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RESERVE
BANK

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MONETARY POLICY STATEMENT

February 1991

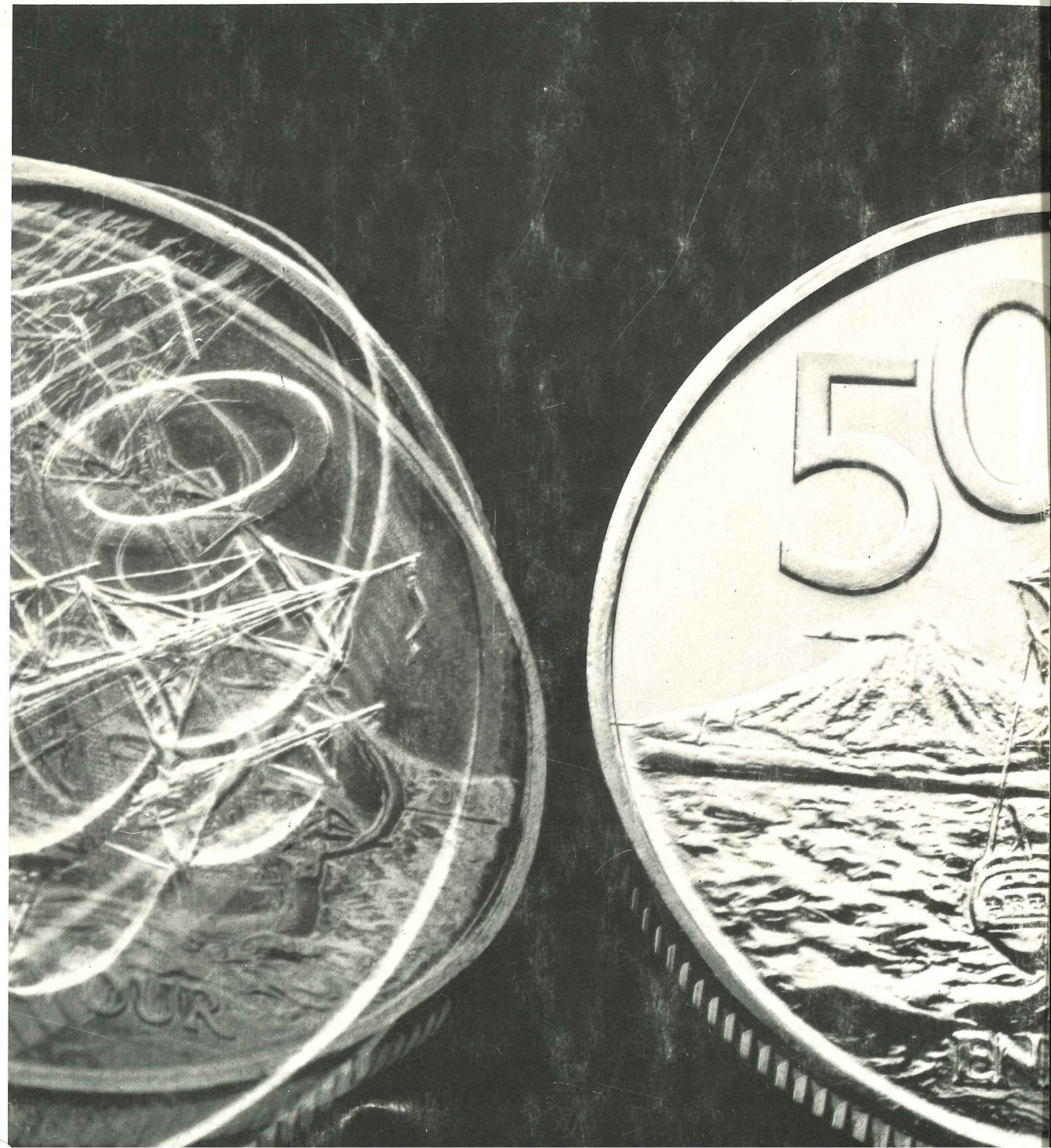




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"The primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices."

Section 8, Reserve Bank of New Zealand Act 1989

EXECUTIVE SUMMARY

The new Reserve Bank of New Zealand Act is now little over one year old. In line with the agreed price stability goal, the Bank has gone a long way towards establishing its credibility in reducing inflation. This, in turn, is providing a sustainable basis for lower interest rates. The Bank has responded consistently to developments, with the aim of ensuring that monetary conditions are kept in line with the inflation goals. The Bank has achieved the first of the inflation goals it set for itself. Underlying inflation has been brought down to the lowest rate for 25 years.

As inflation has come down, and confidence has grown that the fight against inflation will be sustained, interest rates have fallen sharply, particularly since October. Most nominal interest rates have fallen to the lowest levels seen for a decade or more, with the exception of fleeting periods during the time of stringent interest rate controls in 1983 and 1984. Although real interest rates remain relatively high, they have come down a long way, both absolutely and relative to those in other countries.

In the first Monetary Policy Statement, the Bank indicated that it would be aiming to achieve a 3-5 per cent inflation rate in 1990, consistent with the then goal of price stability by December 1992. Over the year, the CPI rose by 4.9 per cent. However, even this inflation rate included 0.7 percentage points directly attributable to the one-off oil price shock last year. Adjusting for this and other one-off effects, the underlying CPI inflation rate is estimated to have been around 4.3 per cent in 1990, slightly lower than the estimated underlying rate for 1989 of around 4.5 per cent (adjusting for GST and commodity price effects), published in our first Monetary Policy Statement. For the first time since 1965 and 1966, the underlying inflation rate has been brought below 5 per cent for two successive years.

This consolidation on the inflation front was achieved against the background of a difficult external environment. The New Zealand economy has remained weaker than we expected, and over the last six months, in particular, confidence has been at a low ebb. At the same time, the world economy has been slowing and the economies of several of our major trading partners have moved into recession. Moreover, to keep monetary conditions on track to achieve the inflation goals, the Bank was forced to act in May and August in ways which put some upward pressure on interest rates. The second of these actions followed the disappointing July Budget, which reversed much of the significant progress towards removing fiscal imbalances which had been made in recent years.

However, both the Bank's demonstrated willingness to fight inflation, and the weak economy, have also helped create the climate for the recent sustainable falls in interest rates. In particular, the degree of wage restraint achieved in the latest round of award negotiations has been greater than had previously been expected. The 'Growth Agreement' between the previous Government and the Council of Trade Unions contributed to this restraint. As the Bank had indicated earlier, the greater wage restraint took some pressure off monetary conditions and the Bank did not stand in the way of this easing.

The other threat to interest rates had been some market doubts about the new Government's commitment to continue with the price stability goal, and about the ability and willingness of the authorities to tackle the rapidly deteriorating fiscal position. However, many of these doubts have been overcome in the Government's first three months in office, particularly following the 19 December 'Economic and Social Initiative'.

Despite a downgrading of New Zealand's sovereign credit rating in January - reflecting past accumulations of debt and the large prospective current account deficits - both short and long term interest rates have fallen very significantly while the exchange rate has eased only slightly. The Bank has welcomed these interest rate falls. At the time of writing, a second full round of reductions in retail lending rates was under way, taking business base lending rates down to around 15 per cent (compared with 23 per cent in 1987), and most mortgage rates to around 13.75 per cent (20.5 per cent in 1987).

Looking ahead, the prospects for both inflation and interest rates are generally favourable over the coming years. The expected adverse impact of the Gulf War has, thus far at least, failed to materialise, and with a further slowdown likely in the world economy, overseas interest rates may well fall further, improving the environment for further reductions here. Continuing progress in lowering inflation is likely to mean that a downward-sloping yield curve - in which short-term rates are slightly above longer-term rates - has to be maintained. Further progress along the path to price stability, supported by continued vigorous efforts to close the still-large prospective fiscal deficits, are the keys to securing significant further sustainable reductions in New Zealand interest rates.

The target date for price stability has been pushed out by one year by the new Government, to December 1993. Prospects for achieving this goal without significant further monetary policy pressure are good at present. The low rate of wage inflation achieved in the 1990/91 round is one particularly positive factor, as is the marked slowing in the rate of increase in house prices. Lower oil prices provide an unexpected bonus, and improve the climate for reducing price pressures and inflation expectations across the community.

On the other hand, the continuing large balance of payments current account deficits and falling export prices may mean that some downward pressure emerges on the exchange rate during the year. The Bank noted in its September 1990 Monetary Policy Statement that a further depreciation in the real exchange rate was required in order to improve the competitiveness of New Zealand industry. The recent reduction in domestic inflationary pressures suggests that the risks to inflation if some part of this adjustment came about through a depreciation in the nominal exchange rate are now somewhat less. There is certainly no scope for an easing in monetary policy to bring about such a fall. However, as the Bank has stated previously, in the current more favourable circumstances it would not stand in the way of limited market pressures on the exchange rate. Safeguarding the price stability target would, nevertheless, require that the Bank prevent any subsequent resurgence in underlying inflation.

Taking all these factors into account, the Bank now considers that ex-oil CPI inflation should take the following track along the path to price stability:

- 2.5-4.5 per cent for the year to December 1991;
- 1.5-3.5 per cent for the year to December 1992;
- 0-2 per cent for the year to December 1993.

In accordance with the requirements of the Policy Targets Agreement reached with the Government, the Bank is fully committed to the achievement of the price stability goal. By demonstrating that commitment and making steady progress towards the goal, the Bank will make its best possible contribution to the economic adjustment New Zealand is undergoing, and build on the substantial gains that have already been achieved.

MONETARY POLICY STATEMENT

FEBRUARY 1991¹

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

INTRODUCTION

The first year of the new monetary policy framework, established under the Reserve Bank of New Zealand Act 1989, has been one of significant milestones. Consolidating on the progress made since 1985 in lowering inflation, 1989 and 1990 marked the first consecutive years since 1965 and 1966 that underlying inflation has been held below 5 per cent. Moreover, prospects are now good for achieving the further reductions in inflation required to meet the revised goal of price stability by the end of 1993.

The Bank's success on the inflation front, and the welcome improvements initiated by the Government in the overall mix of policies, have led to substantial falls in interest rates. The peaks of little under four years ago (well over 20 per cent for both wholesale and retail interest rates) were an unfortunate, but inevitable, side-effect of the fight against inflation. But with the success on the inflation front these high interest rates are now well and truly behind us.

Interest rates have fallen particularly sharply over the last six months, the period under review in this Statement. Both wholesale interest rates and mortgage rates are now at levels not seen in New Zealand for more than a decade - setting aside only a few months during the controls of 1983 and 1984. Contrary to some strands of popular thought, lowering inflation and keeping it down do **not** require permanently high interest rates. Quite the opposite in fact: keeping inflation down is the only reliable way to get interest rates down and to keep them down.

The crucial difference between now and the late 1970s and early 1980s should not be overlooked. The lower interest rates of a decade or more ago were heavily influenced by the government, and because those rates were less than the inflation rate they simply added to inflation and balance of payments pressures, while directly discouraging savings. By contrast, falling interest rates now are based on solid foundations which should ensure that lower rates can be sustained. The general public, and investors both in New Zealand and abroad, have been growing more confident of the ability and willingness of the Government and the Reserve Bank to ensure that low inflation is here to stay. The fiscal deficit and public expenditure are being brought under control. Provided these policies are seen through, interest rates should be able to fall considerably further over the next few years.

Of course, real (inflation-adjusted) interest rates remain high. In part, that is a consequence of New Zealand's very high debt levels, past policy choices, and continuing fiscal and balance of payments pressures. Lowering inflation further also involves keeping some, diminishing, pressure on real short-term interest rates. But here too,

¹ Text and data finalised on 15 February 1991.

progress has been made. Real interest rates have fallen over the last year, and the gap between New Zealand and overseas rates has fallen. Our real wholesale interest rates are now similar to those of several European countries. Most European countries have the added advantage of having tied their exchange rates - and hence the credibility of their disinflationary efforts - to the German mark, through the European Monetary System. In doing so, they have reduced the exchange rate risk premium in their interest rates.

In addition to the falling interest rates, international competitiveness has been improving. Both the nominal and real exchange rate have fallen by around 4 per cent since August. This fall has not threatened the inflation goal because of the added wage restraint achieved in the last round of wage settlements. These gains have reinforced the continuing improvement in the ability of New Zealand firms to compete in international markets, a trend evident since at least mid-1988.

However, despite all this progress, interest rates and competitiveness concerns have continued to provide a focus for increasing disquiet over the state of the economy. As monetary policy is one of the easiest policy levers to adjust, the Bank and the price stability objective have come under pressure from those who believe that if only monetary policy were to be eased economic recovery would follow quickly. This view fails to reflect an adequate appreciation of the depth and severity of New Zealand's economic problems and of the inability of monetary policy to generate sustainable growth. Abundant evidence both here and overseas confirms that abandoning the pursuit of price stability would certainly not be the answer to New Zealand's economic difficulties. Rather, it would simply expose us again to the distortions, inequities, and injustices arising from inflation that have been seen so vividly over the last 25-30 years.

Recent developments in inflation, the economy, and in the various monetary indicators are reviewed in the next section of the Statement. The considerable progress that has been made in the Bank's areas of responsibility is emphasised. The Bank's monetary policy actions over the period since mid-August 1990 are reviewed, and particular attention is given to the Bank's reaction to the September 1990 'Growth Agreement' and to the new Government's 19 December 'Economic and Social Initiative'. (Reserve Bank media releases on monetary policy issues during the review period accompany the Statement as Appendix 2.) The remainder of the Statement discusses the outlook for inflation and monetary policy.

