



**Reserve Bank of New Zealand's  
monetary policy statement,  
December 2009**

Report of the Finance and Expenditure  
Committee

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Forty-ninth Parliament  
(Craig Foss, Chairperson)  
December 2009

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*Presented to the House of Representatives*



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# Reserve Bank of New Zealand's monetary policy statement, December 2009

## Recommendation

The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand's monetary policy statement released on 10 December 2009, 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 for December 2009, and details the main issues we have considered. Our approach to considering the statement and our membership are set out in the appendices to this report.

The Reserve Bank of New Zealand's monetary policy statement released on 10 December 2009 announced the decision of the Governor of the Reserve Bank of New Zealand to leave the official cash rate (OCR) unchanged at 2.5 percent. The OCR has now remained unchanged since April 2009, when it settled at 2.5 percent after having been cut by 575 basis points since July 2008 (from 8.25 percent).

## Reserve Bank's reasoning

The New Zealand economy is continuing to recover, on the back of world growth, higher export commodity prices, increased Government spending, and a stronger housing market. The durability of the expansion is still uncertain. However, if projections prove accurate, conditions may be right for starting to remove monetary stimulus in the middle of 2010, earlier than signalled previously.

The Governor of the Reserve Bank told us he sees little need to increase the OCR immediately, as the markets themselves are tightening financial conditions through an appreciation of the New Zealand dollar, higher long-term interest rates, a wider gap between the OCR and bank borrowing rates (reflecting growing market expectations of an increase in the OCR), and increasingly aggressive competition for deposits among financial institutions.

The Reserve Bank is predicting GDP to grow faster than was forecast in September; it is now expected to grow by 3.6 percent rather than by 3.1 percent in the year ending March 2011, and by 3.9 percent rather than 3.4 percent in the year ending March 2012. This revision of the GDP outlook is based primarily on a more optimistic consumption forecast, which rests on house price gains, an improvement in the external terms of trade, and consolidation of the labour market.

Annual Consumer Price Index (CPI) inflation is forecast to remain at or below two percent for at least the next two quarters, and increase somewhat thereafter. However it is expected to remain inside the target range of between 1 and 3 percent in the medium term.<sup>1</sup>

### **Current account deficit**

We note that the current account deficit has improved markedly through 2009. However we are concerned that this improvement is a result of temporary influences, such as weaker demand for imports, lower interest and profit payments to offshore investments, and tax settlements against the banking sector. Once these short-term effects dissipate, the current account deficit is expected to widen once more. New Zealand's net foreign liabilities are expected to hold at a level equivalent to annual nominal GDP.<sup>2</sup> We are concerned that this will mean that the risk premium charged on New Zealand's international borrowing will continue and perhaps even grow.

When asked about the risks associated with New Zealand's external position, the governor said that although the current account deficit is quite significant he considers New Zealand to be in a better position than countries like Britain and Ireland, which have encountered deeper economic recessions and larger fiscal imbalances. However, he noted that it would take a long time for New Zealand to turn its current account deficit around, and that a soft New Zealand dollar on its own might have little impact over the short or medium term, because of the large New Zealand net investment income deficit. The governor predicts a very slow recovery for New Zealand's external position.

### **Housing market**

House prices have increased recently more than was expected. The governor attributed this increase primarily to a shortage in houses offered for sale, and told us that he expects this price increase to be stemmed shortly, as investment in building increases and more existing houses come onto the market. The bank remains watchful about the possibility of another credit-driven housing bubble, but in the short-term is less concerned as lending from banks into the housing sector appears to have remained limited, and households are being cautious, rebalancing and reducing their debt.

While initial indications of household behaviour are positive, we note that the governor intends to monitor this area closely to ascertain whether the caution being demonstrated will be sustained, or whether it is merely a short-term response to the recent recessionary pressures households have been under.

Like the governor, we are hopeful that the lessons learned by households and banks from the global financial crisis produce long-term behaviour change. We encourage the Reserve Bank to pursue its intended approach.

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<sup>1</sup> Reserve Bank of New Zealand and Minister of Finance, *Policy Targets Agreement*, 18 December 2008, clause 2(b).

<sup>2</sup> Reserve Bank of New Zealand, *Monetary policy statement, December 2009*, p. 5.

## Monetary, fiscal, and tax policy

The Reserve Bank notes the linkages between monetary, fiscal, and tax policy.<sup>3</sup> Faster fiscal consolidation reduces aggregate demand and thereby reduces the need for monetary policy to lean against inflationary pressures. Tax policy can influence savings and investment decisions. Unfavourable tax policy settings can exacerbate the economic cycle (particularly by encouraging demand for housing), and affect structural features of the economy (such as the point at which monetary policy actions are required to curb inflation).

