

# POST-ELECTION BRIEFING PAPER

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## Executive Summary - October 1990

This briefing provides an opportunity to review the environment in which monetary policy, and the Bank's other functions, are performed. With respect to monetary policy, we have reviewed the macroeconomic environment, paying specific attention to the inflation outlook, the state of the balance of payments and the level of the real exchange rate.

The achievement of an inflation rate within the 0-2 per cent range by December 1992 in our view remains feasible. Inflation, exclusive of GST and oil price effects, has continued to fall over the past three years and we believe that the present targets for monetary policy can be achieved.

However, we are concerned that under current fiscal and monetary policy settings, the balance of payments current account deficit could remain uncomfortably high over the next four to five years. In turn, these deficits could lead to an increase in the ratio of external debt to GDP. We project that, under current policy settings, this ratio could rise from the current level of around 72 per cent to around 80 per cent by 1996.

The Bank considers that this outlook indicates that a further improvement in external competitiveness, through adjustment to the real exchange rate, is required. One avenue for this adjustment is via lower domestic cost increases than those occurring in the economies of our trading partners. Recent developments in this respect have been encouraging. The current low level of wage settlements will boost competitiveness. These settlements have also facilitated a fall in the nominal exchange rate since mid-September, so further increasing competitiveness.

However, if one is seeking to have a substantial improvement in the current account deficit over the next two to three years, more rapid improvement in competitiveness is likely to be required. Potentially, this could occur through further market-led nominal exchange rate depreciation, although it is important to emphasise that this could only have value if the nominal depreciation led to a sustained change in the real exchange rate otherwise nothing, other than higher inflation, would have been achieved.

The key to seeing a sustained real exchange rate reduction resulting from a nominal depreciation is to ensure that the direct increase in traded goods prices does not flow through into wage and other price-setting outcomes. Thus, in order to work, a nominal depreciation must produce a sustained real increase in the profitability of the traded goods sector while also producing a reduction in real wages and in other real incomes. Firm monetary and fiscal policies must both be in place in order that these outcomes result.

Historically, the environment was such that these consequences did not eventuate; a system of de facto indexation existed throughout the economy. This meant that nominal depreciations, in general, translated into higher inflation rather than into sustained competitiveness gains.

Our experience of the August 1988 depreciation, which did produce a real depreciation, coupled with the recent evidence of wage moderation, gives the Bank some confidence that a sustained competitiveness gain may, in present circumstances, potentially be achieved through some nominal depreciation, provided that this was associated with the maintenance of a firm monetary policy.

However, the Bank would have to remain concerned about the inflationary potential of a further fall in the exchange rate. Any further fall in the exchange rate would undoubtedly place some upward pressure on price inflation over the following one to two years. The extent to which monetary policy could accommodate any such exchange rate fall would depend in large part on the fiscal and labour market policies in place, which would have a major bearing on the likely ongoing inflation effects of a depreciation.

Given the potential desirability of further real exchange rate depreciation, a postponement to December 1993 for the achievement of price stability would be appropriate in certain circumstances. These circumstances include a significant improvement to the fiscal situation, the implementation of a labour market strategy that can contain future inflationary wage increases and retaining a firm commitment to medium term price stability, so as to avoid any loss of credibility about the Government's and the Bank's commitment to this objective.

The Policy Targets Agreement between the Minister of Finance and the Governor of the Reserve Bank would have to be renegotiated to incorporate this postponement. The Bank considers that the opportunity should now also be taken to review other aspects of the Agreement. Our briefing examines, in detail, whether a 0-2 per cent inflation rate is a reasonable definition of price stability, and concludes that it is. We therefore favour this inflation range being retained as the medium-term goal for monetary policy.

But the accountability structure for the Bank's achievement of this goal needs to be reviewed. The current Agreement requires a renegotiation of the targets in the event of a shock that pushes inflation outside of the 0-2 per cent range, at or beyond the target date. Our experience with this option is that the caveats that are listed in the existing Agreement are incomplete. For instance, increases in central and local government charges should also be incorporated into the list of caveats if monetary policy is not to be tightened at a time when Government chooses to place increased emphasis on user-pays pricing. The problem with increasing the number of explicit caveats is that the likelihood of renegotiations increases and, in so doing, the targets may lose some of their credibility.

We explore two options to overcome this problem. Both retain 0-2 per cent as the medium-term goal for monetary policy, but acknowledge that a number of shocks could push the inflation rate temporarily outside of this band.

The first option establishes a 0-4 per cent "accountability" band for the Bank. Under this option, the targets would not have to be renegotiated if shocks resulted in inflation in the 2-4 per cent band, but the Bank would have to explain publicly what these shocks were and what effect they had had on inflation. However, the targets would still have to be renegotiated if substantial shocks occurred which pushed inflation outside of the 0-4 per cent range. The option also raises the potential problem of the public perceiving there to be two different target bands. This could potentially result in some public confusion, with a likelihood that the public would expect inflation to remain in the upper portion of the wider band.

