

RESERVE BANK OF NEW ZEALAND MONETARY POLICY STATEMENT APRIL 1990¹

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

EXECUTIVE SUMMARY

Introduction

Monetary policy is now governed by an agreement negotiated between the Minister of Finance and the Governor of the Reserve Bank. The agreement commits the Governor to deliver a stable price level by the end of 1992. The Minister and the Governor have agreed that stable prices will be defined as annual consumer price index increases of 0-2 per cent.

The Bank is now obliged by law to issue a policy statement at least every six months to explain how monetary policy will be implemented in the future and to account for the Bank's performance over the previous six months. These procedures are designed to make monetary policy clearer and the Bank more accountable for its actions.

The Policy Targets

The Bank now has just under three years to achieve the price stability target. The Bank will be implementing monetary policy on the basis of its assumptions of trends in the factors which determine the inflation rate. Monetary policy settings will be designed to ensure that inflation will fall from 7.2 per cent in the year to December 1989 along the following indicative track to give annual increases in the CPI of:

- 3-5 per cent increase in the CPI for the year to December 1990;
- 1.5-3.5 per cent increase in the CPI for the year to December 1991; and
- 0-2 per cent increase in the CPI for the year to December 1992.

After December 1992, and until the end of the Governor's term of office on 31 August 1993, the agreement states that inflation must be kept within the 0-2 per cent range.

To deal with unexpected economic events there is scope for the formal targets to be renegotiated. But any departure from the targets is open to public scrutiny and the exceptional circumstances under which this would be permitted are tightly specified. Moreover, departures would only be temporary, accommodating certain large price changes but returning as quickly as possible to the medium-term price stability objective.

It is important to emphasise that there is no reason to believe that these provisions will be invoked in the foreseeable future. Nothing in the agreement or this statement will give the Bank any grounds for failing to achieve its objective in the face of domestic inflationary pressures, such as rapid increases in unit labour costs, asset prices or profit margins. It is the task of monetary policy to achieve and maintain price stability, if necessary by offsetting such factors.

¹ Text and data finalised on 16 March 1990.

The Economic Outlook and Inflation

Inflation has come a long way towards its target range. From a rate of 16.6 per cent in the year to June 1985, CPI inflation fell to 4 per cent in the year to March 1989. In spite of the subsequent lift to 7.2 per cent for the year to December 1989, following the 2.5 per cent increase in GST on 1 July 1989 and sharply rising meat and dairy prices, the Bank believes the underlying trend is both encouraging and on-track.

The Bank forecasts that price stability can be achieved at the same time as the economic recovery continues to gather pace. However, important assumptions underpin this forecast.

The Bank expects unit labour costs (the cost of labour per unit of output) to rise this year at much the same rate as last year. Continued low growth in unit labour costs beyond 1990 is crucial if new pressures on interest rates and the exchange rate are to be avoided. Productivity improvements will have to become the basis for future gains in wages. This will mean fundamental behavioural changes by both workers and employers. Further public and private sector restructuring, and a likely reluctance by employers to take on workers in the early stages of recovery, suggest that more large productivity gains will be made over the course of 1990. But as the recovery gathers strength, and as the pace of restructuring slows, it is likely that labour productivity growth will slacken. If productivity does indeed slow, then wage growth must adjust to that. If productivity trends are ignored and wage increases continue to react only slowly to the fall in actual inflation, then new monetary policy pressures may be necessary. Under these circumstances there would be little prospect of any significant reduction in unemployment over the next few years.

The commodity prices which drove much of last year's food price inflation have already retreated. The GST factor will drop out of the annual CPI in the September quarter this year and the price effect from the 10 per cent drop in the exchange rate in 1988 has dissipated. On the other hand, world inflation this year will be running at a higher rate than last year, averaging 4-5 per cent across our main trading partners.

The Bank forecasts 2 per cent real GDP growth in the year to March 1991. Growth is forecast to accelerate beyond 1991 even if wage-setting behaviour adjusts with a lag to the inflation targets.

On the basis of these expectations the Bank forecasts that by the end of 1990, CPI inflation will be within the indicative range of 3-5 per cent. At present the Bank forecasts the annual rate of growth in the CPI will fall to 3.7 per cent in the year to December 1990, without the need for any change to the stance of monetary policy. Beyond 1990, the Bank is forecasting inflation of 2.5 per cent in the year to December 1991 and 1 per cent in the year to December 1992.

Monetary Policy Indicators

The Bank uses a range of indicators to monitor monetary conditions and to assess whether or not settings are consistent with the inflation targets. Each of the indicators contains some information. None on its own is a sufficient guide to monetary policy.

The indicators used by the Bank include the exchange rate, the level and term structure of interest rates, the rates of growth in money and credit, inflation expectations, and the state of the real economy.

The expected growth in unit labour costs during 1990 will mean that an *exchange rate* similar to the levels experienced since the end of August 1988 should be con-

sistent with achieving the forecast reduction in inflation. Looking beyond 1990, if the growth in unit labour costs exceeds the target inflation rate, or if wage restraint cannot be achieved within the current monetary policy stance, some new pressure may be necessary to ensure targets are met. If that happens, and assuming no other changes to the factors affecting the exchange rate, the exchange rate would appreciate at a faster rate than justified purely by the difference between New Zealand's target inflation and foreign inflation. Such an appreciation would help to offset domestic cost pressures, but would also place some pressure on those producing exports and competing with imports during the transition to price stability. But this pressure will not be required if moderation is exercised in the wage-setting process.

For any given state of world markets, once price stability has been achieved, New Zealand's nominal exchange rate could be expected to appreciate slowly each year to offset the upward pressure on domestic prices resulting from higher foreign inflation. This appreciation would not adversely affect international competitiveness because the real exchange rate is not affected by these nominal exchange rate movements. They simply reflect differences in inflation rates. The average trend appreciation, at that stage, should be approximately equal to the difference between average foreign inflation and New Zealand's target inflation rate.

The other monetary indicator monitored closely by the Bank is the level and slope of the *interest rate yield curve*. The slope of the interest rate yield curve relative to the market's expectations of changes in the inflation rate is an important indicator of the degree of policy pressure actually being exerted. The level of interest rates, interpreted with estimates of the market's inflation expectations, is also an indicator of policy pressure.

Over the past two or three years, both the level of interest rates and the slope of the yield curve have fallen significantly. The Bank expects that these trends will continue over coming years. As price stability comes closer and inflation expectations fall, the level of interest rates should fall significantly, especially if there is a sustainable balance of payments current account position and monetary policy is reinforced by the Government restraining its budget deficit. A relatively flat or slightly upward sloping yield curve should eventually occur.

The timing of interest rates shifts is uncertain. Over the short term, anxieties may cloud the interest rate horizon. Overseas interest rates are rising, and the balance of payments situation may give rise to some future concerns about investment prospects in New Zealand. However, the Bank believes these factors will not prevent a resumption in the downward trend in interest rates at some stage during 1990.

Economic Risks and the Responses

The provisions for any departure from the inflation targets are explicitly covered in the agreement between the Minister and the Governor. In the event of other economic circumstances the inflation targets must still hold. The Bank's likely response in some of these circumstances is discussed below:

1. If wage increases beyond 1990 continue to adjust only gradually in response to reductions in inflation then real wages will rise, and as productivity growth slows, unit labour costs could be expected to grow more rapidly than over recent years. In these circumstances, some additional pressure on real interest rates and the real exchange rate may be necessary to achieve the inflation targets.
2. A rise in offshore interest rates would tend to push up New Zealand's real and nominal interest rates, independently of the state of our economy or of New Zealand's inflation objective. This would place downward pressure on inflation. An attempt to totally offset the effect of a rise in world rates would probably lead

to a reduction in our exchange rate and that would mean greater inflationary pressures. The effect of these conflicting inflationary pressures would have to be weighed up in order that the appropriate interest rate and exchange rate mix emerged to satisfy the inflation targets.

3. Marked fluctuations in New Zealand's exchange rate can have flow-on effects for inflation if they are sustained. If the source of any change is not covered by the provisions for renegotiation of the targets in the agreement between the Minister and the Governor then these targets must still be met. Sharp changes in market sentiment – for instance, caused by political developments or economic developments such as the trend in the balance of payments – are a case in point. In the event of changes in the exchange rate occurring for reasons other than those specifically allowed for, the Bank would generally be obliged to respond with actions which altered both interest rates and the exchange rate to ensure the inflation targets could still be met.

Conclusion

This is the first of the monetary policy statements which the Bank is committed to issue. The statements will prove to be particularly useful if consumers, businesses setting prices and wages, and financial markets which have a key place in determining interest rate levels, build into their behaviour the Bank's commitment to the price stability target that the statements seek to convey.

The lower the inflation expectations of each of these groups the more likely it is that the targets will be achieved without putting pressure on interest rates and the exchange rate.

