middle East. Other commodity prices were supported by returning risk appetite as concerns about Japan reduced. Commodity prices fell sharply in early May, more than erasing the gains seen since early March. However, commodity prices remain highly elevated relative to the middle of 2010 (figure 3.3).

Figure 3.3
CRB commodity price indices



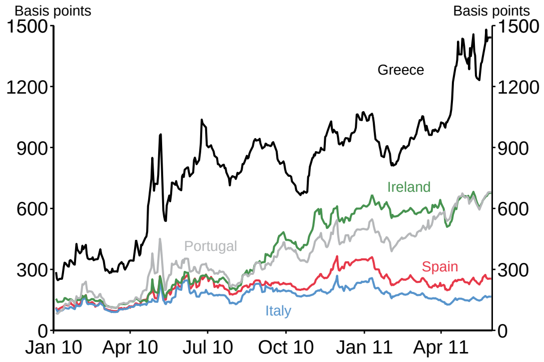
Source: Reuters.

Given the deterioration in global economic data, the recent correction in commodity prices is consistent with expectations of lower demand for commodities, but other factors may have also contributed. In the case of oil prices, market participants appear to have scaled back the risk premium associated with the recent geopolitical tensions in North Africa and the Middle East. The current risk of supply disruption to major oil producers is now seen as fairly low. In addition, increases in futures margin requirements at major exchanges in early May impacted the ability of commodity investors to fund positions, putting further downward pressure on prices.

Sovereign debt concerns in peripheral European economies have intensified since the March *Statement*, as illustrated by the moves higher in sovereign Credit Default Swap spreads (figure 3.4). Ratings downgrades for Ireland and Greece, the acceptance of an EU/IMF bailout by Portugal, and increasing speculation that Greek debt will be restructured, have ensured peripheral Europe remains a focus for market participants. In addition, concern about losses for banks if Greece's debt is restructured has added to market fears. However, investors are increasingly distinguishing Spain and Italy from other peripheral euro zone economies.

Government bond yields in major economies have declined since the March *Statement* as the global growth outlook has deteriorated and concern around peripheral

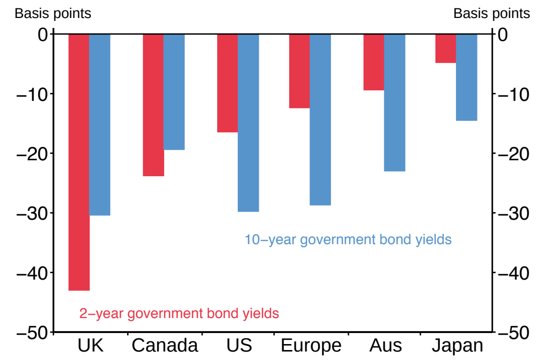
Figure 3.4
Sovereign 5-year credit default swap spreads



Source: Bloomberg.

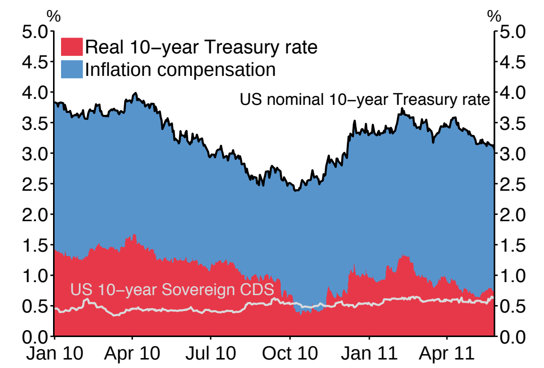
European sovereign debt has seen increased demand for safe-haven government debt (figure 3.5). The falls in United States Treasury yields have been driven by declines in both real interest rates and compensation for inflation (figure 3.6).

Figure 3.5
Changes in global government bond yields
(since the March Statement*)*



Source: Bloomberg.

Figure 3.6
Components of the 10-year US Treasury rate



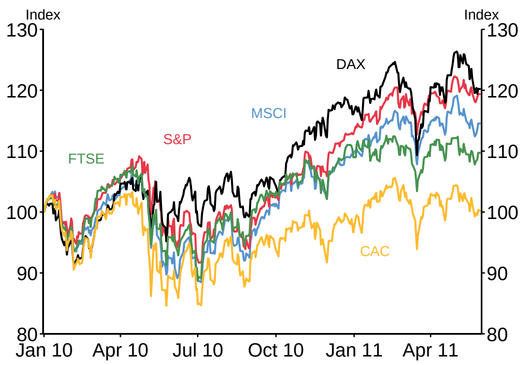
Source: Bloomberg.

The declines have occurred despite ratings agency Standard & Poors cutting the United States long term credit outlook to negative in late April amid increased anxiety around the size of the United States sovereign fiscal debt. To date, there has been no obvious impact on credit default swap spreads, which remain at low levels.

Bond yields have also been pressured lower by recent central bank commentary that policy rates in the United States, United Kingdom and euro zone will remain unchanged for longer than markets had expected. In contrast, central banks in emerging markets have continued to tighten monetary policy in response to rising inflation pressures since the March *Statement*. The People's Bank of China has continued its tightening cycle in recent months, raising reserve requirements for banks, hiking benchmark deposit and lending rates, and also allowing continued appreciation in the Renminbi.

Global equity markets have lost some momentum in recent months (figure 3.7). Disappointing economic data, ongoing sovereign debt concerns in Europe and significant falls in commodity prices have weighed on major equity markets since the March *Statement*. However, some support has come from strong corporate earnings and expectations of continued policy stimulus from the Federal Reserve.

Figure 3.7
Global equity prices
(1 January 2010 = 100)



Source: Bloomberg.

Domestic financial market developments

Local interest rates and market expectations regarding the potential for OCR increases have been pressured higher recently, in response to improving domestic data. Most wholesale short term interest rates have now returned to the highs seen in mid-April, despite continuing volatility in financial markets and falls in international interest rates. The Overnight Index Swap market has recently been pricing increases in the OCR of about 60 basis points over the next 12 months, with the first move occurring in December this year. Most analysts expect the first OCR increase to occur early next year.

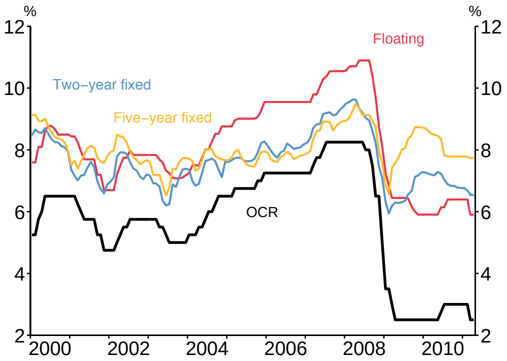
However, increased demand for New Zealand government debt has pushed government bond yields markedly lower since the March *Statement*, closing the gap to wholesale swap rates that has existed since mid-2010. Foreigners have shown particular interest in New Zealand government securities with a sharp increase in the level of non-resident holdings of government securities over the past year.

Financing and credit

Mortgage rates have remained unchanged since moving lower following the March *Statement*. The current positive slope of the mortgage curve has seen borrowers continue to favour floating rate mortgages (figure 3.8). In recent months, the proportion of borrowers on floating rates has continued to rise, reaching more than 50 percent at the end of April 2011. As a result, average mortgage duration is now less than six months, well below the previous lows seen in 2002 (figure 3.9). This suggests that increases in the OCR are likely to affect borrowers more quickly than during the previous tightening cycle.

