

MONETARY CONDITIONS AND POLICY¹

This article, prepared by Samantha Johnson, reviews developments in the monetary indicators and monetary policy over the three months to mid-November.

Executive Summary

During the three months to mid-November many developments have occurred which have had implications, either directly or indirectly, for monetary policy and inflation. These have included further world oil price increases, the 17 September "Growth Agreement", gloomy news on the domestic economy, and the election and subsequent change of government. Finally, in mid-November discussions on improving co-operation in the inter-bank settlement process, which were quite unrelated to monetary policy formulation, set off a significant fall in interest rates.

Monetary conditions remained firm but relatively steady throughout August following the Reserve Bank's firming actions at the beginning of that month. Conditions tightened further towards the middle of September as a result of cash distribution problems and political uncertainty. However, the 17 September "Growth Agreement", and the subsequent lower round of wage settlements, eased the pressures on monetary policy. A prospective rise in retail interest rates was averted and the exchange rate fell over the following month from a trade-weighted index (TWI) level of 61.0 to 59.0.

The short-term outlook for measured inflation became worse as a result of international oil price increases. However, the Reserve Bank's policy of accommodating only the first-round effects of these price rises is designed to ensure that underlying inflation does not increase as a result of the Gulf crisis.

Continuing uncertainty relating to the future path of oil prices led to a change of emphasis in the Bank's indicative inflation ranges. In its April 1990 Monetary Policy Statement the Bank outlined the indicative inflation range it expected to achieve en-route to the formal target of

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¹ Data and text finalised on 21 November 1990.

0-2 per cent annual consumer price index (CPI) increases by the end of 1992. In October, the Bank announced that it would in future operate with the intention of ensuring that oil-exclusive inflation meets these targets. Assuming no further rises in oil prices, the oil effects are currently expected to drop out of measured inflation by the end of 1992. At that time, oil-exclusive and oil-inclusive inflation should coincide. At the time of writing the change of government appeared likely to lead to a one-year change in the target date to December 1993 for the ultimate achievement of price stability.

The September quarter CPI figure was an encouraging 1 per cent, despite some initial impact from the oil shock. This favourable result was close to the 0.9 per cent predicted by the Reserve Bank. Despite some difficult economic developments, the Reserve Bank has continued to secure reductions in underlying inflation, consistent with delivering on the official goal of price stability. Consistent pursuit of price stability, in conjunction with significant moves to balance the fiscal accounts and free-up the labour market, provides the best means of addressing the severe economic imbalances and adjustment problems New Zealand still faces.

Introduction

Since the passage of the Reserve Bank of New Zealand Act 1989, the Bank has formally become responsible for targeting its monetary policy operations at the goal of price stability. This article reviews monetary conditions and policy in the context of this goal during the period since the finalisation of the Bank's last Monetary Policy Statement in mid-August.

