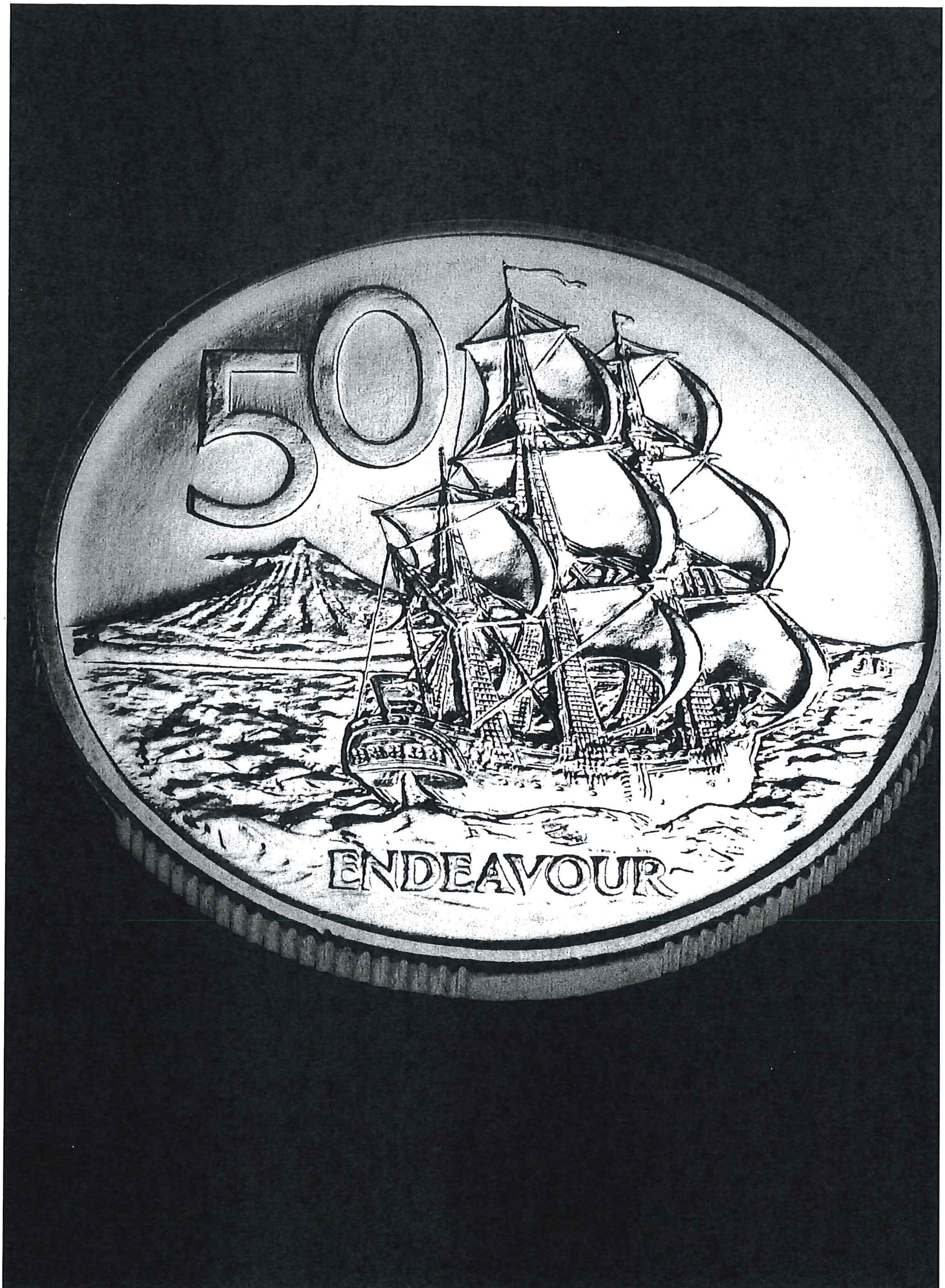
RESERVE
BANK
OF NEW ZEALAND

MONETARY POLICY STATEMENT

June 1995



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Monetary Policy Statement [1]

June 1995

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

Executive summary

Over the past year, underlying inflation has risen to the top of the Bank's 0 to 2 percent target range, and is likely to exceed the range in the June and September quarters. The main factor behind this rise in inflation has been the unsustainably rapid pace of expansion of the economy over the past two years or so. Although the Bank resisted the build-up of inflation pressures with a progressive shift towards a more restrictive monetary policy stance during 1994, it is now apparent that more firming of monetary conditions should have taken place early in 1994.

It is also apparent that strains on the productive capacity of the economy have begun to ease, so that underlying inflation should, in due course, be placed on a downward track. Nonetheless, our projections also indicate that even with monetary conditions maintained at current levels over the remainder of the year, and only a gradual policy easing thereafter, underlying inflation will not return to the middle part of the target range until about mid-1996.

An easing in the stance of policy before the end of this year would extend further into 1996 the period during which inflation is close to or above the upper edge of the target range. As indicated in Section II, this would risk ratchetting up inflation expectations, with consequent damage to our future economic performance.

The Bank's assessment in such circumstances is that an easing of overall monetary conditions at this stage would be premature. Indeed, in view of the particular risks associated with a slower or delayed decline of underlying inflation, the Bank will need to be more than usually vigilant in the period ahead to prevent an easing of monetary conditions.

The appropriate time for moving towards a more neutral policy stance is when expected quarterly rates of underlying inflation six to eighteen months ahead are consistent with annual inflation remaining in the middle part of the target range, after allowing for the effects of the adjustment in monetary conditions. On the basis of our current projections, these conditions are unlikely to be met before the end of this year.

As additional information is received, it may become apparent that an earlier easing of monetary conditions is warranted. Conversely, if indicators point to stronger momentum behind inflation than we currently estimate, not only would easing in monetary conditions be delayed, but a further firming could be required.

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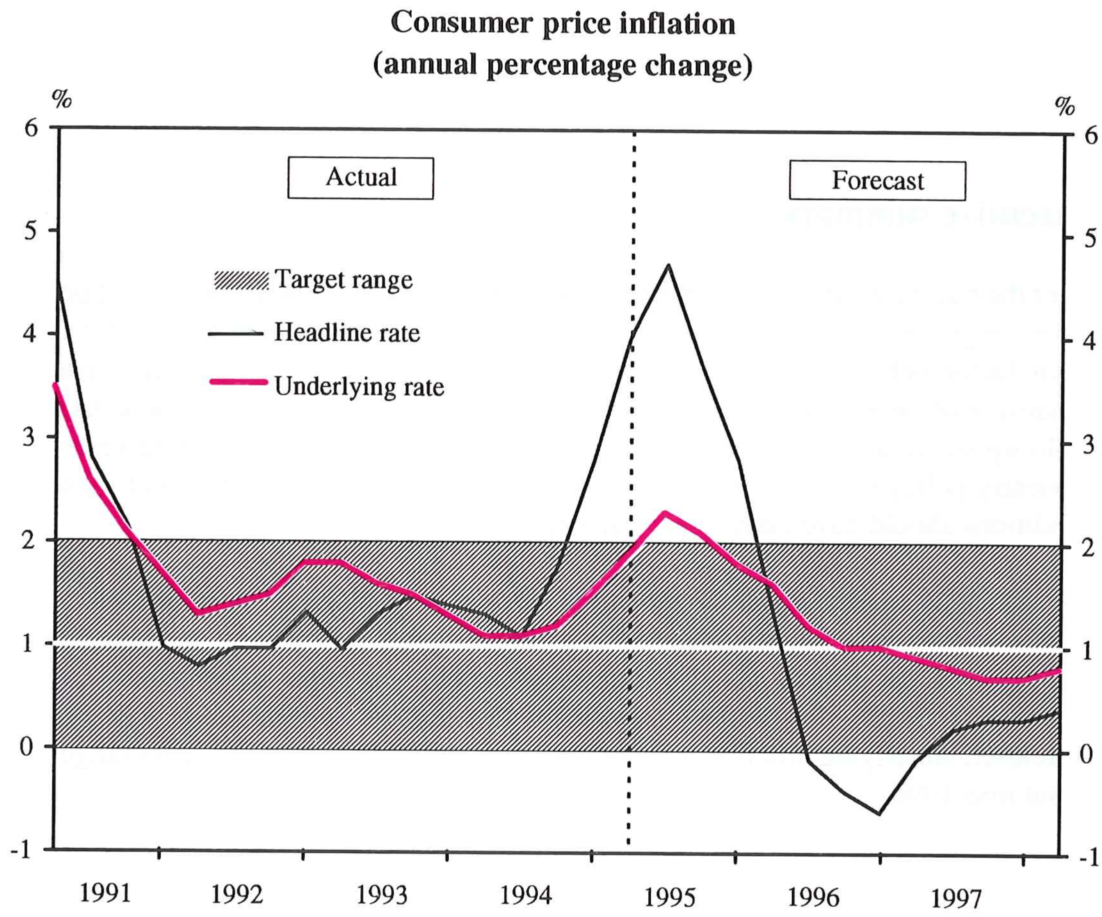
1 Text finalised on 22 June, based on data available to 21 June. Inflation projection based on data available to 16 June.

Figure 1



Consumer price inflation
(annual percentage change)
%
%
6
5
4
3
2
1
0
-1
Actual
Forecast
Target range
Headline rate
Underlying rate
1991
1992
1993
1994
1995
1996
1997

I. Accounting for underlying inflation above two percent

Underlying inflation is expected to exceed 2 percent temporarily.

In the course of the past year, underlying inflation has risen from close to the centre of the Bank's 0-2 percent target range to near the top of the range. Indeed, as indicated in the projections accompanying this *Statement*, underlying inflation is now expected to exceed the 2 percent mark in both the second and third quarters of the year.

Headline inflation will rise higher but decline rapidly thereafter.

The headline inflation rate has climbed much more rapidly than has underlying inflation, and is also expected to decline much more rapidly. As indicated in Box 1, interest rate increases generated by monetary policy actions have led to an unusually large divergence between headline and underlying inflation. Stabilisation of retail interest rates will, in due course, lead to a rapid narrowing of the divergence, while any declines in interest rates will work, in the first instance, to push the headline inflation rate below the underlying inflation rate.

Strong demand and special factors have boosted underlying inflation.

In respect of underlying inflation, the prospective breach of the 0-2 percent target range reflects the combination of demand pressures, and certain special factors. Demand pressures have created some upwards pressure on inflation in several parts of the economy, and nowhere more obviously than in sectors related to housing and the construction industry. Indeed, in the year to June, it is anticipated that inflation in the housing and related sectors will have exceeded 10 percent, and will have contributed fully one-third of the total underlying inflation in that year. The special factors include:

- Adverse climatic conditions, which are expected to result in around a 25 percent increase in fresh fruit and vegetable prices in the year to June 1995 and contribute to up to 0.4 percent to the total increase in underlying inflation.[1]

- An adjustment to the calculation of underlying inflation as from December 1994, to bring the method for excluding movements in credit costs into line with that used by Statistics New Zealand. This is estimated to have contributed an additional 0.2 percent to the Bank's measure of underlying inflation over the year to June 1995.

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1 The movement in food prices arising from adverse climatic conditions is outside the influence of monetary policy, and is therefore akin to items listed in the Policy Targets Agreement (PTA) as permissible reasons for departures of inflation from the target range. However, given difficulty in separating weather-related from other effects, uncertainty about the applicability of the PTA in this instance, and expectations of a quick reversal in the price movement and thus its lack of significance for policy decisions, the Bank does not intend to exclude the food price movement from its estimate of underlying inflation.

Monetary policy needs to allow for the unforeseen...

The food price factor in particular illustrates the risks associated with underlying inflation being close to the edge of the 0-2 percent target range. Inflation is only imperfectly forecastable; at any point in time, unforeseen influences can affect inflation outcomes, and policy needs to allow for this. Had policy better contained upward pressures on underlying inflation, special factors of the kind described above would not have resulted in underlying inflation outside the range.

...by targeting the middle part of the band.

