Reference: 20150254

27 August 2015

[redacted]

Thank you for your Official Information Act request, received on 26 June 2015. You requested the following:

> *"1. All briefing notes, correspondence and advice on the Reserve Bank's monetary tightening in 2014.*
> *2. All briefing notes, correspondence and advice, from February 2014 until now, on the Reserve Bank's failure to meet its 2% inflation target in recent years."*

On 7 July we sought an extension of 30 working days. A response to your request is due by 4 September 2015.

On 2 July 2015 a Treasury official contacted you to clarify the scope of the request. You agreed to keep correspondence at a substantive level.

Further, it should be noted that the Policy Targets Agreement (PTA) requires the Reserve Bank to keep future inflation outcomes between 1% and 3% on average over the medium term, with a focus on keeping future average inflation near the 2% target mid-point.

Information Being Released

Please find enclosed the following documents:

Item	Date	Document Description	Decision
1.	29 January 2014	HYEFU Forecasts Summary: FEC 29 January 2014	Release relevant parts
2.	11 February 2014	BEFU 2014 Monetary Conditions Panel Note	Release relevant parts
3.	11 March 2014	Treasury Report: March 2014 Monetary Policy Statement	Release in full
4.	26 June 2014	PREFU Monetary Conditions	Release relevant parts
5.	19 August 2014	Treasury Report: Meeting with the RBNZ – Board of Directors	Release relevant parts

6.	5 September 2014	Aide Memoire: September 2014 Monetary Policy Statement	Release in full
7.	9 September 2014	Changes Since PREFU	Release relevant parts
8.	25 September 2014	HYEFU Monetary Conditions	Release relevant parts
9.	14 November 2014	Aide Memoire: Comments on Rodney Dickens Analysis on Inflation and Monetary Policy	Release in full
10.	9 December 2014	Treasury Report: December 2014 Monetary Policy Statement	Release in full
11.	12 March 2015	Aide Memoire: Responses to Questions on February 2015 Monthly Economic Indicators and Chart Pack	Release relevant parts
12.	24 March 2015	Treasury Report: Inflation Performance and the Policy Targets Agreement	Release in part
13.	27 May 2015	Monetary Policy Framework / Exchange Rates: FEC 17 June 2015	Release relevant parts
14.	29 May 2015	Email: Reserve Bank SOI	Release relevant parts

I have decided to release the relevant parts of the documents listed above, subject to information being withheld under one or more of the following sections of the Official Information Act, as applicable:

- personal contact details of officials, under section 9(2)(a) – to protect the privacy of natural persons, including deceased people,
- advice still under consideration, section 9(2)(f)(iv) – to maintain the current constitutional conventions protecting the confidentiality of advice tendered by Ministers and officials, and
- names and contact details of junior officials and certain sensitive advice, under section 9(2)(g)(i) – to maintain the effective conduct of public affairs through the free and frank expression of opinions.

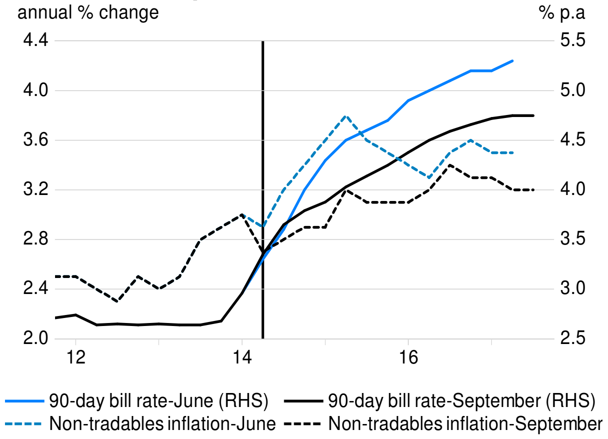
Excerpts of Information to be Released

Excerpts and summaries of the documents listed in the below table are also relevant to part 1 of your request.

Item	Date	Document Description	Excerpts
15.	21 January 2014	Economic Brief: Consumer Price Index: December 2013 quarter	Today's higher-than-expected inflation outturn does not change our expectation that the RBNZ's first OCR hike of the cycle will being March, owing to the source of the upside surprise. Higher tradables inflation than expected will be less of a concern to the RBNZ than if the shock had been to non-tradables prices. However, there is a slightly higher chance of a hike at next week's OCR review (30 January), given other upside of surprises such as to GDP growth in the September quarter and continuing stellar indicators for growth for the December quarter such as the QSBO.
16.	24 January 2014	Weekly Economic Update: Consumers price inflation in December 2013 quarter surprises...	Consumers price inflation surprised markets on the upside, lifting 0.1 % in the December quarter compared to market expectation for a 0.2% fall. This followed the 0.9% rise in the September quarter and took annual inflation to 1.3% Non-tradables inflation was in line with expectations, but tradables inflation was stronger than forecast. This reflected rises across tradables goods, linked to a fall in the exchange rate in mid-2013, and larger-than-expected rises in domestic and international air travel and package holiday prices. The market is now pricing in a 50% chance of a hike in the official rate at next week's OCR meeting, although we and most economists still think the tightening cycle will begin in March. Indeed, the source of upside surprise will be less of a concern to the RBNZ than if the shock had come through non-tradable prices.
17.	31 January 2014	Weekly Economic Update: RB holds OCR, but rates expected to rise soon	As expected by the majority of economists, the Reserve Bank held the OCR at 2.5% at is first review of the year. The Bank's statement provided the clearest signs yet of the imminent tightening cycle, noting the "considerable momentum" in New Zealand's economic expansion, and the need for interest rates to return to more normal levels. Economists expect the Bank to increase the OCR by 25 basis points at the March Monetary Policy Statement meeting, which is in line with HYEFU forecasts.
18.	16 April 2014	Economic Brief: Consumer Price Index – March quarter 2014	Today's result is unlikely to change the Reserve Bank's outlook for further increases in its policy rate. The non-tradables outcome was in line with the Bank's expectation, its focus is on the medium term and it is unlikely to respond to one quarter's result. Analysts still expect a 25 basis point increase in the OCR at the next review on 24 April, although the market has scaled back increases later in the year slightly. The NZ dollar fell about half a cent against the USD following the release and 2-year swap

			rates eased slightly.
19.	18 June 2014	BEFU 2014 Economic Forecasts Summary: FEC – 18 June 2014	• Looking forward, the strength of some of the positive influences on the GDP growth are expected to moderate, including monetary policy moving to a more neutral stance in response to anticipated inflationary pressures. The latter reflects the expectation that the economy will be operation at or above capacity over much of the forecast period. • Fiscal policy restraint and the high exchange rate imply interest rates are lower than would otherwise be the case. The recent application of Loan to Value Ratios (LVRs) is also reducing the amount of work monetary policy needs to do over the short term. In the absence of these downward forces, the impetus to demand from the Canterbury rebuild, means net exports make a negative contribution to GDP growth over the first three years of the forecast period. • Question: *What are the expectations around interest rate changes?* Answer: In the BEFU forecasts, short-term interest rates rise to 4.8% by the March quarter 2016,up from 3.0% in the March quarter 2014, a little faster than projected in the *Half Year Update*, reflecting stronger growth.
20.	16 July 2014	Economic Brief: Consumer Price Index – June quarter 2014	Today's result is unlikely to change the Reserve Bank's outlook for further increases in its policy rate, with headline inflation on target with the Bank's expectation. However, the combination of tradables and non-tradables inflation was different, with lower non tradable inflation than the bank expected. This may point to a weakness in demand and may have implications for nominal consumption in the June quarter. Analysts still expect a 25 basis point increase in the OCR at the next review on 24 July, although the market has slightly lowered expectations of an increase later in the year. On the release, the NZ having already fallen by a similar amount following the GDT auction price and Fed Chair Yellen's "dovish" Senate testimony.
21.	12 September 2014	Weekly Economic Update: RBNZ keeps OCR on hold at 3.50%	As widely expected, the RBNZ kept the OCR unchanged at 3.50% at the September monetary policy meeting. The statement said that the timing of further policy adjustments is conditional on the effects of migration on the housing market, the pass-through of capacity pressures on inflation, and the response of the exchange rate to lower export prices. Following the lower non-tradable inflation outturn in the June quarter, the annual CPI forecast was revised down by 0.2% in the December quarter relative to the June MPS. Annual inflation does not reach the 2.0% target until September 2016, rather than June 2015. The weaker inflation outlook led the RB to revise its 90-day interest rate track down by 50 bps at the end of the forecast period (Figure 1). The 90-day track implies only two 25 bps OCR hikes through to the end of 2015, a 150

<table>
<tr><td></td><td></td><td></td><td>bps increase from the beginning of the tightening cycle.

Figure 1: 90-day bill rate and non-tradables inflation forecasts in September and June MPS


Source: RBNZ

The MPS’s tone was considered slightly more dovish than expected with the NZD/USD rate immediately falling below 0.82 and, along with the AUD, declined further overnight. The TWI has fallen 0.4% since the release to 79.4. Swap rates fell across the curve with the 2-year swap rate down 6 bps to 4.05% and the 10-year swap rate down 4 bps to 4.69%. The market is now pricing a 40% chance of a March OCR hike compared to a 60% chance prior to the release, with a hike not fully priced in until June 2015.</td></tr>
<tr><td>22.</td><td>21 October 2014</td><td>Economic Outlook: Talking points for Minister Bennett</td><td>Inflation pressures have been weaker than expected. The Reserve Bank indicated in its September Monetary Policy Statement that it would “undertake a period of monitoring and assessment” before considering further increases in its policy rate in the light of recent economic developments and uncertainties. Market commentators do not expect an increase in the cash rate before March 2015. More recent commentary suggests even this may be too early. International inflationary pressures are also benign.
Reflecting increased inflation pressures, we expect further increases in the Reserve Bank's Official Cash Rate (OCR) over the forecast period. Ninety-day interest rates are forecast to rise to 5.3% by late 2017.</td></tr>
</table>

23.	23 October 2014	Economic Brief: Consumers Price Index – September 2014	Today's result is at the bottom of the Reserve Bank's target range and below their forecast of 1.3% in the year to September. However, the Reserve Bank had signalled a pause in the tightening cycle in the September Monetary Policy Statement, meaning today's figure has limited implications for the immediate future, but may result in a longer pause if weak inflation outturns continue. Some analysts have pushed back their pick for the next rate hike from March 2015 to mid or late 2015. On the release, the NZ dollar fell 40bps against the USD to 78.69 cents and declined further throughout the day to 78.46 cents on expectations that the Reserve Bank will hold rates for a longer period.
24.	24 October 2014	Weekly Economic Update: Inflation lower than expected	The CPI rose 0.3% in the September quarter to be up 1.0% in the year to September, down from 1.6% in the year to June. This was below our recent forecast and the median market's expectation of a 0.5% for the quarter and well below the Reserve Bank's forecast of 0.7%. The main contributions to the quarterly increase again came from housing and household utilities (0.2 ppts), but this was partially offset by cheaper communications, and household contents and services. Annual inflation in both tradables (-1.0%) and non-tradables (2.5%) surprised on the downside. Despite this, we expect inflation to rise as capacity pressures build and the impact of the lower NZD flows through. However, the lower quarterly increase, combined with weaker than expected inflationary pressures, suggests inflation will be lower over the next year, with analysts now expecting inflation below 2% until the end of 2015. The outturn is at the bottom of the Reserve Bank's target range and well below their forecast of 1.3% in the year to September, possibly resulting in a longer pause in the tightening cycle. This, along with confirmation of benign inflation pressures, has led some analysts to push back their expectation of the next rate hike from March 2015 to the second half of 2015. Some analysts also reduced their peak OCR forecast from 4.50% to 4.00%. On the release, the NZD fell 40 bps against the USD to 78.69 cents, and then continued declining to be 78.28 cents at noon Friday. The 2-year-swap rate fell 5 bps to 3.91% and the OIS curve flattened further, with a full 25 bps hike not priced in until January 2016. The Bank will review the OCR on 30 October.

The below excerpt is relevant to part 2 of your request:

Item	Date	Document Description	Excerpt
25.	21 January 2015	Economic Brief: Consumers Price Index – December quarter 2014	Today's result is below the Reserve Bank's target range and their forecast of 1.0% in the year to December. However, the Reserve Bank signalled a pause in the tightening cycle in the December Monetary Policy Statement, meaning today's figure has limited implications for the immediate future. In addition, the weaker outcome is largely a result of one-off factors, implying that the RB is likely to look through them. Prior to the CPI release, a full 25 bps OCR rate hike was not priced in until the end of 2018. On the release, the NZ dollar fell 40 bps against the USD to 76.3 cents before gaining back 30bps to 76.6. The next OCR review is on 29 January.

Information Publicly Available

The following information is also covered by your request and is publicly available on the Treasury website:

Item	Date	Document Description	Website Address
26.	January 2014	Monthly Economic Indicators January 2014	http://www.treasury.govt.nz/economy/mei/archive/pdfs/mei-jan14.pdf
27.	April 2014	Monthly Economic Indicators April 2014	http://www.treasury.govt.nz/economy/mei/archive/pdfs/mei-apr14.pdf
28.	June 2014	Monthly Economic Indicators June 2014	http://www.treasury.govt.nz/economy/mei/archive/pdfs/mei-jun14.pdf
29.	July 2014	Monthly Economic Indicators June 2014	http://www.treasury.govt.nz/economy/mei/archive/pdfs/mei-jul13.pdf
30.	July 2014	Budget 2014 Proactive Release: Budget 2014	http://www.treasury.govt.nz/downloads/pdfs/b14-info/b14-2872557.pdf
31.	July 2014	Budget 2014 Proactive Release: Fiscal Strategy	http://www.treasury.govt.nz/downloads/pdfs/b14-info/b14-2850547.pdf
32.	November 2014	Monthly Economic Indicators November 2014	http://www.treasury.govt.nz/economy/mei/archive/pdfs/mei-nov14.pdf

Accordingly, I have refused your request for the documents listed in the above table under section 18(d) of the Official Information Act – the information requested is or will soon be publicly available.

Some relevant information has been removed from documents listed in the above table and should continue to be withheld under the Official Information Act, on the grounds described in the documents.

In making my decision, I have considered the public interest considerations in section 9(1) of the Official Information Act.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This fully covers the information you requested. You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Mark Vink
Manager, Macroeconomic and Fiscal Policy

Information Being Released
TOIA 20150254

IN-CONFIDENCE

HYEFU Forecasts Summary: FEC –29 January 2014

[Information not relevant to request]

[Page 2 not relevant to

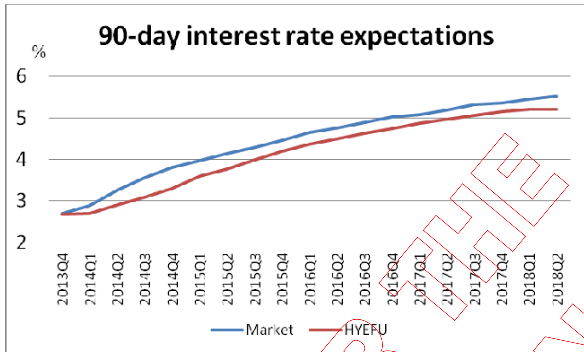
IN-CONFIDENCE

[Information not relevant to request]

Question: What are the expectations around interest rate changes?

Answer: Increasing price pressures are expected to see the Reserve Bank begin to increase the OCR in early 2014. Market expectations are for the first rate hike to occur in March, with a possibility of a hike at the 30 January review. We expect March will be the first date for an increase. There is greater uncertainty around the extent of interest rate hikes over the forecast horizon, which will be dependent on a number of factors, including the amount of inflationary pressure and the exchange rate. A graph is provided below showing the HYEFU forecasts for interest rates and the market-implied rates as at 17 January. We use the same assumptions as the Reserve Bank around the impact of the LVRs: interest rates are assumed to be around 30 basis points lower than it would have been if the LVR restrictions had not been implemented. This is expected to result in house prices being lower by 2.3% in the first year and 1% in the second year than what they would have been without the policy.

