

MONETARY POLICY STATEMENT

SEPTEMBER 1990¹

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

Executive Summary

In passing the Reserve Bank of New Zealand Act 1989, Parliament instructed the Bank to direct monetary policy towards achieving price stability. The Act is based squarely on the weight of evidence that a stable price level is the only enduring contribution monetary policy can make to our economic well-being. Over the period covered by this Statement (mid-March to mid-August), in the face of some worsening in the inflation outlook, the Bank has continued to operate with the goal of stable prices firmly in mind.

Price pressures were particularly strong in the June quarter. Rapid increases in provincial house prices, and some large rises in government charges and local authority rates, contributed to a 1.8 per cent rise in the CPI. The strength of these short-run price pressures posed a risk of higher inflation expectations and wage claims. An easing in liquidity conditions, particularly over April and May, caused added concern. In response, and to reiterate the Bank's commitment to the price stability goal, the Bank undertook a series of operations in late May to firm conditions.

Some price reductions announced in the Budget reduced the short-run pressures on inflation, and effectively offset earlier one-off public sector price increases. However, financial markets' attention was focused on the projected future widening of the financial deficit. As a result, market reaction to the Budget was generally negative.

The underlying fiscal position evident in the Budget was disappointing to the financial markets, and appears to have given rise to new concerns about the direction of policy. Coming on top of existing doubts about economic policy developments after the election, this disquiet led to higher interest rates and a lower exchange rate. The need to maintain progress towards the price stability goal, and our concern at continuing high inflation expectations, led the Bank to firm conditions in response. In doing so, the Bank ensured that the increased market perceptions of the riskiness of New Zealand investments were reflected more fully in interest rates, rather than in a lower exchange rate, which would have threatened the inflation objective.

continued...

¹ Text and data finalised on 17 August 1990.

The impact on interest rates of the Budget and of the Bank's subsequent actions was rapidly overshadowed by the Iraqi invasion of Kuwait, and by the subsequent sharp rise in international oil prices. These price rises have already started to flow into New Zealand pump prices, and will continue to do so over the next few weeks and months. The international situation remains unstable, and it is not yet possible to determine, with any certainty, the overall economic impact, or the most appropriate economic policy response.

However, the Policy Targets Agreement clearly recognises that it is appropriate to allow first-round price effects from such a shock to feed into the general price level, **provided** that these price rises are not then reflected in higher wages. Accordingly, if oil prices remain at around current (mid-August) levels, then some increase in next year's indicative inflation range, to 3-5 per cent, is warranted. This range is consistent with the previous 1991 range, adjusted for an estimate of the oil-shock effect in the 1991 calendar year. In no sense will this change to the indicative range imply an easing of monetary policy. Indeed, conditions will need to be kept very firm to prevent any of the oil price effects flowing through into wage rises. The December 1992 target remains unchanged, given that the direct price effects of the current oil shock on quarterly inflation rates will be contained to within 1990 and 1991; so the effect will drop out of year-on-year inflation before the end of 1992.

But, oil prices aside, more progress in other areas is also needed to help reduce inflation. If price stability is to be secured at minimum economic and social cost, and if New Zealand is to compete successfully in world markets, then more productivity growth and further wage restraint are vital. Indeed, the impact of the oil shock on an already weak balance of payments position will now require even greater efforts to improve the cost competitiveness of New Zealand's export industries. To help redress the external balance, and to provide scope for reductions in the number of people unemployed, it is important that wage increases should not generally exceed the rate of productivity growth.

Wage restraint, however, is not the end of matter. Adjustments are also needed in the rest of the economy. After five years in which fiscal policy has made major strides towards bringing the Government's finances back into balance, the Bank was disappointed to observe the slippage evident in this year's Budget. The implications of that slippage have already been seen in higher interest rates. Price stability and the pursuit of fiscal balance are both vital parts of a balanced macroeconomic strategy. Although the hard choices facing governments pursuing fiscal balance in difficult economic times should not be understated, it is important to recognise that a supportive fiscal policy stance can minimise the degree of pressure on the economy from the real interest and exchange rates which are needed to achieve price stability.

Despite the adjustment costs of recent years, and the solid foundations which have already been laid, tough decisions still have to be made before the full fruits of a freer economy can be realised. But provided these decisions are made, the Bank is confident that the successful pursuit of a stable price level will reinforce the benefits of the many other economic reforms implemented in recent years, and help to provide an environment conducive to strong sustainable economic growth in the 1990s. There should be no doubt about the Bank's commitment to fulfilling its statutory objective of achieving price stability.

INTRODUCTION

Monetary policy has now been operating for six months under the formal framework laid down in the Reserve Bank of New Zealand Act 1989. In passing that Act, Parliament granted the Bank greater operating independence and instructed it to direct monetary policy towards achieving price stability. In the period covered by this Statement (mid-March to mid-August), the Bank has continued to operate with this goal firmly in mind. The Bank's assessment of monetary conditions and its subsequent actions have been governed by the terms of the Policy Targets Agreement signed between the Minister of Finance and the Governor in March 1990. That agreement requires the Bank to operate monetary policy to achieve year-on-year rises in the CPI of 0-2 per cent by December 1992.

It is of some concern, however, that, as more attention has focused on the role of the Reserve Bank, there have been renewed calls for monetary policy to deliver a range of economic and social objectives it cannot directly achieve. The Reserve Bank Act explicitly recognises that monetary policy cannot be all things to all people. The Act is based squarely on the weight of New Zealand and international evidence which suggests that price stability is the single most valuable contribution that monetary policy can make to New Zealand's economic and social welfare, and the only contribution which is likely to endure.

The economic and social benefits of price stability are significant. Providing individuals and firms with money that holds its value helps them to concentrate more effectively on generating real wealth and achieving real growth in jobs and incomes. No less importantly, price stability also ensures that the monetary system does not systematically discriminate against the less sophisticated groups in our society. By contrast, inflation distorts savings and investment decisions. People on fixed incomes are penalised, and arbitrary redistributions of wealth occur between savers and borrowers. The high nominal interest rates caused by high inflation constrain both households' and businesses' spending patterns even if real interest rates are not overly high. And the inevitable uncertainty in an inflationary environment reduces the quality of the economic decisions being made by individuals and businesses throughout the economy.²

Unfortunately, getting rid of inflation also has its costs. To some, the price appears unreasonably high. But the cumulative corrosive impact of inflation on the nation's wealth is significantly greater and, like many forms of corrosion, the magnitude of the costs of inflation is often not immediately visible. Moreover, the costs of achieving price stability are transitory. The Bank is confident that these transitory costs will be eclipsed by the long-term gains to the economy.

² Price stability does not mean, however, that individual prices cannot change: relative price changes are necessary in order to encourage the required movements of resources that are part of an efficiently operating dynamic market economy.

The Bank is committed to carrying out the task the Government has given it - achieving price stability. Our actions over recent months have been directed to that end. But short-term prospects for the economy would be much more favourable if both businesses and individuals started building inflation forecasts into their economic decisions which are more in line with the requirements of the Policy Targets Agreement. Businesses and householders can only benefit themselves by acting on correct assumptions about inflation. And by doing so, they will substantially lower the social and economic costs of achieving the inflation targets and help accelerate the speed of the economic recovery. Put simply, if wages and prices are being set using forecasts of inflation that are higher than the planned disinflation path, suppliers of those goods and services will be pricing themselves out of their markets and exacerbating existing imbalances within the economy. In those circumstances, added monetary policy pressure will be required to ensure that the inflation goals are met. That pressure on real interest and exchange rates will mean more factory closures and job losses.

Recent developments in inflation, the real economy, and the monetary indicators are reviewed in the next section of the Statement, along with an assessment of the Bank's monetary policy in relation to its objectives over the period since mid-March 1990. The remainder of the statement outlines the Bank's expectations regarding future inflation and monetary policy. Specifically, the Bank's assessment of the possible implications for monetary policy of the Middle East situation is outlined, and the possible challenges to monetary policy over the coming year are discussed.

RECENT DEVELOPMENTS

Economic Background

The economy has been weaker than we expected. The recovery in domestic economic activity appears to have continued, but since the September quarter of 1989 the pace has weakened. Spending rose sharply during 1989/90, but domestic production was relatively flat, as much of the increase in spending was directed towards imports. More recently, this imbalance has shown some signs of closing. Spending growth appears to have slowed, and there have also been some signs of a modest pick-up in domestic production.

Business confidence has fluctuated markedly over the last year. This variability has contributed to the hesitant nature of the recovery, and has occurred despite the improvement in the position of many individual businesses. Most major corporates appear to have returned solid profit results in the 1989/90 financial year, after a period of rationalisation and debt reduction. Many companies have been investing in equipment designed to cut costs and improve productivity. The introduction of this new technology has helped lift the efficiency and competitiveness of the productive sector. Unfortunately, although investment grew relatively strongly last year, this growth was heavily concentrated in specific sectors, and general investment intentions have remained relatively weak. In particular, there has been little sign of much investment being undertaken to expand capacity.

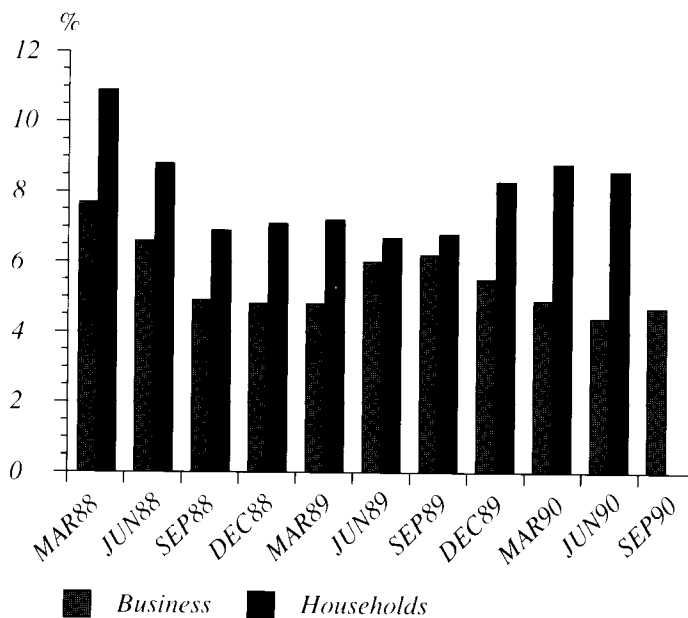
Household inflation expectations have remained disturbingly high this year. Over the

last six months, the falls have been very gradual and from a very high base: the Bank's survey showed that household expectations of year-ahead inflation eased only marginally from the 8.8 per cent peak in February, to 8.6 per cent in May. Business expectations of future inflation are much lower than those of households. The gap between the two sets of expectations has widened sharply over the last year, and has affected the pace and nature of the recovery. Businesses are facing high real interest rates, which acts to deter new investment plans. In contrast, the high inflation expectations in the household sector and the lower perceived real interest rates contributed to strong investment in housing over 1989/90.

