Reserve Bank of New Zealand Monetary Policy Statement, June 2008

Report of the Finance and Expenditure Committee

Forty-Eighth Parliament
(Charles Chauvel, Chairperson)
June 2008

Presented to the House of Representatives

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Reserve Bank of New Zealand Monetary Policy Statement, June 2008

Recommendation

The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand's Monetary Policy Statement released on 5 June 2008, and recommends that the House take note of its report.

Introduction

This report outlines the contents of the Reserve Bank of New Zealand's Monetary Policy Statement of June 2008, and details the main issues we have considered. Our approach to considering the statement, our membership, and a transcript of the hearing of evidence are included in the appendices to this report.

The Monetary Policy Statement released on 5 June 2008 announced the decision of the Governor of the Reserve Bank of New Zealand to leave the official cash rate (OCR) unchanged at 8.25 percent. The OCR has remained unchanged since July 2007, after several increases over the preceding three years. The statement also announced that, provided the economy evolves in line with projections, the Reserve Bank is likely to be in a position to lower the OCR later this year, which is sooner than previously envisaged.

Reserve Bank's reasoning

The Governor explained that the short-term outlook for both inflation and growth in New Zealand has deteriorated considerably since the last Monetary Policy Statement in March, largely because of sharply higher international prices for oil and food. These external cost shocks, comparable to those of the 1970s, come at a time of already intense inflationary pressures and a downturn in the housing market. As a result, New Zealand is likely to face an uncomfortable period of weak economic activity and high inflation.

Annual CPI inflation is now projected to average 4.6 percent in the second half of 2008 (compared with 3.5 percent forecast in the March Monetary Policy Statement), before declining more sharply than previously expected as economic activity weakens. GDP is expected to grow by only 0.7 percent in the year to March 2009 as price increases lead to a contraction in real household spending. There are also signs that the labour market is softening, with unemployment now expected to reach 6 percent in March 2011.

The Reserve Bank has opted to maintain the OCR at its current level as a buffer against the current inflationary pressures, while signalling that the expected decline in economic activity could allow scope for an easing in monetary policy later this year, provided the economy evolves in line with its projections.

Economic situation and the outlook for growth

We noted that a much harder landing is forecast for the economy than previously expected, with a 13 percent fall in nominal house prices and unemployment rising to 6 percent. This contrasts with forecasts prepared by the Treasury at the time of the recent Budget. For example, the growth outlook for the years 2009 and 2010 has been virtually halved compared with Treasury's forecasts, while the fiscal outlook predicts potentially $1 billion less in revenue. We asked about the reasons for such a dramatic change in a short time, and whether all the risks had now been captured in the Reserve Bank's projections.

The Governor said that the Treasury's forecasts had been prepared some two months earlier and dramatic international price rises had occurred since then, along with a softer housing market feeding into consumption. Overall, it was considered a balanced picture though there was, as always, room for change either for better or worse.

As to how this economic situation could be described, the Governor said that while the projections did not strictly amount to a technical recession, that possibility could not be ruled out. A year of flat activity was expected, with an accompanying risk that the economy could move into technical recession; however, a bounce-back was considered more likely given the economy's strong fundamentals and flexibility. The situation was not considered comparable to the stagflation of the 1970s, nor was the trough expected to be as deep as the Asian crisis of the late 1990s.

Interest rate outlook

We sought elaboration of the rationale behind not cutting the OCR now but rather signalling a likely reduction later in the year, and asked what form such a cut might take.

The Governor said that the current projections would be consistent with, for example, a reduction of the OCR in September and another in December. However, much would depend on monetary conditions at the time. There were risks in particular regarding the exchange rate, as any precipitous decline would fuel more imported inflation, and in the possibility that softer domestic activity might not be properly reflected in lower inflation expectations.

As to why the OCR has not been cut now, the Governor stressed the need to wait and see how several factors evolved; in particular, the CPI would need to drop from the peak of 4.7 percent being forecast for the September quarter without boosting inflation expectations for a cut to be feasible. Whereas an OCR cut now would have come as a surprise to the markets, the market reaction to this announcement had been as expected, with an immediate slight softening in interest rates and the exchange rate. There could, however, be lags before further interest rate falls, as mortgages tend to be fixed on a two-yearly cycle.

The CPI and inflation expectations

We noted that the projected fall in the CPI over the medium term was based on three key expectations: that commodity prices stop rising; that inflation expectations remain anchored; and that non-tradable inflation eases. We sought comment on the likelihood of these conditions occurring, and questioned whether the projections could be optimistic given that non-tradable inflation has averaged about 4 percent for the past 6 years.

The Governor said that an easing in domestic non-tradable inflation was considered likely as the factors driving it – housing market activity, domestic consumption, and business confidence – had all started to decline. There was more uncertainty about imported inflation if oil prices and exchange rate movements exceeded projections. A critical factor would be people's inflation expectations, as reflected for example in wage settlements. The Reserve Bank would be watching the labour cost index closely. He proposed that one benefit of the approach taken in this Monetary Policy Statement was that it provided information about expected conditions over the next year or two, on which businesses and households could base decisions about spending, investing, wage negotiating, and pricing.