INTRODUCTION

In carrying out its primary function over the next few years, the Reserve Bank's monetary policy will be governed by the policy targets agreement signed by the Minister of Finance and the Governor of the Reserve Bank on 2 March 1990.² Under that agreement, the Governor is required to direct monetary policy towards achieving price stability by December 1992 and maintaining it thereafter. The signing of the agreement reaffirms the anti-inflationary monetary policy that has been in place since 1985, and formalises the price stability objective which has guided monetary policy since early 1988. The Governor and the Minister have agreed that 0-2 per cent annual increases in the Consumers Price Index (CPI) will be the definition of price stability used for these purposes.

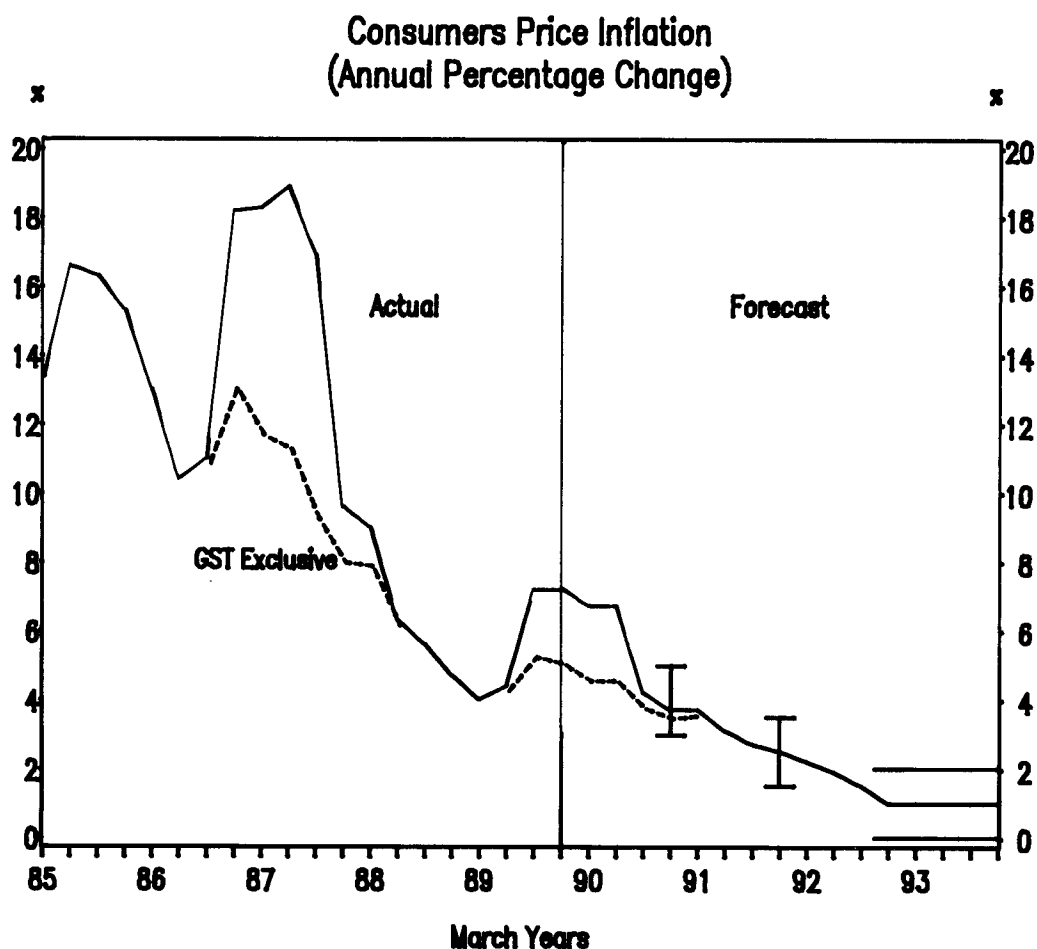
In formalising the price stability objective, the agreement between the Minister and the Governor also allows some scope for the targets for 1992 and beyond to be renegotiated. But such renegotiations can take place only in certain well-specified exceptional circumstances. Material changes in the price level resulting from changes in the terms of trade or in indirect tax rates, or from a major crisis – such as a natural disaster – would prompt a renegotiation. The targets could also be renegotiated if there were to be a significant deviation between the CPI and a more internationally-comparable (housing-adjusted) measure of consumer prices. It should be emphasised, however, that the Bank has no reason to expect that the targets will need to be renegotiated in the foreseeable future.

Accordingly, as required by the agreement, monetary policy over the coming years will be managed with the aim of steadily reducing inflation and achieving price stability by the end of 1992. Over the years until price stability is achieved, the Bank

² The agreement is included as an article in this *Bulletin*.

expects inflation to follow a track leading to annual increases in the CPI of:

- 3-5 per cent increase in the CPI for the year to December 1990;
- 1.5-3.5 per cent increase in the CPI for the year to December 1991; and
- 0-2 per cent increase in the CPI for the year to December 1992.



The Bank is committed to its task of achieving price stability. However, the costs of doing so will depend heavily on the actions of people and businesses throughout the country. The Bank is confident that price stability can be achieved at the same time as interest rates move down and the economic recovery gathers pace. But economic prospects over the next few years will be most favourable if individuals and businesses act on the assumption that inflation will indeed be eliminated. In particular, if future wage increases are governed principally by improvements in productivity, further periods of pressure on real interest and exchange rates should not be required to secure price stability.

This statement is the first of those now required to be made every six months. The statement reviews recent developments in inflation, the real economy, and monetary policy. The Bank's view of the most likely path for the monetary indicators and the economy over the next few years is discussed in the context of the price stability objective. Finally, some alternative assumptions are considered, and the renegotiation provisions of the agreement are outlined in greater detail.

RECENT DEVELOPMENTS

Inflation

Considerable progress has already been made towards achieving price stability. From 16.6 per cent in the year to June 1985, CPI inflation fell to 4 per cent in the year to March 1989. CPI inflation rose subsequently, reaching 7.2 per cent for the years to September and December 1989, but the rise occurred mainly because of the increase in GST. Inflation rose by more than was expected, but after allowing for identifiable one-off influences, the underlying trend in inflation has remained relatively favourable over the last year.

INFLATION OUTCOMES

	(% change)					
	CPI		CPI (excl. GST) ¹		CPI (excl. GST and Food) ²	
	Qtly.	Ann.	Qtly.	Ann.	Qtly.	Ann.
1988						
Dec.	1.2	4.7			1.0	4.3
1989						
Mar.	1.1	4.0			1.2	3.8
June	1.2	4.4			0.9	4.1
Sep.	3.5	7.2	1.8	5.4	1.1	4.4
Dec.	1.2	7.2	1.0	5.3	0.9	4.3

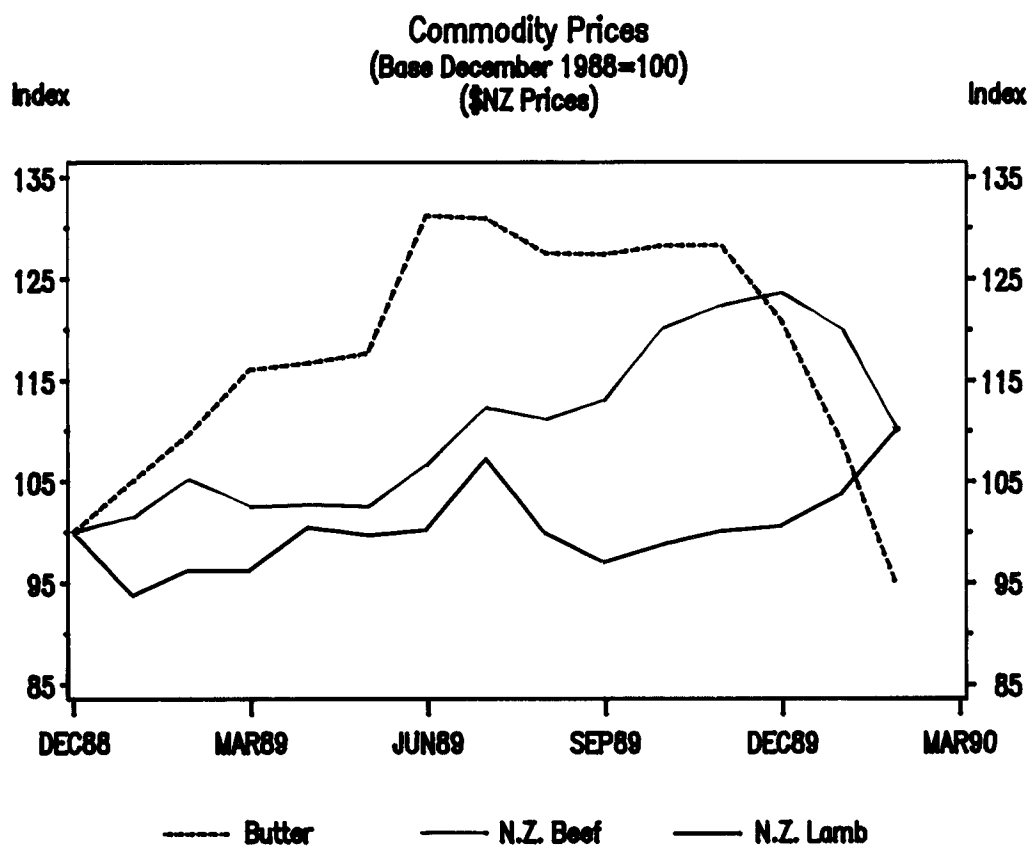
¹ Excluding the Bank's estimate of the direct impact of GST.