Total retail sales have been relatively weak, but spending patterns have differed markedly across the various categories of consumer goods. In particular, continuing tariff reductions have led people to switch away from traditional consumer durables, like furniture, towards imported household appliances and electronic equipment. The most notable change was a big increase in spending on cars, following the drop in both new and used car prices. The regional pattern of demand has closely mirrored activity patterns: spending in Auckland and Wellington has been weak, but in other areas the recovery in demand has been underpinned by relatively buoyant rural incomes over the last year.

Figure 1

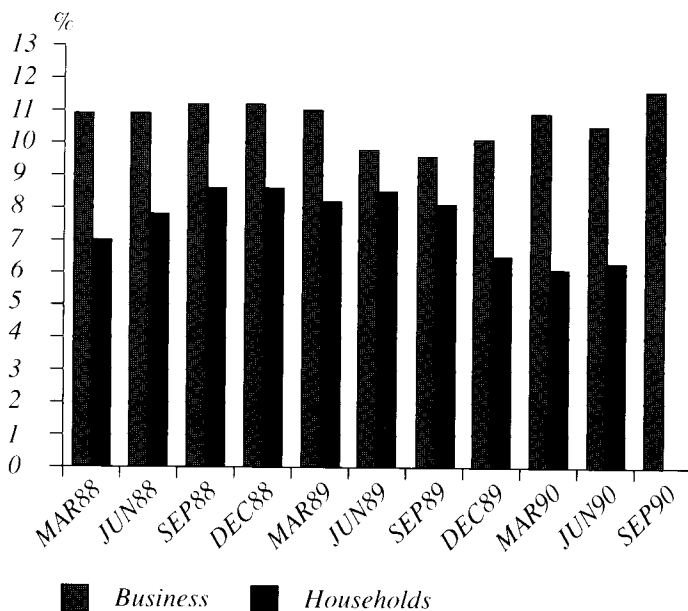
Year Ahead Inflation Expectations
Household and Business



Source: Reserve Bank Surveys

Figure 2

Real Interest Rates
Household and Business



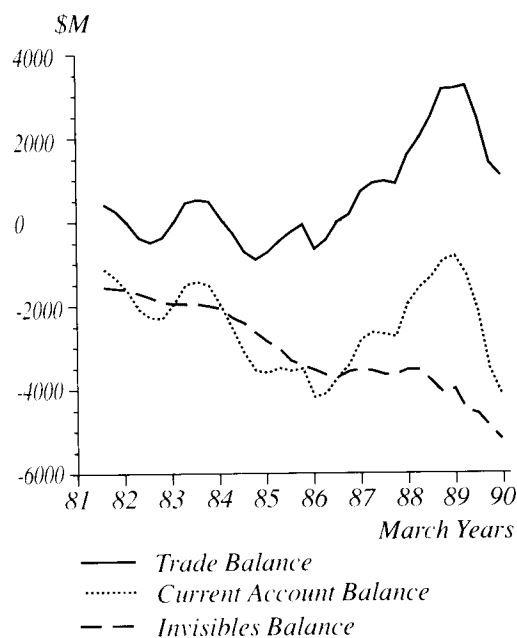
Calculated as base and mortgage lending rates less the year-ahead inflation expectations of businesses and households respectively as measured by Reserve Bank surveys

Relatively rapid investment growth last year and the changes in the composition of consumer spending led to a sharp rise in imports. The impact on the balance of payments current account deficit was exacerbated by a temporary reduction in agricultural export volumes, although strong commodity prices nevertheless ensured that total export receipts remained relatively high. Export volumes were adversely affected by the impact of the 1988/89 drought, stockpiling by the Wool Board, and the timing of several large dairy shipments. As a result, the current account deficit increased sharply. The deficit stood at \$4.1 billion in the year to March 1990, up from \$0.8 billion a year earlier. The deficit for the year to June is expected to have been of a similar magnitude.

Export volumes have been showing signs of recovering this year. The impact of the drought on the supply of agricultural commodities is passing, and there have also been signs of a recovery in forestry and manufacturing export volumes. But these improvements have tended to be offset by falling agricultural prices, most notably for wool and dairy products. Import growth appeared to slow sharply over the first half of 1990. Last year's high retail stock levels were winding down, some of the large investment projects requiring heavy capital imports have been completed, and some of the transitional effects of trade liberalisation appear to have worked through. The implications of the oil price shock for balance of payments prospects are discussed more extensively later in the Statement.

Figure 3

Balance of Payments



Source : Department of Statistics

Inflation

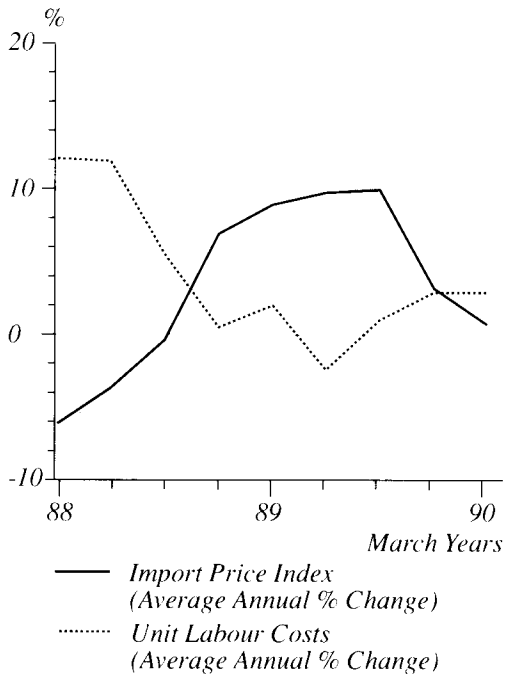
Economic activity has remained sluggish. But price pressures have not, unfortunately, been dormant. Indeed, inflation and the inflation outlook have clearly worsened since our last Statement, even though the Bank has maintained a firm monetary policy. The price level has continued to be buffeted by various, mostly adverse, shocks. For example, over the year to June 1990, the 2.5 percentage point increase in GST in July 1989, the unexpected strength in commodity prices throughout 1989, and continued reform of public sector pricing structures all placed unhelpful upward pressure on the measured CPI inflation rate. These shocks have distorted measured inflation rates and, by holding inflation expectations up, have made the job of monetary policy harder.

These factors have tended to hide the major gains that have been made in fighting inflation. Unit labour costs on average across the economy are rising by only around 2.5 per cent per annum. As foreign prices have been increasing at around 4.5 per cent per annum, it appears that New Zealand's base-line inflation is now running at around 4 per cent.

The CPI rose by 0.9 per cent in the March quarter, and followed the relatively positive 1.2 per cent increase in the December quarter of 1989. These moderate increases helped

Figure 4

Influences on Inflation



Source : RBNZ & Department of Statistics

Figure 5

Consumers Price Inflation
(Annual Percentage Changes)



1. Trade - weighted average of the inflation rates of Australia, Germany, Japan, United Kingdom and USA.

Source : RBNZ

INFLATION OUTCOMES

(% change)

	CPI			HAPI ¹		
	Qtly	Year-on-Year	(Excl GST)	Qtly	Year-on-Year	(Excl GST)
1988						
Dec.	1.2	4.7		2.1	6.7	
1989						
Mar.	1.1	4.0		0.9	5.9	
June	1.2	4.4		1.3	5.6	
Sep.	3.5	7.2	(5.5)	3.8	8.3	(6.6)
Dec.	1.2	7.2	(5.3)	1.2	7.2	(5.3)
1990						
Mar.	0.9	7.0	(5.0)	0.9	7.3	(5.3)
June	1.8	7.6	(5.5)	1.5	7.5	(5.4)

¹ Housing Adjusted Price Index.

THE HOUSING ADJUSTED PRICE INDEX

The Bank's price stability goal has been formally set in terms of the widely-used Consumers Price Index (CPI). This index attempts to measure the prices of goods and services currently being consumed by households. However, the CPI is not an entirely satisfactory measure of these prices, because it also includes the prices of some investment-type goods. This problem is most severe in respect of housing. The CPI employs a 'cash outlay' approach to home ownership: that is, it measures the purchase price of a house and the full cost of mortgage servicing. However, the bulk of these costs are more properly classed as investment spending. A house is a capital asset and a large proportion of mortgage servicing represents the repayment of capital (in inflation-adjusted terms). Only the real interest component of debt servicing costs is related to the **current consumption** of housing services. The Bank considers that the measurement approach used in the CPI is conceptually inappropriate in a consumption-based price index. It is an approach not used by most other OECD countries.

