

MONETARY POLICY STATEMENT¹

FEBRUARY 1992

This statement is the Executive Summary only, taken from the February 1992 Monetary Policy Statement. The full Statement is available on application.

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

Executive Summary

1991 was a significant year along the path to price stability, with both measured and underlying inflation falling faster than expected. This follows two years in which inflation and inflation expectations had failed to drop markedly.

- In February 1991, the Bank published new indicative ranges for underlying inflation, consistent with the achievement of the 0-2 per cent target range by 1993. The ranges were 2.5-4.5 per cent for 1991 and 1.5-3.5 per cent for 1992.
- In the year to December 1991 measured Consumer Price Index (CPI) inflation was 1 per cent, down from 4.9 per cent in 1990 and the lowest rate for 30 years. Allowing for the influence of one-off factors, underlying inflation is estimated to have been 1.7 per cent, below the 1991 indicative range.

Sources of inflationary pressure over 1991 were generally weaker than anticipated at the beginning of the year. This resulted from the combination of a number of factors.

- Weak levels of domestic activity had a greater impact on cost and price pressures than anticipated, with both labour costs and house prices falling over 1991. The move to a more efficient and competitive economy in recent years is likely to have increased the sensitivity of costs and prices to the state of economic activity.
- The prolonged sluggishness in the international economy was also a major contributing factor to the faster than expected fall in inflation, most directly through lower than anticipated prices for exports and non-oil imports.
- The Bank had assumed some depreciation of the nominal exchange rate would occur early in 1991, with an impact on inflation in that year. In the event, however, the currency remained relatively steady until the latter part of the year. This occurred despite the substantial fall in New Zealand interest rates which took place during the year and the publicly stated willingness of the Bank to accommodate some easing in the exchange rate. As a result, the impact of the exchange rate depreciation on inflation was minimal in 1991 and will instead be reflected primarily over 1992 and 1993.

¹ Text and data finalised on 3 February 1992.

Monetary conditions eased significantly over 1991. The Bank accommodated very substantial interest rate declines through to September, in line with reduced inflation and inflation expectations, and then eased monetary policy explicitly in late September when it became clear that, in the absence of this action, underlying inflation for 1992 was likely to fall below the 1.5-3.5 per cent indicative range.

- By mid-September, 90 day bank bill rates had fallen by almost 6 percentage points compared with levels a year earlier, to stand at around 8.8 per cent. Bond rates had fallen almost 4 percentage points to around 9.1 per cent in September. The exchange rate, although still around 58 on the trade-weighted index (TWI), was almost 5 per cent lower than a year earlier.
- The Bank eased monetary policy explicitly on 25 September when revised inflation forecasts suggested that, despite the easing in monetary conditions which had already occurred, underlying inflation was likely to undershoot the indicative inflation range for 1992, as well as undershooting the range for 1991.
- The decision to ease policy reflected the view that, where feasible, monetary policy should aim to keep the inflation rate within the stated indicative inflation ranges. In short, the stance of monetary policy was - and is - guided by the outlook for *inflation* over the medium term, relative to the indicative ranges.
- The easing prompted a further decline in wholesale interest rates, an exchange rate fall, and further retail interest rate reductions.

A number of commentators have argued that the Bank should have eased monetary policy sooner than it did. With hindsight, there is some validity to this view, but some important qualifications need to be noted.

- The effect of the explicit September easing on interest rates was relatively small, compared with the movements in rates which had occurred over the previous year. The Bank's accommodation of these earlier movements had already resulted in substantial declines in local rates relative to overseas rates, as well as substantial declines in real terms.
- The forecasts for inflation underlying the Bank's monetary policy stance over the year were based on the information available at the time and were very much in line with those of other forecasters.
- The exchange rate could well have fallen sooner with an earlier explicit policy easing. But it seems unlikely that this would have resulted in monetary conditions being much different from what they are now, given the current view of the inflation outlook for 1992 and 1993. Indeed, it is possible that longer-term interest rates would have been somewhat higher than they now are, because an earlier explicit easing may have raised doubts about the commitment to price stability.

In mid-December, commenting on the outlook for inflation in its latest economic forecasts, the Bank indicated that some further change in monetary conditions would still be consistent with inflation falling within the Bank's target ranges for 1992 and 1993. Subsequently, the exchange rate moved down further, falling below 53 over late December 1991 - early January 1992. On 6 January, the Bank indicated its concern at the inflation implications of any additional exchange rate decline, and the exchange rate has since consolidated between 53 and 54 on the TWI. This level is still well below the level that prevailed prior to mid-December, and is almost 9 per cent lower than its level a year ago.

In recent months, some attention has focused on the fiscal outlook. The Bank considers that the current fiscal outlook remains sustainable over the medium term, and is perceived as such within the financial markets. This assessment would not necessarily withstand significant further fiscal slippage.

The Bank is comfortable with the current inflation outlook for 1992 and 1993, and with monetary conditions at the time of writing (3 February 1992).

- Given monetary conditions similar to those existing at the beginning of February 1992, CPI inflation is forecast to rise to 3.1 per cent for 1992. Removing the impact of increased government charges and of assumed interest rate falls, underlying inflation is expected to be somewhat lower, in the region of 2.7 per cent, slightly above the middle of the 1992 indicative range.
- After peaking in early 1993, underlying inflation is expected to fall back within the 0-2 per cent target range for 1993, to a rate of around 1.2 per cent.
- This outlook is heavily influenced by the exchange rate depreciation that occurred over the latter part of 1991. The effect of this is expected to feed through more slowly than in similar previous episodes, and is reflected in the outlook for underlying inflation in both 1992 and 1993. There is expected to be only moderate imported inflation over this period, with the other core influences on inflation generally expected to remain weak, consistent with the state of domestic demand.

As the basis of its judgments on the stance of monetary policy, the Bank will continue to assess progress toward price stability directly in terms of the inflation outlook relative to the 1992 indicative range and the 0-2 per cent target range for 1993. It is important to note in this context that no one-for-one linkage exists between any particular indicator, such as interest rates or exchange rates, and a given inflation outcome. The appropriate paths for the monetary indicators will themselves depend on developments in underlying inflation relative to the target ranges.

The major groundwork in achieving price stability has now been put in place. Monetary policy is thus focused increasingly on consolidating the progress that has been made to date so that price stability can be secured in 1993 and maintained thereafter.

Achieving and maintaining price stability will not, by itself, guarantee an early return to healthy real growth in the economy. But it does have a major contribution to make in this regard, particularly by providing a more stable environment for longer-term investment planning, and helping to ensure that the major gains in international competitiveness which have been achieved, are preserved. The best contribution that monetary policy can make to the promotion of sustainable growth is the maintenance of price stability, and we are well on track to achieving this end.