² Excluding GST, and the food group from the CPI.

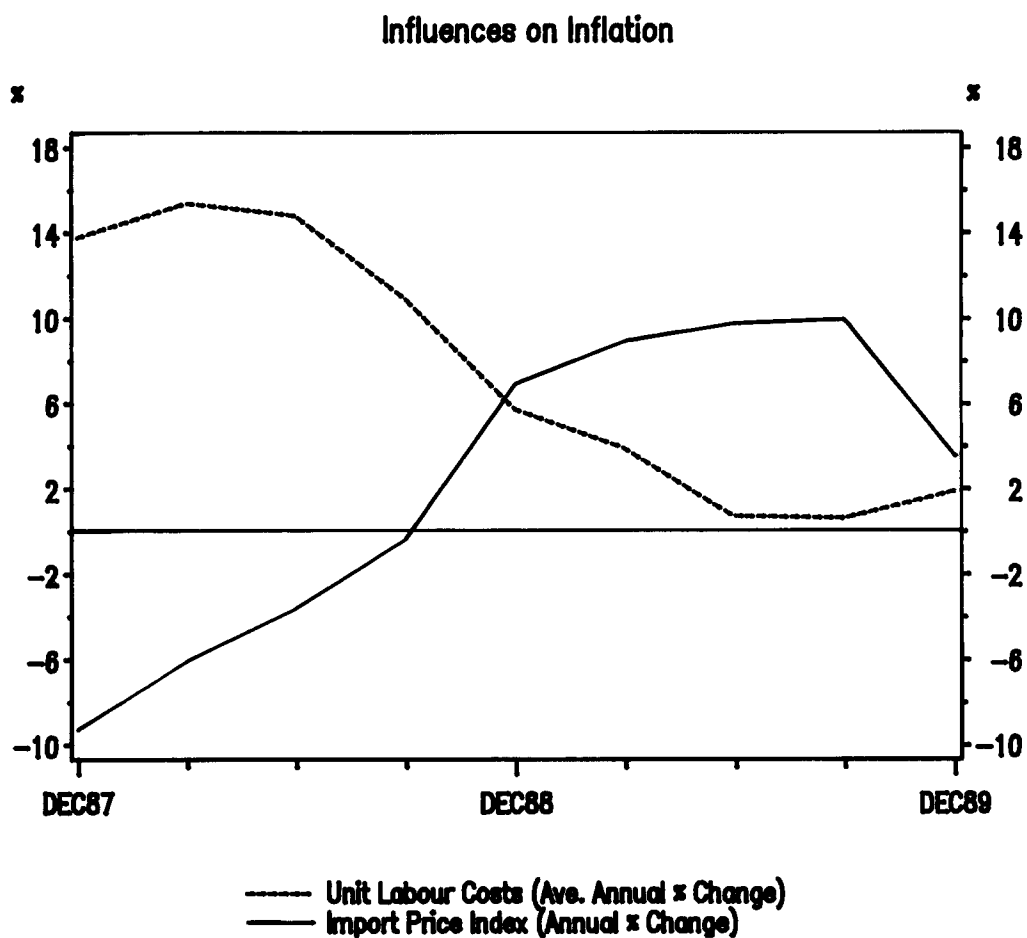
The most important of the one-off effects on prices was the 2.5 percentage point increase in the rate of GST on 1 July 1989. This increase is estimated to have contributed 1.9 percentage points to the 1989 inflation rate. The increase in GST worsened perceptions in the community about the strength of inflationary pressures. This outcome was particularly unfortunate coming at a time when the Bank has been seeking to establish the credibility of the Government's commitment to lowering inflation further.

The inflation rate in 1989 was also significantly boosted by the strength of New Zealand's terms of trade. In particular, the prices of meat and dairy products rose sharply during 1989, with an estimated direct effect on the annual inflation rate of around 0.7 percentage points. These price increases, together with poor winter growing conditions for fruit and vegetables, helped boost the rate of food price inflation to a peak of 12.4 per cent in the year to September 1989.

The Bank believes that it was appropriate to have allowed the direct impact of these increases in commodity prices to feed into the domestic price level. The pressures on inflation were viewed as temporary, and to have tightened monetary policy to offset them would have imposed unnecessary adjustment costs on the economy, at a time when economic activity was still relatively weak. In the event, the food price pressures have indeed proved to be shortlived. Fruit and vegetable prices have eased, and the international prices of beef and dairy products have fallen sharply in the first few months of 1990.



Sources: Meat Board and Dairy Board.



The rate of increase in import prices rose sharply in late 1988 and early 1989 following the August 1988 exchange rate depreciation. The relatively rapid growth in import prices probably contributed to the inflationary pressures in early-mid 1989. However, the impact may have been muted by the less-than-complete flow-on into prices from earlier rises in the exchange rate.

Offsetting the upward pressures on inflation was the sharp fall in the rate of growth of unit labour costs (labour costs per unit of output) over the year to mid-1989. Wage increases of only around 4 per cent in the 1988/89 wage round – after two years of average wage settlements of 6-7 per cent – contributed to this slowing. The other major influence came from the very rapid productivity growth experienced over 1988 and early 1989 as economic restructuring continued and significant labour-shedding occurred. In combination, these two factors meant that labour costs put very little upward pressure on prices during most of 1989. More recently, some slowing in productivity growth has led to an increase in the rate of growth of unit labour costs, but at around 2 per cent the contribution to inflation in late 1989 and early 1990 has still been modest.

In addition to the CPI, the Bank looks at a number of other measures of prices in assessing underlying inflation trends. In particular, the Bank monitors an adjusted measure of consumer prices, and the input and output measures of producer prices.

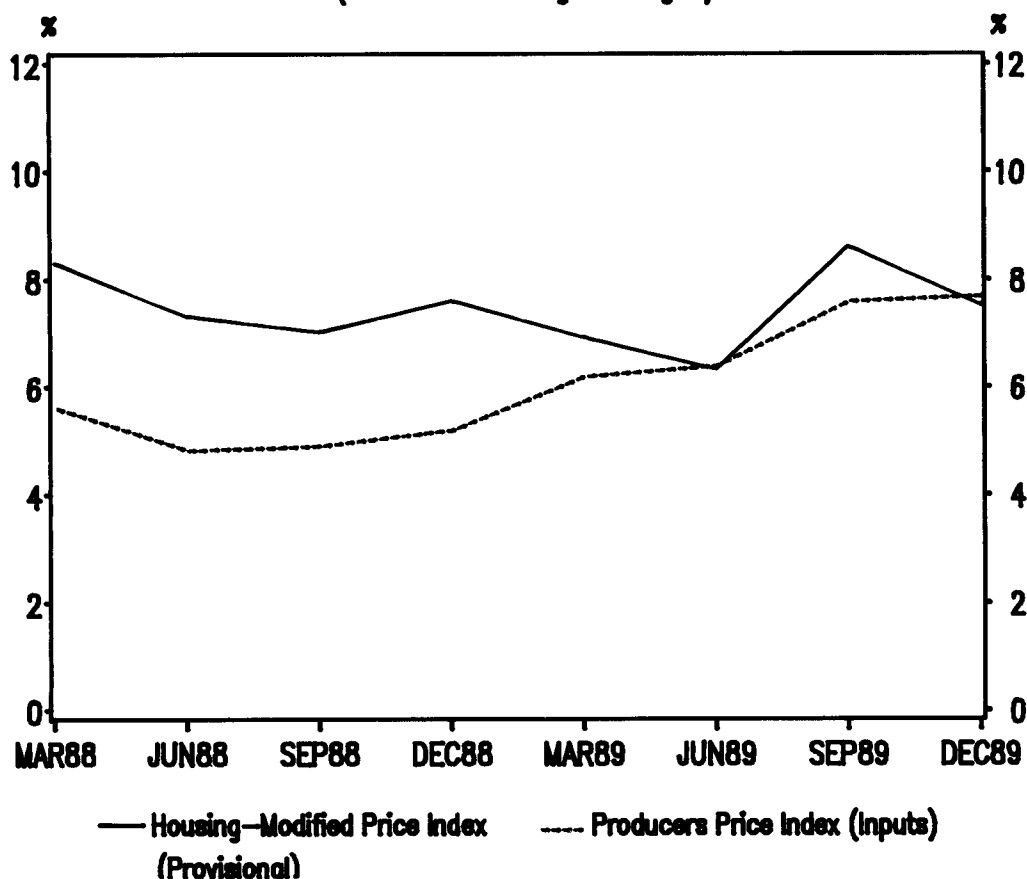
The Bank has believed for some time that consumer price inflation would be measured better by an adjusted index in which house prices and mortgage interest rates were replaced by a measure of the rental value of owner-occupied houses.³ The Bank estimates that, measured on such a housing-modified price index, consumer price inflation fell marginally from around 7.6 per cent in 1988 to 7.5 per cent in 1989. Excluding the impact of the GST and commodity price effects, inflation on this measure would have fallen sharply in 1989.