RECENT DEVELOPMENTS

Economic Background

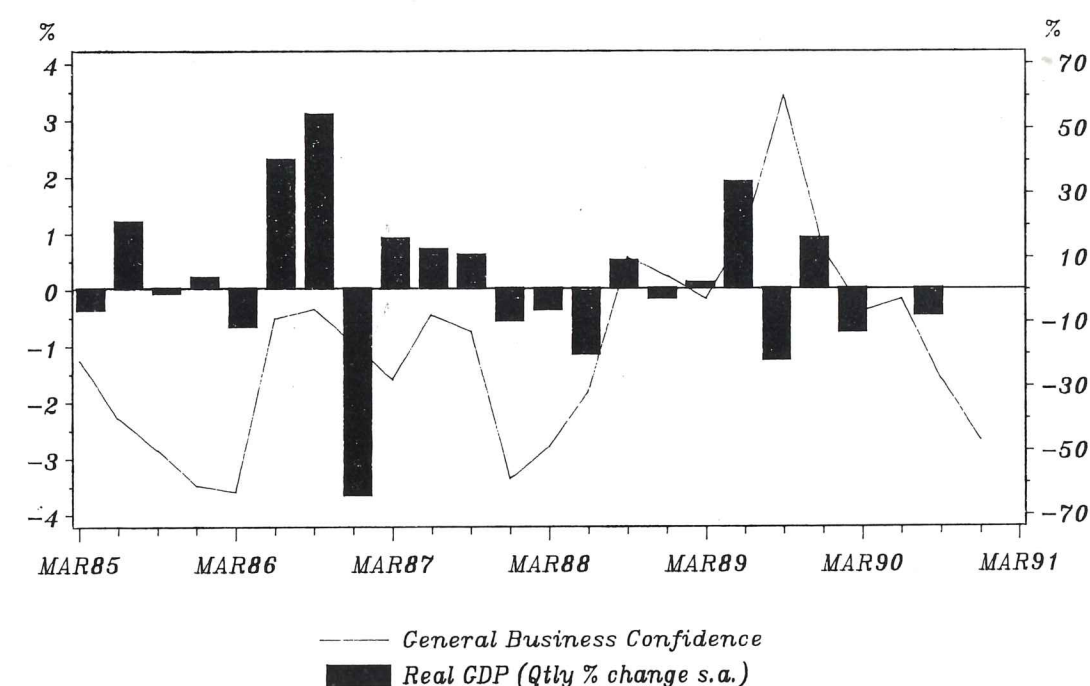
The economy remained weaker than we expected throughout 1990, as the recovery, which had been expected to gather momentum, dissipated. Signs of reduced consumer spending, which were becoming apparent at the time of the previous Monetary Policy Statement, have since been confirmed. Real retail spending fell sharply over the June and September quarters of 1990, reflecting depressed real incomes and eroding economic confidence. Recent data showing increases in retail spending in October and November are somewhat more encouraging, but over the full year to March 1991 it is unlikely that there will be any growth in consumption spending. Domestic production also fell, down by around 1 per cent over the first three quarters of 1990.

The weak economy has been associated with low and fragile general business confidence, despite significant improvements in the competitive position of many firms. The National Bank's Business Outlook survey showed confidence falling markedly from July 1990 on. Important influences on the economy, and on confidence, included the fiscal slippage evident in the 1990 Budget, the related tightening of monetary policy in early August, the international crisis following Iraq's invasion of Kuwait, and the slowing world economy.

Confidence continued falling until October, with pre-election uncertainty perhaps playing some role. Immediately following the change of government, there was a pronounced surge in recorded confidence. However, this appeared to be a temporary 'honeymoon' effect, as more recent surveys showed a sharp fall in general business confidence. The timing of these more recent surveys in relation to the Government's

Figure 1

General Business Confidence and Real GDP

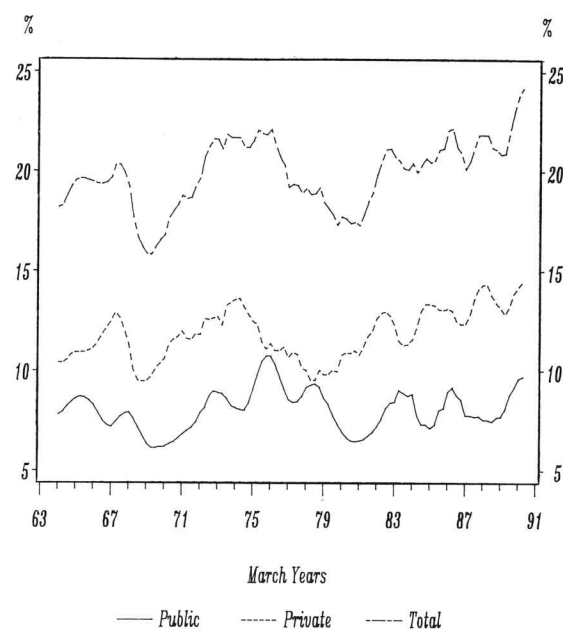


Source: NZIER and Department of Statistics

December package and subsequent reductions in lending interest rates is not entirely clear. Nor is it clear to what extent the fall in confidence was driven by domestic factors as opposed to external factors, such as the uncertain international environment and the fall in the terms of trade. Of course, general business confidence measures typically prove far more volatile than actual economic performance, and than firms' expectations about prospects for their own businesses.

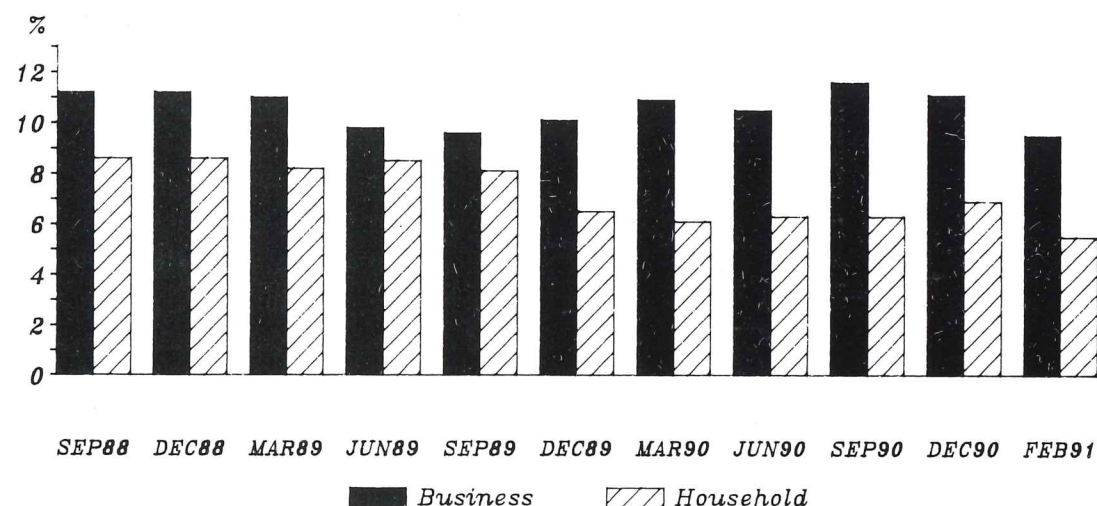
Despite the weak state of business confidence and the high real interest rates most business borrowers have been facing, business has, on average, been investing strongly. Real investment in plant and machinery as a share of Gross Domestic Product (GDP) has risen strongly, reaching an historic peak of 7.2 per cent in the year to June 1990, and is expected to remain at about its present level, growing slightly further over this and the coming year. The strong aggregate investment performance is due partly to several major investment projects, such as the refurbishment of the Kinleith mill, and this pattern is expected to continue with the development of the Maui B platform. Investment in transport equipment was particularly strong over late 1989 and early 1990, as commercial

Figure 2
Investment as a share of Gross Domestic Product



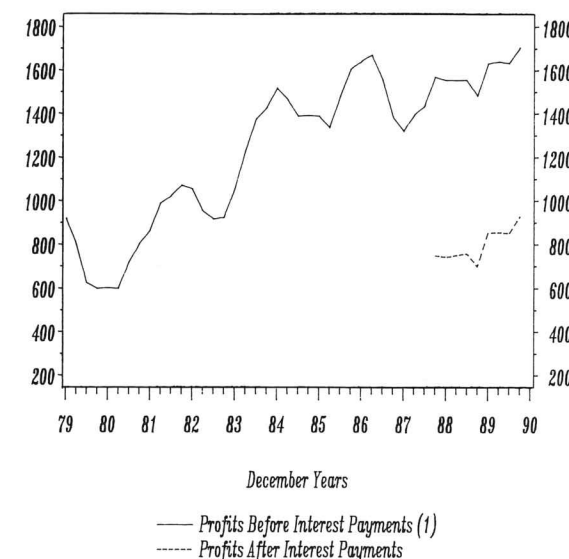
Source: Department of Statistics

Figure 3
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. (February 1991 figures use November 1990 surveys)

Figure 4
Real Manufacturing Sector Profits
Four Quarter Running Totals
(1982 \$Millions)

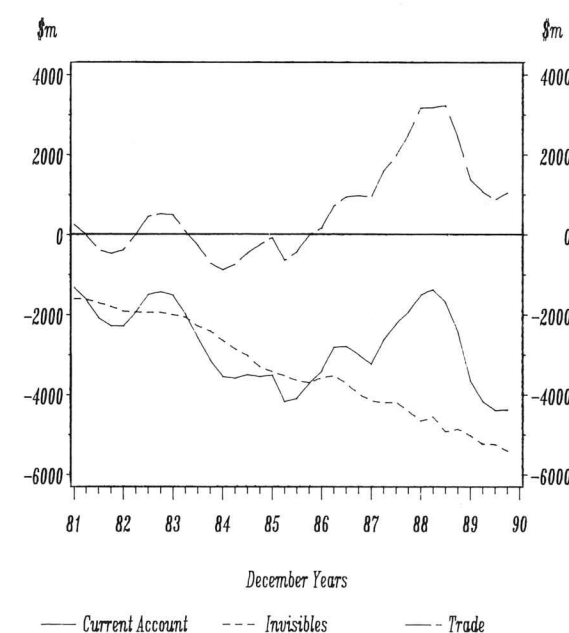


1. Source: Department of Statistics Quarterly Manufacturing Survey

vehicle and aircraft fleets were upgraded, but it is expected that this investment will fall off as upgrading reaches completion. Imports data tend to indicate that this reduction is already occurring.

The strength of recent investment appears to be driven by the new opportunities and challenges created by restructuring in some sectors, and by the greater competitive pressure on many firms to adopt more efficient and productive technology. Improving profits mean that a greater proportion of investment spending is able to be funded from retained earnings. The investment has led to improvements in productivity and competitiveness. However, there has been relatively little expansion in total capacity, because restructuring appears to have led to an abnormally-high portion of New Zealand's stock of capital, which was not able to be transferred to alternative uses, being scrapped. As a result, many jobs have been lost in the course of the adjustment.

Figure 5
Balance of Payments



Source: Department of Statistics

The high level of investment was one factor contributing to the sharp deterioration in New Zealand's balance of payments position over the second half of 1989 and much of 1990. From a shortfall of around \$1,350 million (2.0 per cent of GDP) in the year to March 1989 - the lowest as a share of GDP since the year to March 1974 - the current account deficit has widened to around \$4,400 million (6.3 per cent of GDP) for the year to September 1990.

Export revenues have grown only slowly, reflecting, in part, sharp declines in export commodity prices from their peaks earlier in 1990, particularly for wool and dairy products: in foreign currency terms, New Zealand's export prices are now estimated to have been around 7 per cent lower in the year to

December 1990 than in the previous year. International demand for New Zealand's exports has slowed and, together with the ongoing effects of the severe 1988/89 drought on the supply of agricultural products, this factor has meant that the volume of exports has grown only modestly.

Rising import volumes were also a key contributor to the worsening in the current account. Not only have investment-driven imports risen strongly, but the share of the New Zealand market held by imported consumer goods has also significantly increased, as tariff rates have fallen and import licences have been abolished. These trends are not in themselves cause for concern, because they are the largely inevitable consequence of the economic adjustment programme. In particular, the high level of gross investment, critical to completing the adjustment process, was certain to be reflected first in a widening current account deficit, given that New Zealand does not specialise in the production of capital goods. Resources have moved only slowly into the domestic production of tradeable goods in areas in which New Zealand industry is internationally competitive. Getting this shift will be the key to achieving sustainable medium-term current account outcomes, and to the ultimate success of the wider programme of economic change.

Inflation

1990 has been a significant year for the Bank on the inflation front. Following the signing of the first Policy Targets Agreement in March 1990, the Bank specified for the first time a series of annual inflation ranges which, in the absence of major shocks, it expected to meet to be consistent with the goal of achieving price stability by December 1992. These ranges were intended to boost credibility, and to serve as guideposts in the formulation and implementation of monetary policy, without being binding targets. The Bank has delivered on the first of these ranges, and, by maintaining a consistently firm policy stance, has substantially improved the prospects for reducing the inflation rate over the next three years.

For 1990, the specified indicative range was a 3-5 per cent increase in the Consumers Price Index (CPI). In the September Monetary Policy Statement the Bank indicated that it expected this range would be slightly overshot because of the sharp rise in oil prices following the invasion of Kuwait. Such an overshoot was not seen as a cause for concern, provided that any second-round catch-up effects were avoided. The Bank stated that the underlying (primarily ex-oil) inflation rate was expected to be in the 4.0-4.5 per cent range by the end of 1990.

In mid-August, at the time of writing the previous Statement, the price of Dubai crude (the benchmark price most relevant to New Zealand) had risen to around US\$23 per barrel, from around US\$13-15 per barrel in May and June. Oil prices continued to rise, to a peak of almost US\$38 per barrel of Dubai crude in late September, and remained very volatile in light of developments in the Middle East.

The continuing uncertainty about the future path of oil prices led the Bank to modify the presentation of its indicative inflation ranges in October. Retaining an oil-inclusive approach would have required the ranges to be changed following any major change in

oil prices, as was done in the September 1990 Statement. Instead, the Bank announced that, consistent with its policy of accommodating only the first-round impact of oil price increases on the price level, it would in future aim to achieve an oil-exclusive indicative range. Specifically, the Bank would be aiming to bring underlying inflation, exclusive of the direct effects of oil price changes, within the original indicative range for 1991 announced in the April 1990 Monetary Policy Statement (1.5-3.5 per cent).

Despite the oil price pressures, various factors have acted to lower inflation over the last six months. The prices of some export food commodities have fallen, reinforcing the slow down in annual food price inflation. In 1990, food prices rose by 3.3 per cent, the lowest rate of increase since 1972, excluding the 1982-84 price freeze. Falling commodity prices were also the driving force behind the fall in producer prices over the September quarter. On the domestic front, there are signs that house prices have been flattening - and indeed have fallen slightly over late 1990 - after having been a particularly important contributor to inflation over the first half of 1990. The rise in mortgage interest rates in August is likely to have contributed to this moderation.