The Bank cannot be comfortable, therefore, with projections that fail to show underlying inflation converging on the middle part of the target range over the policy-relevant horizon. Were such convergence not in prospect, policy would be accepting too great a risk of departures from the target band as a result of unforeseen factors, and too great a risk of erosion of confidence in the Bank's ability and willingness to maintain price stability. If the latter risk were to eventuate, it would make it more costly in social and economic terms to bring inflation down subsequently.

Box 1: The difference between 'headline' and underlying inflation

In the year to the March quarter of 1995, the official or 'headline' measure of consumer prices (the CPI) rose by 4.0 percent, just over 2 percentage points higher than the Reserve Bank's underlying inflation measure. The magnitude of this discrepancy is exceptionally large and warrants explanation.

The Bank's measure of underlying inflation specifically excludes three types of influences on inflation:

- the direct impact on the CPI of interest cost components represented in the CPI;
- the direct impact on the CPI of significant changes in government charges, indirect taxes and subsidies;
- the direct impact on the CPI of significant changes in import or export prices.

In each of the successive Policy Target Agreements (PTAs) signed between the Minister of Finance and the Governor of the Bank since the Reserve Bank of New Zealand Act (1989) came into force[1], the Bank has, in effect, been held accountable for controlling inflation not directly attributable to these three sources. There has been no substantive change in the range of items excluded from headline inflation in judging the stance of monetary policy.

The reason for excluding these three sources of disturbances to inflation from the Bank's operational responsibility is to avoid obliging the Bank to act in a manner which would contribute to instability in the New Zealand economy.[2]

This point can be illustrated by considering, for example, a significant jump in import prices (eg. oil prices), government charges or indirect taxes (eg. GST). Requiring the Bank to offset the immediate and direct impact on overall inflation would lead to a severe tightening of monetary conditions and a sharp contraction of economic activity, regardless of other inflationary pressures, in an effort to force offsetting declines in other prices. As a result, activity and the vast majority of prices in the economy would be less stable than otherwise.

Requiring the Bank to offset the direct impact on the CPI of interest cost movements could be even more destabilising. As a general rule, policy would tighten far too much when inflation was rising and loosen far too much when inflation was declining, greatly amplifying the business cycle in the process.

As shown in the figure below, in the year to March 1995 the gap between headline and underlying inflation has widened from approximately zero to 2 percent. Over the same period, the direct impact of interest costs has gone from slightly dampening the headline rate, to boosting it by nearly 1.5 percentage points. In other words, virtually all of the change in the gap between headline and underlying inflation can be attributed to interest cost effects on the headline CPI.

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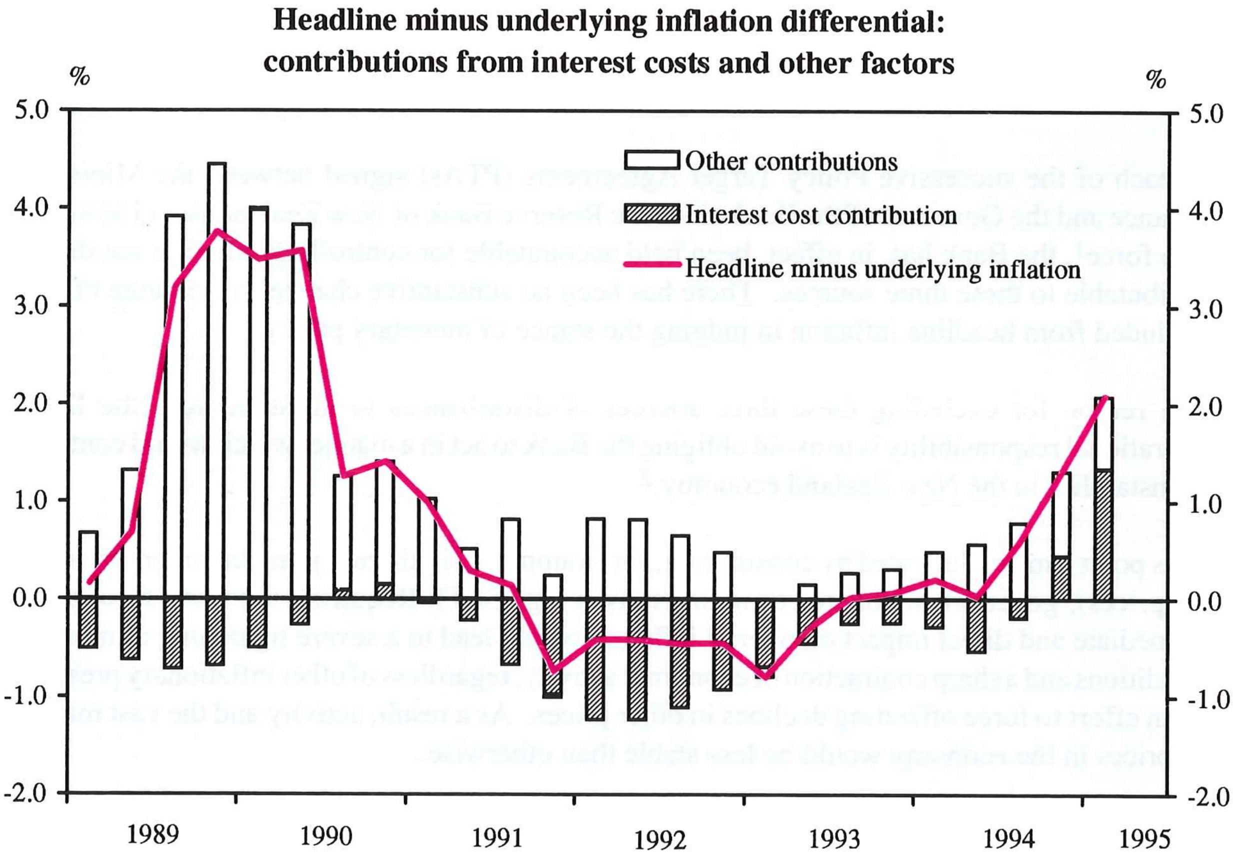
1 The first PTA was signed on 2 March 1990, the second was signed on 19 December 1990, and the third was signed on 16 December 1992.

2 See, for example, S. Roger (1994) "Alternative measures for underlying inflation", *Reserve Bank Bulletin*, Vol. 57(2), pp. 109-29

The current boost to the headline inflation rate from interest cost effects is exceptional in recent experience. As shown in the figure, declines in interest costs have worked to hold down the headline inflation rate almost continuously since 1989, and largely account for the fact that headline inflation fell below the underlying rate from the second half of 1991 until mid-1993.

It may also be noted that, over the full course of a business cycle, the average rates of headline and underlying inflation should be very similar (abstracting from other disturbances to the headline rate, such as GST effects). Stabilisation of retail interest rates will, in due course, lead to a rapid narrowing of the differential, while any declines in interest rates will work, in the first instance, to push the headline inflation rate below the underlying inflation rate.

Figure 2



Note: Other contributions to the differential include significant changes in Government charges and indirect taxes as well as significant changes in international trade prices.

II. Issues facing monetary policy

Policy setting is driven by economic projections...

The experience of the past year illustrates some of the most important challenges involved in maintaining price stability. Because there is a substantial lag between making adjustments to the stance of monetary policy and their ultimate impact on inflation, policy needs to be set on the basis of economic projections. But projections are inherently uncertain. As a result, it is impossible to rule out completely inflation outcomes outside the target range. The closer that projected inflation is to the centre of the target range, the lower the chances of outcomes outside the range.

...which are inherently uncertain.

An essential element involved in translating a set of economic projections into policy decisions is an assessment of the uncertainties or risks surrounding the projections. In the current context, with underlying inflation so close to the upper edge of the inflation target range, it is particularly important that the Bank carefully identify risks in the inflation outlook, as well as their potential consequences.

New Zealand appears less prone to inflation than previously...

The Bank's projections have for some time presumed that the relationship between activity and inflation in New Zealand has been significantly altered by the restructuring of the economy and economic policies over the past decade. The increased exposure of the economy to international competition, together with the stabilising influence on inflation expectations of the New Zealand monetary policy framework, were both expected to dampen the sensitivity of price and wage inflation to developments in activity.

... reflecting a more open economy and expectations of price stability.

The evidence to date suggests that this view has been substantially correct. The information available points to price-setters, employers and employees being keenly aware of the need to remain competitive in domestic and international markets. By and large this behaviour has been consistent with the belief that price stability will be maintained. As a result, the inflation consequences of the strength of the economic expansion have been much more muted - at least so far - than New Zealand's experience over the past 25 years might otherwise have led us to expect.

Too much inflationary pressure built up and...

Nonetheless, the Bank, along with most other forecasters, underestimated by a significant margin the momentum of growth over the past year or so. Although the Bank began to shift its policy stance towards increasing restraint from early in 1994, it is apparent in retrospect that the degree of firming which took place earlier last year should have been somewhat greater. Our failure to ensure this happened meant that inflationary pressures were able to accumulate to a greater extent than was either expected or intended, and these pressures are now being reflected in underlying inflation.

...inflation got too close to the edge of the band.

As underlying inflation approaches the edge of the target range, even comparatively minor forecasting errors can lead to inflation outcomes outside the target range. Indeed, it was with this uncertainty in mind that the Bank began to tighten policy last year: even though we were not projecting inflation to exceed 2 percent, the projections were uncomfortably close to the edge of the target range.

* * *

Growth momentum has already peaked...

The Bank's assessment of recent developments is that the economy has entered a period of consolidation in which the growth of demand is no longer adding upward pressure on inflation. As discussed in Section IV, data in recent months offer few signs of further rises in generalised strains on capacity, while a wide range of indicators point to stabilising or declining pressures.

...but the evidence on inflation is not as clear.

The evidence, however, is not as clear on the question of when inflation will peak. Typically, inflation responds only with a lag to changes in the pressure of demand on the economy's productive capacity. This implies that, even as the pace of activity moderates, underlying inflation will continue to hold up or rise for a period before also turning downward.

When should policy ease?

The key issue for monetary policy is at what point it will be appropriate for the stance of policy to shift from dampening inflationary pressures to a more neutral stance.

The decision must be forward-looking.

The experience over the past year or so underscores the importance of adjusting the stance of monetary policy in a timely, forward-looking, manner. Whether leaning against an accumulation of upward or downward pressures on inflation, monetary policy takes time to have its effects on inflation. This means that it will be inappropriate for policy easing to be delayed until underlying inflation has actually fallen to the centre of the target range, just as it would have been inappropriate to delay tightening policy until inflation had risen to the top of the target range.

Even though it is appropriate to adjust policy in a forward-looking way, this approach also inevitably involves the possibility of acting either earlier or later than ideal. Responding only to actual or past inflation developments, however, ensures that policy adjustment would be too late.

The essence of the risks attached to adjusting policy either too early or too late can be seen most clearly by contrasting extremes, even if the reality is unlikely to be so black and white.

The issues are different for growth and inflation.

In weighing up these alternative possibilities, it is important to draw a distinction between the implications for activity and for inflation. So far as activity is concerned, the short-term risks may be approximately balanced. A premature easing of policy would tend to result in a temporarily stronger real growth profile than envisaged in our projections, while a delay in easing would be likely to result in a temporarily weaker near-term growth profile.

Delay in easing would push inflation lower, but probably still within the target range.

Delay in shifting towards a more neutral monetary policy stance until inflation has already declined to well within the target range would be likely to result in a sharper-than-projected decline in underlying inflation, with the possibility of under-shooting the inflation target range, as well as a more pronounced economic downturn. However, our central projection, in which underlying inflation bottoms out slightly below the centre of the target range, suggests that an improbably long delay would be required for inflation to seriously threaten to breach the lower end of the target range.

Easing policy prematurely...

Conversely, easing the stance of policy at this stage, when it is not at all clear that upward pressures on inflation have dissipated, would run the risk of seeing inflation remain somewhat above the top end of the inflation target range for a considerable period or, worse, a further escalation of inflation.

...could raise inflation expectations...