Rising commodity prices and the impact of the August 1988 exchange rate depreciation meant that the rate of producer price inflation had already been rising during 1988. Producer price inflation rose further during 1989, reaching a peak of 7.8 per cent in the year to December (for inputs). The PPI inflation rate has been somewhat higher than the comparable CPI inflation rate, but this gap has primarily reflected the greater weight given to commodity prices in the PPI. Accordingly, there is no reason to suggest that the relatively rapid PPI inflation will be reflected in any further increase in CPI inflation. The levelling-out of major commodity prices meant that, taken together, the December quarter PPI outcomes, released in early March, were the most favourable since March 1988. As some commodity prices have since eased significantly, further moderation in PPI inflation can be expected to have occurred in early 1990.

In summary, although CPI inflation rose strongly during 1989, the Bank does not consider that this increase jeopardised the steady pursuit of price stability, or required any significant monetary policy response. Most of the increase was accounted for by the direct effects of the GST increase and of the increases in meat and dairy products prices, effects which were clearly one-off in nature. By early 1990 it was clear that the inflationary pressures were receding and that underlying trends remained favourable.

³ As required under the policy targets agreement, the Bank will be taking steps to ensure the publication of such an adjusted index.

Other Inflation Measures (Annual Percentage Changes)



However, although the one-off pressures did not alter the Bank's view of medium-term prospects for inflation, the increase in the measured inflation rate did contribute to an increase in private sector expectations of future inflation, effectively adding to the costs of getting inflation down. Neither financial markets nor businesses and households fully appreciated the temporary nature of the recent pressures on inflation. In the financial markets the higher inflation expectations were reflected in the increase in interest rates over the December quarter. Among households, the Reserve Bank's survey of household expectations has shown a rise in year-ahead inflation expectations from 6.8 per cent to 8.8 per cent between August 1989 and February 1990.

More recently, however, the tide appears to have turned somewhat as the concerns about current inflation ease. This improvement in sentiment was reflected in easing interest rates in January 1990. Although the Bank's February household survey recorded a rise in year-ahead expectations, this increase is likely to have reflected the relatively slower adjustment of households to news about inflation. More favourably, the Reserve Bank and National Bank business surveys have shown some reduction in expectations. The 4.4 per cent two-year-ahead expected inflation rate in the Reserve Bank's February business survey is the lowest two-year-ahead expectation recorded in the three year history of the survey.

Because the temporary inflationary pressures evident throughout much of 1989 were being reflected in higher expectations of inflation, the Bank was concerned about the prospects for the 1989/90 round of wage negotiations. In the event, the outcome was not too unfavourable, although, given the large number of people

unemployed, greater wage restraint should have been achievable. The average wage increases of around 4.5 per cent were slightly higher than those achieved in 1988/89, and in contrast to the 1987/88 wage round there has been only limited evidence of greater flexibility in the provisions of most awards. These wage increases represented a degree of real wage restraint, particularly from the perspective of wage earners. But with some slowing in the rate of growth in labour productivity, aggregate unit labour costs are likely to rise slightly faster over the coming year than in 1989.

Other Economic Developments

The concerns about inflation, and the mixed signals about the path it was taking, have been mirrored in the real economy, where economic indicators have given a mixed picture of the state of the economy. After allowing for timing effects associated with the introduction of GST, the indicators suggest that the recovery which began in late 1988 is continuing at a gradual pace. However, the economy still appears to be vulnerable to shifts in confidence and to waves of undue optimism and pessimism in response to sometimes insignificant pieces of economic news.

Business confidence had been rising until late in the September quarter of 1989. General perceptions of improving economic activity and the continued strength of export prices contributed to the upturn. In addition, a surge of foreign investment into the New Zealand bond and equity markets in the September quarter, following the July 1989 Budget, reinforced the impression of improving confidence.

However, the September quarter surge of optimism proved to be shortlived. The rise in interest rates over the last few months of 1989 in response to concerns about inflation, together with the uncertainty generated by the failure of DFC and the sharp sharemarket downturn in mid-October, adversely affected business confidence. In addition, after the introduction of GST, the underlying level of economic activity proved to be somewhat weaker than many had appreciated. More recently, most of the fears of resurgent inflation have been quelled and interest rates have eased. As a result, confidence indicators are likely to have shown some improvement in early 1990.

Consistent with the fragile state of business confidence over much of the year, the Bank is forecasting that GDP has grown only modestly in the year to March 1990. The largest positive contribution is expected to have come from a slowing of the rapid running-down of stocks that occurred throughout 1987 and 1988. By contrast, domestic spending appears to have remained relatively weak. The Bank is forecasting that private consumption and aggregate business investment have been flat. On the investment side, there has been a steady improvement in investment in plant and machinery (particularly transport and computer equipment), and recent farm expenditure figures show that on-farm investment has picked up considerably over the last twelve months. However, these improvements have mainly been felt in stronger import growth rather than in domestic activity. Furthermore, the effect on total business investment has been offset by the sharp downturn in commercial construction activity.

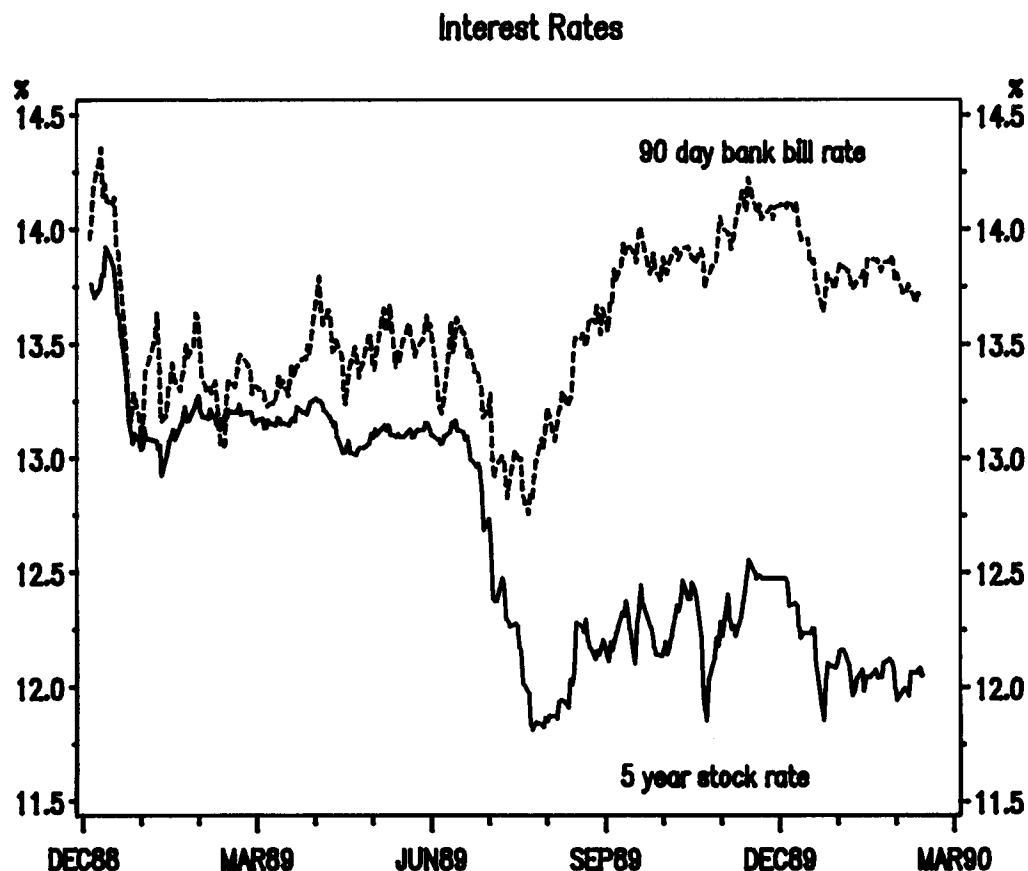
Strong export prices over the last couple of years have also been contributing to the economic recovery. However, in the agricultural sector reductions in livestock numbers and falling meat and wool export volumes – caused in part by the 1988/89 drought – have limited the growth of export receipts. More recently, prices have eased back from the 1989 peaks, further dampening the stimulus coming from the export sector. Over the year ahead, however, an improvement in export volumes is expected to make a significant contribution to the recovery.