The governor said that the Reserve Bank favours a neutral tax policy, where decisions related to savings and investment are neutral across asset-classes, rather than biased towards property investment. The Reserve Bank also expects fiscal policy will move towards neutral settings on the basis of forecasts in Budget 2009.

We note that work is being done on fiscal and tax policy, and expect that the Government may issue policy statements in both areas shortly. We believe that the views of the Reserve Bank should be considered during the policy development phases.

## Prudential tools

The Reserve Bank has been considering how its new liquidity policies, such as minimum levels for the core funding ratio, could be used across the cycle to support monetary policy. For example, the Reserve Bank has worked to assess how the implementation of the core funding ratio over the past five years may have changed the implementation of monetary policy during this period. The Reserve Bank considers that its new liquidity policy may have the potential to act as an automatic stabiliser for the financial system.

The Reserve Bank confirmed that there is increasing international interest in the potential of prudential tools to fill the gap between institutional supervision and stabilisation of the macro-economy. We understand that G20 nations, through the Basel Committee on Banking Supervision, are considering how tools like liquidity policy, counter-cyclical capital requirements, and dynamic provisioning might be most useful; and it is hoped international guidelines—perhaps a Basel III—might be issued, setting out clearly the matters the Basel Committee considers important for bank regulation. We look forward to seeing any guidance issued by the Basel Committee.

## Labour market

The Reserve Bank now forecasts unemployment to peak at 6.6 percent next year, which is considerably lower than previously forecast. In real terms, this projection translates into just under 60,000 jobs lost during the recession. Job losses currently stand at 55,000; the forecast suggests that most of the job losses resulting from the recession have already occurred. One of the reasons that previous forecasts may prove inaccurate is that the labour market demonstrated impressive flexibility in response to the recession. Businesses took steps such as moderating wage growth and reducing work hours, rather than shedding jobs, in response to decreased labour demand.

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<sup>3</sup> Reserve Bank of New Zealand, *Monetary policy statement, December 2009*, p. 7.

While these strategies might have contributed to keeping employment higher than expected, the impact of wage constraint in some areas is now being seen with the incidence of wage disputes growing. When asked whether increasing wage pressure may pose a risk to inflation, the governor suggested it might be reasonable to expect some catch-up from wage rates that were held steady during the recession. He said that the Reserve Bank's projections allowed for increased wage inflation, but acknowledged that the potential risk to inflation depended on the extent of pressure from wages.

### **New Zealand dollar**

We note that the strong currency is largely offsetting any gains from higher export prices, and are pleased to note that, after many months of being considerably overvalued, the value of the New Zealand dollar has recently dropped slightly. The Reserve Bank considers that the dollar is still overvalued, but less so than previously. It attributed the recent drop in part to the uncoupling of the New Zealand dollar from the Australian dollar in the perception of the international community.

Although the Reserve Bank does not have a target exchange rate for the New Zealand dollar TWI (Trade Weighted Index) it noted a long-term average of 60 could help to stabilise New Zealand's current account deficit. However, the Reserve Bank emphasised that to unwind the accumulated effects of overvaluation in the last five years the currency would need to be undervalued for some time.

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## Appendix A

### Committee procedure

The committee met on 10 and 16 December 2009 to consider the Reserve Bank of New Zealand's monetary policy statement, December 2009. We heard evidence from the Reserve Bank of New Zealand, and received advice from our independent specialist adviser, Ulf Schoefisch.

### Committee members

Craig Foss (Chairperson)  
Amy Adams  
David Bennett  
John Boscawen  
Brendon Burns  
Hon David Cunliffe  
Aaron Gilmore  
Raymond Huo  
Rahui Katene  
Peseta Sam Lotu-liga  
Stuart Nash  
Dr Russel Norman

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## Appendix B

### Corrected transcript of hearing of evidence 10 December 2009

#### Members

Craig Foss (Chairperson)  
Amy Adams  
David Bennett  
John Boscawen  
Brendon Burns  
Hon David Cunliffe  
Aaron Gilmore  
Raymond Huo  
Peseta Sam Lotu-Iiga  
Tim Macindoe  
Dr Russel Norman  
Hon David Parker

#### Witnesses

Dr Alan Bollard, Governor  
Dr John McDermott, Assistant Governor/Head of Economics  
Dean Ford, Manager Forecasting  
Simon Tyler, Head of Financial Markets