Monetary Indicators

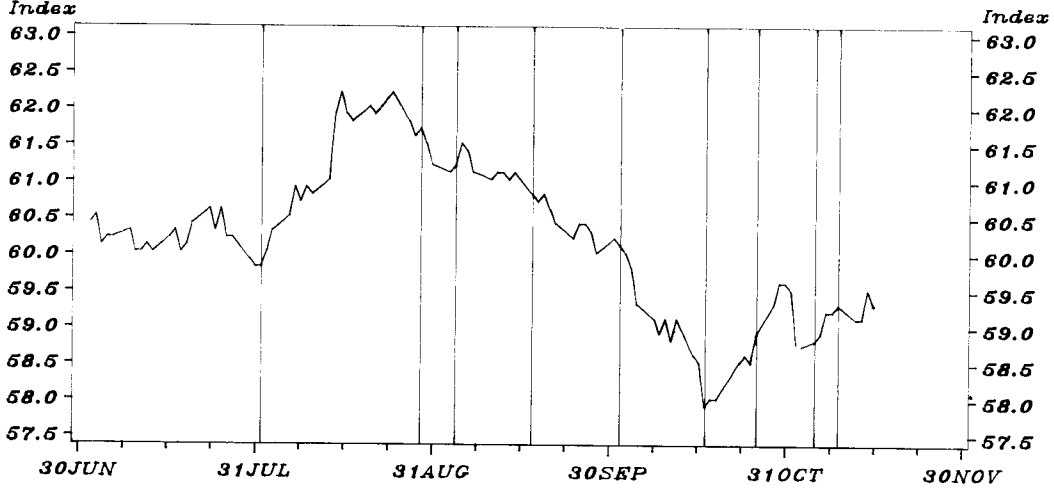
Interest and Exchange Rates

The Reserve Bank uses a number of indicators to monitor monetary conditions and to assess whether current monetary policy is consistent with the goal of price stability. The main indicators include the exchange rate (the trade-weighted index), the 90 day bill and 5-year government stock interest rates, and the (yield) gap between these two interest rates. The real economy, inflation expectations, and the monetary and credit aggregates are also monitored.

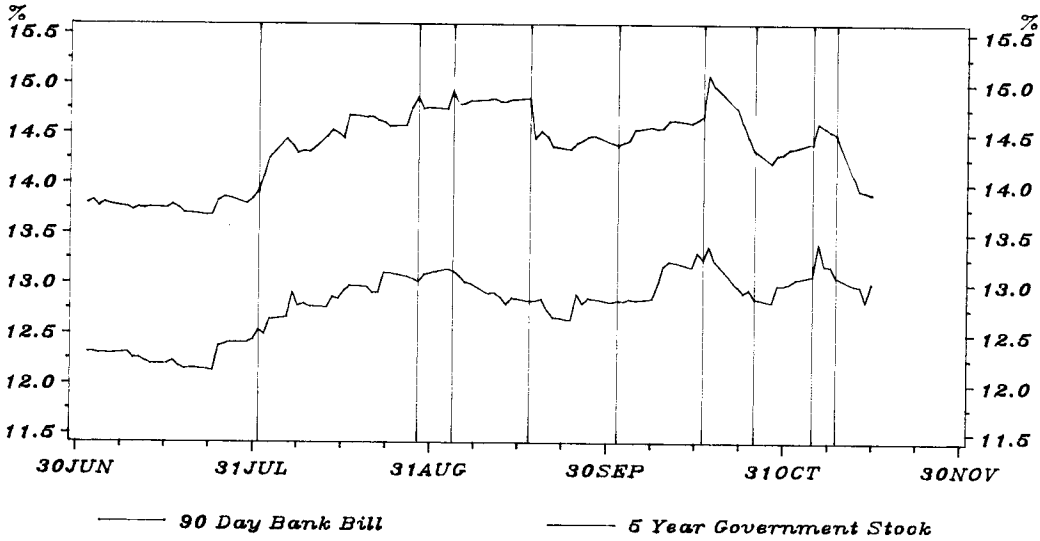
Many events, just prior to and during the review period, have impacted upon or had implications for the monetary policy indicators and inflation. These events are outlined in Appendix 1. Figure 1 features graphs of the main indicators with a time-line illustrating the response of each indicator to these key developments.