The sharp rise in imports and the relatively weak growth in export receipts have contributed to a significant widening in the balance of payments current account deficit over late 1989. The implications of these developments for future trends in the balance of payments remain rather uncertain. Clearly, some temporary or large one-off factors are at work; on the export side the effects of the drought, and on the import side, the impact of some large capital re-equipment programmes. The recent statistics nevertheless also point to an increase in the importance of imports in domestic consumption, largely a result of the reduction in trade protection in recent years. The underlying trends in the balance of payments should become clearer as more data become available during the year.

Monetary Developments and Monetary Policy

Over the past six months, the key indicators the Bank uses in monitoring monetary conditions have remained at levels consistent with the pursuit of the Bank's price stability objective. Accordingly, no significant monetary policy actions were needed. However, changing sentiment about inflation prospects meant that interest rates moved through a relatively wide range over the period, consistent with maintaining an appropriate degree of disinflationary pressure.

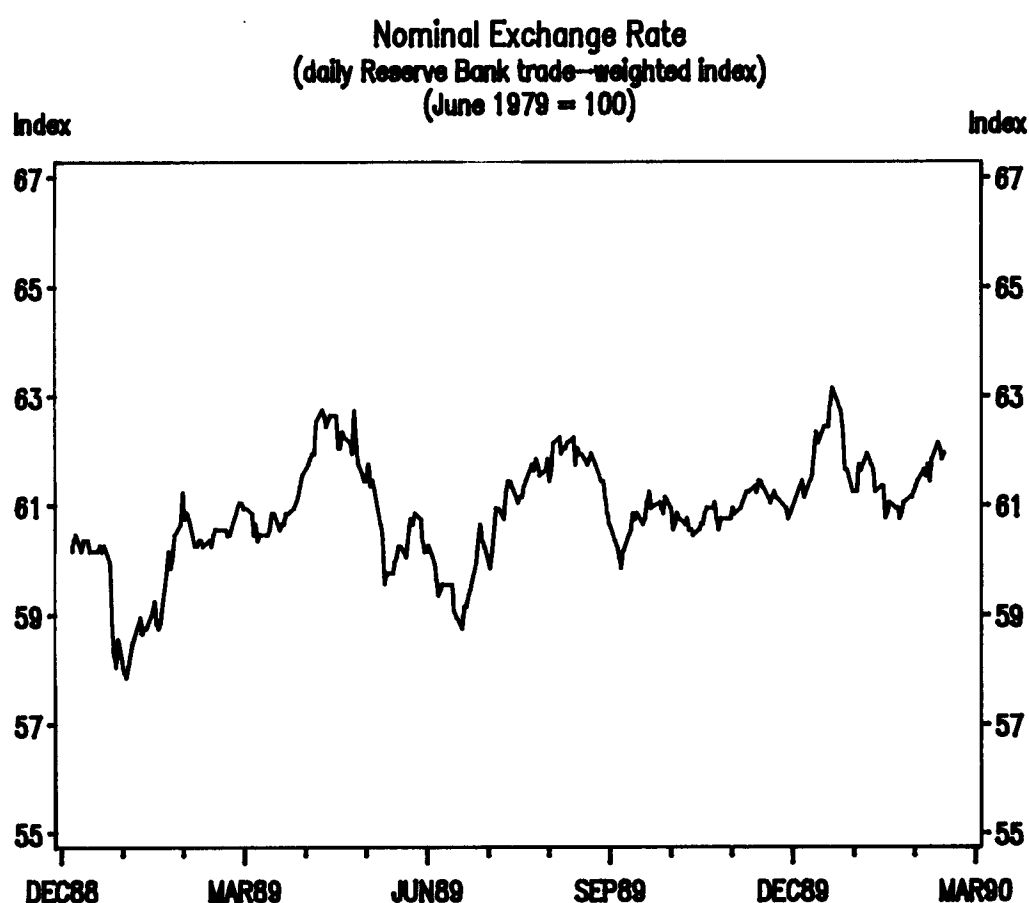
A number of factors around the time of the Budget in July helped bring about a sharp fall in interest rates. Significant overseas buying interest, improving confidence, and a change in the pattern of the Government's debt repayment programme helped lower five year bond rates from around 13.1 per cent to as low as 11.8 per cent. Short-term interest rates also fell initially, but by less than longer-term rates, so that the 90 day-5 year yield gap widened considerably.



However, short-term rates subsequently rose by more than they had fallen. From a low of 12.75 per cent in mid-August, 90 day bill rates rose to trade in the 13.75-14 per cent range over October and November, and at above 14 per cent for much of December and early January. Bond rates also rose – but more modestly – reaching a peak of 12.6 per cent in December. As a result, the 90 day-5 year yield gap widened further. The exchange rate eased back slightly from post-Budget levels, but averaged 60.8 on the Bank's trade-weighted index over the December quarter, almost unchanged from the average of the previous six months.

The unfavourable September 1989 CPI figure appears to have been a key factor behind the initial rise in interest rates. That inflation outcome added to existing fears in the financial markets that increased policy pressure would be needed to ensure a continuing fall in the underlying inflation rate. Other contributing factors included some firming in overseas interest rates, low levels of Primary Liquidity⁴ during September and October, and the DFC collapse.

The Bank took no policy measures to prompt the increase in interest rates, and the steepening of the yield curve. However, the Bank recognised the inflationary fears and pressures coming from overseas rates. Given that the exchange rate had remained firm, the Bank judged that it was these factors, rather than domestic liquidity pressures, which had been the dominant causes. In these circumstances, significant Bank action to have prevented the rise in interest rates could have increased the risks for future inflation. However, as short rates rose above 14 per



⁴ Primary Liquidity is defined as settlement account balances held at the Reserve Bank plus holdings of Reserve Bank bills having 28 or fewer days to maturity.

cent in December, the Bank did structure its open market operations to signal to the market that further rises were considered both unnecessary and inappropriate.

Early in the New Year, sentiment about inflation prospects improved. Attention focused on the favourable December quarter inflation outcome and on signs that export commodity prices had peaked. The exchange rate rose significantly in mid-January – to over 63 on the Reserve Bank's index for the first time since August 1988. This appreciation and the improvement in sentiment prompted a significant reduction in both short and long-term interest rates. The five-year bond rate fell to around 11.8 per cent, and 90-day bank bill rates to around 13.6 per cent in mid-January. However, these falls were shortlived. Following the easing of Australian monetary policy on 23 January, New Zealand interest rates rose again. Short-term interest rates returned to around the levels observed in October and November 1989 and the exchange rate fell back somewhat.

Interest rates have since been maintained at around the levels reached in late January, in the face of further rises in some key overseas interest rates. Current short-term rates are higher than those prevailing a year ago. However, the five-year bond rate has now settled at around the levels reached following the Budget in July 1989, despite the fairly heavy selling of government bonds by overseas holders in recent months, reversing the increase in overseas holdings which occurred over July and August 1989.

Looking back over the past six months, the Bank considers that monetary conditions have remained broadly consistent with achieving the desired rate of reduction in inflation. Over the period, the exchange rate has remained consistent with ensuring appropriate restraint on inflation. As the concerns of late 1989 about inflation have subsided, some of the pressures on interest rates have eased.

THE PATH TO PRICE STABILITY

This section outlines the Bank's view of the most likely trends in inflation, the monetary indicators, and the real economy, as the Bank works towards achieving price stability by the end of 1992.

Inflation and Growth

Significant reductions in the inflation rate are forecast for the remainder of 1990, particularly as the bulk of the GST increase drops out of the annual CPI inflation rate in September. The Bank is forecasting an increase in the CPI for the March quarter of less than 1 per cent, and with key commodity prices easing and only modest growth in unit labour costs expected, CPI inflation should fall to within the Bank's 3-5 per cent indicative range for the year to December 1990. This outcome can be achieved without the need for any change to the present stance of monetary policy. The Bank forecasts that the annual rate of CPI inflation will reach 3.7 per cent in the year to December 1990 and then fall further to 2.5 per cent in the year to December 1991 and 1 per cent in the year to December 1992. As required under the policy targets agreement and the Reserve Bank of New Zealand Act, the Bank will maintain a stable price level over the succeeding years.

As already noted, strong export commodity prices have been an important influence pushing domestic inflation up over the last year. However, some export prices have eased significantly early in 1990, and so the impact of commodity prices on inflation and inflation expectations appears likely to be favourable this year. Over the following few years, it is expected that export commodity prices will, on average, grow at around the same rate as import prices, expected to be around 4-5 per

cent per annum. The impact of overseas inflation on domestic inflation can be expected to be offset by a gradual appreciation in the nominal exchange rate, which will not affect the real exchange rate.

