

# Monetary Policy Statement<sup>1</sup>

December 1997

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

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## I. Summary and policy assessment

Monetary conditions continued to ease over the second half of 1997 in response to prospects for declining inflation. On the basis of our inflation projections and the risks surrounding the outlook, the Bank's assessment is that a level of monetary conditions around 650 on the Monetary Conditions Index (MCI) is now appropriate. This is a decrease of 75 points from the index level of 725 announced in the September *Economic Projections*. Financial markets have fully anticipated this easing in recent weeks.

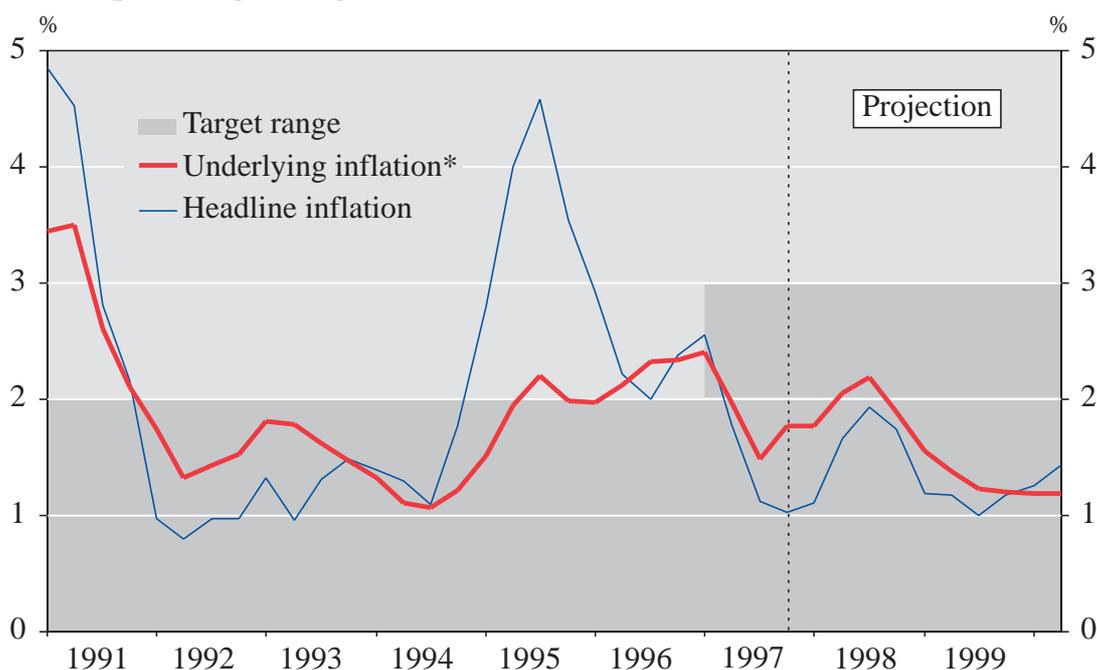
Recent inflation trends have been somewhat disappointing, with domestic inflation pressures persisting, and signs that imported inflation is picking up in response to a lower New Zealand dollar. Moreover, economic activity appears to have picked up slightly faster than anticipated over the second half of 1997, from a starting point of slightly less spare capacity than indicated in our September *Projections*.

Economic activity in New Zealand is projected to continue to gain pace over 1998, although at a slightly more moderate rate than outlined in our September *Projections*. The driving factors remain an expansive fiscal stance, ongoing disposable income growth, improved business productivity, and an easing in the stance of monetary policy over the past year.

The emergence of a margin of excess supply in the New Zealand economy over the past year is expected to exert downward pressure on inflation over the coming year or so. Subsequently, upward pressure on inflation will re-emerge as activity growth outpaces increases in the sustainable capacity of the economy.

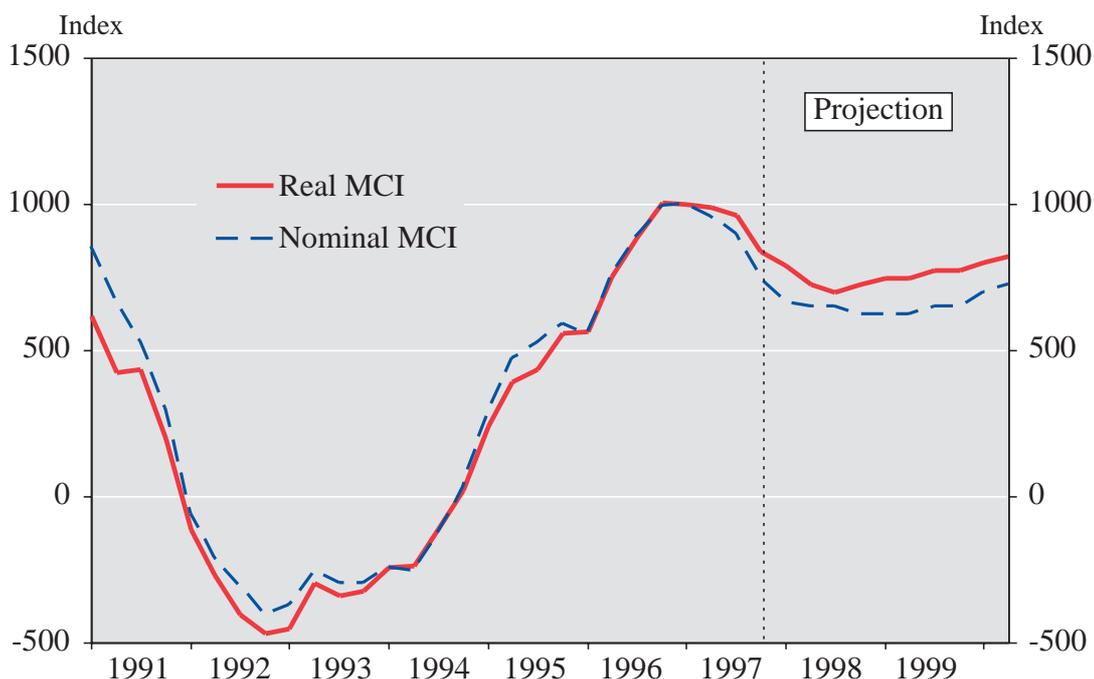
Downward pressures on inflation over the first part of the projection period are expected to be reinforced by dramatically weaker growth prospects in the East Asian economies.

**Figure 1**  
**Consumer price inflation**  
**(annual percentage change)**



\* CPI ex credit services in projection period.

**Figure 2**  
**Real and nominal monetary conditions**  
**(December 1996 quarter average = 1000)**



The projections in this *Statement* incorporate a weaker profile for both export and import prices, and world demand. The gloomier outlook for the East Asian region, however, is not expected to significantly set back prospects for robust economic growth in the United States and Europe.

The inflation projections are surrounded by substantial uncertainties. The most significant risks relate to the potential for a more severe downturn in the East Asian economies and international trade prices than we have allowed for. In addition, there is the potential for a further shift in the mix of monetary conditions towards a weaker exchange rate / higher interest rate combination, possibly in response to further increases in New Zealand's current account deficit. The former set of risks points to the possibility of lower inflation outcomes, while the latter risk could result in higher inflation over the short term.

Our projections suggest that a more aggressive easing of the policy stance is not warranted. On current policy, inflation should remain well within the middle part of the target range. This will leave us well-placed to cope with unexpected inflation developments.

The Asian crisis could well turn out to be more severe than now projected, but it would not be appropriate to base policy decisions on what are unavoidably, at this stage, little more than rough approximations concerning an event that is still unfolding. Clearly, however, these developments will require close monitoring and careful re-assessment in our next projections.

Donald T. Brash  
 Governor

## **II. Review of economic and financial developments**

### **Summary**

The economy continued to expand moderately over 1997, resulting in a further easing of pressures on productive capacity. The easing of pressures has been reflected in a fall in the rate of capacity utilisation in industry as well as a slight rise in the unemployment rate.

Reduced strains on the productive capacity of the economy have not yet had a significant impact on inflation performance. Instead, the most important influence on inflation in 1997 was the past appreciation of the New Zealand dollar, which dampened inflation in the first half of the year. Reflecting these influences, underlying inflation fell from 2.4 percent in the year to December 1996 to 1.5 percent in the year to June 1997.

From late-1996 to mid-1997, the rate of appreciation of the New Zealand dollar slowed, giving way to a significant depreciation over the second half of 1997. Consequently, inflation increased slightly over the second half of the year as the dampening effects from past exchange rate appreciation dissipated. Underlying inflation increased to an estimated 1.8 percent for both the September and December 1997 years.

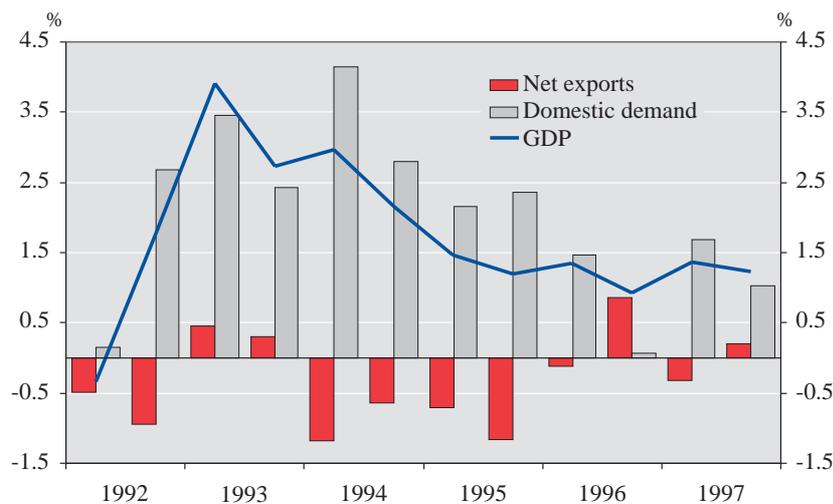
### **1. Economic activity**

Past monetary policy restraint contributed to slower spending growth through 1997. As a result, the economy moved from a position of excess demand to one of excess supply. The easing of pressures on productive capacity in the economy will begin to exert downward pressure on inflation in the period ahead.

In our June *Monetary Policy Statement* we estimated Gross Domestic Product (GDP) to have grown at an annualised rate of about 1.2 percent in the first half of the year. In the event, output growth averaged an annualised 1.6 percent in the first half of the year. For the second half of the year, we estimate a pickup in GDP growth to an annualised rate of around 2.8 percent.

The growth of demand in 1997 came primarily from domestic sources. Consumption grew around 2 percent, while business and residential investment grew at about 6 percent. Offsetting the growth in domestic demand was a deterioration of net exports, which was also reflected in a further weakening of the current account balance. The current account deficit, excluding the import

**Figure 3**  
**Contributions to annual GDP growth**  
**(half years to March and September)**



of the frigate HMNZS *Te Kaha*, stood at 5.6 percent of GDP over the year to June 1997.

### ***Domestic growth***

The stance of fiscal policy has been an important factor supporting domestic demand in 1997. Government spending rose in total by around \$2.6 billion (or 2.7 percent of nominal expenditure-based GDP) over the 1995/96 and 1996/97 fiscal years. The tax cuts of July 1996 injected a further \$1 billion into the economy.

Although fiscal policy provided significant support to growth in disposable incomes, household spending rose relatively slowly and quite erratically. Moderate growth in household spending and a weak export performance have increased competitive pressures on business and eroded unit margins and profitability. Firms have responded by concentrating on restructuring their operations and reducing costs. A significant component of this process is ongoing investment in plant, equipment, and buildings. As a result, investment remained a major source of expansion in the economy. We estimate that in 1997 investment in plant and equipment grew by around 15 percent and non-residential buildings investment by just over 2 percent. In total, investment grew by approximately 6 percent, as already noted.

### ***Net exports***

Total export volumes are estimated to have fallen by around 1 percent in 1997, while import volumes grew in excess of 1 percent. Net exports, therefore, dampened aggregate spending growth. The

external sector would have had an even bigger dampening influence had import volumes grown in line with domestic demand. Instead, total imports rose more slowly than in 1996, mainly due to an estimated 35 percent fall in passenger motor vehicle imports.

Despite weak aggregate growth of exports, some exports expanded strongly over 1997. In particular, non-commodity manufactured exports are estimated to have increased by 14 percent this year, mainly due to a strong third quarter. This growth was offset by falling exports of meat, wool, and forest products. Exports of these products have fallen in response to a number of factors, including:

- weak international demand;
- an output response to falling international commodity prices;
- the past appreciation of the New Zealand dollar; and
- a return to normal levels of dairy production following an exceptional 1996/97 season.

## **2. Developments in inflation and monetary conditions**

By mid-1997 annual underlying inflation had fallen to 1.5 percent – the mid-point of the 0 to 3 percent target range – from 2.4 percent in the year to December 1996. This fall in inflation was due largely to a firm monetary policy stance over the previous several years.

Between the March quarter 1995 and the December quarter 1996, the nominal Monetary Conditions Index (MCI) increased by around 500 points. The tightening in monetary conditions over that period occurred mainly through a rise in the trade-weighted exchange rate index (TWI), and thus has played a large part in the fall in the inflation rate for ‘tradeable’ goods and services.<sup>2</sup> Short-term interest rates were broadly unchanged over the year as a whole.

Since December 1996, in line with reduced pressure on capacity, the Bank has sanctioned successive easings in the level of monetary conditions. These easings have seen the MCI decline to within the 600-700 point range, with most of the decline coming through a lower TWI.