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| Foss    | Welcome, Dr Bollard, and your team. It seems like just yesterday we saw you. Thank you very much. We'll skip the introductions this time I think, and we'll just go straight in. If you'd like to lead in, Dr Bollard, then I'll have a couple of questions, then I'll pass to Mr Cunliffe. The floor is yours, sir. Welcome and thank you for coming.   |
| Bollard | <p>Thank you, Chair. Thank you for the invitation. This is our December Monetary Policy Statement, out this morning. It's a slightly stronger story on the economy, which comes from both international and domestic.</p> <p>Internationally we're seeing reasonably strong numbers coming out of Australia, China, other East Asian countries; less so with the big northern hemisphere - developed countries, where they are all now in growth mode but in some cases it's very much growth that's not driven off stimulus. We're obviously interested in how those international financial markets use some of these things, and also in how the US dollar moves. You'll have noted yourselves over the last couple of days there's been a bit of concern around sovereign risk in other countries—strength in the US dollar. We're</p> |

really asking whether the US dollar is moving into a different sort of driver at the moment.

But in the meantime, we've got a forecast that says our current account deficit improves quite significantly, although at least part of that is driven by one-off factors such as bank payments, tax. We've got a stronger set of external prices—principally dairy prices again—and exports are stronger as a result. But the business sector otherwise is still quite weak. We're not seeing very much business investment, despite confidence surveys showing some strength. The labour market we do see as turning around the middle of next year, and we're picking an unemployment peak of around 6.7, 6.8 percent, which is less than we've done in previous significant recessions.

On the housing side, well, we're all aware that house prices have pushed up a little bit over the last little while, and some of that surprised us a bit. That's really, in our view, a re-equilibration going on. There is a housing shortage at the minute. We're not seeing many houses coming on to the market. We expect that to start happening. We expect to see more investment in building—stocking up again. But we're still seeing very limited credit growth out of banks into the housing sector, and that's one reason why we're not getting particularly concerned at the minute about a credit-driven housing bubble. It just doesn't look like that at the moment.

We are seeing households rebalancing and reducing debt, being quite cautious generally, but again we've got to just caution that we're still learning about how households may have changed behaviour as a result of this recession, and we'll be watching that quite closely.

On the Government side, we continue to anticipate that the Government will, as forecast in this Budget, start to move the fiscal policy back towards neutral. We think that's important because that will assist us in not having to do some work out of monetary policy and pushing up interest rates higher than they otherwise might have to be.

The broad picture we're getting overall is of GDP in recovery. We're expecting some growth in the third quarter and that continuing through next year. But it's still late next year before we see the ground made up that we lost during the global financial crisis. We expect to have a couple of low quarters of CPI, then CPI around 2 percent for a year or so, and then picking up a little bit in further years—out-years—but still medium-term inflation on track.

The market surveyed earlier this week expected to see interest rates pushing up in the second quarter next year. What we've said this time is that if the economy continues to recover as projected, then conditions could support a start to remove monetary stimulus around the middle of 2010. In the meantime we've pointed out that actually the markets themselves have reduced the need that we have to move faster, because you have the higher exchange rate tightening financial conditions. You've got the same effect

from increased long-term interest rates, and also the wider gap between the OCR and bank-borrowing rates, so there is some tightening of financial conditions out there, anyway.

The market this morning has seen our forecast as a little bit more hawkish. Well, there is a little bit more activity there. Is it more hawkish? It's not as hawkish as most of them are, so I sympathise in that. The exchange rate has kicked up a little bit. Again I imagine that's a short-term sort of feature, but we'll see over the next weeks.

Foss Thank you very much, Dr Bollard. Can I ask: on page 7 of your MPS, you've got a section where you're talking about linkages between monetary, fiscal, and tax, and you're basically going on there to explain that the existing tax system exacerbates the economic cycle. Essentially you're saying that that actually leads to higher interest rates in New Zealand, which equates to a disincentive of savings—financial savings. Am I picking that right, and can you expand on that a bit please?

Bollard Yes. First of all I should say we do monetary policy, not tax, but obviously the tax regime does impact monetary policy and that's our focus. Secondly, there are quite properly a whole range of objectives in a country's tax policies—it's a very complex area as you all know—so we're not trying to be simplistic about this, but one of the things we do look for is neutrality from the tax system with regard to how households decide to save and consume, and if they're saving whether they're investing, whether in housing, or what. We have had the view that it does present some incentive to investing in housing, and we think that has been partly responsible for the housing activity that we've seen in previous booms and therefore the very high interest rates. And, again, that's sent back through to the exchange rates. That's what we're repeating here.