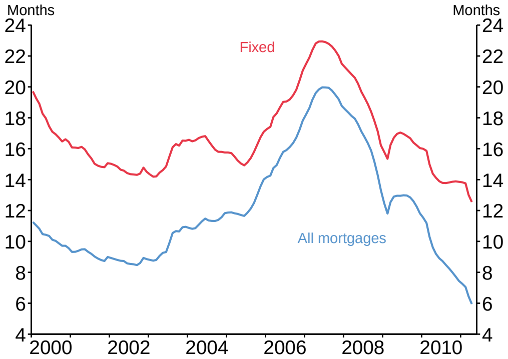
Recently, ratings agency Moody's downgraded the four major New Zealand banks by one notch, following an equivalent downgrade of their Australian parents due to their reliance on wholesale funding. There was very little market reaction to the news, suggesting it was largely expected and had already been reflected in interest rates.

Figure 3.8
Mortgage rates offered to new borrowers



Source: RBNZ.

Figure 3.9
Average mortgage duration

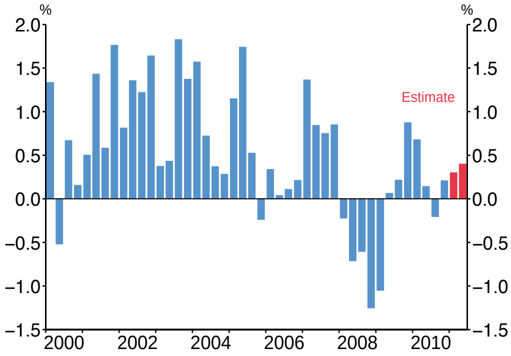


Source: RBNZ.

4 Current economic conditions

The pace of economic growth has lifted over recent months. Business investment and consumer spending are expanding, supported by ongoing trading partner growth and high export receipts. The spillover effects of the February 22 earthquake in Christchurch appear to have been limited, although considerable uncertainty remains about the extent of the disruption to national activity. The effect of the earthquake on business confidence was smaller than feared, and GDP looks to have expanded over the first half of 2011 (figure 4.1).

Figure 4.1
GDP growth
(quarterly, seasonally adjusted)



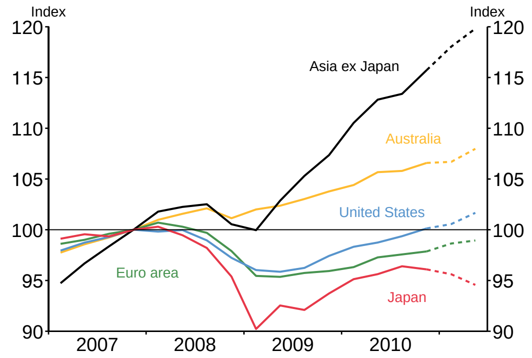
Source: Statistics New Zealand, RBNZ estimates.

The level of activity remains very weak, with GDP per capita well below its pre-recession peak. Measures of capacity are mixed, however, making it difficult to assess the degree of slack in the economy. Recent increases in inflation expectations may be consistent with increasing capacity pressures, but some measures of expectations are inconsistent with this view.

Activity in New Zealand's trading partners continued to increase through the end of 2010 and into 2011. Growth remained strong in the Asia-Pacific region, but has been slower in Western economies (figure 4.2).

The Asian region continues to grow strongly, driven by both robust domestic demand and solid external demand as the world economy recovers. Japan's 11 March earthquake and tsunami caused an immediate disruption to activity and disrupted some regional supply chains, as well as that to United States motor vehicle production. However, the overall effect of the earthquake on the Asian region is expected to

Figure 4.2
GDP by region
(2007Q4=100, seasonally adjusted, dashed lines represent estimates)



Source: Haver Analytics, RBNZ estimates.

have been relatively limited, with strong underlying growth continuing outside Japan.

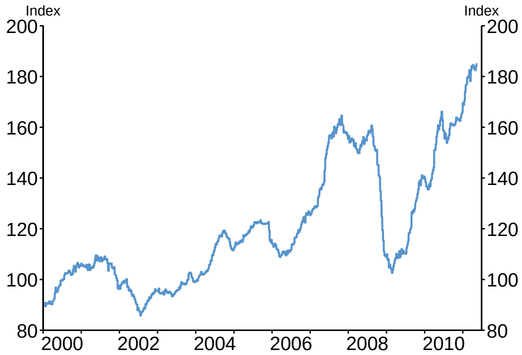
In Australia, a strong terms of trade and demand for commodities continue to support investment in the resource sector. The labour market remains tight, supporting growth in labour incomes, but spending in the household sector is still subdued. Australian output was impacted by severe flooding in January, which temporarily disrupted activity and led to ongoing disruption to mining operations.

Euro area activity continues to be supported by a strong German economy. Indicators of euro area industrial production have expanded, but weaker activity outside Germany means that euro area activity has not yet regained its pre-recession peak. Meanwhile, the pace of growth in the United States slowed through the start of 2011. Although the United States labour market has been improving, unemployment remains high.

Inflationary pressure has increased among New Zealand's trading partner economies. Capacity pressures are highest in the Asian region, prompting some monetary tightening. Monetary authorities in Europe and Australia have also expressed concern about the levels of inflation. High world inflation has been partly driven by rising food and commodity prices, but underlying inflation also appears strong, with core inflation rising in all regions. Increasing food and commodity prices raise some tension between inflation and growth objectives in Western economies, where excess capacity persists.

Rising international commodity prices have translated to elevated prices for New Zealand's commodity exports. Dairy, beef, lamb, forestry and aluminium prices have all risen markedly, with many prices above their 2008 peaks (figure 4.3).

Figure 4.3
New Zealand export commodity prices
(SDR terms)



Source: ASB Bank Ltd.

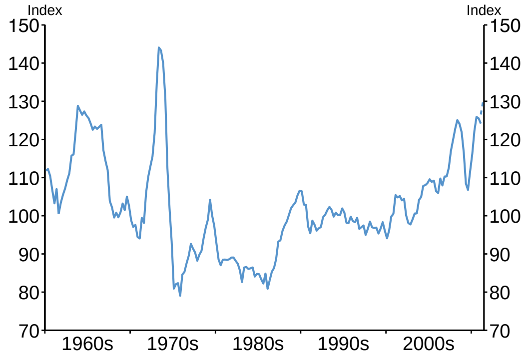
The elevated exchange rate has partly offset the increase in New Zealand's export commodity prices, but New Zealand dollar export prices remain at historically high levels.

High export prices have boosted New Zealand's terms of trade. Import commodity prices have increased, with crude oil prices rising sharply over the past year. These are partly offset by imported manufactured goods prices, which continue to track sideways. As a result, elevated international commodity prices have had a more marked effect upon New Zealand's export prices than import prices. At the end of 2010 the terms of trade reached its highest level since the 1970s, and is estimated to have increased further over the start of 2011 (figure 4.4).

The increase in New Zealand's export prices has been accompanied by solid growth in goods export volumes. Exports of primary produce continue to be boosted by robust demand from Asia, and log export volumes are increasing particularly strongly in response to high prices. As a result, merchandise export receipts have increased rapidly since 2009, generating an impetus that continues to underpin growth in the economy.

Services exports, on the other hand, remain very subdued. Despite increased visitor arrivals, the tourism industry has experienced little relief since the end of the

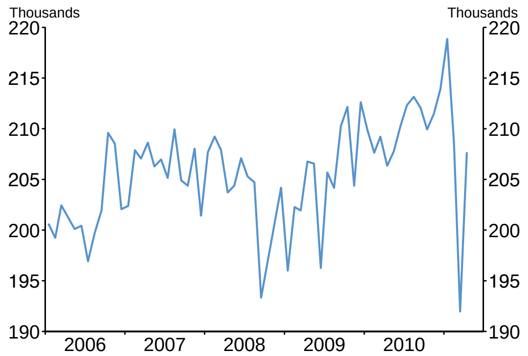
Figure 4.4
OTI terms of trade (goods)
(seasonally adjusted, dashed lines represent estimates)



Source: Statistics New Zealand, RBNZ estimates.

recession, and it is estimated that the volume of services exports has not yet troughed. Tourism appears to be the industry most severely affected, nationwide, by the short-term disruption of the February earthquake. International visitors were hesitant about coming to New Zealand in the immediate aftermath of the earthquake. A sharp fall in visitor arrivals following the earthquake was partly recovered in April (figure 4.5).