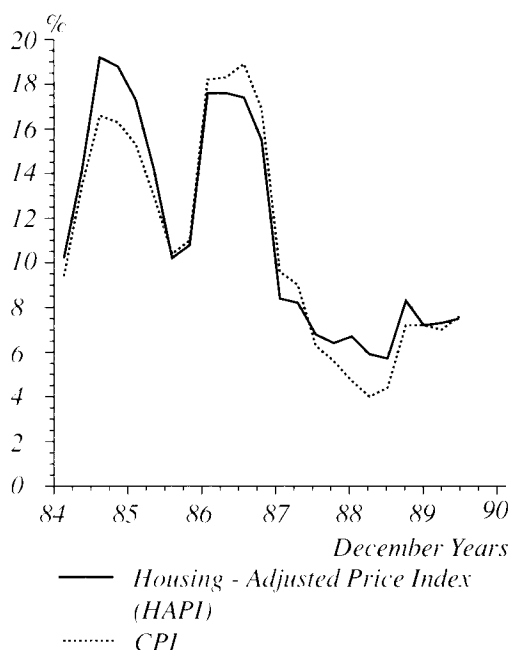
Accordingly, the Policy Targets Agreement of March 1990 required the Bank to develop and maintain an alternative index of consumption prices. In this Housing Adjusted Price Index (HAPI), the home ownership component of the CPI is replaced with a more satisfactory

economic measure of a homeowner's current cost of housing - the cost of living in one's own home, as measured by the rental the house could fetch if leased on the rental market.

Over the longer term the two measures of home ownership costs move similarly. But the short-run divergences which do occur can be significant in relation to the 0-2 per cent inflation target range set down in the Policy Targets Agreement. As a result, CPI inflation could easily be pushed outside the target range in a situation where a firming in policy - and hence an increase in mortgage rates - is required to dampen incipient inflationary pressures. To meet this difficulty, the Policy Targets Agreement allows for the targets to be renegotiated if the actual or expected annual inflation rates of the HAPI and CPI differ by half a percentage point or more in 1992 or 1993 (the years covered by the formal targets). This provision will ensure that the Bank does not face a perverse or ambiguous policy signal merely because the CPI measures the costs of homeownership inappropriately. It should be re-emphasised, however, that the official targets are defined in terms of the CPI. The HAPI simply provides additional information to help interpret inflationary developments and guard against inappropriate policy responses.

Figure 6

Two Measures of Consumer Price Inflation
(Annual Percentage Changes)



Source: RBNZ & Department of Statistics

confirm the exceptional nature of the 3.5 per cent increase in the September 1989 quarter. The March quarter CPI increase was the lowest since the September quarter of 1988 and lowered year-on-year CPI inflation slightly, from 7.2 per cent in December 1989 to 7.0 per cent in March 1990. Following that outcome, the Bank and most commentators were expecting inflation to continue easing over the year to December 1990, to reach around 4 per cent. Regrettably, that outcome is no longer in prospect.

Over the June quarter, further information came to hand on the size of several one-off public sector price rises. This information led to a significant increase in forecasts of 1990 inflation (particularly for the June quarter), and the persistent weakness in the exchange rate from early May onwards confirmed the deterioration.

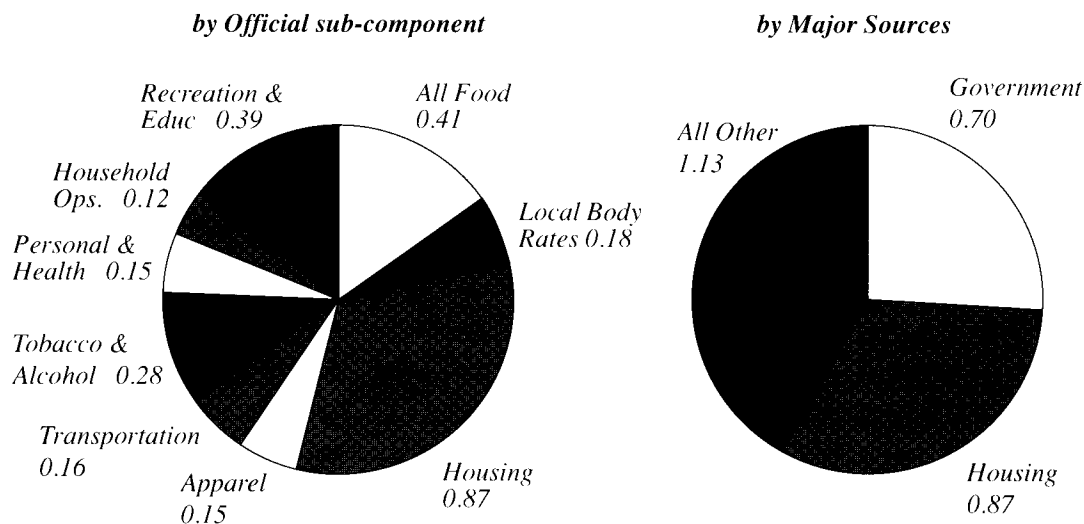
In fact, the CPI rose by 1.8 per cent in the June quarter, pushing year-on-year inflation up to 7.6 per cent. The 1.5 per cent increase in the Bank's new Housing Adjusted Price Index (HAPI) also contributed to a modest rise in the year-on-year rate of increase in this measure of inflation.

Housing and public sector price rises dominated the June quarter CPI outcome. House prices have been rising strongly, particularly in provincial areas. Other influences on the June quarter outcome included large increases in fruit and vegetable prices, and price rises for public transport.

Public sector sources account for approximately 0.5 percentage points of the June quarter increase in the CPI. Of these, the most important were higher-than-expected rises in local authority rates and increased tertiary education fees. Part of the local authority effect was purely statistical in nature, an aberration arising from the change to the local authorities' financial year. But even putting this factor aside, many local authority rate increases appear to have been out of line with the general climate of price restraint in the rest of the community. The public sector price increases were, of course, generally 'one-off' in nature. But they nevertheless posed risks to the disinflation

Figure 7

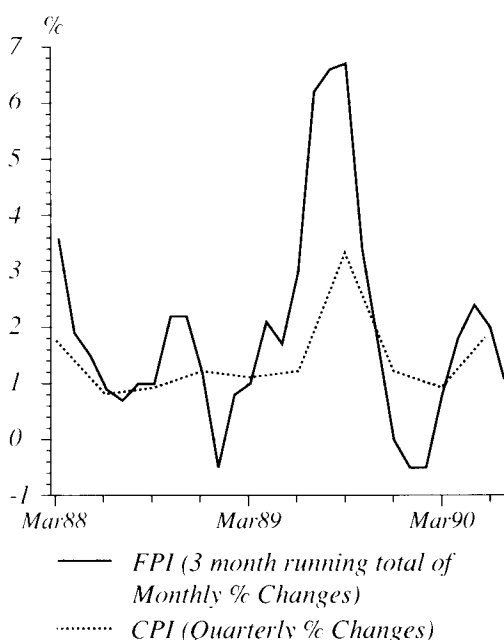
Breakdown of 2.7% Increase in CPI
In The March and June Quarters 1990 (Percentage Points)



Source: Department of Statistics & RBNZ

Figure 8

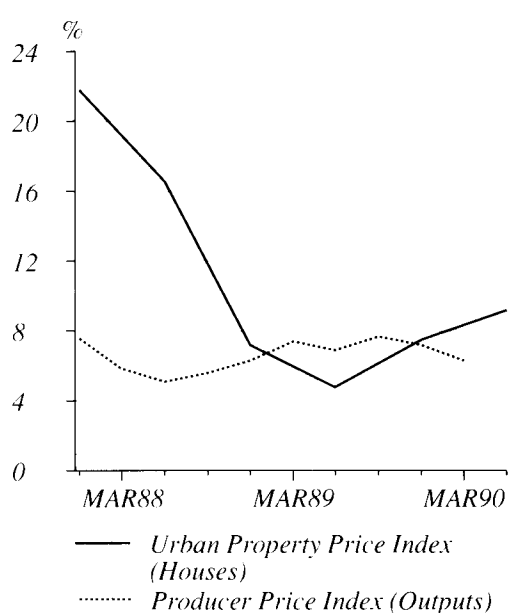
Consumer and Food Price Inflation



Source : RBNZ

Figure 9

Influences on Inflation
(Annual % Changes)



Source : Department of Statistics

strategy. In particular, the resulting increase in inflation risked holding up inflation expectations, and feeding into higher wage settlements.

Monetary Developments and Monetary Policy

The operation of monetary policy is governed by the terms of the Policy Targets Agreement: More specifically, the Bank has been continually assessing the consistency of monetary conditions with the disinflation track set out in the first Monetary Policy Statement released in April. That track has placed a more formal discipline on the Bank's interpretation of the monetary indicators, and has provided a useful standard against which to measure the appropriateness of the stance of policy.

The 90 day-5 year yield gap - one of the Bank's major monetary indicators - narrowed from 1.8 percentage points in mid-February to a low of 1.1 percentage points by early May. A major factor was the 0.4 percentage point fall in the 90 day bank bill rate from a peak of 13.9 per cent in mid-February. Relevant influences included a relatively stable and evenly distributed cash market, an improvement in inflation sentiment following the December and March inflation outcomes, and an easing in Australian short-term interest rates.

Five year bond rates, on the other hand, firmed from around 12 per cent in early March to a peak of 12.4 per cent in early May. Although inflation outcomes had been favourable, any impact on bond rates appears to have been offset by other factors. Specifically, the risk premium on New Zealand dollar investments was probably rising because of the deterioration in the balance of payments. And New Zealand bond rates were also being influenced by the rise in many overseas bond rates, which had

commenced in August 1989 and continued until mid-1990. Given these pressures, the rise in New Zealand bond rates over the first half of the year was relatively modest.

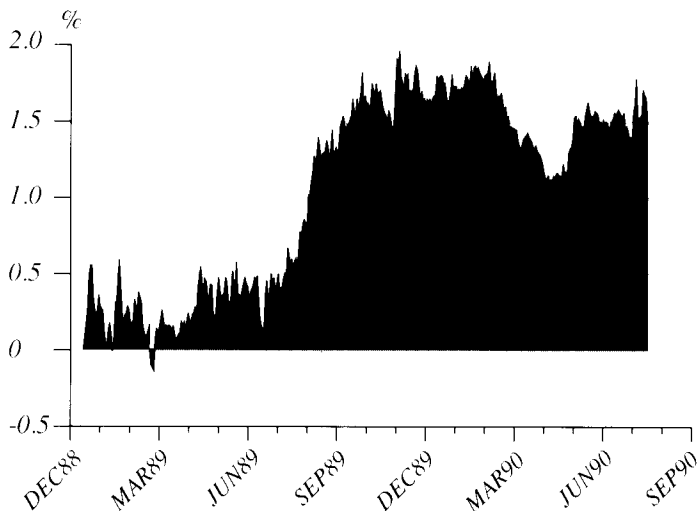
Although the yield gap had been narrowing since February, this did not initially cause the Bank any concern. At the time, the short-term inflation outlook still appeared relatively favourable, and the stable exchange rate - the other major indicator - tended to reinforce this view. After some initial softening in February, the exchange rate had firmed to a peak of 62.2 on the trade-weighted index (TWI) by mid-March and then continued trading in a range of 61-62 until early May.