The second option is to keep the 0-2 per cent medium-term target for monetary policy, and have no formal wider accountability band or requirement for target renegotiations in the event of shocks to inflation. Instead, the Bank would be required to document, in its six-monthly Monetary Policy Statements, any shocks that caused inflation to deviate from 0-2 per cent at any point in time. The shocks would have to be listed and their estimated effect on inflation would have to be quantified. The Finance and Expenditure Select Committee would have the role of holding the Bank accountable for its analysis and explanations on the occasions when inflation deviated from the 0-2 per cent range.

This option precludes the need for incorporating explicit caveats into the Policy Targets Agreement and also precludes the need to renegotiate the targets in the event of significant shocks. At the same time, the medium-term price stability target - to be met by December 1993 - is stated unambiguously, and the Bank is still held accountable for its actions. On balance, this is the option that the Bank favours for the renegotiated Policy Targets Agreement.

In implementing monetary policy, the Bank intends to maintain its "checklist" approach to the various monetary indicators. Under this approach, the Bank considers the information regarding potential inflation developments which is contained in a variety of indicators, including: the level and term structure of interest rates, the nominal exchange rate, the monetary and credit aggregates, real sector developments, inflation expectations, and cost and price developments. The Bank considers that this approach is superior to any approach that focuses on only one of the indicators, such as an exclusive focus on the money base, M3, or the exchange rate. The Bank will continue to describe, in its Monetary Policy Statements, how it is interpreting the indicators.

In terms of the implementation of monetary policy, the Bank considers that its current system is workable but is, in some respects, fragile. The existing structure is built around the Government's daily net financial flows to and from the private sector flowing through the Reserve Bank. The nature of these flows provides a cause for banks to hold settlement cash balances with the Reserve Bank and to hold Reserve Bank bills, thereby providing the basis for the Bank to engender changes to monetary conditions.

On the wider fiscal front, the Bank stresses the importance of achieving a credible, sustained and reasonably rapid reduction in the fiscal deficit. The projected worsening in fiscal outcomes in this year's Budget was instrumental in pushing up interest rates in both the wholesale and mortgage markets. An increased fiscal deficit is also likely to place greater pressure on the balance of payments. If the Government wishes to act both

to reduce real interest rates and to improve the current account situation, it is imperative that it moves to reduce its deficit. There are few easy options for fiscal consolidation that have not already been taken. But given the importance of reducing the current account deficit and of reducing real interest rates, further difficult decisions in the fiscal area cannot be avoided.

In promoting growth, Government also has a role in reducing legislative and regulatory barriers that currently impede a return to growth. The Bank has long favoured a less regulated labour market in which employers and employees are free to negotiate on wages and conditions within the individual firm. The Bank advocates that legal barriers to this process be removed, so leaving in place a permissive, rather than prescriptive, environment for labour relations.

However, as well as acting to alter the process of labour market negotiations, the Government will also have a continued interest in labour market outcomes. The "growth agreement" between the last Government and the CTU has produced lower wage outcomes than expected prior to the agreement (albeit within a reasonably centralised wage-fixing process). This is an important outcome because it has enabled an improvement in competitiveness to evolve, both through the direct effect of the lower wage round and through the indirect outcome of the recent exchange rate decline.

On the basis of overseas experience, the Bank cautions that a completely hands-off approach to labour market outcomes on the part of Government, even within a reformed environment, may not engender the rapid, beneficial outcomes (especially regarding wage moderation) that may be hoped for. The Bank therefore suggests that there are some dangers in immediately jettisoning the "growth agreement", and sees the potential for some gain in maintaining an ongoing constructive dialogue between Government, employer and union groups regarding economic matters.

With regard to the Bank's other prime function, banking supervision, a number of developments are taking place. Under the new Reserve Bank Act, the Bank has implemented, or is in the process of implementing:

- (a) minimum capital standards for banks (based on the internationally agreed BIS framework);
- (b) limits on banks' large exposures;
- (c) constraints on the nature and extent of the relationships between a bank and its owners; and
- (d) broad guidelines on banks' internal control systems.

Work is also in train on developing revised public disclosure requirements for banks. In relation to its lender of last resort role, the Bank has developed, with the New Zealand Bankers' Association, a framework within which individual institution liquidity crises can be addressed in a collaborative manner. Policies are also being developed on strengthening the New Zealand payments system.

With regard to DFC New Zealand Ltd, which was placed in statutory management in October 1989, a proposal has recently been put to creditors which we believe should see this problem being resolved.

The new Act makes provision for the Bank to charge banks fees relating to bank supervision. We will be approaching the Minister of Finance shortly for approval of the fees to apply for 1990/91.