Labour market conditions

We recalled that tightness in the labour market had often been cited by the Reserve Bank as a key factor behind recent inflationary pressures. Given that a significant rise in unemployment was now being forecast over the next two years, from 3.6 percent to 6 percent, we sought comment on whether this meant that inflation was nearly conquered.

The Governor said that softer labour market conditions and a consequent easing in consumption would undoubtedly make monetary policy more effective, but the forecast rise in unemployment was a regrettable downside of the current adjustment. Compared with historical unemployment rates, however, the impact of the current adjustment should be less harsh because of the economy's stronger fundamentals and greater flexibility.

Implications for households and home-buyers

We asked about the picture for households and home-buyers, and in particular the likely impact on lower-income households. The Governor explained that mortgage rates should ease and houses could be expected to become more affordable; house prices are expected to fall over the next two years by 13 percent in nominal terms and 22 percent in real terms. On the other hand, the higher CPI would continue to affect consumers. To the extent that lower-income households have a higher propensity to consume, they are likely to be relatively harder hit.

The terms of trade

Given that the large upward revision of the inflation forecasts was predominantly due to higher international oil, food, and other commodity prices, we asked whether there were corresponding benefits for New Zealand's economy in terms of higher prices for its food exports.

The Governor said the recent price changes had had a negative terms-of-trade effect, as higher prices for oil and other imports had offset the benefit of dairy prices remaining strong. More recently, meat prices were starting to improve at last, along with prices for horticulture exports. The recent slight softening in the New Zealand dollar would compound benefits for exporters.

New Zealand's growth relative to Australia

We asked why New Zealand's GDP growth rate, projected at 0.9 percent for 2009, lagged so far behind that of Australia (3 percent) and the world economy as a whole (2.9 percent), despite favourable commodity prices for our exports.

The Reserve Bank explained that the main difference lay in our relative terms of trade. New Zealand's were expected to decline as higher oil prices offset beneficial returns for our commodity exports such as dairy, while Australia's terms of trade were projected to improve by about 10 percent this year thanks to hard commodity exports such as iron ore.

Oil prices and forecasting methods

We reiterated the unease we have expressed in previous meetings with the Governor about the Reserve Bank's oil price projections, noting that the Monetary Policy Statement continues to project a steady decline, albeit now from a significantly higher current level. Given that the forecasts have proved consistently wrong for the past four years, we asked whether the Reserve Bank remains confident that its methodology is sound, or whether another forecasting approach should be adopted. We also asked about the consequences for the Reserve Bank's other projections if oil prices continue to track upward, as some groups suggest is inevitable as physical production limits are reached, with several forecasters suggesting it could go as high as $200 per barrel.

The Governor said that the Reserve Bank was not an expert in the field of oil price forecasting, and so chose to adopt the consensus of a group of some 40 international forecasting experts. While admittedly they had proved wrong time and again, the Reserve Bank continues to consider this the soundest approach. Prices on the futures market have accorded more closely with reality of late, but there was no guarantee this would continue to happen. In fact, the Governor suggested that much of the price rise since March appeared to be driven by financial speculation rather than supply and demand, and so could fall off quite sharply. As to the potential impact on the Reserve Bank's other projections, if oil prices continue to rise they would maintain inflationary pressures; however, he suggested the rate of any decline was potentially more critical given its deflationary effect on the economy.

Monetary policy and the Policy Targets Agreement

Noting forecasts that oil and food prices could continue to rise internationally as the physical limits of supply are reached, we asked how the Reserve Bank might address this through monetary policy, other than continually increasing the OCR, and whether oil price shocks should be factored out when designing monetary policy, as provided for in the Policy Targets Agreement (PTA).

The Governor said that so far the PTA has provided an appropriate framework, allowing sufficient flexibility for the Bank to look beyond short-term price shocks (admittedly this price shock has lasted four years) and to focus on the medium term. If oil prices continue to rise for another four years and it becomes clear that higher prices are an enduring structural feature, then this will be an issue for all central banks, and will need to be incorporated into the PTA in some way.

The Governor added that the Reserve Bank was sensitive to the need not to run a pro-cyclical monetary policy. New Zealand was in a more comfortable position than many countries, where central banks were now faced with a need to raise rates, in that monetary policy here had already been tightened in response to domestic conditions. The OCR had not been increased for a year now, and was still being held steady despite unpalatable inflation figures, with the prospect of loosening later in the year if conditions allowed.

Impact of emissions trading scheme

From a monetary policy perspective, the Governor noted that the delay in introducing an emissions trading scheme was helpful in easing short-term inflation pressures. However the scheme would entail a significant economic cost in later years, raising the CPI by around 0.4 percent in each of the years 2010 and 2011. The greatest uncertainty was the price of carbon units, which the Reserve Bank had assumed at $25. The actual price could well be higher, with a correspondingly greater impact on inflation and to a lesser degree on economic activity.