However, the interpretation placed on various comments by the Governor and the Minister of Finance in late April and early May about exchange rate policy contributed to a 2.5 per cent drop in the exchange rate, to 59.5 on the TWI by mid-May. Relatively easy liquidity conditions in the short-term cash market helped facilitate the fall. The combination of these events led some in the financial markets to believe that policy had been eased.

These factors prompted a reassessment in mid-May of the degree of downward pressure being imposed on inflation. The Bank's forecast of the inflation rate for 1990 had also been revised up. Although that forecast was still narrowly within the 3-5 per cent indicative range for 1990, the significant increase was considered to pose a threat to the slowly-emerging confidence that underlying inflation was falling. That in turn increased the risk that inflation expectations and wage settlements would remain high. Accordingly, the Bank signalled its unease at developments through a series of

Figure 10

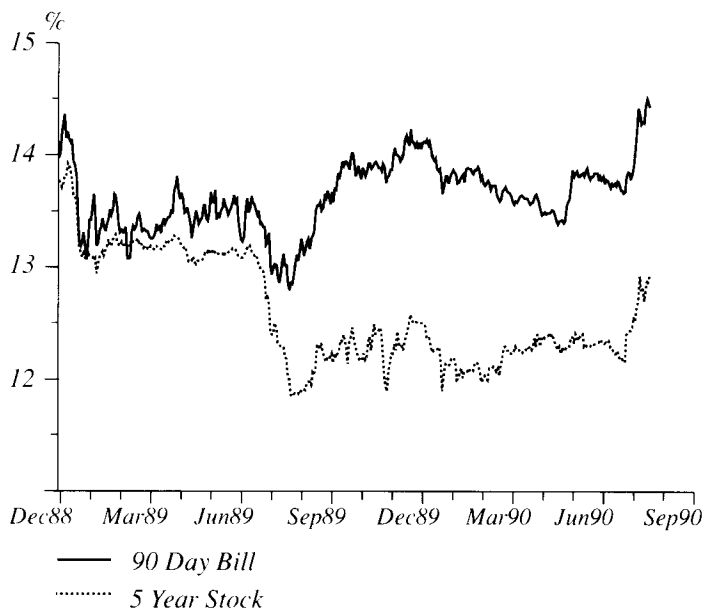
Yield Gap
(between 90 day bank bills and 5 year government stock rates)



Source : RBNZ

Figure 11

Interest Rates



Source : RBNZ

operations over the last ten days of May. These actions were designed to tighten monetary conditions and, more importantly, to publicly reaffirm the Bank's commitment to the price stability objective.

The 90 day bank bill rate quickly rose to average over 13.8 per cent for the month of June. The exchange rate continued to firm over June to a peak of 61.0, before gyrations in the major currencies and some slight easing in domestic interest rates eroded most of the earlier gains in the TWI by mid-July. The 90 day bank bill rate on the other hand continued to trade in a relatively narrow 13.7 to 13.9 per cent range until optimism ahead of the Budget prompted a slight easing in rates to a low of around 13.6 per cent. As expected, the announcement of the June quarter CPI a week before the Budget prompted little or no market reaction.

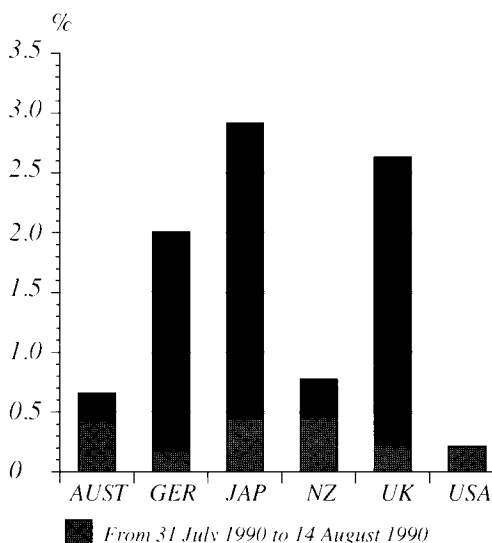
Financial market reaction to the Budget, however, was generally negative. Concerns focused, in particular, on the use of the proceeds from the sale of forestry cutting rights as the means of achieving the \$89 million financial surplus for 1990/91, on the less-than-expected volume of debt repayment, and on the large projected financial deficits for future years. Bond rates rose to 12.4 per cent, more than reversing the fall in the run-up to the Budget which had taken the five year rate to a low of around 12.1 per cent. Ninety day rates also firmed back to around 13.8 per cent.

Various Budget decisions (including reduced doctors' fees and lower excise duty on cars) had improved the short-run CPI inflation outlook. However, financial market participants were concerned about the medium-term consequences of the relaxation in fiscal policy which was implicit in the Budget, and about the perceived difficulty of closing the gap next year. Greater volumes of debt sales could be expected, and more of the burden of adjustment would then have to be carried by monetary policy. Investors have also had continuing doubts about the prospects for developments in fiscal and monetary policy after the election. The heightened uncertainty about the future direction of economic policy fed quickly into a renewed weakening in the exchange rate. The TWI fell to a low of around 59.6 at the end of July, and most reports pointed to the likelihood of further falls.

Because of the implications for the inflation objective of a falling exchange rate, the Bank considered it important that the impact of increased concerns about the riskiness of New Zealand dollar investments should be reflected more fully in interest rates rather than in the exchange rate. The Bank also remained concerned about underlying inflationary pressures arising from high inflation expectations. Accordingly, action was taken to firm conditions in early August. Following an initial signal on 1 August, the Bank issued a clear statement of its intention to maintain downward pressure on

Figure 12

Change in Bond Rates of Various Countries
August 1989 to 14 August 1990



Note: The rise in USA bond rates over the entire period since August 1989 was 17 basis points, less than the increase during August 1990.

Source : RBNZ

inflation, and followed that up with a further action on 3 August. The Bank's aim was to send a clear message to both the financial markets and to the public that the Bank is committed to delivering price stability, and to do what it could to put to rest doubts about the direction of policy.

However, the markets' response to the Bank's first action was quickly caught up in the international maelstrom. The Iraqi invasion of Kuwait and the subsequent escalation of tensions in the Middle East led to sharp sell-offs in many sharemarkets and to a firming in world bond rates by around 0.3-0.4 percentage points over the first few days of August.

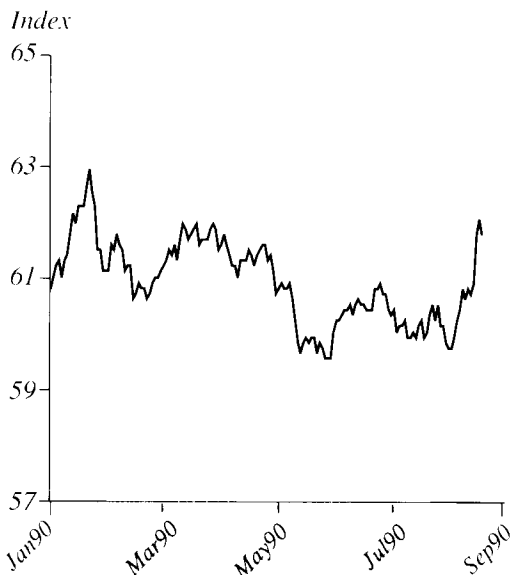
Overseas short rates have been relatively flat since the crisis began, but New Zealand 90 day rates have risen to a peak of around 14.65 per cent. It appears therefore that the Bank's actions in early August added around 0.7-0.8 percentage points to 90 day rates. Despite the initial upward pressure that higher short-term rates would normally place on bond yields, our bond yields have risen broadly in line with world rates over the first half of August, reaching almost 13 per cent on 17 August. Meanwhile, amid volatile international trading, the exchange rate has firmed significantly, reaching a peak of around 62.3 on the TWI on 15 August, before easing slightly to around 62. The sharp increase in the gap between New Zealand and Australian short-term yields following the Bank's actions in early August, and the easing of Australian monetary policy on 2 August, appears to have attracted considerable Asian investment into the short end of the New Zealand market.

The Bank has continued to monitor closely the money and credit aggregates. The rapid growth in Private Sector Credit since mid-1989 has been the most notable feature of the aggregates. PSC growth reached a peak of 14.6 per cent in the year to May, before easing back slightly to around 14 per cent in the year to June. The pace of growth has given rise to some unease, although, because of the weak empirical support for the use of short-term developments in the aggregates as monetary indicators, the Bank has been careful not to place undue reliance on this trend, particularly as the broader credit aggregate, Domestic Credit, has been growing more slowly.