INFLATION OUTCOMES

(% change)

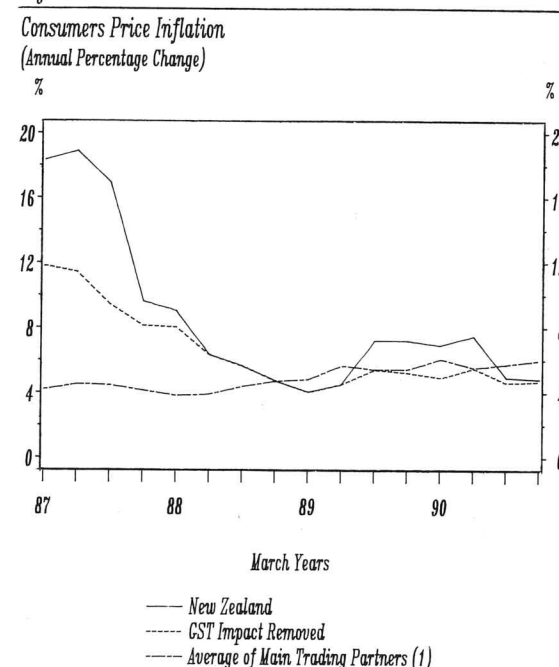
	CPI			HAPI ¹		
	Qtly	Year-on-Year	(Excl. GST)	Qtly	Year-on-Year	(Excl. GST)
1989						
Mar.	1.1	4.0		0.9	5.9	
June	1.2	4.4		1.3	5.6	
Sep.	3.5	7.2	(5.5)	3.8	8.3	(6.6)
Dec.	1.2	7.2	(5.3)	1.2	7.2	(5.3)
1990						
Mar.	0.9	7.0	(5.0)	0.9	7.3	(5.3)
June	1.8	7.6	(5.5)	1.5	7.5	(5.4)
Sep.	1.0	5.0	(4.7)	1.1	4.7	(4.4)
Dec.	1.1	4.9	(4.8)	1.4	5.0	(4.9)

1 Housing-Adjusted Price Index.

The July 1989 increase in the rate of GST largely dropped out of year-on-year CPI inflation in the September quarter, helping to lower the inflation rate to 5 per cent for the year to September. Very minor effects of the oil price rise were felt in the September CPI. The effects on consumer prices came through more strongly in the December quarter. The CPI rose by 1.1 per cent over the quarter, and approximately 0.6 per cent of this increase was due to the impact of rising oil prices. In underlying terms, this quarterly increase was the lowest since the December quarter of 1969, including the period of the 1982-84 wage and price freeze - a very encouraging outcome along the road towards price stability.

As a result of the low December quarter increase, and to the surprise of most forecasters, the inflation rate for the year to December 1990 fell marginally to 4.9 per cent, just inside the Bank's 1990 range despite the oil price shock. The direct effects of oil price rises on fuel and transportation costs are estimated to have contributed around 0.7 percentage points to the full year CPI outcome. When the oil effects are excluded, and allowance is made for falling commodity prices and changes in various public sector charges, underlying inflation was

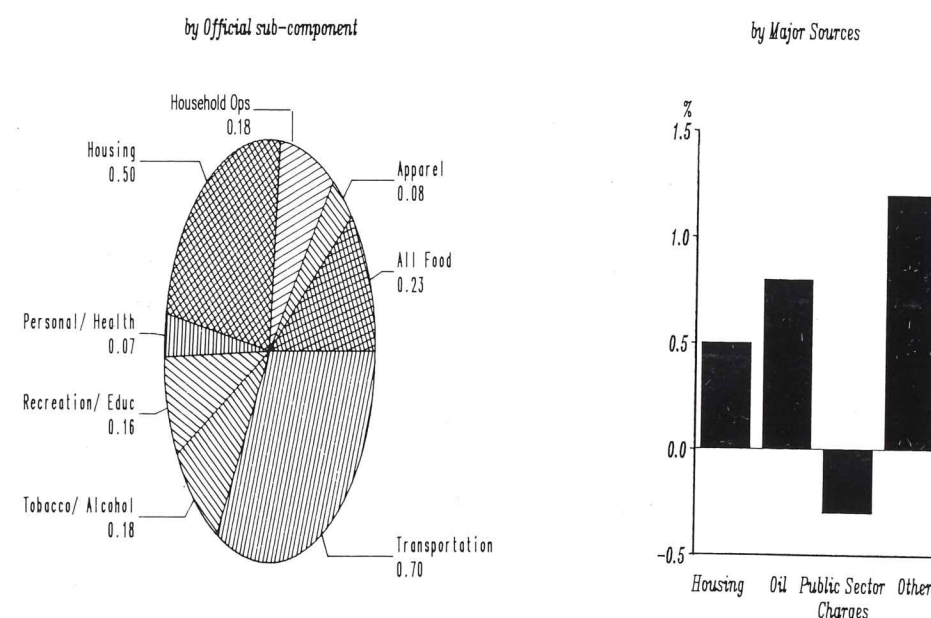
Figure 6



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

Figure 7

Contribution to the 2.1% Increase in CPI
In The September and December Quarters



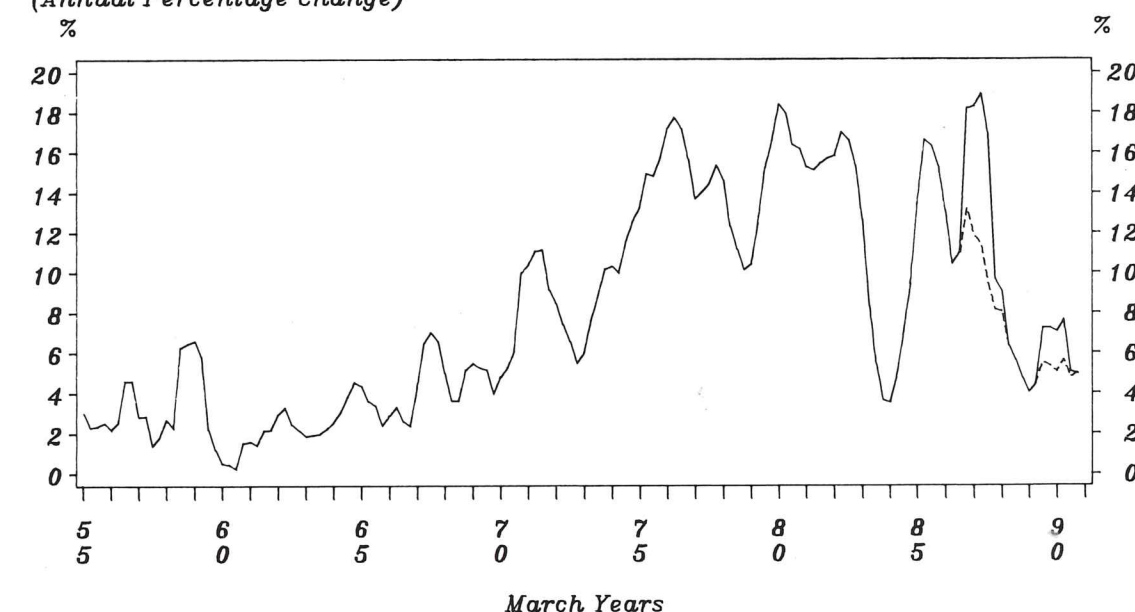
Source: Department of Statistics

not only near the midpoint of the Bank's indicative inflation range of 3-5 per cent, but also within the narrower range (4.0-4.5 per cent) forecast in our last Statement. The success in achieving these inflation goals, despite the difficult external environment, should help build confidence in the Bank's ability and willingness to deliver on the price stability goal.

Although the 3-5 per cent range for 1990 was achieved, the underlying inflation rate in 1990 was little different to that in 1989 (in which measured inflation was boosted by the increase in GST and strong export food prices). No significant reduction in underlying inflationary pressures was expected over the year as a whole, but by late 1990 these pressures did appear to be easing. The achievements on the inflation front over the past two years are significant: 1989 and 1990 represent the first two years since 1965 and 1966 in which New Zealand has held underlying inflation to less than 5 per cent. As the year progressed, more attention began to focus on ensuring a climate consistent with securing further sustainable reductions in inflation, without undue short-term economic costs.

Figure 8

Consumers Price Inflation
(Annual Percentage Change)

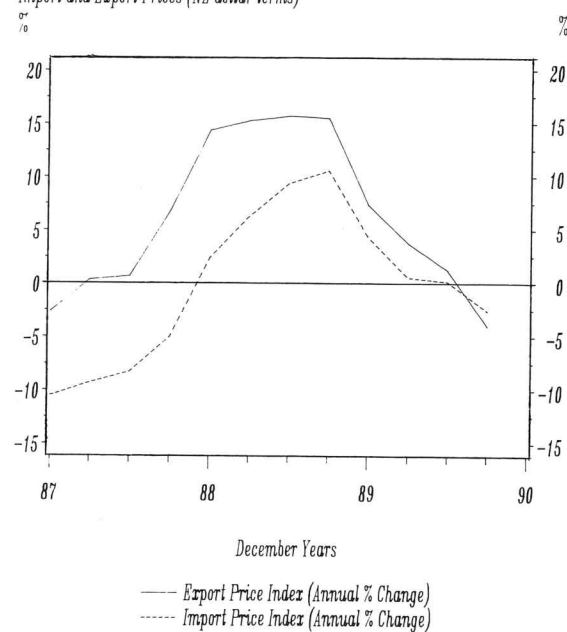


Source: Department of Statistics, RBNZ for GST adjustment

From already disturbingly high levels, the inflation expectations of households jumped in response to the oil price rises. The Bank's survey showed household expectations of year-ahead inflation rose from 8.6 per cent in May to 9.1 per cent in August. Surveyed inflation expectations of businesses also rose over the same period, from 4.4 per cent to 4.7 per cent. These increases in expected inflation were not surprising, but it was nevertheless imperative that they did not flow into higher wage settlements or provide impetus to a further round of house price inflation.

Despite these risks, wage increases during the recent round of award negotiations came in considerably lower than had been expected by most observers. A growing recognition of the consistently anti-inflationary stance of monetary policy, of the difficult economic climate (particularly in the wake of the Middle East situation), and further rises in

Figure 9

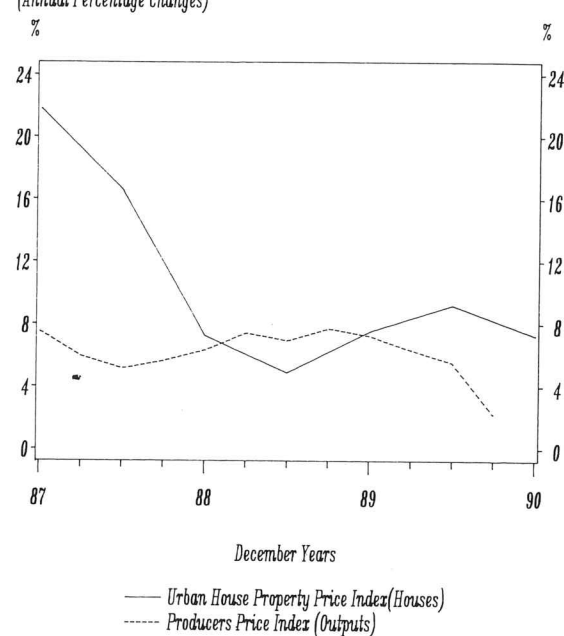
Influences on Inflation
Import and Export Prices (NZ dollar terms)

Source: Department of Statistics

unemployment contributed to this restraint. On the union side these factors were recognised in the form of the 'Growth Agreement'. Many settlements have granted a 2 per cent basic increase, plus an increase of between 0 and 2 per cent, notionally linked to realised productivity gains. Overall, wage settlements appear to have averaged a little over 3 per cent, compared with increases of around 4.5 per cent in the 1989/90 round of settlements.

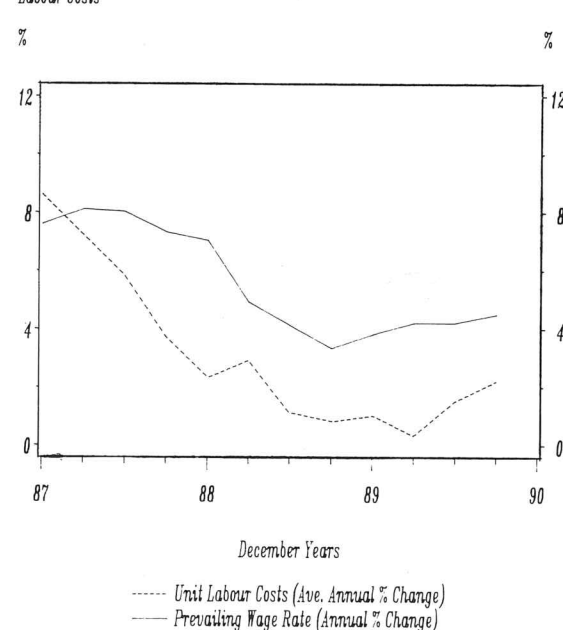
The lower wage round, the slowing in food price rises, and the fall in CPI inflation to 5 per cent in the year to September appear to have prompted a significant drop in household inflation expectations. The Reserve Bank's November survey showed a year-ahead expectation of 8.3 per cent. In contrast, there was a further increase in the rate of inflation expected by businesses, to 5.2 per cent. Businesses were already expecting a much lower rate than households, partly because they better recognised the temporary nature of the GST impact on inflation.

Figure 10

Influences on Inflation
(Annual Percentage Changes)

Source: Department of Statistics and Valuation New Zealand

Figure 11

Influences on Inflation
Labour Costs

Source: Department of Statistics and RBNZ

The recent sharp fall in oil prices should, if sustained, help generate further improvements in inflation expectations over coming months, and reinforce a generally positive outlook for domestic inflationary pressures. In addition, the slowing in house price inflation has marked a welcome development in recent months. This slowing appears to represent a change in the inflationary psychology which has pervaded New Zealand for so long, that house prices are sure to rise. The sustainability of significant further reductions in interest rates will depend importantly on securing reductions in household inflation expectations.