Figure 1

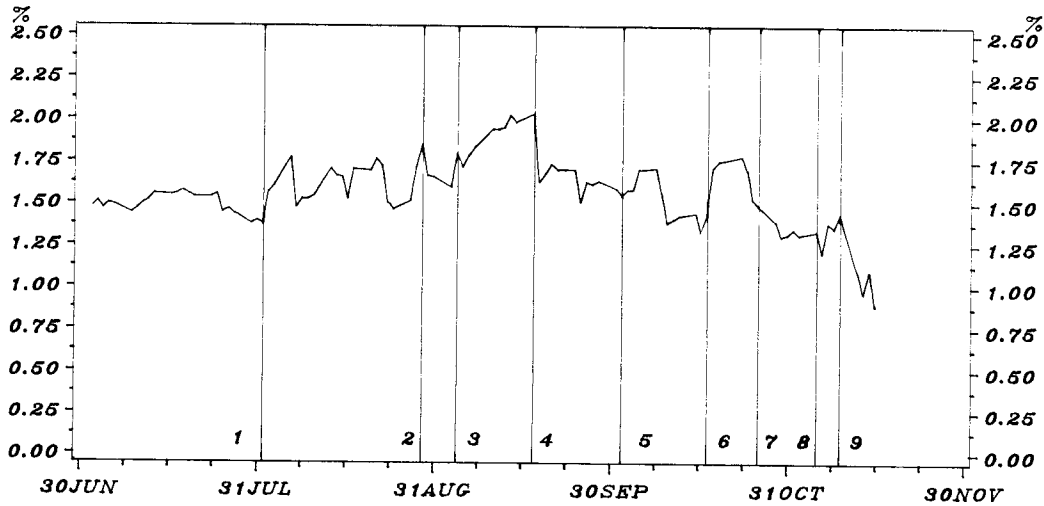
Nominal Exchange Rate
(daily foreign exchange trade weighted index)
(June 1979 = 100)



Interest Rates
government stock and bank bill rates



Yield Gap
between 90 day bank bills and 5 year government stock rates



1. Reserve Bank actions in money market. Iraqi invasion of Kuwait
2. Reserve Bank acts to relieve cash distribution problems
3. Change of Prime Minister
4. Announcement of "Growth Agreement"
5. Exchange Rate continues to fall
6. Reserve Bank acts to tighten monetary conditions
7. General Election
8. Announcements on the BNZ and New Zealand's fiscal position
9. Reserve Bank meets banks about cooperation in the settlement process

A significant and sustained fall in the trade-weighted index (TWI) at a time when interest rates generally remained under considerable pressure was the dominant feature of the period covered by this article. In the middle of August, the TWI stood at 62.0 and by mid-November the index was steady at just above 59.

Following the early-August tightenings, 90 day bill rates settled at around 14.6 per cent. Cash distribution problems at the end of August lifted rates further for a while (with 90 day rates peaking at 14.85 per cent) and temporarily interrupted a gradual fall in the exchange rate. The Reserve Bank acted to relieve the cash market problem and 90 day rates fell back to 14.7 per cent. The TWI ended the month at around 61. Bond rates had firmed to 13.1 per cent towards the end of August, in line with higher local funding costs and the impact on foreign bond rates of the deteriorating situation in the Middle East.

The change of Prime Minister at the beginning of September caused some rise in interest rates, until it was made clear that David Caygill would remain as Minister of Finance. Both interest rates and the exchange rate were then relatively stable until the middle of September. Bond rates fell very gently following the removal of political uncertainty and a lower than expected June Producers Price Index result. Despite this more favourable climate, 90 day bill rates edged up to around 14.8 per cent. The higher 90 day rates threatened further increases in mortgage rates.

Such rises did not occur. The announcement on 17 September of the Government-CTU "Growth Agreement" (discussed below in greater detail) significantly eased short-term interest rate pressures. The prospect of lower wage settlements and the promise of an improved fiscal position provided some scope for easier monetary conditions. In addition, there were some market perceptions that the stance of policy could be eased. Together these factors led initially to a relatively sharp fall in 90 day bill rates. This, in turn, contributed to a steady fall in the exchange rate, which was finally to reach a low of 57.3 on the TWI in mid-October.

Bond rates did not respond significantly to the "Growth Agreement" despite improved prospects for inflation. Favourable news on the wages front was offset by continued uncertainty surrounding the price of oil.

However, illiquidity in the bond market, arising from market friction caused an artificial and temporary drop in rates towards the end of September. This pressure was eased following the reopening of a swap facility by the Reserve Bank on 26 September, allowing illiquid bonds to be converted into benchmark liquid bonds.

The supposed existence of a specific Reserve Bank target for the exchange rate has become part of popular market folk-lore over the past year. Certainly many within the financial markets were surprised when in early October the trade-weighted exchange went below 60.0 and the Reserve Bank did not express concern about this fall, or act to keep it above 60. The fall was exacerbated by a drop in the Australian dollar following a further easing in Australian monetary policy.