The risks associated with inflation that is either higher or lower than projected, however, are unlikely to be as evenly balanced. As discussed earlier, our forecasting assumption of very moderate price and wage reactions to pressures in goods and labour markets has been largely borne out by actual developments so far. But there is no guarantee that this would continue to hold if strains in the economy do not ease and if confidence in price stability is shaken by an extended period of inflation at or above the upper end of the target range.

... and damage the economy.

A premature easing of policy, resulting in a much more gradual abatement of inflationary strains in the economy than currently envisaged, would by itself be likely to keep inflation close to or above the upper end of the inflation target range for a prolonged period of time.

If this were to occur, doubts would naturally be raised about the Bank's ability or willingness to deliver on its commitment to price stability. In such circumstances, bringing inflation down would become much more difficult - and more costly in social and economic terms - than is currently envisaged.

The risks associated with higher inflation...

From a medium-term perspective, the key difference between these scenarios is that, in the case of a premature policy easing, confidence in the Bank's willingness to maintain price stability would be placed at risk, while in the case of a delayed easing it would not. And, over time, a loss of confidence in price stability would be reflected in lower sustainable growth.

The discussion above is bound to give a somewhat exaggerated impression of the risks associated with not getting policy settings exactly right. Contrasting the extremes, however, is helpful in clarifying the nature of the issues and risks. In practice, the Bank will aim to adjust the stance of policy in a timely way.

...lead us to be cautious.

The timing of policy adjustment will turn on the degree of confidence that an easing of conditions will not jeopardise a significant decline in underlying inflation. The discussion in this section suggests that, as a precondition for shifting towards a more neutral policy stance, the Bank will need to have a fairly high degree of confidence that underlying inflation will converge on the middle part of the target range within a reasonable period, after allowing for the impact on inflation of the policy adjustment itself.

III. Financial market developments

Monetary conditions firmed last December.

In the period immediately prior to the release of the December *Monetary Policy Statement,* monetary conditions firmed considerably, in line with (correct) market perceptions that the *Statement* would signal the need for a tighter monetary policy stance. Accordingly, there was little immediate reaction once the *Statement* was released.

Since then...

The major financial market developments since then have been:

interest rates have eased...

- the 90-day bill yield has fallen very gradually to around 9.05 percent, from 9.6 percent at the time of the release of the December *Statement*;

...and the exchange rate has risen.

- the exchange rate has risen, due in part to relatively high short-term interest rates in New Zealand;
- domestic bond yields have fallen substantially, primarily reflecting the downward trend in international bond yields.

Markets have anticipated an easing in policy...

Throughout the period, the Bank sought to hold monetary conditions relatively firm. During much of the period, however, domestic financial markets were inclined to anticipate easier monetary conditions in the months immediately ahead. This anticipation was most apparent in respect of short-term interest rates - the financial market prices most immediately responsive to monetary policy actions.

...but the Bank has reiterated its position...

Though formal adjustments to policy levers were not needed during the period under review, on various occasions public statements were felt necessary to reiterate the Bank's position that there was no room for any easing in monetary conditions. These statements highlighted the fact that, if the desired policy stance was to be maintained, there were limits to falls in short-term interest rates, given our assumptions regarding the strength and sources of inflation pressures and state of other major monetary indicators.

... and kept conditions firm.

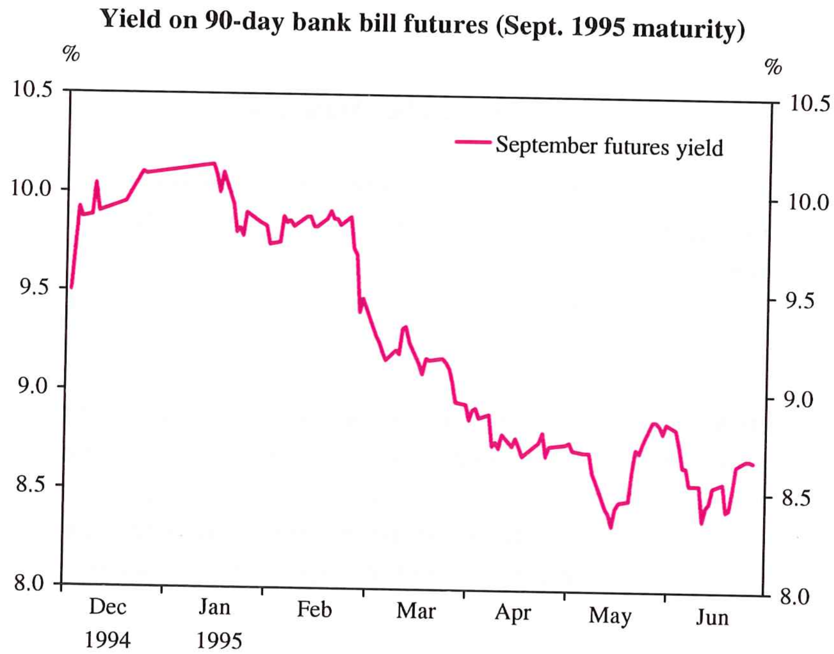
In the event, overall monetary conditions remained consistent with the intended stance of monetary policy. Taken over the period as a whole, the degree of disinflationary pressure exerted by monetary conditions has been little changed, with a modest strengthening in the real exchange rate offsetting a slight easing in short-term interest rates and a rather larger fall in longer-term bond yields.

Short-term interest rates

Markets expected short rates to fall...

At the beginning of 1995, expectations of future short-term interest rates suggested that the market foresaw little change in short-term interest rates until at least September 1995. From the end of February, however, an earlier reduction of short-term interest rates came to be expected.

Figure 3



... as some indicators of inflation pressure eased...

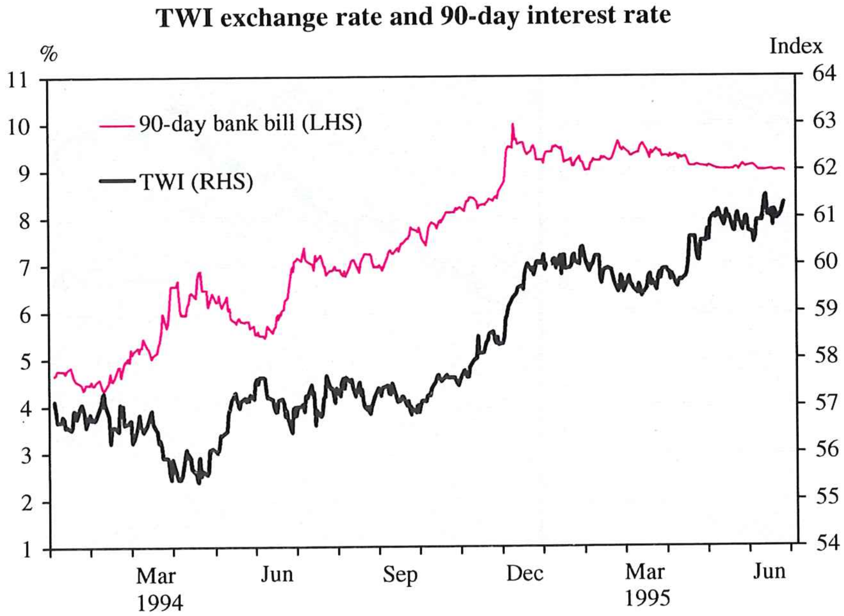
Indicators suggesting that the turning point in the domestic economic cycle had been reached and that inflationary pressures would soon abate contributed to this shift in expectations. Also, the emerging evidence of a slowing in the United States economy led to a growing expectation of looser (or at least not tighter) policy settings and, hence, lower interest rates in the United States.

...but the Bank's statements kept them above 9.0 percent.

These expectations, in combination with the capital inflows occurring in response to our high short-term interest rates, produced significant downward pressure on our shorter-term rates. However, Bank statements stressed that any easing in monetary conditions before clear evidence of reduced inflationary pressures emerged would be premature and that, if necessary, policy action would be taken to hold monetary conditions firm. As a result, 90-day yields settled at just above 9.0 percent.

At the time of writing, expectations of future 90-day rates remain well below actual 90-day yields, suggesting that the markets (in aggregate) expect either some easing in conditions, or at least some change in the mix between interest rates and exchange rates, during the September quarter.

Figure 4



TWI: Trade-weighted exchange rate index of New Zealand dollar.

Long-term interest rates

Falls in U.S. bond yields ...

Bond yields in the United States have been falling substantially since February, in line with indications of a slowing economy and growing expectations that no further monetary policy tightening in the United States will occur this year.

... were initially smaller than in New Zealand...

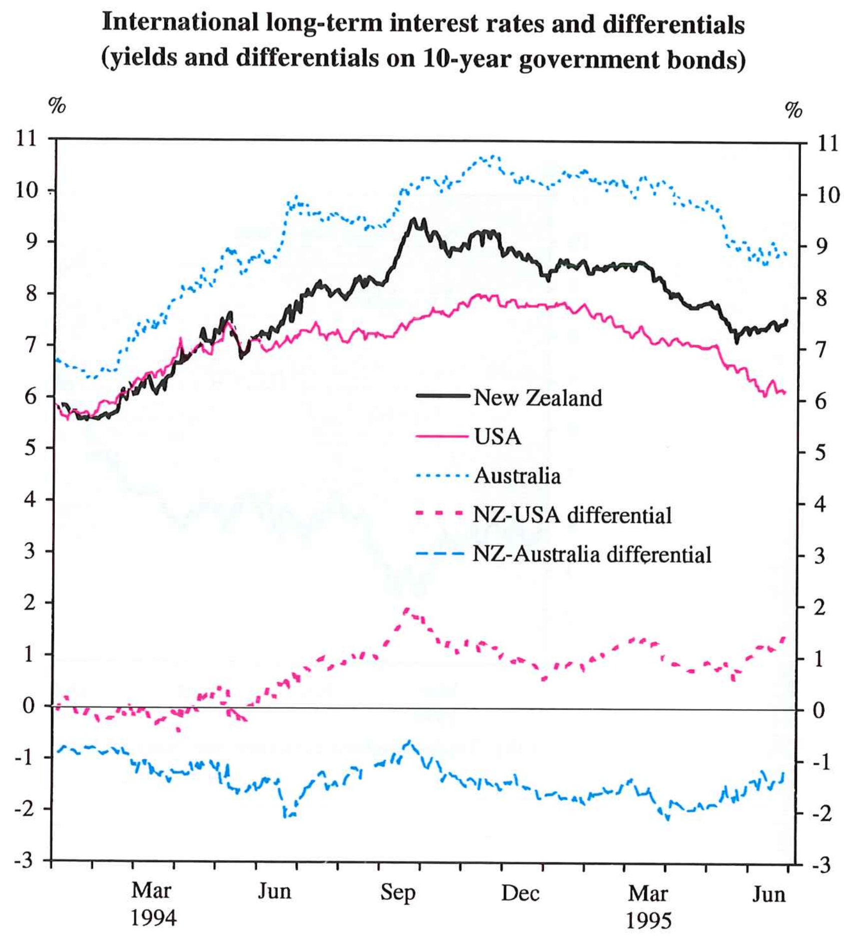
By late March New Zealand bond yields had begun to decline relatively rapidly. Yields on 10-year bonds fell by around 150 basis points in two months to a low of 7.1 percent. As this rally occurred, the margin of New Zealand bond yields above those in the United States fell to a recent low of 50 points in mid-May.

... but that did not continue.

Since mid-May, however, New Zealand bond yields have risen, particularly in relative terms. At around 7.55 percent at the time of writing, our bonds were trading at around 140 points above US 10-year bond yields. Over the period as a whole, the relationship between New Zealand and foreign bond yields has been little changed, although the spreads have moved through a relatively wide range as foreign interest in the market has waxed and waned.

Falling bond yields over the period as a whole have lowered fixed-rate funding costs for domestic borrowers. In terms of the impact on overall monetary conditions, to the extent that this fall in yields

Figure 5



outpaced the fall in domestic inflation expectations - due, for example, to expected future falls in short term interest rates, or lower international interest rates - it represented a slight easing.

House mortgage interest rates

Floating mortgage rates have not changed...