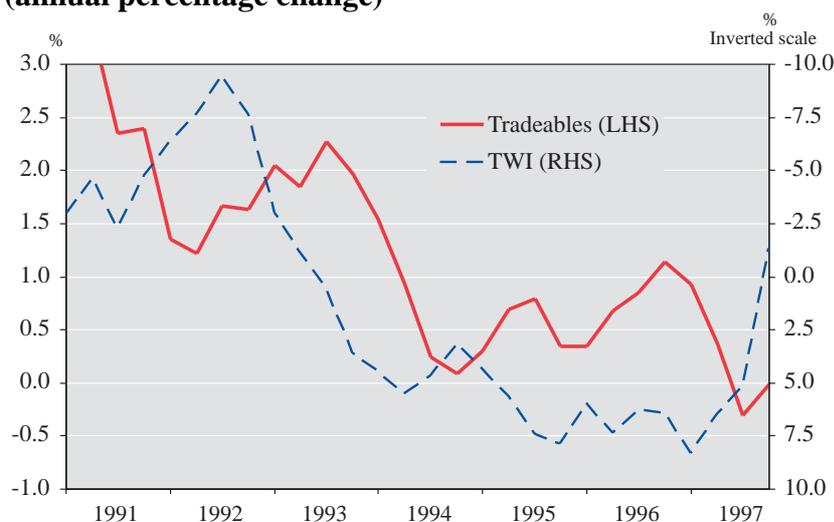
### ***Short-term inflation***

The Bank’s inflation estimate for the December 1997 and March 1998 quarters is determined by analysing component and sub-group prices of the goods and services included in the CPI. This

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<sup>2</sup> ‘Tradeable’ goods and services refer to those goods and services whose prices are primarily determined in international markets. ‘Non-tradeables’ refer to goods and services whose prices are primarily determined by supply and demand within New Zealand.

**Figure 4**  
**Tradeables inflation and the exchange rate**  
**(annual percentage change)**



approach takes into account recent trends, established seasonal patterns, leading indicators, and other specific information gathered from a wide variety of sources. Our analysis suggests that underlying inflation will be 0.6 percent in the December quarter, and 0.5 percent in the March quarter. These quarterly rates imply inflation of 1.8 percent over the year to December 1997, and 2.1 percent over the year to March 1998.

The December and March quarter estimates are higher than those contained in the September *Economic Projections*, reflecting two main factors. First, business contacts had suggested that prices on various household appliances would increase in immediate response to the currency depreciation. These price increases did not show up in the September quarter, however, and are now likely to occur in the December and March quarters. Second, the housing market has been stronger than we expected and is likely to remain a source of inflationary pressure in the short term.

However, apart from the specific factors mentioned, the depreciation appears too recent to be a direct cause of the increase in inflation since the June quarter. Instead, the end of several years of strong exchange rate appreciation in early 1997 has reduced the dampening effect on aggregate CPI inflation. This has better revealed the persistent trend in non-tradeables inflation.

### ***Inflation expectations***

Current price-setting behaviour is influenced by inflation expectations. Two recent surveys show that, despite the easing in monetary conditions, short-term inflation expectations have barely changed over recent months. In particular, in the *Quarterly Survey of Business Opinion* (QSBO), firms' expected selling prices for the

December quarter were almost unchanged, while the Reserve Bank's *Survey of Expectations* recorded headline inflation expectations of 0.4 percent for the December and March quarters.<sup>3</sup> Further out:

- Inflation expectations, as measured by the Bank's *Survey of Expectations*, have edged up marginally. The average expectation for underlying inflation is 1.6 percent and 1.7 percent over the years to September 1998 and September 1999, respectively.
- The Aon Consulting October survey (formerly the Alexander Consulting Group) recorded no change in inflation expectations over the one year and four year horizons (1.4 percent and 1.8 percent respectively). The average expectation for inflation seven years hence is 2.0 percent.

### *Non-tradeables inflation*

Non-tradeables inflation continues to run well ahead of tradeables inflation. We expect that over the year to December 1997, non-tradeables prices will have increased by over 3 percent, while tradeables prices will have increased by less than 0.5 percent.

Inflation in the housing sector has been a major element contributing to non-tradeables inflation over the last couple of years. The construction cost component of the Consumers Price Index (CPI) has been rising more slowly than the average price of all houses (as measured by Valuation New Zealand), but broadly in line with increases in the average price of houses less than three years old. We expect some further price pressures from this component over the short term, given robust residential construction activity and continued increases in section prices and construction expenses.

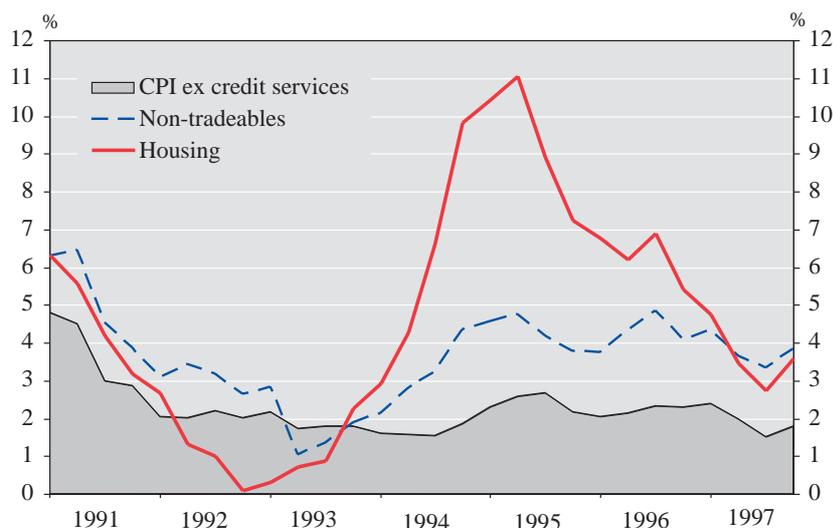
Non-tradeable goods and services inflation has also been boosted by sharp increases in some public sector charges, including tertiary education fees, Housing New Zealand rents, and household electricity prices. Government health policy measures have also been an important factor in raising medical insurance premiums. These increases have been partially offset by falls in general practitioners' fees and hospital out-patient charges.

Annual wage growth slowed over 1997 to an estimated 3 percent, in line with reduced business profitability, falling full-time employment, and declining CPI inflation. Despite the slower wage growth, wage increases have proved to be slightly higher than expected. Nonetheless, ongoing inflation and rising productivity

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<sup>3</sup> The Reserve Bank survey was completed on 12 November 1997, and the New Zealand Institute of Economic Research's QSBO was published on 17 October 1997.

**Figure 5**  
**Non-tradeables and housing price inflation**  
**(annual percentage change)**



have meant that real unit labour costs are estimated to have fallen 1.5 percent over 1997.

Overall, the evolution of inflation in 1997 is a little disappointing. Although underlying inflation fell briefly to the mid-point of the target range, a larger fall had been expected. In particular, inflation in the domestic-currency price of imports and CPI tradeables prices have been higher than expected given the previous increases in the nominal exchange rate. Furthermore, although trending down over early 1997, non-tradeables inflation has been kept up by government charges.

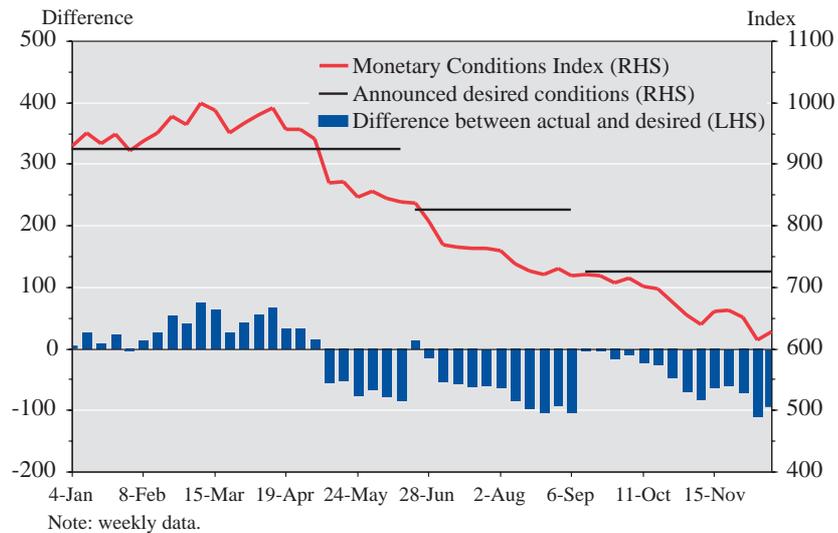
Looking forward into the projection period, the Bank now expects trend inflation to be reduced by the lagged effects of economic activity operating below potential during 1997 and 1998. However, the inflationary impact of the lower exchange rate will partly mask this decline over the short term.

### 3. Financial market developments

#### *Views on the stance of monetary policy*

Monetary conditions have eased over the last six months, continuing the trend since late last year. The easing in conditions has been larger and more prolonged than the Bank and markets had first expected. In the June *Monetary Policy Statement* the Bank projected that overall conditions by the end of December would be similar to the 'desired' level announced in June. Financial markets were of a broadly similar view at that stage, as reflected in the structure of interest rates and commentaries prevailing at the time.

**Figure 6**  
**Monetary Conditions Index and announced desired conditions**



The easing that has occurred since June has primarily reflected new information suggesting reduced inflation pressures over the medium term. A marked shift in expectations about future monetary policy occurred following the March quarter GDP out-turn released shortly after publication of the June *Monetary Policy Statement*. More recently, expectations about future monetary policy have shifted with the falls in global equity markets and the deepening economic crisis in East Asia.

As the prospects for easier monetary conditions in New Zealand increased, especially compared to overseas, the exchange rate came under periods of significant downward pressure, falling around 5.6 percent on a TWI basis since June. While the trend in the relative stance of monetary policy appears to have been the overwhelming influence, other factors may have had some impact, including:

- falls in other currencies, most notably, the Australian dollar and some Asian currencies;
- the introduction of the MCI, which has clarified the fact that the Bank can not control the mix of conditions, and has no independent target for the exchange rate; and
- the increasing size of the current account deficit.

As discussed in Box 1, sharp downward movements in the TWI have often triggered rises in short-term interest rates, dampening movements in the MCI. Over the full period since June, however, the predominant influence on the MCI has been the downward trend in the TWI.

## Equity and bond markets

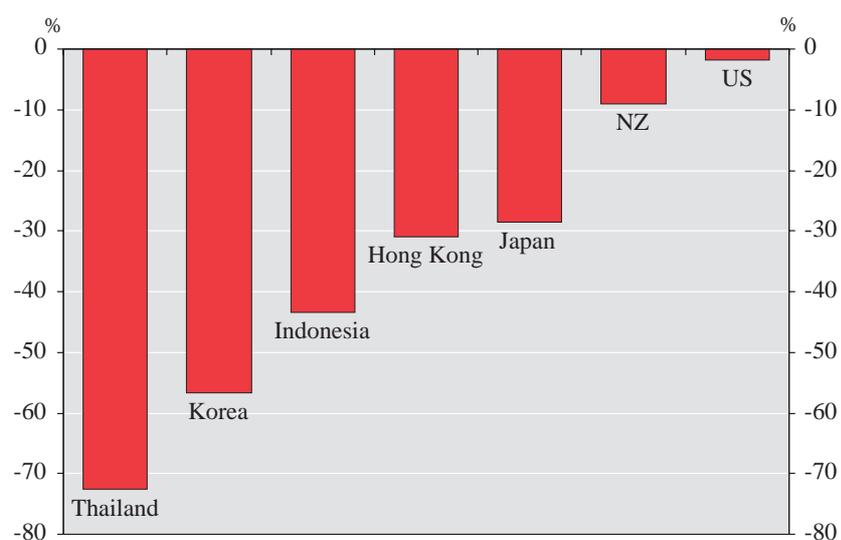
Equity markets around the world experienced significant downward adjustments late in October. The corrections were rather short-lived in some cases, but in others, particularly in East Asia and Latin America, many markets reversed the gains made over the last several years. As a result, expectations of weaker global inflation pressures, and the effects of investors shifting funds to 'safe-haven' markets, have tended to place downward pressure on bond yields in countries such as the United States, Australia, and Canada.

Against this backdrop, the New Zealand equity market experienced a period of volatility, falling around 9 percent from its 1997 high achieved on 23 October. Bond yields here have also fallen in line with developments abroad.

Alongside the equity market adjustments, there has been a significant re-pricing of credit risk on debt instruments. Consequently, a marked widening in corporate bond and swap interest rates relative to government bond rates has occurred world-wide, including New Zealand.

The rise in the premium for corporate credit risk may have been one of the factors contributing to the decline in Eurokiwi issues recently<sup>4</sup>. In the six weeks since late October, for example, when many of the equity market adjustments began, only \$200 million of

**Figure 7**  
**Relative equity market performances**  
(percentage change from the 1996/97 peak to the November 1997 level)



4 Eurokiwi bonds are debt instruments denominated in New Zealand dollars and issued outside the New Zealand domestic market.

Eurokiwi bonds have been issued. This is in stark contrast to the \$2 billion issued in the six weeks previously.