Of the other major factors, labour costs will remain a crucial influence on prices, employment and output. Over 1988 and 1989 the sharp slowing in unit labour cost growth was a major contributor to moderating inflationary pressures. Relatively low nominal wage increases occurred at the same time as substantial gains in labour productivity were achieved. Continuing low rates of growth in unit labour costs will be an important element in the smooth transition to price stability.

In respect of productivity, economic restructuring is continuing in both the public and private sectors. Moreover, employers will probably be reluctant to take on new workers in the early stages of the recovery. These factors suggest that additional relatively large productivity gains will be made during 1990. However, as the recovery takes stronger hold, and as the pace of restructuring slows, it is likely that the contribution from labour productivity growth will diminish further after 1990. There will then be little scope for wages to rise faster than the intended inflation path, unless productivity growth can be maintained through more flexible working practices or a faster introduction of new technology. If such restraint cannot be achieved with the current stance of monetary policy and if wages continue to adjust only slowly to the targets for inflation, some additional policy pressure on real interest rates and the real exchange rate would be needed to ensure that price stability is achieved.

Even if some additional policy pressure is necessary, the Bank is confident that the recovery in economic activity will gather strength. The Bank expects that the rate of growth in real GDP will accelerate further from the 2 per cent forecast for 1990/91. As activity picks up, growth in private sector employment can also be expected to occur. However, unemployment is unlikely to fall significantly in the early years of the recovery.

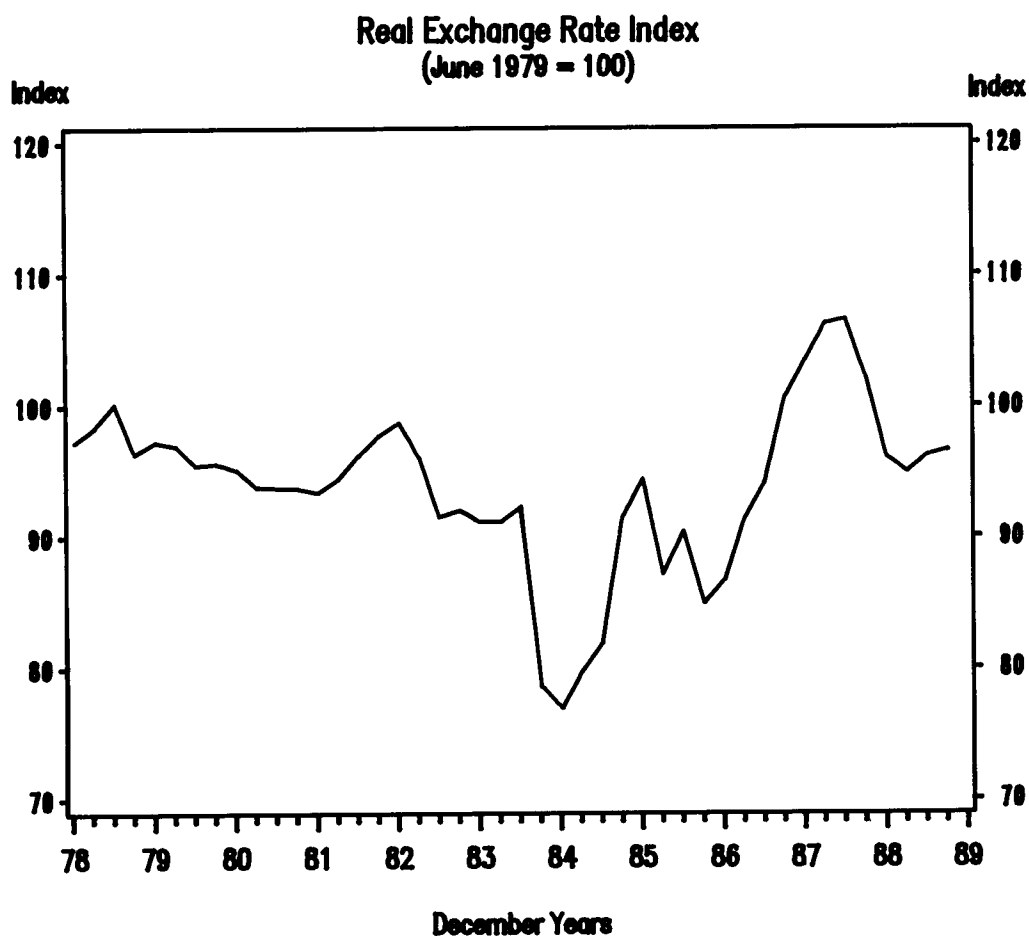
As the degree of disinflationary pressure eases after 1992, the Bank believes that growth rates of real GDP of 3-5 per cent can be sustained for some years, as the full benefits of the reforms undertaken in recent years, and of the achievement of price stability, are realised. Such growth rates were experienced in various other OECD countries as they emerged from periods of high inflation and economic reform in the early 1980s. To maximise the prospects of achieving rapid growth throughout the 1990s, however, it is important that restructuring and reform continue in those sectors which have not yet felt the full force of change.

Monetary Indicators and Policy

The Bank uses a number of indicators to monitor monetary conditions and to assess the appropriateness of the settings of the various instruments. The list of indicators includes the exchange rate, the level and term structure of interest rates, the rates of growth of money and credit, inflation expectations, and the real economy. Each of these variables contains some information and none on its own is sufficient to guide monetary policy.

However, among these indicators the exchange rate has a special place. The exchange rate is not only a useful indicator of monetary developments, but it is also an important direct influence on the New Zealand prices of internationally-traded goods. Accordingly, the exchange rate will be a key factor influencing the future course of inflation.

The implications for the exchange rate of successfully achieving price stability will



depend heavily on developments in the other influences on prices. In particular, significant growth in unit labour costs (relative to the inflation objectives) would mean that a firmer monetary policy would be necessary, putting new pressure on the real exchange rate for a period to offset domestic cost pressures. Over 1990, the low expected growth in unit labour costs means that an exchange rate around the levels experienced since the end of August 1988 should prove consistent with achieving the desired inflation outcome. However, avoiding pressure on the real exchange rate over the remainder of the transition to price stability will require that future rounds of wage settlements are influenced predominantly by productivity trends and the price stability objective, rather than by past experiences of inflation.

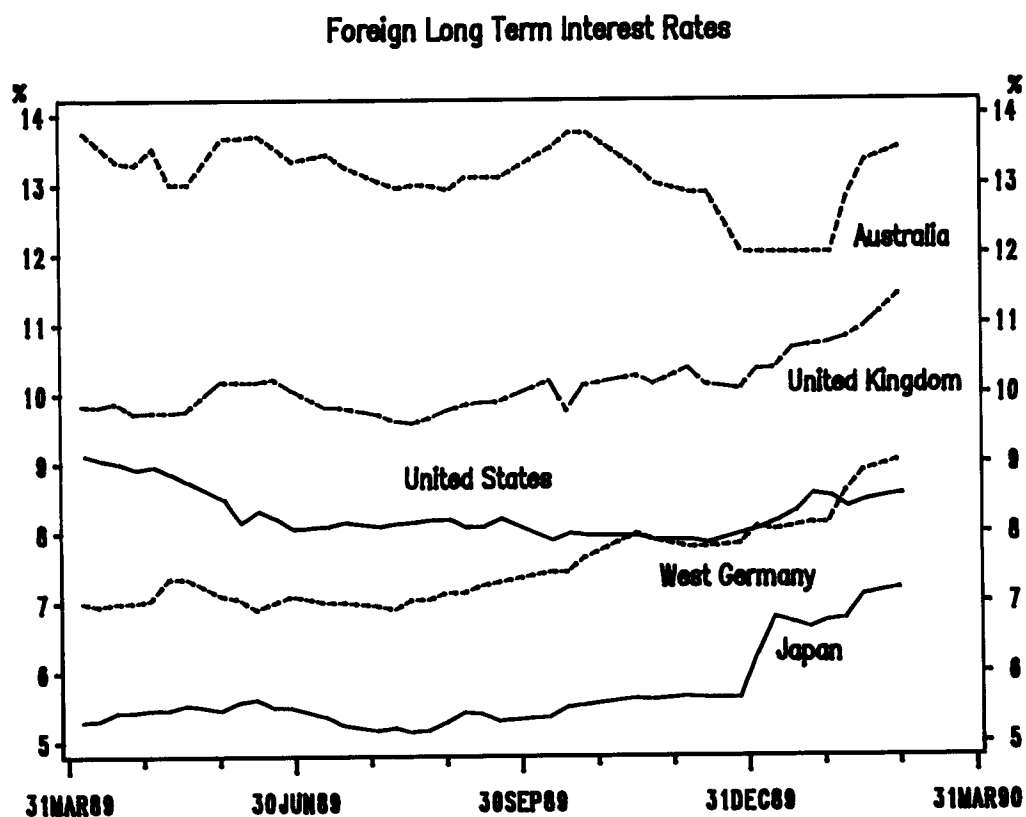
The difference between New Zealand inflation and that of our trading partners will be an important influence on the trend in the nominal exchange rate, though not on the real rate. For any given state of world markets, once price stability has been achieved the New Zealand nominal exchange rate could be expected to appreciate slowly each year to offset the upward pressure on domestic prices resulting from higher foreign inflation. Such an appreciation would not adversely affect international competitiveness, because the real exchange rate is not affected by those nominal exchange rate movements which simply reflect differences in inflation rates. The average trend appreciation at that stage should be approximately equal to the difference between average foreign inflation and New Zealand's target inflation rate.