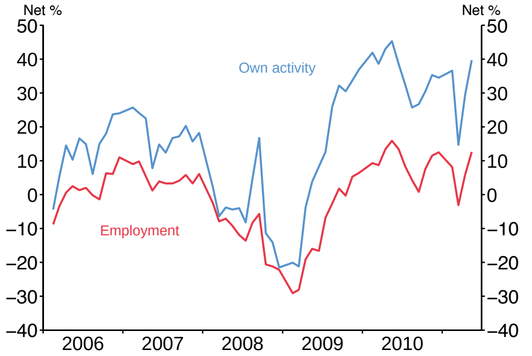
Figure 4.5
Short-term visitor arrivals
(seasonally adjusted)



Source: Statistics New Zealand

The February earthquake also adversely affected business confidence. Business surveys registered a large fall in confidence immediately after the earthquake. However, high-frequency surveys show a subsequent recovery in many measures of business confidence both inside and outside Canterbury, suggesting that the spillover effects of the earthquake on national activity are relatively contained (figure 4.6).

Figure 4.6
Business expectations
(next 12 months)

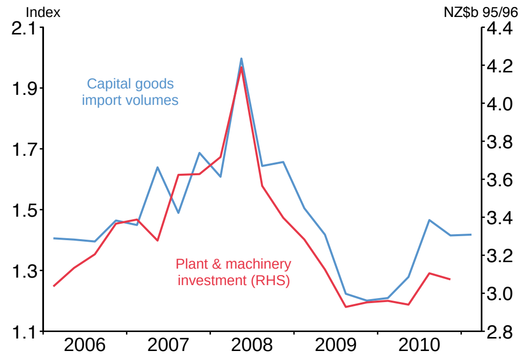


Source: ANZ National Bank Ltd.

Considerable uncertainty remains around the degree to which activity has been disrupted by the earthquake, both within Christchurch and nationally. Although aggregate indicators point to reasonable nationwide growth in many sectors of the economy, there is a risk that indicators have failed to fully capture the effects of earthquake disruption.

Business investment is starting to expand, having remained low since the end of the recession. Capital goods imports have increased strongly over the past year and remain firm (figure 4.7). Importing will have been encouraged by the elevated level of the exchange rate.

Figure 4.7
Capital goods import volumes and investment in plant and machinery
(seasonally adjusted)

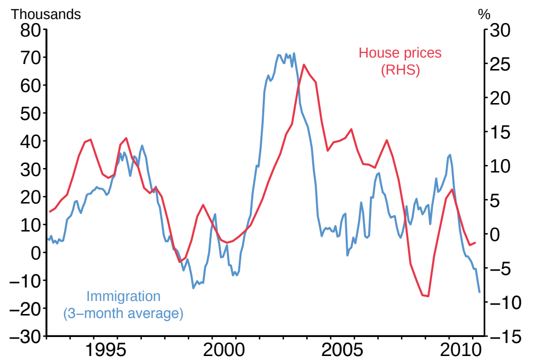


Source: Statistics New Zealand, RBNZ estimates.

Some of the increase in investment is likely to be catch-up to compensate for depreciation during the period of low investment, and some may be related to replacement of capital equipment damaged in the Canterbury earthquakes. However, there is also reason to believe there has been a fundamental pick-up in investment. Elevated export receipts have increased firms' profit expectations, and this is likely to have translated into an increased willingness to invest.

Consumer spending has expanded, with the value of electronic card transactions increasing strongly in recent months. Supporting this strength in consumer spending are signs that the housing market has troughed. House prices and sales have both been increasing since late 2010. Nonetheless, house price inflation still appears somewhat elevated relative to net migration (figure 4.8). A moderation in house price inflation, consistent with low net migration, would imply weak consumption going forward.

Figure 4.8
Net total immigration and house price inflation
(annual)

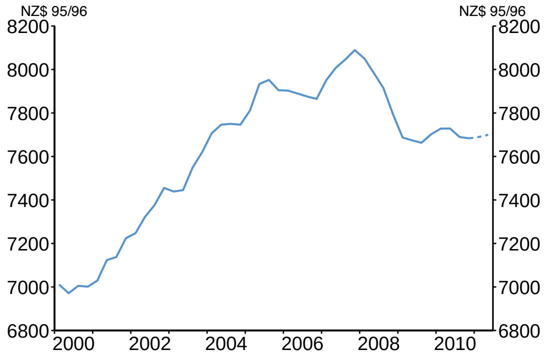


Source: REINZ, Statistics New Zealand, RBNZ estimates.

Recovery in the labour market is providing some support to consumer spending. Improvements in economic conditions in late 2010 and early 2011 have led to solid growth in employment, as well as in hours worked outside Canterbury. While February's earthquake did have a pronounced impact on labour market conditions in Canterbury, it appears many of those whose employment was disrupted have now returned to some form of employment. Indeed, the number of people claiming the unemployment benefit has held steady even as the Earthquake Support Subsidy has been phased out.

Although parts of the economy are expanding, the level of activity remains weak, with GDP per capita remaining near its recessionary low (figure 4.9). However, indicators of excess capacity are mixed, with some suggesting that there is less slack in the economy than might be expected given this weak activity picture.

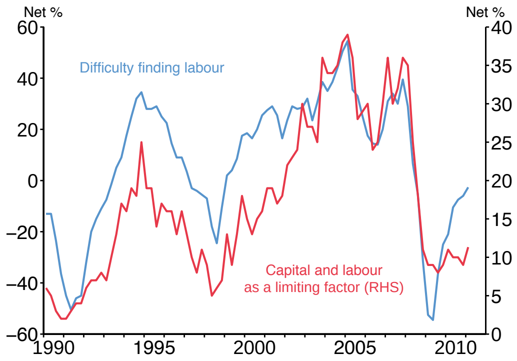
Figure 4.9
Real GDP per capita
(seasonally adjusted, dashed lines represent estimates)



Source: Statistics New Zealand, RBNZ estimates.

Business surveys highlight increasing capacity pressures. The difficulty of finding labour has increased rapidly since the trough of the recession and is now halfway back to its previous peak. At the same time, capacity has edged higher as the main reason survey respondents give for being unable to increase output, although this measure is still near its trough (figure 4.10).

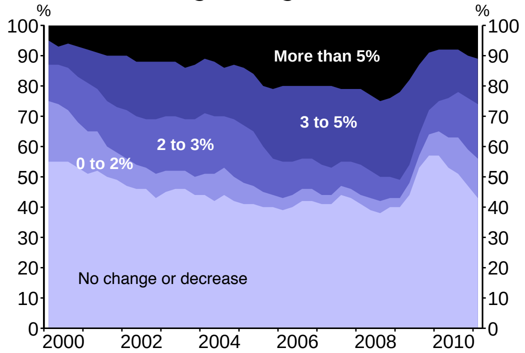
Figure 4.10
Survey measures of capacity pressures



Source: NZIER.