### *Monetary conditions and the MCI*

Financial markets have interpreted the implications of new information for future inflation in a manner broadly consistent with the Bank's view. This reflects the fact that the Bank and markets share essentially the same information, and that the Bank's inflation objectives are well understood. Markets largely anticipated the cuts in the Bank's 'desired' monetary conditions announced in both the June *Monetary Policy Statement* and September *Economic Projections*. However, there have been times when markets have been quicker to factor in any prospects for conditions to ease than the Bank felt was warranted. Accordingly:

- Early in the six month period, the Bank issued three statements, in which we expressed a preference for actual conditions to firm towards the stated 'desired' level. To some degree, the need for statements by the Bank reflected a learning process about how the Bank would implement the new MCI framework – particularly in the degree of tolerance for deviations of monetary conditions relative to the stated 'desired' level – and how often the Bank would usually revise its desired policy stance. In this context, the Bank's approach – as foreshadowed in June – has taken into account a wide range of factors which may have implications for monetary policy, rather than being characterised by strict rules to be followed under all circumstances.
- More recently, in the lead-up to this *Statement*, a further statement was issued, noting that overall conditions had become too loose, with no sign of an imminent reversal. There was concern that, if conditions continued to ease at that point, the Bank would have had to act to tighten conditions, perhaps relatively aggressively, in the December *Monetary Policy Statement*.

In summary, despite considerable volatility in international currency and equity markets, and a large shift in the mix of monetary conditions locally, markets have evolved in an orderly fashion. By and large, we are satisfied that our approach to policy implementation has operated effectively and smoothly.

## Box 1: The MCI and interpreting changes in monetary conditions

Monetary policy in an open economy like New Zealand affects inflation through both interest rates and the exchange rate. For a number of years this has been taken into account in the Bank's policy settings. This year, however, we have begun using a more explicit summary measure of overall conditions – the MCI – to describe the overall stance of monetary policy.

The usefulness of the new measure can be illustrated with reference to developments between June and August of this year. Over that period, the TWI exchange rate fell sharply, while the 90-day interest rate increased sharply.

In such circumstances the two indicators gave quite conflicting impressions of the way in which the overall stance of policy is evolving.

The MCI provides a simple and consistent method of 'adding up' interest rate and exchange rate movements to give a better indicator of the overall stance of policy than can be captured by interest rates or the exchange rate alone.

The weights given to the 90-day interest rate and the TWI exchange rate in the MCI are based on estimates of their relative impact on aggregate spending in the economy.

Research at the Bank suggests that a 100 basis point fall in 90-day interest rates has approximately the same impact on spending pressures over the medium term as a 2 percent depreciation in the TWI exchange rate.<sup>1</sup> In calculating the MCI, therefore, a 2 percentage point movement in the TWI is treated as a 100 basis point change in the 90-day interest rate.

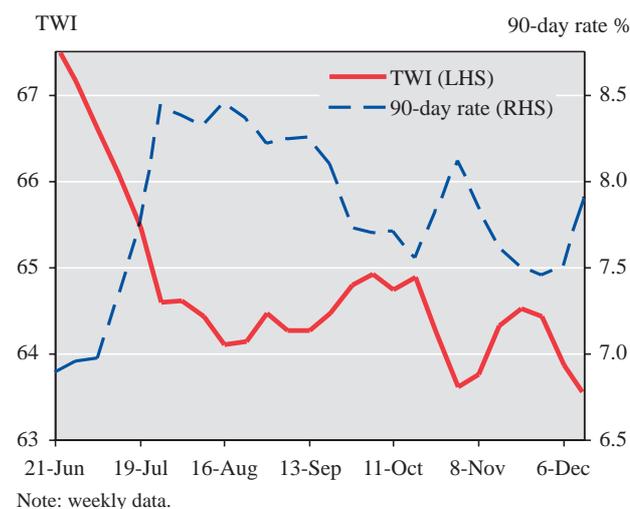
The MCI is a useful summary measure of monetary conditions, but the Bank also recognizes its limitations. For example:

- the 2:1 ratio used in constructing the MCI is approximate, and may vary over the business cycle; and
- the MCI incorporates only two channels of policy influence on activity and inflation pressures.

In the implementation of policy, these limitations are recognized by the Bank's tolerance of significant movements in the measured MCI within quarters.

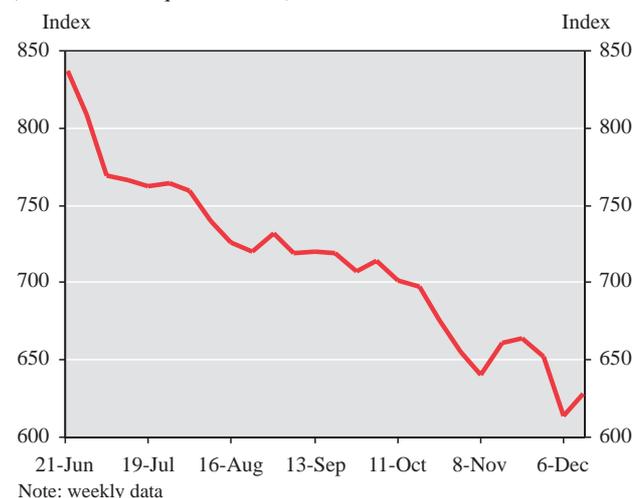
<sup>1</sup> See "Summary indicators of monetary conditions", *Reserve Bank Bulletin*, vol. 59 (3), 1996, pp. 223-8.

### TWI and 90-day interest rates



### Monetary Conditions Index

(December 1996 quarter = 1000)



In addition, of course, the appropriate stance of policy will vary over time as economic circumstances and inflation prospects change. As a result, the Bank reassesses the appropriate level of monetary conditions following a comprehensive review of the economic outlook each quarter.

In contrast to our quarterly reviews, financial markets continuously reassess inflation prospects and the likely implications for the stance of monetary policy. These reassessments are facilitated by the Bank's commitment to an explicit inflation target, by the Bank's publication of its projection framework in addition to the projections themselves, and by the fact that the markets have access to virtually the same information as the Bank regarding economic developments.

### III. The economic outlook

#### 1. Summary

The rate of growth in economic activity is projected to strengthen over the next two years. We project output to grow by slightly more than 3 percent in the year to March 1998, increasing further to around 4 percent by March 1999. As discussed in the *June Statement*, increased government spending and tax cuts in July 1998 will provide a major stimulus to the economy, boosting disposable income, consumption, and investment. This will be supplemented by improved productivity and business profitability, and ongoing employment growth.

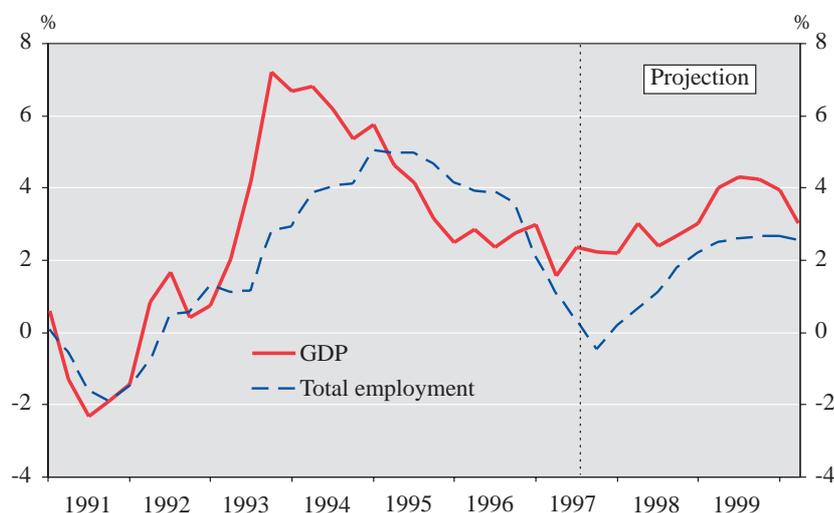
However, the negative impact from the unfolding Asian crisis (see Box 2) will act to weaken external demand and world prices, dampening overall growth. The Asian crisis will also place additional strain on New Zealand's external trade position.

Although growth is expected to strengthen, overall demand conditions are estimated to remain slightly below the economy's productive capacity throughout 1998. This will place downward pressure on inflation during the remainder of the projection period.

Despite a declining inflation trend over the projection period as a whole, inflation is expected to increase in early 1998 as the dampening effects of the past exchange rate appreciation dissipate, giving way to import-price pressure from the recent depreciation.

Beyond the immediate two quarters, and throughout 1999, the downward pressure on inflation from past excess supply conditions

**Figure 8**  
**Real GDP growth and employment**  
**(annual percentage change)**



is likely to be reinforced by lower world prices. Export prices are assumed to be more severely affected than import prices as a result of the Asian economic slowdown, with most of the impact on export prices being seen over 1998. Import prices are assumed to be affected more gradually over the next few years.

## **2. The outlook for activity**

### ***Assumptions about fiscal policy***

Fiscal policy is assumed to evolve in a manner consistent with that outlined in the Government's 1997 *December Economic and Fiscal Update (DEFU)*. We allow for differences in our macroeconomic outlook relative to the Government's *DEFU*, but this alters the expenditure profile only marginally (around \$100 million per year). Government expenditure is projected to be 34.6 percent of GDP in fiscal year 1997/98, before declining slightly to 33.4 percent in 1999/2000.

On the revenue side, our projections incorporate the July 1998 tax cut of around \$1.1 billion. These expenditure and revenue assumptions result in an operating surplus of around 1.5 percent of GDP over the projection period.

### ***Domestic demand***

Household disposable income is projected to continue growing faster than inflation, with real income growing in excess of 3 percent per annum. Much of this growth is based on increased government spending and the 1998 tax cut (though the tax cut is marginally offset by the recent increase in the Accident Rehabilitation & Compensation Insurance Corporation (ACC) earner premiums). As the economy strengthens, firms are projected to increase their demand for labour, resulting in a fall in unemployment.

The boost to household income is expected to be slow to translate into increased spending. In the immediate future, households are expected to be cautious in their spending decisions because of:

- increased job insecurity arising from recent slow employment growth;
- high real interest rates;
- heightened awareness of the need to save as a result of the recent referendum on the government's Retirement Savings Scheme, and a shift toward more user pays in health and education; and
- perceptions of lower wealth due to recent slower growth in property prices and reduced equity values.

**Table 1. Summary of economic projections<sup>1</sup>**  
**(Annual percentage changes, unless specified otherwise)**

March years	Actuals/Estimates		Projections		
	1996	1997	1998	1999	2000
<i>Inflation measures</i>					
CPIX inflation	2.1	2.0	2.1	1.4	1.2
Consumer Price Index (CPI)	2.2	1.8	1.7	1.2	1.4
Import prices	-1.3	-4.6	2.6	-1.7	-1.3
Export prices	-3.5	-6.6	3.0	0.5	0.1
Wages	3.7	4.0	2.6	2.8	3.6
<i>Monetary conditions (year average)</i>					
Real MCI	578	970	825	725	800
Nominal MCI	608	961	750	625	675
Exchange rate (TWI)	62.2	66.4	65.3	64.1	64.2
90-day bank bill yield	8.8	9.0	7.6	7.5	7.9
<i>Output and labour force</i>					
Output gap (year average)	1.7	0.5	-0.6	-0.5	0.7
Real GDP (production)	2.9	1.4	3.0	4.0	3.0
(annual average)	(3.1)	(2.4)	(2.5)	(3.0)	(3.9)
Potential output	3.7	3.6	3.5	2.7	2.6
Total factor productivity	1.0	1.0	1.1	0.6	0.5
Labour force	3.4	1.4	1.2	2.0	1.6
<i>Other information</i>					
Government operating balance (June year average, % of GDP)	3.6	2.0	1.5	1.5	1.6
Current account balance (year average, % of GDP)	-3.6	-4.7	-7.7	-7.3	-6.4
Terms of trade	-2.2	-2.1	0.4	2.3	1.4
Unemployment rate (year average, % of labour force)	6.2	6.2	6.9	6.9	6.0
<i>World economy</i>					
Industrial production (OECD)	0.4	3.6	3.0	1.9	2.0
Consumer prices	2.7	2.3	1.6	1.7	2.4
Short-term interest rates (year average)	6.0	5.6	5.5	5.5	5.7

<sup>1</sup> Notes for tables 1 and 2 are provided in Appendix 1.

**Table 2. Summary of short-term projections<sup>1</sup>**  
**(Quarterly percentage changes, unless specified otherwise)**

	<u>Actuals/Estimates</u>		<u>Projections</u>			
	<u>Sep-97</u>	<u>Dec-97</u>	<u>Mar-98</u>	<u>Jun-98</u>	<u>Sep-98</u>	<u>Dec-98</u>
<i><b>Inflation measures</b></i>						
CPIX inflation	0.7	0.6	0.5	0.5	0.3	0.4
(annual percentage change)	(1.8)	(1.8)	(2.1)	(2.2)	(1.9)	(1.6)
Consumer Price Index (CPI)	0.5	0.8	0.3	0.4	0.3	0.3
“Consumer” import prices	2.2	0.7	-0.5	-0.6	-0.5	-0.5
Wages	0.6	0.2	0.9	1.0	0.3	0.3
House prices	0.4	0.5	0.5	0.2	0.4	0.2
Construction costs (residential)	1.4	1.5	1.1	0.7	0.9	0.6
<i><b>Monetary conditions (quarter average)</b></i>						
Nominal MCI	746	665	650	650	625	625
Exchange rate (TWI)	64.8	64.4	64.2	64.2	64.1	64.1
90-day bank bill yield	8.1	7.6	7.6	7.6	7.5	7.5
<i><b>Output and hours worked (s.a.)</b></i>						
Real GDP (production)	0.7	0.7	0.4	0.6	1.0	1.0
Total hours worked	-1.3	0.7	0.5	0.6	0.5	0.6

<sup>1</sup> The notes for tables 1 and 2 are provided in Appendix 1.