IN-CONFIDENCE



[Information not relevant to request]

[Pages 5 & 6 not relevant to request]

BEFU 2014 Monetary Conditions Panel Note

[Information not relevant to request]

[Page 2 not relevant to

[Information not relevant to request]

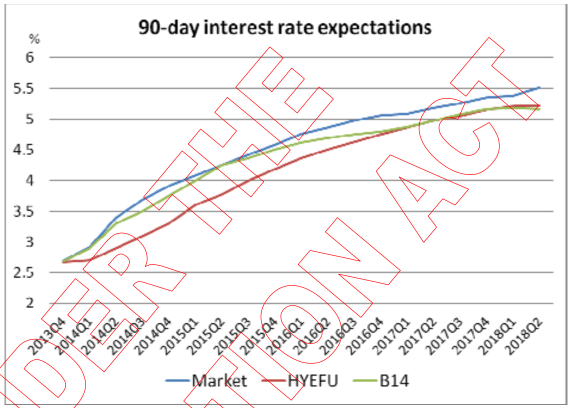
Medium-term forecasts

Annual CPI inflation is expected to dip slightly in the second half of 2014, as the large increase in 2013Q3 drops out of the calculation. From there, inflation is expected to peak at 2.6% in 2015Q4. Annual inflation is forecast to be above the RBNZ's target of 2.0% from 2015Q4. Implicitly this means that we think the RBNZ will allow more inflation (or will be surprised). Because of the composition of growth and inflation, with a significant proportion coming from the Canterbury rebuild, we see the RB allowing more inflation in this instance.

[Information not relevant to request]

[Pages 4 & 5 not relevant to

90-day rates



90-day interest rates rose at the start of 2014, after having remained steady for several years. They rose on anticipation of a possible OCR hike from the RBNZ in January, as momentum continued to gather in the economy. After the RBNZ held in January, rates pared slightly, but remained higher in anticipation of a hike in March. Most economists expect a 25 basis point hike in the OCR at the March MPS meeting, with a total of 75 basis points of hikes by June. The expectations for the degree of hikes after this are uncertain, and will depend a lot on actual economic outcomes. Our preliminary BEFU track for the output gap is more positive than at HYEFU and inflation is higher, leading to higher interest rates, as the RBNZ looks to keep inflation in check. We have 90-day rates slightly above 5% at the end of the forecast period, which is a similar end point to HYEFU. This is above the 'neutral' interest rate, which we and the RBNZ see as around 4.5%. It is above neutral at the end owing to the inflationary pressures coming from the tradables side as the TWI depreciates. While our 90-day track is similar to the market-implied track in the near term, it is lower by the end of the forecast period.

Our track implies 75 basis points of OCR hikes by June 2014, with another 75 basis points by June 2015 (OCR of 4%). The implied OCR at the end of the forecast period is about 5.0%.

[Information not relevant to request]

SENSITIVE

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: March 2014 Monetary Policy Statement

Date:	11 March 2014	**Report No:**	T2014/392
		File Number:	MC-1-3

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note** this report before your economic outlook meeting with the Prime Minister, Governor of the RBNZ and the Treasury	12:00 pm on Wednesday 12 March
Associate Minister of Finance (Hon Steven Joyce)	**None**	N/A
Associate Minister of Finance (Hon Dr. Jonathan Coleman)	**None**	N/A

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Dhritidyuti Bose	Senior Analyst, Macroeconomic and Fiscal Policy	04 890 7289 (wk)	[Withheld under s9(2)(a)]	✓
Mark Blackmore	Principal Analyst, Macroeconomic and Fiscal Policy	917 6247 (wk)		

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Enclosure: Yes (Letter from the Governor)

11 March 2014 MC-1-3

Treasury Report: March 2014 Monetary Policy Statement

Executive Summary

The Reserve Bank of New Zealand (RBNZ) will announce its Official Cash Rate (OCR) decision and release a set of economic projections in the March 2014 *Monetary Policy Statement* (*MPS*) at 9.00am, Thursday 13 March. The OCR is currently 2.5%. Market pricing shows an almost certain expectation of a 25 basis point increase in the OCR on Thursday.

The March 2014 *MPS* presents a more cyclical outlook for the economy compared to the December 2013 *MPS*. The RBNZ has revised upwards its growth forecasts for all the years from March 2014 to March 2017. Annual average real GDP growth is expected to increase to 3.5% in early 2015 and moderate to 2.3% in early 2017 rather than peak at 3.0% in early 2015 and moderate to 2.3% in early 2016 as projected in December. The RBNZ now expects actual output to expand faster than potential output in the years to March 2014 and March 2015 respectively leading to a positive output gap and increasing inflationary pressures. Private consumption and investment growth are expected to be strong contributors of demand growth, offset partly by strong growth in imports and fiscal consolidation. Annual CPI inflation is forecast to increase to 1.7% and 1.9% in the years to March 2014 and March 2015 respectively, before stabilising at 2.1% for the years to March 2016 and March 2017. The Bank assesses that the OCR will need to increase by about two percentage points over the next two years to steer inflation towards the middle of the target.

Treasury's *Preliminary BEFU 2014* forecasts show a slightly larger economic cycle with annual average real GDP growth expected to peak at 3.9% in the March 2015 year moderating to 2% in the March 2017 year. The Treasury's forecasts show annual CPI inflation at 2.3%, 2.5% and 2.4% for the three years to March 2017 respectively, higher than the RBNZ's March *MPS* forecasts. This difference is consistent with the difference between the RBNZ's and the Treasury's expectations of monetary tightening to come. In the March *MPS*, the average 90-day interest rate is projected to increase by 250 basis points over the forecast years compared to 210 basis points in Treasury's *Preliminary BEFU 2014* forecasts.

You are meeting with the Prime Minister, the Governor of the RBNZ and Treasury officials on **Wednesday 12 March at 12.00pm** to discuss the outlook for the economy and inflation. The attached letter from the Governor of the RBNZ provides an overview of the March *MPS* projections.

Recommended Action

We recommend that you note this report before your meeting on the economic outlook with the Prime Minister, Governor of the RBNZ and Treasury officials on Wednesday 13 March 2014 at 12.00pm.

Mark Blackmore
Principal Analyst, Macroeconomic Policy

Hon Bill English
Minister of Finance

Treasury Report: March 2014 Monetary Policy Statement

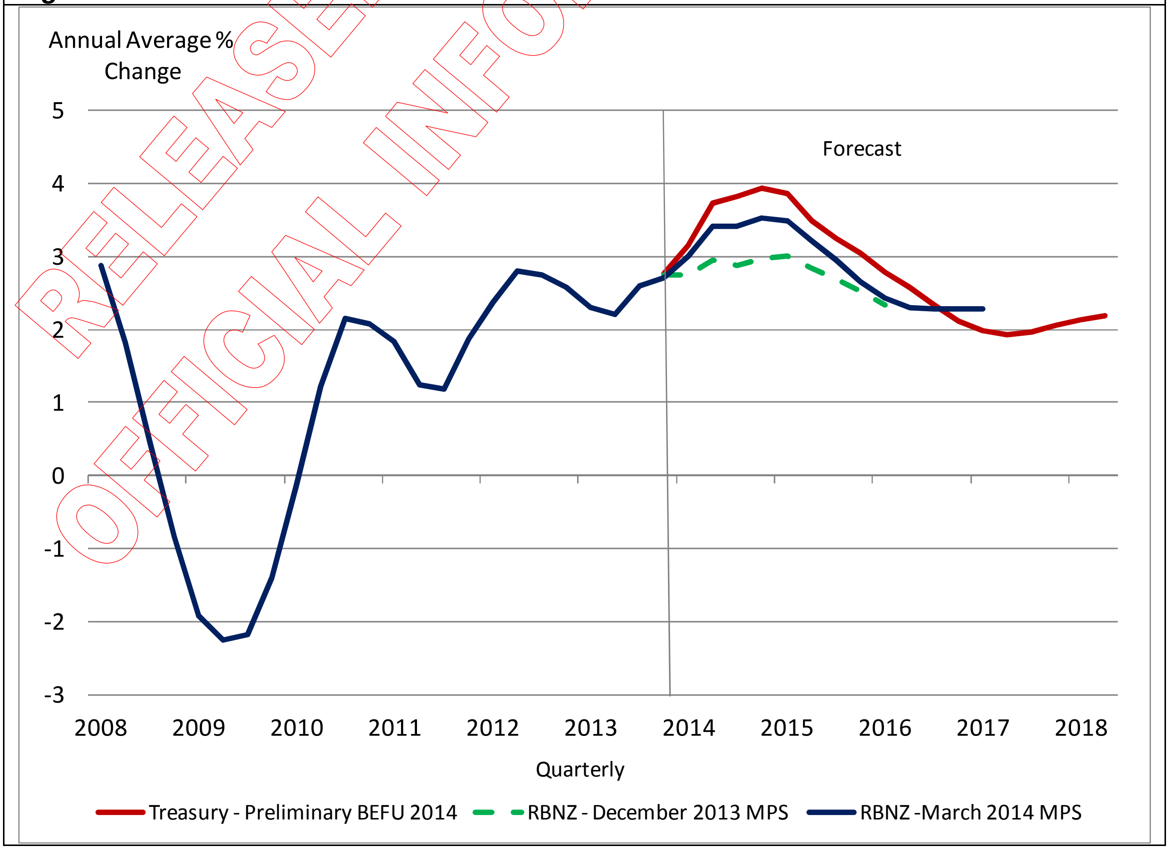
Purpose of Report

1. This report briefs you ahead of the meeting with the Prime Minister, the Governor of the Reserve Bank of New Zealand (RBNZ) and the Treasury on Wednesday 13 March. It compares the RBNZ's March 2014 *Monetary Policy Statement (MPS)* projections with the December 2013 *MPS* projections and Treasury's *Preliminary BEFU 2014* forecasts.

Analysis

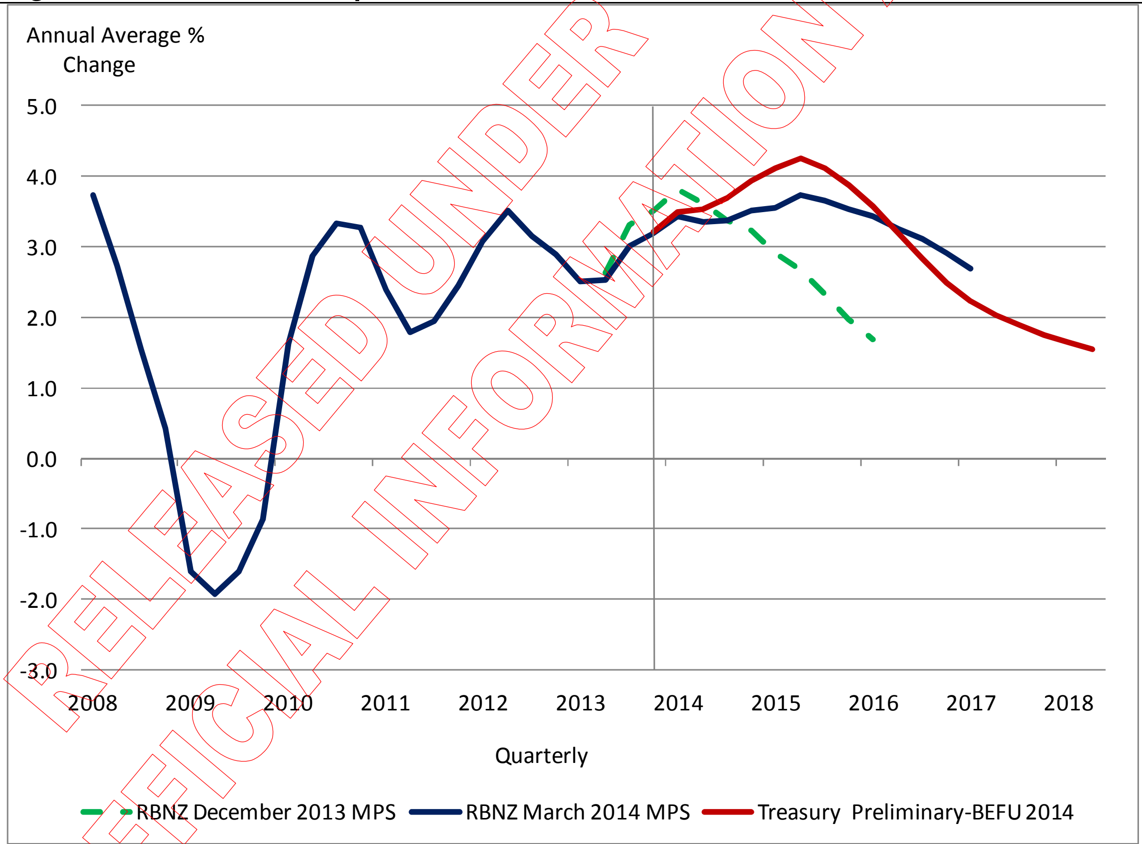
2. The March *MPS* presents a more cyclical economic outlook than the December *MPS* forecasts. The RBNZ has revised upwards its growth forecasts for the four years to March 2017, reflecting a combination of cyclical forces and higher potential growth. Annual average real GDP growth is now forecast to increase from 3.0% to 3.5% and then moderate to 2.4% and 2.3% for the years from March 2014 to March 2017. The December *MPS* forecasts showed growth increasing from 2.8% in the year to March 2014 (annual average) to 3.0% for the year to March 2015 before moderating to 2.3% in the year to March 2016 year. Treasury's *Preliminary BEFU 2014* forecasts show a slightly larger cycle with annual real GDP growth of 3.2%, 3.9%, 2.8% and 2.0% for the four March years to 2017 (Figure 1).

Figure 1 **– Real Production Growth**



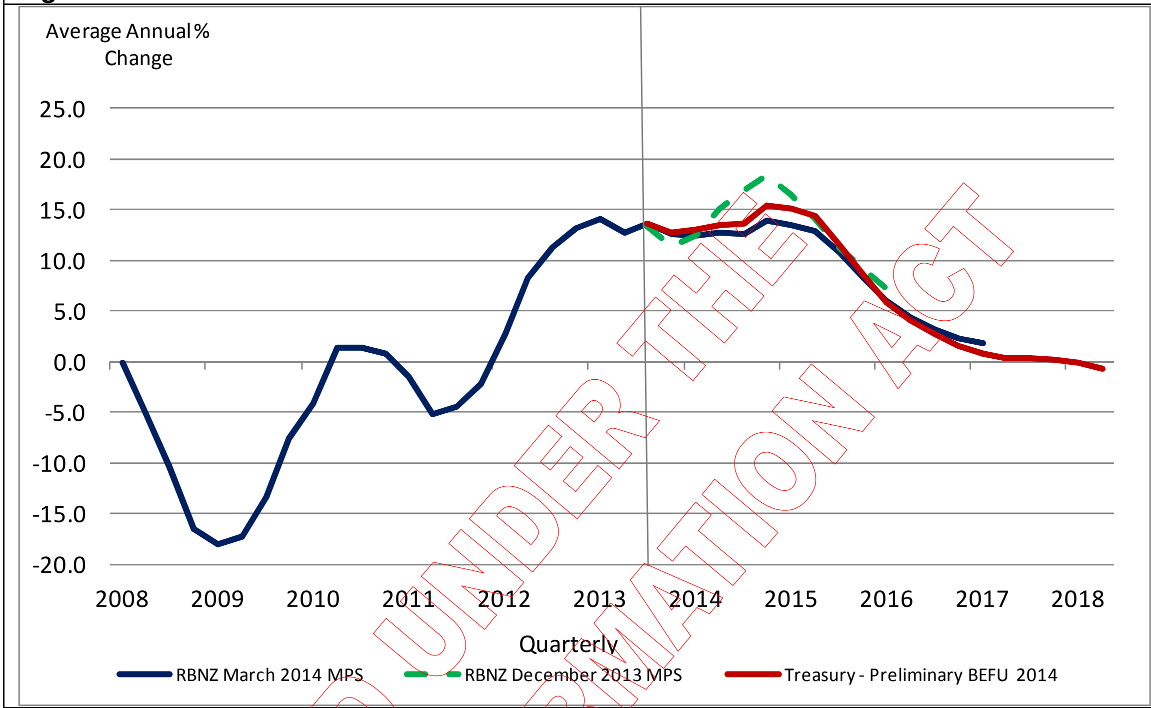
3. The RBNZ now projects private consumption growth to be sustained through the next two years rather than moderate after the current year as was forecast in December. Strong net immigration, robust employment growth and high exchange rate are expected to be the principal drivers. The March *MPS* forecasts average real private consumption expenditure growth of 3.4%, 3.6% and 3.4% in the three March years to 2016 respectively, compared with the growth of 3.8%, 2.9% and 1.7% projected in the December *MPS*. Private consumption growth is expected to ease to 2.7% in the March 2017 year. Treasury also forecasts stronger near-term private consumption growth although the cycle is more pronounced than shown in the RBNZ's March *MPS* forecasts (Figure 2). **You may wish to ask the Governor of the RBNZ about the relationship between consumption and house prices through the forecast period particularly if housing market momentum moderates further ahead.**

Figure 2 **– Private Consumption Growth**



4. The RBNZ's projection for investment remains broadly similar to the December *MPS* track with growth likely to be stronger in the current year and the next year. The March *MPS* forecasts show investment growth of 12.1%, 10% and 5.2% in the three March years to 2016 respectively, compared to the growth of 9.2%, 10.4% and 6.8% projected in December. Investment growth is forecast to ease to 3.1% in the March 2017 year. Business investment growth is expected to remain stronger than expected in December. The RBNZ expects construction activity to drive investment activity. Treasury expects residential investment growth to be sustained for the years up to March 2016 (Figure 3). The RBNZ has indicated that the housing market momentum has moderated, partly due to the high loan-to-value restrictions.