Fiscal policy

The Governor indicated that the timing of tax cuts and Government spending decisions announced in the Budget would help to offset weaker activity. While they would also add to inflation pressures, this impact, while significant, was not considered major.

Appendix A

Committee procedure

We met on 5 June and 18 June to consider the Reserve Bank of New Zealand Monetary Policy Statement released on 5 June 2008. We heard evidence from the Governor of the Reserve Bank, and received advice from our independent specialist adviser.

Committee members

Charles Chauvel (Chairperson)
Hon Bill English
Jeanette Fitzsimons
Craig Foss
Hon Mark Gosche
Hone Harawira
Rodney Hide
Moana Mackey
Dr the Hon Lockwood Smith (Deputy Chairperson)
Hon Paul Swain
Chris Tremain
Judy Turner
R Doug Woolerton

Evidence and advice received

Reserve Bank of New Zealand, Monetary Policy Statement, 5 June 2008.

Briefing Paper, prepared by specialist adviser, dated 5 June 2008.

Appendix B

Corrected transcript

Reserve Bank of New Zealand: Monetary Policy Statement

Finance and Expenditure Committee

5 June 2008

Members

Charles Chauvel (Chairperson)
Hon Bill English
Jeanette Fitzsimons
Craig Foss
Lesley Soper
Hon George Hawkins
Dr the Hon Lockwood Smith (Deputy Chairperson)
Hon Paul Swain
Jill Pettis
R Doug Woolerton

Staff

Lesley Ferguson, Clerk of Committee
Meipara Poata, Clerk of Committee
Victoria Moore-Jones, Report Writer

Witnesses

Reserve Bank of New Zealand
Dr Alan Bollard, Governor
Dr John McDermott, Head of Economics
Mr Tim Hampton, Head of Forecasting

Chauvel Welcome to Dr Bollard and colleagues. It seems like a long time since we've seen you, but you're welcome to tell us what you want to tell us.

Bollard Well, thank you, Chairman. Good morning, members. Yes, it is a long time since March in one way, because there's been some significant things that have changed. We have, of course, been through quite a wave of financial news on the international arena. We still see turbulence going on internationally,

although pleased to say that, generally, credit conditions have smoothed since our last Monetary Policy Statement, although still costly. However, we are now seeing rural growth slowing, and that's having an impact, and we're seeing some quite unpleasant international inflation stories as a result of oil prices and food prices, particularly in emerging markets that don't necessarily get a lot of air play, and some of those have got quite loose monetary policies, as well.

The oil price has gone up more than 20 percent since our last forecast. Food prices have similarly gone up a lot. *The Economist's* commodity price index, for example, has doubled in the last year. These are very big increases, comparable or even more than the 1970s. In addition, the fact that the New Zealand dollar is a few cents lower than March is enough to have a bit of an impact, as well.

On the domestic side, we do now see the housing market bubble deflating. Housing is coming off significantly. We're starting to see negative house price movements. We're expecting nominal house prices to drop 13 percent over the next year and a half, and that does have quite a significant effect through on to consumption. In addition, these very high oil and food prices are also impacting consumption, and you can see them in our terms of trade. The terms of trade impact this time has been negative, so despite the dairy price rises, they're outweighed by these import price rises.

As you know, it's been a dry summer. That was enough to take some revenue off the dairy industry, despite the fact that they're still getting very good prices. The labour market we are now starting to see softening. We're actually seeing that happening now, and we do forecast it will continue. Labour costs are still high. We'll be watching the labour cost index with a lot of interest through this year.

On Government policy side, fiscal policy, including the tax cuts that we've had recently, we feel, have come in at a time where they help activity but they do add to short-term inflation pressure. I'd regard that as significant though not major in its impact.

It's helpful—I'm speaking, of course, purely from a monetary policy point of view—that we've had the emissions trading scheme impacts that were due for next year on liquid fuel prices being delayed. That does have an impact, as does the fact that it looks unlikely that there will be any regional petrol taxes through that next year on the inflation numbers. However, the emissions trading scheme effects that we still face in outer years are quite significant on their inflation effects.

We see growth going quite flat this year. That is a change and a softer picture than we had in March. We see a gradual pick-up next year. When we look at inflation, the imported inflation or tradables inflation side is quite problematic, now getting to quite high numbers—it's oil prices, it's food prices, it's other imported prices, and it's the New Zealand dollar being a little weaker, as well. On the more encouraging side, domestic price picture is looking softer, and that's encouraging. It's 4 percent and reducing—that's important for us. But

overall, we do get an unattractive picture on the CPI. It hits 4.7 percent in September. It's a very high number; it's a long time since we've been at that number. It means we're going to have two quite large inflation quarters in June and September.

We do note, on the other hand, that if you take out the food and energy components to the CPI—you can see it in our Monetary Policy Statement—that's a much more restrained figure. Actually, at the minute it's quite low—it's 1.6 percent—but don't be deceived by that; it will rise, but it stays much more within target.

