Six monthly Monetary Policy Statement June 1994

Executive summary

The current outlook for inflation is somewhat higher than the assessments contained in the Reserve Bank's December *Monetary Policy Statement* and March *Economic Forecasts*, particularly over the period to mid-1995.

The underlying rate of inflation is now forecast to be 1.3 percent in the year to March 1995. A further increase in the underlying rate, to 1.8 percent and 1.7 percent, is forecast for the years to March 1996 and March 1997, respectively. The higher profile for inflation shown in this Statement reflects a number of considerations:

- Our interpretation of recent economic indicators, discussed in Section II [of the Statement], is that the slowing of growth and inflation witnessed in the December and March quarters, respectively, represented temporary departures from underlying trends. Accordingly, we anticipate a continuation of robust growth and no easing of inflation pressures in the period ahead.

- As discussed in Section III [of the Statement], domestic developments are expected to contribute to higher forecast inflation this year. Current evidence suggests that a pickup in wage growth is occurring somewhat sooner than had been anticipated in previous forecasts. The impact of higher wage growth on inflation is expected to be partly, but not completely, offset by narrower profit margins than previously anticipated.

- The forecast also shows inflation, particularly in the near term, being increased by external developments. These include higher world market prices for a variety of important commodities, including oil and wool. A lower assumed exchange rate than in the March forecasts also adds to the increase in forecast inflation.

Our forecast indicates that, although underlying inflation is currently near the centre of the target range, it could move to near the top of the range in little over a year. This suggests that somewhat firmer monetary conditions than prevailed through the March quarter are appropriate. Some firming—mainly through higher interest rates—has already occurred.

Even with monetary conditions at current levels, however, the prospects for inflation leave very little margin for error if inflation pressures turn out to be stronger than we anticipate. A somewhat higher exchange rate or interest rate profile than is assumed in our forecast would reduce the risk of an inflation outcome above the 0–2 percent target range.

As in the March forecasts, our current judgement is that the balance of risks, at this stage of the economic cycle, lies on the side of more inflation pressures, particularly later in the forecast horizon. The extent to which a further adjustment of monetary conditions may be necessary will depend on the degree to which those pressures strengthen or dissipate over time.

In Section I [of the Statement], attention is drawn to important similarities between the current situation faced by monetary policy in New Zealand and those faced by several industrial countries in the latter part of the 1980s. In retrospect, it is apparent that, had monetary policy in these countries responded in a more timely fashion to emerging inflation pressures, the run-up of inflation and the subsequent recession and employment losses would probably have been substantially less severe. In the period ahead, the aim of the Reserve Bank is to avoid a repetition of that kind of policy error here. If we are successful in doing so, we will not only maintain price stability but also underpin enduring increases in incomes and employment in New Zealand.

Figure 1
Consumer price inflation
(year-over-year percentage changes)