Having confirmed market expectations of the need for a tighter monetary policy stance, the December *Monetary Policy Statement* and the associated rise in wholesale interest rates had the effect of lifting floating rate house mortgage interest rates to a new benchmark level of 11 percent. Since that time, the floating rate for house mortgages has remained unchanged.

...but fixed and capped mortgage rates have fallen.

Recently, however, several banks have reduced the interest rates applied to fixed rate and capped rate mortgages, consistent with falls in other longer-term interest rates. As noted above, to the extent that these reductions moved ahead of the reductions in domestic inflation (and specifically house price expectations) they amounted to some reduction in the degree of downward pressure monetary policy was placing on inflation.

Exchange rates

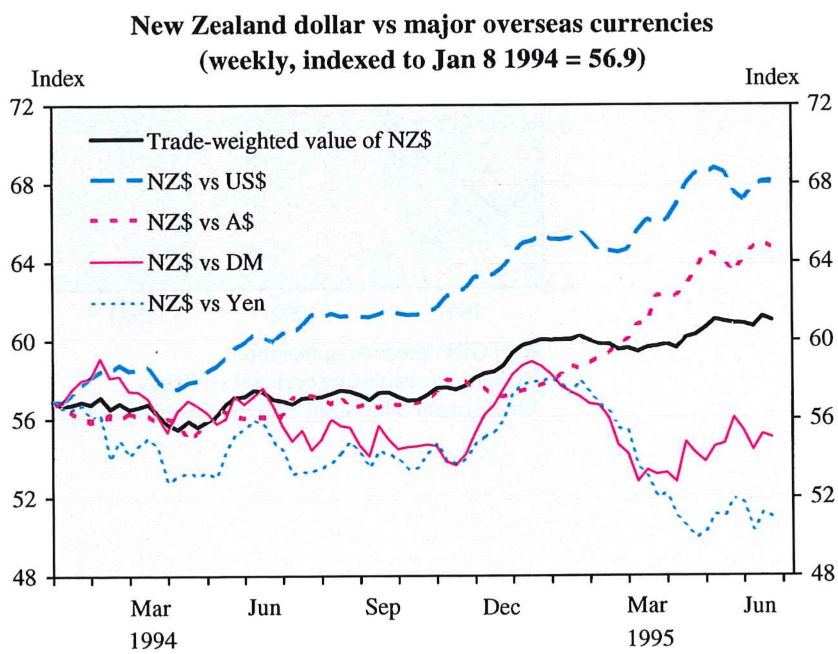
The TWI has risen somewhat since December.

Immediately prior to the release of the December *Monetary Policy Statement*, the exchange rate (as measured by the trade-weighted index (TWI)), appreciated in line with the general tightening of monetary policy conditions which occurred at that time. Some weakening in the TWI occurred in February. However, from around the end of March the TWI strengthened and stood at 61.2 on 21 June. This compared with 59.5 prevailing at the time the December *Monetary Policy Statement* was published.

Movements in bilateral exchange rates have varied considerably more than the TWI itself.

Overall, the TWI remained generally stable through a period of substantial international currency volatility. Although the TWI has risen by 2.8 percent since the publication of the December *Monetary Policy Statement* - representing a modest real appreciation and hence a slight firming in monetary conditions - movements in bilateral exchange rates against individual foreign currencies have reflected the considerable turmoil in international currency markets over the period. For example, the New Zealand dollar appreciated nearly 13 percent and 6 percent against the Australian and American currencies respectively, but against the German and Japanese currencies depreciated by around 7 percent and 11 percent respectively. The greater overall stability in the New Zealand currency may in part reflect the growing underlying confidence in international markets in New Zealand's policy framework and general economic performance. However, even the strongest economies are not immune to occasional periods of volatility in their currency markets.

Figure 6



IV. Economic activity: recent developments and outlook

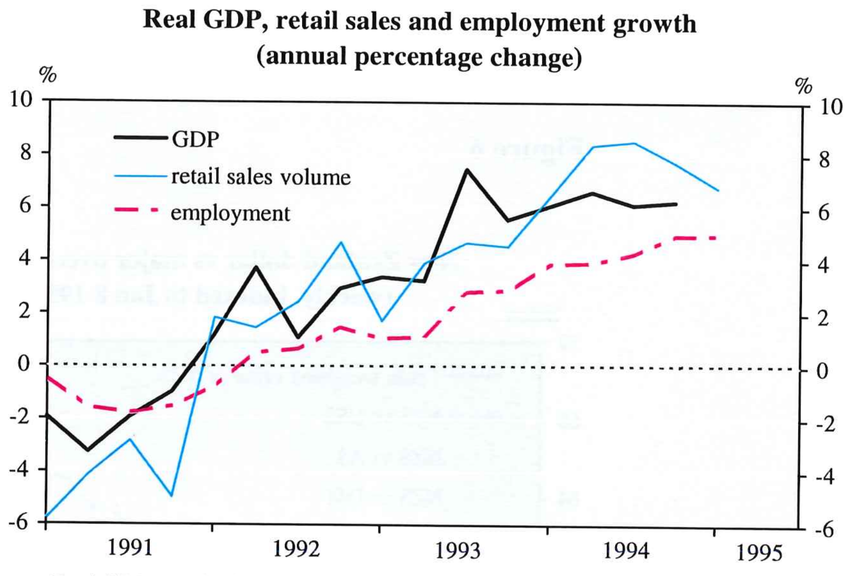
Economic growth has begun to slow somewhat faster than projected.

New Zealand recorded a further period of very strong economic growth over the year to December 1994. However, as foreshadowed in the Bank's March 1995 *Economic Forecasts*, the rate of economic expansion appears to have begun to slow during the December quarter, while a further slowing in growth is estimated to have occurred during the first six months of 1995. Forward-looking indicators suggest that the economy will undergo a more pronounced growth cycle than projected in the March 1995 *Economic Forecasts*. As a result, the near-term growth outlook is now slightly weaker than previously expected.

(i) Recent trends and developments

Following growth of 2.0 percent in the September quarter, Statistics New Zealand's estimate of real GDP (using the more reliable production-based measure) increased by 0.8 percent in the December quarter.[2] This result was somewhat weaker than estimated in the Bank's March *Economic Forecasts*.

Figure 7



Real GDP: production measure.
Retail sales: excluding personal services.
Employment: HLFS full and part-time employment.

2 Alternative seasonally-adjusted estimates constructed by the Bank using a slightly different methodology suggest a somewhat smoother quarterly profile. However, they confirm that growth in economic activity slowed during the December quarter.

Growth in 1994 was still strong, as...

Despite this slowdown, the level of economic activity during calendar 1994 was 6.2 percent higher than during calendar 1993. Growth in economic activity remained strong in virtually all market sectors, and was driven by both strong growth in internal demand and continued growth in demand for New Zealand's exports.

...higher income and wealth boosted consumption...

Continued growth in household incomes has stimulated further consumption growth, notwithstanding the moderation in consumer confidence during the second half of 1994. Wealth effects stemming from increasing house prices, as well as higher demand for durable goods (partially as a result of the increase in house turnover), and the lagged effects from falling real interest rates during 1993, have also boosted consumer spending. Growth in household incomes and the lagged effects from falling real interest rates during 1993 also account for the rapid growth in residential construction during 1994, along with the impetus to demand resulting from higher levels of net immigration.

... and investment grew rapidly.

Business investment continued to grow strongly during 1994. High rates of capacity utilisation, a continued drive towards innovation and the introduction of modern technologies, and a generally positive medium-term outlook for the economy appear to have underpinned this result.

Export growth was robust, but import growth was stronger.

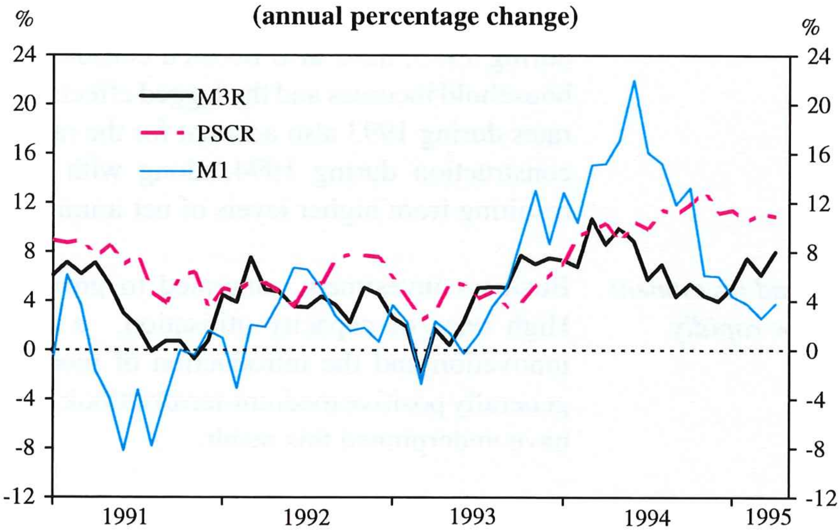
Solid growth in the economies of most of our major trading partners, coupled with further gains in market share, resulted in another year of very strong export growth. Total merchandise export volumes increased by around 10 percent during calendar 1994 compared with calendar 1993, while growth in non-commodity manufactured exports exceeded 20 percent. However, with continued growth in imports of capital goods strongly contributing to a 16 percent increase in merchandise import volumes during calendar 1994, the trade surplus has narrowed further since the December *Monetary Policy Statement*, notwithstanding an improvement in the terms of trade.

Information on growth in the March quarter is mixed.

Economic indicators provide a rather mixed picture of developments in economic activity during the March 1995 quarter. Indicators of continued strength in the economy include a 1.3 percent increase in the volume of retail sales and a 1.1 percent increase in the number of people employed. By contrast, activity indicators contained in the Quarterly Survey of Business Opinion (including the rate of capacity utilisation), together with information obtained from our contacts with businesses, suggest a further slowing in growth during the quarter. In addition, although the number of hours worked increased by 0.8 percent, this was considerably weaker than recorded through most quarters of 1994.

Money and credit aggregates also provide a mixed picture. Growth in the narrower monetary aggregates (currency and M1) has slowed significantly since the middle of last year, consistent with the Bank's projections for nominal activity. However, growth in the broader money and credit aggregates has shown little sign of slowing. Indeed, growth in both the resident M3 and Domestic Credit series accelerated in the early months of 1995.

Figure 8



M3R: M3 held by NZ residents; growth rates adjusted for structural breaks.
PSCR: credit extended to private sector NZ residents.

On balance, these indicators suggest that growth during the March quarter is likely to have been broadly in line with that envisaged in the March 1995 *Economic Forecasts.*

(ii) The economic outlook

Near-term growth may be lower than previously expected.

Forward-looking indicators, including information obtained from our contacts with businesses, have led us to revise down our near-term growth forecasts:

- Business confidence moderated further than anticipated as measured by both the Quarterly Survey of Business Opinion and the National Bank Business Outlook. Activity, employment and investment intentions have also declined more than expected.

- Both building consents data and information from our business contacts suggest a sharp slowing in residential building activity.

- Our business contacts also suggest a slightly more rapid slowdown in the rate of growth in consumer spending, and some downside risk to the rate of growth of non-commodity manufactured exports, compared with the assumptions in our March projections.

The projected slowdown is partly due to natural cyclical factors...

The projected slowing in activity growth reflects a combination of "natural" cyclical factors, strongly reinforced by the lagged impacts of the firming in monetary conditions during 1994. For example, the slowdown in new home construction and house turnover, a decline in employment growth, and a lesser influence from "catch-up" effects (relating in particular to previously deferred spending on durable goods) are all expected to result in a moderation in growth of consumer spending over the remainder of this year.

...especially business investment...

Cyclical factors also explain a good deal of the projected slowdown in investment growth over the next year. Changes in investment spending (along with the stock cycle) typically account for much of the cyclical variation observed in economic activity. The very high rate of investment growth during the last two years was a significant factor underlying the strong growth seen in overall activity. As the economy approaches a higher trend growth path for the capital stock, the additional increases in the level of investment required to sustain the desired increase in the capital stock are much smaller than those initially required, leading to a natural moderation in investment growth.