Risks—well, the global outlook is not yet stable, and there are risks there, particularly on inflation but possibly on activity, as well. The New Zealand dollar remains quite a risk for us. We have seen the New Zealand dollar drop by a cent since our announcement this morning. That's not out of line with what we might have expected. We have some softness built into our forecasts. That softness is generally desirable from an export point of view. However, were we to see the New Zealand dollar really drop, then that would be a pretty unpalatable picture on inflation and could cause us some issues around monetary policy.

We'll also be watching inflation expectations very closely. We think the numbers that we've got are short-term inflation spikes, but were we to see them get ingrained into people's expectations, then that would be a problem for us, as well. We're focused on the medium term, as we're required to do with our policy targets agreement, and we still expect inflation to come comfortably inside the band in the medium term, despite these quite unpalatable short-term numbers. Provided the economy evolves in line with our projections and our assumptions, we have said that we feel we're likely to be in a position to lower the official cash rate later this year. That's sooner than we previously envisaged. However, that does depend on the economy tracking through as we've predicted in this picture. Mr Chairman, we're very happy to take any questions or comments.

Chauvel I suppose the big question in my mind is do you have any idea, if things do track the way you think they will, what sort of cuts you'll be able to put in place at the end of the year? Is it the sort of gradual cutting as an inverse to the rising steps that you've taken, or will it be something steeper than that?

Bollard I think that depends on a couple of things. We've certainly looked at that, and we've been doing quite a lot of internal work to ensure that we're not totally focused on tight economy, tight monetary policy. We want to know what the other side of the cycle looks like, how monetary policy might respond, and could it be sticky downwards? Well, it could be a bit sticky downwards. The reasons for that are, one, as you know, a lot of mortgages the main channel is done on 2-year deals now, although we're seeing a bit of a reduction in the average duration of those mortgages at the minute. Secondly, we do have an international environment which, once again, is out of step with New Zealand monetary policy, where there's quite a lot of upward intentions, tightening

intentions, around a number of OECD countries. Thirdly, there's pipeline pressure in there already. What we would be looking at is how that pans out, how soft the New Zealand economy is, how that goes through into people's expectations of inflation, and particularly what might happen around the exchange rate. Big and untidy moves in the exchange rate have got quite an impact on imported inflation, and, indeed, quite an impact on monetary conditions. So we would be looking at that, as well. Our numbers are consistent with, for example, a cut in September and, for example, another cut in December. Those are only examples.

Chauvel Just in terms of the numbers, in the March statement inflation was expected to average at 4.6 percent. In the second half of 2008 you've got 3.5 percent. Sorry, you had 3.5 percent last time; 4.6 percent now. It's quite a big movement in numbers. What's the reason for that?

Bollard It's an uncomfortable movement, and it's a much bigger movement than we would like to see between forecasts. The main drivers are oil prices going up 20 to 30 percent in that time, and food and other commodity prices increasing in that time, as well. You're seeing similar size projection increases in inflation around most OECD countries at the minute, but that shouldn't discount from the fact that it is quite uncomfortable.

Chauvel So it's solely due to the international situation?

Bollard Solely? No.

McDermott Predominantly.

Chauvel And if there are very much higher international food prices, won't that flow through positively for our economy in the sense that we're a major food exporter? And also, where does that show up in the numbers?

Bollard I mean, basically we're seeing commodity prices of all sorts going up, but not all commodity prices going up. Some of those are bad news for us—oil and many other imported products. Some are good news—we've mainly seen that in dairy. You can see that the net effect that's come through this time has resulted in a negative turn for trade impact. It's been net bad news for us, but dairy is staying up strong, and actually the numbers that came through yesterday were encouraging rather than discouraging. These were a new set of commodity price numbers, and they showed upwards pressure on horticulture prices and, at last, on meat prices. That's important, because we do see reasons why meat prices should be increasing, and they haven't been, so far. In addition, a slightly softer New Zealand dollar means that a 1 percent or so improvement in commodity prices that month results in a 2 percent or so improvement in New Zealand dollar prices.

English I'm just wondering about the risks around this outlook. I mean, you have now produced forecasts that show 6 percent unemployment, a 13 percent drop in house prices—almost halving the growth outlook, compared with Treasury's

just 3 weeks ago. Have you soaked up all the downside, or is there still some out there?

Bollard That's a hard question, but I think on balance we'd feel we've roughly balanced risk on that. Treasury's, of course, were finalised probably near enough to 2 months ago now, and there's been big price changes since then. Well, there could be downside to those, but of course there could also be upside, mainly from commodity prices. So we'd say it is a balanced sort of picture.

English So you haven't soaked up all the downside?

Bollard Well, no; there's always potential for both downside and upside on those.

English So just explain to me a bit more how much has changed. I don't want to get into an argument about forecasts between Treasury and the Reserve Bank, because I think that's pretty pointless. The critical point seems to be that you're forecasting an economy over 2009/10 that is almost 2 percent smaller, cumulatively, over those 2 years, which is pretty significant. I think the fiscal outlook says 1 percent, which is $500 million in revenue. So 2 percent is about $1 billion in revenue, potentially.