The Bank's view was and is that monetary conditions must remain consistent with the achievement of price stability. Lower wage outcomes in the context of the "Growth Agreement" provided scope for some market-led easing in conditions, without threatening the goal of price stability. Thus there was no reason for the Bank to intervene in the market, so long as the easing in conditions was consistent with the changed inflation outlook.

However, by mid-October, as a result of continuing exchange rate falls, many investors were questioning the strength of the Bank's commitment to price stability. These doubts were also reflected in rising interest rates. After an initial statement was misinterpreted, the Bank had to send a small signal to the financial markets to allay their concerns.

The 18 October firming of monetary conditions stabilised the exchange rate, and temporarily increased 90 day bill rates sharply (reaching a peak of around 15.15 per cent). However, as the Bank expected, rates settled to lower levels within a week. They fell even further immediately after the election following the incoming Government's reiteration of its commitment to price stability.

The 5 November announcements of the recapitalisation of the Bank of New Zealand and the confirmation of a serious worsening in the Government's fiscal position, initially caused both 90 day bill rates and bond rates to firm to peaks of 14.6 per cent and 13.4 per cent respectively. However, once again the initial nervousness quickly passed, and interest rates fell back, helped by the Minister of Finance's strongly stated commitment to securing government expenditure cuts.

Further falls in both these rates occurred only a week later in response to the prospect of greater co-operation in the inter-bank settlement process. A meeting of settlement banks and the Reserve Bank on 12 November was held to discuss the recent high degree of inter-bank friction, and an understanding reached among the leading banks was designed to help ease the unnecessary tensions which had been arising periodically. The Reserve Bank undertook to release a discussion document outlining possible methods of improving the system. These steps were taken quite independently of monetary policy formulation, but were nevertheless given considerable significance by the markets. Both 90 day bill rates and bond rates fell sharply to lows of 13.7 and 12.8 per cent respectively. By 15 November the 90 day-5 year yield gap had fallen to a fifteen month low of 0.8 percentage points.

Monetary and Credit Aggregates

After six months of relatively rapid growth, monetary and credit growth slowed significantly in September. The year-on-year M3 and Private Sector Credit growth rates both fell by about 1 per cent, and the monthly growth rates were the lowest recorded since February. This slowing was expected and followed the rise in lending rates and the deterioration in business confidence over recent months.

Monetary Conditions

Overall monetary conditions during the three months to mid-November remained consistent with ensuring further progress toward price stability. In particular, despite the relatively sharp fluctuations in interest rates, the exchange rate remained consistent with the Bank's anti-inflationary aims, and signs emerged that monetary growth was falling more into line with the target path for inflation. Some weakening in the exchange rate was consistent with maintaining a steady degree of anti-inflationary pressure, because of the apparent weakening in economic activity and the less-than-expected inflationary pressures emerging from the wage round.

The "Growth Agreement"

The 17 September "Growth Agreement" between the Government and the Council of Trade Unions was a significant development during the review period, although at the end of the period, following the change of government, the future of the agreement remained unclear.