... but tightening of monetary policy is also having an impact.

The impact of the firming in monetary conditions during 1994 is also beginning to be seen in the net contribution of the external sector to overall growth, with the appreciation in the real exchange rate, in particular, expected to result in some near-term slowdown in export growth (especially with regard to manufactured goods) and a further increase in import penetration.

Growth will slow temporarily to two percent...

At this stage, the extent of the emerging slowdown still remains unclear. The outlook suggests a more pronounced growth cycle than previously expected, although not a slower trend rate of growth over time. Therefore, on the basis of data currently available, and the technical assumptions underlying the projections[3], the Bank now expects economic activity in the March 1996 quarter to be around 2 percent higher than in the March 1995

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3 The technical assumptions underlying the Bank's real economy and inflation projections are discussed in Section V.

... but will pick up later next year.

quarter (we had forecast 2.6 percent growth in our March 1995 *Economic Forecasts*). Nevertheless, we continue to expect growth of around 3.0 percent in the year to March 1997.

The implications of the real economy outlook for the Bank's inflation projections are discussed in Section V. Section V also analyses the key risks surrounding the real economy outlook and the associated risks to the inflation outlook.

V. Inflation: recent developments and outlook

Pushed by unexpectedly strong demand, underlying inflation will exceed two percent temporarily.

As would be expected, the pressures generated by a rapidly expanding economy have seen underlying inflation accelerate over the past year. On the basis of our assumptions (discussed later in the section), the annual rate of underlying inflation is now expected to rise above the target band in the June and September quarters of 1995. However, the firming of monetary conditions over the past year is expected to be sufficient to result in underlying inflation falling back to the centre of the target band towards the middle of 1996.

(i) Recent inflation developments

Annual underlying inflation...

The Bank's measure of underlying inflation represents the most appropriate indicator of trend inflation available at present, and best reflects the intent of the current Policy Targets Agreement. Therefore, the Bank focuses on the outlook for underlying inflation when determining the required stance of monetary policy.[4]

Underlying inflation

... continued to rise in March...

In underlying terms, consumer prices increased by 0.5 percent in the March 1995 quarter, following a 0.6 percent increase in the December 1994 quarter. As a result, the underlying inflation rate accelerated to 1.9 percent in the year to March 1995, compared with 1.5 percent in the year to December 1994.

... and by more than expected.

The March quarter result was 0.1 percent higher than anticipated in the March 1995 *Economic Forecasts*. Higher private sector dwellings rentals and used car prices were the main contributors to the forecast error. Although an analysis of the Bank's past forecast errors suggests no systematic tendency to either over- or under-predict inflation,[5] a similar forecast error was also made with respect to the December quarter outcome. As a result, underlying inflation has edged closer to the top of the target band than envisaged at the time of the December 1994 *Monetary Policy Statement.*

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4 The Bank also monitors movements in a range of other measures of trend inflation such as the weighted median and various trimmed mean measures. These were discussed in S. Roger (1994) "Alternative measures for underlying inflation", *Reserve Bank Bulletin*, Vol. 57(2), pp. 109-29. The weighted median index, for example, increased by 1.6 percent in the year to March 1995.

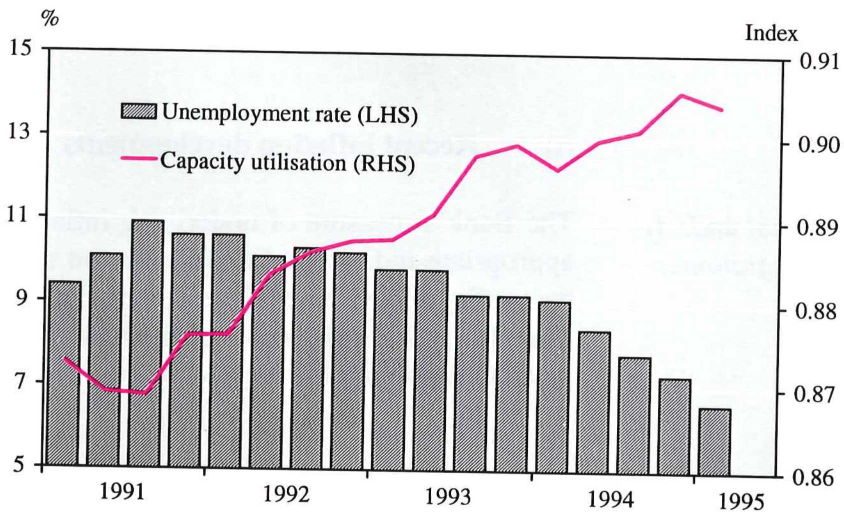
5 See A-M. Brook and C. Connolly "Inflation Forecast Errors", RBNZ Research Note N95/2, forthcoming.

...particularly for non-tradeables.

The degree of inflationary pressure is not evenly distributed through the economy. The most significant price pressures appear to be coming from those parts of the economy facing the greatest strain on capacity and those least exposed to the discipline of international competition.

Figure 9

Unemployment and capacity utilisation



Unemployment: HLFS measure.
Capacity utilisation: Capacity utilisation for manufacturing calculated using QSBO data from NZIER.

Tradeable goods and services prices[6]

World commodity prices have grown strongly,...

World commodity prices have continued to show strong growth over the last six months. Some commodities, such as rubber, cotton and plastics, have shown very strong increases. As far as the prices of New Zealand's major export commodities are concerned, increases in dairy, wool and pulp prices have more than offset recent weakness in meat prices, particularly for beef. However, despite the recovery in world commodity prices, overall world price inflation for those non-commodity goods and services that New Zealand actually exports and imports appears to have remained relatively moderate.

...partly offset by the rising exchange rate...

Reflecting the aggregate effect of these influences, along with movements in the nominal exchange rate, the price of tradeable goods and services fell in underlying terms by 0.1 percent in the March quarter, limiting the rate of increase to just 0.4 percent in the year to March 1995. The strong appreciation of the trade-weighted exchange rate index over the last 18 months has exerted a signifi-

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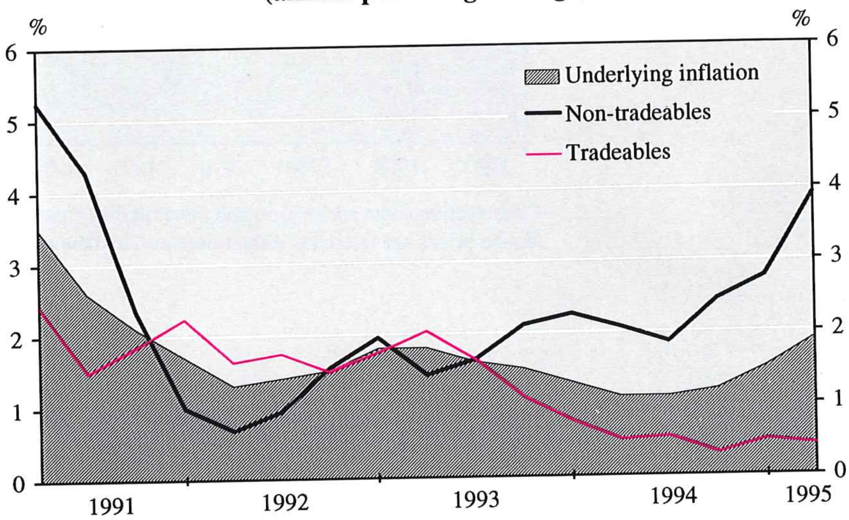
6 Tradeables refer to goods and services whose prices are primarily determined in international markets, while non-tradeables refer to goods and services whose prices are set mainly by domestic demand and supply.

... but the offset was lower than expected.

cant downward influence, although this influence has been weaker than expected given our estimates of world price inflation, and the Bank's view of the long-run pass-through from the exchange rate to consumer prices. This continues to suggest that robust demand conditions have allowed a widening of profit margins, and indicates that the tradeables sector has also faced inflationary pressures.

Figure 10

Underlying inflation: tradeable vs non-tradeable components (annual percentage change)



Note: 'Tradeables' refers to goods and services whose prices are primarily determined in international markets, while 'non-tradeables' refers to goods and services whose prices are primarily determined in domestic markets.

Non-tradeable goods and services prices

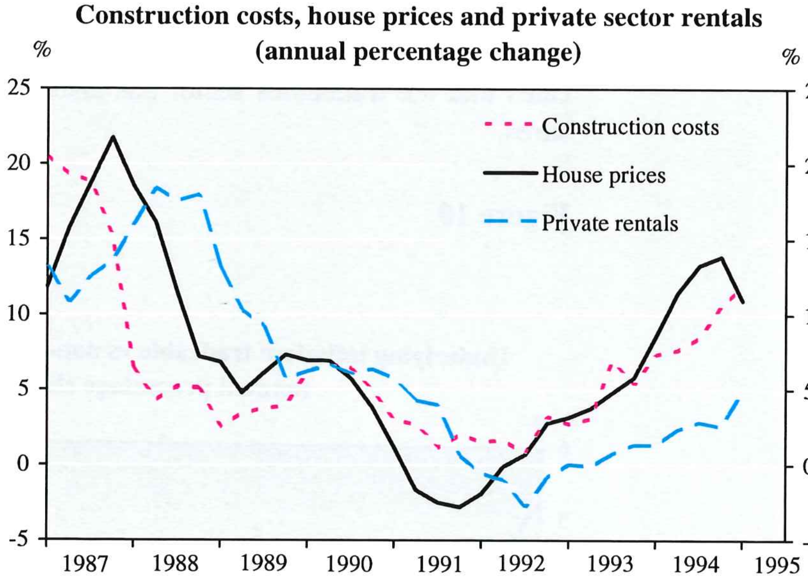
Inflation pressures have shown through strongest...

In contrast with the very low rate of inflation in the tradeables sector, underlying inflation in the non-tradeables sector has accelerated sharply, reaching 3.9 percent in the year to March 1995, compared with 2.1 percent one year earlier.

...in construction.

Pressures on spare capacity in the construction industry have continued to lead to sharp increases in construction costs. Measured construction costs increased by 2.7 percent during the March 1995 quarter, and by 11.8 percent over the year to March. Higher wages paid to attract and retain skilled staff, along with increases in profit margins, appear to account for the majority of this increase. Increases in construction costs have accounted for just over one-third of the total underlying increase in consumer prices over the last year.

Figure 11



Construction costs are section and construction costs, weighted by CPI weight. House prices are from the Valuation New Zealand quarterly house price index.

But construction cost inflation should now weaken.

The price of existing houses is an indicator of general conditions in the housing market, and hence throws light on the prospects for construction costs in the near-term. Data collected by Valuation New Zealand indicate that house prices increased by 0.8 percent in the March quarter, following increases in excess of 3 percent in each of the previous four quarters. The marked slow-down in the rate of house price inflation suggests that pressures on construction costs are likely to weaken over coming quarters.

Other non-tradeables prices have also risen...

Other significant contributions to underlying non-tradeables inflation include:

- Further rises in dwelling rentals (as owners seek to maintain the return on their investments in the face of rising house prices) and real estate agents' fees.

- Increases in the price of some services, such as electricity, and restaurant and takeaway meals.

...more so for services than for goods.

The annual rate of underlying inflation in goods markets increased from 1.5 percent over the year to March 1994 to 1.8 percent over the year to March 1995, whereas the annual rate of underlying inflation in services markets increased from 0.3 percent to 2.2 percent over the same period. To some extent, this reflects the fact that a greater proportion of goods are internationally traded. The slow growth of the retail trade deflator also reflects the high proportion of tradeable goods in that index.

Headline inflation

Headline inflation has been higher than underlying...

The headline CPI increased by 1.2 percent in the March quarter, the same rate of increase as recorded in the final two quarters of 1994. As a result, the headline rate of inflation accelerated to 4.0 percent in the year to March 1995, compared with 2.8 percent in the year to December 1994.

Table 1

Reconciliation of underlying and headline CPI inflation to March 1995 (percent changes)

	March quarter	Year to March
Underlying inflation	**0.5**	**1.9**
Plus the impact of interest rates	+0.7	+1.4
Plus/minus the impact of government charges	-0.1	+0.4
Plus the impact of oil price movements	+0.1	+0.3
Headline CPI	**1.2**	**4.0**

... mainly reflecting higher mortgage rates.