Bollard You mean smaller than we were forecasting last time?

English No, smaller than the Budget forecasts, OK? It's about 2 percent smaller than the Budget forecast. And you've put that down simply to things that have changed in the last 3 months?

Bollard Yeah; mainly international prices—meaning that New Zealand is relatively poorer because oil prices and other importable prices are relatively higher. It is not entirely that. There's a bit more softness in the housing market, and that feeds through to consumption being very flat. And once consumption is flat, the economy is flat because it is so big.

English I'm just interested in your relative optimism about inflation. If you look at non-tradable inflation, it's now been running at 4 percent for 6 years. From 2002 to 2008 it's roughly 4 percent, which is a very persistent performance on non-tradable. And then, on the tradable inflation, you're sort of hoping that it might peak in the next 6 months. So there is no evidence that non-tradable inflation will drop—on past performance, anyway. Maybe you can enlighten us about that. But you are looking at a drop back in inflation, from very high—possibly as high as 5 percent. You are looking at it halving over the forecast period—and that inflation expectations are anchored just like that. So can you just take us through that story again? It does sound a bit optimistic.

Bollard Sure. It's the first time today that I've been called optimistic on inflation, since we're actually forecasting numbers that are more pessimistic than the market's or most forecasters'. But, yes, absolutely. We are optimistic about domestic inflation—embedded, non-tradable-type inflation—because it relies very strongly on housing market activity, and that's definitely come off; on domestic consumption activity, and that's pretty definitely coming off; and on

confidence, and that's come off. We might not like the other aspects of that, but we're pretty sure those things have come off. Through this period inflation expectations have been pretty well anchored, despite the unpleasant headline numbers. Imported inflation is another story. But you know that that varies very much with both the exchange rate and these international prices. If we are seriously wrong in terms of underestimating further increases in oil prices, then we'll be wrong on that inflation number coming off. I don't think we are wrong on that, but only the future will show that.

English So the scenario imagines a significant shift down in non-tradable inflation?

Bollard Well, an enduring, ongoing shift from 4 percent to well under 4 percent, which you can see there. But the key thing to look at in that is the inflation expectations survey, and we will be really poring over those.

English Yeah; so that's risen a bit, but not as much as you might have expected?

Bollard Exactly.

English And is it your expectation that that will anchor wage expectations, as well?

Bollard That's a very important thing this year, and it's obviously important that both employers and employees look at the future of the economy quite closely, in terms of setting wages—and prices as well, for that matter. That is one of the things we will be looking at. The labour cost index has been disciplined but high. We wouldn't want to see it lose that discipline, as that would make a difference to monetary policy.

English So when you say they should look at where the economy is going, what should they really be looking at?

Bollard They should be looking forward, not looking backward.

English Yeah, but what should they be looking at in looking forward? Six percent unemployment?

Bollard They'll take a whole range of things into account, depending on what industries they're in. But we know that there are a number of businesses that do face a much softer environment for trading—and of course that has to come through in negotiations.

English The unemployment forecast has shifted a lot since the last time. It's looking at moving off by—what is it—3.5 percent to 6 percent over the next 2 years, which is quite a big change.

Bollard It's a significant change. It's less of a soft landing than we might have hoped for. There's basically higher numbers in there, yes. It feeds off the general domestic activity, which is much softer.

Swain I've just got a couple of questions. The first one is, on the one hand you've got commodity prices rising—mainly fuel and food—but, on the other hand, the picture in your report is quite a lot of softening on the other side of it. So why not a cut now? Was it a line call, or was it not really in the ball park yet?

Bollard We are, of course, forecasting a higher headline number. We want to see that come off. We want to see that those inflation expectations don't get embedded. And, of course, we have an unknown, which is the exchange rate. That is very important in our considerations and we are watching that quite closely. So we thought we had enough evidence to say that it is a softer picture and, despite the higher headline inflation numbers, we still have a picture that is coming back within. That gives us enough confidence to put out a softer monetary policy track than we did last time. There are still some things on which we want to wait and see. But we are very sensitive to the need not to run a pro-cyclical monetary policy. When the economy comes off, the last thing you want to be doing is tightening. There are some countries overseas that will be in that position, unfortunately.

Swain The second and last one is on your heroic projections around oil prices.

Chauvel You're stealing Jeanette's thunder.

Swain I am. Since Jeanette pointed this out, I have now gone to this graph every time. I now agree that your graph always gets to a nice point. Last time it was $85, and then it drops away at a very nice, steep angle. It's a beautiful piece of graph work. You are now projecting—now that it's up around $120—exactly the same, and it's going to drop—oh, I'm not stealing your thunder, Jeanette?

Fitzsimons No, no. I'm just illustrating the talk. There's no collaboration there, whatsoever.