***Figure 3:* Residential Investment Growth**



5. On the international side, the RBNZ expects global economic conditions to improve gradually. The *March MPS* forecasts the trading partner growth of 3.5%, 3.8% and 4.2% for the March years to 2016, unchanged from the December MPS forecasts. The growth is forecast to remain at 4.2% in the March 2017 year. The RBNZ forecasts are similar to that of Treasury.

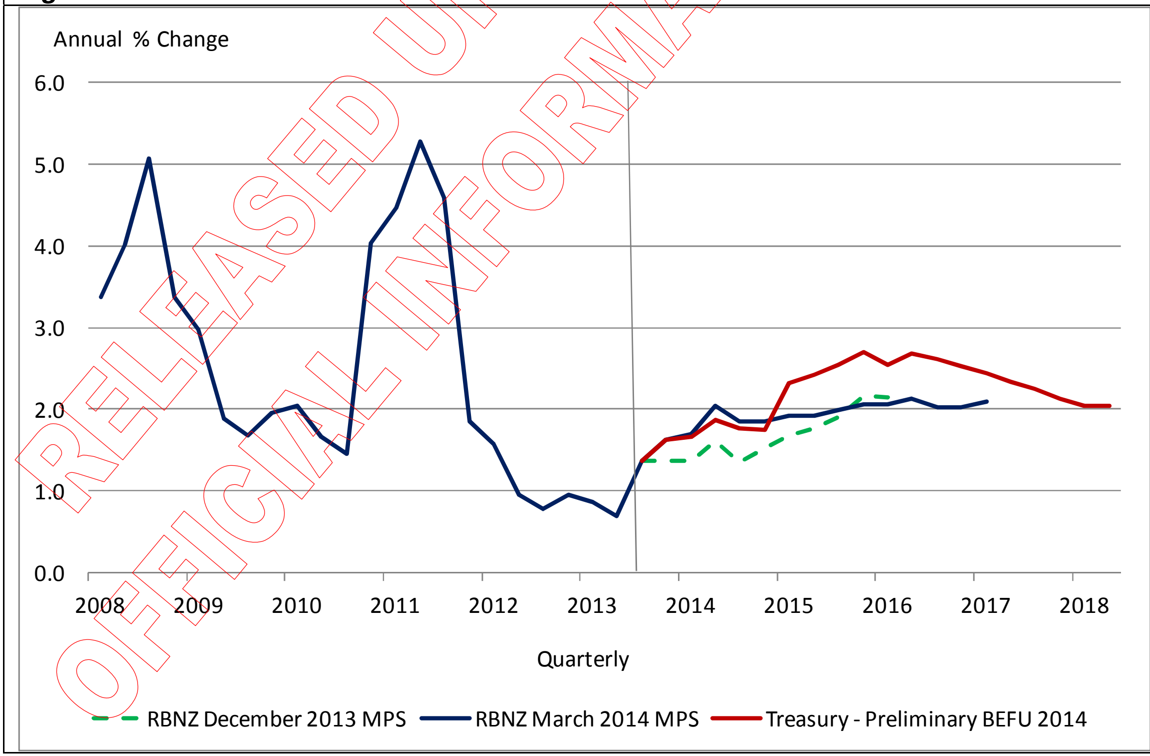
6. The RBNZ has revised upwards its exchange rate forecasts. The March *MPS* projects the trade-weighted index (TWI) to remain at a high of about 78 till early 2015 before declining by 3.5% to around 75 by early 2017. Export growth has been revised up somewhat reflecting a stronger post-drought recovery in primary exports this year. The growth of exports is forecast to increase to 3% in the March 2017 year alongside a lower exchange rate. Imports are forecast to grow 6.3% and 5.3% in the two March years to 2016 respectively (compared with 4.6% and 3.1% predicted in the *December MPS*). After declining this year, the current account deficit (as % of GDP) is expected to increase to 3.7%, 5.2% and 5.6% in the three years to March 2017 respectively. Although Treasury's forecasts for the current account deficit are higher than the RBNZ's forecasts in the March *MPS*, the increase of 1.9 percentage points of GDP from the March 2015 year to the March 2017 year remains the same in the two forecasts. **You may wish to ask the Governor of the RBNZ about the Bank's view of the impact of the high exchange rate on export competitiveness of manufacturing.**

7. The RBNZ's view of the overall demand-supply balance is that demand pressures are likely to absorb spare capacity gradually with actual output growing faster than potential output for the economy. The March *MPS* forecasts the unemployment rate of 5.6%, 4.9%, 4.9% and 5.0% in the four years to March 2017, compared to Treasury's forecasts of 5.9%, 5.5%, 5.3% and 4.9% respectively.

Inflation Outlook

8. The RBNZ has revised upwards its inflation forecasts for the March years 2014 and 2015 amidst rising underlying demand pressures. Annual CPI inflation is forecast to increase from 1.7% to 1.9% in the years to March 2015 respectively and stabilise at 2.1% in the following two years. The Bank assesses that the OCR will have to increase by two percentage points over the coming two years to steer inflation towards the middle of the target range. In the March *MPS*, the average 90-day interest rate is projected to increase by 250 basis points over the forecasts years from March 2014 to March 2017, compared to 210 basis points in Treasury's *Preliminary BEFU 2014* forecasts. As a result, the inflation outlook in the March *MPS* is lower than the *Preliminary BEFU 2014* forecasts. Treasury's *Preliminary BEFU 2014* forecasts annual CPI inflation to be 1.7%, 2.3%, 2.5% and 2.4% in the March years to 2017 respectively. The RBNZ expects annual non-tradable inflation to peak to 4.1% in December 2015, while Treasury forecasts it to peak to 4.3% in June 2016. The *MPS* March forecasts show the annual tradable inflation to remain negative at -0.6% and -0.5% in March 2015 and March 2016 compared to positive inflation forecasts of 0.3% and 0.8% respectively in the *Preliminary BEFU* 2014. This is because the RBNZ forecasts the exchange rate to be higher than in the Treasury's forecasts.

Figure 4: **CPI Inflation**



Fiscal Outlook

9. The RBNZ now expects the Government's operating balance to return to surplus in the June year to 2015, a year earlier than projected in its *December* MPS. The March *MPS* projects operating balance to be in deficit of -1% of GDP in the June year of 2014, before surpluses of 0.2%, 0.8% and 1.6% in the three June years to 2017 respectively.

PREFU Monetary Conditions 2014

[Information not relevant to request]

[Pages 2 & 3 not relevant to request]

[Information not relevant to request]

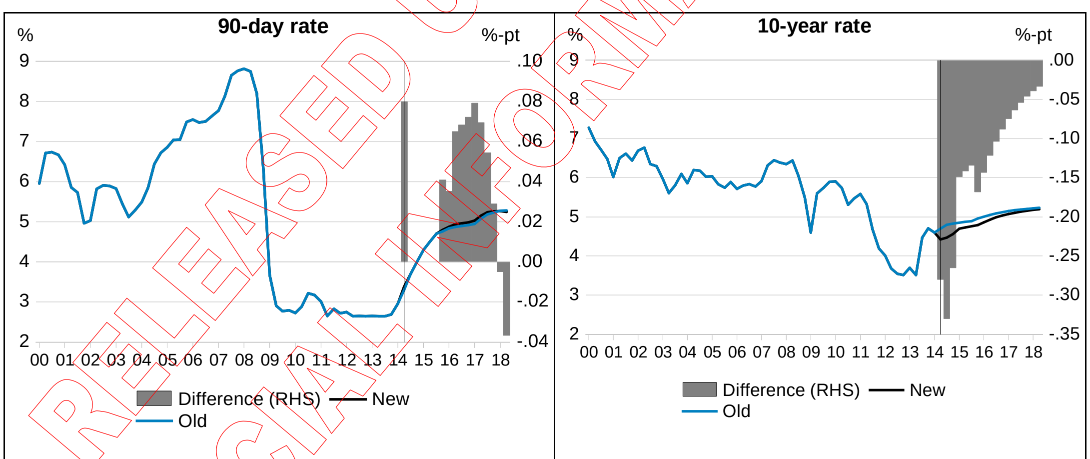
Recent developments

The NZD remains elevated against other currencies. The TWI has been steadily increasing since 2013Q4 after the weak international environment and the anticipation of RBNZ OCR increases. The June MPS was more hawkish than the market was expecting and this resulted in the NZD climbing against our major trading partners and, so far, remaining at this level. The USD has been weaker following the weak, weather affected March quarter and Yellen's statement about not increasing short term rates until next year. There is also greater risk appetite in the global economy given the more stable outlook, despite the continuing risks (low iron ore prices, Ukraine and Iraq geo-political risk).

[Information not relevant to request]

[Information not relevant to request]

Interest rates



90-day rates

90-day interest rates have been rising steadily since the start of the quarter after the OCR hikes in April and June. The more hawkish than expected June MPS led to a jump in the 90-day rate with the June quarter 90-day rate at 3.4% up from 3.3% forecast in BEFU. Many economists now expect a 25 basis point hike in the OCR in July, with the market pricing an 88% chance, and one other hike before the end of 2014. The expectations for when the hikes occur are less certain than the fully anticipated hikes in April and June, and will depend on economic outcomes. The 90-day rate is forecast to be 3.7% and 4.0% for the September and December quarters, equal to the BEFU forecast. In later periods, 90-day rates are very similar to the BEFU track with an end point of slightly above 5%. This is above neutral at the end, as non-tradables inflation peaks above 4% in 2016Q3 following the peak in the output gap of above 1% of potential output in 2015Q3. In addition, there will be less offset from tradables inflation as the TWI depreciates.

OCR rises expected by local bank economists

	Jul 14	Sep 14	Oct 14	Dec 14	Jan 15	Mar 15	Apr 15	Jun 15
Implied RBNZ OCR	3.50	3.50	3.75	3.75	4.00	4.25	4.25	4.25
OIS (02/07)	3.47	3.53	3.61	3.72	3.83	3.91	4.01	
ANZ (30/06)	3.50	3.50	3.50	3.50	3.50	3.75	4.00	4.00
BNZ (23/06)	3.50	3.50	3.50	3.75	3.75	4.00	4.00	4.25
ASB (30/06)	3.50	3.50	3.50	3.75	3.75	4.00	4.00	4.25
Westpac (16/06)	3.50	3.50	3.75	3.75	4.00	4.25		
Westpac (30/06)	3.50	3.50	3.50	3.75	3.75			
Kiwibank (12/06)	3.25	3.50	3.50	3.75				
Deutsche Bank (20/06)	3.50	3.50	3.50	3.75				4.25

[Information not relevant to request]

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Meeting with the RBNZ - Board of Directors

Date:	19 August 2014	**Report No:**	T2014/1453
		File Number:	MC-1-2-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note** suggested discussion points before your meeting with the RBNZ's Board of Directors	12:00pm on Thursday, 21 August

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Oscar Parkyn	Senior Analyst	04 917 6912 (wk)	[Withheld under s9(2)(a)]	✓
Tim Ng	Director, Macroeconomic Policy	04 917 6124 (wk)		

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Enclosure: No

[Pages 2 - 3 not relevant to request]

[Information not relevant to request]

Performance monitoring

20. The Board is responsible for performance monitoring. We have provided some commentary on performance with respect to the Reserve Bank's organisational outcomes. We have suggested some potential discussion points (in bold), which are summarised in Annex 2.

Price Stability

21. Measures of consumer price inflation, both headline and underlying, are comfortably within the 1-3% target range and forecast to return to the 2% midpoint. Annual CPI inflation was 1.6% in June 2014, which is in line with the Reserve Bank's forecast for CPI inflation made a year earlier in the June 2013 *Monetary Policy Statement*.

22. Monetary policy is in a tightening cycle with the Reserve Bank having increased the OCR by 100 basis points earlier this year. Market analysts expect the Reserve Bank to pause this tightening to assess developments and then undertake further increases in the OCR from early next year. **You may wish to ask how the Board is monitoring the effects of monetary tightening in this cycle, particularly in light of the atypical domestic and global conditions.**

23. The PTA requires that in pursuing its price stability objective, the Bank shall implement monetary policy in a way that seeks to "avoid unnecessary instability in output, interest rates and the exchange rate". **You may wish to ask the Board how it assesses the Bank's performance in this respect, particularly in light of the relatively subdued recovery in output in the recent cycle compared to past recoveries.**

24. The PTA requires that the Reserve Bank monitor asset prices and implement monetary policy with regard to the efficiency and soundness of the financial system. Similarly, the macro-prudential MOU stated that macro-prudential instruments can play a useful secondary role in stabilising the macro economy. As a result, the Reserve Bank will consider any interaction with monetary policy settings when implementing macro-prudential policy and will explain the implications, if any, for monetary policy. The Reserve Bank's position is that it is essential to retain clear primary objectives for both monetary and macro-prudential policy. These primary objectives are price stability and financial system stability respectively. However, the Reserve Bank considers there is an appropriate role for policy coordination in certain circumstances and with certain policy tools. **You may wish to ask about the Board's view of the Reserve Bank's position on the coordination of monetary and macro-prudential policy.**

[Information not relevant to request]

[Pages 6 - 8 not relevant to

Annex 2: Potential discussion points

[Information not relevant to request]

Monetary policy

- How is the Board monitoring the effects of monetary tightening in this cycle, particularly in light of the atypical domestic and global conditions?
- How does the Board assess the Bank's performance with respect to the PTA's requirement that in pursuing its price stability objective, the Bank shall implement monetary policy in a way that seeks to "avoid unnecessary instability in output, interest rates and the exchange rate"?
- What is the Board's view of the Reserve Bank's position on the coordination of monetary and macro-prudential policy?