Despite an increase in the surveyed difficulty of finding labour, the unemployment rate lingered up at 6.6 percent in the March quarter. In line with this apparent excess capacity in the labour market, wage inflation has remained contained. However, there are signs that underlying wage pressures have started to lift. In the March quarter, the proportion of wages left on hold declined, while the number of settlements for a 2 or more percent increase has picked up (figure 4.11).

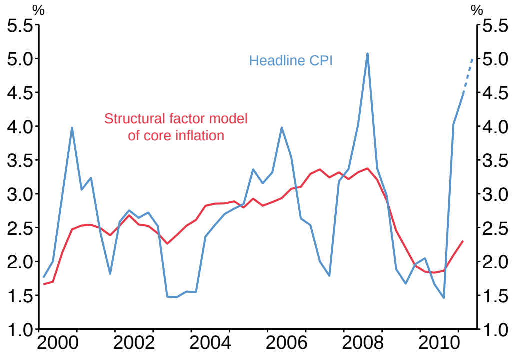
Figure 4.11
Distribution of wage changes



Source: Statistics New Zealand.

Consistent with some increase in capacity pressures, core inflation has increased in recent quarters. There are a number of ways to estimate core inflation. The structural factor model approach considers the extent to which CPI items move together in any given quarter.[1] This approach, adjusted to exclude the estimated effect of the increase in the rate of GST in the December quarter, points to core inflation above 2 percent for each of the previous two quarters (figure 4.12).

Figure 4.12
Core and headline CPI inflation
(annual, dashed line represents estimates)



Source: Statistics New Zealand, RBNZ estimates.

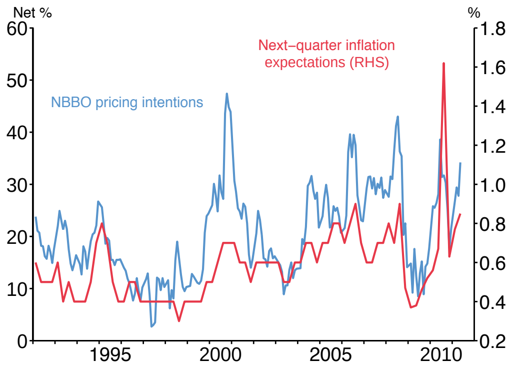
1 Kirker, Michael. What drives core inflation? A dynamic factor model analysis of tradable and nontradable prices. Reserve Bank of New Zealand. DP 2010/13. http://rbnz.govt.nz/research/discusspapers/dp10_13.pdf

Headline inflation is currently elevated. The October 2010 increase in the rate of GST was a key factor behind this. Other short-term factors have led to further increases in inflation, with the CPI rising 0.8 percent in the March quarter 2011. These short-term factors including increases in the tobacco excise and petrol prices. Excluding these factors, the CPI would have increased by around 0.1 percent in the March quarter.

Rising petrol and food prices are estimated to have increased inflation further through the middle of 2011. These influences are expected to reduce by the end of the year, allowing the rate of inflation to fall to well within the target band.

High world commodity prices, a tightening labour market, and increasing capacity pressures are currently potential sources of inflationary pressure. Consistent with increasing inflationary pressure, surveyed pricing intentions have risen in recent months. This has occurred alongside an increase in near-term inflation expectations in the Reserve Bank's Survey of Expectations, which surveys business expectations (figure 4.13).

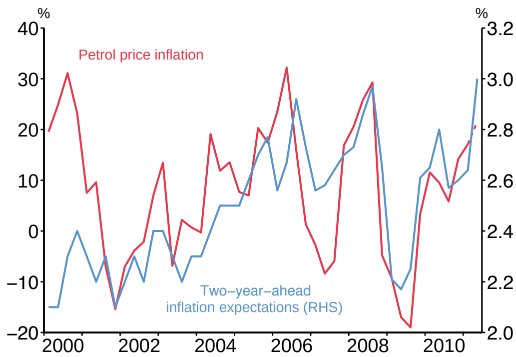
Figure 4.13
Pricing intentions and quarterly inflation expectations
(next three months)



Source: ANZ National Bank Ltd, RBNZ.

Longer-term measures of inflation expectations have also increased. Expectations measures are sensitive to the observed level of headline inflation as well as some highly visible prices, particularly petrol prices. The level of inflation is currently elevated as a result of the increase in the rate of GST in the December quarter. While it is unlikely that the GST increase would be driving expectations six months after the fact, it is possible that the high level of headline inflation is having some influence upon expectations. The increase in businesses' inflation expectations may also be related to recent large increases in petrol prices (figure 4.14).

Figure 4.14
Inflation expectations and petrol price inflation
(annual, dashed line represents estimates)



Source: Statistics New Zealand, RBNZ estimates.

Household inflation expectations might be expected to be easily affected by rising petrol prices and high headline inflation. However, they show no sign of being displaced at present, having held steady at both short and long horizons in the June 2011 survey.

Table 4.1

Measures of inflation and inflation expectations

(annual)

	2009		2010				2011	
	Sep	Dec	Mar	Jun	Sep	Dec	Mar	
CPI	1.7	2.0	2.0	1.7	1.5	4.0	4.5	
CPI components								
CPI non-tradable	3.0	2.3	2.1	2.2	2.5	4.6	5.2	
Non-tradables housing component	0.6	0.8	1.2	1.4	1.7	2.7	2.8	
Non-tradables ex housing, cigarettes and tobacco component	4.2	2.9	2.6	2.2	2.1	4.8	5.1	
CPI tradable	-0.1	1.5	2.0	1.0	0.3	3.3	3.7	
Petrol	-19.0	3.3	11.5	9.5	5.8	14.2	17.1	
Other inflation measures								
Factor model estimate of core CPI inflation	2.0	2.0	2.0	2.0	2.0	3.0	3.1	
Structural factor model estimate of core CPI inflation (ex GST)	2.2	1.9	1.8	1.8	1.9	2.1	2.3	
CPI trimmed mean (of annual price change)	2.0	2.2	2.3	1.8	1.7	3.9	4.2	
CPI weighted median (of annual price change)	2.8	2.2	1.7	1.3	1.6	3.2	3.3	
CPI ex food, petrol and government charges	1.9	1.7	1.3	1.4	1.0	2.8	3.1	
CPI ex food and energy	2.5	2.1	1.7	1.7	1.4	3.1	3.3	
GDP deflator (derived from expenditure data)	0.9	-1.6	0.1	1.5	2.5	5.3	n/a	
	2009		**2010**				**2011**	
	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
Inflation expectation measures								
RBNZ Survey of Expectations - inflation one-year-ahead	1.8	2.1	2.1	2.9	3.9	3.4	2.9	3.1
RBNZ Survey of Expectations - inflation two-years-ahead	2.3	2.6	2.7	2.8	2.6	2.6	2.6	3.0
AON Hewitt Economist survey - inflation one-year-ahead	1.7	1.6	2.2	3.4	5.0	4.3	2.6	3.0
AON Hewitt Economist survey - inflation four-years-ahead	2.5	2.4	2.5	2.5	2.6	2.5	2.4	2.6
NBBO - inflation one-year-ahead (quarterly average)	2.6	2.6	2.6	2.8	3.1	2.9	3.0	n/a

5 The macroeconomic outlook

Overview

GDP growth is expected to increase over the coming year. Growth in New Zealand's trading partner economies, strength in export commodity prices, and further recovery in investment appetite among firms underpin this outlook. In addition, reconstruction in Canterbury will create jobs and add to resource pressures. However, household spending is expected to increase at only modest rates. Underlying inflationary pressure is expected to increase, but headline CPI inflation is expected to settle within the target band over the medium term.

International economic projection

Growth in New Zealand's trading partners is expected to continue. While the impact of flooding in Australia and Japan's earthquake will moderate growth in the near term, the rebuild associated with these disasters will provide a boost to aggregate growth over the medium term.