Foss OK, I'm sure another member might come back to that. Just one other point: does New Zealand need, or should we be getting used to a positive yield curve in New Zealand?

Bollard Could I ask Simon Tyler of our financial markets department if he might help on that?

Foss Sure.

Tyler Well, it is very strange for us to have a positive yield curve, but I think, yes, we possibly will have one for a while. Part of it is driven by international funding markets. All Australasian banks, and countries which have got negative current accounts need to borrow from wholesale markets. One thing that's happened through the global financial crisis is that the cost of term money has gone up, and it's very hard to see that getting back to anywhere nearly as cheap as it's been, and that probably means we will have a positive yield curve for a while.

Foss OK.

- Cunliffe Thanks very much. Governor, I'm interested first in the market reaction to your statement. As you've said, there's been a perception that it's been a little more hawkish than expected, and perhaps a little less gloomy, and the dollar rose quite sharply on the crest of this news. The perception follows from that, that perhaps the bank has given up on lending against the markets, like \_\_\_\_ saying that the dollar was higher than justified, and that the markets have taken this as a bit of a white flag. How do you respond to that suggestion?
- Bollard I think, as you know, the markets tend to be a bit binary the way they sort of interpret these things; it's either dovish or hawkish. But on the exchange rate, we still feel that the New Zealand dollar is probably overvalued for the condition of the economy, but a little less, though, than we might have felt in June and in September. That's because on the one hand the New Zealand dollar has come down a little bit since then; on the other hand we've actually had upside surprises on commodity prices, particularly dairying.
- Cunliffe So you're driving off the data really, Governor?
- Bollard Absolutely. I mean, it's a period when we in the market have had all sorts of surprises in the data. Early this year we were just getting very bad news; now we're getting slight improvement.
- Cunliffe I was very interested in the discussion, following on from my colleague's question, about the outlook becoming increasingly more unbalanced, and on page 5 of your commentary you talked about the current account deficit likely to widen once some short-term features start to dissipate, and talked about the high level of overall borrowing indebtedness. Most significantly, that sets up a possible—one might interpolate—vicious cycle. Governor, can you elaborate a little more on the kinds of policy instruments that you might as complementing your efforts to reduce those imbalances and smooth the cycle going forward?
- Bollard Well, just to repeat an answer to previous questions, we'd like to see tax regimes that are neutral on savings versus consumption. At the margin we'd expect that to have some impact on households consuming less and saving more for the longer term. We think that's actually happening at the minute. We're a little unclear how much that's a short-term reaction response to the events of the last year and how much it's actually a change in behaviour. It could be both.
- We think that needs to continue. That's still quite important that households believe that they are being rational in terms of building up some savings. Even so, you could still see a situation whereby from a New Zealand macroeconomic point of view there are advantages in households saving a little bit more than they might rationally decide to individually, but ultimately a lot of those things are linked back to savings.

- Cunliffe So it's a saving versus investment and balance-neutral investment environment question?
- Bollard And as you know, we tend to talk household savings, but there's corporate savings and Government savings, and they vary over time.
- Cunliffe Thanks, Governor. Thank you. You have warned again that the high level of the New Zealand dollar might jeopardise somewhat the required structure adjustment in the economy, with a corresponding reduction in the current context. In the bank's view, what level of NZ\$/TWI would facilitate sufficient structural change to reduce the CAB to a more sustainable level?
- Bollard Well, we don't have a sort of a target exchange rate there. We are, of course, quite competitive against currencies like the Australian dollar. This has been a US dollar story. Actually, what's emerging at the minute is quite different conditions depending on whether you're in dairying and a few other areas, or whether you're pushing against the tide in some other areas where you're stuck with the US dollar and quite low prices. So we don't have a particular target, but we have had some ballpark figures on current accounts.
- McDermott Yes, so if we look at the end of our projections, we'll see the TWI moving to the range of about 60, and that we think is a long-term average, which will help stabilise the current position in terms of New Zealand's net foreign liabilities. Of course if you're wanting to unwind the build-up over the last 5 years, you would need a position of an undervalued currency for about the same length of time.
- Burns Supplementary on that, could that projection be influenced by early changes in things like foreign investment laws, strategic asset \_\_\_\_\_ from offshore? Could that affect that?
- Bollard Well at the margin, but you'd need to see it having quite a significant effect, I would have thought. Those things tend to impact marginal investments rather than the core.
- Burns Does that also sort of \_\_\_\_\_
- Bollard Sure.
- Cunliffe Governor, going back to 2007, the Reserve Bank expressed concerns about the effectiveness of the OCR as the only policy instrument, and that is given the high share of mortgages on fixed rates. Has that changed now that the proportion of fixed-rate mortgages has changed, or are you still in a sense wanting to explore some sort of complementarity between the OCR and other financial tools?
- Bollard At the minute, the proportion has changed quite significantly. There is a lot of borrowing, done not necessarily so much on flexible but on very short-term rates.