Swain And now it drops away very beautifully, again. So the questions are: what gives you the confidence that it's going to do that track, given that in March it did the absolute opposite? The second thing: what's the impact on projections if it does not follow your nice graph and actually goes higher, because there are obviously counter-predictions on this? And the third thing: is this an example where there could be an agreement to make some adjustments around the PTA because of shocks like oil? I think oil shocks is one of them, as I remember, where you might get some breathing space.

Bollard Yes. Well, I'm afraid my answers are exactly the same as I gave last time, which is that we're not experts on oil forecasting, so we go to the experts and they come up in the consensus forecasts. Can either of you remember how many forecasters would be in consensus forecasts? They are sort of international forecasters. There could easily be 40 independent forecasting units doing this, and we're running our forecasts off that. They've all been completely wrong on this. As it happens, the market futures prices, which you've got mapped out there, have been closer to it, but that doesn't give us a lot of confidence they necessarily will be in the future. Most of the transactions in terms of people

who actually buy and take delivery of oil are not reflected through in the futures markets. A lot of that is financial speculation.

An interesting feature has been that we think that a lot of the upside in that oil price since March has been speculators coming into the market, so they're financial operators in there and they're driving that up. There's now a lot of focus on that, and at the minute the US Congress is going through some hearings on it, and actually I don't think it's complete chance that as a result oil price has come off, probably about $8 in the last week, which you haven't actually got in your forecasts there yet, but you might next time.

Fitzsimons The latest is showing it as under $120.

Bollard It came off another a couple of dollars last night. But the interesting thing is what role are speculators playing in that, as opposed to real suppliers and real demanders? The calculations are that there is a very big build-up of speculative positions, partly by pure speculators and hedge funds, and partly by pension funds wanting to invest in the commodity boom, and this is the easiest way they have of doing it. The amount of speculative positions built up over the last 5 years is roughly equal to 1 year of China's real oil demands now, so they're big. We don't know how that's going to pan out. Some of that might come off. That will only keep going up while the market actually thinks there is future oil price increases in there. When it doesn't, some of that will come off. It could come off quite sharply, but we don't know that. It is highly problematic for us. What difference does it make if we're wrong yet again and there's that same step-up? The real thing that makes a difference in our forecasts is the future rate of decline in oil prices. So that's the real thing that we need to be right on, rather than wrong on. Again, if that goes up there will be more inflationary pressure. But you can get these effects if oil comes off faster. Even from that higher level it can have a deflationary effect in the short term.

Chauvel That probably segues nicely into Jeanette's slot.

Fitzsimons I will give you a copy. You used monthly averages, so we've used monthly averages too, so that's why last night's change is in there. It doesn't really affect the monthly average. I was going to ask you, given that today's line of decline is roughly parallel to all the lines over the last 4 years, how confident are you in it? You're saying that you're not the expert, that you're taking the views of experts, and that it's a group of experts, and there may be 40 of them. But they have been consistently wrong over 4 years. There are other people who forecast oil prices whose forecasts have actually matched that trajectory very closely. Do you think maybe you should look at what they're saying, too?

Bollard Look, we can find any forecasts we like there, out in the market. There have been others who have forecast it as coming back to $35. No, we are sure that, in the long term, taking a consensus of the experts is the best way. All of these aren't individuals. You will find Goldman Sachs' commodities forecasts in

there. They have got huge specialist industry expertise. So, no, we still think that's the best, despite the fact that they have been wrong, wrong, and wrong.

Fitzsimons Hypothetically, if they are wrong again and if the people—and there is now a very substantial number of them who are predicting that we are in for constantly rising oil prices and food prices because we are bumping up against some physical limits—if that is true and oil prices and food prices continue to rise fast, how will you address that with monetary policy? What scope do you have to do other than just keep on putting up the OCR forever?

Bollard Well, of course, we haven't put up the OCR for a year. We've kept it flat through this period, despite the fact that some central banks are responding to this by putting it up. We're in a more comfortable position. We've had it up. We've had tight monetary policy focused on domestic conditions, not these imported ones. That's an important question, and we haven't got a simple answer. In fact, some of it goes back to the previous question, as well, which is: how did the policy targets agreement deal with that? The policy targets agreement says that stuff happens in the nature of price shocks, and short-term price shocks are envisaged, and you should look through them and you should look out to the medium term.

We've had here a 4-year price shock, and that is stressing that view. It's still our view and we still think it's the appropriate way through it. But if we were to have another 4 years, then, yes, it would put us all in a very difficult position like that. That isn't our picture at the minute. We do see a softening world. We do see a speculative bubble. We do think it comes off. We don't, obviously, have any confidence about how and when. If it were to stay up, we and all other central banks would have to think about how you would deal with the fact that oil has become very much more expensive and it's there for the very long term, and that New Zealand and other oil importers are poorer as a result.

Fitzsimons I'm just interested in how the policy target agreement will cope if we are into a situation of permanent rises. There have been not just the people in ASPO and so forth, who have been right all along, but there are some very reputable people, like the heads of oil industries and financial institutions, who are saying it could be $200 a barrel quite soon. If that happens, what will you advise the Government to do?