Growth in the Asian region is supported by strong domestic demand, as well as growing external demand as the world economy continues to recover. Some policy-induced slowing is expected in the region, particularly in China. Risks appear balanced between reheating and a slowdown in the region.

In Australia, despite near-term weakness associated with the January floods, the medium-term outlook remains positive. Investment in the resource sector is expected to remain the main driver of growth, with flow-on benefits to business services sectors. Household spending is expected to remain relatively subdued in light of weakness in the housing market and the expected resumption of monetary tightening by the Reserve Bank of Australia.

Growth is expected to continue in Western economies at around trend pace. Concerns about sovereign debt levels will continue to motivate fiscal consolidation efforts through European economies as well as in the United States. This fiscal consolidation is likely to weigh on medium term growth in the United States and will underpin continued uneven growth performance across the euro area.

Moreover, some peripheral European countries are coming under increasing pressure to restructure debt. This increases the risk of financial spillovers to the wider euro area that could impact severely on growth outcomes for many European countries and further fuel the need for fiscal consolidation. The Bank continues to monitor events in the euro area closely.

Headline inflation in New Zealand's trading partners is expected to moderate through the second half of 2011 and into 2012. This is because of a stabilisation in food price inflation and because of continued policy tightening in some regions (particularly, in Asia-Pacific economies). However, while headline inflation is expected to ease, core inflation is expected to be relatively resilient, with elevated input costs and the ongoing recovery in global demand limiting the downside for prices.

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

Country	2004	2005	2006	2007	2008	2009	2010	2011f	2012f	2013f
Australia	3.8	3.1	2.6	4.6	2.6	1.3	2.7	2.9	4.0	3.6
Asia ex-Japan*	7.2	6.5	7.2	7.9	4.4	2.1	8.9	6.7	6.8	6.6
United States	3.6	3.1	2.7	1.9	0.0	-2.6	2.9	2.8	3.3	3.0
Japan	2.7	1.9	2.0	2.3	-1.2	-6.3	4.0	0.0	3.2	3.2
Euro area	1.9	1.8	3.2	2.8	0.3	-4.0	1.7	2.0	1.7	1.8
United Kingdom	3.0	2.2	2.8	2.7	-0.1	-4.9	1.3	1.7	2.2	2.2
16 Country Index	4.1	3.6	3.8	4.3	1.8	-0.8	4.6	3.8	4.6	4.3

Source: Haver Analytics, RBNZ estimates
* Includes China, Hong Kong, Indonesia, Malaysia, the Phillipines, Singapore, South Korea, Taiwan, Thailand and Vietnam.

Domestic projection

External sector

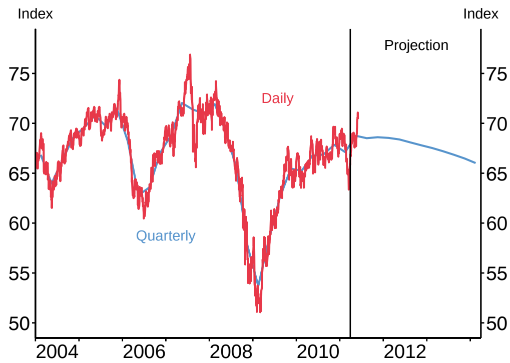
New Zealand's commodity export prices are projected to remain elevated over the forecast horizon, providing a key support to activity (figure 5.1). In the near term, agricultural prices could fall slightly as supply becomes less weather-disrupted. However, demand is supported by income growth and urbanisation through Asia, trends likely to persist for some time.

Figure 5.1
OTI export prices (goods)
(seasonally adjusted)

Source: Statistics New Zealand, RBNZ estimates.

Offsetting these high world export prices somewhat, the New Zealand dollar TWI remains elevated. The TWI is assumed to remain around current levels over the coming year and thereafter depreciate only gradually (figure 5.2). This gradual decline reflects the projected slight deteriorating in the terms if trade, along with an eventual rise in global interest rates.

Figure 5.2
New Zealand dollar TWI

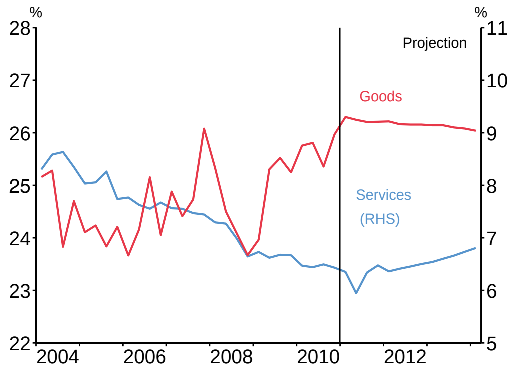


Source: RBNZ estimates.

New Zealand's aggregate export volumes are expected to grow in line with the overall economy, despite favourable export prices (figure 5.3).

- Agricultural export volumes have recently increased, with particular strength in dairy and forestry. Over the projection, however, biological and land constraints imply the scope for agricultural export volume growth is likely to be limited to productivity-driven increases.
- Manufacturers' export volumes are expected to remain reasonably strong, given a favourable outlook for the Australian economy and historically low NZD/AUD bilateral exchange rate.
- Conversely, services exports, although likely to increase slightly over the coming years, still remain at weak levels relative to the past decade. Natural disasters both here and abroad are likely to suppress visitor arrivals. The Rugby World Cup later in the year will see a pick-up in tourist spending. However, the weak state of consumer spending in Northern Hemisphere economies weighs on the outlook further ahead, with visitors from these regions typically higher spending than from Asia-Pacific countries.

Figure 5.3
Export volumes
(share of potential GDP, seasonally adjusted)

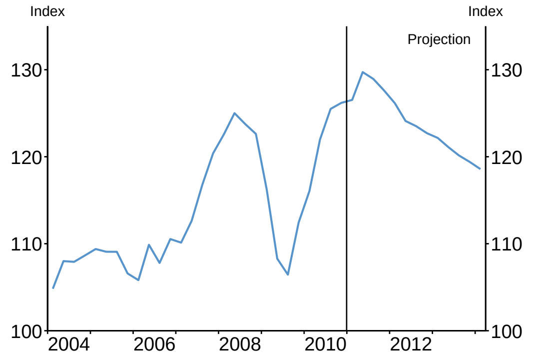


Source: Statistics New Zealand, RBNZ estimates.

With limited volume response, the benefit of strong external demand is expected to be reflected through high export prices. Indeed as discussed in Chapter 4, New Zealand's terms of trade is estimated to be at a four-decade high. As the global economy recovers, import prices are expected to increase roughly in line with global inflation. This will see the terms of trade moderate somewhat (figure

5.4). Nevertheless the terms of trade is expected to remain very high over the entire projection.

Figure 5.4
OTI terms of trade (goods)
(seasonally adjusted)



Source: Statistics New Zealand, RBNZ estimates.

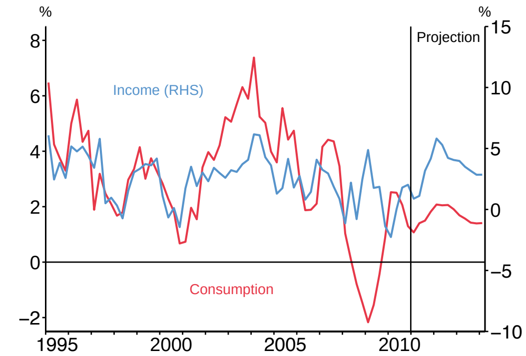
Business and household sectors

An improving profit outlook, particularly for export-oriented firms, is one factor that will likely see business investment increase from current low levels. Capital goods are also likely to be relatively cheap, given the above-average level of the exchange rate. As activity recovers, the labour market is expected to tighten and difficulty finding skilled staff increase, which will also encourage firms to increase capital expenditure.