Exchange rate outcomes will also be influenced by important factors other than monetary policy; factors affecting the competitiveness and profitability of New Zealand's traded goods producers. If, for example, export commodity prices

strengthen then some rise in the exchange rate would be consistent with the resulting improvement in the balance of payments position, as well as with ensuring that the inflation rate does not overshoot its target range. Alternatively, a worsening external position may be compensated for in part by some depreciation in the exchange rate, provided that the resulting price increases do not flow into higher domestic cost inflation.

The other major monetary indicator monitored by the Bank is the level and slope of the interest rate yield curve. The slope of the interest rate yield curve, relative to the markets' expectations of changes in the inflation rate, is an important indicator of the degree of policy pressure actually being exerted. Thus, a downward-sloping curve, as experienced in New Zealand since 1985, can be expected while inflation continues to fall. The level of interest rates, in conjunction with estimates of market inflation expectations, is also an indicator of policy pressure.

Over the last two to three years, both the level of interest rates and the slope of the yield curve have fallen significantly. 90 day bill rates have fallen from around 19 per cent in mid-1987 to just below 14 per cent at present, and over the same period bond rates have fallen by around 4 percentage points. The Bank expects that these trends will continue over coming years. As the path to price stability is successfully negotiated and inflation expectations fall, the level of interest rates should fall significantly. Continuing success in restraining the Government's financial deficit and a sustainable balance of payments current account position would provide a favourable climate for such reductions. A relatively flat, or slightly upward sloping, yield curve can eventually be expected to emerge.



Source: The Economist

Over a shorter time horizon, two important factors may limit the rate at which interest rates fall. First, overseas interest rates have been rising recently, particularly in Japan and West Germany. These rises partly reflect greater inflationary concerns in those economies, but may also reflect the impact on real interest rates of the increased demand for investment capital following the political and economic changes in Eastern Europe. Second, the emerging balance of payments situation may give rise to some overseas concerns about investment prospects in New Zealand. However, the Bank does not believe these factors will prevent a resumption in the downward trend in New Zealand interest rates at some stage during 1990. Favourable news will emerge on inflation during the year and general economic confidence should improve as economic activity gradually recovers. Together these factors should help encourage a return of foreign investment, and a reduction in the premium above world that rates investors have been requiring on New Zealand dollar investments.

At present, the Bank places relatively little weight on the monetary and credit aggregates. Various measurement problems and behavioural changes which have continued to take place in recent years have meant that reliable statistical linkages between the aggregates and nominal income and prices have not been established. However, the aggregates will continue to be monitored, and if the growth rates of all or most of the aggregates begin to shift sharply in one direction then this information will be used, in conjunction with that from the other indicators, in assessing policy settings.

MONETARY INDICATORS

	90-Day ¹ Bank Bill Yield (%)	5-Year ¹ Govt, Stock Yield (%)	Yield ^{1,2} Gap ¹ (%)	Exch. ^{1,3} Rate	M3 Annual %	Private Sector Credit Changes ⁴
1988						
Mar.	16.5	14.2	2.3	66.3	16.1	18.0
June	16.0	13.1	2.9	66.7	10.5	11.7
Sep.	14.6	13.0	1.7	64.4	9.4	13.2
Dec.	14.4	13.4	1.0	60.6	3.4	9.2
1989						
Mar.	13.5	13.3	0.2	59.8	3.3	4.4
June	13.5	13.1	0.3	61.1	5.4	6.7
Sep.	13.3	12.4	0.9	60.9	5.4	7.1
Dec.	13.9	12.3	1.6	60.8	4.6	10.4
1990						
Mar. (to 15th)	13.8	12.1	1.7	61.6	3.3	3.3

Policy Implementation

The Bank envisages that the mechanics of implementing monetary policy and signalling the Bank's policy intentions will remain unchanged from the patterns adopted over the last three to four years.

¹ Quarterly averages of daily observations.

² Gap between yields on 90-day bills and 5-year government stock.

³ Daily trade-weighted index (June 1979 = 100).

⁴ At end of period, and January 1990 for March quarter 1990.

The Bank uses a number of instruments to implement monetary policy. The daily open market operations target a level of settlement cash balances. This target is currently set at \$30 million. Institutions hold Reserve Bank bills (currently totalling \$400 million) which are discountable on demand at a penal margin now 1.5 percentage points above market rates. Settlement cash and discountable Reserve Bank bills together comprise Primary Liquidity. The Bank considers the current settings of these various instruments are consistent with the intended stance of monetary policy.

The Bank signals its policy intentions in a number of ways. If monetary conditions temporarily become more or less firm than desired, but there does not seem to be any basis for a longer-term change in policy settings, the Bank generally acts by altering its stance in open market operations or by making temporary adjustments to Primary Liquidity by buying or selling discountable bills in the market. However, if more fundamental changes in monetary conditions occur, the Bank can respond with more substantive adjustments to policy settings. The Bank can change one or more of the targets for Primary Liquidity or settlement cash, or the penal discount margin.

RISKS AND RESPONSES

In addition to outlining the Bank's view of likely developments in the economy and the various monetary indicators, it is also important to consider the impact of possible unexpected events which could have implications for the Bank in its pursuit of price stability. Under most circumstances the Bank would still be required to meet its inflation targets. However, several sorts of events could prompt a renegotiation of the inflation targets in line with the provisions of the policy targets agreement.

Events Where Policy Targets Would Still be Achieved

Wage-setting behaviour will be one of the crucial determinants of the degree of policy pressure required over the next five years, and thus of the output and employment costs of achieving price stability. If wage increases continue to adjust only gradually in response to reductions in inflation then real wages will rise, and, as productivity growth slows, unit labour costs could be expected to grow slightly more rapidly than over recent years. In these circumstances, some additional policy pressure on real interest rates and the real exchange rates would probably be necessary to ensure that the policy targets are achieved. The potential for such growth in unit labour costs is one of the reasons why significant reductions in the number of people unemployed may be difficult to achieve over the next few years.

On the other hand, the inflation targets could be accepted by wage negotiators as being credible objectives, which are likely to be achieved. If wages were to be set on the basis of the targets for *future* inflation rather than on *past* actual inflation, then less monetary policy pressure would be required over the next few years. In turn, the economic recovery would be stronger during the remaining years of the transition to price stability. Stronger growth in output, combined with moderation in the growth of unit labour costs, would encourage employers to take on staff at a more rapid rate. Such an outcome would bring about significant cuts over the next five years in the number of people unemployed.

A change in *overseas real interest rates* would be another event which could require a policy response from the Reserve Bank. If overseas rates rose, market forces would tend to push up New Zealand real and nominal interest rates, independently of the state of our economy or of New Zealand's inflation objective. An attempt to prevent the rise in world rates from having any effect on New Zealand interest rates would most probably lead to a reduction in our exchange rate. In

deciding on a policy response to a change in overseas interest rates to ensure that the policy targets continue to be met, the greater inflationary pressures arising from a lower exchange rate would have to be assessed against the greater disinflationary pressure that higher real interest rates would impose.

The experience of recent years has shown that the *exchange rate* can fluctuate markedly at times. Such fluctuations can have important implications for inflation if they are sustained. Some situations which might lead to a significant change in the exchange rate are covered in the renegotiation provisions of the policy targets agreement, and are discussed further below. Other circumstances are not. For example, market sentiment regarding an economy can shift sharply at times, in response to political developments, or to economic developments such as trends in the balance of payments. Such changes in sentiment can have a large and rapid impact on the exchange rate as investors reassess their positions. In the event of changes in the exchange rate occurring for reasons other than those in which renegotiation of the targets is provided for, the Bank would generally be obliged to respond with actions which altered both interest rates and the exchange rate to ensure that the price stability objectives continued to be met.

Events Which Could Lead to Changes to the Targets

The Government and the Bank are both committed to achieving price stability, as set out in the policy targets agreement. However, the agreement does specify a limited number of circumstances in which the targets could be renegotiated.

These provisions in the agreement do not, in any sense, compromise the position held by both the Government and the Bank that, over the long term, price stability is the only useful objective monetary policy can achieve. Rather, they recognise that certain major economic shocks, which occur infrequently, can impose significant real adjustment costs. Although these costs do not justify any deviation from the long-term objective of price stability, they would call into question the viability – and indeed the desirability – of sticking rigidly to the target date specified in the policy targets agreement.