Until March, PSC growth had clearly been driven by strong growth in household borrowing. The reorientation of banking business in the last two years towards the household market prompted a sharp rise in mortgage lending (up 36 per cent in the year to March 1990). This lending has helped stimulate significant house price growth in many regions (although, of course, mortgage finance is now being widely used for more than simply housing purposes). This growth in lending to households has had both supply and demand explanations. Banks have become keener to lend to households because of the requirements of the new capital adequacy regime³, and in reaction to the large losses sustained on corporate lending in the aftermath of the 1987 sharemarket

Figure 13

Nominal Exchange Rate
(daily Reserve Bank trade - weighted index)
(June 1979 = 100)



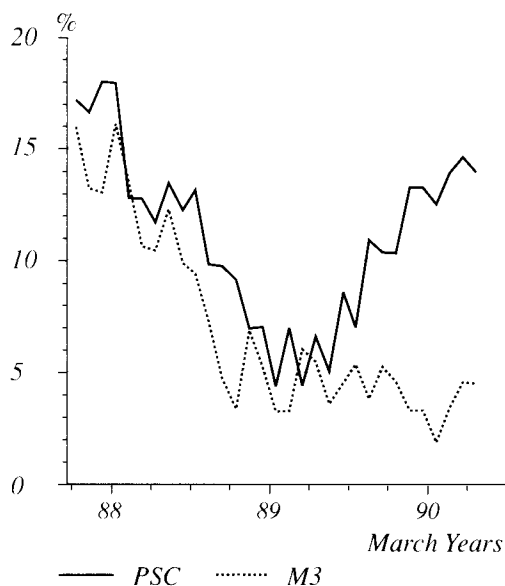
Source : RBNZ

crash. On the other hand, households' strong demand for credit reflected, in part, their continuing high inflation expectations and, by implication, the lower real cost of borrowing funds they saw themselves as facing. Latest reports and statistics suggest, however, that household credit demand has eased in recent months, particularly following the Bank's actions in late-May, and that this slowdown has been offset, in part by an upturn in corporate borrowing. The rise in mortgage rates in early August and the uncertain international environment should further slow household credit demand over coming quarters.

There has also been some increase in the money supply growth rate during the June quarter. After falling to a record low of 0.3 per cent growth in the year to February 1990, year-on-year M3 growth accelerated to 1.9 per cent in the year to March and then increased further to 4.5 per cent in the

Figure 14

M3 and PSC
(Annual Percentage Changes)



Source: RBNZ

MONETARY INDICATORS

	90 Day ¹ Bank Bill Yield (%)	5 Year ¹ Govt Stock Yield (%)	Yield ^{1,2} Gap (%)	Exchange ^{1,3} Rate	M3 Annual % Changes ⁴	Private Sector Credit
1988						
Sep.	14.6	13.0	1.7	64.4	9.4	13.2
Dec.	14.4	13.4	0.9	60.6	3.4	9.2
1989						
Mar.	13.5	13.3	0.2	59.8	3.3	4.4
June	13.5	13.1	0.3	61.1	5.5	6.7
Sep.	13.3	12.4	0.9	60.9	5.4	7.1
Dec.	13.9	12.3	1.6	60.8	4.6	10.4
1990						
Mar.	13.8	12.1	1.7	61.6	1.9	12.6
June	13.6	12.3	1.3	60.7	4.5	14.0
Sep. (to 15 Aug)	13.9	12.4	1.5	60.5	-	-

1 Quarterly averages of daily observations.

2 Gap between yields on 90-day bills and 5-year government stock.

3 Daily trade-weighted index (June 1979=100).

4 At end of period.

3 Under the new capital adequacy requirements for banks, residential mortgage lending must be supported by only half as much capital as business lending.

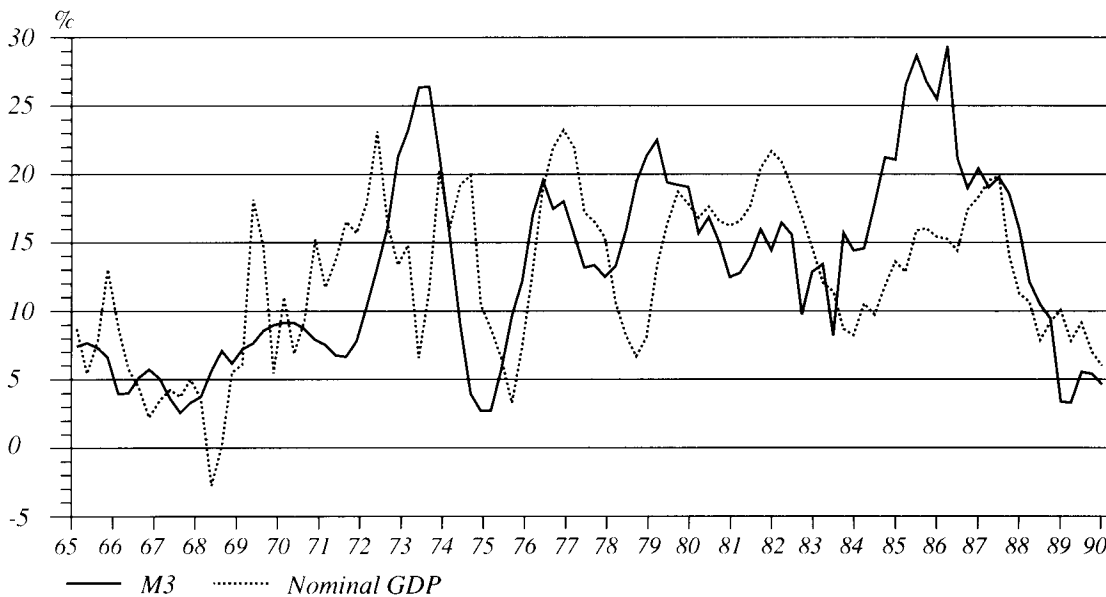
year to June. This pick-up in year-on-year growth has been driven by four successive seasonally adjusted monthly increases of over 1 per cent. Given the low base, not too much weight should be put on this pick-up. It appears to signify a return to more normal growth rates following a number of technical shifts in the funding patterns of some banks between New Zealand dollar liabilities (which are in M3) and foreign currency liabilities (which are not).

THE ROLE OF MONEY AND CREDIT IN THE INDICATOR FRAMEWORK

Since the mid-1980s, most countries have operated what is known as a 'checklist' approach to monetary policy. Under this approach, central banks monitor a wide range of prices (interest and exchange rates) and quantities (money and credit aggregates). This information is used to ensure that the stance of monetary policy remains consistent with achieving whatever goals are set for it. In preference to focusing exclusively on any one indicator, e.g. a measure of the money supply, the 'checklist' approach has been adopted in New Zealand throughout the entire post-1984 period. During this time, however, the relative weights attached to each of the indicators have varied.

Figure 15

Nominal GDP and M3
Year-on-Year Percentage Changes



Source : RBNZ

Continued

Recently, the Bank has come in for some criticism regarding its approach to the conduct of monetary policy. Some commentators have called for the Bank to de-emphasise the exchange rate and the level and term structure of interest rates - the main indicators in the checklist - and to focus instead on one or more of the monetary and credit aggregates. One suggestion was that the Bank should simply fix the level (or growth rate) of Primary Liquidity (PL), and then leave the market to sort out the resulting mix of interest and exchange rates.

The critics argue that quantity targets are inherently superior, in the sense of representing a more 'free market' approach, than a policy focusing on interest rates and the exchange rate as the main indicators of monetary conditions. They also argue that the costs of getting inflation down - particularly the costs to the traded goods sector - can be significantly reduced by using a monetary targets approach.

The Bank strongly rejects these views. Monetary policy is, by its very nature, an intervention; there is no such thing as a non-interventionist monetary policy. Focusing on a price, such as an interest rate or the exchange rate, is, in principle, simply the obverse of focusing on the quantity to which that price applies. For example, any Reserve Bank action to reduce the quantity of PL will tend to raise interest rates, while a move to raise real interest rates would generally require some alteration to the supply of PL.

Moreover, any policy pressure, whether guided by the monetary base, interest rates, the exchange rate, or M3, will put pressure on real interest and exchange rates, which in turn will affect the more exposed sectors of the economy. In this respect, the impact of any particular stance of monetary policy depends on the characteristics of the economy - not on the chosen framework of monetary policy indicators.

The choice of whether to pay most attention to the quantity of money and credit or to financial prices must therefore be made on the basis of the empirical evidence. Paying most attention to one or more of the money or credit aggregates is valid only if a stable relationship exists between the aggregates and national income or inflation.

The empirical evidence simply does not support the case for a policy based on quantity targets. Over the last few years the Bank has conducted several studies to assess the potential usefulness of the monetary and credit aggregates. The most favourable result pointed to the existence of a reasonably stable long-term historical relationship between M3 and national income. But this relationship did not hold over the shorter-term horizons over which policy is actually implemented. Operating a policy based on an M3 target would therefore be likely to generate considerable short-term interest rate and exchange rate volatility - i.e. on a week-to-week and month-to-month basis. Past experience suggests that such volatility would not be widely welcomed.

By contrast to the quantity indicators, the exchange rate is closely linked to prices and inflation, and the level and term structure of interest rates are relatively closely linked to the exchange rate. Furthermore, the exchange rate and the interest rate yield gap have also proved to be reasonably reliable indicators of the degree of monetary pressure on domestic demand. As a result, these two variables have proved their worth as indicators of monetary conditions and the inflation outlook. The Bank's

Continued

monetary policy operating regime is able to exert a timely and relatively consistent influence on these variables. In so doing, the Bank can transmit monetary policy signals throughout the economy more effectively in the current environment than by relying on one or more of the money and credit aggregates to guide policy.

Nevertheless, the Bank continues to monitor the monetary and credit aggregates and to conduct research in the area. Money and credit creation are clearly linked to the process of inflation and so cannot and should not be disregarded in the operation of monetary policy. Any additional relevant information from any source is a welcome input to the monetary policy decision-making process. As stated in our April Monetary Policy Statement, significant movements in the growth rates of all or most of the monetary and credit aggregates would certainly be a factor accorded due weight in the assessment of monetary conditions.

TOWARDS PRICE STABILITY

The Bank has been implementing monetary policy with the aim of achieving the 3-5 per cent indicative inflation range specified in the last Monetary Policy Statement. Achieving this goal was intended to be the first step along a path of steady reductions in the inflation rate towards the ultimate 1992 objective. However, the Middle East crisis has given rise to a new set of circumstances which may significantly alter the transitional path towards price stability. The oil price shock is one of three major areas of concern which will bear on monetary policy and the pursuit of price stability.