[Information not relevant to request]

SENSITIVE

Reference:	T2014/1562	MC-1-1-1
Date:	5 September 2014	
To:	Minister of Finance (Hon Bill English)	
Deadline:	Read before 4.00 pm, Monday, 8 September	

Aide Memoire: September 2014 Monetary Policy Statement

This note briefs you on the Reserve Bank of New Zealand (RBNZ)'s economic forecasts ahead of your meeting with the Governor of the RBNZ and Treasury officials on Monday, 8 September at 4.00 pm. The RBNZ will announce its Official Cash Rate (OCR) decision on Thursday, 11 September at 9.00 am. It will also publish its updated economic projections in the accompanying September 2014 *Monetary Policy Statement* (*MPS*). The OCR currently is 3.5%.

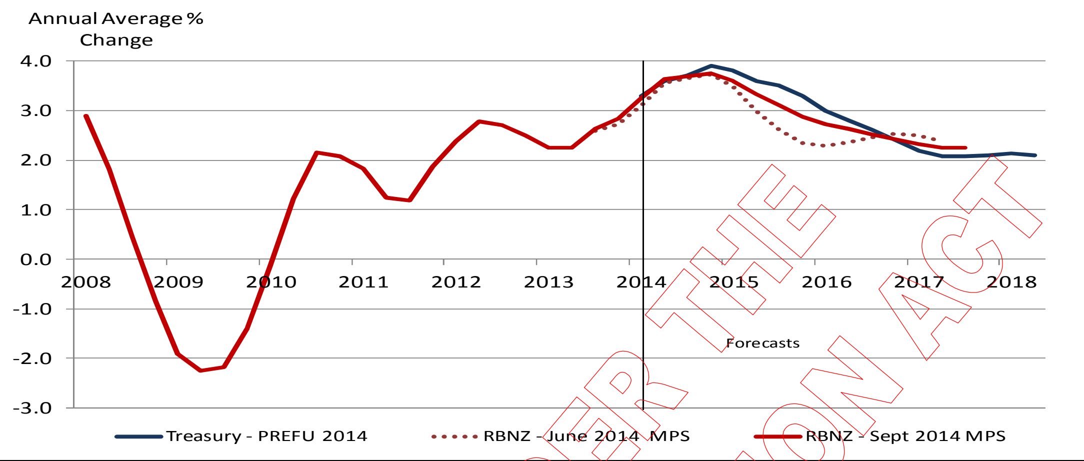
Summary

- Slightly stronger real GDP growth expected than in the June *MPS*
- Weaker nominal GDP growth than forecast in the June *MPS* due to lower inflation and a sharper fall in export prices

Economic Outlook

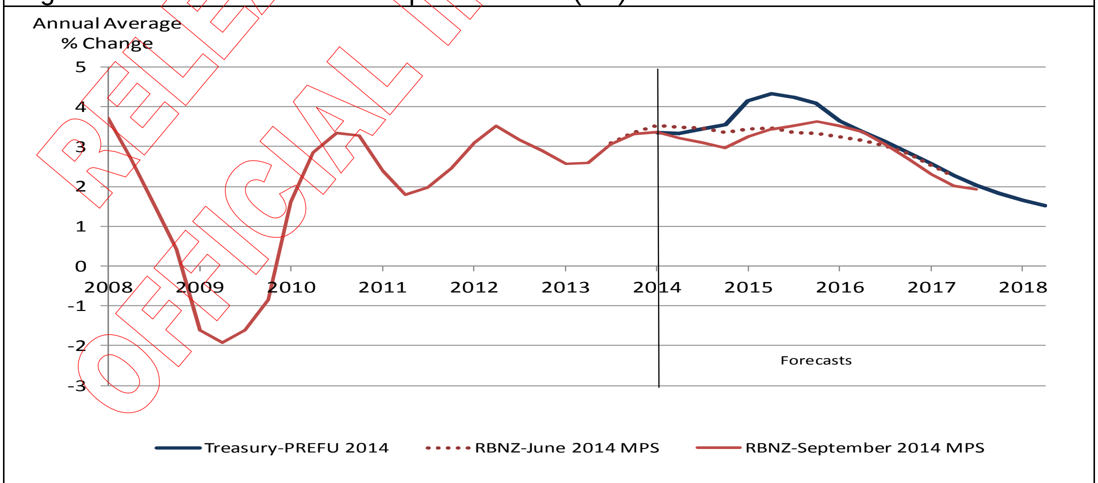
The September *MPS* presents a less cyclical outlook for the economy compared to the June *MPS*, with the growth momentum likely to be sustained longer than was previously expected. The RBNZ forecasts annual average real GDP growth to reach a peak of 3.7% in December 2014 as was expected in June, and then moderate. The RBNZ now expects current growth momentum to continue up to mid-2016. The real growth forecasts have been revised up for the March 2015 and March 2016 years in the September *MPS* as compared to in the June *MPS* (Figure 1). Real GDP growth (annual average) is now forecast to increase from 3.3% to 3.6% and then moderate to 2.7% and 2.3% for the years from March 2014 to March 2017. Treasury's *Pre-election Fiscal Update* (*PREFU*) 2014 forecasts show a larger cycle with annual average real GDP growth increasing from 3.3% to 3.8% and then decreasing to 3.0% and 2.2% for the four years to March 2017 respectively.

Figure 1 – Real Production Growth (s.a)



A less cyclical outlook for private consumption relative to Treasury's contributes to the RBNZ's less cyclical economic outlook (Figure 2). Private consumption growth is likely to remain strong in the near term as was previously expected. The RBNZ has noted that some drivers of household spending are changing. While net immigration has remained strong, house price inflation has eased. In the September *MPS*, real private consumption (annual average) is projected to grow by 3.3%, 3.5% and 2.3% for years from March 2015 to March 2017 compared to 3.4% in the March 2014 year. Treasury's *PREFU* forecasts show real private consumption growth (annual average) to increase from 3.4% to 4.1%, before moderating to 3.6% and 2.6% for four March years to 2017.

Figure 2 – Real Private Consumption Growth (s.a)



Investment continues to remain a key driver of GDP in the September *MPS* mainly reflecting construction activities in Canterbury and Auckland. The RBNZ's forecast for investment is largely unchanged from the June *MPS* and is similar to Treasury's *PREFU* forecast.

On the international side, the RBNZ expects only a gradual increase in growth in advanced economies. The September *MPS* projects trading partner growth to pick up from 3.7% to 4.0% over the forecast period. The RBNZ's trading partner outlook is similar to the forecasts in *PREFU*.

The RBNZ now expects the exchange rate to be weaker compared to the June *MPS* forecasts. The September *MPS* projects the Trade Weighted Index to come down from the high of 80.1 in mid-2014 to 74.9 by mid-2016 and further to 73.4 by late 2017. With the exchange rate expected to depreciate, exports are projected to grow by 3.5%, 1.7% and 3.1% in the March years from 2015 to 2017. The June *MPS* forecasts showed exports to grow by 0.4%, 2.4%, 2.1% and 3.0% in the March years to 2017 respectively. Overall, the current account deficit as a percentage of GDP in the September *MPS* is projected to be - 4.4%, - 6.3% and - 6.1% in the years to March 2017 compared to *PREFU* forecasts of - 4.8%, - 6.2% and - 6.4%. **You may wish to ask the Governor of the RBNZ about the prospects of future depreciation of the New Zealand dollar, especially in the light of developments in the global economy.**

Inflation Outlook

The RBNZ's inflation track is lower in the September *MPS* forecasts, but CPI inflation is projected to pick up to the mid-point of the target band by 2017 as was in the June *MPS* (Figure 3). Annual CPI inflation is now forecast to decrease from 1.5% to 1.4% and then increase from 1.7% to 2.1% in the March years to 2017(Figure 3). While inflationary pressures from construction activity and net immigration could ease, the RBNZ expects domestic demand to become more broad-based. To contain the CPI inflation around the 2% target by 2017, the RBNZ expects to increase the OCR towards more neutral levels gradually. Treasury's *PREFU* forecasts show annual CPI inflation to increase from 1.5% and 1.7% to 2.4% and 2.3% for the four years to March 2017 respectively. The lower CPI inflation forecasts in the September *MPS* compared to Treasury's *PREFU* are on account of lower non-tradable inflation (Figure 4). The RBNZ has revised upwards its forecasts for tradable inflation for the outer years reflecting a depreciating exchange rate outlook (Figure 5). **You may wish to ask the Governor of the RBNZ about how the Bank is assessing the effects of the increase in the OCR by 100 basis points from March to July.**

The RBNZ's potential growth forecasts point to capacity expansion that could anchor inflationary pressures. Treasury's assessment points to capacity pressures arising from capital stock constraints, mainly owing to under-investment following the GFC. Currently, these pressures are being offset with spare capacity in the labour market. As the economy continues to grow, a tightening in the labour market could push up wages and inflation. **You may wish to ask the Governor of the RBNZ about the level of spare capacity in the economy, and the impact of net migration flows on the balance of demand and supply.**

SENSITIVE

Figure 3: CPI Inflation

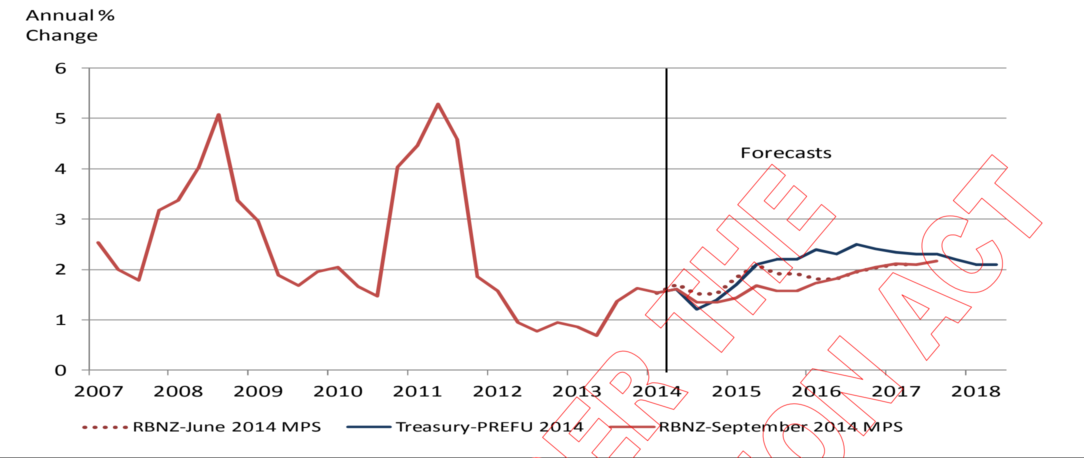


Figure 4: Non-tradable CPI Inflation

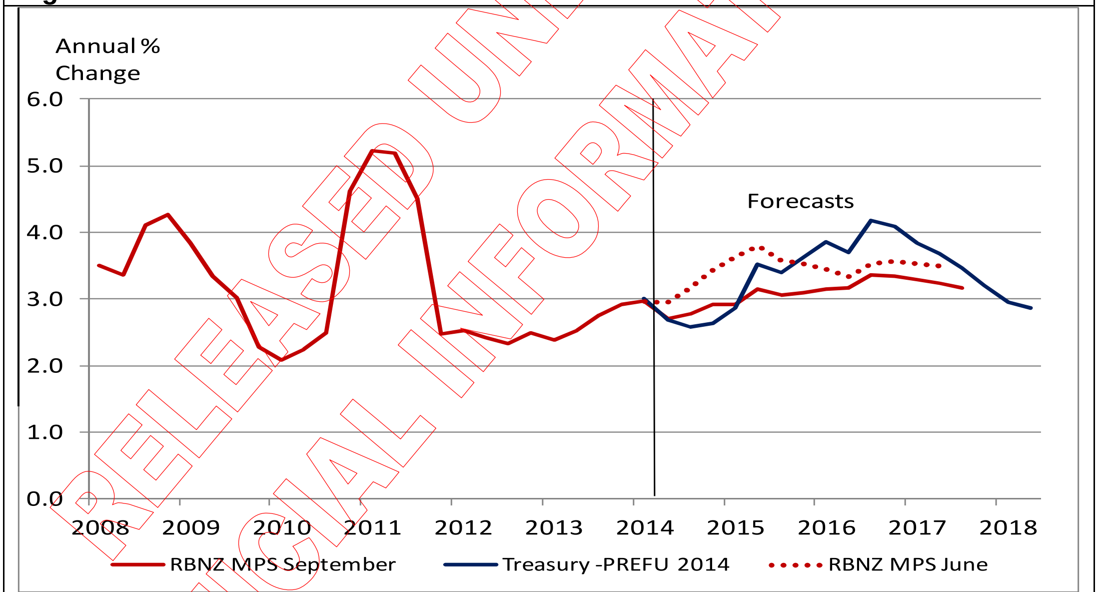
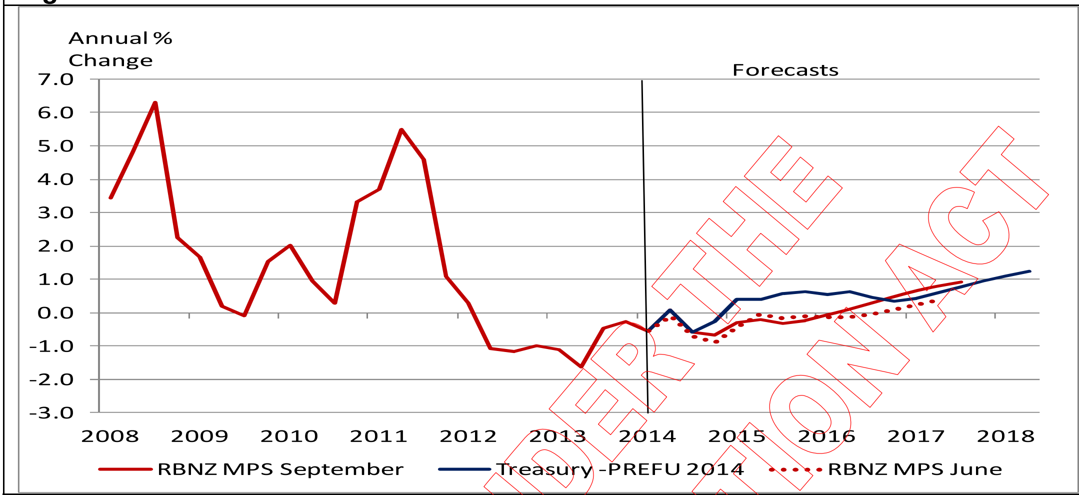


Figure 5: Tradable CPI Inflation



Nominal GDP growth outlook

The RBNZ has revised downwards its forecasts for nominal GDP growth as compared to in the June *MPS*. Nominal GDP growth is expected to be weaker than was previously expected reflecting lower inflation forecasts. September *MPS* forecasts show nominal GDP growth (annual average) to come down from 7.0% to 2.9% before recovering partly to 4.3% and 5.8% for the March years to 2017. The terms of trade forecasts have also been revised downwards, contributing to the lower expected nominal GDP growth in the near-term. The RBNZ now expects export prices to decline by 12.7% in the March 2015 year, compared to a decline of 10.5% previously expected. The September *MPS* forecasts show the import prices are expected to grow more strongly than previously expected. **You may wish to ask the Governor of the RBNZ about how his views on the outlook of terms of trade and nominal GDP growth in the coming years.**

Fiscal Outlook

The RBNZ has revised downwards projections of Government's operating balance compared to in the June *MPS*. The operating balance is forecast to return to surplus in 2015/16 as was previously expected by the RBNZ. However, the Bank has revised downwards the forecasts of the operating surplus for the next two years mainly reflecting its weaker nominal GDP expectations compared to in the June *MPS*.

Market Expectations

Private economists expect the OCR to remain unchanged at 3.5% on Thursday 11 September. Market participants do not expect another 25 basis point increase in the OCR until at least March 2015.

Dhritidyuti Bose, Senior Analyst, Macroeconomic & Fiscal Policy, 04 890 7289
Renee Philip, Principal Adviser, Macroeconomic & Fiscal Policy, 04 917 6046

Changes since PREFU

August FPI – Friday
RBNZ MPS – Thursday

[Information not relevant to request]

Interest Rate Outlook

90-day rate

- The current September quarter 90-day rate is on track with our forecast of 3.7%.