Higher mortgage interest rates accounted for around two-thirds of the discrepancy between the annual rates of underlying and headline inflation over the past year. However, increases in government charges and crude oil prices also made a significant contribution. With respect to government charges, increases in Housing New Zealand rentals (due to the removal of subsidies), local authority rates, and tertiary tuition fees more than offset the fall in motor vehicle licence fees.[7]

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7 In calculating underlying inflation, the Bank has removed from headline inflation those increases in Housing New Zealand rentals which stem from the removal of state subsidies. This reflects the one-off nature of these adjustments, which clearly do not reflect generalised inflationary pressures. However, future increases in rentals designed to maintain ongoing relativities with private sector rates (such as those scheduled to occur in the September quarter) will not be excluded.

Producer Price Indices

The Producer Price Indices for both inputs (PPII) and outputs (PPIO) rose by 0.1 percent in the March 1995 quarter. As a result, the PPII increased by 1.1 percent over the year to March 1995, while the PPIO increased by 1.7 percent over the same period.

Analysis within the Bank has shown these indices - which are quite different in composition to the CPI - to be, at best, coincident indicators of CPI inflation, and as such, do not generally provide the Bank with forward-looking information regarding inflationary trends.

(ii) The outlook for inflation

As already noted, the Bank's projections of underlying inflation play a central role in determining the stance of monetary policy. This reflects the lags with which changes in monetary policy settings impact on economic activity, and ultimately inflation.

Underlying inflation is expected to return towards the centre of the band.

On the basis of our assumptions, which are outlined below, our projections suggest that the year-to-date rate of underlying inflation will slightly exceed the Bank's 0-2 percent target band in the June and September quarters of 1995. Thereafter, the lagged effect of the firming in monetary conditions in 1994 is projected to return underlying inflation towards the centre of the target band by the middle of 1996.

Technical assumptions regarding policy

The forecasts are conditional on...

The Bank's inflation projections, as with all "forecasts", are strictly conditional on a number of technical assumptions. These assumptions cover external influences, policy responses, and behavioural relationships.

Clearly, to the extent that important assumptions fail to hold, the projections will also tend to prove inaccurate. Indeed, errors made regarding the assumptions can represent an important source of overall forecast error.

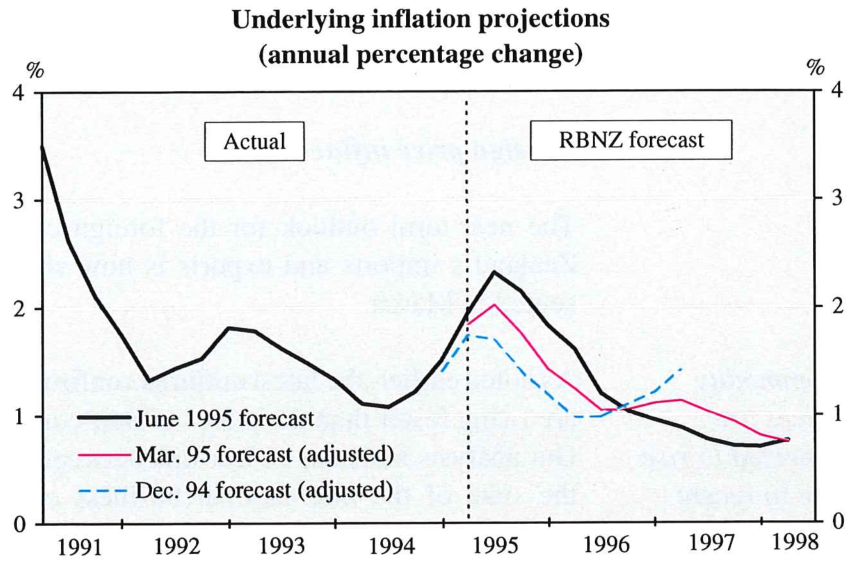
...two technical assumptions:

As in previous projections, the key policy assumptions underlying the inflation outlook are as follows:

...nominal exchange rate appreciation...

- The nominal exchange rate is assumed to appreciate annually by the average difference over the forecast period between expected trade-weighted foreign CPI inflation (3 percent according to the most recent international *Consensus Forecasts*) and the mid-point of the Bank's inflation target range (i.e 1 percent). Therefore, from a starting point of 60.7 in the

Figure 12



Note: For reasons of comparability, the previous projections have been adjusted to bring them on to the same exchange rate tracks as used for the June 1995 projection.

June quarter, these projections assume that the nominal exchange rate appreciates by 2 percent per annum, reaching 64.1 by March 1998. By contrast, the March *Economic Forecasts* assumed a June quarter TWI of 60.1, rising to 63.5 by March 1998.

...and a gradual decline in domestic interest rates in 1996.

- Interest rates are assumed to follow international interest rates, with some allowance for conditions particular to New Zealand. In this instance, allowance is made for a slight reduction in New Zealand's country risk premium, and a for a small and gradual easing in the extent of monetary policy pressure. On the basis of these assumptions, 10 year bond yields are assumed to fall gradually from a June quarter starting point of 7.5 percent, while the 90-day bank bill rate is assumed to remain over 9 percent for at least the rest of 1995 before also declining gradually.

We reiterate the purely technical nature of the Bank's exchange rate and interest rate assumptions. The actual path required for the nominal exchange rate and interest rates (which are not independent) will depend on the extent to which indicators of inflation turn out to be consistent with maintaining underlying inflation within the 0-2 percent target range.

Tax cuts are not incorporated into the projections.

Importantly, these projections have made no allowance for the possibility of tax cuts during the forecast horizon. This reflects the fact that, at this stage, no detail has been announced about the magnitude, timing or the structure of such cuts. Clearly, tax cuts have potential implications for the conduct of monetary policy. These are discussed more fully in the risk assessment at the end of this section of the *Statement*.

Foreign price influences

The near-term outlook for the foreign currency prices of New Zealand's imports and exports is now slightly higher than presented in March.

Commodity prices are expected to rise due to recent strong world economic growth.

As noted earlier, the latest outturns confirm that commodity prices are rising faster than the prices of non-commodity manufactures. Our analysis indicates a clear link between commodity prices and the state of the international business cycle. Recent outturns indicate that the upturn in OECD industrial output was stronger than expected in 1994, and this is expected to lead to a more significant rise in commodity prices than anticipated in March. However, the latest international consensus forecasts project slower growth in economic activity over the forecast period due to slower growth in the United States, and continued weakness in Japan and continental Europe. Therefore, following further moderate growth over this year, we expect a modest fall in imported commodity prices over the latter half of the forecast horizon.

Although the latest quarterly outturns for the prices of non-commodity manufactured goods were also slightly higher than expected, we expect the rate of increase to moderate over the forecast horizon.

Domestic influences

The profile of the combined contribution from unit labour costs and profit margins to inflation is expected to follow the projected cycle in real activity with a lag. As discussed in Section IV, a slowdown in growth is projected in 1995, with a renewed strengthening thereafter.

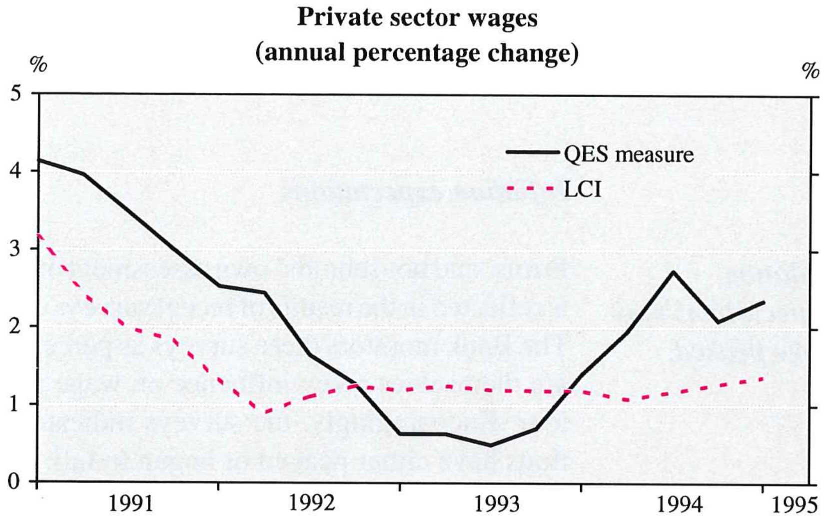
...the recent pickup in wage growth...

Recent official statistics on wage movements suggest that upward pressures on wage inflation have remained fairly muted by historical standards, notwithstanding the sharp fall in unemployment over the past year. The Quarterly Employment Survey (QES) measure of private sector hourly wage rates provisonally recorded an increase of 1.1 percent in the March quarter, and 2.3 percent over the year to March 1995.[8] The Labour Cost Index (LCI)

8 The final result for the March quarter will not be released until September. Provisional March quarter figures have subsequently been revised down over the last couple of years.

measure of private sector hourly wage rates, which is based on a slightly different concept, increased by 0.4 percent during the March quarter, and 1.4 percent over the year to March 1995.[9]

Figure 13



QES: Quarterly Employment Survey of average hourly earnings.
LCI: Labour Cost Index of private sector salary and wage rates. Note: the Prevailing Weekly Wage Rate Index is used as a proxy for the LCI for the period to September 1992.

... is projected to continue.

On the basis of the outlook for the real economy, and information obtained from our business contacts, we expect wage inflation to continue to increase. Stronger wage growth reflects a further tightening in labour market conditions and an element of "catch-up" as a result of relatively low wage settlements in the recent past. However, with actual outturns continuing to surprise on the downside, we have slightly lowered our expectation of the rate of increase over the next few quarters.

Higher unit labour costs will partly offset...

To some extent, the impact of increases in wage growth on final price setting will be offset by continued productivity growth. However, with recent data suggesting a cyclical slowing in labour productivity growth, unit labour costs are expected to make a greater contribution to upward pressures on inflation over the next

9 Several factors help explain the divergence between the rates of increase in the QES and LCI measures. The most important difference is that the LCI measure is quality-adjusted, so that only changes in salary and wage rates for the same quality and quantity of work are reflected. Therefore, the LCI is better interpreted as a measure of unit labour costs, whereas the QES is a measure of nominal wage movements. This implies that the QES wage series will tend to increase at a faster rate than the LCI measure when productivity growth is positive. It is also worth noting that the methodology used to construct the LCI means that it has a tendency to systematically overstate unit labour cost growth when productivity growth is positive.

... by narrower profit margins.

two years than projected in the March 1995 *Economic Forecasts*. This is expected to be offset to some extent by a reduction in profit margins which -according to the Bank's estimates - have increased significantly over the last couple of years.

With indicators suggesting a more significant slowdown in residential construction activity than previously expected, a substantial decline in the rate of inflation in construction costs is expected over the coming year.

Inflation expectations

Inflation expectations may have peaked.

Firms' and households' own assessment of the outlook for inflation is reflected in the results of recent surveys of inflation expectations. The Bank monitors these surveys as perceptions of future inflation are themselves a key influence on wage and price setting behaviour. Encouragingly, the surveys indicate that inflation expectations have either peaked or begun to fall:[10]

- The Reserve Bank *Survey of Expectations* indicated a fall in one-year-ahead inflation expectations from 2.8 percent to 2.6 percent between the February and May surveys, while one-year-ahead inflation expectations as measured by the National Bank's survey have stabilised at around 2.8 percent during late 1994 and early 1995 (the May 1995 survey, however, indicated a slight increase to 2.9 percent);

- The May Marketscope survey of household expectations showed one-year-ahead expectations to have fallen slightly during the last three months, following a sharp increase towards the end of 1994.

Thus far, the recent increase in headline inflation is clearly seen as being temporary by respondents to the Reserve Bank's May *Survey of Expectations*. Headline inflation is expected to fall to 2.8 percent in the year to March 1996, and to 1.9 percent in the year to March 1997. Longer-term inflation expectations as recorded by the April Alexander Consulting Group survey of economists showed inflation expectations unchanged at around 1.5-1.6 percent over both a four- and seven-year-ahead time horizon.