Monetary Policy Developments

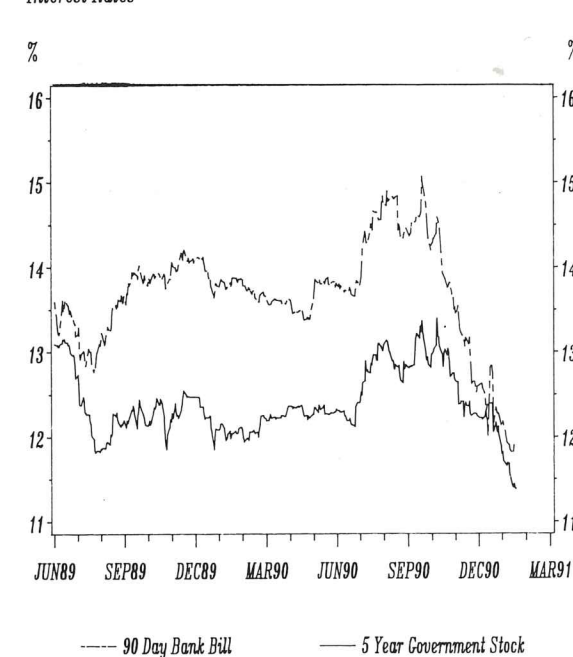
On 19 December 1990 the Minister of Finance and the Governor of the Reserve Bank signed a new Policy Targets Agreement, which altered the target date for the achievement of price stability to December 1993. However, for most of the period covered by this Statement, monetary policy was conducted under the terms of the previous Policy Targets Agreement signed in March 1990. The Bank has continued to monitor the monetary indicators closely, in light of the indicative inflation ranges and of the successive Policy Targets Agreements, acting when appropriate to ensure that monetary conditions remained consistent with meeting these goals.

In mid-August 1990, following the post-Budget tightening of monetary policy in early August and Iraq's invasion of Kuwait, the exchange rate had firmed to 62 on the TWI, supported by 90-day rates that, at about 14.65 per cent, were around 1.2 percentage points higher than those three months earlier. Bond rates stood at about 13 per cent, after firming along with foreign long-term interest rates in response to escalating tensions in the Middle East. Over the remainder of August, however, the exchange rate depreciated to about 61 on the TWI. This fall was temporarily interrupted by a sharp rise in short-term interest rates caused by cash distribution problems in the banking system, but continued when the Bank acted to relieve these unnecessary pressures on interest rates.

The change in Prime Minister on 4 September led to a further rise in interest rates, until it was made clear later that day that the Hon. D. Caygill would remain as Minister of Finance. After firming temporarily in response to the rise in interest rates, the exchange rate remained relatively stable. Bond rates eased to around 12.8 per cent once this source of political uncertainty was removed. Ninety-day rates, however, ended slightly up on their level prior to the change in Prime Minister, at 14.8 per cent. Wholesale funding costs at this level threatened further increases in

Figure 12

Interest Rates



Source: RBNZ

retail lending rates, perhaps by as much as 1 percentage point.

In the event, such rises did not occur. The announcement on 17 September of the 'Growth Agreement' between the Government and the Council of Trade Unions eased short-term interest rates, with 90 day rates falling to around 14.4 per cent. (The reaction of the Bank to the 'Growth Agreement' is discussed in the next section.)

Bond rates did not respond significantly to the 'Growth Agreement'. It is probable that the agreement was seen only as easing the degree of monetary policy pressure that would be required to achieve the 1990 and 1991 inflation goals, rather than as improving the medium to long term chances of price stability finally being achieved.

Moreover, the widespread expectation that the Labour Government would be defeated in the October election meant that little or no weight was put on the promises of fiscal savings, and there was little expectation that the agreement would prove to be an enduring part of New Zealand's economic landscape.

The exchange rate began to fall steadily in response to lower short-term interest rates. Many in the financial markets were surprised that the Reserve Bank did not express concern when the exchange rate went below 60 on the TWI - a rate believed by many in the markets to have considerable significance - in early October. Monetary conditions, of course, must remain consistent with the achievement of price stability. Given the strength of other influences on prices, meeting that target has implications for the extent to which the exchange rate can fluctuate. However, the lower wage settlements being achieved as the wage round got underway meant that there was some scope for the Bank to stand aside in the face of downward market pressures on the exchange rate without jeopardising the inflation goals.

By mid-October, however, the continuing exchange rate falls led some investors to begin to question the strength of the Bank's commitment to price stability. The Bank was concerned to avoid any erosion of the growing, but hard-won, credibility of its commitment to the price stability objective. Accordingly, the Bank responded with a public statement reiterating its intention to maintain monetary conditions consistent with the 0-2 per cent inflation objective. In the event, this statement was misinterpreted by some commentators as signalling that the Bank was largely indifferent to exchange rate developments. In consequence, the exchange rate fell further, reaching a four-year low on the TWI of 57.3.

To prevent any further confusion developing, the Bank acted to reaffirm its monetary stance on 18 October, and issued a further statement emphasising that it remained

Figure 13

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



Source: RBNZ

committed to achieving the price stability target. This action stabilised the exchange rate at around 58 on the TWI, and sharply increased 90-day rates which rose by about half a percentage point, peaking slightly over 15 per cent. However, as the Bank expected, rates settled back to significantly lower levels within a week. They fell slightly further immediately after the election following the incoming Government's expression of commitment to the goal of price stability by 1993, and to reducing the fiscal deficit.

MONETARY INDICATORS

	90 Day ¹ Bank Bill Yield (%)	5 Year ¹ Govt Stock Yield (%)	Yield ^{1,2} Gap (%)	Exchange ^{1,3} Rate	M3 Annual %	Private Sector Credit Changes ⁴
Annual						
1987	21.1	16.7	4.3	63.0	16.0	17.2
1988	15.4	13.4	1.9	64.5	3.4	9.2
1989	13.6	12.8	0.8	60.6	4.6	10.4
1990	13.9	12.5	1.4	60.5	12.5	11.0
Quarterly						
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.	14.3	12.7	1.6	60.8	7.0	13.3
Dec.	13.9	12.8	1.1	59.1	12.5	11.0
Monthly						
1991						
Jan.	12.4	12.2	0.2	58.4	-	-
Feb.(to 14 Feb)	11.9	11.6	0.3	58.3	-	-

1 Averages of daily observations.

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

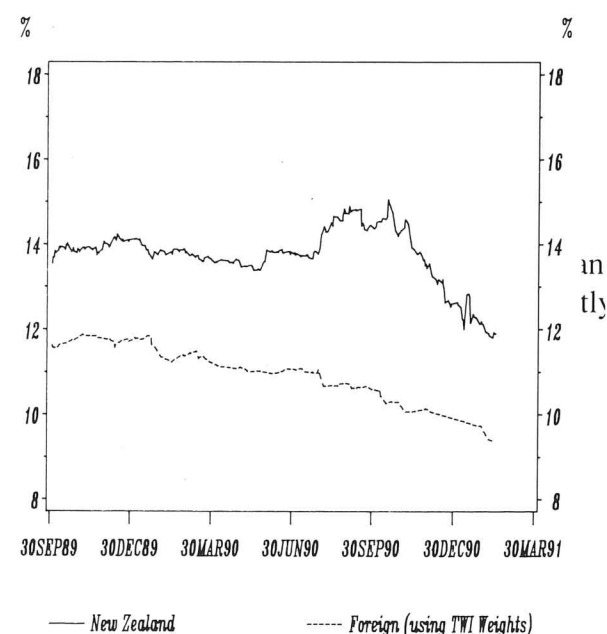
3 Daily trade-weighted index (June 1979=100).

4 At end of period.

These falls were to be quickly reversed. The announcement of further capital injections by the Government into the Bank of New Zealand on 5 November, along with confirmation of a serious worsening in the fiscal position, initially caused both 90-day rates and 5-year bond rates to rise to peaks of 14.6 per cent and 13.4 per cent respectively. Once again though, the initial nervousness quickly passed, and interest rates fell back, assisted by strong statements from senior ministers stressing the Government's commitment to secure significant cuts in public expenditure. The exchange rate remained very steady at around 59 on the TWI, the level to which it had risen immediately prior to the election.

Interbank friction and so-called cash-play activity have been constant sources of tension and disruption in the financial markets over the last couple of years. These activities have engendered unnecessary and, at times, inappropriate movements in short-term interest rates. In response, the Reserve Bank initiated a meeting with settlement banks on 12 November to discuss the operation of the interbank settlement process, and an understanding was reached among the leading banks to help ease the unnecessary recurring frictions.

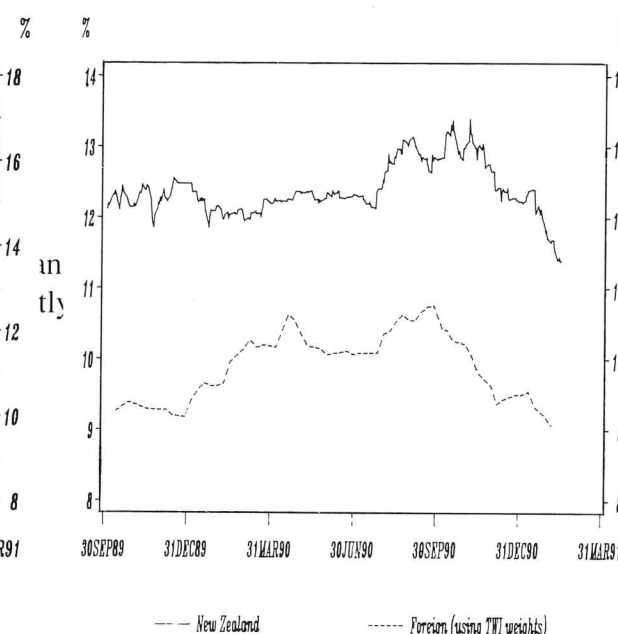
Figure 14
NZ and Foreign 90 day Rates



Source: RBNZ

These moves themselves were not intended to have any monetary policy significance. However, the reduction in the precautionary demand for Reserve Bank bills and settlement cash which had arisen from the previous tensions meant that with unchanged settings of the Bank's policy levers, monetary conditions tended to become somewhat easier. Initial efforts by some market participants to ascribe a policy significance to these moves, together with the easing of the tension itself, led to a sharp fall in 90-day rates, of about 0.6 percentage points, to 13.9 per cent. The relatively loose conditions in the call market were to continue to contribute to the downward pressure on rates until the Governor's statement on 11 January. Bond rates also fell slightly, while the exchange rate remained steady between 59 and 60 on the TWI.

Figure 15
NZ and Foreign Long Term Interest Rates



Source: The Economist and RBNZ

Over the latter half of November and into December there was a continuing gradual, but substantial, easing in interest rates, with 90-day and 5-year rates reaching 13.2 per cent and 12.4 per cent respectively by mid-December. These interest rate falls were supported by the continued smooth operation of the interbank market, which eased pressure on call interest rates. Growing market confidence in the new Government's preparedness to tackle the major economic challenges by reducing public expenditure, comprehensively reforming labour market legislation, and aiming for price stability by December 1993 also contributed to the fall in bond rates. Meanwhile, easing overseas rates, especially in the United States and Australia, took some of the pressure off New Zealand interest rates, and helped account for the general stability in the exchange rate despite the fall in domestic interest rates.

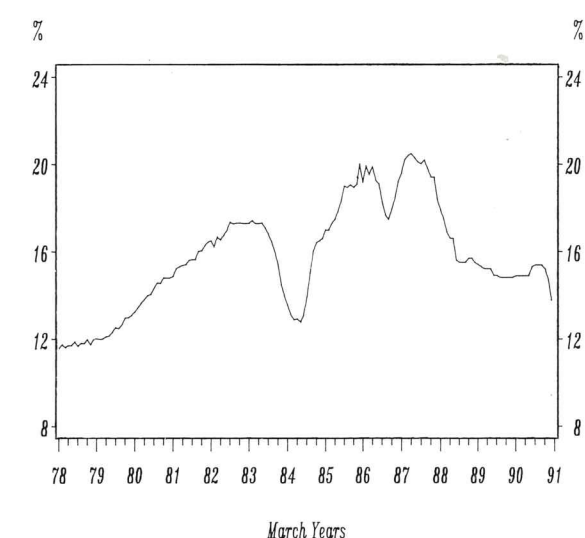
Some nervousness developed in the foreign exchange market just prior to the release of the Government's economic package on 19 December. However, the package was generally well received by financial markets. The extent and systematic nature of the cuts in government expenditure came as a surprise to most observers. The Bank issued a statement welcoming the direction of measures in the package, which was broadly in line with that advocated in the Bank's September Monetary Policy Statement. The Bank indicated its belief that the markets would regard the package as having validated the fall in wholesale interest rates which had taken place over the previous few weeks. Ninety-day rates fell to 12.6 per cent, and bond rates eased to around 12.25 per cent, while the exchange rate stabilised at around 58 on the TWI. (The Bank's response to the 19 December package is discussed in greater detail later in the Statement.)

The announcement of the package removed market perceptions of a risk that the recent falls in wholesale rates would be quickly reversed. In response, banks announced reductions in retail lending rates. Mortgage rates generally fell by almost 1 percentage point to 14.5 per cent, their lowest effective level in over 10 years, excluding a brief period in 1984 when mortgage rate controls were in place. Business base lending rates were reduced by somewhat less.

Early in the New Year short-term rates continued to fall, encouraged by the persistently low call rates (call rates averaged only 11.4 per cent over the first two weeks of January). Without a commensurate easing in inflation expectations and bond rates, 90-day rates fell to about 12 per cent, around 0.35 percentage points below the 5-year rate.