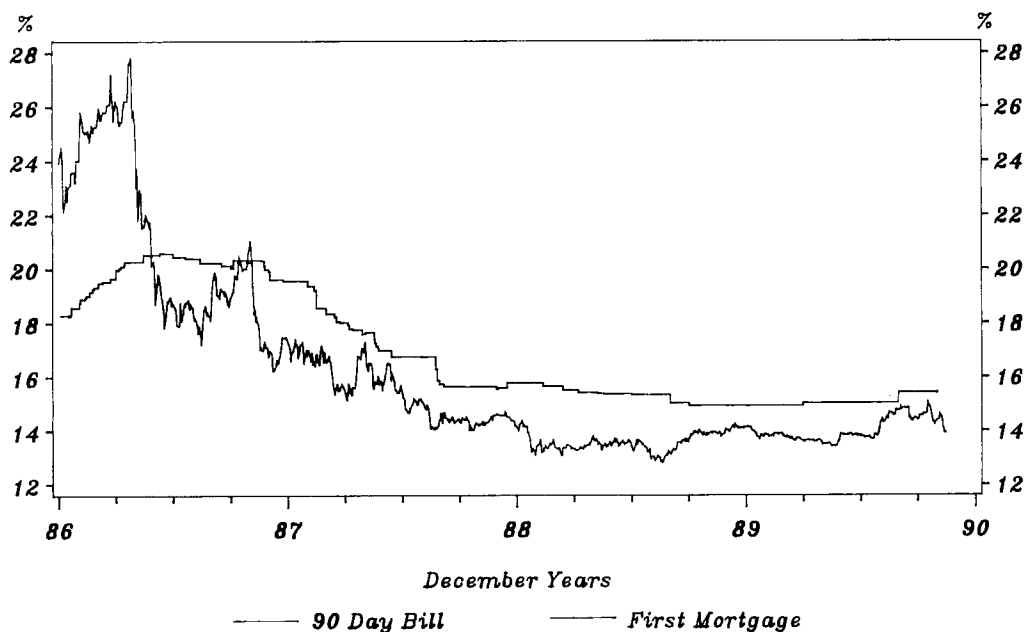
Under the terms of this agreement:

- the New Zealand Council of Trade Unions agreed to exercise its influence to achieve wage settlements of 2 per cent, with any further increases to be linked to productivity growth; and
- the Government undertook to take substantial steps toward reversing the deterioration in its fiscal position.

In economic terms, the package was designed to alleviate monetary policy pressures and to assist in reducing interest rates. As the Bank has repeatedly stressed, inappropriately high wage settlements have been an important contributing factor to the costs of eliminating inflation. Moreover, the markets' response to emerging fiscal imbalances had already contributed to the early-August tightening in monetary policy. Thus, from the Reserve Bank's point of view, the agreement was significant in that it addressed the issue of achieving wage and fiscal policy outcomes that would be consistent with the achievement of both price stability and improved employment and output prospects.

Figure 2

Funding Costs and Retail Interest Rates
90 Day Bank Bill Rate and First Mortgage Lending Rate



The Bank's monetary policy response to the "Growth Agreement" was essentially a reiteration of its past statements: that as wage and fiscal pressures eased then, other things being equal, less pressure on interest rates would be necessary. In making this response the Bank was reiterating its long-standing policy that it would not halt a fall in interest rates which reflected a fundamental improvement in market confidence about the inflation outlook.

The Bank is, however, also aware that whatever the favourable short-term effects of incomes policies, such policies can often cause serious problems over long periods of time, by discouraging or preventing the development of the sort of competitive and flexible labour markets most conducive to a strong long-term economic performance. The Bank has been a long-time public supporter of substantial labour market reform. It believes that such reform is an important element contributing towards future growth in productivity and employment in New Zealand.

The "Growth Agreement" is a form of incomes policy, but it is unlike most previous incomes policies adopted in New Zealand. In particular, it did not formally amount to centralised wage-fixing, as the agreement was not binding on any particular award settlement. The accord appears to have been a useful stop-gap measure for achieving wage restraint this year. Had the agreement not been reached, it seems likely (on the basis of recent wage rounds and intimations earlier this year) that higher wage settlements would now be occurring. Positive results in key documents such as the drivers and metal trades awards appear to have set the trend for a 2 per cent-plus-productivity award round. Even some unions not affiliated to the CTU, have reached settlements consistent with the agreement. Without such settlements, interest rates would almost certainly have been higher than they are now.

Although the "Growth Agreement" appears to have been a useful stop-gap it should not obscure the critical issues still to be addressed: achieving significant fiscal restraint, and providing labour market structures which ensure that over the long-term appropriate wage settlements are reached.