[1] Quarter estimate with today's rate carrying through to the end of the quarter.

	PREFU	Quarter Average Est.[1]	Today	20-day average
90-day rate	3.7	3.68	3.68	3.69

- It's likely the next OCR hike will occur early 2015 owing to the weaker economic outlook since the June MPS and PREFU and, given the significantly weaker commodity prices, exchange rates have further to fall. This means a lower 90-day rate for the December quarter. PREFU was 4.0%.
- Analysts' current OCR forecasts

	October	**December**	**January**	**March**
OIS (Today)	3.50	3.53	3.56	3.65
ANZ	3.50	3.50	3.50	3.75
Kiwibank	3.50	3.50	3.75	3.75
UBS	3.50	3.75	3.75	3.75
ASB	3.50	3.50	3.50	3.75
BNZ	3.50	3.50	3.50	3.75
Westpac	3.50	3.50	3.75	3.75

Note: After the July MPS, most banks had an OCR forecast increase for December and OIS pricing was 3.60%.

[Information not relevant to request]

[Information not relevant to Request]

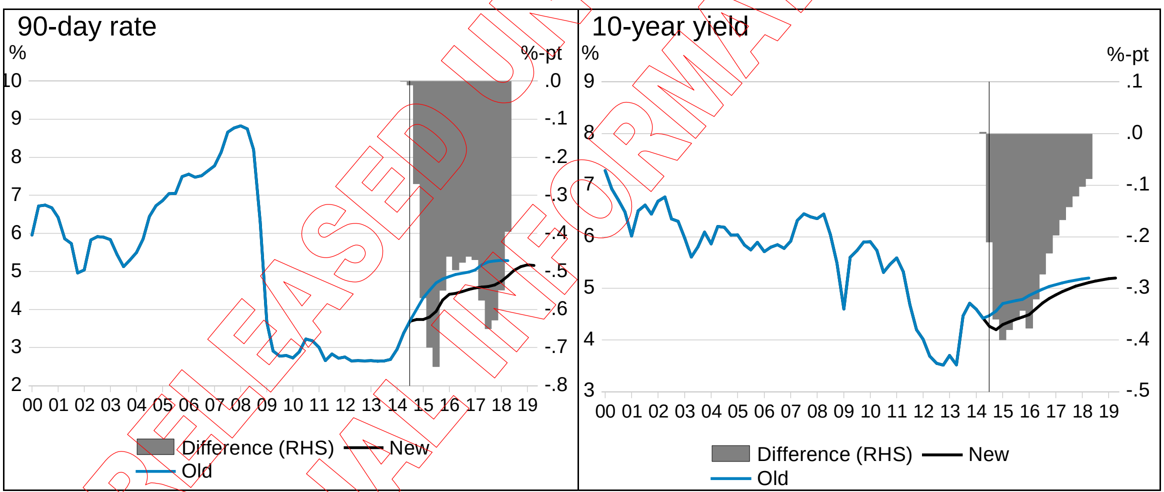
HYEFU Monetary Conditions

[Information not relevant to request]

[Pages 2 - 4 not relevant to request]

[Information not relevant to request]

Interest Rates



90 day rates

Table 3: OCR rises expected by local bank economists

	October	December	January	March	April	June
OIS (1/10)	3.50	3.51	3.53	3.58	3.65	3.72
ANZ	3.50	3.50	3.50	3.75	4.00	4.00
ASB	3.50	3.50	3.50	3.75	3.75	4.00
Westpac	3.50	3.50	3.50	3.50	3.50	3.75
BNZ	3.50	3.50	3.50	3.75	3.75	4.00

90-day rates have been steady since the September MPS when the RBNZ indicated the OCR would be on hold until next year and lowered their inflation and 90-day tracks. Local economists are now expecting the next OCR hike in either March or June 2015. The market prices an 88% chance of a June hike. The 90-day rate is forecast to be 3.7% in the

December quarter. This is lower than the PREFU forecast of 4.0% for the December quarter, when a December OCR hike was expected.

In the medium term, the 90-day track is below PREFU for the forecast period. As we don't expect another OCR hike this year, the 90-day track doesn't increase again until 2015Q2, when the RB tightens. The 90 day rate peaks at 5.2% at the beginning of 2019, lower and later than PREFU (5.3% in 2017Q3) reflecting the weaker inflation outlook and lower output gap peak. The 5.2% end-point is above neutral, as non-tradable inflation peaks in 2016Q3 following the output gap peak in 2015Q4. In addition, there will be less offset from tradables inflation with the TWI depreciating.

[Information not relevant to request]

THE TREASURY
Kaitohutohu Kaupapa Rawa

Reference: T2014/1900 MC-1-1-1

Date: 14 November 2014

To: Minister of Finance
(Hon Bill English)

Deadline: None
(if any)

Aide Memoire: Comments on Rodney Dickens Analysis on Inflation and Monetary Policy

You have requested Treasury's comments on Rodney Dickens' analysis on inflation and monetary policy appearing in *Opinion* on 7 November 2014. Dickens argues that the drop in the inflation rate in September 2014 should not be a reason for the Reserve Bank of New Zealand (RBNZ) to postpone timely hikes of the Official Cash Rate (OCR). He argues that by allowing the economy to grow above the sustainable growth rate inflation could become a problem in the medium term. This note examines his analysis and briefs you with our views on the matter.

Dickens' arguments

New Zealand has not yet entered a low inflation paradigm

Dickens argues that the New Zealand economy has not entered a new low inflation paradigm. He cites evidence to show that the New Zealand economy is behaving in a relatively normal and predictable fashion to low global inflation, the high exchange rate, falling oil prices and increased retail competition. He does not address the issue of global deflation being systemic, but does point out that world prices are flowing through to the New Zealand economy in a normal fashion.

In particular, he argues that the drop in annual CPI inflation to 1% in September 2014 (the bottom of the 1-3% target range and below the RBNZ's forecasts) is not a permanent change in how inflation typically responds to drivers working currently, namely, low global inflation, downward pressure to local retail prices due to competition from online shopping and lower than normal labour cost inflation. He supports his arguments with the following evidence:

- import price inflation is not running lower than what is to be expected based purely on the exchange rate movements, and import and export price inflation is also consistent with movements in tradable CPI inflation

- retail pricing intentions are reasonably tracking all firm pricing intentions rather than running below the latter due to competitive pressures

- the labour market has already adjusted to higher participation rates, and further increases in employment would result in a lower unemployment rate and drive up productivity adjusted labour cost inflation.

The RBNZ should not delay raising interest rates and "go for growth"

Since New Zealand is not in a new low inflation paradigm, Dickens argues that the RBNZ should not allow the economy to grow by more than the sustainable growth rate and let inflationary pressures build up.

He emphasises that the current dip in inflation is cyclical rather than structural, and that the import price and retail price inflation rates could turn up in the coming months as the exchange rate is expected to depreciate.

History shows that a fall in the unemployment rate has pushed up wage costs and CPI inflation most strongly after a lag of three quarters in New Zealand. Thus, he argues that the fall in the unemployment rate over the last three quarters points to upside inflationary risks over the next three.

In view of the upside risks to inflation, he argues that the RBNZ should not hesitate to undertake timely hikes in the OCR.

Our comments

Globally inflation likely to remain low though New Zealand is not in a low inflation paradigm

Our view is that inflation is likely to remain low for some time in many advanced countries, particularly in the Euro area. However, we agree that the New Zealand economy has not entered a new low inflation paradigm, and there has not been a change in how the economy normally responds to drivers of inflation. The RBNZ's forecasts in the September 2014 *Monetary Policy Statement (MPS)* show annual CPI inflation rates in both the tradable and non-tradable components increasing over the coming two years, and the exchange rate depreciating. Our HYEFU 2014 final forecasts also point to increases in both tradable and CPI non-tradable inflation over the next two years.

The RBNZ is expected to raise the OCR in the coming years and does not expect inflation to be structurally lower

The RBNZ has projected interest rates to go up in future, and does not argue that inflation is structurally lower. The RBNZ has been indicating over the past few months that pressures on productive capacity are increasing. It has also been signalling likely increases in the OCR in the coming years to contain CPI inflation from rising above the target mid-point of 2%. The RBNZ has already raised its OCR by one percentage point during the current year so far, and its forecasts show further increases totalling around one percentage more by 2017. Given the likely increase in interest rates, the RBNZ's forward stance on monetary policy is not much different from what Dickens is advocating.

The RBNZ is currently assessing how the economy is responding to the monetary tightening measures already taken

Dickens is arguing that the RBNZ should continue increasing the OCR, which has remained unchanged since July 2014. However, the RBNZ has indicated that it is not currently changing the OCR in the light of several uncertainties, so as to better assess the moderating effects of policy tightening measures already taken. While noting that CPI inflation is currently below trend on account of subdued wage inflation, well-anchored inflation expectations, weak global inflation, falls in oil prices, and the high New Zealand dollar, the RBNZ has also pointed out that inflation is expected to increase as the expansion continues. On balance, the RBNZ's forecasts in September indicate a fall in the unemployment rate, an increase in labour costs and a depreciation of the exchange rate by March 2017. All these factors are likely to put upward pressures on inflation. However, the RBNZ seems to be less certain about how the economy is responding to the OCR hikes that have already taken place during the year so far. As a result, the RBNZ is currently assessing the impact of the past OCR hikes on the economy before deciding about further increases. This seems to be prudent in view of the transmission lags associated with monetary policy.

Some other factors that could be relevant for deciding further OCR increases but not discussed by Dickens are:

- the RBNZ's downward revision of the neutral interest rate (consistent with aggregate output growing at potential rate and inflation at target mid-point range of 2%) from 6% to 4.5% after the global financial crisis

- the RBNZ's upward revision of potential output growth reflecting higher migration and higher participation increasing labour force growth

- the downside risks of meeting the inflation target on account of falling dairy prices and a slowdown in China.

Dhritidyuti Bose, Senior Analyst, Macroeconomic & Fiscal Policy, 890 7289
Renee Philip, Principal Advisor, Macroeconomic Policy, Macroeconomic & Fiscal Policy, 917 6046

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: December 2014 Monetary Policy Statement

Date:	9 December 2014	**Report No:**	T2014/2133
		File Number:	MC-1-3

Action Sought

	Action Sought	Deadline
Prime Minister (Hon John Key)	**Note** this report before your economic outlook meeting with the Minister of Finance, Governor of the RBNZ and the Treasury	4:45 pm on Wednesday 10 December
Minister of Finance (Hon Bill English)	**Note** this report before your economic outlook meeting with the Prime Minister, Governor of the RBNZ and the Treasury	4:45 pm on Wednesday 10 December
Associate Minister of Finance (Hon Steven Joyce)	**None**	N/A
Associate Minister of Finance (Hon Paula Bennett)	**None**	N/A

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Dhritidyuti Bose	Senior Analyst	04 890 7289 (wk)	[Withheld under s9(2)(a)]	✓
Mark Blackmore	Principal Adviser	04 917 6247 (wk)		

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Enclosure: Yes (Letter from the Governor)

Treasury Report: December 2014 Monetary Policy Statement

Executive Summary

The Reserve Bank of New Zealand (RBNZ) will announce its Official Cash Rate (OCR) decision and release a set of economic projections in the December 2014 *Monetary Policy Statement* (*MPS*) at 9:00am, Thursday 11 December. The OCR is currently 3.5%. Economists and market-pricing both expect no change in the OCR on Thursday.

The December *MPS* forecasts show growth momentum remaining strong over the RBNZ's three-year forecast horizon. The RBNZ has revised up its real GDP growth forecasts for the March 2016 and March 2017 years (both to 3.1%) compared with the September *MPS* forecasts (2.7% and 2.3% respectively), following 3.5% in the current March year. The main drivers of demand growth are expected to be private consumption, business investment and residential investment growth, partly offset by fiscal consolidation and growth of imports. Annual CPI inflation is forecast to increase to 1.1%, 1.7% and 2.0% in the three years to March 2017 respectively. Notwithstanding current low CPI inflation, the RBNZ thinks that spare capacity in the economy has been eliminated. It is assessing the impact of monetary tightening taken in the year so far, and expects that a very gradual increase in the OCR to its neutral rate will be needed to settle CPI inflation at 2% over the medium term.

Treasury's *HYEFU* 2014 forecasts show similar total real GDP growth over the next three years but with a slightly different profile (decreasing from 3.5% to 3.4% and 2.8% in the three years to March 2017). Treasury's *HYEFU* 2014 forecasts for CPI inflation are higher than the *MPS* forecasts, with annual CPI inflation forecast to increase to 1.3%, 2.0% and 2.1% in March 2015 to 2017 respectively.

You are meeting with the Prime Minister, the Governor of the RBNZ and Treasury officials on **Wednesday 10 December at 4:45pm** to discuss the outlook for the economy and inflation. The attached letter from the Governor of the RBNZ provides an overview of the March *MPS* projections.

Recommended Action

We recommend that you **note** this report before your meeting on the economic outlook with the Prime Minister, Governor of the RBNZ and Treasury officials on **Wednesday 10 December 2014 at 4:45pm**.

Mark Blackmore
Principal Advisor, Macroeconomic Policy

Hon Bill English
Minister of Finance

Treasury Report: December 2014 Monetary Policy Statement

Purpose of Report

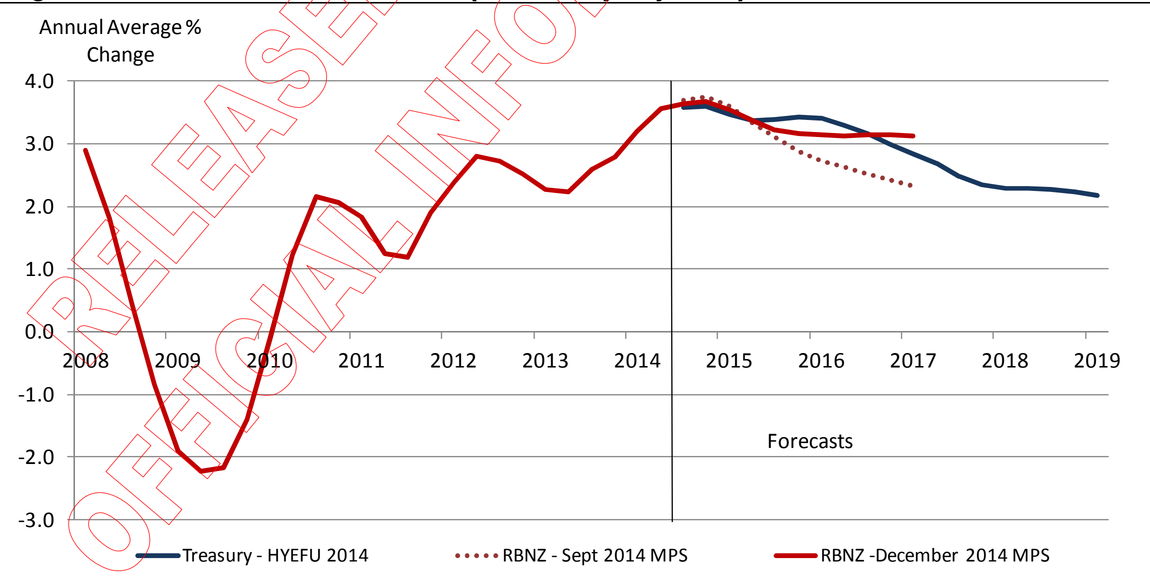
1. This report briefs you ahead of the meeting with the Prime Minister, the Governor of the Reserve Bank of New Zealand (RBNZ) and the Treasury on Wednesday 10 December. It compares the RBNZ's December 2014 *Monetary Policy Statement (MPS)* projections with the September 2014 *MPS* projections and Treasury's *HYEFU 2014* forecasts.

