RESERVE BANK OF NEW ZEALAND POLICY TARGETS AGREEMENT

The following is the text of the policy targets agreement signed by the Minister of Finance and the Governor of the Reserve Bank on 2 March 1990.

In terms of section 9 of the Reserve Bank of New Zealand Act 1989 (the Act), the Minister of Finance (the Minister) and the Governor of the Reserve Bank of New Zealand (the Governor) agree as follows:

1. Inflation Targets

Consistent with section 8 of the Act, the Reserve Bank should formulate and implement monetary policy with the intention of achieving price stability by the year ending December 1992. An annual inflation rate in the range of 0 to 2 per cent will be taken to represent the achievement of price stability. The inflation rate should be kept within that range for the remainder of the Governor's current term of office, which ends on 31 August 1993, and conditions at that date should be consistent with the maintenance of sustained price stability thereafter. In pursuing this target, and subject to the caveats below, the Bank's implementation of monetary policy should be designed to achieve a steady reduction in the annual rate of inflation (exclusive of the direct impact of the July 1989 GST increase) throughout the period to December 1992. Each policy statement released by the Bank under section 15 of the Act should contain a projected path for inflation over the following five years.

2. Measurement of Inflation

Section 8 of the Act requires the Bank to direct monetary policy towards the stabilisation of the "general level of prices". In pursuing this objective, the Bank will monitor price movements as measured by a range of price indices. However, it is considered that the primary measure of prices used to calculate the inflation rate for the purpose of these targets should relate to the prices of goods and services currently consumed by households. Unfortunately, the All Groups Consumers Price Index (CPI) is not an entirely suitable measure of these prices since it also incorporates prices and servicing costs of investment-related expenditures, notably in the housing field. The New Zealand CPI is unusual amongst OECD consumer price indices in including components for both the purchase price of dwellings and the cost of mortgage finance. For this reason, while the CPI will, for practical purposes, be the measure of inflation used in setting the targets, the Bank is to prepare an alternative measure of consumer prices based on an internationally comparable approach, so as to provide a basis for assessing the impact of investment-related housing costs on the CPI. In particular, the Bank's adjusted index will replace the current expenditure based measure of housing costs in the CPI with a measure based on imputed housing rentals. The Bank shall publish this index on a quarterly basis and is to ensure that the calculation of the index is verifiable by reputable external sources.

3. Variations to Targets

A. If an Order-In-Council comes into force under section 12 of the Act, the policy targets in this document cease to have effect and must be replaced by new targets within 30 days of the making of the order in accordance with section 12(7) of the Act.

B. These targets may also be varied at any time by agreement between the Governor and the Minister in accordance with the provisions of section 9(4) of the Act. The following specific instances will trigger a renegotiation of these targets in accordance with these provisions:

(i) The Bank shall notify the Minister if, in 1992 or 1993, there is, or is likely to be, a divergence of at least one half of one percentage point between the annual inflation rate of the CPI and of the Bank's internationally comparable measure of consumer prices. Within 30 days of this notification, the Governor may choose to renegotiate new policy targets so as to take account of the effect of the deficiencies in the construction of the CPI.

(ii) Any decrease or increase in GST, or any material change in other indirect taxes, will automatically lead to a renegotiation of these targets where the change is expected to impact directly on the 1992 or 1993 annual inflation rate. In general, a material change in indirect taxes will be interpreted as one which has a positive or negative impact on the price level of at least one half of a percentage point within a one year period. It is intended that the targets will be renegotiated on the basis of allowing the direct effect of the change to impact on the price level, with no accommodation of second round effects. Following a GST change, or following what the Bank estimates to be a material change in other indirect taxes, the Bank shall inform the Minister in writing of its estimate of the direct effect of the change on the price level. If necessary, new policy targets shall be set within 30 days of this estimate being received by the Minister.

(iii) A significant change in the terms of trade arising from an increase or decrease in either export prices or import prices will trigger a renegotiation of the policy targets, where the Bank indicates to the Minister in writing that it estimates the change will have a significant direct impact on the 1992 or 1993 annual inflation rate. In informing the Minister that a significant change has occurred, the Bank should provide an estimate of the direct price effects of the terms of trade change on the price level. Following the provision of this estimate, new policy targets shall be set within 30 days. The intention of this provision is to enable some or all of the direct price effect of a significant terms of trade change (whether positive or negative) to be accommodated but it is not intended to accommodate any second round influences. Thus it is intended that any terms of trade change will have, at most, only a transitory effect on the inflation rate.

(iv) In the case where some other crisis situation, such as a natural disaster or a major disease-induced fall in livestock numbers, is expected to have a significant impact on the price level, the same procedures should be followed as in the case of a terms of trade change.

C. It is intended that section 9(4) of the Act will not be utilised to alter the policy targets in response to any domestically sourced inflationary shock other than the particular cases already considered. In particular, increases in wages or profit margins that are inconsistent with these targets will not be accommodated by the Bank and will not give grounds for automatic renegotiation of the policy targets.

4. Implementation

Sections 10 and 14 of the Act set out certain considerations that the Bank must take into account when implementing monetary policy; provided, in accordance with section 13 of the Act, that these considerations do not limit the Bank's obligation to meet its monetary policy objectives. Within this context, considerations that the

Bank should take into account when formulating and implementing monetary policy shall include the following:

A. The Bank must take into account the effects of its actions on the efficiency and soundness of the financial system. Where it considers that its actions may have a materially adverse effect on the efficiency or soundness of the system, it must inform the Minister. Following the provision of this advice to the Minister, the Governor and the Minister may review whether the existing policy targets remain appropriate, and may fix new policy targets in accordance with section 9(4) of the Act.

B. Where the Bank considers that the actions of any other party (including the Government) may have an adverse effect on the achievement of the policy targets, or may increase the economic or social costs of achieving the policy targets, or may prejudice the efficiency or soundness of the financial system, the Bank shall consult with that party in an attempt to change that party's actions as necessary to reach the desired policy outcomes at minimum cost.

C. The policy targets are established on the basis of the current institutional structure of the financial sector, particularly in relation to the settlements process within the banking sector. If the Bank considers that the institutional structure has changed or is likely to change in a manner which will prejudice the Bank's ability to implement monetary policy, it shall inform the Minister. If the institutional changes continue to hamper the implementation of policy, the Minister and the Governor may set new policy targets in accordance with section 9(4) of the Act.

David Caygill

Minister of Finance

Donald T. Brash

Governor