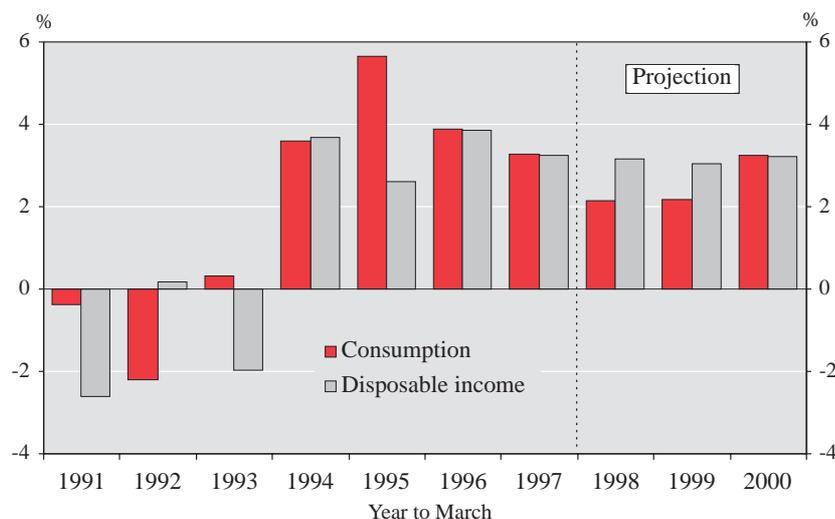
Partly offsetting the wealth effect of weaker property and equity markets will be the share issue associated with the AMP demutualisation.<sup>5</sup> Although the share issue will be negligible in terms of total household wealth, the additional liquidity of tradeable shares will affect consumption to the extent that households as a group sell their shares and spend the proceeds.

By the second half of 1998, household spending is projected to strengthen as a result of rising employment levels and disposable income. However, past expansionary factors – such as expected capital gains in equities and housing, and the expectation of expansionary fiscal policy – will have a waning impact on household spending over the projection period. Over the medium term, household consumption growth is projected to grow around 2 to 3 percent per annum, with the household savings rate rising to above 3 percent.

Although surplus productive capacity is expected to constrain business investment over the 1998 year, continued pressure on business profitability will encourage firms to improve their competitiveness by investing in more productive and flexible plant and equipment. Thus, while growth in other types of investment is projected to remain subdued over 1998, investment in plant and machinery is expected to grow by up to 10 percent per annum.

Rising domestic demand over 1998 will begin to place pressure on firms' capacity, leading investment growth to accelerate from early 1999. We project that growth in aggregate business investment

**Figure 9**  
**Real household income and consumption**  
**(annual percentage change)**



5 The AMP demutualisation is estimated to add about 0.3 percent to consumption growth over 1998.

will exceed 10 percent per annum in the year to March 1999 and beyond.

### *East Asia and external demand*

The events unfolding in East Asia will certainly weaken the international outlook. Box 2 describes how the impact on New Zealand will depend on a wide range of factors.

We have departed from the usual practice of using average *Consensus Forecasts* of international growth.<sup>6</sup> Instead, our projections are based on a subset of the *Consensus Forecasts* respondents that are relatively pessimistic, and includes a larger group of New Zealand's trading partners than in the OECD measure that we normally use. We estimate that growth in our trading partners will average 1 percent less than otherwise over 1998/99 due to the recent events in Asia. However, compared with the September *Projections*, the overall downward adjustment is partly offset by the US and European growth prospects having been revised upwards over recent months.

The recent depreciation of the New Zealand dollar is expected to improve the aggregate profitability of New Zealand exporters. However, those with a significant exposure to East Asian markets will face sharply weaker profitability from stronger bilateral exchange rates, weaker demand, and lower international commodity prices.

It is estimated that the Asian crisis will reduce the *aggregate* world prices facing New Zealand exporters by 3 percent more than would otherwise occur over 1998/99. Industries such as aluminium, beef, dairy, fishing, forestry, iron and steel may face significantly weaker export prices. Exporters to the United States or Europe are likely to be less affected.

Overlaying the Asian effects on other developments leads us to project export prices to increase only marginally in domestic-currency terms, by around 0.5 and 0.1 percent respectively in the March years 1999 and 2000. In contrast, import prices are expected to decline moderately. As a result, the terms of trade are projected to increase only gradually, by an average of around 1.5 percent per annum through to 2000.

With regard to imports, initially subdued household consumption is expected to constrain import growth and improve the merchandise trade balance in the short term. However from mid-1998, import growth is projected to accelerate in line with household

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6 *Consensus Forecasts* from 10 November 1997.

consumption growth. Import growth is projected to be further boosted in 1999 by imports of capital goods.

The second frigate, HMNZS *Te Mana*, is expected to arrive in New Zealand in March 1999. This will be valued at roughly \$560 million, or 0.5 percent of GDP, creating a spike in the import profile and the current account deficit.

### ***Current account***

The current account deficit is projected to deteriorate to around 7.2 percent of GDP by March 1998.<sup>7</sup> Over the medium term, the current account deficit is projected to improve only slowly and to be approximately 6.4 percent of GDP in the year to March 2000.

A sizeable part of the deterioration of the current account deficit is attributable to a weaker profit performance by New Zealand-owned firms operating abroad and a fall in migrant transfers. One factor driving the weaker profit performance has been falling international prices for pulp and paper. New Zealand firms have invested heavily in offshore forest product processing, and returns have been weak, prompting write-downs on foreign assets. Foreign-owned firms operating in New Zealand, meanwhile, have continued to benefit from a growing economy and significant efficiency gains. However, the falling returns on New Zealand-owned foreign assets are not expected to continue, and the sharp deterioration in the migrant transfers balance is projected to be partly reversed.

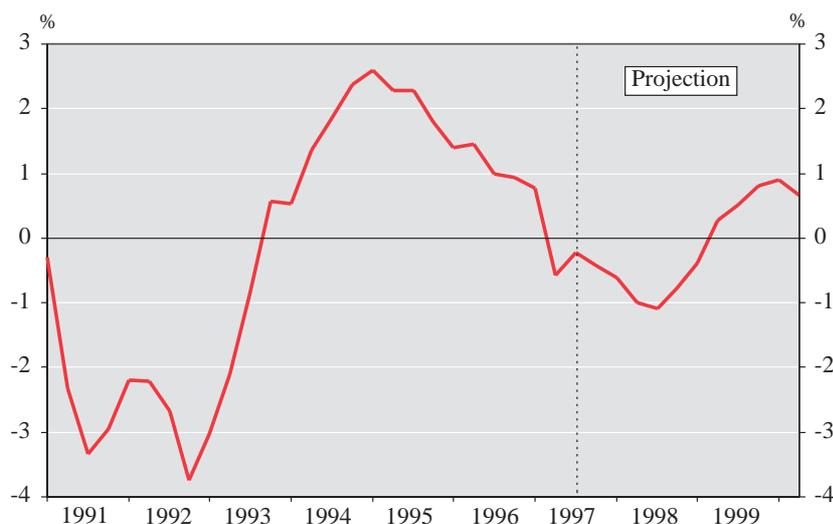
### ***Output gap***

The emergence of excess supply conditions in 1997 is expected to persist throughout 1998. However, rising economic activity is projected to absorb this excess supply and, from March 1999, to push actual output above potential output. This cyclical profile for pressures on the productive capacity of the economy is similar to the September *Economic Projections*, although the starting point in the December 1997 quarter has been revised slightly.

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7 This figure excludes the importation of HMNZS *Te Kaha*.

**Figure 10**  
**Output gap**  
**(percentage of potential GDP)**



### 3. Inflation and monetary conditions

Annual inflation in the Consumer Price Index excluding Credit Services (CPIX) is expected to rise over the first two quarters of the projection, peaking at 2.2 percent in the year to June 1998. The rise is primarily due to rising domestic price trends which are no longer masked by a rapidly appreciating currency. Upward price pressure is also expected as a result of the more recent decline in the exchange rate.

#### *Inflation trends*

Beyond mid-1998, inflation is projected to trend back toward the mid-point of the 0 to 3 percent target range. The key drivers of reduced inflation include the previous excess capacity in the economy, and a projected decline in the price of New Zealand imports due to a steady nominal exchange rate and weakening world prices.

The profile for inflation is similar to the one in the September *Economic Projections*, although annual inflation is slightly higher over calendar 1998, and then lower for the remainder of the projection period. The main impetus for the initially higher profile is our projection of less excess capacity and the recent absence of exchange rate appreciation, while the key influence further out is bigger falls in domestic-currency import prices.

**Table 3**  
**CPI inflation projections**  
**(Percent changes)**

	Underlying		CPIX <sup>1</sup>		Headline (CPI)	
	Quarterly	Annual	Quarterly	Annual	Quarterly	Annual
1995 - Mar.	0.5	1.9	0.5	2.6	1.2	4.0
June	0.6	2.2	0.6	2.7	1.0	4.6
Sep.	0.3	2.0	0.4	2.2	0.2	3.5
Dec.	0.6	2.0	0.6	2.1	0.6	2.9
1996 - Mar.	0.6	2.1	0.6	2.1	0.5	2.2
June	0.8	2.3	0.8	2.3	0.8	2.0
Sep.	0.3	2.3	0.4	2.3	0.6	2.4
Dec.	0.6	2.4	0.7	2.4	0.7	2.6
1997 - Mar.	0.2	2.0	0.2	2.0	-0.3	1.8
June	0.3	1.5	0.3	1.5	0.1	1.1
Sep.	0.6	1.8	0.7	1.8	0.5	1.0
Dec.	-	-	0.6	1.8	0.8	1.1
1998 - Mar.	-	-	0.5	2.1	0.3	1.7
June	-	-	0.5	2.2	0.4	1.9
Sep.	-	-	0.3	1.9	0.3	1.7
Dec.	-	-	0.4	1.6	0.3	1.2
1999 - Mar.	-	-	0.3	1.4	0.3	1.2
June	-	-	0.3	1.2	0.2	1.0
Sep.	-	-	0.4	1.3	0.4	1.2
Dec.	-	-	0.3	1.2	0.4	1.3
2000 - Mar.	-	-	0.3	1.2	0.4	1.4

1 SNZ series CPI ex Credit Services, using whole index numbers.

With the exchange rate and world import price effects stripped out, trend inflation is projected to be in the upper half of the 0 to 3 percent target range. However, excess capacity is projected to bring trend inflation down toward the middle of the range. Subsequently, excess demand is expected to occur by March 1999 and is projected to exert mild upward pressure on inflation beyond March 2000.

### *Housing and other domestic influences*

With activity in the economy recently having fallen below productive capacity, the forthcoming reduction in trend inflation pressure is likely to be manifest through a number of channels:

- Pressures in the housing market are projected to abate, particularly in the rental market. Already there is considerable anecdotal evidence suggesting that Housing New Zealand and private sector rents will fall. Construction costs and house prices are expected to flatten out as residential investment eases, and as previous decisions to develop apartment blocks increase the supply of housing.

- Local authorities are under pressure to contain costs, and the re-balancing of electricity prices between commercial and residential users appears to have slowed down. Some power companies have frozen residential power prices for one to two years. Other utilities, such as the telecommunications industry, are increasingly competitive and this should continue to translate into price falls.

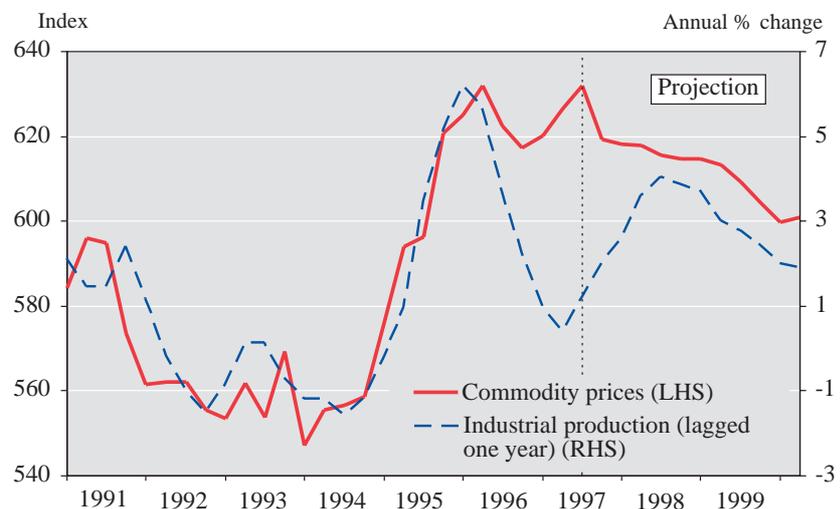
Of course not all prices will be trending downwards. Tertiary education fees, for example, could continue to increase sharply over the projection period. However, the overall trend in inflation is projected to come back near to the centre of the target range.

### *External prices*

External prices are projected to be significantly weaker than in the September *Projections*. This reinforces the trend toward lower inflation over the latter part of the projection.

