Appendix 2

Policy Targets Agreement

This agreement between the Treasurer and the Governor of the Reserve Bank of New Zealand (the Bank) is made under sections 9 (1) and 9(4) of the Reserve Bank of New Zealand Act 1989 (the Act), and shall apply for the balance of the Governor's present term and for his next five year term, expiring on 31 August 2003. It replaces that signed on 10 December 1996.

In terms of section 9 of the Act, the Treasurer and the Governor agree as follows:

1. Price stability

Consistent with section 8 of the Act and with the provisions of this agreement, the Bank shall formulate and implement monetary policy with the intention of maintaining a stable general level of prices, so that monetary policy can make its maximum contribution to sustainable economic growth, employment and development opportunities within the New Zealand economy.

2. Policy target

a) In pursuing the objective of a stable general level of prices, the Bank shall monitor prices as measured by a range of price indices. The price stability target will be defined in terms of the All Groups Consumers Price Index excluding Credit Services (CPIX), as published by Statistics New Zealand.

b) For the purpose of this agreement, the policy target shall be 12-monthly increases in the CPIX of between 0 and 3 percent.

c) Notwithstanding clause 2(a), the Treasurer and the Governor may agree to use an alternative index of consumer price inflation following the implementation of the changes to the calculation of consumer prices proposed by the Government Statistician to take effect during 1999.

3. Unusual events

a) There is a range of events that can have a significant temporary impact on inflation as measured by the CPIX, and mask the underlying trend in prices which is the proper focus of monetary policy. These events may even lead to inflation outcomes outside the target range. Such disturbances include, for example, shifts in the aggregate price level as a result of exceptional movements in the prices of commodities traded in world markets, changes in indirect taxes, significant government policy changes that directly affect prices, or a natural disaster affecting a major part of the economy.

b) When disturbances of the kind described in clause 3 (a) arise, the Bank shall react in a manner which prevents general inflationary pressures emerging.

4. Implementation and accountability

a) The Bank shall constantly and diligently strive to meet the policy target established by this agreement.

b) It is acknowledged that, on occasions, there will be inflation outcomes outside the target range. On those occasions, or when such occasions are projected, the Bank shall explain in Policy Statements made under section 15 of the Act why such outcomes have occurred, or are projected to occur, and what measures it has taken, or proposes to take, to ensure that inflation comes back within that range.

c) The Bank shall implement monetary policy in a sustainable, consistent and transparent manner.

d) The Bank shall be fully accountable for its judgments and actions in implementing monetary policy.

[Hon Winston Peters]
Treasurer

[Donald T Brash]
Governor
Reserve Bank of New Zealand

DATED at Wellington, this 15th day of December 1997

22 October 1999

The Hon Bill English
The Treasurer
Parliament Buildings
Private Bag
WELLINGTON

Dear Treasurer

The current Policy Targets Agreement, signed by the Treasurer and me on my re-appointment as Governor on 15 December 1997 pursuant to section 9(1) of the Reserve Bank of New Zealand Act 1989, specifies (in clause 2(a)) that "the price stability target will be defined in terms of the All Groups Consumers Price Index excluding Credit Services (CPIX), as published by Statistics New Zealand".

Clause 2(c) of that Policy Targets Agreement notes that "notwithstanding clause 2(a), the Treasurer and the Governor may agree to use an alternative index of consumer price inflation following the implementation of the changes to the calculation of consumer prices proposed by the Government Statistician to take effect during 1999". This sub-clause was included in the Policy Targets Agreement because both parties were aware of the Government Statistician's intention to amend the Consumers Price Index during 1999 to exclude several items which, from a monetary policy point of view, would make that index a more appropriate measure of inflation.

The new Consumers Price Index will be published by the Government Statistician for the first time on 29 October 1999, covering the increase in prices between the June quarter of 1999 and the September quarter of 1999. The new index will update a number of the weights in the index, and will, importantly, remove interest rates and section prices from the index completely. The removal of interest rates makes the new index more similar to the CPIX index which is the focus of the existing Policy Targets Agreement, while the removal of section prices removes an asset price from the index which, in the Bank's view, is a desirable improvement in the index. (We have also argued for the exclusion of new house prices and the inclusion of imputed rentals instead, but at this stage the Government Statistician has not agreed to do this.)

I recommend that we agree that, with immediate effect, the price stability target in the Policy Targets Agreement be defined in terms of the new Consumers Price Index.

Because the Government Statistician will not be restating consumer price inflation in terms of the new index for any periods prior to the June quarter of 1999, the introduction of the new index raises a question about how best to calculate the "12-monthly increases" which, according to clause 2(b) of the Policy Targets Agreement, should be kept within a range of 0 to 3 per cent.

There is no perfect way of resolving this problem, but I recommend that, until it is possible to use four quarters of the new Consumers Price Index to calculate a "12-monthly increase" (in July 2000 for the year to the end of June 2000), we simply add the quarterly increases in the new Consumers Price Index to the quarterly increases in the old Consumers Price Index adjusted for the exclusion of interest rates and section prices. The two indices, even with the adjustments suggested, are not absolutely identical, so this is not a totally satisfactory solution. But I am advised that it is the best option available.

If you agree, I would be grateful if you would sign this letter indicating that agreement. We would propose to announce this minor technical change within the next few weeks, and in any case not later than the release of our next Monetary Policy Statement on 17 November 1999.

Yours sincerely

[Don Brash]
Governor