- Tyler A year ago only 10 percent of mortgages would have been floating-rate; now there are 20 percent. Of the 80 percent that are actually fixed rate, 80% are fixed for less than 2 years. We are now seeing that most mortgages reset in one year, so the OCR will have far more bite now, far more than it would have had in 2006-07 where you had a far longer duration on the average mortgage.
- Cunliffe So just linking that to an ongoing conversation that we've had in the FSR context around the evolution of prudential policy in that space, between pure prudential and pure monetary goals: do you think that new liquidity requirements could be used in such a way as to take some pressure off the OCR, and that in a sense is a counter-cyclical use of that still a possibility in future?
- Bollard Yes, at the margin, but we don't want to over-promise on that. We have done a bit of work at the core funding ratio, which is the key part of liquidity policies, and projecting what that might have looked like over the last 5 years if we had had that in place. It looks interesting enough for us to want to look further at it. But that is more in the nature of an automatic stabiliser. It is not a high discretionary, short-term sort of tool.
- Cunliffe Are you also looking around for other potentially either automatic stabilisers or complementary measures that might assist that?
- Bollard We are always looking. We are doing a little bit of work on capital adequacy ratio movements at the minute, but we expect that would be rather less useful. The core cutting ratio looks most useful to date. But we have to do this in the context that the G20 nations through the Basel committee on bank supervision are coming out with their recommended international moves right at the moment, and we are expecting to see a push to liquidity policy roughly of the sort we are talking about. Counter-cyclical capital, where there is some thought that internationally there might be better ways of dealing with these things, but I guess we have to really look at that quite carefully. There is also dynamic provisioning, which would generally help as an automatic stabiliser.
- Cunliffe Would it be fair to say that that represents an evolution of what we might call an international consensus around the balance of monetary policy instruments?
- Bollard A lot of it is driven off a desire for better prudential supervision of individual institutions. That is where the powers are, in most cases, overseas. But there is certainly this increasing interest in whether that can fill the gap between supervision of individual institutions and stabilisation of the macro-economy generally.
- Cunliffe Would it therefore be a fair extrapolation, or not, to say that if one were to adopt a policy that there was no room for evolution of the status quo, in

terms of the basket of policy tools, that would increasingly not represent the international status quo or the international mainstream?

Bollard

Sorry, that was a triple negative. Could you rephrase that?

Cunliffe

Sorry, let me express it more clearly. If the international consensus is moving towards a broader basket of potentially complementary tools, which really bends the cycle as well as improving prudential supervision, and if one were to take the position perhaps not to investigate that or not to act on it, would it be fair to say that that would be moving progressively away from the international mainstream?

Bollard

Well, there are two classes of policies coming through. Some of them, frankly, don't look like they are that relevant to Australasia. They are things like leverage ratios, stuff on remuneration, and other things. But there are some that do look very relevant, as I say, like liquidity policies, maybe counter-cyclical capital, and certainly dynamic provisioning. The world's banking regulatory community has to decide what it considers as important for most first-class country bank regulation, in the form of Basel III or something like that. We are yet to see quite what is in there. We would certainly be expecting to look at those and stay in line where relevant.

Cunliffe

And just elaborating on that—chairman, this is my final question, and I know that Mr Parker has some as well as your team—I understand from the press conference this morning that when asked whether the bank was talking to the Government about its fiscal impact policy preferences, you indicated that, yes, it was, and that the Government had been generally receptive. Can you give us a bit of detail about which particular policy that that comment included?

Bollard

Yes. I don't think that should be taken as any particular change in what we do. I was very careful to state that we talked to the Government in exactly the way that we always have, which is that a couple of days before the Monetary Policy Statement we talked to them about the forecast, but we don't talk about the decision. In that context, we have made it clear what our views are on the broad tax area. But we have declined to go into detail. We do not have the expertise; it is not our role to do that. That is what the Government—

Cunliffe

It was more around the tax area than the monetary intervention?

Bollard

Yes, but certainly we've kept the Minister in touch with developments in macro-financial instruments internationally, and where things are going in New Zealand.

Foss

Just a quick one from myself: what was your forecast for the unemployment labour market last MPS? You've got 6.6 percent for 2010 now. You can come back to me, but I think it was nudging through 7 percent? How does that translate into the number of jobs?