Analysis

Economic Outlook

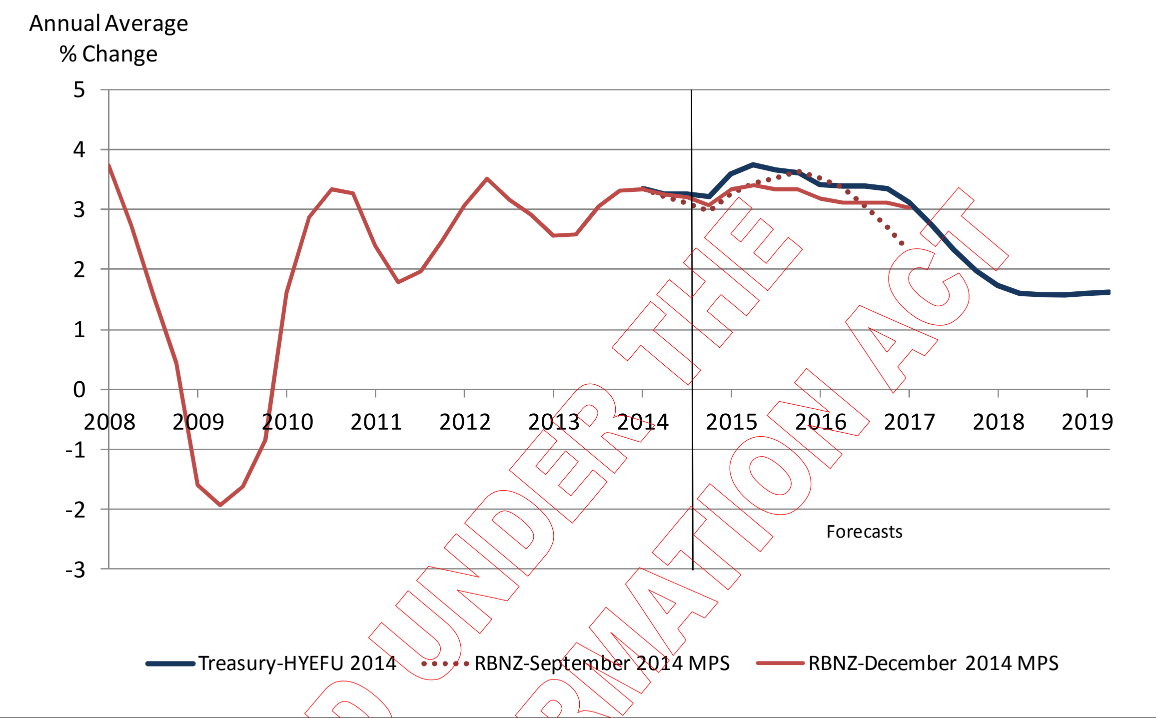
2. The RBNZ's December 2014 *MPS* forecasts show a stronger real GDP growth outlook compared with its September 2014 *MPS* forecasts, with growth remaining above 3% over its three-year forecast horizon. The September *MPS* forecasts showed annual average real GDP growth slowing from 3.7% in December 2014 to 2.3% in March 2017. Treasury's *HYEFU 2014* forecasts show annual average real GDP growth remaining around 3.5% over the next two years before slowing to 2.8% in March 2017 (Figure 1).

Figure 1 **– Real Production Growth (seasonally adjusted)**



3. The RBNZ's new higher growth path reflects small upward revisions to the drivers of demand, along with lower import growth, rather than a change to any one growth driver. The RBNZ notes rising labour incomes, strong immigration and stimulatory interest rates to be the key drivers of household spending. In the December *MPS*, real private consumption (annual average) is projected to grow by 3.3%, 3.2% and 3% for years from March 2015 to March 2017 (Figure 2). Treasury's *HYEFU* forecasts show somewhat higher real private consumption growth. Real investment growth exceeds real GDP growth in both the RBNZ and Treasury forecasts, underpinned by double-digit residential investment growth over the next two years. **You may wish to ask the Governor for his views on the sustainability of current rates of growth.**

Figure 2 **– Real Private Consumption Growth (seasonally adjusted)**

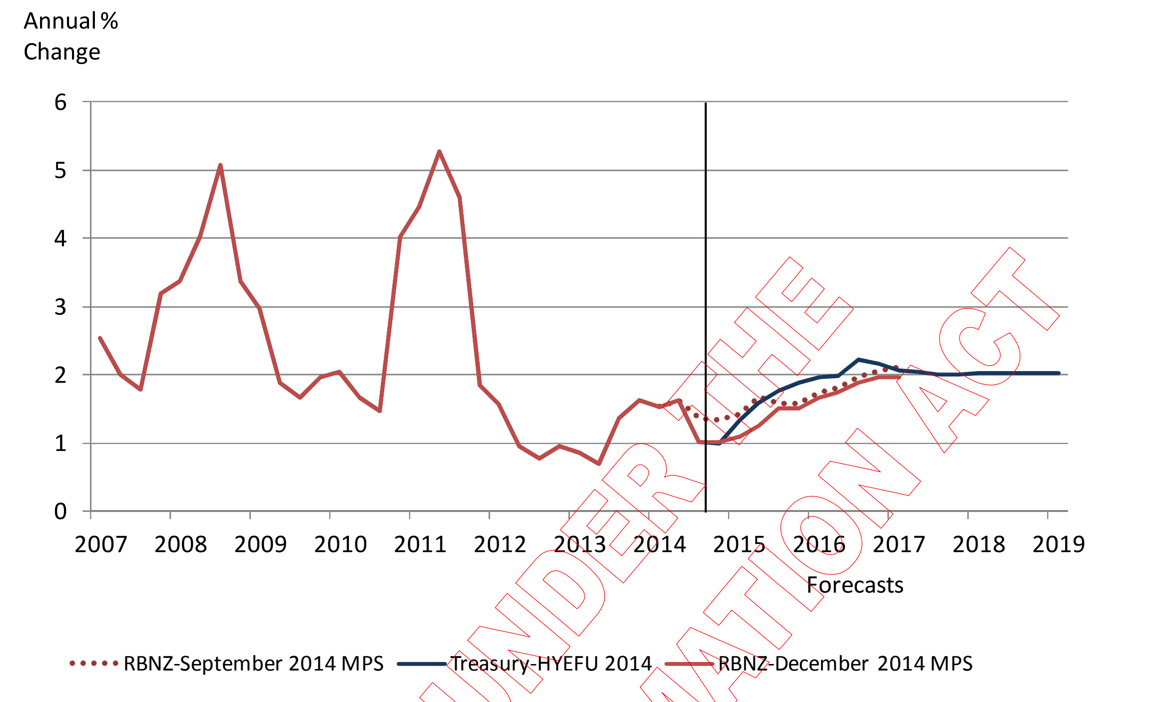


4. On the international side, the RBNZ has not altered its forecasts for trading partner growth and expects annual average trading partner growth to increase from 3.5% in March 2014 to 4.0% in March 2017. The RBNZ assumes the exchange rate will depreciate from a high of 80.2 in mid-2014 to below 74 over next three years, slightly more than was assumed in September. The current account deficit as a percentage of GDP in the December *MPS* is projected to be - 4.4%, - 5.8% and - 5.4% in the three years to March 2017 respectively, compared with Treasury's *HYEFU* forecasts of - 5.3%, - 6.2% and - 5.8%.

Inflation Outlook

5. The RBNZ has revised down its CPI inflation forecasts compared to the September *MPS* forecasts, especially over the next twelve months, although the Bank still expects inflation to increase to the mid-point of 1%-3% target band inside its forecast horizon (Figure 3). The RBNZ has identified the high exchange rate, low import price inflation and falling fuel and food prices to be the factors currently suppressing CPI inflation. It notes that inflation is currently lower than capacity pressures and inflation expectations would suggest. However, it points out that spare production capacity has been eliminated and inflationary pressures are likely to rise as output growth is expected to remain higher than its estimate of potential growth. Annual non-tradables inflation is projected to remain subdued at 2.5% until September 2015 and then rise towards 3% by September 2016 as capacity pressures increase. Annual tradables inflation is expected to turn positive from September 2015 as exchange rate depreciates. Overall, annual CPI inflation is projected to remain subdued at 1.1% until March 2015 and then increase to 1.7% and 2.0% in the two years to March 2017 respectively in the December *MPS*. In contrast to broadly similar real GDP growth outlooks, Treasury's *HYEFU* forecasts show higher annual CPI inflation, with the mid-point of the target band being reached about a year earlier than the RBNZ. For the very short term, this may reflect more recent information on oil prices available to the RBNZ.

Figure 3: CPI Inflation



6. In its letter, the RBNZ weighs the upside and downside risks to inflation. On one hand, fewer firms were reporting about lack of demand, and strong output growth was eliminating spare capacity in the economy. On the other hand, the RBNZ's surveys showed inflation expectations not to be rising significantly above 2% for a period up to four years ahead. Further, the economy's response to monetary tightening measures already taken during the year so far also needs to be assessed. Based on balance of risks, the RBNZ feels that a gradual increase in the OCR to its neutral level is needed for CPI inflation to settle at 2% over the medium term. **You may wish to ask the Governor about the balance of upside and downside risks to inflation, both over the short term (given oil movements for example) and the medium term.**

Nominal GDP growth outlook

7. The RBNZ has revised up its forecasts for nominal GDP growth compared to the September *MPS* forecasts reflecting higher real GDP growth forecasts. They are also a little higher relative to Treasury's *HYEFU* forecasts. The December *MPS* forecasts show nominal GDP growth (annual average) decreasing from 6.7% to 3.5% and recovering partly to 4.5% and 6.7% for the March years 2014 to 2017. The terms of trade (average basis) is projected to decline for the two years to March 2016 and increase thereafter, similar to Treasury's *HYEFU* forecasts. **You may wish to ask the Governor of the RBNZ about his views on the outlook of terms of trade and nominal GDP growth in the coming years.**

SENSITIVE

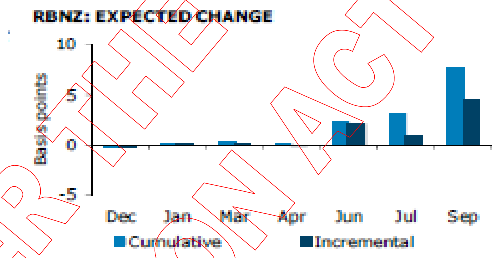
Market Expectations

8. Private economists expect the OCR to remain unchanged at 3.5% on Thursday 11 December. Market pricing assigns a very low probability of an increase in the OCR over the next year (Table 1).

Table 1: Policy Rate Expectations

Monday, 8 December 2014

New Zealand	Rate	*Change*
Current Rate	3.50	*from current*
Thu 11 Dec 14	3.50	0.00
Thu 29 Jan 15	3.50	0.00
Thu 12 Mar 15	3.50	0.00
Thu 23 Apr 15	3.50	0.00
Thu 11 Jun 15	3.52	0.02
Thu 23 Jul 15	3.53	0.03
Thu 10 Sep 15	3.58	0.08



Source: ANZ Research

SENSITIVE

THE TREASURY
Kaitohutohu Kaupapa Rawa

Reference: T2015/478 BM-3-3

Date: 12 March 2015

To: Minister of Finance
(Hon Bill English)

Deadline: None
(if any)

Aide Memoire: Responses to questions on February 2015 Monthly Economic Indicators and Chart Pack

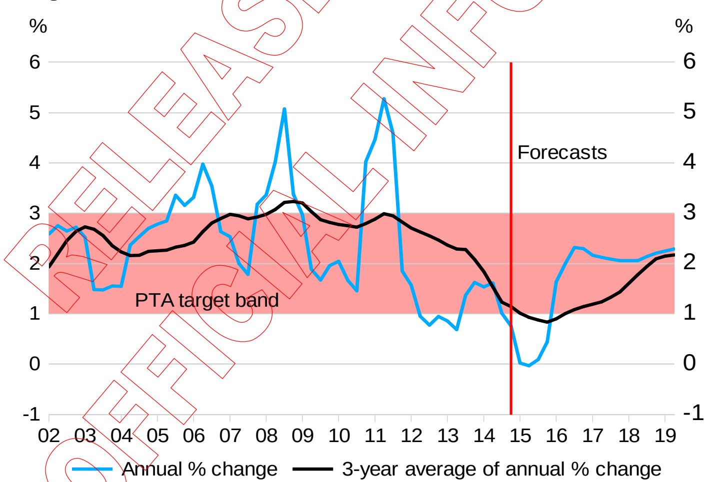
[Information not relevant to request]

1. *How long has inflation been outside the Policy Target Agreement zone – and for how much longer in forecasts?*

Since 2002, the Policy Targets Agreement (PTA) has defined the price stability target as "to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term", with the further guidance added in September 2012 "with a focus on keeping future average inflation near the 2 per cent midpoint." If we interpret the medium term as three years, inflation outturns have been generally consistent with the PTA, remaining above 1.0% since 2002 and exceeding 3.0% only when high oil prices prior to the Global Financial Crisis (GFC) lifted the 3-year average above 3% (Figure 1). However, based on our BEFU preliminary forecasts, we expect the three-year average of annual inflation to be below 1% from the June quarter 2015 until the March quarter 2016.

Annual inflation has fallen outside of the PTA range on three occasions since the GFC. Inflation exceeded 3.0% in the period from the December quarter 2010 to the September quarter 2011 following the increase in the GST from 12.5% to 15.0% in October 2010. Inflation was below the 1.0% between the June quarter 2012 and the June quarter of 2013, primarily as a strong exchange rate led to falling tradable prices. Inflation fell below 1.0% again in the December quarter 2014, owing to a decline in petrol prices. Based on our BEFU preliminary forecasts, inflation is expected to remain below 1.0% until the March 2016 quarter, when it is forecast to rise to 1.6%.

Figure 1: Consumer Price Index



Sources: Statistics NZ, Treasury

[Pages 3 - 11 not relevant to request]

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Inflation Performance and the Policy Targets Agreement

Date:	24 March 2015	**Report No:**	T2015/502
		File Number:	MC-1-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note**	None
Associate Minister of Finance (Hon Steven Joyce)	**Note**	None
Associate Minister of Finance (Hon Paula Bennett)	**Note**	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
[Withheld under s9(2)(g)(i)]			[Withheld under s9(2)(a)]	✓
Tim Ng	Director, Macroeconomic and Fiscal Policy	04 917 6124 (wk)		

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Enclosure: No

Treasury Report: Inflation Performance and the Policy Targets Agreements

Executive Summary

The Policy Targets Agreement (PTA) with the Governor of the RBNZ requires the RBNZ to keep future Consumers Price Inflation (CPI) between 1% and 3% on average over the medium term, with a focus on keeping future average inflation near the 2% target mid-point.

The RBNZ, along with the Treasury and other forecasters, has been persistently overestimating CPI inflation in their forecasts over the last three years. More recently, CPI inflation in the December 2014 quarter has fallen below the 1-3% target band specified by the PTA, while measures of core inflation and medium-term inflation remain below the mid-point of the target band. The RBNZ, along with other forecasters, has been grappling to understand the drivers behind the low inflation outturns. Tradables inflation is a significant factor which has frequently driven headline CPI to vary outside of the target band, with the recent drop in oil prices being the most recent example. Weak tradables inflation in the past three years is consistent with low global inflation and the high exchange rate, which has translated into lower import prices.

The key puzzle is the muted behaviour of non-tradables inflation over the past year given an environment where domestic activity has been robust and capacity pressures have tightened. The key factors that inform the RBNZ's forecast for non-tradables inflation are the current degree of spare capacity in the economy (ie, the output gap) and inflation expectations. There is a high degree of uncertainty in the measurement of both variables as they cannot be fully observed. It is possible that the RBNZ may have underestimated the degree of spare capacity in the economy. The extent of the moderation in inflation expectations has also been a surprise, which may have dampened price and wage setting behaviour. Both the RBNZ and the Treasury are currently investigating these issues.