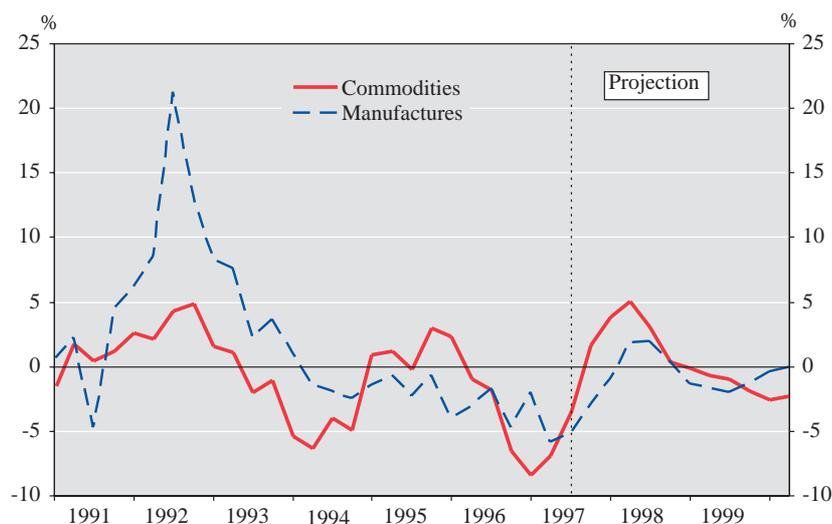
The East Asian crisis has its most direct and significant impact on New Zealand inflation through world import prices. As noted earlier, the Bank's assessment is that East Asian developments will reduce the aggregate foreign-currency price of imports by 1.5 percent more than would otherwise occur. We have assumed that these reductions are spread more evenly across import categories than the reduction in export prices. Clearly, however, the magnitude of reductions in some manufacturing prices, especially cars, and reductions in the prices of imported commodities may be particularly severe.

**Figure 11**  
**World price of commodity imports and OECD industrial production growth**



Note: Imported commodity prices is an RBNZ series derived from Statistics New Zealand OTI data.

**Figure 12**  
**Domestic import prices**  
**(annual percentage change)**



The East Asia effects overlay an already flat outlook for world import prices, implying that the total foreign-currency price of imports is expected to decline by around 2 percent and 1 percent in the years to March 1999 and March 2000 respectively. Given the relatively flat projection for the nominal exchange rate, a very similar profile exists in terms of domestic-currency import prices.

Our aggregate projection for import prices is built up from separate projections for the prices of transport equipment, electrical machinery, non-electrical machinery, food and beverages, non-food commodities, and petrol and petroleum products. The first three categories are linked to specific foreign inflation rates and bilateral exchange rates. The latter three are linked to OECD industrial production growth and the TWI. Thus, while the TWI is used as a 'rule of thumb' measure of the exchange rate between projections, our quarterly projections assess import price pressures with more care. That is, they account for changes in the TWI, specific bilateral exchange rates (particularly the US dollar and yen rates) and specific commodity price outcomes.

We project the domestic price of non-commodity manufactured imports to fall around 2 percent over 1998/99, and then stabilise by 1999/2000. The main factor is a fall in the price of transport equipment. New car prices are likely to fall as domestic car assemblers source components from countries with lower exchange rates (such as Thailand). Moreover, competitive pressure from other Asian countries is likely to weaken world prices for new cars. It may also prove relatively more profitable to import built-up cars, rather than assemble them in New Zealand. However, partly offsetting this price decline are reports that the price of used cars in Japan have increased recently as other countries – such as Ireland and Russia – have begun importing used Japanese cars.

Reinforcing the upward pressure on used car prices has been the reduced supply of used cars as Japanese car owners delay upgrading.

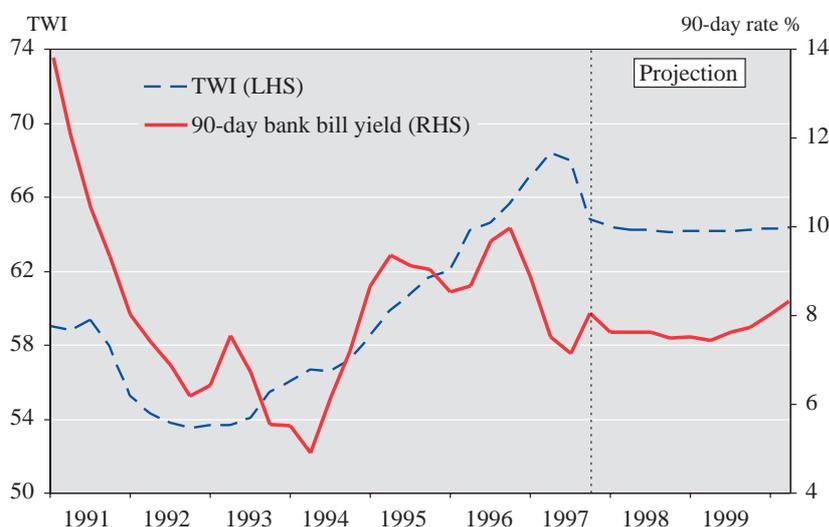
A key factor that will determine the timing of the pass-through of lower world prices into lower domestic consumer prices will be the extent to which domestic competitive pressures cause importers to compress margins. Importers may delay passing on the additional costs from the depreciation, because of sluggish aggregate demand. This is the reverse of recent years, where strong demand allowed importers to raise their margins as the New Zealand dollar appreciated. Exporters to New Zealand may behave similarly by pricing to the domestic New Zealand market.

As discussed above, world export prices are projected to be weakened by the East Asian crisis. Some of this will pass through into lower consumer prices. For example, lower world prices for timber may encourage competition in the New Zealand market, and thereby reduce domestic prices for timber. This in turn will help reduce the construction cost component of the CPI.

### *Monetary conditions*

Nominal monetary conditions are projected to be relatively stable over 1998 and most of 1999. However, after allowing for inflation, real monetary conditions are projected to firm gradually from late-1998 onward. This firming anticipates the increased inflation pressure as excess capacity gives way to excess demand, and the economy runs above its potential. Beyond our three year projection horizon, inflation falls and monetary conditions ease significantly. The initial firming in real monetary conditions occurs despite our projection that nominal short-term interest rates and exchange rates

**Figure 13**  
**Nominal 90-day interest rate and the nominal exchange rate**



remain almost constant through to mid-1999. Instead, the fall in inflation is sufficient to raise real short-term interest rates, while the very similar projections for New Zealand and international inflation rates leave the real exchange rate virtually unchanged. Beyond mid-1999 both nominal and real monetary conditions tend to move in parallel.

#### **4. Uncertainties in the projection**

These projections represent the Bank's estimate of the most likely outlook for economic growth and inflation based on current information. However, as always, the projections are subject to a number of uncertainties, both domestic and international. Domestic uncertainties arise from the recent change in the mix of monetary conditions and fairly erratic household spending patterns. International uncertainties relate to the prospects for world growth and the associated impact on New Zealand's terms of trade.

The Bank's judgement is that the risk for inflation is evenly balanced over the two year projection horizon. This means that the probability that inflation may actually turn out higher is approximately equal to the probability that inflation may be lower than projected.

This section describes the uncertainties in some detail.

##### ***Regional and world economies***

The severity and consequences of the East Asian economic crisis is a principal source of risks. Although we have already reduced our assumption for trading-partner growth by an average of 1 percent, there is further downside risk. However, it is important to keep this in perspective relative to positive surprises about the strength of Europe and the United States. Of course, it also remains unclear exactly how these events will affect international trade prices faced by New Zealand.

A related risk arises from the impact of the substantial depreciation of many East Asian currencies. We have assumed that the sharp currency depreciations will reduce the foreign-currency price of New Zealand's imports by an average of 1.5 percent more than would otherwise have occurred. Recent anecdotal evidence from New Zealand importers suggests large price reductions on some products. We have assumed these price reductions will be persistent. However, the Asian currency depreciations may generate significant inflationary pressure in their economies and reverse some of the decline in their real exchange rates. This would limit the extent and duration of any price declines.

### ***Household spending***

Despite a strong June quarter for GDP, and improving indications for the second half of 1997, the recent erratic pattern of growth suggests ongoing uncertainty. This is particularly true of household spending, given the current weakness in retail sales and household wealth (ie house values and equity holdings). Negative perceptions about wealth may cause households to save more of the 1998 tax cuts than assumed, leading to weaker growth and lower inflation. Alternatively, on the upside, the impact of the AMP demutualisation may be greater than the 0.3 percent increase in consumption we anticipate.

### ***Productive capacity***

An economy's level of productive capacity is unobservable and must be inferred indirectly from a range of data (see Box 1, September 1997 *Economic Projections*). Moreover, the estimate of capacity may change as new data arrive, as old data are revised, and as the business cycle evolves. Such changes mean that domestic sources of inflation pressure may be stronger or weaker than projected.

### ***Non-tradeables inflation***

After falling for two quarters, inflation in the non-tradeables components of the CPI increased significantly in the September quarter. As a result, we have assumed that non-tradeables inflation is more persistent than estimated in the September *Economic Projections*. However, there is a risk that the September quarter out-turn was an aberration, and that inflation may be lower than projected over the short term. Factors that may contribute to lower-than-expected inflation include larger-than-expected reductions in Housing New Zealand rents, significant downward pressure on private sector rents and local authority costs, and cheaper electricity prices.

### ***Exchange rate pass-through***

The full magnitude and timing of changes in the exchange rate on consumer prices remain uncertain. Data for the June quarter showed that movements in some, but not all, import price components were consistent with price margins on imported goods being unwound as the New Zealand dollar depreciated. We continue to expect margins to unwind slowly over the projection period, although this could happen more quickly as domestic demand growth remains slow.

### *The mix of monetary conditions*

Although the Bank is able to control the *level* of monetary conditions, it is not able to sustainably influence the *mix* of monetary conditions. Instead, interest rates and the exchange rate are determined by decisions made in the private sector, both in New Zealand and in the rest of the world. A further significant depreciation of the exchange rate is possible, and represents an upside risk to the short-term inflation projection. Pressures that may lead to continued change in the mix include New Zealand's substantial and persistent current account deficit.

### *Balance of risks*

In summary, the risks for inflation are reasonably balanced. Growth may be stronger than expected in the US and Europe, but weaker than expected in Asia. The risk of weaker than expected domestic demand compares with the risk of stronger short-term inflation pressure from a further depreciation of the exchange rate. With recent inflation performance being in the top half of the 0 to 3 target range, there appears to be minimal risk of inflation going through the bottom of the range.

## Box 2: Recent developments in Asia

The September 1997 *Economic Projections* alluded to the risk that the financial market and banking disturbances apparent in Thailand, the Philippines, Indonesia and Malaysia (the 'ASEAN-4') could worsen. Since then, the crisis has indeed worsened, and has continued to evolve throughout the Bank's December projection round. Pressure has come to bear on the currencies and equity markets of Hong Kong, Taiwan, and South Korea, with flow-on effects to equity markets worldwide (see section II.3). The currencies of South Korea and the ASEAN-4 have been most affected by the disturbances, each depreciating by around 25 to 40 percent against the US dollar since the end of May. Weaknesses have also become apparent in the banking systems of a number of countries in the region, including South Korea, Japan, Thailand, and Indonesia.

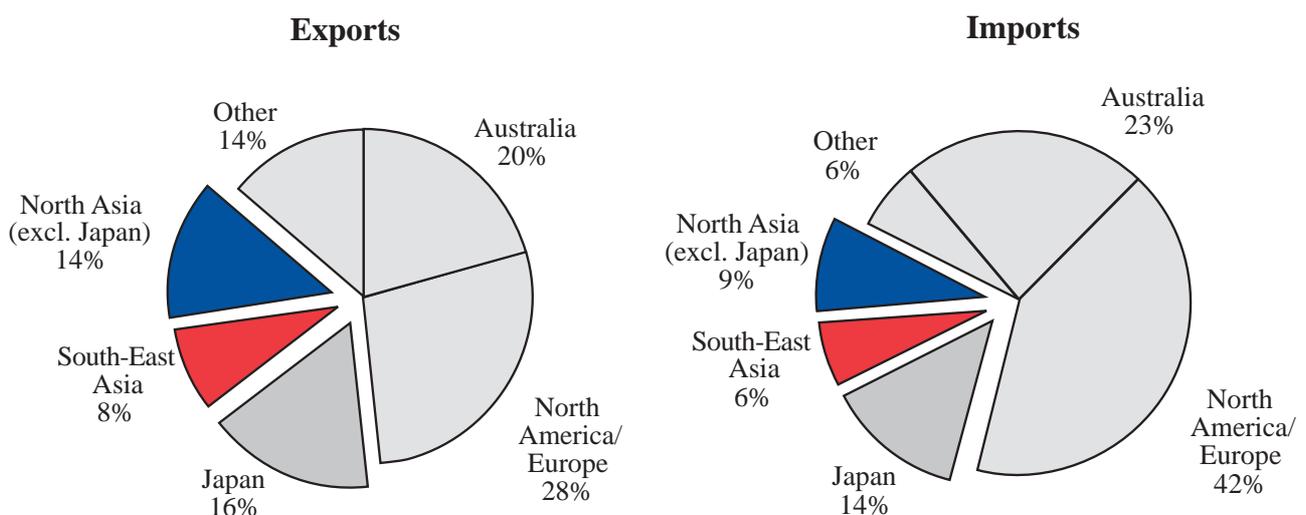
The financial and banking crises will undoubtedly slow growth dramatically in the affected countries. However, the magnitude of the impact on New Zealand is uncertain. The main channels through which the disturbances are likely to be felt are:

- lower demand for our merchandise exports to the region, including Japan and Australia;
- downward pressure on the prices of goods imported from the region;
- downward pressure on our commodity export prices;
- reduced numbers of tourists visiting New Zealand; and
- declining flows of foreign direct investment from Asia.