- Ford We had a peak, I'm pretty sure, at 7 percent. It was around about there. The current projection translates through the recession to be just under 60,000 jobs lost. I think so far the number is about 55,000, so most of the job losses from the recession we think have occurred.
- Foss Hopefully we are through the worst.
- McDermott Maybe I will just clarify: the number was 6.8 percent in March 2010, and we don't publish it until quarter numbers. It just sneaks up to about 7 percent in the middle on 2010. We actually printed 6.8 percent.
- Bennett Can I say—with the residential housing market, you are seeing it sort of possibly peak early next year. Do you think it is sustainable that banks will still be tight coming out of that period, and do you see any risks in that time when post that peak we see a decrease in prices as newer houses come on the market? What do you think would need to be done to stabilise those banking prospects going forward when the market seems to be doing it by itself now?
- Bollard At the moment we are seeing house prices going in one direction and household credit, new loans, going in another direction. That won't continue. It has to come together in some way. So if we were to see not much new lending going on, then any housing recovery would be very credit-constrained. I don't necessarily think that is happening yet, but it is something for us to look at. That would be a bit different if we were to see that; we haven't seen that recently. We expect to see the house price increase slow down as more houses get built and more people start putting their houses back on the market. That deals to the real demand that is there. There is an additional question as to how that feeds through into consumption, which is also a complex one, but we will just have to keep watching.
- Bennett And with the US dollar stuff, you said that the drivers are different now. Last time I think we talked about how the New Zealand dollar was in a basket of other commodity dollars that had grown. When you look at us on page 9, figure 3.6, we are at the bottom of the growth now, whereas some of the commodity ones are still at the top. Is there something going on about the New Zealand dollar that is different from the other commodity-producing ones at the moment?
- Bollard Those move around a bit. There is a bit more of an understanding in the international market place that New Zealand is not Australia, and the exchange rates could move a little more independently. The Kiwi has been softening a bit as a result of that. I don't know if you could say there has been a particular driver of that.
- Tyler No, but, as Alan said, for the last 6 months the Australian dollar has been very strong on the international market, and initially many investors saw New Zealand as being the same as Australia. But the Governor has been at

pains to say that our commodity basket in New Zealand is different. The hard commodity prices have been going up, and the dairy prices have gone up. However a lot of other exporters, such as winemakers, clearly aren't making the gains, and it has been recognised that our New Zealand commodity basket is different, and that is why we have slightly lower currency than other commodity countries. You can see that the Canadian dollar is down as well.

- Gilmore You've forecast a bit of an improvement in the economy, generally, which is obviously positive news, but there's an interesting mix going on. You are looking at a slightly lower export growth performance and a slightly higher investment, particularly in housing for example. In 2010-11 we are looking at a 24 percent increase, which is quite a big chunk in a one-off sort of type scenario. But equally with the export thing, you're talking a very high commodity price path still, so are you expecting actual volumes to go down, because that is the only thing that seems to make sense, with commodity prices staying very high, and the economy going faster, for the actual export growth to tail off a bit?
- Bollard Can I ask Dean Ford, who is head of forecasting. Sorry, I didn't reintroduce John McDermott, head economist.
- Ford So the export volumes are predicted to go up. There are a few reasons for that, thinking through the different categories. Part of it is just recoveries. For example, the exports of the tourism industry and the manufacturing industry are very, very low at the minute, and you'd expect, even with stabilisation in the world, that you'd get some recovery. But it is not a particularly strong picture for tourism or manufacturing, but you just get recovery because things are so low at the moment.
- Gilmore OK. So that export growth, though, with that big high commodity price, and you are expecting that to remain over the medium term for the next 2 or 3 years—and it has been quite a rapid movement; it has been for the last year or so—are you expecting a change in the export mix as a result, from what you just said?
- Ford You would expect so—
- Gilmore You're looking at 2 or 3 percent export growth, but you're looking at 3.5 to 4 percent GDP growth. Obviously, the proportion of tradable sector is going down relative to the rest of the economy; the rest of the economy is going up.
- Ford Sorry, I thought you meant within the export sector. But, yes, exports relative to the rest of the economy are suffering from the high exchange rate. But there is quite a big benefit from higher export prices as well. I think, in net, you are still getting a reasonable contribution from net exports. But, yes, I think we have a line in the statement that says that the

increase in the currency is largely offsetting the gains in the world and the gains from higher export prices. So you are still getting growth—