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10 With the exception of the Reserve Bank's *Survey of Expectations*, survey questions do not differentiate between headline and underlying inflation. However, one would expect that respondents are more likely to answer the question in terms of headline inflation.

Inflation projections

Drawing together the technical assumptions with the outlook for the various determinants discussed above, the Bank's latest forecasts for underlying and headline inflation for the period to March 1998 are shown in Table 2 and Figure 13. Table 2 also presents the Bank's projections for the *CPI ex Credit Services* series published by Statistics New Zealand, and used by the Bank as the base for calculating underlying inflation.

Table 2

CPI inflation projections
(percent changes)

	Underlying		CPI ex credit services		Headline	
	Qtrly.	Ann.	Qtrly.	Ann.	Qtrly.	Ann.
1994						
Mar.	0.1	1.1	0.2	1.6	0.0	1.3
June	0.3	1.1	0.5	1.6	0.4	1.1
Sept.	0.5	1.2	0.9	1.9	1.2	1.8
Dec.	0.6	1.5	0.7	2.3	1.2	2.8
1995						
Mar.	0.5	1.9	0.4	2.6	1.2	4.0
June	0.7	2.3	0.7	2.8	1.1	4.7
Sept.	0.4	2.1	0.4	2.4	0.3	3.7
Dec.	0.3	1.8	0.3	2.0	0.3	2.8
1996						
Mar.	0.3	1.6	0.3	1.8	-0.4	1.3
June	0.3	1.2	0.3	1.3	-0.3	-0.1
Sept.	0.2	1.0	0.2	1.0	0.0	-0.4
Dec.	0.2	1.0	0.2	1.0	0.1	-0.6
1997						
Mar.	0.2	0.9	0.2	0.9	0.1	-0.1
June	0.2	0.8	0.2	0.9	0.0	0.2
Sept.	0.2	0.7	0.2	0.7	0.1	0.3
Dec.	0.2	0.7	0.2	0.7	0.1	0.3
1998						
Mar.	0.3	0.8	0.3	0.8	0.2	0.4

Underlying inflation peaks in June 1995.

The table shows that underlying inflation is projected to peak at 2.3 percent in the year to June 1995, declining to 2.1 percent in the year to September 1995. Thereafter, the lagged effect of the firming in monetary conditions during 1994 is expected to see the rate of underlying inflation fall back within the Bank's 0-2 percent target band, reaching 1.2 percent in the year to June 1996, and 0.8 percent in the year to June 1997.

Adjusting for the higher exchange rate track incorporated in these projections compared with that underlying those published in the March 1995 *Economic Forecasts*, we are now forecasting the pressures on underlying inflation that do not relate to the exchange rate to contribute an additional 0.3 percent to the underlying inflation rate in the year to March 1996. This reflects a stronger contribution from import prices and lower-than-expected productivity growth, offset to some degree by weaker building costs, margins and wages. Over the year to March 1997, we are forecasting the pressures on underlying inflation that do not relate to the exchange rate to contribute 0.2 percent less, while the track for 1997/98 remains unchanged.

Headline inflation also peaks in June, but falls faster.

The headline rate of inflation is projected to peak at 4.7 percent in the year to June 1995, falling rapidly thereafter. As in the recent past, mortgage interest rates account for the majority of the difference between the projected rates of underlying and headline inflation. In contrast to the March 1995 *Economic Forecasts*, the projected contribution of government charges is now expected to be slightly lower than the threshold for exclusion, there are no further exclusions relating to government charges. In calculating underlying inflation, the effect of the recent rise in world oil prices has been excluded from headline inflation in the June and September quarters of 1995. The lack of movement in the New Zealand dollar price of petrol reflects the offsetting influence of the appreciation of the nominal exchange rate. Our removal of only the impact of the change in tthe world price (as opposed to that related to exchange rate movements) is consistent with the *Policy Targets Agreement*. Previous exclusions due to changes in government charges and those relating to changes in world oil prices contribute more-or-less equally to the difference between CPI ex-interest inflation and underlying inflation over the year to June 1995.

(iii) Risk Analysis

Taking our technical assumptions as given, the projections outlined in this section represent our best central estimate of the outlook for inflation. However, as with all projections, the outlook is subject to a variety of uncertainties. These can be loosely grouped into two categories - those related to the outlook for the real economy and those that exist even if the real economy were to evolve broadly as expected.

General uncertainties regarding the real economy outlook

There are risks to the real economy projections.

The risk distribution around the near-term real economy projections is considered to be evenly balanced, while looking further out, foreshadowed changes to fiscal policy are a potential source of additional pressures on demand. On the one hand, historical and overseas experience would suggest that a more accentuated reduction in growth could occur. On the other hand, the momentum gathered over the last year may prove more resistant to the firming of monetary conditions than we have assumed, especially if businesses and consumers base their spending decisions on the expectation of early easing of monetary conditions.

The impact on inflation would vary with circumstances.

The impact on inflation stemming from either a stronger or weaker economy would, of course, depend on the specific factors underlying the divergence. For example, consider the case of stronger-than-expected growth in the economy driven by either consumer spending or investment. Although the short-term impact on inflation of both would be similar, all other things equal, an investment-led expansion will tend to be less inflationary over the medium-term. This is because, by increasing the economy's capital stock, higher investment would also increase the economy's capacity to meet demand without generating inflationary pressures.

The impact of changes to fiscal policy

Expected developments in fiscal policy will also have the potential to generate stronger-than-projected real economy outcomes, particularly during the latter half of the forecast horizon, with consequent implications for the projected inflation outlook.

Tax cuts may boost demand...

The impact of tax cuts on the economy will depend on their size, structure and timing, and the extent to which spending decisions are brought forward in anticipation. Although no specific details have been announced, it is possible to make a few general comments regarding the nature of the possible impacts. While there are likely to be supply-side benefits stemming from the tax cuts as lower marginal tax rates encourage more people to participate in work, overseas empirical research suggests that these effects are not likely to be large over the forecast horizon relevant to monetary policy. This suggests that, in the short-term at least, the demand effects from an easing in fiscal policy are likely to dominate.

...which could increase inflation pressures...

Given the current strains evident in the economy, there would have been inevitable inflationary consequences had a tax cut been implemented in 1995. This would have required an offsetting monetary policy response in order to maintain underlying inflation within the Bank's target band. However, our projection of declining underlying inflation suggests that a gradual adjustment of fiscal policy could be accommodated later without undue risk to the inflation outlook, though it would diminish the already limited scope for an easing in monetary policy.

... but this effect is unlikely to be large.

The Bank welcomes the fact that the Government has stated that tax cuts will only proceed if they are expected to be non-inflationary (certain conditions have also been set regarding the evolution of the net debt-to-GDP ratio). We do not expect, therefore, a significant conflict between monetary and fiscal policy to eventuate. Obviously, as always, the Bank stands ready to react to any threat to the maintenance of price stability, including those stemming from changes to fiscal policy.

The Bank will undertake further assessments once additional details of the tax cuts are announced.

Other uncertainties regarding the inflation outlook

There are a number of additional uncertainties regarding the inflation outlook:

Falling construction costs,...

- The upside risks to construction costs appear to have diminished since the publication of the March 1995 *Economic Forecasts*. Indeed, considering the outlook for residential construction activity, construction costs now represent a source of downside risk to the inflation outlook, with information from our business contacts indicating a recent easing of upward pressures.

...rising nominal wages,...

- Overall wage movements have so far been largely unresponsive to the both the tightening in labour market conditions and the divergence between headline and underlying inflation. While our projections allow for a further slight rise in wage inflation over the coming year, in the Bank's view the labour market remains a significant source of upside risk to the inflation outlook.

...changes in profit margins,...

- The risk associated with the wage outlook cannot be separated from the risk surrounding the path for profit margins. To the extent that wage increases prove higher than expected, the impact on pricing is likely to be at least partially offset by a contraction in profit margins due to the competitive pressures stemming from a weaker economy and increasing import penetration. The allocation of income between wages and profits is a matter for employers and employees to decide, and some increase in the share of income going to labour would not be unusual at this stage of the economic cycle. The Bank's only interest is in ensuring that, in aggregate, pricing behaviour remains consistent with price stability.

...the exchange rate pass-through...

- The degree of pass-through from the appreciation of the nominal exchange rate remains a significant risk. For these projections, we have retained our usual assumption that a 1 percent increase in the nominal exchange rate will lead to around a 0.3 percent decrease in consumer prices, with the full impact being felt over a six to eighteen month horizon. If the unusually small impact on inflation from the exchange rate appreciation over the last year persists, there is some upside risk to inflation. As noted earlier, businesses seem to have used the cost reduction from lower import prices to increase their profit margins. At the same time, there may be some downside risk to inflation if the exchange rate pass-through proves to have been merely delayed due to temporary margin widening as a result of the strength in the economy. If this is so, competitive pressures may force the full long-run pass-through into prices, especially as the rate of economic growth continues to slow.

...and higher world commodity prices...

- A near-term risk to the inflation outlook from higher-than-expected increases in world commodity prices remains. While the international commodity price cycle may have peaked, lagged adjustments to higher price levels may still feed into New Zealand's import prices. However, given the widening in margins on the back of lower landed import prices over the last year, higher world prices during a period of weakening domestic growth may simply lead to a reversal of increases in margins.

...are all sources of risk.

Viewed independently, the near-term risks appear to be reasonably evenly balanced around our central projection. However, we note that the risks may not be entirely independent. For example, higher inflation outcomes as a result of increased profit margins can feed back into the risks surrounding wage inflation. Further out, the effects of tax cuts on demand suggest some upside risk to the inflation projections, although at this stage the effects are not expected to be large.

VI. Policy assessment

As indicated in this Statement, underlying inflation is likely to exceed the Bank's 0 to 2 percent target range in the June and September quarters. Recent data and forward-looking indicators also suggest, however, that the firming in monetary conditions during 1994 is having the desired effect of bringing growth back to a more sustainable pace. As strains on the productive capacity of the economy ease, underlying inflation should, in due course, return to well within the target range. Recent developments therefore lessen the possibility that a further firming of monetary conditions will be needed.

Our projections indicate, however, that even with monetary conditions maintained at current levels over the remainder of the year, and only a gradual policy easing thereafter, underlying inflation will not return to the middle part of the target range until mid-1996. An easing in the stance of policy before the end of the year would extend further into 1996 the period during which inflation is uncomfortably close to the upper edge of the target range.

An important concern, highlighted in Section II, is that a sustained period of inflation above or close to the top of the target range could lead to such inflation rates becoming embedded in expectations or, worse still, undermine confidence in the Bank's commitment to price stability. This would make it much more difficult - and more costly in social and economic terms - to bring inflation down subsequently.

The foregoing considerations lead us to the conclusion that an easing of overall monetary conditions at this stage would be premature. The appropriate time for moving towards a more neutral policy stance is when anticipated quarterly inflation rates six to eighteen months ahead are consistent with annual inflation remaining in the middle part of the target range, after allowing for the effects of the adjustment in monetary conditions. On the basis of our current projections, these conditions are unlikely to be met before the end of this year.

As additional information is received, it may become apparent that an earlier shift in monetary conditions is warranted. Conversely, if indicators point to stronger momentum behind inflation than we currently estimate, not only would easing in monetary conditions be delayed, but a further firming could be required.

It should be noted that the mix of monetary conditions - that is, the combination of interest rates and the exchange rate - portrayed in our projections is illustrative rather than prescriptive. How the mix evolves over time will be determined by financial markets both in New Zealand and abroad. And although the Bank cannot determine this mix, it will need to be taken into account in deciding when to adjust the overall policy stance.

Over the medium term, the path of inflation is guided less by the particular mix of conditions than by the overall degree of monetary restraint that they represent. Thus a somewhat higher level of interest rates could be coupled with a slightly lower average level of the exchange rate, or vice versa, without altering the overall degree of monetary policy pressure.