The 19 December expenditure cuts had eased the burden on monetary policy and meant that some reduction in the yield gap was appropriate. Moreover, the price stability target date had been pushed out by one year. However, the Bank's assessment of New Zealand's

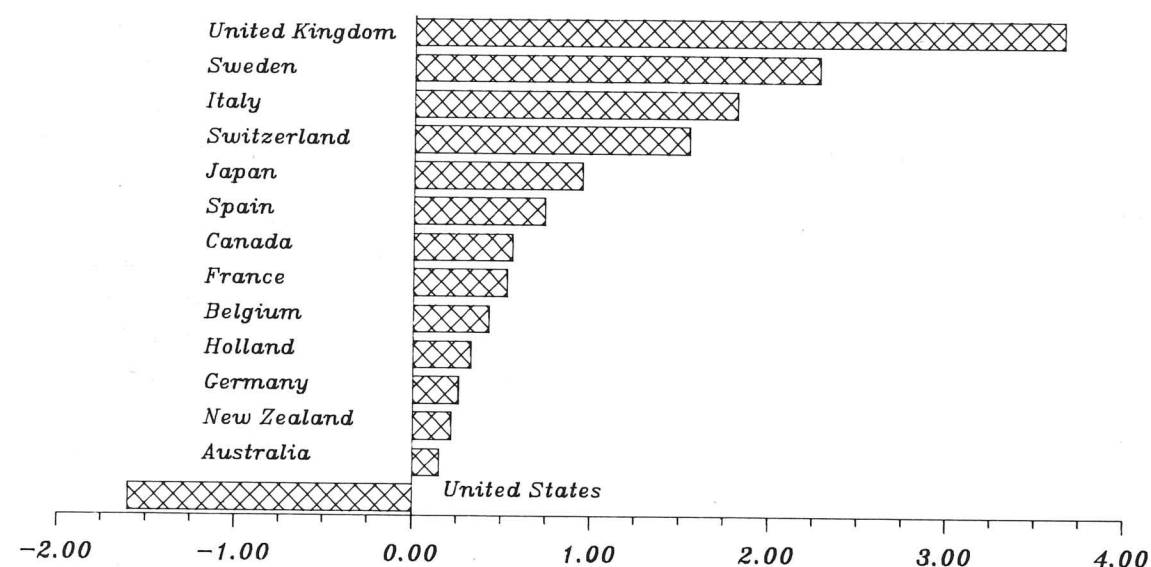
Figure 16
Mortgage Interest Rate



Weighted average rate on new mortgage registrations (excluding Govt institutions) until December 1986. Surveyed first mortgage rates from January 1987.
Source: RBNZ and Department of Statistics

own past experience and of overseas experience is that a slightly downward sloping yield curve is necessary if downward pressure on inflation is to be maintained. For example, almost all other OECD countries currently have 90-day rates higher than those on longer-term bonds. Accordingly, in response to the upward-sloping yield curve which had emerged, the Bank released a public statement on 11 January, reiterating that short-term rates should generally exceed long-term rates while inflation is being brought down. The statement made it clear that very loose cash conditions were inconsistent with an anti-inflationary monetary policy. It indicated that a modest firming in short-term wholesale interest rates would be appropriate and would be the likely result of the new procedures for interbank settlement which were to be announced within weeks. The statement made clear that the reductions in retail lending rates announced in December would not be jeopardised.

Figure 17
Interest Rate Yield Gaps
at 5 February 1991



Source: RBNZ and The Economist

This statement evoked a heavy barrage of criticism of the Bank. Despite the clear statement to the contrary, some claimed that the Bank was threatening the announced reductions in lending rates. Others claimed that the Bank was preventing any fall in interest rates. The critics appeared to overlook the fact, that by the time the statement was made, 90-day rates had fallen by over 2.5 percentage points from their average level in October, and were well below the levels prevailing at the start of 1990. Indeed, 90-day rates were by then at the lowest levels seen in New Zealand since early 1979, setting aside only a few months in 1983 when rates were heavily influenced by the controls then in place. In contrast, bond rates, which are more influenced by longer-term fundamentals and less influenced by current monetary policy, had fallen by only around 1 percentage point since October.

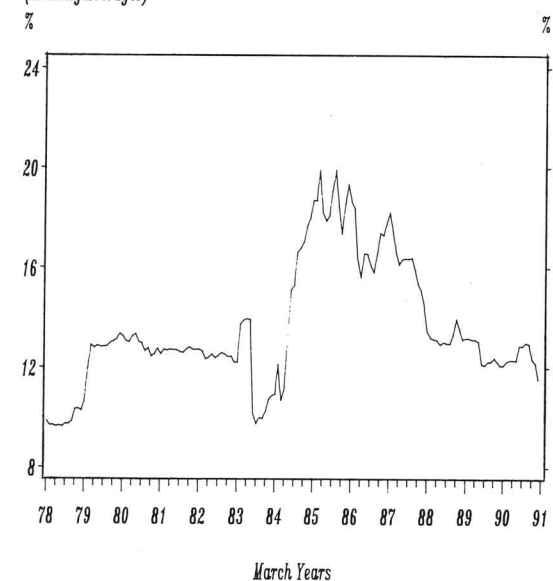
The Bank's critics also appeared to overlook the fact that the gap between New Zealand and most overseas real short-term wholesale interest rates had closed substantially. Real retail lending rates remain relatively high by world standards, although competitive

Figure 18
90 Day Bill Rate
(Monthly Averages)
%



Source: RBNZ

Figure 19
Medium Term Government Stock Rate
(Monthly Averages)
%



2-5 year rate until March 1985, 5 year rate subsequently.
Source: RBNZ

pressures can be expected to close that gap over time, as retail rates adjust fully to changes in funding costs.

Following the 11 January statement, short-term interest rates rose significantly, with 90-day rates reaching a peak of 12.95 per cent. However, this new peak was shortlived. Following the outbreak of war on 17 January, overseas interest rates fell, helping to return 90-day rates to around 12.2 per cent by late January. The impact of the Gulf War on monetary conditions has, to date, been much less than had been expected by almost all observers. The widely expected sharply higher oil prices and higher interest rates have not, to date at least, occurred. Instead, falling oil prices have improved global inflation prospects and created a climate allowing some easing in overseas interest rates. At the same time, the positive December quarter inflation result announced on 17 January helped encourage a further gradual fall in local bond rates, with the 5-year rate falling to below 12 per cent in late January for the first time since the sharp post-Budget fall in bond rates in mid-1989.

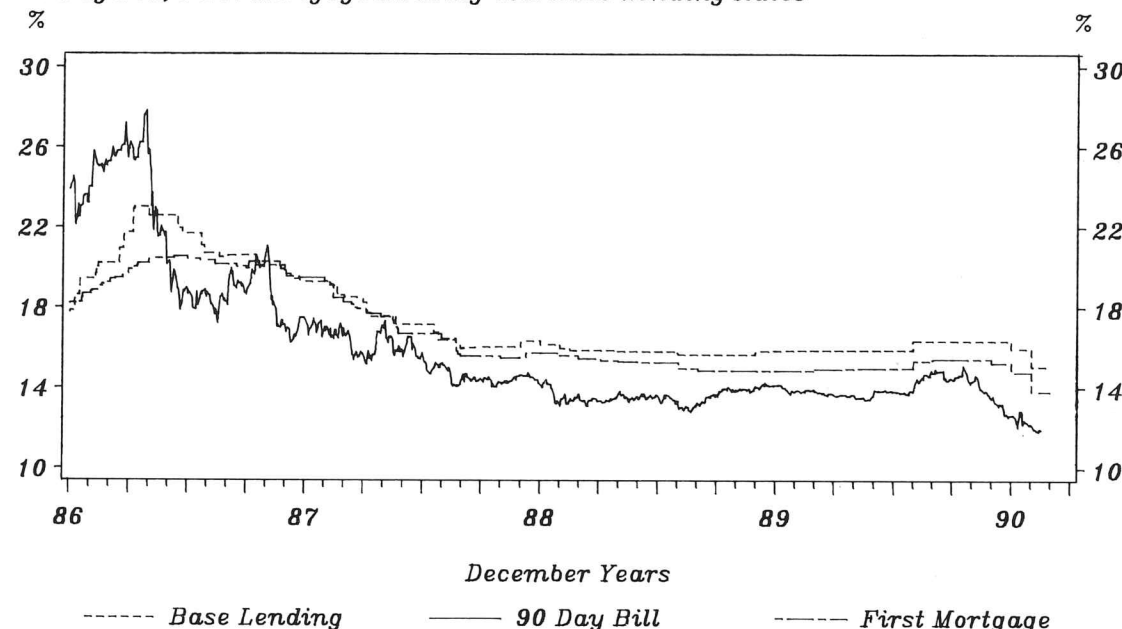
A downgrading of New Zealand's credit rating was announced by the Standard and Poor's agency on 23 January. This move had been widely expected in the financial markets, in view of New Zealand's high debt levels and the prospects for the current account, and simply moved the Standard and Poor's rating into line with that announced some time previously by the Moody's agency. Accordingly, the announcement had little discernible direct impact on domestic financial market prices.

The Bank's new liquidity management arrangements were announced on 1 February. The details of this package are discussed later in the Statement. The new array of instrument settings was intended to be neutral in its effect

on the level and structure of interest rates and was broadly accepted as such by the markets. Over early February interest rates continued to ease gradually. By mid-February, bond rates had fallen to around 11.4 per cent, a new twelve year low, with the sole exception of a period during the 1983 and 1984 controls. Short-term rates had also eased further, reaching a low of 11.8 per cent. In response, there was a further round of reductions in retail lending rates. Most mortgage rates fell to around 13.75 per cent, and business base rates fell to around 14.75-15 per cent. By mid-February, the exchange rate, as measured by the TWI, continued to hover at just above 58.

Figure 20

Funding Costs and Retail Interest Rates
90 Day Bill, First Mortgage Housing and Base Lending Rates



Source: RBNZ

As foreshadowed in our last Statement, credit growth slowed over the second half of 1990. The expected slowing in household credit demand, particularly following the rise in retail lending rates in August, appears to have occurred. Reports at that time of an upturn in corporate borrowing demand have not been fully realised following the fall in business confidence. Moreover, caution by banks about assuming new corporate credit risks following the large loan losses of the late 1980s appears to have continued to restrict the supply of credit to firms. A reduction in the borrowing being undertaken by the state-owned enterprises to repay debt outstanding to the government also appears to have contributed to a slowing in measured private sector credit growth.

Private Sector Credit (PSC) growth has fallen from 14 per cent in the year to June to 11 per cent in the year to December. Growth in the broader credit aggregate, Domestic Credit (DC), has picked up from 7.4 per cent in the year to June, to 11.2 per cent in the year to December. In seasonally adjusted terms, PSC has increased by a total of only 1 per cent in the four months to December, while DC rose by 1.8 per cent over the same period, compared with increases of 4.5 per cent and 3.5 per cent respectively in the four months to August, confirming that credit growth slowed markedly over the final third of the year.

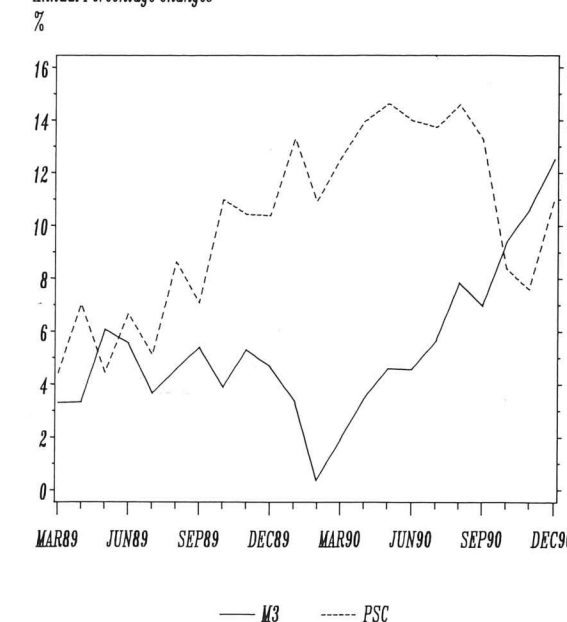
On the other hand, however, the broad money aggregate (M3) grew by 12.5 per cent in the year to December, up from only 4.5 per cent in the year to June. Recent monthly

growth rates have been quite rapid. These divergences are partly accounted for by movements in institutions' foreign currency assets and liabilities, which are not included directly in the aggregates. Financial institutions' funding appears to have been shifting back more heavily to New Zealand dollar sources (boosting M3), with a corresponding reversal in the trend towards increased reliance on foreign currency borrowing evident over much of 1989 and 1990.

The Bank does not, at present, place great weight on the money and credit aggregates in the assessment of policy. However, the narrower aggregates are all contracting in real terms and, with the evidence of a marked slowing in credit growth over recent months, the aggregates generally appear to be consistent with the relatively weak economy and the firm monetary policy that has been in place for most of the last year.

Figure 21

M3 and PSC
Annual Percentage Changes



Source: RBNZ

The Reserve Bank and the 'Growth Agreement'

On 17 September 1990 the then Government and the Council of Trade Unions announced an arrangement which became known as the 'Growth Agreement'. It was a significant event during the period under review in this Statement, although following the change of government the informal agreement has, in effect, been allowed to lapse. Under the terms of the 'Growth Agreement':

- the New Zealand Council of Trade Unions agreed to exercise its influence to achieve wage settlements of 2 per cent, with any further increases to be based on productivity growth; and
- the Government undertook to take substantial steps towards reversing the deterioration in its fiscal position.

The agreement was designed to help lower interest rates and preserve employment by restraining wage increases. It was reached against a background of weaker economic prospects, and the sharp rise in oil prices. The agreement also took into account the implications for the pursuit of price stability of excessive wage rises, which had been spelled out in the Bank's second Monetary Policy Statement published in early September.

The Bank was not a formal party to the agreement, but was associated with it because the parties sought some assurance that the Bank would not step in to offset any falls in interest rates generated by the agreement. As the Bank has stressed repeatedly,

inappropriately high wage settlements have significantly and directly contributed to the costs of eliminating inflation, by imposing unnecessary pressures on real interest and exchange rates. In stating publicly that, other things being equal, the Bank would not interfere with any favourable interest rate developments arising from improved wage and fiscal prospects and improved market confidence about the inflation outlook, the Bank was therefore doing nothing more than reiterating a longstanding policy position. Monetary policy was in no way hamstrung by the agreement, and the Bank's response to the agreement also recognised the market's doubts about the magnitude and permanence of its effects, given the imminence of the election. As already mentioned, the response of bond rates to the agreement was minimal. (The commitment to lower the deficit, although welcome, was never accorded a great deal of weight by markets, given electoral prospects and the nature of the July Budget.)