The Outlook for Inflation

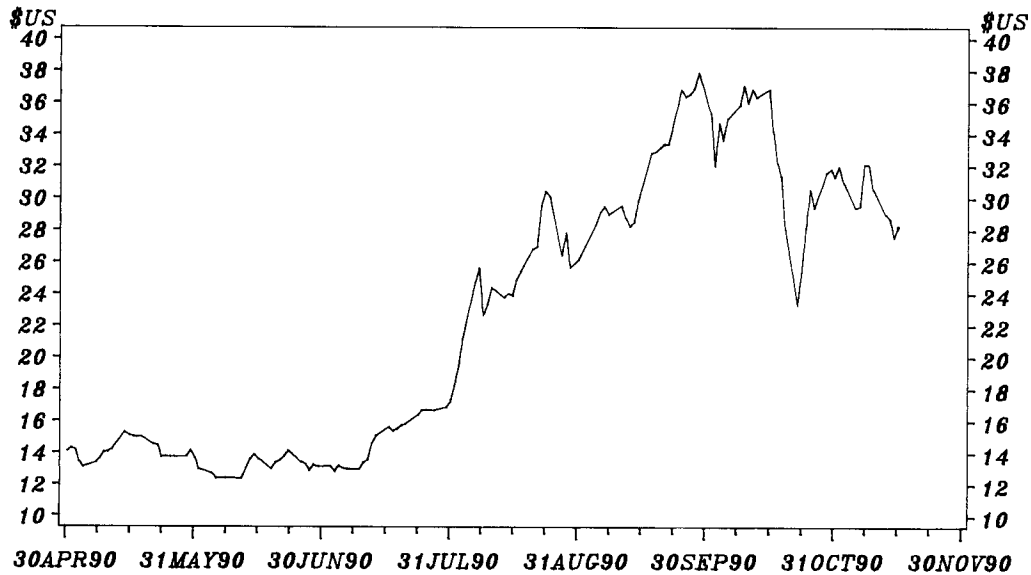
Despite relatively encouraging recent inflation outcomes, the short-term outlook for inflation has deteriorated substantially since the crisis in the Middle East began. This section reviews recent developments and the outlook for inflation.

The September quarter Consumer Price Index inflation figure released on 15 October was an encouraging 1.0 per cent. As a result, inflation in the year to September fell to 5 per cent from 7.6 per cent in the year to June. The effect of last year's increase in GST has now largely dropped out of measured inflation.

The favourable result for September was close to the 0.9 per cent predicted by the Reserve Bank and means that, exclusive of oil price effects, the Bank is on track for the 3-5 per cent indicative inflation range set for the year to December 1990. Despite some difficult economic developments, the Reserve Bank has continued to make progress towards delivering on the official goal of price stability.

Figure 3

Oil Prices
Dubai Fateh Crude Oil Spot Prices US\$ per Barrel



There have also been some favourable results on other inflation measures; all figures are consistent with a downward trend for underlying inflation. The 1990 June quarter Producer Price Input Index results were positive, with the Producer Price Index (PPI-I) increasing by 1.0 per cent and the Producer Price Output Index (PPI-O) increasing by 0.6 per cent over the quarter. The increase in the PPI-O was the lowest quarterly increase recorded since the index began in 1977.

The year-on-year rate of food price inflation has fallen over the last few months. For the year to August 1990 food price inflation was 4.9 per cent, for September it was 4.6 per cent and in October (influenced by fine weather) it fell to 3.3 per cent.

Inflation Expectations

Not surprisingly, the rise in oil prices has led to an increase in inflation expectations. The National Bank Business Outlook, the Reserve Bank household survey, and the Reserve Bank Survey of Business Expectations have all recorded increases in expected inflation over the past quarter. The October National Bank survey recorded an increase in the year-ahead expected inflation rate for the third month in a row, to 7.2 per cent. This was up from 7.1 per cent recorded in September and the 6.8 per cent reported in August. Similarly, the August household survey recorded an increase in year-ahead inflation expectations of households to 9.1 per cent. In the Reserve Bank's August business survey the inflation rate for the year to June 1991 was expected to be 4.7 per cent, somewhat higher than the 4.4 per cent expected in the June quarter survey.