Nevertheless, it is important that the favourable factors already in place should not be overlooked. The impact of the 1989 GST increase will drop out of year-on-year inflation figures in the September 1990 quarter, lowering the twelve-month inflation rate to around 5 per cent. Moreover, lower doctors' fees and car prices are among the direct budgetary effects expected to lower the CPI by around 0.5 percentage points this year. These price reductions will offset the direct price effects of higher mortgage interest rates. Early indications of slowing household credit demand should be reinforced by the impact of the recent rise in mortgage rates. Together with the likelihood of some fall in household inflation expectations as the year-on-year inflation rate falls, a significant reduction in the rapid rate of house price inflation experienced over the last year should occur. These factors, and the Bank's commitment to a continuing firm policy stance, suggest that, putting aside the Middle East crisis, a fall in the underlying inflation rate from around 4-4.5 per cent in 1990 to around 3 per cent in 1991 remains a reasonable prospect.

Impact of the Oil Price Shock

Iraqi threats to Kuwait in the run-up to the OPEC Council meeting on 26 July, the invasion on 2 August, and the subsequent international military standoff, have pushed oil prices up sharply. From around US\$13-15 per barrel in May and June, the price of Dubai crude (the benchmark price most relevant to New Zealand) rose to a peak of around US\$27 per barrel in early August before settling back to around US\$23 per barrel by mid-August.

As a result, it is now clear that unless there is an early peaceful resolution to the crisis, New Zealand's monetary policy, the course of inflation, and the degree of pressure being imposed on the real economy over the next year or two will be influenced critically by the developments in the Middle East, and by the response of wagesetters to those developments. The price of oil has risen substantially, and, if current prices persist, the rise will have a significant impact on the domestic price level.

Given the degree of uncertainty in the international environment, it is clearly not yet possible to be definitive about the most appropriate monetary policy response to the events of recent weeks. However, it is important for the Bank to outline its views on the issues as they stand, and on the ways in which the Bank is likely to respond in certain circumstances, to help ensure that wage and price setting behaviour remains consistent with the inflation objectives.

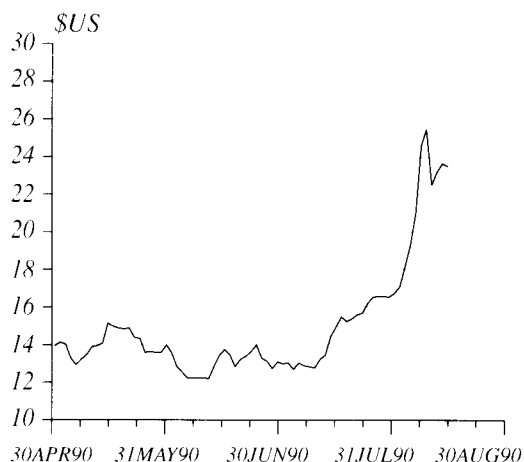
It is, of course, far from clear where oil prices will finally settle. One possibility is presumably that the production of other countries will be increased significantly to counter the loss of Iraqi and Kuwaiti production. In the absence of armed conflict, such an outcome could allow prices to drift further back over the coming months, perhaps to around or slightly below the prices agreed at the OPEC council meeting in late July. On the other hand, an escalation of conflict cannot be ruled out. Such an outcome would almost certainly lead to further losses of production and production facilities, and could take prices to US\$30 per barrel or higher. However, for the moment at least, the discussion will continue on the basis of the best information available at present - the current price of around US\$23 per barrel (as at mid-August).

From the Bank's perspective, as the agency responsible for monetary policy and the control of inflation, the most important effect of the higher oil prices is the impact on the general price level and inflation. (Other economic impacts are discussed briefly later.) Oil prices affect the price level in a number of ways. Most obviously, the higher cost of imported crude oil will flow fairly quickly into pump prices for petrol: we assume here the historical relationship of a little over one New Zealand cent per litre rise in petrol prices per US\$1 per barrel rise in the price of crude oil. The prices of transport services are then also likely to rise fairly quickly. The less obvious effects will occur as higher petrol and transport costs, and higher overseas inflation, feed into price rises throughout the economy. The extent of price rises for individual goods will depend on the degree of direct and indirect reliance on petroleum products.

The impact of the oil price rises cannot be determined precisely in advance. However, the results of Reserve Bank research suggest that a 10 per cent rise in the price of crude oil will add about 0.3 per cent to the general price level over a period of about a year.

Figure 16

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



Source : RBNZ

Thus, if current crude prices were to be sustained, the implied 60 per cent price rise could boost the New Zealand price level by around 1.8 per cent. This estimate is consistent with those published to date for other similar economies (including Australia, the United Kingdom, and the United States) and for the entire OECD group of countries.

This estimated price effect includes the direct influence of transport costs and the indirect impact arising from higher intermediate input costs. It excludes any of the type of second round effects caused by higher wages and a lower exchange rate that were such a significant part of the total price response in New Zealand to the oil shocks of the 1970s. Just as these second round effects varied substantially between countries in the 1970s depending on domestic policy responses, so too the second round effects of the current shock will depend crucially on the response of the monetary authorities.

The Bank's views on the issue were outlined in some detail in our previous Monetary Policy Statement. That passage bears repeating.

Consider, for example, a doubling in the price of oil. It may be technically feasible for the Reserve Bank to tighten monetary policy immediately, pushing up the exchange rate sufficiently to lower the prices of other traded goods, and eventually to lower domestic nominal wage rates enough to leave the overall price level unchanged. But an attempt to maintain the price level constant over the short-run in the face of such a shock would be likely to engender real costs, in terms of lost output and rises in unemployment, that would be out of all proportion to the benefits of short-run price stability.

The necessary adjustment to such a change in relative prices could, at times, be unduly hampered if some of the adjustment was not able to take place through a change in the aggregate price level. However, in allowing a one-off increase in the price level, policy would also have to be kept sufficiently firm to prevent any resurgence in inflation expectations or any pass-through into higher wage increases, so that the underlying trend in inflation is not affected. In the face of such a shock, it would generally be important to get inflation back onto the trend path within 12-18 months of the shock.

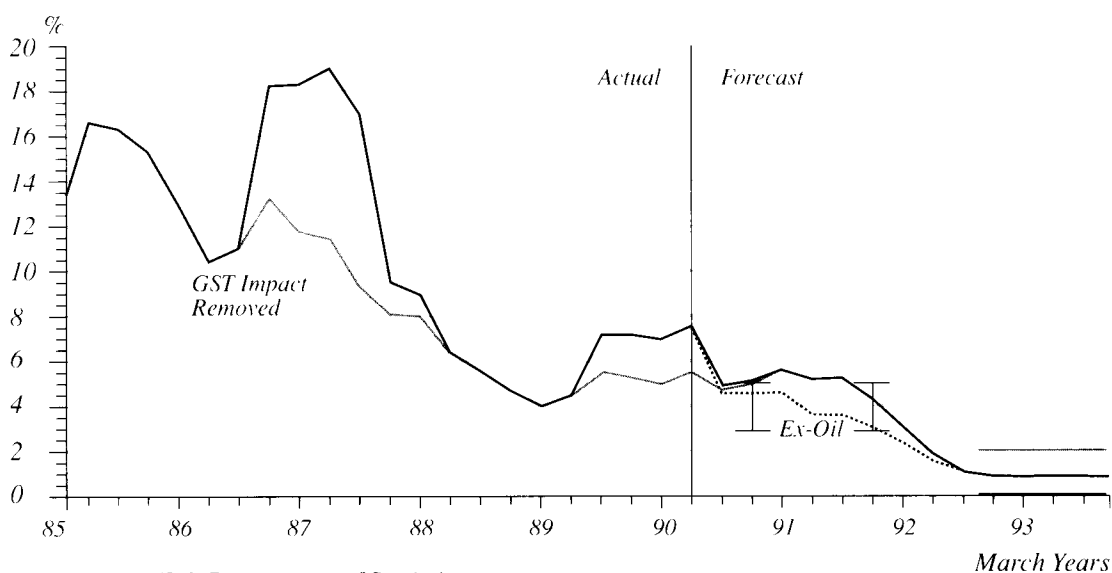
Simply put, the Bank believes that the price effects arising from the oil shock should be allowed to feed into an increase in the general level of prices **provided** that those price rises do not in turn feed into higher inflation expectations and higher wage settlements. If the oil price shock is sustained, New Zealand has become a relatively poorer country and, as nothing countervailing has happened to improve our competitiveness or productivity, there are no grounds for compensatory wage increases.

The extract above was originally written in the context of a discussion of the caveat provision which allows the policy targets to be renegotiated when "a significant change in the terms of trade arising from an increase or decrease in either export prices or import prices...will have a significant direct impact on the 1992 or 1993 annual inflation rate". However, there are no grounds for formally invoking this caveat in this instance. The Bank's forecasts indicate that the entire direct impact of the current shock will have dropped out of the quarterly CPI inflation rates by December 1991, and out of the year-on-year inflation rate before December 1992.

But equally clearly, there are implications for the Bank's indicative inflation track. In the April Statement the Bank projected that the CPI inflation rate would be in the 3-5 per cent range for the year to December 1990, and in the 1.5-3.5 per cent range for the year to December 1991, before dropping to within the target 0-2 per cent range by the year

Figure 17

Consumers Price Inflation
(Annual Percentage Changes)



Source : RBNZ & Department of Statistics

to December 1992. In the circumstances, the policy stance outlined above means that, if current oil prices persist, it will be neither sensible nor appropriate to stick to the current indicative inflation track. However, it is equally clear that the one-off nature of the oil price rise means that higher measured inflation rates over the coming 12-18 months can still be consistent with the achievement of the 0-2 per cent target in 1992.

If current oil prices persist, the Bank is now picking that the 1990 inflation rate will be around 0.6 per cent higher than previously forecast, at around 5.2 per cent. This outcome would be slightly outside the 1990 indicative inflation range, but, leaving aside the oil price shock, should represent clear evidence of the Bank's commitment to achieving the targets set for it.