New Zealand's direct exports to the Asian region will suffer. As shown in the pie-charts, non-Japan Asia accounts for around 20 percent of our merchandise exports. Tourism and investment income earnings from the affected region will also be adversely affected.

Additionally, there will be indirect effects on our exports. Australia and Japan, our two largest export markets, send over 40 percent of their

**New Zealand's 1996 merchandise exports and imports by region**



South-East Asia includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam. North Asia (excluding Japan) comprises China, Hong Kong, North Korea, South Korea, Macau, Mongolia and Taiwan.

merchandise exports to non-Japan Asia. Weaker Australian and Japanese exports to the affected region are likely to dampen our exports to these two countries. Of course, the magnitude of this indirect impact will depend heavily on how monetary and fiscal policy in Japan and Australia respond to the recent developments.

The currency depreciations experienced by many Asian nations are likely to increase their exports. This will put downward pressure on the world prices of goods like electronics, iron and steel, textiles and clothing, and wood products. The profitability of New Zealand producers competing with these products will be reduced, and in aggregate, import costs are likely to fall. The degree to which world prices actually fall depends on how readily world demand absorbs the excess supply, and the ability of Asian exporters to maintain their prices in stronger markets such as the United States.

New Zealand's exports to the affected countries (including Japan) tend to be primary commodities, especially food, wood products, and aluminum. While the volume of these exports will be adversely affected in the short term, the impact may be less than if our exports to Asia were mostly finished goods. Some exports to the region are processed and re-exported, and may not be strongly affected by declining regional growth. Furthermore, commodity prices are essentially determined by world demand and supply, and it is not certain that falling growth in Asia will substantially slow overall world growth. Many of the

affected economies are relatively small on a global scale, and the weaker prospects in Asia are partly balanced by an improved outlook in Europe and continued strength in the United States.

The Bank has lowered its world growth and inflation projections to reflect these concerns. Specifically, we have assumed the disturbances will:

- Cut growth in our trading partners by 1 percent in 1998/99, to around 2 percent. This is based on output growth in our Asian trading partners falling by about 2 percent, with a smaller flow on effect on Australia and the rest of the world.
- Lower the terms of trade by 1.5 percent in 1998/99 (reflecting a 3 percent fall in aggregate export prices, and a 1.5 percent fall in aggregate import prices). The terms of trade is still expected to rise by around 2 percent in 1998/99.
- Reduce CPI inflation in the TWI countries by 0.5 percent over the same period, to 1.7 percent.

The impact on the terms of trade is assumed to be fairly persistent, reflecting our view that recovery in the affected nations may be fairly slow. Past experience suggests that banking system problems of the scale facing South Korea, Indonesia, and Thailand will contribute to a prolonged period of slow growth in those countries. In addition, as increased regional competition cuts export prices, any 'export-led' recovery the affected countries hope to engender may prove limited.

## IV. Policy issues and risks

The path for monetary conditions shown in this *Statement* is consistent with keeping inflation within the 0 to 3 percent inflation target range. However, it is not the only path consistent with the inflation target. An essential task in formulating monetary policy is to choose the most suitable path from among the alternatives. Key to this choice is an assessment of which path of conditions is most sensible in the light of the uncertainties and risks associated with the projection.

Box 3 compares the central scenario in our projections with two alternatives: one involves a more aggressive approach to keep inflation near the mid-point of the target range; the other involves a more gradual approach than in the central scenario. The alternative scenarios illustrate several points relevant to choosing a sensible path for monetary conditions:

- Both more aggressive and more gradual approaches are compatible with meeting the inflation target over the long term.
- A more aggressive approach generally leads to greater volatility in monetary conditions and economic activity.
- A more gradual approach generally allows inflation to vary more widely within the target range, leading to a higher risk of breaching the range.
- A more pronounced easing of policy at this stage of the business cycle would require a more aggressive tightening in 1999.

The alternative scenarios shown in Box 3 make no explicit allowances for uncertainties in the projections. In choosing the appropriate stance of policy the Bank must also take account of uncertainties about the current economic situation and about potential future developments. The existence of such uncertainties tends to tug policy in two somewhat different directions.

On the one hand, uncertainty about the current state of the economy and how the economy works suggests that policy adjustments should be cautious. This is because sharp policy adjustments in an uncertain environment could lead to significant policy errors, resulting in more volatility of output and inflation rather than less. Thus, rather than acting aggressively, policy should be adjusted only gradually until the outlook becomes clearer.

On the other hand, the more uncertain the outlook is, the better it is to be close to the centre of the inflation target range. Staying close to the centre provides more room to absorb inflationary or deflationary shocks without breaching the target range. In general, this

argument would favour a relatively aggressive policy of eliminating deviations of inflation from the centre of the range.

A simple example illustrates the differences between the two responses to uncertainty. Consider driving an unfamiliar car in foggy weather. In such circumstances, if the car strays from the centre of the lane, caution would suggest steering back towards the centre of the lane only gradually because of uncertainty about how the car will respond. But prudence also suggests trying to stay close to the centre of the lane so that there is more room to handle unknown road conditions masked by the fog.

As discussed in Section III of this *Statement*, the projections involve several sources of uncertainty. These include, for example, uncertainties regarding the strength of spending in the economy, the level of sustainable capacity, and the pass-through to prices of currency depreciation. These kinds of uncertainty all suggest that the Bank's policy adjustments should be gradual rather than aggressive.

At the same time, there are considerable uncertainties surrounding the eventual consequences of developments in Asia and the potential for further marked shifts in the mix of monetary conditions. These types of uncertainty suggest aiming for inflation outcomes close to the centre of the target range.

In this regard, our central projection indicates that over the next five years inflation is expected to remain within the middle part of the target range. This implies that a more aggressive adjustment to the stance of policy is not warranted at this stage.

Striking the right balance between adjusting policy too gradually or too aggressively is facilitated by the quarterly frequency of our policy assessments. The quarterly reviews, taking into account the latest information, guard against undue delay in responding to a changing outlook. At the same time, the frequency of the reviews means that there is less pressure to adjust policy on the basis of very incomplete information about recent developments.

### Box 3: Alternative paths for monetary conditions

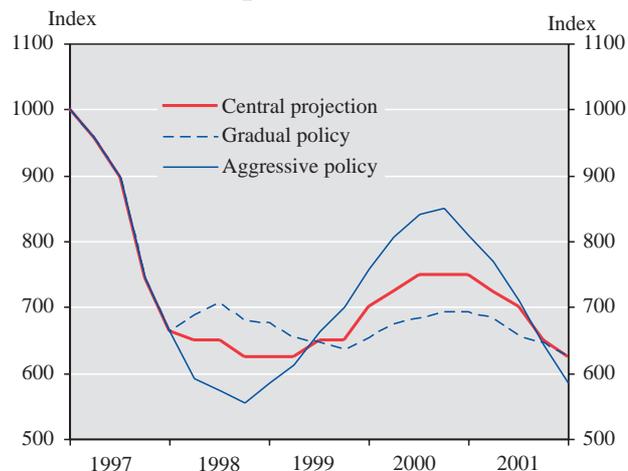
The path for monetary conditions shown in this *Statement* is based on a particular ‘rule’ according to which monetary policy reacts to deviations of projected inflation from the mid-point of the target range. In this box we examine the implications of policy responding either more aggressively or more gradually to deviations of projected inflation from the mid-point of the range. It should be emphasized that each of the alternatives is still consistent with achieving the mid-point of the target, *on average*, over time.

The graphs show the implications for monetary conditions, GDP growth and inflation of alternative policy scenarios compared with the central projection.

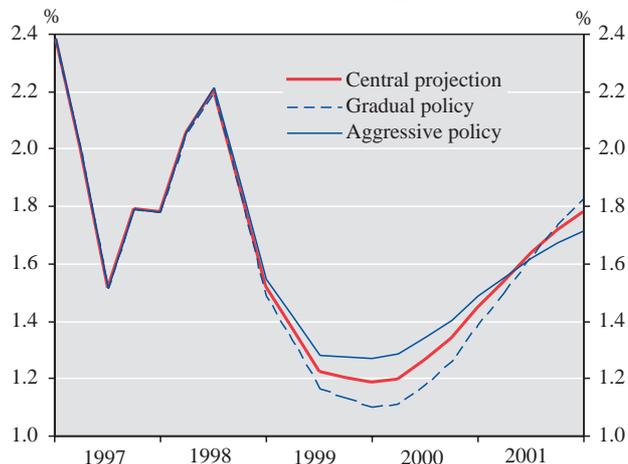
In the more aggressive scenario, monetary conditions would be eased more rapidly early in the projection period (in response to prospective declines in inflation), but would then need to rise sharply later to counter a re-emergence of inflation pressures. Inflation would remain fairly close to the mid-point of the range, but monetary conditions and growth would be more strongly cyclical.

In the more gradual scenario, firmer monetary conditions in the earlier period would lead to more of a dip in inflation and, subsequently, less upward pressure on inflation and monetary conditions later on. This approach would allow inflation to vary more widely through the target range, while dampening variability of output and monetary conditions.

**Alternative MCI paths**

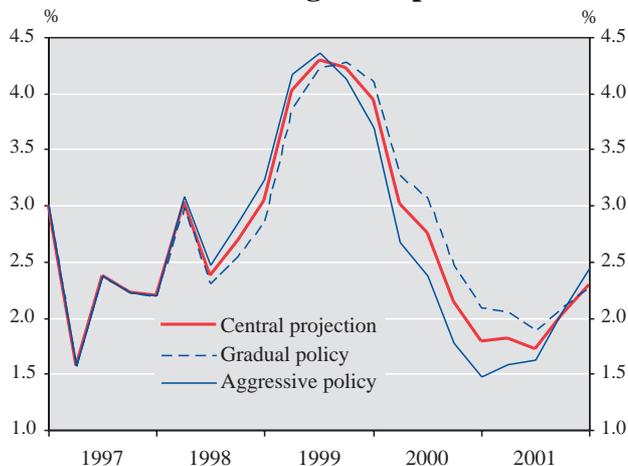


**Alternative CPIX\* inflation paths**



\*CPIX is the CPI excluding credit services.

**Alternative real GDP growth paths**



## Appendix 1:

## Notes to tables 1 and 2

<b>CPIX inflation</b>	CPI excluding credit services.
<b>Import prices</b>	<i>Overseas Trade Index</i> (domestic currency).
<b>“Consumer” import prices</b>	Selected group of import prices relevant to CPI inflation. Reserve Bank of New Zealand estimate of <i>Overseas Trade Index</i> (domestic currency) excluding non-fuel crude materials and petroleum and petroleum products.
<b>Export prices</b>	<i>Overseas Trade Index</i> (domestic currency).
<b>Wages</b>	Private sector ordinary time average hourly earnings, <i>Quarterly Employment Survey</i> .
<b>House prices</b>	Average house price index, Valuation New Zealand.
<b>Construction costs (residential)</b>	Component of the Housing Group, Consumer Price Index.
<b>Real MCI</b>	Reserve Bank of New Zealand, defined as: $\{(R_{90day}-R_0) + (1/2)*[\log_n(RTWI) - \log_n(RTWI_0)]*100\} * 100 + 1000$ where R90day and RTWI are the estimated real 90-day interest rate and the real TWI exchange rate. R90day is calculated as the nominal 90-day rate less the annual (four quarter) inflation rate in the CPI excluding credit services. RTWI is calculated as the TWI multiplied by New Zealand’s GDP deflator (interpolated from annual data) and divided by the trade-weighted average of GDP deflators of our trading partners. R <sub>0</sub> and RTWI <sub>0</sub> are base levels for the December 1996 quarter, where R <sub>0</sub> = 6.5 and RTWI <sub>0</sub> = 1 (normalised). Revisions to deflators will result in revisions to historic MCI numbers. Projected MCIs are rounded to the nearest 25, 50 or 75 points.
<b>Nominal MCI</b>	Reserve Bank of New Zealand, defined as: $\{(90day-r_0) + (1/2)*[\log_n(TWI) - \log_n(TWI_0)]*100\} * 100 + 1000$ where 90day and TWI are nominal rates and r <sub>0</sub> and TWI <sub>0</sub> are corresponding averages of daily rates for the December 1996 quarter, where r <sub>0</sub> = 8.9 and TWI <sub>0</sub> = 67.1. Projected MCIs are rounded to the nearest 25, 50, or 75 points.
<b>Exchange rate (TWI)</b>	Reserve Bank of New Zealand.
<b>90-day bank bill yield</b>	Reserve Bank of New Zealand.
<b>Output gap</b>	Defined as percentage difference between real GDP (production, seasonally adjusted) and potential output GDP.
<b>Potential output</b>	Reserve Bank of New Zealand definition and estimate.
<b>Total factor productivity</b>	Reserve Bank of New Zealand estimate, based on potential output.
<b>Labour force</b>	<i>Household Labour Force Survey</i> .
<b>Total hours worked</b>	<i>Household Labour Force Survey</i> .
<b>Government operating balance</b>	Percentage of nominal GDP (expenditure), June year.
<b>Current account balance</b>	Percentage of nominal GDP (production).
<b>Terms of trade</b>	Defined using domestic-currency export and import prices, <i>Overseas Trade Indexes</i> .
<b>Unemployment rate</b>	Seasonally adjusted rate, <i>Household Labour Force Survey</i> .
<b>Industrial production (OECD)</b>	Actuals sourced from OECD. Projections based on <i>Consensus Forecasts</i> . Seasonally adjusted.
<b>Foreign consumer prices</b>	Reserve Bank of New Zealand definition and estimate. TWI trading partners’ CPI inflation, weighted by TWI weights. Projections based on <i>Consensus Forecasts</i> .
<b>Foreign short-term interest rates</b>	Reserve Bank of New Zealand definition and estimate. 80:20 weighted combination of US and Australian short-term interest rates. Projections based on <i>Consensus Forecasts</i> .
<b>Annual percentage change</b>	$(Q/Q_{-1})*100$
<b>Quarterly percentage change</b>	$(Q/Q_{-1})*100$

Except where noted, all historical data is sourced from Statistics New Zealand.