The RBNZ has communicated clearly in the March 2015 MPS the factors that have led to the recent low inflationary outturns and actions it will take to ensure that future inflation outcomes are consistent with the medium-term target in the PTA. The RBNZ has moved to an on-hold policy stance as the inflation outlook softened and the global growth prospects were downwardly revised. The latest MPS also signalled that a move to a more accommodative policy stance could be necessary if inflation expectations continued to moderate further.

To assess consistency with meeting the PTA, the Treasury focuses on measures that give some guide to future inflation outcomes. These include measures of surveyed inflation expectations, market expectations of future interest rates and other forecasters' views about the inflation outlook. The RBNZ's forecasts can been viewed as credible and remain consistent with other forecasters, while market pricing of future short-term interest rates do not appear to be materially out of line with the RBNZ's projection. Inflation expectations have been falling recently, although to levels that are still near 2%. As such, these indicators currently remain consistent with an outlook in which annual CPI inflation returns to the mid-point of the inflation target range in the medium term. We will continue to closely monitor these indicators for any deterioration that would indicate future inflation outcomes may not be consistent with the PTA.

The Reserve Bank Board is formally responsible for assessing the Governor's performance in meeting the PTA. While you can expect to receive the Board's annual report later in the year, you may also wish to bring the matter up in your next meeting with the Board chair.

Recommended Action

We recommend that you **note** the contents of this report on inflation performance in recent years and the RBNZ's performance against the Policy Targets Agreement.

Tim Ng
Director, Macroeconomic and Fiscal Policy

Hon Bill English
Minister of Finance

Treasury Report: Inflation Performance and the Policy Targets Agreements

Purpose of Report

1. This report provides information on inflation performance in recent years and the RBNZ's performance against the PTA.

Analysis

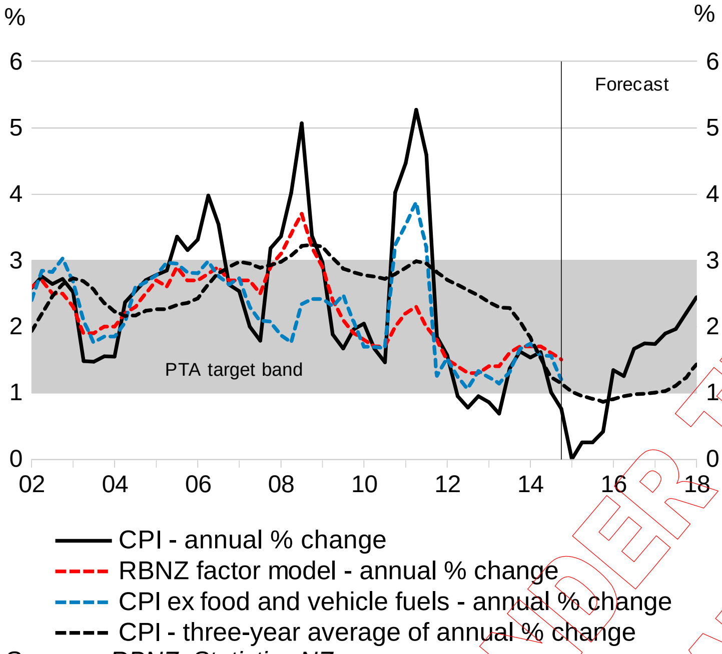
Mandate under the Policy Targets Agreement

2. The PTA outlines the objective for maintaining a stable general level of prices under Section 9 of the Reserve Bank Act (1989). The current PTA signed in September 2012, requires the RBNZ to keep future inflation outcomes between 1% and 3% on average over the medium term, with a focus on keeping future average inflation near the 2% target mid-point. In pursuing this objective, the RBNZ must have regard to avoiding unnecessary instability in output, interest rates, and the exchange rate. The PTA also states that monetary policy should have regard to the efficiency and soundness of the financial system.

3. The RBNZ must also be transparent on occasions when annual CPI inflation is outside the medium-term target range or when such occasions are projected. This requires an explanation through their policy statement of why such outcomes have occurred, or are projected to occur, and what measures it has taken, or proposes to take, to ensure that inflation outcomes remain consistent with the medium-term target.

4. The actual annual rate of CPI inflation can vary around the medium-term trend of inflation, and outside of the PTA target band, owing to one-off shifts in the price level. These temporary shifts can arise from a range of events for example, fluctuations in international commodity prices and changes in policy settings such as the rate of GST in 2010 (Figure 1). More recently, low fuel prices drove CPI inflation below the target band to 0.8% in the December 2014 quarter. The PTA allows the RBNZ to not respond to the first-round impact of such temporary price shifts in order to avoid unnecessary instability in the economy. A range of "core" measures of inflation, such as the CPI excluding food and vehicle fuels, aim to strip out temporary idiosyncratic factors to estimate underlying inflation. These particular measures suggest that core inflation has been broadly contained within the target band over history but are currently below the mid-point (Figure 1). A similar picture emerges when looking at the three-year moving average of annual CPI inflation, which can be interpreted as a medium term trend.

Figure 1: Measures of CPI inflation and March 2015 MPS forecast



Sources: RBNZ, Statistics NZ

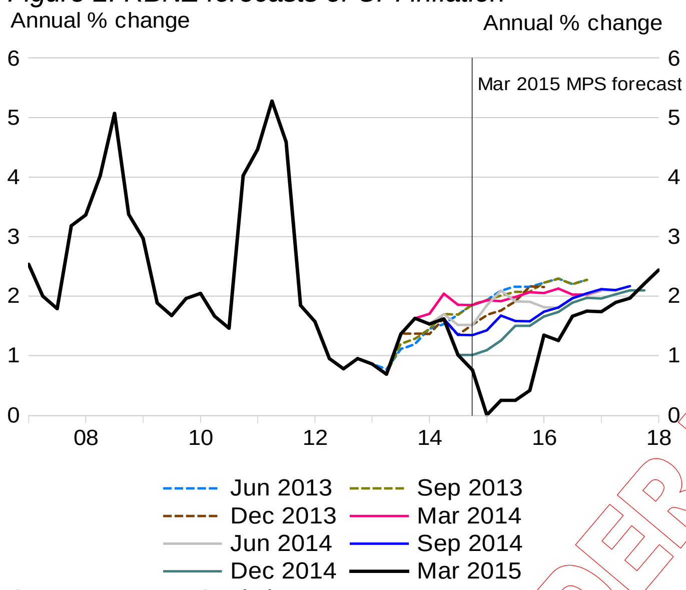
5. In the RBNZ's March 2015 MPS, annual CPI inflation is forecast to gradually increase to 2.0% by the second half of 2017 and then to 2.4% by March 2018. On a three-year average basis, annual inflation remains below the mid-point of the target band over the forecast horizon.

Recent forecast performance for inflation

6. A recent RBNZ paper on forecast performance looking at MPS forecasts between December 2011 and June 2013 found that inflation has been lower than what the RBNZ and other forecasters expected.[1] CPI inflation has also consistently been falling below the RBNZ's forecasts over the past three years since the March 2014 MPS (Figure 2). The undershooting of inflation forecasts recently is not unique to the Reserve Bank as the Treasury and other bank forecasters have also been grappling to understand the drivers behind the low inflation outturns. A large part of the story is the weakness in tradables inflation over the past three years owing to low global inflation, the high exchange rate, falling prices for capital goods, and more recently, the sharp falls in world oil prices. What is less understood is the surprisingly low non-tradables inflation given an environment where economic activity has been robust and capacity pressures have tightened.

[1] Kergozou, N. & Ranchhod, S., (2013), 'Why has inflation in New Zealand been low,' Reserve Bank of New Zealand: *Bulletin*, Vol. 76, No.3, Wellington.

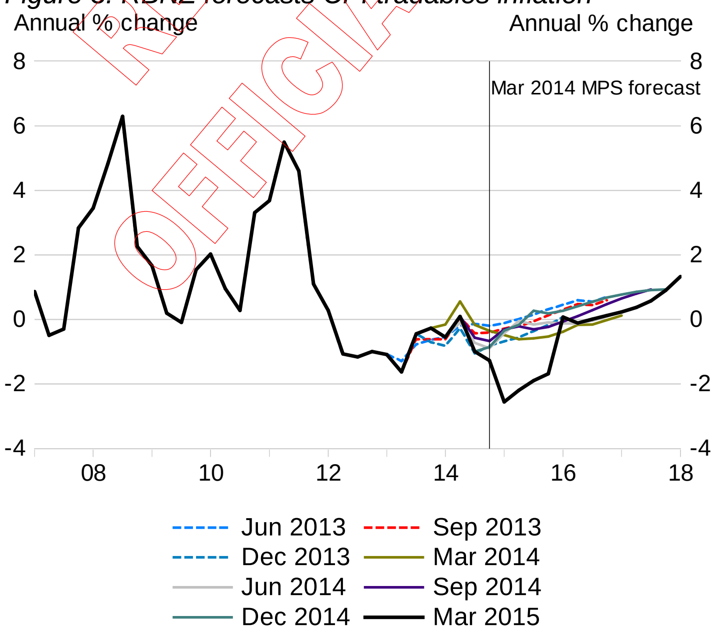
Figure 2: RBNZ forecasts of CPI inflation



Sources: RBNZ, Statistics NZ

7. Over history, tradables inflation has been a key driver of the movements in headline CPI, which has seen inflation temporarily move out of the target band, for example the effect of lower world oil prices in the December 2014 quarter. The RBNZ expects the fall in fuel prices to subtract 0.9% points from annual CPI inflation in March 2015, taking it to 0% (Figure 2). Tradables inflation has not significantly deviated from the Reserve Bank's forecasts in recent years (Figure 3) and the movements appear consistent with the high exchange rate and weak global inflation, which has flowed through to lower import prices. The high exchange rate in recent years partly reflects New Zealand's relatively positive economic conditions compared with most other advanced economies, leading to a divergence in policy rates. The low inflationary environment in developed economies owing to weak demand has been persistent, and has led to responses by monetary authorities (e.g. the European Central Bank and Bank of Japan) to stimulate their economies.

Figure 3: RBNZ forecasts CPI tradables inflation

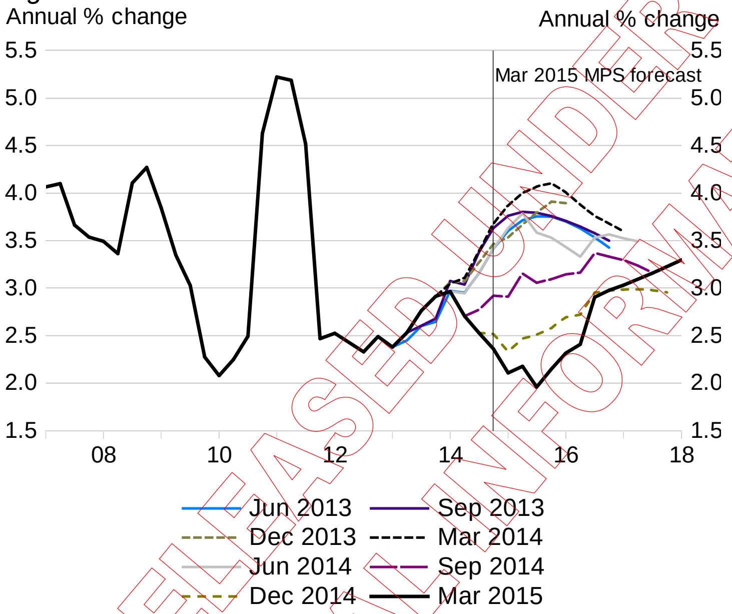


Sources: RBNZ, Statistics NZ

IN-CONFIDENCE

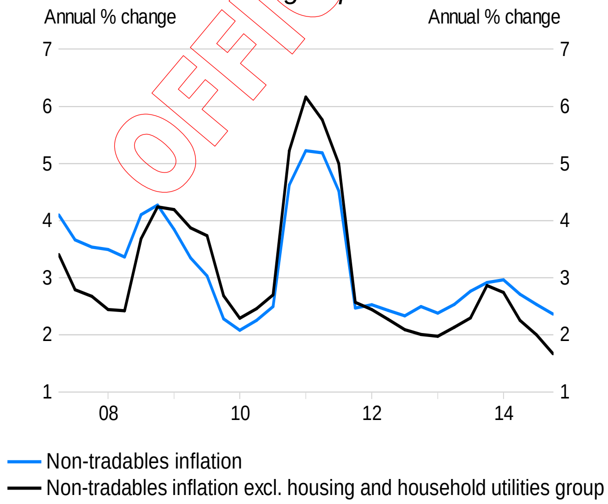
8. In contrast to tradables inflation, non-tradables inflation has been positive and within the target band over the past three years (Figure 4), although remains below its long-run average of 3.3%. Inflation in the housing and household utilities group has been a significant contributor to total non-tradables inflation over recent years given housing pressures in Auckland and Canterbury (Figure 5). One notable group that has suppressed non-tradables inflation since 2011 is the communications group where prices have been falling in the CPI (Figure 6). This partly stems from regulatory changes and increased competition that led to quality improvements for customers in telecommunication services (eg, more internet data for a given price). However, sectoral trends do not account for the more generalised weakness in non-tradables inflation over the past year against historical MPS forecasts, which has been stark (Figure 4). Understanding this is important as the RBNZ has a greater influence over non-tradables inflation given that changes in tradables inflation are generally driven by global conditions and volatility in the exchange rate.

Figure 4: RBNZ forecast of CPI non-tradables inflation



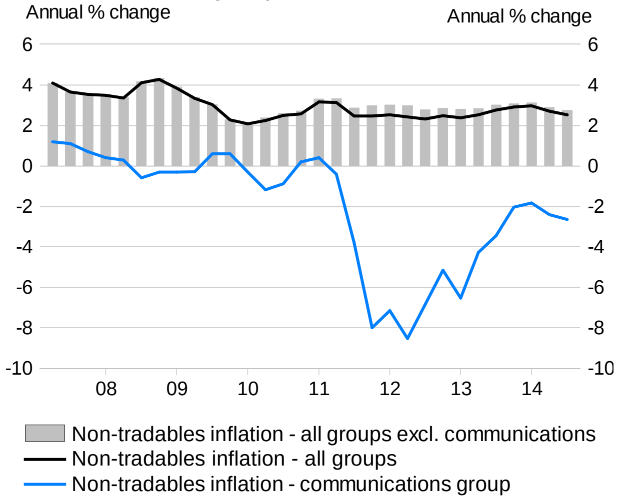
Sources: RBNZ, Statistics NZ

Figure 5: Non-tradables inflation and housing and household utilities group



Source: Statistics NZ

Figure 6: Non-tradables inflation and communications group



Source: Statistics NZ, RBNZ

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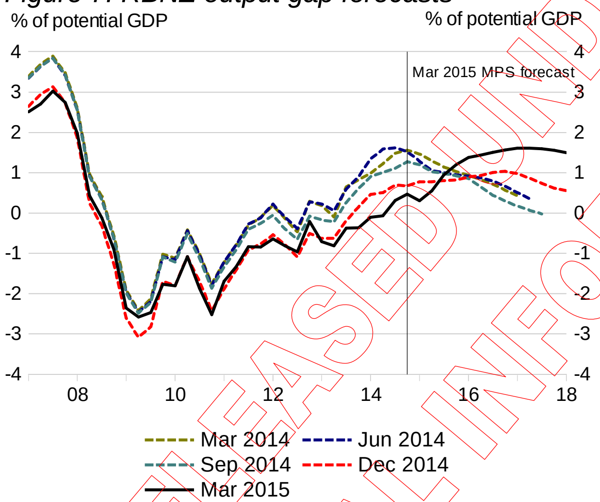
Weakness in non-tradables inflation is the key puzzle

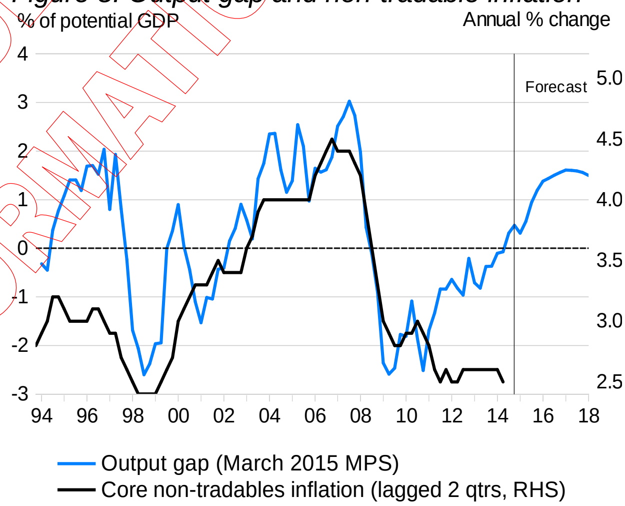
9. The main factors that inform the RBNZ's forecast for non-tradables inflation are the degree of capacity pressures (ie, the output gap) and surveyed inflation expectations. If the output gap is positive, this indicates that the domestic economy is operating above its productive capacity, translating to upward pressure on input prices and the prices faced by consumers. Given that the output gap is an unobservable economic concept, there is a high level of uncertainty surrounding its estimation, making it an inherent challenge for all forecasters. Underestimating the degree of spare capacity in recent years is one possible explanation behind the over-forecasting of non-tradables inflation. It could be the case that the level of potential GDP has been higher than assumed, particularly given the recent strong growth in the labour force. The RBNZ have gradually revised down their forecasts of the output gap over the past year as more data on domestic activity, capacity utilisation and labour market capacity have become available (Figure 7). Despite these downward revisions, the current estimate of the output gap still appears to be out of line with the recent trend non-tradables inflation given their historical correlation (Figure 8).