Conversely, households are not expected to increase spending at a rapid pace. Households have accumulated a significant amount of debt over past decades, and are expected to undertake a period of consolidation. This implies that consumption growth is likely to be modest, both relative to recent history and when compared to the projected increase in real labour incomes (figure 5.5).

This judgement around household spending is a key difference between the Bank's projections and that of many external forecasters. Real consumption is expected to return to the share of the economy seen prior to the years of strong consumption growth in the mid-2000s. However, more unusually, this is expected to occur at a time when the terms of trade is very strong, so that nominal GDP is growing quite rapidly.

Figure 5.5
Real earnings and consumption spending
(seasonally adjusted)

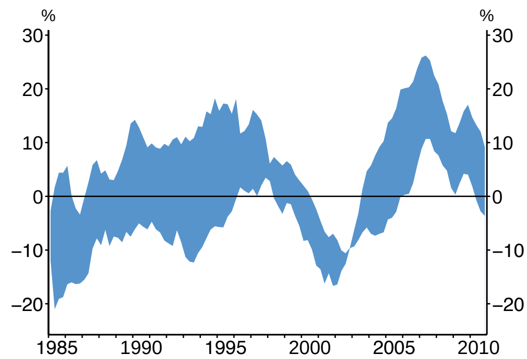


Source: Statistics New Zealand, RBNZ estimates.

Such an adjustment in household behaviour is needed to see household debt stabilise, but whether it eventuates remains uncertain. The Bank will be monitoring this closely. Recent fiscal policy changes (discussed further below) may increase the likelihood of conservative household spending. In addition, projected interest rate increases will tend to reduce consumption.

Consistent with subdued consumption, house prices are likely to increase only modestly over coming years. A number of in-house statistical models suggest that house prices continue to be overvalued when compared to metrics such as nominal GDP or rental yields (figure 5.6). As a result, house price increases are expected to be at or below the rate of inflation over the projection.

Figure 5.6
House price overvaluation according to statistical models
(seasonally adjusted)



Source: RBNZ estimates. The shaded area represents the range of estimates of house price under or overvaluation according to three statistical models developed at the Bank. These are based on variables including nominal GDP, population growth, mortgage rates and rental yields.

Box C

Reconstruction in the Canterbury region

The earthquakes in Canterbury have had a significant effect on the lives of many New Zealanders, as well as causing substantial damage and disruption. These events will continue to have a pronounced impact on the economy for several years. This box summarises the Bank's assumptions regarding the reconstruction process.

Cost of reconstruction

The Bank's working assumption for the total cost of reconstruction is $15 billion (around 8 percent of nominal GDP). This represents reconstruction of approximately $9 billion of residential property, $3 billion of commercial property, and $3 billion of damaged infrastructure.[1] This assumption is unchanged since the time of the March *Statement*. In part, this is because of the ongoing uncertainties that surround the reconstruction process. Damage is widespread and, in many cases, severe. It will take some time before precise estimates of the extent of damage are available and it is inevitable that the estimated cost of reconstruction will be revised over time. The limited information that has become available since the previous *Statement* (such as the results of the Earthquake Commission rapid assessment programme) indicates that the March *Statement* assumptions remain reasonable at this stage.

Timing of reconstruction

Emergency repairs have begun and will continue for some time. However, large-scale reconstruction is not expected to begin until 2012. Substantial demolition and land remediation is still necessary. Additionally, detailed assessment and planning processes will be required.

When reconstruction does commence, it will initially boost residential investment and essential infrastructure spending. Residential investment will rise to an elevated share of the economy's potential level of output, similar to the levels seen during the mid-2000s construction boom. At this assumed rate of work, residential reconstruction is completed in five to six years.

A more gradual increase in commercial building is assumed, such that non-residential reconstruction continues beyond 2020.

Effects on prices and wages

Some increases in prices can be expected as a result of the earthquakes. Of note are the costs of construction, insurance and rents.

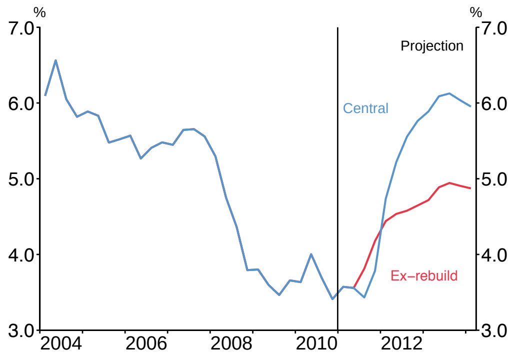
- Construction costs account for 5.5 percent of the CPI. Over the coming years reconstruction will absorb excess labour and capacity in the construction sector, resulting in a period of above-average increases in building costs. There are also likely to be increases in construction sector wages. Pressure on prices will be centred on the Canterbury region. However, given the extent of reconstruction required, there is a risk that construction costs could rise by more than assumed.
- There will be upward pressure on rents for residential and commercial buildings in Canterbury during the reconstruction period. Private rents account for 7.9 percent of the nationwide CPI.
- Insurance premiums for dwellings, contents and vehicles (accounting for around 0.4 percent of the CPI) are also expected to rise as the international cost of reinsurance increases. Such increases will not be limited to Canterbury.

Given the timeframe necessary for reconstruction, generalised pressure on prices will persist for several years.

1 This amount reflects the estimated costs of repairs and reconstruction. It does not include policy responses by central Government such as employment support packages.

Although the residential property market for existing houses is expected to remain subdued, reconstruction in Canterbury will generate significant new building activity. Residential construction is projected to rise to a share of the economy last seen during the mid-2000s construction boom (figure 5.7). Even at this elevated pace, given the assumed amount of rebuild required, residential reconstruction would continue for five to six years. In addition, there will also be a significant amount of work to repair damage to infrastructure and commercial buildings in the Canterbury region. There continues to be a substantial amount of uncertainty around these estimates (see box C).

Figure 5.7
Residential investment
(share of potential GDP, seasonally adjusted)



Source: Statistics New Zealand, RBNZ estimates.

The increase in investment and reconstruction activity over the projection is expected to be import intensive. Accordingly, despite the very favourable level of the terms of trade, the goods and services balance is expected to deteriorate gradually over the coming years. This implies that once re-insurance inflows drop out of the annual measure, the current account will worsen to an annual deficit of about 5 percent of nominal GDP over the latter part of the projection.

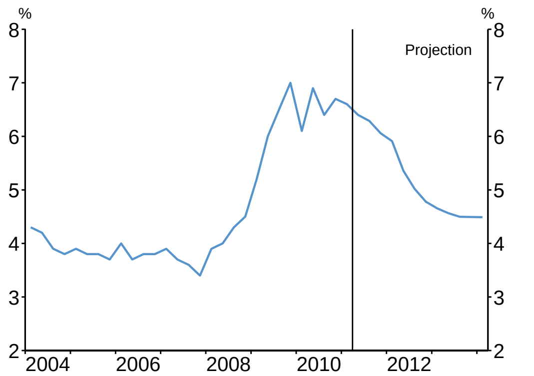
Fiscal

Over the coming years the fiscal costs associated with the reconstruction of Canterbury as well as other previously announced fiscal spending plans will place significant pressure on the Crown's financial position. To limit the accumulation of debt over the coming years, *Budget 2011* announced a $1.2 billion reduction in new discretionary spending over the coming four years. Consequently, as reconstruction in Canterbury winds down, the fiscal position is expected to become less stimulatory with the government operating balance returning to surplus in 2014/15.