The Bank has for a long time supported changes to legislative labour market arrangements which would provide for greater flexibility in bargaining arrangements at the level of individual industries and enterprises. Nevertheless, given the legislative structure in place at the time, the Bank believes the 'Growth Agreement' had value as a useful interim measure to promote the wage moderation important to achieving both macroeconomic and microeconomic goals. Certainly, wage settlements since the agreement have been more favourable than earlier appeared likely and, as mentioned previously, these outcomes contributed to a reduction in the need for monetary policy pressure. This additional progress towards lowering underlying domestic inflationary pressures was achieved without cementing-in any new limitations on medium-term labour market flexibility.

The 'Economic and Social Initiative'

On 19 December the new Government announced a comprehensive package of measures, together known as the 'Economic and Social Initiative', broadly along lines foreshadowed in its election commitments. The three strands to the package were:

- major fiscal announcements (actual and foreshadowed);
- the introduction of legislation to facilitate and promote much greater flexibility in labour market arrangements; and
- the signing of the new Policy Targets Agreement extending the target date for the achievement of price stability by one year to December 1993.

The focus of the package was on improving the overall 'mix' of policies. One specific goal was to ease the burden borne by monetary policy in the process of economic adjustment.

On the fiscal front, faced with burgeoning prospective deficits (of up to \$5,000 million by 1993/94) and the likelihood that tax increases would have a detrimental impact on economic confidence and incentives, the Government announced major cuts in public spending, concentrated in the area of welfare expenditure. These policies were forecast to stabilise prospective deficits at below \$3,000 million, while further moves to reduce spending in health and other social policy areas were foreshadowed.

The interaction between aggregate fiscal outcomes and monetary policy had not been a major problem over the period from 1987 until the 1990 Budget. Cyclically and inflation adjusted financial surpluses had been achieved. However, the sharp increase in the deficit, following the expansionary 1990 Budget and the deterioration in economic prospects, had renewed pressures on interest rates, and had prompted the Bank's post-Budget tightening in early August.

The expenditure cuts announced on 19 December were crucial not only in substance (reducing domestic demand, and hence the need for pressure on short-term real interest rates), but also as an indication of the Government's seriousness about the pursuit of its macroeconomic policy objectives. These credibility gains were critical in lowering long-term bond rates, by building confidence that the price stability goal would not be abandoned in future in the face of severe fiscal problems.

The fundamental reform of the legislative framework governing labour relations announced in the economic package was a welcome development. The reforms will allow the basis of employment arrangements, whether individual, work-place, enterprise, industry-wide or occupational, to be determined by workers and employers directly. The Bank supports the general thrust of these reforms, and believes that change along these lines will go some way to facilitating more rapid productivity growth.

Taken together, the policy measures announced on 19 December pointed in the direction of lower interest rates. Longer-term inflation risks had been lowered, tending to lower the overall level of interest rates; domestic demand pressures had been eased, pointing to the need for a smaller yield gap. On top of this, the Government's decision to extend the disinflation process by a further year, pushing out the price stability target date to 1993, meant that the Bank had a responsibility to exert slightly less downward pressure on inflation, by allowing somewhat easier monetary conditions.

The Bank welcomed the package, much of which was in line with the approach advocated in the September Monetary Policy Statement. It is certainly not the end of the policy adjustment process, but it is a welcome development, and has helped to facilitate a significant lowering and flattening of the yield curve. The Bank's statement released following the announcement (see Appendix 2) indicated the Bank's belief that the package would be seen by the markets as having vindicated the fall in interest rates and the flattening of the yield curve that had taken place over the previous few weeks.

THE PATH TO PRICE STABILITY

Inflation Outlook

Fulfilling the new Government's election commitments, and consistent with the economic adjustment difficulties facing the country, the new Policy Targets Agreement has extended the target date for achieving price stability by one year, to December 1993. After achieving the 3-5 per cent indicative range last year, and having maintained a consistently anti-inflationary stance, there can now be little doubt about the strength of the Bank's commitment to achieving the price stability target set for it: 0-2 per cent annual CPI increases by the end of 1993. Monetary policy will be implemented to maintain monetary conditions that will achieve that target. The consistently firm monetary policy maintained over the last year has already meant that the scene is now set for further progress in lowering underlying inflation.

The international environment remains rather uncertain. The future course of oil prices is one example of this uncertainty. At present it appears that oil prices may settle at below US\$20 per barrel for the benchmark Dubai crude while the Gulf War continues and fall further after the cessation of hostilities. Such an outcome would cancel out the adverse impact on domestic inflation of the much higher prices which prevailed from August to January. At this stage, the Bank's forecasts are based on the assumption that oil prices (Dubai crude) will average US\$18 for the coming year - still slightly higher than before the Middle East crisis - before falling away further over the following year. On this basis, we expect a -0.3 per cent direct CPI impact in the year to December 1991, as opposed to an increase of 1.2 per cent expected at the time of our last Statement.

Other, more fundamental, influences on inflation also appear relatively favourable at present. With average wage increases in the 1990/91 wage round of a little over 3 per cent, continuing productivity growth should ensure that labour cost pressures on prices are restricted to little over 2 per cent. However, it will be critical to ensure that wage settlements under the new labour relations regime are consistent with the achievement of **aggregate** wage restraint. The Bank expects that unemployment will continue to rise over the next year, which should work to maintain wage restraint.

Turning to the other fundamental influences, import prices, excluding oil price effects, have also been very weak recently, although the depreciation in the exchange rate in the December

Figure 22

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

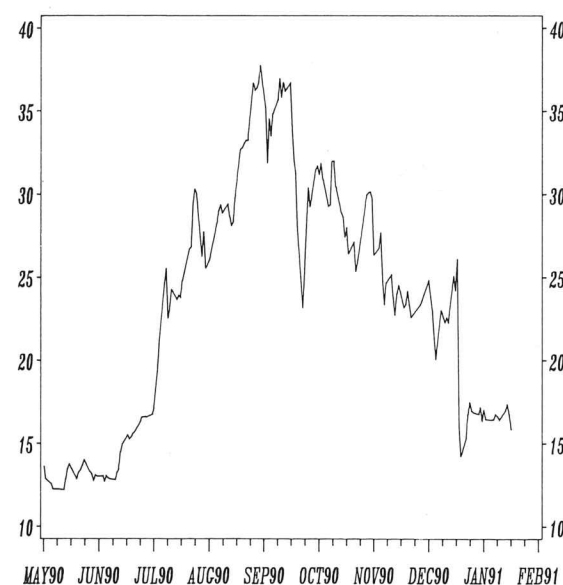
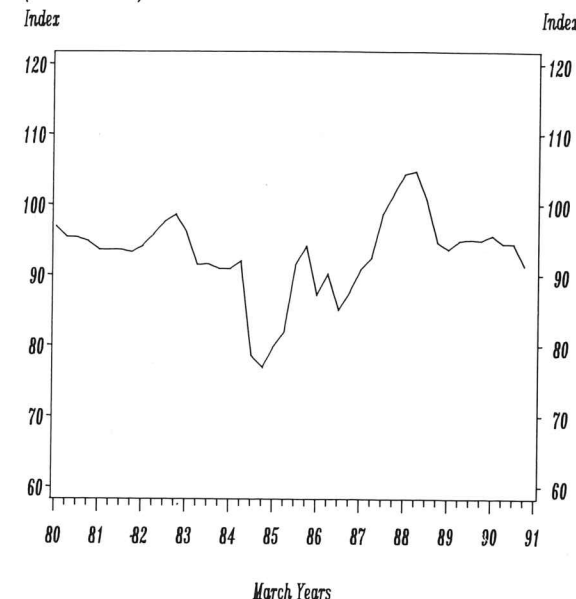


Figure 23

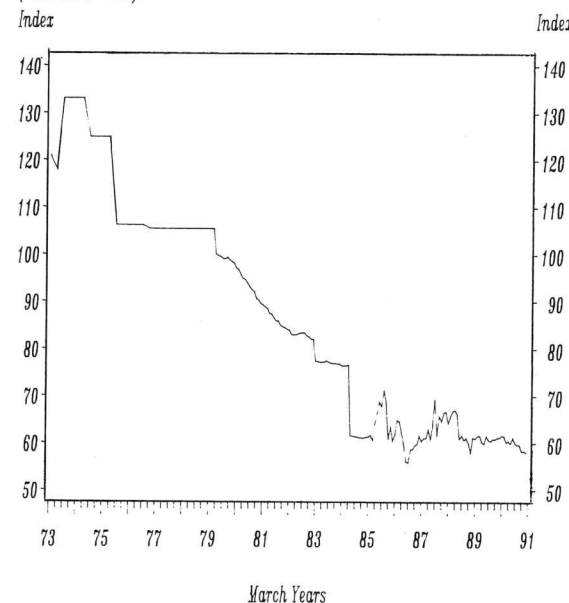
Real Exchange Rate (Relative CPI Basis)
(June 1979 = 100)



Source: RBNZ

Figure 24

Nominal Exchange Rate (TWI)
(June 1979 = 100)



Source: RBNZ

quarter may have pushed prices up a little. Import prices have been growing less rapidly than general consumer prices among our trading partners, in part because of the composition of our imports, and in part because falling tariffs in New Zealand are encouraging substitution in favour of cheaper imported goods.

Most anecdotal and statistical evidence is also pointing to a significant slowing in the rate of house price inflation - in particular, house prices fell slightly in late 1990. Constrained household incomes and falling inflation expectations should mean that gradual mortgage interest rate cuts can be sustained without a major risk of reigniting inflation. (The falling mortgage rates themselves can be expected to lower the CPI, although this factor does not affect the Bank's Housing-Adjusted Price Index (HAPI).) All these influences were broadly consistent with ensuring that inflation fell within the 1.5-3.5 per cent ex-oil indicative inflation range for 1991, set when the price stability target date was December 1992.

However, given the likely continuing balance of payments pressures, the deteriorating terms of trade, and the impact of continuing high debt levels it may be that some, limited, pressure on the exchange rate will emerge over the coming year. Such pressure would of course initially contribute to an improvement in the competitive position of New Zealand industry. Greater competitiveness was identified in our last Statement as an important ingredient in generating the shift of resources needed to sustain a durable recovery in New Zealand's economic performance.

At that time, the Bank indicated its view that a nominal depreciation in the exchange rate was not the most appropriate route to achieve such adjustment, because of the resulting inflation risks.

However, the weaker economy which has become apparent since then, the more realistic attitudes adopted by employers and unions in the last wage round, and the additional leeway provided by the one year extension to the price stability target date, together suggest that a greater degree of flexibility in the nominal exchange rate is now possible, with less risk of reigniting underlying inflation pressures. The Bank's view on the need for an improvement in competitiveness has certainly not changed, but the circumstances for some nominal depreciation to lead to a sustained improvement in the real exchange rate have become somewhat more favourable.

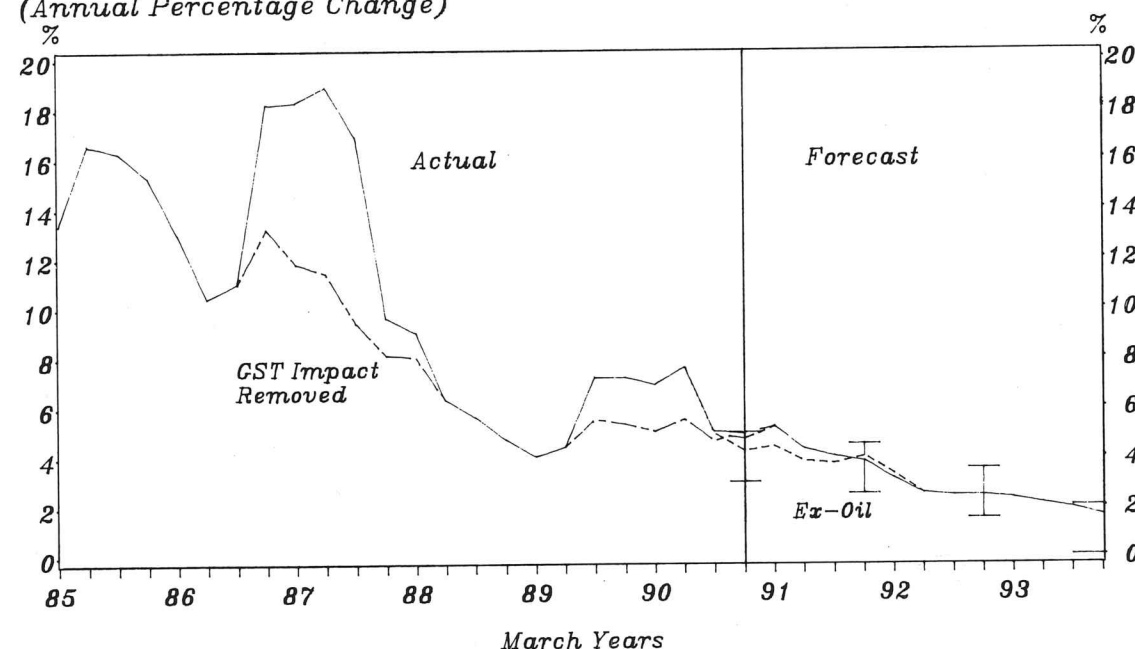
Given all these considerations, the Bank now considers that it would be appropriate for ex-oil inflation to follow a track leading to annual CPI increases of:

- 2.5-4.5 per cent for the year to December 1991;
- 1.5-3.5 per cent for the year to December 1992; and
- 0-2 per cent for the year to December 1993, and thereafter.

This track is broadly similar to that specified in our first Statement in April 1990, moved out by a year. The first year's indicative range has been reduced by half a percentage point compared with the previously stated range for the year to December 1990, reflecting the progress that has already been made in reducing inflation. The new track for the final two years mirrors that previously specified for 1991 and 1992. This pattern is consistent with the extension of the final target date.