- Gilmore I have one more question. It's more about what Mr Foss talked about, about the yield curve. We are seeing a move from a flat yield curve to a normally shaped yield curve. I am interested in some of the reasons why you think those things are occurring.
- Tyler Without wanting to repeat myself, the cost to money is more. So, previously, the banks were very happy to offer people relatively cheap 5-year mortgages, because the banks borrowed the money in the short term wholesale market and they only passed on the cost of this borrowing. They didn't borrow much long term—that is one of the things we were concerned about for financial stability—they funded themselves probably a little bit short and it was costing them very little over the bill rate. Now when a bank offers a mortgage for a 5 year term, the cost of that money globally in the international capital markets has gone from practically 0.25 percent to over 2 percent. Even now it is close to 1.75 percent and the banks will pass this cost onto mortgage borrowers.
- Gilmore OK. So you see that remaining in place for the medium to long term—in fact, moving to more of a normal yield curve?
- Tyler Yes.
- Norman I think one of the more alarming parts that you're reporting on is that on the one hand you are saying that everything is getting nicer. Actually, the alarming part is what you say about the current account deficit. The fact is we have to service it, we're building up the net liabilities and that over time, we're going to keep building up more, which will mean that we may be paying a higher risk premium on the more borrowings we'd have to take account of that current account deficit. How does this kind of thing play out when we are now, after Iceland, the next in the queue in the OECD in terms of net liability condition? It seems to be an extremely risky position for New Zealand to find ourselves in.
- Bollard I don't think it is necessarily that risky. We think we are heaps different from Iceland, and it has been interesting to see the flurry of market concerns about sovereign risk over the last few days, with countries like Greece and Spain last night—even concern last night in the markets about the latest British numbers on the deficits and borrowing requirements, and the Irish Budget coming out today. I don't think New Zealand is in that class at all. We think our finances are in a much better condition. But it is absolutely true to say that the current account deficit is quite significant and it takes a lot to turn it around. Simply a softer New Zealand dollar on its own could take a long time for it to have a response—more so than, say, the Americans have with their current account deficit and their soft US dollar, because we have a much bigger net investment income deficit. It is not just a trading side; it is the investment income side that is the big driver.

- Norman In some ways, the recession has helped, because sending profits back to the overseas-owned companies has dropped off.
- Bollard It depends on profitability in New Zealand compared to overseas, as well as the different volumes involved. But, of course, the crisis has knocked down imports here as it has in a lot of countries, hugely, but that is a short-term sort of thing. We are looking for what the medium term has on all of this, and, yes, it is a very slow recovery.
- Norman Just on the dollar, I just want to try \_\_\_\_\_. Last time you came I was quoting various erratic ideas like: “Let’s \_\_\_\_\_ the Brazilian tax \_\_\_\_\_”
- Norman Not to be confused with the Brazilian \_\_\_\_\_ talking about one of the ideas is that you target a level of the New Zealand dollar and you can say to overseas investors: “Look, this is the level the New Zealand Government’s targeting. If it heads over this level, we are basically going to print money, effectively or \_\_\_\_\_ and you actually borrow for it. What is your view on this kind of policy restricting laws that put down a cap on the New Zealand dollar?”
- Bollard We don’t think it would work for New Zealand. I mean, that’s a variant of the Singapore sort of story. The big differences are that in the case of Singapore, exports and imports are 200 percent of GDP. Here they are far less than that. In Singapore, the Government has a huge surplus and the private sector has huge surpluses, and we don’t have those here. They’ve got huge intervention ability. Trade is a very big driver of the dollar in those cases, and they have very strong capital controls on what goes in and out. We don’t think, really in almost any of those, that New Zealand could do that. What Bill is suggesting is a variant of that, which presumably would end up where inflation is in terms of printing money. That has a lot of distributional consequences.
- Norman So having inflationary pressures can also be good, depending on capital imports, effectively, but also have issues in terms of disrupting capital imports and people will be less productive?
- Bollard Also it would be very hard for us impact the level of the New Zealand dollar across the cycle.
- Norman Wouldn’t it act as a cap? If people thought you were going to print New Zealand dollars people would go: “Oh, I wouldn’t want to buy New Zealand dollars.”
- Bollard Well, with the consequence of printing those New Zealand dollars goes through the economy more generally—
- Norman The inflationary consequences.