Unless specified otherwise, all data conform to Statistics New Zealand definitions, and are not seasonally adjusted.

## Appendix 2: Chronology

Key events of relevance to monetary policy and inflation since the last *Statement* was finalised are listed.

### 1997

- 27 June: The Reserve Bank released its sixteenth *Monetary Policy Statement*. The news release accompanying the *Statement* is reproduced in Appendix 3.
- 30 June: GDP production figures were released showing that the New Zealand economy had grown by 2.3 percent in the year to March 1997.
- 3 July: The Reserve Bank issued a statement on current monetary conditions. The statement is reproduced in Appendix 3.
- 11 July: The Reserve Bank issued a statement on current monetary conditions. The statement is reproduced in Appendix 3.
- 15 July: The June 1997 quarter CPI was released. Headline inflation for the year to June 1997 was 1.1 percent. Underlying inflation was calculated to be 1.5 percent in the same period.
- 18 August: The Reserve Bank issued a statement on current monetary conditions. The statement is reproduced in Appendix 3.
- 18 September: The Reserve Bank released its September *Economic Projections*. Underlying inflation was projected to be 1.6 and 1.3 percent in the years to December 1997 and 1998, respectively. The accompanying news release is reproduced in Appendix 3.
- 26 September: GDP production figures were released showing that the New Zealand economy had grown by 2.4 percent in the year to June 1997.
- 15 October: The September 1997 quarter CPI was released. Headline inflation for the year to September 1997 was 1.0 percent. The annual underlying rate of inflation was calculated to be 1.8 percent.
- 5 December: The Reserve Bank issued a statement on current monetary conditions. The statement is reproduced in Appendix 3.

## **Appendix 3: Reserve Bank statements on monetary policy**

The following are reports or texts of official statements on monetary policy issues made by the Bank during the period under review in this *Monetary Policy Statement*.

### **Reserve Bank eases monetary policy**

27 June 1997

The Reserve Bank today eased monetary policy, thereby sanctioning the market-led easing in actual monetary conditions that has occurred in recent weeks.

This came with the release of the Reserve Bank's June *Monetary Policy Statement*.

The easier monetary policy stance took the form of a 100 point cut in the desired level of the Bank's new Monetary Conditions Index (MCI) to 825. This cut is the equivalent of a one percentage point reduction in interest rates, or a two percent fall in the exchange rate.

Reserve Bank Governor Don Brash commented, "The Reserve Bank is increasingly confident that inflation pressures are dropping away, and for the second time in six months we are able to ease monetary policy. The economy has looked weaker in recent months and inflationary pressures have been easing. As well, previous rises in the exchange rate are now more clearly reducing prices.

"However, actual monetary conditions have already eased considerably, fully anticipating today's statement, and we are not seeking a further easing in conditions."

Dr Brash also noted, "The combined effect of impending tax cuts and increased government spending, together with the easing in monetary conditions that has now occurred, will stimulate the economy over the next 12 to 18 months, and halt the current decline in inflationary pressures. As a result, there is likely to be little scope for further significant easing in the desired stance of monetary policy in the period ahead."

(Note: The MCI is an index that combines the exchange rate (TWI) and interest rates (90 day). *Desired monetary conditions* refers to the MCI level that the Reserve Bank seeks, while *actual monetary conditions* are those that occur in the market day-to-day.)

## Notes for briefing journalists at the release of the June 1997

### *Monetary Policy Statement*

27 June 1997

#### **Introduction**

Good morning and welcome to this briefing on the Reserve Bank's June 1997 *Monetary Policy Statement*, the 16th we have issued since the 1989 Reserve Bank legislation became effective in February 1990.

As you will be aware from earlier announcements, this *Statement* is different from earlier *Statements* in two ways.

First, whereas in the past we projected how *inflation* was expected to evolve given 'straight-line' assumptions about how monetary conditions (interest rates and the exchange rate) would behave, we are now projecting how we believe *monetary conditions* will need to evolve to deliver inflation in the middle part of our inflation target.

Note that I said the *middle part* of the inflation target: it will be obvious to you when reading the *Statement* that the projected path of monetary conditions does not mechanically or immediately drive the inflation rate back to precisely 1.5 percent, as some have apparently expected. The projected path for monetary conditions takes into account our assessment of the outlook for the real economy, and the balance of the risks involved.

It is particularly important to note also that the monetary conditions shown as appropriate beyond the next quarter must be treated as highly conditional – or in other words, with as much caution as our quarterly *inflation* numbers were treated previously. It is very likely that, as more information comes to hand, we will need to adjust our view of what monetary conditions are appropriate in the future.

The second change in our presentation is that, whereas in our last *Monetary Policy Statement* we went further than previously by informing the market how we saw the relative impact of interest rates and the exchange rate on the medium-term inflation rate, and indeed by informing the market precisely how firm monetary conditions needed to be by specifying one appropriate combination of interest rate and exchange rate, we are now simplifying that by adopting an index of monetary conditions – the Monetary Conditions Index, or MCI. In future we intend to use the MCI to indicate the overall firmness of the conditions which we seek, and to describe actual monetary conditions. We are confident that this further increase in the transparency of our signalling will assist financial markets, and the public more widely, to understand the intended stance of monetary policy.

#### **The outlook**

As you will have seen from reading the *Statement*, the Bank now believes that the economy grew more slowly in the first two quarters of 1997 than we thought likely when we issued our March *Economic Projections*. Indicators for the March quarter in particular suggest that there was quite an abrupt slowing during the first three months of

the year. Indeed, it is not inconceivable that the economy may even have contracted slightly in that quarter. Indicators for the June quarter, however, together with our own business contacts, suggest that the economy may have rebounded somewhat in that quarter, and we currently project that growth will strengthen in subsequent quarters. By the March 1998 quarter, we see GDP being 2.4 percent above that in the March 1997 quarter. This growth rate, being slightly below our assessment of the economy's long-term sustainable growth rate, is consistent with an easing in inflationary pressures on capacity in the economy.

Beyond that, we see growth accelerating to between 3.5 and 4 percent in each of the following two March years, in large part as a result of the significant fiscal stimulus currently planned for the year beginning 1 July 1998.

On the basis of this real economy outlook, signs that price effects from the recent exchange rate appreciation are finally coming through more strongly (as in the car market), and monetary conditions evolving as outlined, we are anticipating a decline in underlying inflation to about 1 percent in the year to March 1998. Inflation should then remain at around that level through the balance of 1998 and into 1999, before rising gradually to slightly above the middle of the target at the end of the period covered by the projection.

This pleasingly low inflation track, coming as it does after two years during which the Bank has had to grapple with inflation at, and at times marginally above, the top of our target range, should help in the task of convincing New Zealanders that low inflation really is now the norm, not some temporary aberration. As that is accepted, we would expect to see rates of credit growth, and real interest rates, move closer to those found in other low inflation countries.

But we are not deliberately attempting to push the inflation track below the middle of the range: the fact is that, once an inflation trend develops some momentum, it is neither sensible nor feasible to try to change it very quickly. It is perhaps worth recalling that, through almost all of 1996, the period most relevant to inflation outcomes in 1997 and the first part of 1998, we were in fact targeting inflation at the mid-point of our previous 0 to 2 percent range, or 1 percent.

Is this low inflation achieved only at the cost of doing severe damage to the real economy? If we are right that real economic growth will fall only marginally below our estimate of sustainable long-term growth over the next year, before accelerating to rates of growth somewhat higher than the economy's sustainable growth rate, then clearly low inflation does nothing to inhibit the economy's growth.

The matter can be put in another way. The New Zealand economy has been growing virtually without interruption since price stability was first achieved. The trough of the present cycle seems likely to involve growth of around 2 percent. And just as monetary policy aimed at price stability inevitably means that the Bank will be leaning against growth in demand which exceeds the economy's long-term potential to deliver, it also means that the Bank will be easing conditions as demand falls below long-term potential and inflationary pressures abate.

## **Policy implications**

And this is where we are now: for the second time in six months, sanctioning an easing in monetary conditions. The inflation projection which I have outlined, and which is set out in more detail in the *Statement*, is based on monetary conditions being the equivalent of 100 basis points easier during the September quarter than the conditions we saw as appropriate in our March *Economic Projections*; or in terms of our new MCI, we judge that desired monetary conditions for the September quarter are around 825, in contrast to the 925 we saw as appropriate in March. This new level of *desired* monetary conditions is in fact very close to where *actual* monetary conditions have been in recent weeks. In other words, we are not seeking any further easing in *actual* monetary conditions.

There may be some scope for a further small easing in monetary conditions in the last quarter of 1997, but beyond that we see the need for monetary conditions to remain broadly stable in real (inflation-adjusted) terms. This maintenance of monetary conditions at a reasonably firm level relates to our expectation that the economy will have only minimal excess capacity available by mid-1998, when further tax cuts and increased government spending take effect.

I want to stress two things. First, as already indicated, our present judgement about the firmness of monetary conditions in quarters beyond September is inevitably highly conditional. For example, because we do not as a rule build in policy changes until these are firm commitments, we have assumed that there is no compulsory retirement savings scheme instituted next year. Clearly, however, if such a scheme *were* instituted, and if as a consequence the net fiscal stimulus was rather smaller than now assumed, monetary conditions would almost certainly need to be easier than now envisaged to keep the inflation rate in the middle part of the target range. Similarly, if the international economy evolved differently from the path now assumed, monetary conditions would need to be different than now projected. Again, if, contrary to our expectations, the domestic economy turned out to be much weaker than now projected, appropriate monetary conditions beyond the end of the year would be easier than now anticipated in order to keep inflation headed back to the middle part of the target range.

Secondly, although we have shown a projected track not only for monetary conditions in aggregate but also for both 90 day interest rates and the TWI, the projected tracks for interest rates and the exchange rate are purely illustrative. How the 'mix' of conditions actually evolves will depend on the relationship between monetary conditions in New Zealand and monetary conditions abroad, and on the perceptions of hundreds of thousands of individuals, here and abroad, about the riskiness of investing in New Zealand dollar assets. For this reason the projected tracks for interest rates and the exchange rate are only one of a very large number of alternative 'pairs', all of which would have a broadly similar impact on medium-term inflation in New Zealand.

## **Two more points about signalling**

Two additional points should be made about our approach to signalling our view of the appropriate stance of monetary policy. First, as a general rule, we only make a comprehensive assessment of the inflation outlook on a quarterly basis. It follows that in normal circumstances we only make a comprehensive assessment of desired monetary conditions on a quarterly basis, and we will announce that when we release our quarterly

inflation projections (generally June and December in *Monetary Policy Statements* and March and September in *Economic Projections*). We will in normal circumstances resist the temptation to change our view of projected inflation on receipt of every new piece of data. If, on a rare occasion, our view of desired conditions does change significantly between quarterly projections, we will announce that fact (unless we change our view in the days immediately preceding the release of a new quarterly projection) in the form of a statement released over all the relevant media simultaneously. We will not be giving nods and winks to the market, nor coded signals.

I realise, of course, that there is no way I can stop people trying to read between the lines and making guesses. After all, an essential role for market participants is to try to predict the future direction of monetary policy; profitable trading depends on doing that successfully. We try to make this task as easy as possible by making our projections public every three months, together with a substantial amount of the detail underlying those projections. At this stage, I believe we reveal more about the thinking which underlies our projections than does any other central bank in the world.

The second issue involves some uncertainty in the market about the extent to which we are willing to accept deviations between actual monetary conditions in the market and desired monetary conditions. In recent weeks in particular there has been a great deal of market commentary on the extent to which we might be willing to tolerate such deviations.

It is not a simple issue. On the one hand, it is clear that deviations from desired monetary conditions can be very large indeed without threatening either edge of our inflation target if those deviations are of relatively short duration. This suggests that the Bank should be relatively tolerant of quite large deviations from desired. On the other hand, large deviations, even for relatively short periods, may raise doubts – either about the Bank’s determination to achieve the inflation goals we have been set or about the possibility that the Bank, in accepting those large deviations, may have changed its view of desired conditions. These doubts can create uncertainty, and that uncertainty has real costs, both short-term and long-term. We already allow monetary conditions to move within a range, without reaction from the Bank, which is at least as wide as that allowed in other developed countries.