Bollard The IEA and other forecasts we've seen with high numbers are saying that those are possible but they're not their main forecast. We would have to make a judgment as to whether or not we're seeing a cyclical or structural feature. If it's an enduring structural feature, then it needs to be accommodated within the policy targets agreement in some way. So far the policy targets agreement, we think, has been the appropriate way to deal with this, and we think it's given us enough room not to tighten unnecessarily for short-term features. We've tightened for domestic features. We're still there, saying 4.7 percent inflation. We won't tighten; if things go as expected, we will loosen. So it is there, giving us the room to do that. But it does stress the policy targets

agreement. If you get these price hikes staying up there for longer, we would need to look at that.

Fitzsimons Looking at who else it stresses, would it be fair to say that rising food prices and rising oil prices, compared with the CPI generally, is going to have a much greater effect on low-income households than high-income households, and therefore it may drive inequality? I know it's not your job, but you do analyse and make predictions. It's not your job to deal with the consequences.

Bollard Well, in so far as lower-income households have got a higher propensity to consume than higher ones, then anything that goes across the CPI like that can hit those relatively more, but I would hesitate to say they're generalised results, because rich people's food has got a higher import content, and that could be hit, especially if there's softness in the New Zealand dollar, as well. So you'd get these complicating features. But it's certainly going to have a general hit on consumers; it already is.

Smith Dr Bollard, I'm interested in your decision to talk loosening but not loosen. That must have been quite an intentional decision to not change the OCR but to talk of a reduced rate. What's the difference between talking loosening in the near future, and not changing—what's the intended outcome from that? What do you expect the markets to do differently from had you lowered the OCR by, say, 25 basis points today, for arguments sake?

Bollard We've always done it, of course. It's just that this time we're talking about a possible cut rather than rates staying up. But the Reserve Bank has, for years and years, put out a forward track and talked about that. What are we aiming to do with it? We're aiming to get the sort of reaction that we got in the financial markets over the last 2 or 3 hours, which is an understanding of a softer economy, and their take on how that should be dealt with in its mixture of lower exchange rates and slightly lower interest rates. That's already actually happened out there.

We're also, however, putting out a much longer-term view for the market, which is a slightly softer view than the market had already priced in, but not out of line with it. And we're also putting out some information for both businesses and householders in New Zealand, to help them make their decisions about spending, saving, investing, and wage negotiating and pricing in New Zealand over the next year or so.

Smith And you think that, the way you've observed the last few hours, the markets are responding differently from the way they would have had you chopped, say, 25 basis points today? I'm not saying you should have, but I'm just curious.

Bollard Well, I'm speculating, but probably, yeah—in fact, almost certainly, yes. It would have caught the markets quite by surprise.

Smith OK. If I could draw your attention to the GDP growth projections, and now that you've got us down to 0.9 percent, is it, for production of GDP for next

year—for 2009—and if you compare that with, say, Australia, you still have Australia and they're forecast at 3 percent. Is that a timing issue that your figure for Australia doesn't update their situation, or is that their latest projection and you're telling us that Australia's on 3 percent? If I look at your table C, you've got the world economy at 2.9 percent for next year—similar to Australia—and New Zealand at 0.9 percent, and I guess the follow-up question to "Is that just a timing issue?" would be, given the same international environment and given commodity prices being quite favourable for New Zealand, what the hell are we doing wrong that our GDP growth projection is so low compared with the world and Australia, three times higher?

Bollard As you know, I've got John McDermott, our assistant governor, and Tim Hampton, the head of our forecasting team. Can I ask Tim to answer the first part of that question, and I'll answer the second part.

Hampton Probably the main difference relates to the terms of trade, in that the commodities that Australia is currently exporting—the iron ore and those real hard commodities—have continued to increase and have gone up a lot further than what dairy prices and those things have, such that the positive influence on commodity export prices is, by a long shot, offsetting the negative consequences of the higher oil prices. Whereas in New Zealand at the moment, yes, we had the dairy increases last year and, notwithstanding the upside risk that the governor just spoke about before, our terms of trade are projected to decline, whereas the Australians are expected to increase by about 10 percent this year.

Smith So it's a real difference?

Hampton It's a real difference.

Smith And you feel there's no other policy difference—you feel it's just the terms of the trade?

Bollard Oh, there are policy differences there, sure, but the real big things are terms of trade differences, and, in addition, with the New Zealand housing market coming off, that brings consumption off. Once households stop spending, the economy stops growing.

Smith Just one last area I'd be interested in your comments on. Obviously one of the issues that's going to have quite a profound impact on New Zealand's economy is the introduction of the emissions trading scheme. You mention it on page 5 and again, I think, at about page 30 or somewhere down the back there. On page 5 you say uncertainty surrounds this scheme and its effects on the economy. How large do you see that uncertainty, and are you able to offer us any more comment on that?