- Foss Do you want to round up Mr Norman, and then to David Parker.
- Parker I just wanted to carry on with the topic that Russel raised earlier, which was the current account deficit this year, which this year went down, partly because the banks are paying some of their overdue tax \_\_\_\_\_. They then go back up to 5.6 percent and 6.5 percent. We don't seem to be getting to an export level recovery, do we, based on Russel's point?
- McDermott No, that is correct. What we're seeing through the recovery is that this has been a global financial crisis, so every country is responsible, some more than others, and everybody is sort of recovering. It is actually mathematically impossible for everybody to have an undervalued currency. Some have it and we don't. So as a consequence, we can't, this time, expect our recovery to come solely from exports, unlike other recoveries.
- Parker The main drivers of the increase in the current account deficit in out-years the increases in borrowings from overseas sources that are going to a concern to New Zealand. Would that be right?
- McDermott Well the overseas borrowing won't finance that kind of capital issue. What we're seeing as the economy recovers, business profits increase, some of that is flowing on, and we will see the current account deficit fall to a 6.5 percent level. We're also likely to see a higher interest payments and dividend levels.
- Parker So most of that effectively has been consumed rather than going into investment in the tradable sector?
- McDermott I think if I understand the question, that's correct—I mean, we are not seeing a big change in the investment at the moment.
- Parker So it's really more of a return to the resurgent problems of the past, rather than where you create the paradigms \_\_\_\_\_
- Bollard We don't have a structural change build into this, but as I say, we're pretty interested in what households' borrowing and savings behaviour will be like. That does impact on this.
- Lotu-Iiga Just looking at your comments on the labour market, you've said that it's nearing a trough and the weakness during the 2009 year has led to moderation in wage growth. We've seen some disputes throughout this year, and if it starts to take off, do you see pressure on wages as being a threat to the inflation levels?
- Ford One of the interesting things we have seen through the recession was just how flexible the labour market turned out to be. We saw a big drop in labour demand, but rather than that being reflected in lower employment, it seemed as though firms for a large part put in wage freezes, and also they tried to reduce the hours of existing staff. We're starting to see the economy improve now, and some of those things will turn round, and there has been

- numerous headlines about wage disputes going in. In the projections we have, wage inflation is picking up, so you'd expect more of this to happen. Certainly, there will probably be some catch-up from wage rates that were held steady. Does it put some risk on inflation? Well, it all really depends on how strong those things come through. But certainly the projections would allow for a pick-up in wage inflation.
- Foss With the RBA running ahead of yourselves in their short-term official rates, will that flow into the 1, the 2, the 3-year rates so we could start to see the margin, or the premium, of New Zealand over Australia come in? Because they're very, very bullish on their economy and you've become less bearish, perhaps a little bit more bullish today, and other reports seem to be heading that way, as well. Do you see any implications there?
- Tyler Yes, their whole term structure for interest rates is far higher than ours, and it's a very strange time. But it's been like that for 6 months, ever since they've signalled higher rates. At this stage, as the governor mentioned, we are quite competitive against Australia in the exchange rate, and we would expect that to continue. A lot of people are predicting the Australian exchange rate would continue to appreciate, because they are effectively quite a high interest rate currency relative to other currencies at the moment.
- Foss But you still see New Zealand's interest rate curve as being Aussie plus something?
- Tyler Well, in the short term, no; I think our interest rates will be Aussie minus something.
- Foss OK, but a bit further out, 3 and 5 years ahead, there's a fundamental shift going on. We have years and years of a negative curve. We've now got a positive curve, and it just changes the whole approach. So I'm just wondering if that would flow through to the premium. Do you have any thoughts?
- Bollard There are two things going on. The first is risk premia for New Zealand, but the other is higher sustained growth prospects in Australia, with their mineral possibilities.
- Parker How do we ever get away from that risk premium; if we can't get away from it, how can our New Zealand - owned borrowers keep reliant on New Zealand sources of finance in their small to medium sized businesses? How do they ever become competitive in the world to increase their exports?
- Bollard Well, that risk premium has been in there for a long, long time. Some of it's probably liquidity rated for very small markets. Some of it is a view of risk in the New Zealand economy. Some of it indirectly reflects the fact that we're not saving and, therefore, we're not in net and we're not contributing in net terms to that pool of funds of investment in New Zealand. That's why we keep coming back on this issue of, do we care about owning our

own homes or owning our own businesses? I think from a macro-economic point of view, it loops back in.

Parker So we're going to get a dramatic increase in saving?

Bollard I don't know about a dramatic increase; I think it needs to have a change in behaviour. We are seeing some change in behaviour at the minute, but, as we were saying, we are not sure how permanent that is.

Parker Well, we've got house price inflation and expectations of increased consumption.

Bollard Well, we've got a more gradual growth in consumption this time. If you look at the relationship between house prices and consumption historically, it is a very strong relationship. We're assuming it's not quite as strong in the future, but, again, we've just got to wait and see.

Foss Thank you, Dr Bollard. Thank you to your team.

#### **conclusion of evidence**