Figure 25

Consumers Price Inflation
(Annual Percentage Change)



Source: RBNZ and Department of Statistics

It is important to reiterate the provisions of the Policy Targets Agreement which cover the circumstances in which the Bank would not be expected to counteract a price shock. In these circumstances, inflation might legitimately fall outside the 0-2 per cent range at the end of 1993. The Bank envisages applying these same standards to monitoring the indicative inflation ranges. Thus, a significant negative oil price effect or a significant fall in mortgage interest rates would be regarded as a justification for inflation undershooting this year's indicative range. By the same token, the move foreshadowed

THE NEW POLICY TARGETS AGREEMENT

Following the passage of the Reserve Bank of New Zealand Act 1989, the first Policy Targets Agreement (PTA) between the Minister of Finance and the Governor of the Reserve Bank was signed on 2 March 1990. This agreement was reproduced as an Appendix to the first Monetary Policy Statement.

Such agreements are required under Section 9 of the Act. They put in concrete form the general statutory objective for the Bank's monetary policy: achieving and maintaining a stable general level of prices.

Following the October 1990 general election, a new Policy Targets Agreement was signed on 19 December 1990. That agreement is reproduced as the Appendix to this Statement. The revised agreement gave effect to the new Government's commitment to extend the target date for the achievement of price stability out by one year. The opportunity was also taken to review the early working of the first Policy Targets Agreement. Stemming from this review, a number of other changes have been made to the Agreement. These changes will provide a more workable and robust operational and accountability framework.

Under the first PTA, the Bank had the right to seek a renegotiation of the agreement (and, specifically, of the target date for the achievement of price stability) in the case of specified events outside the Bank's control which would have made it either impossible or inappropriate to have achieved price stability by the original target date. Such events included a change in the rate of GST, a sharp change in the terms of trade (such as an oil shock), housing market distortions to the CPI (as captured by the Bank's HAPI index), or natural disasters which could significantly affect the price level. Under this mechanism, the inflation target and timetable could be adjusted in agreement with the Government, with the new agreement available for public scrutiny and comment.

In the revised Policy Targets Agreement this procedure has been altered. It was judged that a formal renegotiation of the Agreement was not necessary in the face of such shocks, and indeed that frequent renegotiations could be counterproductive, detracting from confidence in the medium-term focus and the consistency of policy that the new legislative arrangements for monetary policy were intended to promote.

In its place is a system which also recognises that certain shocks should be allowed to pass directly into a higher or lower price level, and thus that at times the CPI inflation rate might move outside the 0-2 per cent target range. The Bank is now made directly accountable for the handling of such shocks. The Bank must detail fully its estimate of the direct price impact of such a shock, and set out the actions it has taken or proposes to take to ensure that the inflationary effects are transitory. It will be up to the monitoring agencies - the Bank's Board, the Minister, and Parliament's Finance and Expenditure Committee - and the public to assess whether the Bank has acted appropriately and responsibly in the circumstances.

The list of shocks to which these provisions are envisaged to apply does not attempt to cover every eventuality. However, in addition to the specific shocks outlined in the previous PTA, the new agreement recognises that some allowance should be made for significant price level impacts arising from changes to government or local authority charges.

It should be emphasised that these changes to the Agreement are of a technical nature, flowing from a review of the new policy framework in action. The changes in no way represent any change in the joint commitment of the Government and the Bank to ensure that price stability is achieved and sustained.

in the Government's December package towards direct charging of high income people for some health and welfare services could lead to a significant upward CPI effect. Clearly, this effect would not represent underlying inflationary pressure and so would be a justification for being outside the top of the indicative range.

At present, and recognising the numerous uncertainties, the Bank is forecasting that CPI inflation will fall to 3.8 per cent in the year to December 1991 (although, after allowing for the impact of falls in mortgage rates and oil prices, underlying inflation would be a little higher), to around 2.4 per cent in the year to December 1992, and into the 0-2 per cent range in 1993 and subsequent years. Achieving these inflation rates will provide a sustainable basis for continued further reductions in interest rates, in turn helping to underpin the economic recovery.

Monetary Policy Indicators

Monetary policy actions do not immediately influence inflation. Because of the lags, policymakers must have some idea about the relationships between the things they can influence over a short-term horizon and the ultimate inflation objectives. It is these variables which are the 'indicators' of monetary policy.

The Bank uses a 'checklist' of indicators, reflecting the diverse channels through which monetary policy operates. We monitor principally a range of prices (exchange rates, and the level and term structure of interest rates) and quantities (money and credit aggregates). We also draw on other information such as inflation expectations and forecasts, wage developments, and real economic activity. Together, this information is used to assess the consistency of the overall stance of monetary policy with the goal of price stability. Economic developments are included in the list of monetary indicators not because the state of the economy is an independent objective of monetary policy, but rather because the state of the economy is a factor which will influence the degree of inflationary pressure being experienced in the goods and labour markets.

The Bank has operated a checklist approach throughout the entire post-1984 period, although the relative weight attached to each indicator has varied over the six years. The exchange rate has come to assume a greater weight in the checklist, particularly since 1988, and the relative importance of the yield gap has diminished.

However, the whole point of the checklist approach is that neither the exchange rate nor interest rates nor any other intermediate variable is explicitly targeted. Rather, the Bank interprets each indicator in the light of the information contained in all the other indicators. Moreover, it should be emphasised that use of particular policy indicators does not mean that the indicator becomes an instrument of policy - or a target in its own right - as a number of commentators have suggested. It simply reflects an assessment of the relative usefulness of the indicator in interpreting monetary conditions and/or direct inflationary pressures, and the desire to avoid placing undue emphasis on less important indicators or policy channels.

The uses of each of the main indicators can be summarised briefly. The exchange rate is a major direct influence on the prices of internationally traded goods and services in the local market and hence is a major direct influence on inflation. With a fixed inflation target, and given certain behaviour in unit labour costs and the other influences on

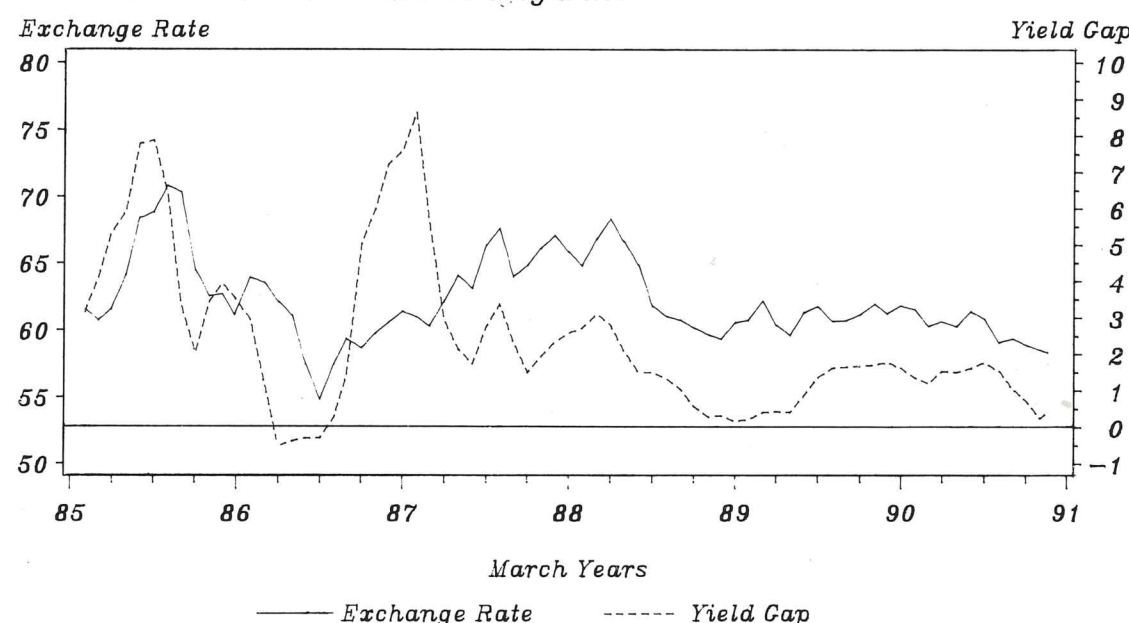
inflation, clear implications follow about the maximum degree of exchange rate flexibility the Bank can afford to tolerate comfortably in normal circumstances.

For example, if wage settlements are particularly low, so that unit labour costs are rising more slowly than expected, the Bank can afford to accommodate some easing in the nominal exchange rate - as happened following the 1990 round of wage settlements. However, the logical corollary to this downward flexibility is that in the face of particularly rapid increases in labour costs, the achievement of the Bank's targets would mean not simply that there should be no depreciation of the exchange rate, but that a tightening in monetary policy would be needed to counteract the resulting inflationary pressures. Such a tightening would have the effect of increasing the exchange rate.

In conjunction with information on the level and term structure of interest rates, the exchange rate can also be an indicator of developments in short-term liquidity conditions in domestic financial markets. However, since the Bank began to focus more closely on the exchange rate in 1988, the information on liquidity conditions has inevitably become more clouded because the exchange rate now, to a much greater extent than previously, incorporates market views of likely Reserve Bank policy responses to movements in the rate.

Figure 26

Nominal Exchange Rate (TWI) and the Yield Gap between 5 Year Bonds and 90 Day Bills



Source: RBNZ

The level and term structure of interest rates, particularly when interpreted along with data on inflation expectations, provide useful pointers to the degree of monetary pressure being imposed on the domestic economy. The gap between 90-day and 5-year yields is accorded special significance. Five year rates are essentially market-determined rates, and over reasonable periods of time are influenced predominantly by required real rates of return and longer-term assessments of inflation and exchange rate risks. By contrast, 90-day rates (and other shorter rates) are heavily influenced by the Bank's monetary policy, as these rates are a key transmission mechanism through which monetary policy operates.

Since 1988, volatility in the term structure has led the Bank to become less confident about accurately interpreting the implications of movements in the interest rate structure. However, New Zealand's own past experience, and that of other OECD countries, is that, in the absence of major short-run disturbances, a downward sloping yield curve is likely to be a necessary part of maintaining a disinflationary stance, and of signalling to the markets that the Bank is maintaining such a stance. This judgment helped motivate the Bank's 11 January statement.

Growth in the money and credit aggregates also provides some information on nominal activity and spending in the economy. The so-called 'monetarist' approach to controlling inflation prescribes that control of the monetary aggregates is all that is required to achieve the inflation goals. However, consistent with foreign experience, the information in the aggregates has been of limited use in recent years, particularly since the financial deregulation of 1984, and given the subsequent pace of financial innovation. The Bank does not, therefore, pursue a 'monetarist' approach to controlling inflation, preferring instead to adopt the more pragmatic 'checklist' approach in accordance with the practice of most foreign central banks.

The pitfalls of any proposals to place heavy reliance on the aggregates were amply illustrated over the past year. The broad monetary aggregate, M3, has the best historical relationship of any of the aggregates with inflation and nominal income. Yet, in the year to June 1990, M3 grew by only 4.5 per cent, and in the year to December 1990, M3 grew by 12.5 per cent. A 'monetarist' approach would indicate that, in response to this recent, relatively rapid growth, monetary policy should now be tightened considerably. But this approach ignores the other indications that inflationary pressure is currently being reduced. Although it cannot be denied that monetary and credit aggregates contain some useful information, it is not, at present, possible to base monetary policy predominantly on developments in these aggregates.

Surveyed inflation expectations provide a pointer to potential price and wage developments in the economy. Moreover, these expectations help monitor the public credibility of the Bank's pursuit of price stability, and, together with data on interest rates, information on inflation expectations helps us to determine the real interest rates, and hence the degree of disinflationary pressure, facing the various sections of the economy.

The interpretation of the indicators is often far from unambiguous. In a world prone to shocks from various directions, characterised by imperfect information, and with no simple reliable relationships between a single indicator and the ultimate objective, the interpretation of the indicators can be complex, especially if the indicators appear to be telling conflicting stories. It is partly for this reason that the Bank looks at a wide range of indicators, so as not to lose sight of other potential sources of inflationary pressure.

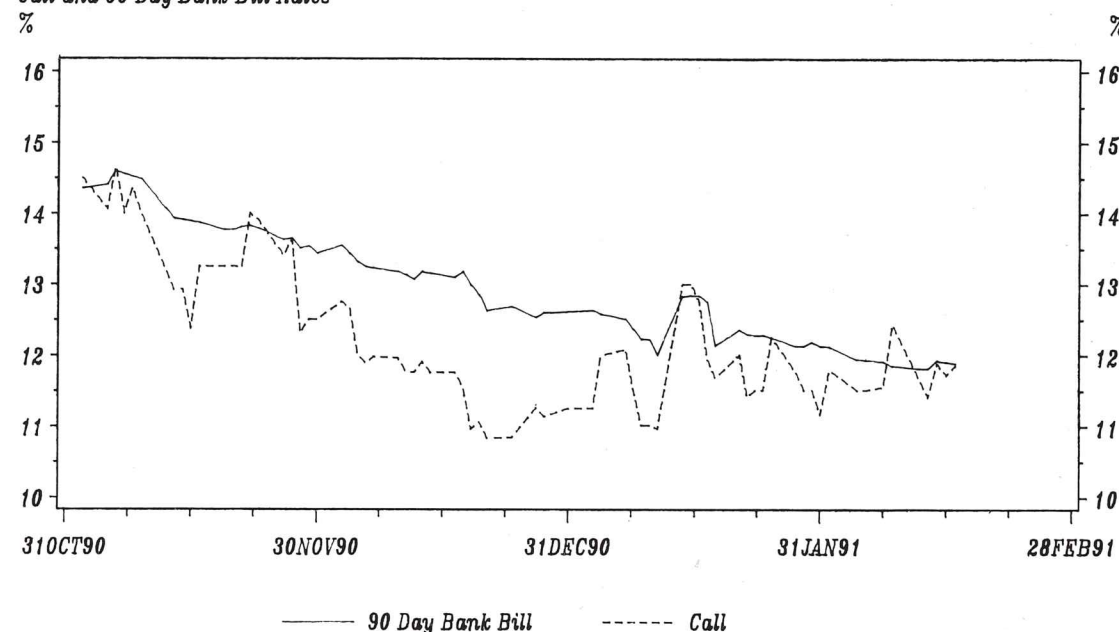
The Bank has regular internal discussions regarding the consistency of developments in the major indicators with its price stability objectives, but it must be stressed that this process does not lead to the establishment of rigid targets and rules. At any point in time, the Bank's view on the appropriateness of the overall stance of policy, and of the levels of the exchange rate and interest rates, is conditioned by the overall picture presented by the complete range of indicators.