Bollard Well, yes—and once again these comments are only in a monetary policy sense; we're not the agency that should have a view on the broader issues or purposes of that. From a monetary policy point of view, there's a cost to this, and this is the cost coming home into the New Zealand economy, and it's

significant. It's sort of been up to 0.4 percent of CPI in each of the 2 years, 2010 and 2011, from liquid fuels coming in and then stationary fuels coming in. And that, of course, is based on a quite—probably the biggest uncertainty is the carbon price number; that's based at $25. We know that there could be quite significant reasons why it might be higher than that, but we don't have enough confidence to put in a higher number at the minute. Were the number to be higher, then that inflationary effect would be quite a lot higher. We also have some uncertainty as to what activity impact that might have. We think that's probably not so significant.

Smith Thanks for that.

Pettis I'm just thinking about the ordinary wage and salary earners who are going to watch the news and read the newspaper over the next 24 hours, and they will be wondering what your announcement today means for them. I would like you to briefly answer that. In particular, for instance, I guess the question of interest is what does that mean for them about the potential to purchase a house for first-time homeowners or people wanting to trade up?

Bollard This means that there's likely to be a softer mortgage rate track than otherwise would have been the case. So from that point of view, for people who are borrowing or want to become borrowers it's slightly better news, but it's not a very big change from what was there before. Housing affordability is still an issue in New Zealand. We are seeing house prices coming off—nominal, about 13 percent; real terms, around 22 percent—over the next 2 years. That starts bringing new house prices down—a bit more affordable—but of course it means that people who own houses are less wealthy. In addition, this is relatively bad news for savers, but from a pretty high level; they're not going to really notice that so much. So it's got those sorts of effects.

Foss Dr Bollard, you're forecasting nominal house prices to come down 13 percent, unemployment up to 6 percent, high inflation. How close are we to either a recession, or how far is this from a stagflation?

Bollard Our numbers don't say it's a technical recession, but they're flat enough and low enough that we couldn't remove the possibility that we do have a technical recession. Stagflation? Well, no, we don't think so. I think stagflation is a sort of structural position that a country could get itself into, and did in the 1970s. I don't think we're there, because we expect this economy to take something of a hit to its economic activity, and then to bounce out of it in a reasonably flexible sort of way. We're looking at a response which doesn't go as low, but still has the sort of bounce back that, say, we had with the East Asian crisis—1997, 1998—and that isn't stagflation. There is a general worry around the world that some countries could get themselves into that, if they're not pretty careful about their policies. We don't think that's happening to us.

Foss But throughout the statement you refer to the 1970s two or three times, I think, and rather less so than the Asian crisis in the late 1990s—

Bollard	Yes, oh sure—on commodity prices it looks like it's a similar story; even possibly a worse story than the 1970s. On policy responses it's not the same, at all. We have floating exchange rates; we have capital markets, as you know, that move around flexibly; and we've got monetary policy that's been focused on inflation stability for some time.
Foss	It's a very, very finely balanced "to recession or not recession" right now.
Bollard	We're looking at a very flat year of activity, and the numbers are such that it could move around either looking a lot better than that or looking into technical recession.
Foss	Thank you.
English	I've just had a look at your unemployment forecast, which is considerably higher than Treasury's again—I presume, related to the fact that your growth forecasts are much lower. You've talked for quite some time when you've come here around the point that inflation won't be quite under control until or unless there is a shift in unemployment. I mean, is this the kind of shift that gives you—purely from a monetary policy point of view—the confidence that your inflation job is almost done?
Bollard	Well, you know, none of us want to see unemployment kick up. We have been speculating as to how countries with inflation-targeting monetary policy can go through an adjustment without softer labour market conditions. We are now forecasting softer labour market conditions and that will bite more, and it will have more effect on consumption getting off. So it will make monetary policy more effective, bearing in mind that there are other downsides too—higher unemployment.
English	And as this picture has unfolded over the last, say, 9 months, it looks a lot more like a hard landing and a bad hangover than a sort of drift through the problem, isn't it?
Bollard	Well, it's less of a soft landing than we had hoped for, say, a year ago.
English	But that kick up in unemployment is pretty strong.
Bollard	Well, it's significant. It's not high by our historic standards, but it's significant in view of the last few years of very low unemployment.
English	Well, it's as high as it has been since 1996, I think—1996 or 1997. The last time it was higher was the recession of the early 1990s.
Bollard	Yeah, I mean—
English	A bit of a kick up in 1998, 1999.
Bollard	Yes, at the turn of this century it just kicks a little bit. But it is a significant unemployment level.

English So why do you think we will get through this with a lower absolute level of unemployment than either the Asian Crisis or the 1991 recession?

Bollard Because consumption and growth aren't falling away to those sorts of levels that we had in those years, and because we think there's going to be enough realism in the labour market to not to want to try and inflate this. But that's what we're going to be watching.

English So that's a bit more resilience?

Bollard A bit more flexibility.

Chauvel Stronger fundamentals?

Bollard We don't see as deep a trough as in those previous years. This is an adjustment; it's a soft period. But it doesn't go negative like it did in those years, or not to that level.

Chauvel Thank you very much, Dr Bollard, and your team.

Bollard Thank you very much.

conclusion of evidence