Over the near term, however, a different constellation of the exchange rate and interest rates would affect the path of inflation. A combination involving a lower exchange rate and higher interest rates, for example, would work to slow the projected decline of both headline and underlying inflation over the next year. This reflects the larger initial impact on underlying inflation from movements in the exchange rate than from interest rate movements. More generally, even if the overall level of monetary conditions is maintained at current levels, the timing of adjustments to the stance of policy may be affected at the margin by the actual evolution of the exchange rate and interest rates.

In view of the particular risks associated with a slower or delayed decline of underlying inflation, the Bank will need to be more than usually vigilant to prevent an easing of monetary conditions.

Donald T Brash

Donald T Brash
Governor

Appendix 1

Chronology

Over the period, key events of relevance to monetary policy and inflation included:

1994

7 December:	The Minister of Finance, the Rt Hon Bill Birch, commented that his focus remained on foreign currency debt repayment and that tax rate reductions were some time off.
13 December:	The Reserve Bank released its eleventh Monetary Policy Statement.
20 December:	The Minister of Finance announced that the Government believed it desirable to achieve zero net foreign currency debt. This decision was made for two reasons. First, to remove a very large exchange rate risk from the Crown's balance sheet. Second, to enhance the Crown's chances of obtaining a better credit rating. The Minister also said that the Government had asked Treasury's Debt Management Office to develop plans for the introduction of a wholesale inflation-indexed bond to be introduced in the 1995/96 fiscal year. Standard and Poor's credit rating agency upgraded its rating of NZ foreign currency debt from AA- to AA.

1995

17 January:	The December quarter CPI outcome was released. Headline inflation was 2.8 percent for the year to December 1994. Underlying inflation was estimated at 1.5 percent.
31 January:	GDP figures were released showing the New Zealand economy had grown by 6.2 percent in the year to September 1994.

1 February:	The U.S. Federal Reserve Board increased both the federal funds and discount rates by 0.50 percentage points to 6.0 and 5.25 percent respectively.
23 February:	The Minister of Finance released the Budget Policy Statement, which outlined *inter alia* pre-conditions that would need to exist before income tax cuts could be implemented: 1. Net public debt would need to be within 20 to 30 percent of GDP; 2. There should be no risk of a return to deficits in the foreseeable future given reasonable expectations of economic performance and the level of Government spending (ie debt reduction must be sustainable); 3. There would be no scope for tax cuts if there were significant risks of strong inflationary pressures emerging.
16 March:	The Reserve Bank released its March *Economic Forecasts*. GDP for the years to March 1995 and 1996 was projected to grow by 6.4 and 3.4 percent, respectively. Underlying inflation for the years to March 1995 and 1996 was projected to be 1.8 and 1.5 percent, respectively.
4 April:	GDP figures were released showing the New Zealand economy had grown by 6.2 percent in the year to December 1994.
18 April:	The March quarter CPI was released. Headline inflation was 4.0 percent for the year to March 1995. Underlying inflation was estimated at 1.9 percent.
1 June:	The New Zealand Government Budget was released. The 1994/95 operating balance was estimated to be a $2603m surplus, while the 1995/96 operating balance was projected to be a $3287m surplus.

Appendix 2

Reserve Bank statements on monetary policy

The following are reports or texts (some of which are abbreviated) of significant public comments on monetary policy issues made by the Bank during the period under review in this *Monetary Policy Statement*:

Reserve Bank says current monetary conditions are warranted
13 December 1994

Speaking at the release of the Reserve Bank's eleventh *Monetary Policy Statement*, the Governor of the Bank, Dr Don Brash, said that the recent firming in monetary conditions was warranted and timely, given signs that inflationary pressures had begun to emerge because of the economy's very strong growth.

"Monetary conditions need to remain broadly in line with the current situation if price stability is to be maintained," Dr Brash said. On the basis of current monetary conditions, Dr Brash estimated that underlying inflation would peak at 1.7 percent in early 1995, and decline to around 1.4 percent by early 1996.

The Bank believed that the risks to this outlook were probably more on the upside given the increasing evidence of capacity constraints, such as the tight supply of skilled and even unskilled labour affecting some sectors.

"Monetary policy will continue to lean in the direction of restraint until such time as we are satisfied inflationary pressures have been contained," said Dr Brash.

He added that the longer-term prospects for monetary conditions would hinge on the degree to which inflationary stresses, currently visible in particular sectors of the economy, spread into prices and wages more generally. Also relevant would be the extent to which prices and wages react to the headline as opposed to the underlying rate of inflation. "It is the latter that more accurately reflects the ongoing trend of inflation and is the focus of monetary policy," Dr Brash said.

Comments by Peter Brady, Acting Chief Manager, Financial Markets Department
31 January 1995

Peter Brady said "The Reserve Bank's current assessment of monetary conditions is that they are broadly consistent with the price stability objective, though any fall in the 90 day bank bill rate from current levels would be unhelpful at this stage."

Comments by Grant Spencer, Chief Manager, Financial Markets Department
20 February 1995

Grant Spencer said "There is considerable volatility in international exchange rates at present and this has adversely impacted the Trade Weighted Index of the New Zealand dollar. We are watching the situation closely, though at this stage, pending our new forecasts in March, we believe that monetary conditions are still consistent with price stability."

Reserve Bank adheres to firm policy
16 March 1995

"Given the risks to inflation in the short-term, monetary conditions need to remain firm," said Reserve Bank Governor, Dr Don Brash, at the release today of the Bank's latest *Economic Forecasts*.

"With underlying inflation projected to be close to the top of the Bank's 0-2 percent target range for much of 1995, there is absolutely no scope for an easing of monetary conditions at present. However, the Bank expects the recent firming in monetary conditions should have its effect later in the year and bring underlying inflation back towards the middle of the target range.

"The Bank will not hesitate to take action if it becomes clear that inflation pressure is not abating. The Bank projects annual underlying inflation to peak at 2.0 percent in the June quarter of this year, before falling back to 1.5 percent by early 1996 and to 1.2 percent a year later.

"The New Zealand economy is very sound. GDP growth is expected to slow to between 3 percent and 3_ percent p.a. over the next two years, after reaching an unsustainable 6 percent over the past year.

"This move to slower, more sustainable growth avoids the boom/bust cycles of the past. Our forecasts also show a further pleasing decline in the unemployment rate to 6.8 percent in March 1997."

Dr Brash speaks to Southland farmers about inflation, the exchange rate and monetary policy
10 April 1995

While monetary policy cannot directly improve the competitive position of exporters, it can help exporters indirectly - not by manipulating the exchange rate to make it more 'favourable' to farmers and other exporters, but by continuing to deliver price stability, the Governor of the Reserve Bank, Dr Don Brash, told a Federated Farmers group in Invercargill today.

"By delivering price stability, we encourage all New Zealand businesses to focus not on how much real estate they can buy with borrowed money, but on how productivity can be improved, how product quality can be improved, how post-sale service can be improved, how new products can be developed - and these are the aspects of business performance which make for lasting export competitiveness."

One thing which farmers themselves could do to help maintain price stability was to exert pressure on the distributors of imported goods to pass on the reduced New Zealand dollar cost of imports flowing from the higher exchange rate. "In this way farmers can help to reduce the need for monetary policy pressure," Dr Brash said.

Reserve Bank welcomes Government decision to issue inflation-indexed bonds
12 April 1995

The Government's recently-announced decision to begin issuing inflation-indexed bonds in the next financial year would benefit the Government, the Reserve Bank and savers alike, the Governor of the Bank, Dr Brash, told the New Zealand Society of Actuaries today.

Assuming that price stability was maintained, inflation-indexed bonds would enable Government to borrow at a significantly lower real cost than was implied by the current yield on conventional, non-indexed bonds.

Issuing indexed bonds would also assist the Reserve Bank in maintaining low inflation by making plain to all savers the Government's commitment to low inflation. "Issuing inflation-adjusted bonds is the best way of saying that, even if some future Government decides to sanction theft-through-inflation, the present Government does not approve of such theft, and is willing to provide a means by which savers can protect themselves against it," said Dr Brash.

Finally, indexed bonds were an obvious way of encouraging New Zealanders to save. That, too, was something to be welcomed, Dr Brash said.

Reserve Bank inflation forecast still on target
18 April 1995

The latest estimates published by the Reserve Bank today show that underlying inflation was 0.5 percent during the March 1995 quarter, bringing underlying inflation for the year to 1.9 percent.

This outcome is broadly in line with the Reserve Bank's March *Economic Forecasts* and underlying inflation remains within the Bank's 0 to 2 percent target range.

The difference between underlying inflation and the figure of 4.0 percent published earlier today by Statistics New Zealand for 'headline' inflation, the Consumer Price Index, is accounted for mainly by interest rate increases (1.4 percent), with the balance accounted for by government and local body charges, and oil prices.

Commenting on these figures Dr Don Brash, Governor of the Reserve Bank, said, "These results confirm the Bank's view that there is absolutely no scope for an easing of monetary conditions at present".

Reserve Bank emphasizes absolutely no scope for easing in monetary conditions
21 April 1995

Dr Don Brash, Governor of the Reserve Bank of New Zealand, said today that the inflation outlook remained finely balanced. He reiterated the Bank's position that there is absolutely no scope for an easing of monetary conditions at present, adding that any further decline in 90-day bank bill rates would risk undermining the price stability objective.

Looking further out, Dr Brash said "If price and wage-setters start reacting to the headline inflation rate, interest rates could rise further."

"Only as inflationary pressures show clear signs of abating will there be scope for monetary conditions to ease."

Dr Brash talks to business audience about the link between inflation, interest rates and the exchange rate
26 April 1995

The path which both interest rates and the exchange rate took in future would depend to a large extent on the Reserve Bank's success in maintaining low inflation, the Governor of the Bank, Dr Don Brash, told a business audience in Whangarei today.

Dr Brash's address was the first in a series of 21 identical presentations he was giving around New Zealand in April and May as part of a 'roadshow' organized in conjunction with banks.

The Reserve Bank was determined to stick to its commitment to price stability and this had important implications for business people. "You would be wise to plan on the assumption that you will have no scope to increase your prices unless you are marketing a better product. It means that you should avoid paying higher wages unless you can improve productivity or are willing to reduce your profit margins. It means that you should, as far as possible, resist price increases from your own suppliers," Dr Brash said.

"You should also remember that the official headline inflation figure, the CPI, is currently a rather bad reflection of the rate at which private sector goods and services are increasing in price. The official figure is substantially inflated by increases in interest rates and government charges, neither of which give you as an employer any additional revenue from which to pay wage increases. Indeed, roughly half of the increase in the headline inflation figure in the year to March 1995 was caused by increases in interest rates and increases in government charges."

Reserve Bank Governor warns on interest rates
16 May 1995

The Governor of the Reserve Bank, Dr Don Brash, today repeated that there is currently no scope for an easing of monetary conditions. He warned that any further decline in bank interest rates at this stage would risk refuelling domestic demand and inflationary pressures and, if necessary, the Bank would take action to prevent that from occurring.

"I am particularly concerned about mortgage rates and the short-term wholesale money market rates that have a direct bearing on mortgage rates. We will be prepared to see interest rates ease once evidence is available that inflationary pressures are abating," Dr Brash said.

While the rising exchange rate had largely stifled inflationary pressures in the export and import-competing sectors of the New Zealand economy, the situation in the domestic economy is very different: "Underlying inflation in that part of the economy over the year to March 1995 was close to 4 percent. Inflationary pressures here have been rising since last year, especially in the rental and construction sectors," Dr Brash said.

The firming of monetary policy last year, particularly the rise in interest rates, is now helping to restrain domestic inflationary pressures, as recent indications of slowing in economic activity show. The Bank considers that, if monetary conditions are maintained at current levels, underlying inflation will fall back later in the year, while economic activity will continue to expand but at a more sustainable rate.

"But this outcome could be jeopardised if interest rates ease prematurely. Such an easing would risk a resurgence of spending and a further expansion of inflationary pressures in the domestic economy. That in turn would require tougher monetary policy action. It is better to ensure that rates don't fall too early than to have to push them back up again later," Dr Brash said.