Capacity pressures and inflation

In aggregate, GDP growth is expected to rise to around 4 percent in annual average terms. The recovery in activity will draw on domestic resources and see capacity pressures rise. Labour demand will increase, although initially this is expected to result in stronger growth in hours worked than in employment. This is because of the lingering uncertainty regarding the economic outlook, which will mean firms remain cautious about taking on additional staff. As economic activity continues to lift, employment growth will increase, resulting in the unemployment rate falling to 4.5 percent (figure 5.8).

Figure 5.8
Unemployment rate
(seasonally adjusted)



Source: Statistics New Zealand, RBNZ estimates.

Wage inflation will pick up as economic activity recovers and excess labour capacity is absorbed. Annual LCI inflation is projected to peak at 2.4 percent in early 2012. While some lift in wage inflation is expected in most sectors, increases are expected to be most apparent in the construction sector.

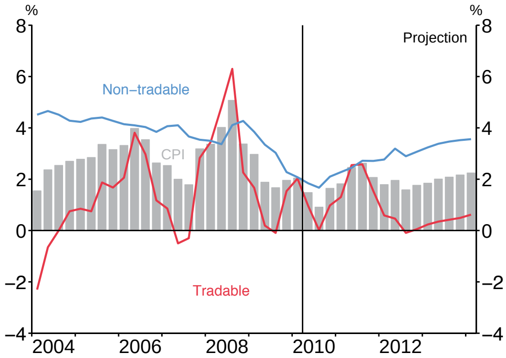
Having said that, construction cost inflation is not expected to reach the peaks seen during the mid-2000s construction boom. It is expected that the localised nature of the rebuild will lead to some efficiency gains, and that centralised management will limit cost pressures. Further, aggregate capacity pressure is forecast to be more limited relative to the peak of the previous construction boom. On the other hand, there is a risk that the regional concentration of the rebuild causes capacity constraints to be more pronounced than this.

Inflationary pressures are expected to build, although be partially offset by the gradual removal of monetary policy stimulus. As economic slack reduces, underlying non-tradable inflation is expected to increase to around 3 percent (figure 5.9). In contrast, tradable inflation is expected to moderate initially, reflecting a fall in oil and food prices. Over the projection tradable inflation is expected to pick up towards average levels, with imported costs rising due to some increase in world prices and an assumed modest depreciation in the exchange rate. Consequently, annual CPI inflation excluding policy changes is expected to remain steady around the centre of the target band over the latter part of the projection.

Figure 5.9

CPI, tradable and non-tradable inflation

(annual, excluding policy changes)



Source: Statistics New Zealand, RBNZ estimates. 'Excluding policy changes' is the Bank's CPI inflation projection which from the June quarter 2010 excludes the direct impact of the increase in the rate of GST, the incorporation of the stationary energy and liquid fuel sectors to the amended Emissions Trading Scheme, and increases in the excise tax on tobacco.

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
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	1.6	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	0.3	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	0.3	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	0.2	-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	0.8	0.5	1.8	71.4	8.7
	Dec	0.9	1.2	3.2	71.0	8.8
2008	Mar	-0.2	0.7	3.4	71.9	8.8
	Jun	-0.7	1.6	4.0	69.3	8.8
	Sep	-0.6	1.5	5.1	65.5	8.2
	Dec	-1.3	-0.5	3.4	57.8	6.3
2009	Mar	-1.0	0.3	3.0	53.7	3.7
	Jun	0.1	0.6	1.9	58.4	2.9
	Sep	0.2	1.3	1.7	62.6	2.8
	Dec	0.9	-0.2	2.0	65.5	2.8
2010	Mar	0.7	0.4	2.0	65.3	2.7
	Jun	0.1	0.2	1.7	66.8	2.9
	Sep	-0.2	1.1	1.5	66.9	3.2
	Dec	0.2	2.3	4.0	67.8	3.2
2011	Mar	0.3	0.8	4.5	67.1	3.0
	Jun	0.4	0.7	5.0	68.8	2.6
	Sep	0.9	0.9	4.8	68.5	2.7
	Dec	1.2	0.1	2.5	68.6	3.0
2012	Mar	1.8	0.3	2.0	68.5	3.4
	Jun	1.1	0.9	2.2	68.4	3.8
	Sep	1.0	0.5	1.8	68.1	4.3
	Dec	0.8	0.2	1.9	67.8	4.6
2013	Mar	0.8	0.7	2.2	67.5	4.7
	Jun	0.7	0.9	2.3	67.2	4.8
	Sep	0.5	0.7	2.4	66.9	4.8
	Dec	0.5	0.2	2.5	66.5	4.9
2014	Mar	0.4	0.4	2.3	66.0	4.9

[1] Notes for these tables follow on pages 27 and 28.

Table B

Composition of real GDP growth

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

	Actuals							Projections			
March year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Final consumption expenditure											
Private	6.3	4.5	4.4	2.5	3.3	-1.1	0.3	1.7	1.7	1.9	1.5
Public authority	5.0	4.5	4.9	4.4	4.7	4.2	0.3	2.4	2.3	-0.1	-0.3
Total	6.0	4.5	4.5	2.9	3.6	0.1	0.3	1.9	1.8	1.4	1.1
Gross fixed capital formation											
Market sector:											
Residential	14.9	2.8	-5.3	-1.4	4.4	-23.4	-13.1	3.6	7.4	47.7	10.3
Business	12.7	10.9	10.1	-1.9	8.9	-5.8	-9.1	8.8	8.3	11.3	3.6
Non-market government sector	14.5	10.8	6.5	-6.7	-10.5	20.4	-8.3	-3.0	5.4	4.1	4.1
Total	13.3	8.9	6.3	-2.2	6.7	-7.8	-9.7	7.1	8.0	16.4	5.0
Final domestic expenditure	7.7	5.6	5.0	1.6	4.4	-1.9	-2.1	3.0	3.2	5.0	2.1
Stockbuilding[1]	0.2	0.2	-0.5	-0.7	0.7	-0.0	-2.0	1.9	0.5	-0.3	-0.1
Gross national expenditure	7.8	6.0	4.7	0.7	5.4	-1.9	-3.6	4.9	3.3	4.7	2.0
Exports of goods and services	1.1	4.9	-0.1	3.0	3.2	-3.5	4.7	2.0	2.2	2.6	2.8
Imports of goods and services	12.9	12.4	4.2	-1.4	9.9	-4.2	-9.5	11.9	7.0	4.4	1.4
Expenditure on GDP	4.1	3.5	3.3	2.1	3.1	-1.6	1.1	1.7	1.6	4.1	2.5
GDP (production)	4.4	3.8	3.2	0.8	3.0	-1.6	-0.7	1.2	2.5	4.6	2.7
GDP (production, March qtr to March qtr)	5.3	2.5	2.4	1.7	2.2	-3.6	1.8	0.4	4.4	3.6	2.2