Figure 7: RBNZ output gap forecasts



Source: RBNZ

Figure 8: Output gap and non-tradable inflation



Source: RBNZ

10. Inflation expectations play a key role in price and wage setting behaviour and have moderated over the past year, possibly influenced by the recent low inflation outturns domestically and globally, although they still remain consistent with medium-term inflation returning to the mid-point of the target band (Figure 9). A greater moderation in inflation expectations has had a dampening impact on wages in particular, which has prevented non-tradables inflation from gaining momentum given wages make up a large proportion of the cost of providing services. That said, greater capacity in the labour market (high rates of labour force participation and net migration) and constrained public sector wages have also limited overall wage growth. Inflation expectations are observed from household and business surveys which may not be adequately capturing the evolution of actual inflation expectations, increasing the uncertainty in its measurement.

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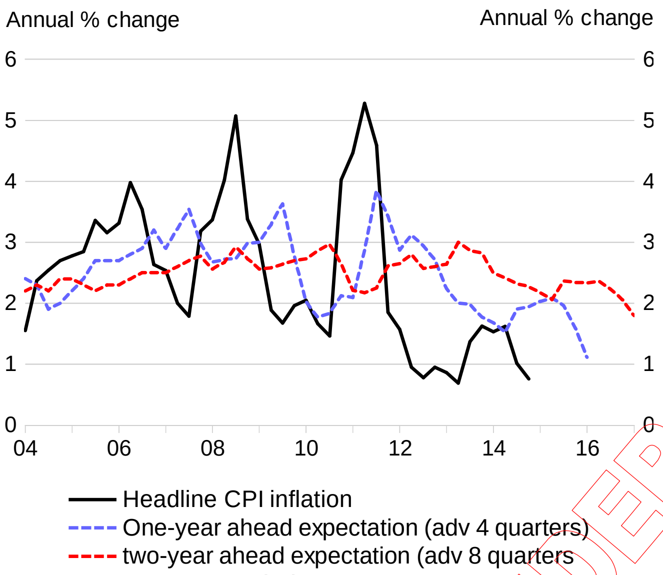
Figure 9: CPI and RBNZ survey of expectations



Sources: RBNZ, Statistics NZ

11. An extended period of low tradables inflation may also be having a dampening effect on non-tradables inflation as final goods and services often involve both elements despite belonging to one group or the other. The subdued growth in the price of imported intermediate inputs has likely limited the costs pressures for domestic firms. In addition, relatively subdued household demand since the crisis has also meant that lower import costs are more quickly passed on to consumers as evident by the higher-than-usual levels of retail discounting in recent years.

12. Given the recent overestimation of CPI and the ongoing puzzle around low non-tradables inflation in particular, both the RBNZ and Treasury are closely examining the following factors:

- the degree of spare capacity in the economy;
- whether the moderation in inflation expectations becomes more entrenched;
- global factors and its impact on domestic inflation and inflation expectations;[2]
- the impact of increasing retail sector competition and evolution of supply chains.

Monetary policy developments

13. The RBNZ had held down short-term interest rates below the neutral nominal interest[3] (4.5%) rate following the 2008/09 recession to stimulate the economy given the large negative output gap that resulted from the crisis. The RBNZ then began to raise the OCR in March 2014 as spare capacity was being steadily absorbed and their inflation outlook suggested it was appropriate to do so. This judgement was consistent with other forecasters at the time, particularly as demand in the housing market was strengthening. After lifting the OCR by 100 basis points to 3.5% by July 2014, the RBNZ decided to pause and assess the impact that recent interest rate rises were having on the economy, but remained on a tightening basis. In January 2015, the

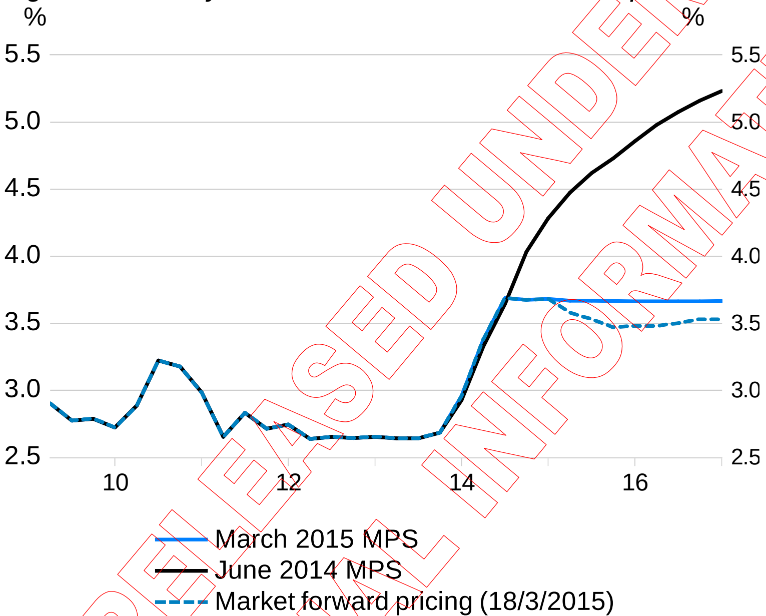
[2] Two draft analytical notes (not yet published) are currently being prepared by the RBNZ in relation to this question: '*The pass-through of global economic conditions to New Zealand inflation*,' (Richardson, 2015) and ' [Withheld under s9(2)(f)(iv)]

[3] The neutral nominal interest rate represents the dividing line between where interest rates are stimulating the economy, to prevent deflationary forces gaining momentum, or constraining economic activity, to prevent inflationary forces from gaining momentum.

RBNZ Governor then signalled an on-hold policy stance owing to the softer outlook for inflation and downward revisions to growth prospects in the global economy.

14. In the March 2015 MPS, the RBNZ left the OCR on hold and confirmed its on-hold policy stance (Figure 10), although CPI inflation is still forecast to return back to the mid-point of the target band. In support of this stance, the RBNZ noted that the effects of the recent falls in fuel prices were viewed as temporary and that medium-term price and wage setting behaviour remained consistent with inflation settling at 2.0%. Despite the on-hold outlook, the market is currently pricing in a cut by the end of 2015 (Figure 10). The latest MPS did signal that a move to a more accommodative policy stance could be necessary if inflation expectations continued to moderate further. Given this risk, the RBNZ will be closely monitoring surveyed inflation expectations along with the current degree of spare capacity. It was also noted that the assumption around the neutral nominal interest rate was being revisited given the recent downward adjustment in long-term inflation expectations.

Figure 10: 90-day bank bill forecasts and market expectations



Sources: RBNZ, Reuters

Performance against the PTA

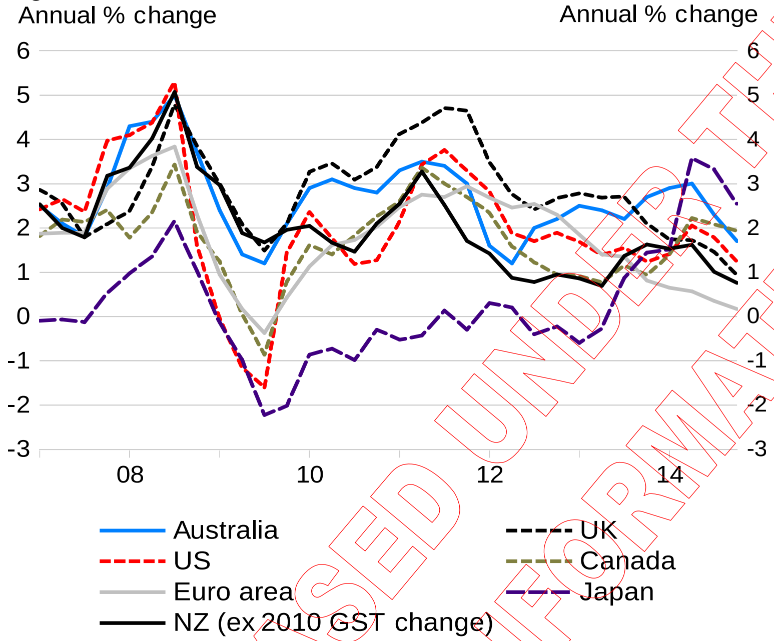
15. The PTA is forward looking, requiring the Bank to focus on keeping *future* average inflation near the 2% target mid-point. In addition, the PTA provides scope for the Bank to make trade-offs between achieving the inflation target and avoiding unnecessary instability output, interest rates and the exchange rate. This means that inflation outcomes below target is not necessarily inconsistent with the PTA, and assessing the Bank's performance against the PTA is more complicated.

16. The RBNZ has communicated clearly in the March 2015 MPS the factors that have led to the recent low inflationary outturns and actions it will take to ensure that future inflation outcomes are consistent with the medium-term objective of the PTA.

17. One possible benchmark is to compare the Reserve Bank's performance against that of other central banks. In an international context, recent inflation outcomes amongst other advanced economies have also been low, reflecting the impact of common global factors such as soft demand and falls in the prices of internationally traded goods and commodities (Figure 11). Central banks in these economies have also tended to overestimate inflation over the past year as spare capacity has lingered and recoveries have been more gradual. During 2011, some of these advanced economies such as

the UK, the US and Euro area struggled with a period of nominal stickiness with inflation of around 3% or above. This may have reflected the reluctance of firms to reduce wages in order to retain staff in the post-crisis period, which further emphasises the uncertainty around the lagged relationship between spare capacity and domestic inflation pressures. Although it is difficult make international comparisons given somewhat different specifications of policy targets and country-specific factors (and shocks), it appears that the RBNZ's performance in keeping inflation low and stable has been broadly in line with other central banks.

Figure 11: Inflation trends in advanced economies



Source: Haver

18. Another factor to consider is whether there is any systematic bias in the RBNZ's performance. Looking at the full period of inflation targeting in New Zealand since 1990, inflation has tended to average above the mid-point of the prevailing target range and there has not been another period where underlying inflationary outcomes have persistently been below the mid-point of the target band as they have been in the last three years. However, there was a period between 2004 and 2008 where the RBNZ tended to *underestimate* the extent of inflation, which saw core inflation measures persist around the top half of the target band or exceed it. With the full benefit of hindsight, a tighter stance in the early-to-mid 2000s was probably warranted to contain inflationary pressures. This contrasts with the current low inflation environment which suggests that there is not an institutional bias, although it may in part reflect differing approaches of different Governors.

19. To assess *future* inflation performance, the credibility of the RBNZ's forecasts is critical. Listed below is a set of circumstances in which the Treasury would begin to be concerned about the RBNZ's performance against the target for future inflation outlined in the PTA:

- the RBNZ's forecasts begin to diverge from those of other forecasters, particularly with respect to the inflation outlook;
- likewise, the market expectation of interest rates begins to diverge from the RBNZ's forecast, which would suggest the market does not believe they are credible;
- inflation expectations become unanchored and fall outside the target range.

20. Our reading of the above indicators is that they currently remain consistent with an outlook in which annual CPI inflation returns to the mid-point of the inflation target range in the medium term. The RBNZ's projections can been viewed as credible, as they are consistent with other domestic forecasters who also expect inflation to rise to 2% over the medium term (ie, other forecasters expect the RBNZ to continue to be effective in meeting the PTA objectives). In addition, market expectations of future short-term interest rates are not materially out of line with the RBNZ's projection. Although inflation expectations have fallen recently, they remain near 2%. However, we will continue to closely monitor these indicators for any deterioration that would indicate future inflation outcomes may not be consistent with the PTA.

21. Under the Reserve Bank Act, the Reserve Bank Board is formally responsible for assessing the Governor's performance in meeting the PTA. While you can expect to receive the Board's annual report later in the year, you may also wish to bring the matter up in your next meeting with the Board chair.

Monetary policy framework / Exchange rates: FEC – 17 June 2015

[Information not relevant to request]

[Information not relevant to request]

Question: Do you think interest rates should be cut given low inflation and the fall in oil prices?
Answer: The operation of monetary policy is a matter for the Governor. The Governor has said it would be appropriate to lower the OCR if demand weakens, and wage and price-setting outcomes settle at levels lower than is consistent with the inflation target.

Question: Do you have concerns about the performance of the Governor, given inflation has persistently undershot the target midpoint?
Answer: The Treasury monitors inflation performance with respect to the Policy Targets Agreement, as does the Reserve Bank's Board of Directors. We have provided advice to the Minister of Finance on this. Our most recent report noted that most indicators showed that recent low inflation outcomes had surprised most forecasters, including Treasury. Nevertheless, inflation has been below the mid-point of the target range for some time, so we will continue to be monitoring key indicators closely such as inflation expectations and other forecasters' views of the inflation outlook.

[Information not relevant to request]

From: Carole Van Grondelle [Carole.Vangrondelle@rbnz.govt.nz]
Sent: Friday, 29 May 2015 1:22 p.m.
To: Oscar Parkyn [TSY]
Cc: ^RBNZ: Mike Hannah
Subject: Reserve Bank SOI
Attachments: SoI Draft 3h.pdf

Hello Oscar,

[Information not relevant to request]

Please find attached the latest version of the SOI which has been delivered to the Minister's office today. Here are some specific comments (in blue) to address your questions and concerns:

[Information not relevant to request]

[Information not relevant to request]

- With persistent undershooting of the mid point of the inflation target, I am surprised there is not greater prominence on understanding why there has been persistent undershooting of (non-tradable) inflation and the level of the neutral interest rate, as alluded to in the most recent MPS. We have not had a sustained period of below target inflation. The target is 1 to 3% and we have been below this range for two quarters.
- I also find it odd that the SOI makes the assertion that inflation expectations are at levels more consistent with the midpoint of the inflation target. This proposition seems rather uncertain given that underlying inflation is near the bottom of the target band and the historical relationship between these survey measures of expectations and actual inflation. The comment that inflation expectations are now consistent with the midpoint is in accordance with the Bank's analysis and judgement, as reflected in our monetary policy deliberations and MPS.

[Information not relevant to request]

Best wishes

Carole van Grondelle
External Communications Adviser | Reserve Bank of New Zealand
2 The Terrace, Wellington 6011 | P O Box 2498, Wellington 6140
T. +64 4 471 3807 | [Withheld under s9(2)(a)]
www.rbnz.govt.nz

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