For next year, if current oil prices persist, the Bank expects a further additional CPI effect of around 1.2 per cent. In these circumstances, it is appropriate to modify the present indicative range, raising it by around the estimated size of the impact, to 3-5 per cent. Achieving that range will be consistent with lowering underlying inflation from around 4-4.5 per cent this year to around 3 per cent next year. But success on that front, and the creation of a climate which will ensure the minimum cost achievement of price stability the following year, poses a major challenge to monetary policy.

In one sense, of course, there are simple solutions. Over recent years the Reserve Bank has demonstrated that it is serious about disinflation and the pursuit of the price stability objective. Along the way the Bank has continually urged people to recognise this commitment and plan their economic transactions accordingly. The message, however, has been slow to get through, and real costs have been incurred during the disinflation

period. Following the oil shock it is all the more important that people recognise the Bank's continuing commitment to price stability. If this commitment is recognised, and if people are willing to acknowledge the lessons of 1973 and 1979 - that oil shocks are adverse external events which we cannot compensate ourselves for by attempting to give everyone a bigger slice of a slightly smaller cake - then the magnitude of the task facing monetary policy will be reduced, allowing the first round effects of the shock to be accommodated comfortably.

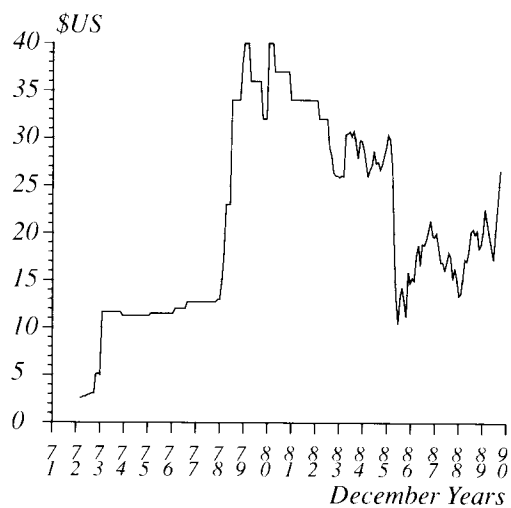
But experience does not leave us overly sanguine. In the absence of such restrained wage and price setting behaviour, there are two alternatives: either the price stability goal is deferred or abandoned, or a sufficiently firm monetary stance is maintained to ensure that adequate wage and price restraint is achieved. If the real costs to the economy of higher oil prices are ignored and second-round wage and cost pressures occur, then further pressure on real interest and exchange rates will be an inevitable outcome, contributing directly to further losses of output and employment.

One of the important lessons of the 1973-74 and 1979 oil shocks was that the countries which took their 'medicine' first and adopted sufficiently firm policy measures to ensure that oil price effects were one-off and shortlived, not only emerged from the adjustment earliest but also generally emerged strongest. Notable examples include Japan, Switzerland, and West Germany. By contrast, countries which sought to put off the adjustment, including Australia, the United Kingdom, and especially New Zealand, have spent much of the last 15 years trying to deal with the consequences of that approach. There are no soft options for policymakers in responding to an oil shock: a country can take the necessary 'medicine' of economic adjustment earlier or later, but unless its citizens are willing to recognise the true nature of the shock and act accordingly then there will be economic pain at some point. Moreover, some claims to the contrary notwithstanding, it is not the case that weak economies can legitimately take the adjustment more slowly: in fact, weaker economies with a poor track record have less leeway. Such countries have less of a buffer to cushion the necessary adjustment and a greater need to demonstrate their commitment to orthodox solutions for effectively adjusting to shocks.

The implications for the New Zealand economy of the oil price shock do not, however, stop with prices. Our annual import bill will be some 250-300 million dollars higher, placing more pressure on the current account of the balance of payments. Our trade with Iraq and Kuwait is small, and this means that the direct impact of the international sanctions on our exports will be limited. The indirect effects are not easy to disentangle. Oil producers with whom New Zealand trades - including the Soviet Union, Mexico, and Iran - will be better placed to purchase our exports. However, it is unlikely that these gains will offset the impact of the general slowdown in world economic activity which is likely as higher input prices and counterinflationary monetary policies slow activity

Figure 18

Oil Prices
UK Brent Crude Oil
US\$ Price per Barrel



Source: Equitinet

in the major western economies. Moreover, the international uncertainty, and the impact of higher domestic interest rates, can be expected to act as a further dampener on investment confidence, except perhaps in the energy sector. The only positive feature is that a weaker economy will help to contain balance of payments and domestic inflationary pressures. Overall, it seems inevitable that the oil price shock will slow New Zealand's gradual economic recovery further.

Productivity, Labour Costs, and Competitiveness

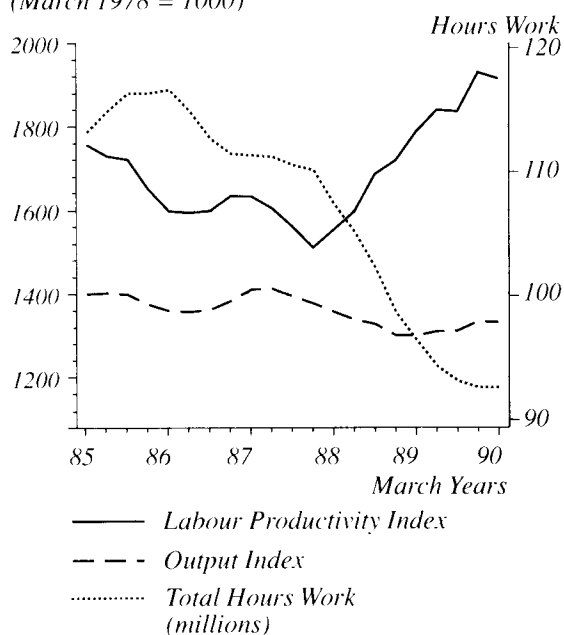
The second major area of concern which will impinge on monetary policy is developments in domestic goods and labour markets. In particular, trends in unit labour costs will critically influence the future cost of lowering inflation, the extent of New Zealand's international competitiveness, and our ability to close the gaping balance of payments deficit without persistently frustrating the nation's growth and employment aspirations.

Significant productivity gains have been achieved in the New Zealand economy over the last few years. The pressures imposed by trade liberalisation, domestic deregulation, and disinflation have reaped a rich harvest in that respect, as all manner of organisations have reassessed the ways they operate and generally achieved marked efficiency gains. Some of these gains have come from the application of new technologies, but most of the gains over 1988/89 in particular have stemmed directly from labour-shedding. As labour-shedding has eased, the rate of productivity growth also appears to have eased over the last year or so. Nevertheless, unit labour costs still appear to be growing at only around 2.5 per cent per annum. As unit labour costs have run well below the inflation rate over the last couple of years, firms in those industries which have remained viable after restructuring and liberalisation have been able to re-establish reasonable profit records; the first step towards new investment for future growth.

By comparison with our historical experience, labour productivity is still expected to continue increasing relatively strongly in the short term. The continuing restructuring in both private and public sectors, and the continuing competitive pressure facing the exposed sectors of the economy, should ensure this above-average growth. Also, because employers are reluctant to take on new fulltime workers early in a recovery, some cyclical improvements in productivity can be expected. But some employment growth is expected over the coming year, and as the pace of externally-imposed restructuring inevitably slows, scope for rapid improvements in labour productivity

Figure 19

Trends in the Manufacturing Sector
(March 1978 = 1000)



Source: Department of Statistics

beyond 1990 will depend on the initiative and innovation of firms and their workers.

To maximise profits and employment, and give themselves the best possible chance of competing successfully in world markets, employers will in future have to pay greater attention to linking pay rises to improvements in productivity. They will also need to focus on achieving greater efficiency by introducing new technology more rapidly and effectively, and on negotiating for more flexibility in the workplace.

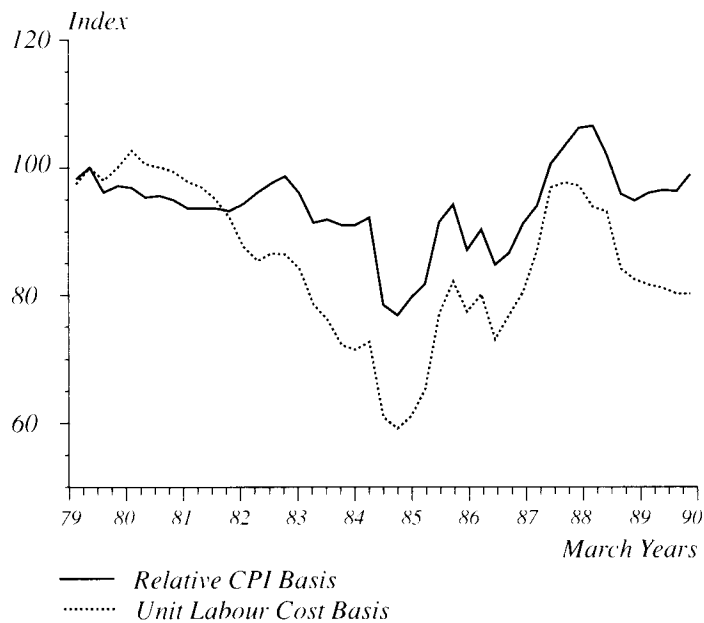
Workers and their representatives also need to be alive to these imperatives. Their actions and negotiating positions need to have regard to the twin goals of helping the unemployed back into work and of successfully moving towards a high-skill and high-wage society.

The state of competitiveness is very difficult to measure or define at an aggregate level, and it is very difficult for officials to attempt to determine what changes to New Zealand's competitive position might be required. However, the current state of the balance of payments, exacerbated by the pressures which may arise from the oil price shock, does suggest that some further depreciation in the real exchange rate is required over the next few years - to improve New Zealand's competitiveness and to support sustainable growth in output and employment.

But long experience tells us that such an adjustment must be achieved primarily via wage restraint and further productivity gains, rather than by a nominal exchange rate depreciation. In the long run a sustained improvement in competitiveness can only be obtained by such real changes, not by fiddling with the nominal exchange rate. A nominal depreciation brought about by an easing in monetary policy would only temporarily boost competitiveness - at the expense of a resurgence in inflation, as the short-run gains are swallowed up in higher wages and second-round price increases. By contrast, sustainable competitiveness gains, generated by cost savings and the introduction of new production technologies, would help to lower inflation, minimise the need for policy pressure on the real exchange rate and, at the same time, provide an environment in which job prospects will improve.