[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	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Price measures											
CPI	1.5	2.8	3.3	2.5	3.4	3.0	2.0	4.5	2.0	2.2	2.3
Labour costs	2.1	2.5	3.0	3.0	3.5	3.1	1.3	2.0	2.4	2.0	2.3
Import prices (in New Zealand dollars)	-10.3	0.6	6.9	0.2	0.5	12.4	-8.3	0.7	3.8	2.8	3.6
Export prices (in New Zealand dollars)	-5.0	5.0	3.4	4.3	11.9	6.6	-8.4	9.8	3.5	-0.5	0.5
Monetary conditions											
90-day rate (year average)	5.3	6.5	7.3	7.6	8.6	6.7	2.8	3.1	2.9	4.3	4.9
TWI (year average)	63.6	67.1	70.1	65.6	71.6	61.6	62.9	67.1	68.6	67.9	66.6
Output											
GDP (production, annual average % change)	4.4	3.8	3.2	0.8	3.0	-1.6	-0.7	1.2	2.5	4.6	2.7
Potential output (annual average % change)	3.4	3.2	2.8	2.2	1.9	1.6	1.1	1.3	1.5	2.1	2.3
Output gap (% of potential GDP, year average)	2.2	2.8	3.2	1.8	2.8	-0.3	-2.1	-2.3	-1.4	1.1	1.4
Labour market											
Total employment (seasonally adjusted)	3.4	3.6	2.8	2.0	-0.3	0.7	-0.1	1.8	1.8	3.5	1.5
Unemployment rate (March qtr, seasonally adjusted)	4.3	3.9	4.0	3.9	3.9	5.2	6.1	6.6	5.9	4.7	4.5
Trend labour productivity	1.1	0.9	0.8	0.7	0.6	0.4	0.4	0.4	0.5	0.7	0.8
Key balances											
Government operating balance (% of GDP, year to June)	3.9	4.7	4.4	3.5	3.1	-2.1	-3.4	-8.3	-4.1	-1.6	-0.3
Current account balance (% of GDP)	-4.3	-6.1	-8.6	-7.9	-7.9	-7.8	-2.4	0.2	-3.6	-4.8	-5.5
Terms of trade (OTI measure, annual average % change)	3.9	5.8	-0.8	1.8	7.8	3.2	-9.1	12.9	2.4	-3.9	-2.7
Household saving rate (% of disposable income)	-7.4	-6.0	-8.3	-8.9	-4.0	-4.5	-2.2	-1.3	0.5	2.0	3.5
World economy											
Trading partner GDP (annual average % change)	3.5	3.8	3.8	3.8	4.2	0.2	1.1	4.3	4.0	4.6	4.2
Trading partner CPI (TWI weighted, annual % change)	1.4	2.1	2.5	1.9	3.3	0.9	1.6	2.3	2.1	1.8	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 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)	*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*.
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	(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

Air New Zealand Ltd
Amalgamated Builders Ltd
Andar Holdings Ltd
Anton's Seafoods Ltd
Arthur Barnett Ltd
Ashburton District Council
Auckland Chamber of Commerce
Auckland Transport
Beca Group Ltd
Canterbury Employers Chamber of Commerce
Carr Canterbury Ashburton Ltd
Carterholt Harvey Ltd
Colliers International New Zealand Ltd
Croys Ltd
Dan Cosgrove Ltd
Darroch Ltd
Debtworks (NZ) Limited
Delta Ltd
Destination Marlborough
Duncan Ag Limited
Dunedin City Council
Electricity Ashburton Ltd
Employers and Manufacturers Association (Northern) Inc
Flight Timbers Ltd
Forrest Wines Ltd
Gibbons Holdings Ltd
Golden Bay Cement Ltd
Hellaby Holdings Limited
Insurance Council of New Zealand
Juken New Zealand Ltd
Kelly Services (New Zealand) Ltd
Kirkcaldie & Stains Ltd
Kordia Ltd
Landcorp Farming Limited
LSH Business Services Ltd
Marlborough District Council
McDonald's Restaurants (NZ) Ltd
Ministry of Economic Development
Ministry of Social Development
Motor Trade Finance Ltd
Naylor Love Construction Ltd
Nelson City Council
Nelson Pine Industries Ltd
Nelson Tasman Chamber of Commerce
NZ Council of Trade Unions
Port Nelson Ltd
Port of Otago Ltd
PricewaterhouseCoopers
Primeport New Zealand Ltd
Progressive Enterprises Ltd
Rakon Ltd
Rata Industries Ltd
Realestate.co.nz Ltd
Scott Technology Ltd
Silver Fern Farms Ltd
Staples Rodway Limited
Talley's Group Ltd
The New Zealand Sock Company Ltd
Villa Maria Estate Ltd
Viterra Ltd
Wakatu Incorporation
Westfield (New Zealand) Ltd
Zespri International Ltd

Appendix C
Reserve Bank statements on monetary policy

OCR reduced to 2.5 percent

10 March 2011

The Reserve Bank today reduced the Official Cash Rate (OCR) by 50 basis points to 2.5 percent.

Reserve Bank Governor Alan Bollard said: "The Reserve Bank extends its sympathies to all those affected by the Christchurch earthquake. Our condolences go especially to those who have lost family, friends and colleagues.

"The earthquake has caused substantial damage to property and buildings, and immense disruption to business activity. While it is difficult to know exactly how large or long-lasting these effects will be, it is clear that economic activity, most certainly in Christchurch but also nationwide, will be negatively impacted. Business and consumer confidence has almost certainly deteriorated.

"Even before the earthquake, GDP growth was much weaker than expected through the second half of 2010. Households have continued to be very cautious, with retail spending volumes and residential investment both declining. The export sector has benefited from very high commodity prices, however, farmers have focused on repaying debt rather than increasing spending. Also the early summer drought constrained farm output through this time. Signs that the economy was beginning to recover early in 2011 have been more than offset by the Christchurch earthquake.

"In putting together the forecasts underlying this Monetary Policy Statement, the Bank has had to make many important assumptions based on limited information. Over the coming weeks and months, these judgments will be tested as new information comes to hand. For now, GDP growth is projected to be quite weak through the first half of the year. This will gradually build up to a very large reconstruction programme by 2012 that will last for some years and contribute to a period of relatively strong activity.

"Future monetary policy adjustments will be guided by emerging economic data. We expect that the current monetary policy accommodation will need to be removed once the rebuilding phase materialises. This will take some time. For now we have acted pre-emptively in reducing the OCR to lessen the economic impact of the earthquake and guard against the risk of this impact becoming especially severe."

OCR unchanged at 2.5 percent

28 April 2011

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

Reserve Bank Governor Alan Bollard said: "The outlook for the New Zealand economy remains very uncertain following February's Christchurch earthquake.

"As was expected, business confidence, consumer spending and tourism activity all declined sharply following the earthquake. The OCR was cut as insurance to help limit these adverse effects. Confidence and consumer spending have since shown signs of recovery, but many firms and households remain adversely affected in Christchurch. To date, activity in the rest of the country appears relatively unaffected, with housing market turnover and business investment beginning to increase.

"Trading partner growth remains robust, helping push New Zealand's export commodity prices higher. Along with relatively favourable climatic conditions, the improved price outlook is supporting a pickup in on-farm investment. Higher oil prices and the elevated level of the New Zealand dollar are both unwelcome. They will have some dampening effect on economic activity.

"Headline inflation is currently being boosted by recent increases in indirect taxes. Annual inflation is expected to settle comfortably within the target band once these tax increases drop out of the annual rate.

"Given the outlook for core inflation and continued economic disruption stemming from the earthquakes, the current level of the OCR is likely to remain appropriate for some time."

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		
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 2011-12:

2011	
Thursday 28 July 2011	OCR announcement
Thursday 15 September 2011	*Monetary Policy Statement*
Thursday 27 October 2011	OCR announcement
Thursday 8 December 2011	*Monetary Policy Statement*
2012	
Thursday 26 January 2012	OCR announcement
Thursday 8 March 2012	*Monetary Policy Statement*
Thursday 26 April 2012	OCR announcement
Thursday 14 June 2012	*Monetary Policy Statement*

Dates for 2012 are provisional, subject to confirmation in August 2011.

The Reserve Bank reserves the right to make changes to this schedule, if required, due to unexpected developments. In that unlikely event, the markets and the media will be given as much warning as possible.

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