The increases in inflation expectations are not surprising. Nevertheless, it is important that they do not flow into a round of generalised price inflation and higher wage claims. Such expectations would inevitably increase the monetary policy pressure required to reduce inflation, hindering potential interest rate falls.

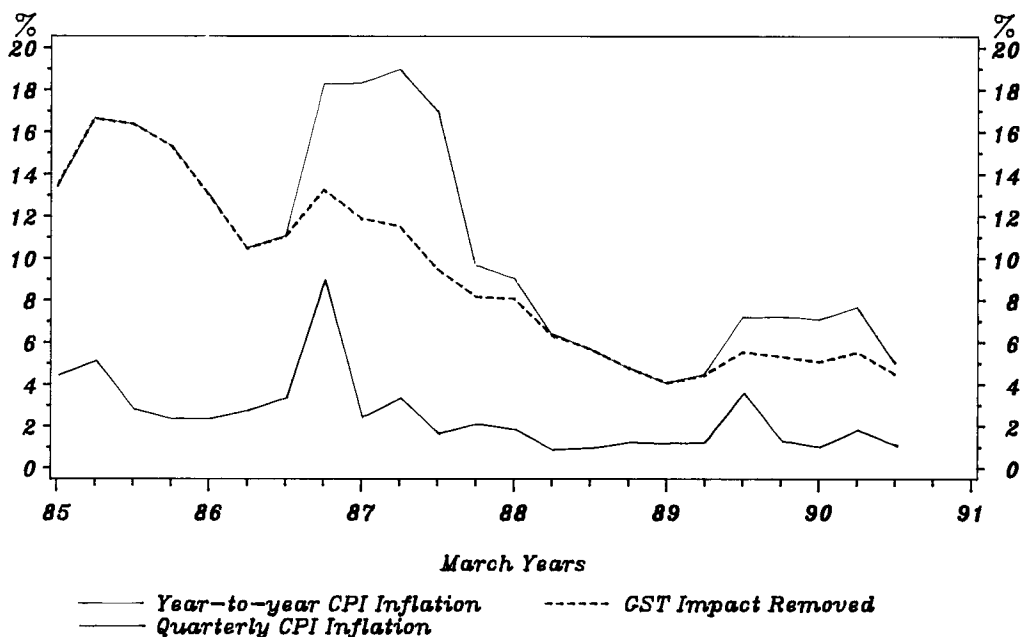
The Oil Price Shock

The oil price shock is clearly a major risk to future inflation prospects. The Reserve Bank's approach to the oil shock was outlined in some detail in the Bank's last Monetary Policy Statement.

Monetary policy is being operated to allow the first-round effects of the oil shock - such as petrol price increases and the impact of such price rises on the prices of other goods and services (including transportation) - to feed into an increase in the general level of prices. However, monetary policy will not accommodate second-round inflationary effects. Such effects include, for example, higher inflation expectations flowing into higher house prices, or attempts to claim higher wage settlements to compensate for the first-round price rises. Accommodating second-round effects was the mistake made by New Zealand in response to the oil shocks of the 1970s. The economic problems caused by the resulting stagflation should not be forgotten, and the Reserve Bank is committed to ensuring that adjustment to this shock is handled more effectively.

At the time of preparing the September Monetary Policy Statement (finalised 17 August) the price of Dubai light crude oil had settled at around US\$23 per barrel. The Reserve Bank calculated that this would add 0.6 per cent and 1.2 per cent respectively to the December 1990 and December 1991 annual inflation rates.

Figure 4
CPI Inflation



The oil price rise was not expected to affect the final achievement of price stability by December 1992. However, it did mean that inflation would be outside its December 1991 target range of 1.5-3.5 per cent outlined in the April Monetary Policy Statement. As a result, the Bank altered the target range for the December 1991 year to an annual increase in measured inflation of between 3 and 5 per cent.

Unfortunately, the oil price situation has deteriorated since the middle of August.

The October Reserve Bank forecasts (based on an oil price of US\$30 per barrel) predicted that inflation would reach 6.8 per cent (4.5 per cent excluding oil) in the year to March 1991 and 3.4 per cent (2.5 per cent excluding oil) in the year to March 1992.