Turning directly to the cost side of the unit labour cost equation, the inflation targets and the high number of people unemployed mean that continued annual wage increases averaging 4.0-4.5 per cent are neither appropriate nor sustainable if productivity is growing by only 1-2 per cent. Unless greater restraint is shown - or faster productivity

Figure 20
Real Exchange Rate Indices
(June 1979 = 100)



Calculated using OECD and RBNZ data.

PRICE STABILITY AND THE REAL ECONOMY

Various commentators have claimed that achieving and maintaining stable prices will permanently depress economic growth. The Bank strongly disagrees with this view. The claim made by these critics is not consistent with either orthodox economic theory, or with the experiences of other countries which have significantly lowered their inflation rates.

Few would deny (and the Bank is certainly not among them) that monetary policy can have an impact on the real economy, particularly in the short term. These effects are, of course, most obvious during a period of disinflation, such as has occurred in New Zealand since 1985. In a world where fixed-term contracts and slowly adjusting expectations of inflation are features of the economy, real short-term losses of

output and employment are an almost inevitable consequence of an attempt to eliminate inflation, especially after a period when inflationary pressures have become deeply embedded. However, although these consequences are widely acknowledged, it is equally true that adjustment costs have generally proved to be transient, albeit stretched over several years.

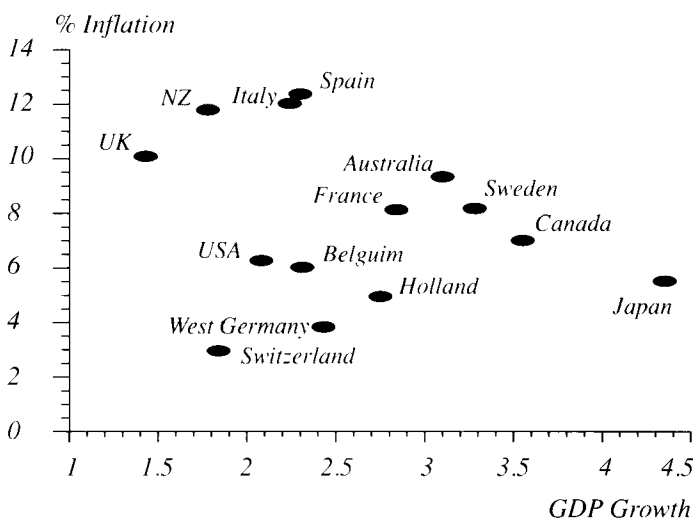
Specifically, there is no evidence to support the contention that persistently low inflation will restrict our long-term economic performance, or that interest rates will be held permanently at artificially high levels. Furthermore, there is nothing to suggest that the degree of pressure required to **maintain** price stability will be any greater than that required to maintain, say, a 5 per cent inflation rate.

Various critics claim that price stability will require permanent upward pressure on real interest and exchange rates. If this were the case, the competitiveness of the traded goods sector would be permanently impaired. The argument appears to rest on the view that, because New Zealand would still be importing inflation, domestic prices would continually have to be driven down to offset the impact of the rising international prices. What is overlooked is that the degree of monetary policy pressure required to break a deeply-embedded inflation is quite different from that required to keep inflation down once the cycle of inflation expectations and steady wage and price increases is broken. More importantly, the claim also

Continued

Figure 21

*Inflation and Real GDP Growth Rates
Averages over 1971 - 1989 for 14 OECD Countries*



Source : OECD Main Indicators & The Economist

overlooks the factors which allow individual countries to pursue lower inflation rates than their trading partners without doing any permanent damage to their economies.

Countries such as Japan, Switzerland and West Germany already successfully maintain a gap between their own low target inflation rates and the higher inflation rates of their trading partners, without impeding their strong economic performance. These countries succeed in doing so by allowing their nominal exchange rates to rise, or to fall by less than profitability and competitive pressures would otherwise suggest. Such increases in the nominal exchange rate do not affect the competitiveness of domestic producers vis-a-vis foreign producers. The reason is because wages and domestic costs in the low inflation economies will also generally be increasing more slowly in the low inflation country than those in higher inflation countries. To illustrate the point at its most extreme: simply because a relatively low inflation country like New Zealand traded with Argentina, which has at times had, say, a 20,000 per cent inflation rate, does not mean that the New Zealand economy would have to be permanently depressed to avoid importing Argentine inflation; it would simply mean that the New Zealand dollar would appreciate rapidly relative to the Argentine austral. But these appreciations would not affect the competitiveness of New Zealand firms trading with Argentina, or New Zealand's ability to maintain low inflation. New Zealand's relative competitiveness is determined by real unit labour cost considerations, i.e. real wages and productivity, not by the differences between the inflation rates of various countries.

Of the three low inflation countries referred to earlier, the case of Japan is perhaps the most interesting for New Zealand. Until the mid-1970s, Japan was a country with a relatively high average inflation rate. The Japanese authorities then resolved to improve this performance, and over the last decade have consistently achieved very low inflation rates without appearing to jeopardise the growth performance of their economy. It is experiences such as those of Japan which, together with orthodox economic theory, give us confidence there will be no permanent adverse tradeoffs between achieving and maintaining price stability and New Zealand's real economic performance. Indeed, far from being an anti-growth measure, the commitment to price stability is a means of ensuring that best and most efficient uses are made of the technology and resources available to us, and that the country's future growth and income prospects are maximised.

improvements can be generated - workers and firms will continue to price themselves off world markets, and additional monetary policy pressure may be required to ensure that price stability is attained. The resulting pressure on real interest and exchange rates would adversely affect profits and employment, and further slow the speed of the recovery. In these circumstances, a large balance of payments deficit and a high rate of unemployment would be likely to persist for longer than is necessary.

To support the real economic adjustments which appear still to be necessary, the Bank has consistently advocated further reform and liberalisation of the legislative arrangements governing the labour market and the conduct of industrial relations. In particular,

it appears desirable to provide for the greatest possible freedom for employers and their workers to be able to negotiate wages and working conditions directly, as willing buyers and willing sellers of labour. There is, of course, already some scope for flexibility within the confines of the legislation, and moves announced earlier this year for a limited extension of this flexibility are welcomed. Nevertheless, the Bank would welcome and encourage further steps in the direction of liberalisation, to increase the opportunities available to workers and employers, and to reduce the costs of achieving the vital further improvements in competitiveness. Although it is unlikely that legislative change alone will prove to be a panacea for New Zealand's competitiveness problems, reform along these lines would at least help to establish a climate more conducive to changing deeply-entrenched centralist attitudes to wage bargaining and worker-employer relations.

Fiscal Policy

The third major imponderable which will affect New Zealand's economic performance over the next few years is the fiscal situation. After five years in which fiscal policy has made major strides towards bringing the Government's finances back into balance, the Bank was disappointed to observe the slippage evident in this year's Budget. The implications of that slippage have quickly been seen in higher interest rates as investors, already concerned about the possible policy outlook after the election, rerated New Zealand dollar assets downwards.

The Bank welcomes the stated commitment of both major political parties to the goals of price stability and fiscal balance. The case for price stability has been outlined earlier in the Statement. But the pursuit of fiscal balance is just as important a part of a balanced macroeconomic strategy. New Zealand still has a very high level of external debt. As a result, the nation remains particularly vulnerable to external shocks and, in these circumstances, it is incumbent on the public sector to ensure that its own financial deficits do not exacerbate that exposure. Also, an appropriate degree of fiscal restraint helps to ease the magnitude of the task facing monetary policy in the remaining years of disinflation. In particular, a supportive fiscal policy stance minimises the degree of pressure on real interest rates needed to achieve the desired degree of downward pressure on inflation.

Neither price stability nor fiscal balance will be achieved without some pain - particularly in the face of significantly higher oil prices. The Bank has no wish to understate the difficulty of the choices facing governments pursuing fiscal balance in difficult economic times, but without further tangible progress towards both price stability and fiscal balance, there is little prospect of significant reductions in interest rates in the foreseeable future. Lower interest rates are not of themselves vital to securing a sustainable economic recovery - as testified by the experience of many of the major OECD countries in the early 1980s. However, in a small exposed economy such as New Zealand's, with a long track record of poor economic management and high external debt levels, it is essential for confidence that consistent and responsible economic policies be maintained. Because of its past record, New Zealand has fewer choices open to it. The hard decisions are forced on us more immediately than in some countries. Despite the adjustment costs of recent years, and the solid foundations which have been laid, further tough decisions still have to be made before the full fruits of a freer economy can be realised.

CONCLUSION

Over recent months, the Bank's assessment of the monetary indicators has been focused on ensuring the consistency of overall monetary conditions with the inflation objectives laid down in the Act and the Policy Targets Agreement. The deterioration in the short-run inflation outlook in May, and the market reaction to the Budget in late July both posed risks of inflation outcomes inconsistent with the announced indicative inflation track. On both occasions the Bank signalled its unease at developments and in so doing confirmed the consistently anti-inflationary stance of monetary policy.

The battle against inflation is by no means over. In recent weeks the progress the Bank had been making in lowering expectations and building credibility has been overshadowed by a major new external inflationary threat - namely, sharply higher oil prices. The Bank is confident that the 1992 objective can still be achieved, even though it is considered appropriate to accommodate the first round effects of the shock on the CPI. But achieving the objective has been made more difficult. Getting over the hurdle of the oil shock without extra policy pressure will depend critically on the behaviour of individuals and firms. Whether negotiating wages and salaries, planning investment, taking out a mortgage, or setting fees or prices, due regard needs to be given to the inflation target. In particular, we all need to recognise that a sharp rise in oil prices is not the sort of shock for which we can compensate ourselves, except by working harder and more effectively to regain the lost ground. Failure to recognise this lesson of the 1970s and early 1980s will unnecessarily threaten the economic recovery and constrain our ability to move back up the world's economic league tables.