Monetary Policy Implementation

On 1 February, the Reserve Bank announced some adjustments to the technical settings of monetary policy. As noted earlier, the added variability in, and unnecessary pressures on, interest rates generated by frictions and 'cash plays' in the short-term money market and the interbank settlement process have been a cause for concern over the last couple of years. In November, the Bank began a formal process of consultation designed to lead to new arrangements which would reduce or eliminate the incidence of such disturbances in future. The Bank noted in the consultations that it would also have to adjust operating settings to take account of the consequent reduced precautionary demand for primary liquidity assets. This reduced demand contributed to the very sharp easing in short-term interest rates over late December and early January.

Figure 27

Interest Rates
Call and 90 Day Bank Bill Rates
%



Source: RBNZ

The Bank's 11 January statement took the opportunity to remind market participants that the new policy settings to be announced shortly thereafter would be designed to offset the reduced demand for settlement cash and Reserve Bank bills. Interest rates firmed in response. Accordingly, when the package was finally announced, the Bank did not intend to generate any systematic movement in interest rates.

The details of the package involved:

- a reduction in the term of Reserve Bank bills to 63 days and an increase in the size of each tender to \$70 million, thus increasing the volume of discountable securities;
- a reduction in the penalty discount margin from an effective 1.2 percentage points above market rates, to an effective 0.9 percentage points above, thus reducing the cost of discounting;
- a reduction in the daily settlement cash target to \$15 million, hence increasing the expected frequency of discounting.

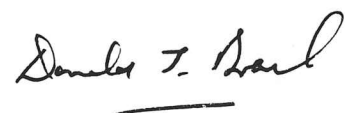
In addition, the Bank formalised the arrangement - accepted by the banks in November - that disruptive competitive behaviour in the interbank settlement market should be avoided. To this end the Bank restated that it retained the right to lend at the point of settlement to foil any attempted disruptive tactics.

The new arrangements come into effect fully on 22 February 1991. These changes have no implications for the stance or direction of monetary policy, or for the degree of pressure the Bank will be looking to apply. They are technical adjustments designed to overcome certain operational difficulties. However, the Bank does believe that the new framework will prove conducive to the more effective, consistent, and transparent implementation of monetary policy.

CONCLUSION

The first anniversary of the new monetary policy framework, enacted in the Reserve Bank of New Zealand Act 1989, was reached on 1 February 1991. This legislation was an integral part of the overall economic adjustment programme. The results of the new structure are already apparent, with the success of the Bank in achieving the first of its indicative inflation ranges. This success has helped to deliver the marked reductions in wholesale interest rates achieved during the year, which are now being translated into significant and welcome reductions in retail lending rates.

The success has been achieved against a difficult external environment, which is likely to continue for some time. The weak world economy and the Middle East situation remain particularly important constraints. In the circumstances, a rapid return to fast growth is unlikely over the next year. However, the Bank looks forward to the time when the price level has stabilised, and hence nominal interest rates have fallen back sustainably into single figures. Such outcomes in turn will boost growth, employment and balance of payments prospects. The Bank is committed to doing all in its power to facilitate such outcomes. The essence of this will be our commitment to pursue price stability consistently. Acting on this commitment should continue to increase confidence among investors, here and abroad, and provide the basis for interest rates to fall still further. Significant progress has already been made in the battle against inflation - and hence in the battle against high interest rates. Over the next few years the Reserve Bank's task is to finish the job, and so lay the basis for a sustainable low interest rate structure, with the attendant benefits for the whole economy.



Donald T Brash
Governor

APPENDIX 1

RESERVE BANK OF NEW ZEALAND POLICY TARGETS AGREEMENT

This agreement replaces that signed under section 9(2) of the Reserve Bank of New Zealand Act 1989 (the Act) on 2 March 1990.

In terms of section 9(4) of the Act, the Minister of Finance (the Minister) and the Governor of the Reserve Bank of New Zealand (the Governor) agree as follows:

1. Price Stability Target

Consistent with section 8 of the Act and with the provisions of this agreement, the Reserve Bank shall formulate and implement monetary policy with the intention of achieving a stable general level of prices by the year ending December 1993 and maintaining price stability beyond that date.

2. Measurement of Price Stability

- (a) In pursuing the objective of a stable general level of prices, the Bank will monitor prices as measured by a range of price indices. The formal price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), being the measure that is monitored most closely by the public.
- (b) For the purposes of this agreement, annual rises in the CPI of between 0 and 2 per cent will be considered consistent with price stability.
- (c) The CPI is unusual amongst OECD consumer price indices in its treatment of housing costs. The Bank is to continue to publish quarterly its housing-adjusted (consumer) price index (HAPI), which incorporates a different approach to the measurement of housing costs compared with the CPI.

3. Deviations from the Targets

- (a) There is a range of possible price shocks arising from external sources, certain government policy changes, or a natural crisis which are quite outside the direct influence of monetary policy. The Bank shall generally react to such shifts in relative prices in a manner which prevents general inflationary pressures emerging.
- (b) This approach means that the CPI inflation rate can be expected to move outside the 0-2 per cent range in response to particular shocks. The principal shocks are considered to be:
 - significant changes in the terms of trade arising from an increase or decrease in either import or export prices;


- an increase or decrease in the rate of GST, or a significant change in other indirect tax rates;
 - a crisis such as a natural disaster or a major disease-induced fall in livestock numbers which is expected to have a significant impact on the price level;
 - a significant price level impact arising from changes to government or local authority levies; and
 - a significant divergence between the CPI and HAPI inflation rates.
- (c) In the event of such shocks, the Reserve Bank shall be fully accountable for its handling of the price effects, and, in particular, for any movements outside the 0-2 per cent band. In each Policy Statement made under section 15 of the Act, the Bank shall detail fully its estimate of the direct price impact of any such shock and the impact on the Bank's achievement of the price stability target. The Bank shall also detail what measures it has taken, or proposes to take, to ensure that the effects of such shocks on the inflation rate are transitory.

4. Renegotiation of the Targets


The policy targets are established on the understanding that the monetary policy instruments available to the Bank are adequate to achieve the objective. The Governor shall inform the Minister if he considers that any changes in these policy instruments impair the effective conduct of monetary policy. The Minister and the Governor may then set new policy targets.

5. Implementation

- (a) The Bank shall implement monetary policy in a sustainable, consistent and transparent manner.
- (b) Each Policy Statement released by the Bank under section 15 of the Act shall contain a statement of how the Bank proposes to formulate and implement monetary policy to ensure that price stability is achieved and maintained over the succeeding five years. The Policy Statement should also contain a projected path for inflation for each of the years until the price stability target is achieved.


 Ruth Richardson
 Minister of Finance

19 December 1990


 Donald T. Brash
 Governor
 Reserve Bank of New Zealand

APPENDIX 2

RESERVE BANK STATEMENTS ON MONETARY POLICY

The following significant media releases on monetary policy issues were made by the Bank during the period under review in this Statement:

The Reserve Bank and the 'Growth Agreement'

17 September 1990

The Governor of the Reserve Bank, Don Brash, welcomed today's joint initiative by the Government and the CTU.

"I am very hopeful that the cooperative spirit of the agreement will help to deliver the improvement in competitiveness that this country needs.

"As emphasised in the Bank's recent monetary policy statement, if we are to make progress in reducing the balance of payments deficit and reducing the numbers of unemployed then it is very important that wage increases be aligned with productivity performance rather than past inflation.

"In particular, any flow through of the recent oil shock into higher wages could severely damage the prospects for a return to sustainable, non-inflationary, growth.

"If the Government-CTU initiative can help achieve this objective, then clearly there will be less work for monetary policy to do.

"Similarly, if new fiscal initiatives can make a greater contribution to the adjustment process then the burden on monetary policy will be further reduced.

"It is my view that today's commitments by Government and the CTU leave scope for some easing in current monetary conditions.

"At the end of the day, the interest rate path over the coming year will depend very much on actual wage and fiscal outcomes.

"But I am happy to enter into the spirit of this agreement and am keen to see it succeed by spreading the burden of adjustment away from monetary policy."

Reserve Bank Reiterates Commitment to Price Stability

17 October 1990

The Governor of the Reserve Bank, Dr Don Brash, today reiterated the Bank's intention to achieve the 0-2 per cent inflation objective of monetary policy. He was reacting to concerns that some investors were questioning the Bank's commitment to the inflation objective following recent falls in the exchange rate.

"The Bank has not had a specific exchange rate target," said Dr Brash, "and in this context we have been content to allow the exchange rate to adjust to recent economic developments. However, we also have to ensure that monetary conditions remain consistent with the achievement of 0-2 per cent inflation.

"Our future actions will continue to be directed to this end," he said.

Governor Explains Today's Open Market Operation

18 October 1990

The Reserve Bank's action today confirms yesterday's statement by the Governor that the Bank is committed to maintaining monetary conditions consistent with its inflation objectives.

"It is clear, after recent exchange rate falls, that overseas investors, in particular, are still questioning the Bank's commitment to the price stability objective," said Reserve Bank Governor, Don Brash. He reiterated the Bank's intention to achieve the objectives that have been set for the Bank.

"Some commentators interpreted yesterday's statement that the Bank had no specific exchange rate target as meaning that the Bank had become indifferent to foreign exchange market developments. But as our first Six Monthly Statement made clear, the exchange rate remains an important indicator of monetary conditions."

Economic Package Response

19 December 1990

The Governor of the Reserve Bank, Dr Don Brash, has welcomed the direction of the measures contained in the Government's economic package. He said that the announcements are broadly in line with the approach to policy advocated in the Bank's September Monetary Policy Statement.

Dr Brash said: "In that statement, we advocated further reform and liberalisation of

labour market legislation. We also stated that 'an appropriate degree of fiscal restraint helps to ease the magnitude of the task facing monetary policy'. We repeated this message both in our response to the 'Growth Agreement' and in our Post-Election Briefing.

"The Bank has consistently stressed the importance of wage moderation in easing the burden of monetary policy. We have already seen considerable moderation in wage inflation over recent months. We are now encouraged to see that there is evidence also of substantial moves towards labour market reform and towards fiscal restraint," said Dr Brash.

He noted that the financial markets had anticipated the broad thrust of the announced measures. As a result, wholesale market interest rates had fallen in recent weeks. He thought that the announced package would be seen by the markets as broadly validating these falls in wholesale interest rates. "There is now room for these wholesale interest rate falls to feed through to reductions in retail interest rates," said Dr Brash.

Monetary Conditions

11 January 1991

The Reserve Bank Governor, Dr Don Brash, stressed today that monetary conditions must remain consistent with the price stability goal. Accordingly, the Bank was concerned to ensure that easy liquidity conditions did not lead to excessively rapid falls in short-term interest rates, and so risk reigniting inflationary pressures.

Dr Brash explained that medium-term bond rates are key pointers to the longer-term sustainability of lower interest rates. These rates have fallen by around 1 percentage point in recent months. The significant and welcome moves announced in the Government's 19 December economic package provided a solid basis for this fall. Many lending rates have also been reduced by up to 1 percentage point, providing a welcome boost to economic prospects.

In contrast, 90-day wholesale interest rates have fallen by around 3 percentage points since October. But fundamentals - improving inflation and fiscal prospects - explain only a part of this fall. Dr Brash said that easy liquidity conditions brought on in part by less-disruptive behaviour in the interbank cash market, have exaggerated the decline in 90-day rates.

Dr Brash explained that some modifications in the Bank's liquidity management arrangements would be announced within the next 2-3 weeks after the completion of market consultations. It is expected that these new arrangements will underpin short-term rates to a greater degree than in recent weeks and lead to some retracement in short-term wholesale interest rates.

Dr Brash stressed that such a retracement would not place in jeopardy the recent falls in retail lending rates, and would not be unexpected by financial markets. Indeed, he noted

that yields in the futures market for 90-day bills are appreciably higher than in the physical market. Experience here and overseas shows that short-term rates must generally exceed long-term rates while inflation is being brought down, and this is fully understood by financial market participants.

Dr Brash noted that the entire interest rate structure has already fallen by 6-7 percentage points since mid-1987. He expressed confidence that further success in lowering inflation and moving towards a financial surplus would provide the basis for both real and nominal interest rates to gradually trend further down. "But", Dr Brash concluded, "it is critical not to do anything now to jeopardise these excellent prospects, by tolerating unduly loose liquidity conditions."

Reserve Bank Reaffirms Policy Consistency

5 February 1991

"There really is not the slightest excuse for any bank to be confused about Reserve Bank attitudes to current interest rates," the Governor of the Reserve Bank, Dr Don Brash, said today. He was commenting on remarks by a banker reported in the Dominion recently that the Reserve Bank had been sending out confused messages on interest rates.

"Our absolute commitment is to the achievement of price stability by 1993, and we will always seek to keep monetary conditions consistent with that objective," Dr Brash said.

"But as inflation reduces, we would expect long-term interest rates to reduce gradually, and this makes possible a gradual reduction in the whole interest rate structure. This process has been going on for some years but has accelerated in recent months.

"Last September we made it clear that we would not prevent a promised commitment to low wages by the CTU having a beneficial effect on monetary conditions.

"In December we welcomed the Government's measures to reduce the fiscal deficit and noted that these validated the significant falls in wholesale interest rates which had occurred and which had taken key 90-day rates to little over 13 per cent.

"In early January we issued a statement, at a time when 90-day interest rates had fallen to 12 per cent - nearly 3 per cent lower than in October - pointing out that short-term rates had fallen in part because of temporary factors and that, if interest rate reductions were to be sustainable, bond rates (reflecting the market's view of future inflation) should lead short rates down. Since then bond rates have fallen further.

"Last Friday, with 90-day rates at 12.1 per cent, and bond rates at 11.7 per cent, I made it explicitly clear at a meeting of all settlement banks in Wellington that the Reserve Bank was happy with the level and structure of interest rates under present conditions. It is hard to be much more clear than that."