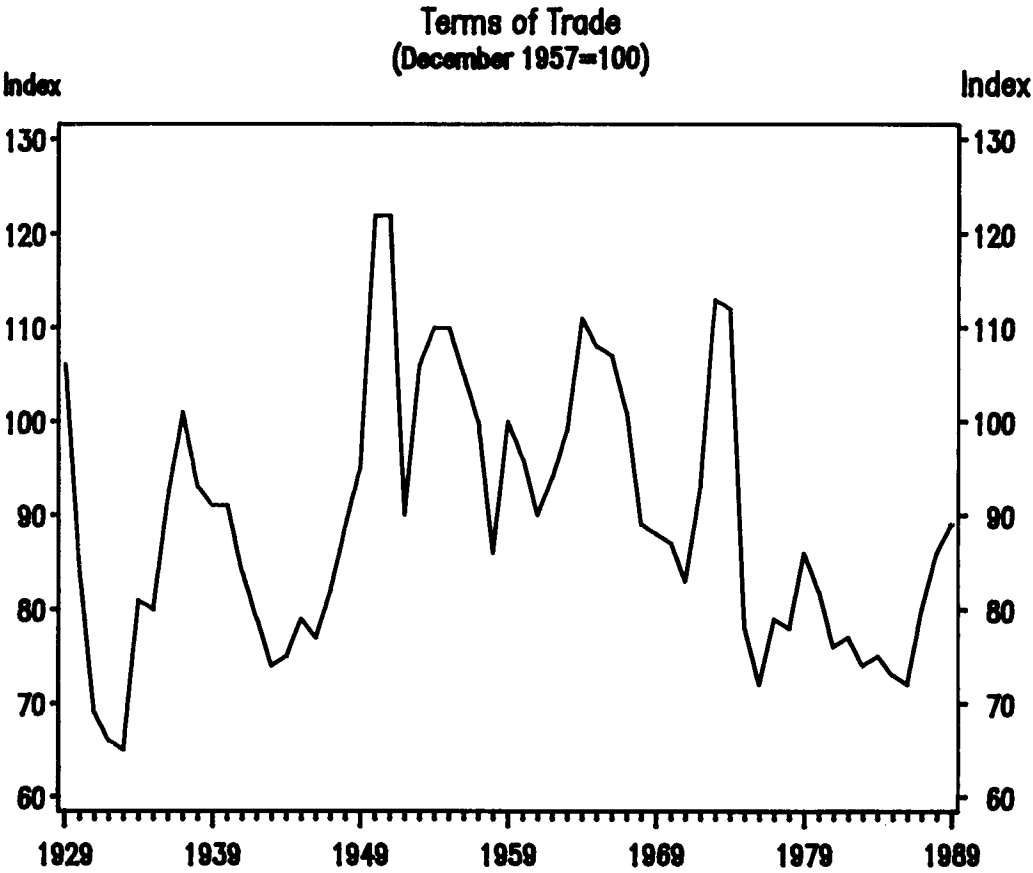
The first specific provision relates to the possibility of a large *change in house prices or interest rates*. This provision allows the Governor the option of choosing to renegotiate the policy targets if, in 1992 or 1993, there is, or is likely to be, a divergence of at least one half of a percentage point between the annual rate of increase in the CPI and that of an alternative measure of consumer prices that the Bank will be required to maintain. In the alternative index, mortgage interest rates and house prices will be replaced with a measure of the imputed-rental value of owner-occupied housing. A divergence between the two indexes could come about because of house prices rising more or less rapidly than residential rentals. More importantly, a divergence might occur as a result of an increase in interest rates, which might be required to keep inflation pressures in check. Such an increase in interest rates would directly boost the CPI inflation rate, even though it would have little direct impact on the cost of current consumption. The provision allowing for renegotiation of the targets in these circumstances is designed to ensure that the Bank does not face a perverse incentive to avoid necessary anti-inflation measures, simply because the target index handles housing costs in a manner which the Bank considers to be conceptually inappropriate.

The targets will also be renegotiated following a *change in the rate of GST or a material change in other indirect taxes*. The Bank and the Minister have agreed that the first-round or direct impact of any such tax changes should be allowed to affect the price level. Such changes generally reflect other government policies rather than changes in the underlying inflation rate; for example, the move in recent years to

collect a greater proportion of government revenue from indirect taxes. Accordingly, it would be inappropriate for the Reserve Bank to be held accountable for these price increases, or for the rest of the economy to have to endure the adjustment costs of keeping measured inflation within a prespecified target range while such changes are introduced.

However, it is also important that second-round consequences of such tax changes should not be accommodated. The underlying trend rate of inflation should not be disturbed by a one-off change in the tax rate. Following the announcement of a GST change, or what the Bank considers to be a material change in other indirect taxes, the agreement provides for the Bank to advise the Minister in writing of its estimate of the direct price effect of the change. If the tax change is expected to directly affect the 1992 or 1993 annual inflation rates, the agreement provides for the targets to be automatically renegotiated and, if necessary, for new targets to be set within 30 days.

The third event which would lead to the renegotiation of the targets would be a sharp *change in the terms of trade* which was expected to have a significant direct effect on the price level. A rise or fall in the terms of trade is, of course, a change in relative prices. In general, relative price changes should have no lasting impact on the general level of prices. However, large terms of trade movements associated with significant changes in the prices of our exports or of important imported goods can have major implications in the short term.



Consider, for example, a doubling in the price of oil. It may be technically feasible for the Reserve Bank to tighten monetary policy immediately, pushing up the

exchange rate sufficiently to lower the prices of other traded goods, and eventually to lower domestic nominal wage rates enough to leave the overall price level unchanged. But an attempt to maintain the price level constant over the short-run in the face of such a shock would be likely to engender real costs, in terms of lost output and rises in unemployment, that would be out of all proportion to the benefits of short-run price stability.

The necessary adjustment to such a change in relative prices could, at times, be unduly hampered if some of the adjustment was not able to take place through a change in the aggregate price level. However, in allowing a one-off increase in the price level policy would also have to be kept sufficiently firm to prevent any resurgence in inflation expectations or any pass-through into higher wage increases, so that the underlying trend in inflation is not affected. In the face of such a shock, it would generally be important to get inflation back onto the trend path within 12-18 months of the shock.

The policy targets agreement provides that where the Bank considers that a terms of trade change would have a material impact on the price level in 1992 or 1993 (the years for which formal targets are specified), the Bank would advise the Minister of its estimate of the expected direct price impact of the change. Following the provision of this estimate, the Minister and the Governor would be required to set new policy targets within 30 days.

The final situation which would lead to a renegotiation of the policy targets is the advent of a *major domestic crisis*, such as a natural disaster or a major disease-induced fall in livestock numbers, which materially affected the price level. In this case, the impact on the price level could be direct, or through the one-off impact of the event on the exchange rate. In the face of such a crisis, with nominal wages generally being relatively inflexible downwards and a reduction in real wages being a necessary part of adjusting to the shock, the most appropriate response would generally be to allow the required real exchange rate adjustment to occur through a fall in the nominal exchange rate. This fall would lead to a one-off rise in traded goods prices and, hence, in the general price level. If the appropriate response to such a crisis affected the price level in 1992 or 1993 the Bank would advise the Minister of its estimate of the expected impact on prices, and a renegotiation would follow on the same basis as for a terms of trade change.

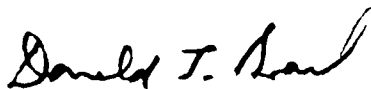
As is appropriate in the first Monetary Policy Statement, considerable space has been devoted to explaining these provisions of the agreement. However, it is important to reiterate that there is no reason to envisage that these provisions will be invoked in the foreseeable future. Nothing in the agreement or in this statement will give the Bank any warrant for failing to achieve its objectives in the face of domestic inflationary pressures, such as rapid increases in labour costs, asset prices, or profit margins. It is the task of monetary policy to achieve and maintain price stability, if necessary by offsetting such factors.

CONCLUSION

This first Reserve Bank six-monthly Monetary Policy Statement has set out the monetary policy objectives the Bank will be pursuing, and the Bank's view of the likely path towards those objectives. Under present assumptions the Bank believes that the objective – price stability by the end of 1992 – can be achieved at the same time as interest rates ease and the economic recovery continues to gather pace. However, if trends in unit labour costs are unfavourable, a further period of monetary policy pressure on real interest and exchange rates may be necessary to secure the objective. To avoid such pressures on the real economy, and on the tradeable

goods sector in particular, it will be important for those setting prices and wages to bear in mind the constraints imposed by underlying productivity trends and by the price stability objective which the Bank is committed to achieving.

The Bank welcomes the greater scrutiny of, and accountability for, the implementation of monetary policy provided for under the new legislation. These regular monetary policy statements will form a part of that process. The statements will prove to have been particularly useful if those setting prices and wages, and indeed all participants in the economy, build into their behaviour the commitment to achieving price stability that this statement has sought to convey.



Donald T Brash
Governor