In view of the uncertainty relating to the future path of oil prices, the Bank decided to state publicly that it would target the underlying, ex-oil inflation rate. As a result, it returned to the original 1991 indicative inflation range as outlined in the April Monetary Policy Statement for inflation exclusive of first-round oil effects. Table 1 reproduces the ready reckoner published with the October forecasts. It illustrates the estimated impact of alternative oil price assumptions on New Zealand's inflation rate in the year to December 1991.

TABLE 1

DECEMBER 1991 INDICATIVE INFLATION RANGE

'Dubai Light' Crude Oil Price US\$ Per Barrel	Approximate Oil Price Effect on CPI in Year Ending December 1991 %	Non-Oil Inflation Range %	Measured Inflation Range %
\$25	1.3	1.5-3.5	2.4-4.8
\$30	2.0	1.5-3.5	3.5-5.5
\$35	2.9	1.5-3.5	4.4-6.4
\$40	3.9	1.5-3.5	5.4-7.4

As noted above, a new set of policy targets, including the revised date for the achievement of price stability, is likely to be negotiated in the near future, consistent with the announced policies of the new Government. The implications of the agreement for the Bank's indicative inflation ranges, and for monetary policy more generally, will be discussed in the next Monetary Policy Statement scheduled for February.

Conclusion

Monetary policy over the last three months has been formulated against a backdrop of the oil price shock and worsening domestic economic news, including falling consumption spending and mounting unemployment. Despite this backdrop there have been a number of encouraging developments. Low wage settlements, and a favourable September CPI out-turn have facilitated some easing in both interest rates and the exchange rate, in turn assisting the process of economic adjustment, without jeopardising the goal of price stability.

These developments cannot, however, obscure the imbalances and policy challenges which persist. Dealing with the critical issues of low growth, high unemployment and mounting external debt, will require consistent and integrated resolute economic decision-making. Pursuit of fiscal balance, and significant reform of labour market arrangements, in the context of a monetary policy consistently directed towards price stability, is likely to prove the best way to address these challenges.

APPENDIX 1 : MAIN DEVELOPMENTS

Many events, just prior to and during the period, have impacted upon or had implications for monetary policy and inflation. These events were:

- 1 August: The Reserve Bank undertook a minor action in the money market designed to firm monetary conditions.
- 2 August: Iraq invaded Kuwait and triggered the beginning of rapid oil price increases.
- 3 August: The Reserve Bank undertook a further firming action in keeping with its 1 August move.
- End of August: Cash distribution problems temporarily caused an increase in 90 day bill rates.
- 4 September:
- Mike Moore took over from Geoffrey Palmer as Prime Minister.
 - The Reserve Bank released its second Monetary Policy Statement.
- 17 September: The Prime Minister and the President of the New Zealand Council of Trade Unions announced the "Growth Agreement".
- 15 October: The September quarter CPI was released. The 1 per cent figure brought year-on-year inflation to 5 per cent. This result was consistent with the Reserve Bank's indicative range of 3-5 per cent inflation for the year to December 1990.
- 18 October: The exchange rate had continued to fall causing investor concerns about the Bank's commitment to price stability. In response, the Bank acted to firm monetary conditions.

- 27 October: The General Election resulted in a change of government.
- 5 November:
- The Government announced that it was committing \$620 million to recapitalise the Bank of New Zealand following problems arising from the increase in the bank's non-performing loans in Australia.
 - The Government announced the revision of its projected 1990/91 cash surplus from a projected \$4.98 billion surplus to an expected \$2.55 billion surplus. The Government also announced its intention to borrow \$1.2 billion on the domestic market.
 - The Government announced a revision in its 1990/91 financial balance from an originally forecast \$89 million surplus to an expected deficit of \$1 billion.
- 12 November: The Reserve Bank met with representatives of the settlement banks to discuss the potential for better co-operation and less friction in the settlement process. The Bank announced its intention to release a consultative document for the banks on this matter.
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