I am reluctant to be too precise about how much deviation we are willing to accept and for how long. Much will depend on the circumstances in which the deviation occurs. We may, for example, be more tolerant of deviations which appear to arise out of sharp movements in overseas exchange rates, where local interest rates or exchange rates may take a brief period to adjust. We may be more tolerant of deviations during the weeks immediately preceding our next quarterly inflation projection, since it is at that time when our last comprehensive review of desired conditions is, by definition, getting most dated. We are likely to be less tolerant if monetary conditions change very rapidly, and appear to be building some momentum, without any obvious explanation in terms of overseas exchange rates or changed prospects for inflation.

As a very approximate guideline, we would expect actual monetary conditions to be within a range of plus or minus 50 MCI points from desired in the weeks immediately following a comprehensive inflation projection. As more data comes to hand over the ensuing three months, and as our last comprehensive inflation projection recedes into

history, we may be rather more tolerant. But this is not, repeat not, a binding rule which the market can expect us to follow under all circumstances, and those expecting us to do so are likely to be disappointed.

### **Conditions have eased too far**

3 July 1997

Don Brash, Governor of the Reserve Bank today reiterated that desired monetary conditions had not changed since the release of the Reserve Bank's *Monetary Policy Statement* last Friday (that is, 825 on the Bank's MCI).

"Against this background, actual monetary conditions have been too easy over recent days. We will be looking to see actual conditions settle closer to the announced desired levels", Dr Brash said.

### **Monetary conditions too loose**

11 July 1997

Reserve Bank Governor Don Brash today said, "Overall monetary conditions have settled too far from the Reserve Bank's desired monetary conditions, as stated in the June *Monetary Policy Statement*.

"Neither the level of monetary conditions desired by the Reserve Bank nor the stated comfort zone around the 825 MCI has changed, although naturally the Bank will continue to pay close attention to all new data," Dr Brash concluded.

### **Monetary conditions too loose**

18 August 1997

David Archer, Chief Manager of the Reserve Bank's Financial Markets Department, today said "Overall monetary conditions have become too loose, given our current monetary policy stance.

"Consistent with the approach the Bank set out in June, we have been allowing monetary conditions increasing room to move as the quarter has progressed, and as our last complete look at inflation pressures becomes more distant. We have also been waiting to see whether the drift in conditions in recent days would reverse. It hasn't, leaving overall conditions beyond levels that we are comfortable with.

"As usual, the Bank remains ready to act if necessary," Mr Archer concluded.

## **Reserve Bank views current monetary conditions as appropriate**

18 September 1997

With the release of the Reserve Bank's September *Economic Projections* today, the Bank endorsed the market-led easing in monetary conditions that has occurred over recent weeks. This is the third easing in the Bank's policy stance in the last nine months.

Today's move took the form of a 100 point cut in the desired level of the Reserve Bank's Monetary Conditions Index (MCI) to 725, close to the current level of market conditions.

Reserve Bank Governor Dr Don Brash commented that "the economy appears to have more spare productive capacity than expected at the time of our June *Monetary Policy Statement*, and that will offset other pressures on inflation. As a result, monetary conditions do not need to be as firm as we had expected then to maintain price stability.

"Markets appear to have assessed prospects much as we have, so monetary conditions now are broadly appropriate and we are not seeking a further easing.

"Over the next 12 to 18 months, we expect economic growth to pick up fairly strongly as a result of continued international growth, improved prospects for the export sector, business investment, rising household income, increased government spending, tax cuts, and the easing in monetary conditions which has occurred in recent months. This will gradually reduce the degree of unused capacity in the economy and eventually halt the decline in inflationary pressures.

"As a result there is likely to be little scope for further easings in the stance of monetary policy in the period ahead, and the probability of a gradual firming in policy from the middle of 1998," Dr Brash concluded.

## **Notes for briefing the press at the release of the September 1997**

### ***Economic Projections***

18 September 1997

#### **Introduction**

Good morning, and welcome to this briefing on the Reserve Bank's September 1997 *Economic Projections*.

You will recall that, in contrast to our June and December *Monetary Policy Statements*, which the Bank is obliged to produce by statute, the *Economic Projections* which we release each March and September are more in the nature of 'self-initiated' documents. Their primary purpose is to assist us in assessing economic developments that have a bearing on inflation trends, and thereby to assist us in forming judgements on how monetary policy should evolve. In publishing our *Projections*, we take the opportunity to inform financial markets and the public generally on what is driving our day-to-day policy decisions. Typically, you can expect to see in our *Economic Projections* more discussion of matters such as investment behaviour, labour market trends, the balance of payments and so on than is to be found in our *Monetary Policy Statements*, which

concentrate more on assessments of past and future financial market conditions, and the stance of monetary policy.

However, both documents require us to produce a comprehensive view of the future trends in the New Zealand economy, and to test our previously articulated views against the stream of emerging data and opinion. A key ingredient in that process is our new forecasting and policy system (FPS) – the system of models we now utilise in developing our projections.

One important change which that new system of models has made possible was introduced with our June *Monetary Policy Statement*. Whereas we had previously projected inflation on the basis of an assumed track for interest rates and the exchange rate, in June we shifted to a structure that constrains our projections of inflation to converge on the mid-part of the 0 to 3 percent inflation target, while allowing the track of monetary conditions to vary as necessary to produce that outcome. You can see that process at work again in these *Projections*.

One point made in relation to FPS when it was first introduced bears repeating. While it is an important tool which helps shape our view of the economy and its likely future path, it is not a 'black box'. FPS provides a coherent framework for thinking about the economy, but considerable judgement is still required to arrive at a final projection. There are clearly a number of different paths through which the economy can evolve to essentially the same point. What is portrayed in this document is just one of those paths, but one that we feel is both realistic and sound as a base for our policy judgements.

### **The real economy**

Shortly after our June *Monetary Policy Statement* was published, the release of March quarter GDP data seemed to suggest that the economy was significantly weaker than we had allowed for. Our subsequent analysis indicated that there were particular factors (notably that Easter, unusually, fell into the March quarter) which explained much of the small decline in GDP in that quarter.

Since then, the emerging data have suggested that the economy is a little weaker than we had portrayed in June, but that it is also resuming a robust growth path. Whereas we were projecting an annualised growth rate through the first half of calendar 1997 of a little over 1 percent, the estimate incorporated in these *Projections* is closer to 0.5 percent. Having said that, data released since we completed the *Projections* are, if anything, suggestive of stronger rather than weaker outcomes for June quarter GDP. In any event, we remain of the view expressed in June that activity will pick up in the second half of the year. Over the year to March 1998, we expect the economy to expand by around 2.5 percent, accelerating further to 4.6 percent growth in the year to March 1999.

The factors driving that expansion include a robust global economy, gradually increasing household expenditures, improved productivity, stronger exports (partly the result of a lower exchange rate), business investment and an expansionary fiscal policy – both from increased government spending under the Coalition Agreement and from the tax cuts scheduled for July 1998. Easier monetary conditions since earlier this year are also supportive of stronger growth.

It seems clear that, in the middle of this decade, the New Zealand economy became somewhat over-stretched in terms of its ability to support the pace of spending. It seems equally clear that the economy has entered a period in which there is some spare capacity. Given the current and imminent expansionary forces that I have described, the spare-capacity phase should be short-lived, but long enough to take the pressure off inflation, and long enough to make it unlikely that we will experience the kind of destructive crunch that has so often brought past cycles to a shuddering halt. In this sense, we are describing a growth profile that reflects the steadying influence of maintaining low inflation, which in turn should contribute to New Zealand's future growth potential.

We expect continued job creation throughout the period to March 2000, continued growth in real disposable household income (averaging over 3 percent per annum through the projection period), continuing modest fiscal surpluses, further declines in the government's debt-to-GDP ratio, and an improvement in the current account deficit from nearly 6 percent of GDP to around 4 percent of GDP.

### **Inflation**

As I mentioned earlier, our new projections framework takes as given that inflation should converge on the mid-part of our target range, and derives the monetary conditions that are needed to achieve that outcome. In that sense there is no particular news in the fact that we expect underlying inflation to be close to the middle of the target over the projection period. But there are some aspects of the inflation track that require comment.

In particular, we now expect inflation outcomes over the next two quarters to be rather higher than was the case in June. There are two principal sources of that upward revision.

First, the last few months have seen a 6 or 7 percent depreciation of the trade-weighted exchange rate. The increased inflation now expected over the next two quarters is, in part, a direct consequence of that depreciation.

Secondly, domestic inflation continues to be strongly influenced by the policy decisions of the Government. We now estimate that, over the next two quarters, policy-related increases in Housing New Zealand rentals and tertiary education fees could well exceed the materiality threshold which is applied in determining our measure of underlying inflation. In that event, underlying inflation would be slightly lower than the estimates given in these *Projections*.

### **Policy implications**

We now view an MCI level of 725 as being appropriate for the next quarter. This is 100 basis points lower than the desired MCI level which has applied for the last quarter, but roughly equivalent to actual monetary conditions over recent weeks. You will recall that a 100 point reduction in the MCI is equivalent to a 1 percentage point decline in 90 day bill rates, a 2 percent decline in the TWI, or some equivalent combination. You may also recall that the average MCI for the December 1996 quarter was 1000. The extent of easing over the past nine months has clearly been significant, although certainly off a high base.

Our projections point to further, but quite small, easings in the first two quarters of 1998 before emerging inflationary pressures lead us to expect monetary conditions to enter

another tightening phase. However, as we make clear in our policy assessment section, whether those further easings eventuate in 1998 is very much dependent on how the economy develops over the next few months. Financial market participants eager to bring forward the small, and conditional, easings shown in these *Projections* clearly do so at their own risk! On the face of it, with inflation over the next two years, and especially over the next two quarters, being a little higher than we thought likely back in June, easing now by more than we foreshadowed in June may seem surprising. The explanation is straightforward, and relates to the lags inherent in the operation of monetary policy. While inflation is a little higher in the short term than we had previously expected, it is still well within our target range, and has been boosted by factors which should be essentially transitory, such as the impact of moving Housing NZ rentals to market. Of more relevance to the outlook in 18 months to two years' time is the margin of spare capacity in the economy. That now looks somewhat larger than it did previously, and warrants somewhat easier monetary conditions. Although activity will be accelerating through 1998, it is not until 1999 that the inflation pressures associated with strong growth begin to emerge. A gradual tightening of monetary conditions from mid-1998 fits with that profile.

There are, of course, alternative paths for monetary policy that could deliver inflation within our target range. As was discussed in June, one alternative path would involve more aggressive easing now, followed by earlier and more aggressive tightening next year. Another path would involve holding conditions relatively flat at about current levels until the latter part of 1998 before beginning a somewhat gentler tightening beyond that date. Inevitably, there is rather more art than science in selecting the best of these alternatives. What we have chosen reflects the risks that we see around us at present, and also reflects the benefits we see in providing a relatively smooth path for monetary conditions over time.

### **The mix of monetary conditions**

On numerous occasions over the past year or two, I have indicated that the particular mix of monetary conditions was unhelpful – that the exchange rate was too high, putting excessive pressure on exporters, and that interest rates remained too low to discourage borrowing for housing purposes, or to encourage increased domestic savings.

The past quarter has seen a substantial, and welcome, shift in the mix of monetary conditions in the direction we believed appropriate. The fall in the exchange rate will boost the incomes of exporters and those competing with imports, and will ultimately increase export volumes. The projected improvement in the current account balance reflects that. The increase in interest rates is also helpful, given the continuing pressures we have seen in the domestic or non-tradeables sector of the economy, and especially in real estate markets. There is no benefit to New Zealand in seeing real estate prices increase to a point where they become vulnerable to a sudden, and damaging, correction. (Anyone who has been observing events in South-East Asia over the past couple of months will be conscious of the enormous damage that can be inflicted in those circumstances. Our own experience post-1987 is also instructive in that regard.)

The shift in the mix of conditions, while substantial, has occurred in a manner which is fully consistent with our inflation target, and fully consistent with our use of an MCI in assessing the overall stance of monetary policy. It is certainly the case that the sharp

decline of the exchange rate will boost inflation to some degree in the short term. That is already apparent in our projections. But even with that increase, projected inflation remains well within our target range. And the increase in interest rates that has accompanied the exchange rate fall will work in the opposite direction, dampening inflation in the longer-term.

### **The MCI**

At the time when the exchange rate was declining, and interest rates were rising, we heard a good deal of criticism of our MCI. It was, it was claimed, too rigid; it was forcing up interest rates at a time when the economy was already in recession; it was based on a relationship between interest rates and the exchange rate which was no longer valid; and so on.

As I made clear in my speech to the Counties Kiwifruit Growers Association on 22 August, I regard those criticisms as ill-founded. I think the MCI structure has performed admirably over the past three months. In making that assessment, I think it is important to reflect on just how volatile international exchange rates have been over that period. Any of the alternative monetary policy arrangements we could have adopted in place of the MCI would also have been subject to a good deal of stress. I certainly see no reason to change the MCI approach at this point.

Likewise, the description I offered in June of how the Bank might react to deviations in actual market conditions from the central or 'desired' MCI track appears to us to have weathered the tests of the past quarter rather well. I see no reason to modify that description now, and our response to evolving market conditions over the next three months will be consistent with my comments of June.

### **Monetary conditions becoming too loose**

5 December 1997

“Overall monetary conditions have progressively eased over the last ten days or so, with few signs of an imminent reversal”, David Archer, Chief Manager of the Reserve Bank’s Financial Markets Department, said today.

“The overall extent of easing has been substantial. The greater the extent of loosening now, the greater the chance that we will have to act to tighten conditions when we release the Monetary Policy Statement on 16 December.”



